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Tax Law Update
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Tax Benefit from Leveraged Partnerships Shut Down By New IRS Regulations

On October 5, 2016, the IRS and Treasury released a package of new regulations under Code sections 707 and 752 designed to curtail the use of debt to reduce tax on the contribution of appreciated assets to leveraged partnerships.[1] In recent years, such structures have been commonly used in drop-down capitalizations of joint ventures and publicly-traded partnerships (usually referred to as "MLPs"), frequently in high dollar value transactions that allowed cash from the partnership to be distributed to the corporate sponsors with minimal gain recognition. Under the new rules, partnership debt which would previously have been allocated to the corporate sponsor to increase its basis and decrease its gain recognition is much less likely to be so allocable.

The package of regulations, which includes final, temporary and proposed regulations provides new rules in the following areas: (1) with respect to the disguised sale of assets through use of a partnership, all debt is effectively treated as nonrecourse, meaning that a partner contributing assets cannot protect against gain recognition except to the extent of the partner's percentage share of partnership profits; (2) the exception for preformation expenses which reduced taxable gain recognition on the contribution of appreciated assets to a partnership has been narrowed; (3) the rules regarding the allocation of debt among the partners when a partner guarantees the partnership's debt have been changed in a number of respects, including the exclusion of bottom-dollar guarantees and the application of a facts and circumstances test to determine when and how a guarantee of debt affects the allocation of debt among the partners.

Code section 707, addressing disguised sales, requires partners to recognize gain on certain contributions of property to a partnership. Under the prior rules, it was possible for the owner of appreciated assets to transfer the assets in exchange for cash (essentially, to sell the assets) without triggering current gain recognition by entering into a leveraged partnership with the cash-contributing partner (or "buyer"). The business would be contributed to the partnership which would borrow money and then distribute the loan proceeds to the contributor (or "seller"). To the extent the seller is considered liable for the partnership debt, the cash is not considered to be taxable proceeds of a sale under the debt-financed distribution exception in Treas. Reg. section 1.707-5(b). Therefore, it was possible for a partner to contribute built-in gain property to a partnership, the partnership to borrow and distribute the proceeds to the partner, and to the extent the partnership debt was allocated to the partner (because, for instance, the partner guaranteed the debt), the distribution to the partner was not treated as disguised sale proceeds requiring gain recognition.

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[1] T.D. 9787 (final regulations under sections 707 and 752); T.D. 9788 (final and temporary regulations under sections 707 and 752); REG-122855-15, 81 Fed. Reg. 69301-69309 (proposed regulations under sections 704 and 752).

Under the new temporary regulations, however, all debt will be treated as nonrecourse for purposes of disguised sales, curtailing the effectiveness of many leveraged partnership structures by limiting the applicability of the debt-financed distribution exception in Treas. Reg. section 1.707-5(b). Under the new rules, the maximum amount of debt that may be allocated to a partner for purposes of overcoming sale treatment is that percentage of the debt that is equal to the contributing partner's percentage share of partnership profits. A guarantee by the partner will not affect this rule.

The temporary regulations provide that, whether debt is in form recourse or nonrecourse, a partner's share of liability in the partnership is determined by applying the same percentage used to determine the partner's share of excess nonrecourse liabilities under Treas. Reg. section 1.752-3(a)(3) as limited in its application for disguised sale purposes, meaning the partner's share of partnership profits. A partner's share of liability in the partnership will not only be determined in accordance with the partner's interest in the partnership profits but also without taking into account any amount of the liability for which another partner bears the economic risk of loss under Treas. Reg. section 1.752-2.

The IRS has successfully challenged several high-profile leveraged partnerships in recent years under the theory that various guarantees and indemnities entered into by the contributor/seller did not confer a real risk of loss with respect to the partnership debt. See Canal Corp. v. Commissioner, 135 T.C. 199 (2010) and ILM 201324013, involving the Tribune's disposition of Newsday to Cablevision through use of a leveraged partnership (which the Tribune recently agreed to settle by paying tax on a portion of the asserted gain). These new rules are a reflection of the IRS position in those matters.

The rule that requires that all debt be treated as nonrecourse for purposes of the disguised sale rules under section 707 will apply to transactions on or after January 3, 2017. The delayed effective date is an acknowledgment of the fact that there will likely be many deals that have not yet closed but that will need to be restructured in light of the changes to the debt-financed distribution exception.

This rule is not retroactive so closed deals are not affected by it. A refinancing of debt incurred in closed deals could be caught by the rules, however: refinanced debt is subject to being treated as new debt under the principles of section 1001 for purposes of applying the effective date of the final regulations. That is, if refinanced debt is considered a modification of the original debt under section 1001, it will be treated as new debt for purposes of applying the effective date.

The Preformation Capital Expenditures Exception

With respect to the preformation expenses exception to disguised sale treatment, the final regulations are similar to the previously proposed regulations, containing rules designed to prevent doubling up on the exceptions to disguised sale treatment ("double dipping") and applying the testing thresholds on a property-by-property basis. A limited aggregation of properties for purposes of this rule is allowed.

The regulations include a number of provisions to limit the "double dipping" that Treasury and the IRS perceive to exist in some of these transactions. In addition to the exception for preformation expense reimbursement, the regulations contain an exception to disguised sale treatment for the assumption of certain liabilities of the contributing partner by the partnership, known as "qualified liabilities." Although the general rule is that liability relief enjoyed by a partner arising from a partnership's assumption of the partner's debt is treated as a deemed distribution of cash to the partner and thereby potentially giving rise to gain recognition from a sale of assets, the assumption of qualified liabilities does not give rise to this result. One type of a qualified liability is a liability the proceeds of which could be traced to capital expenditures. So it was possible for a contributor to use both exceptions to claim no recognition to the extent of the liability spent on the capital expenditures as well as the value of the preformation capital expenditures themselves to reduce taxable income. The new regulations prevent this double-dipping by providing that, to the extent the liability (regardless of the type of qualified liability incurred) is traceable to capital expenditures or used to fund the capital expenditures, the preformation expense exception cannot be used because there is no outlay by the partner to reimburse.

The final regulations also make clear that when the preformation expense exception is applied, it must be applied on a property-by-property basis. The exception has long contained very specific thresholds which limited the reimbursed capital expenditures to 20% of the fair market value of the contributed property at the time of the transfer and lifted the 20% limitation if the value of the transferred property did not exceed 120% of the basis of the property contributed. In other words, it the property contributed had significant built-in gain, then at most 20% of the value of the property could be protected by the exception. By now applying these tests on a property-by-property basis, taxpayers cannot assert that assets contributed as a group had little built-in gain in order to allow an isolated but expensive capital expenditure to be reimbursed in its entirety without sale treatment.

In response to concerns that a property-by-property test is cumbersome when the contribution of a business may include thousands of separate items of property, the final regulations allow a limited aggregation of assets for purposes of applying the above thresholds. Aggregation will be allowed to the extent that the total value of such aggregated property is not greater than the lesser of $1 million or 10 percent of the total value of all property being contributed to the partnership.

The regulations also include new rules that will help to identify property that is eligible for the preformation expenses exception. There is a new "step in the shoes" rule with respect to capital expenditures a person incurred with respect to property transferred to the partnership by the partner to the extent that the transferor partner acquired the property from a person in a non-recognition transaction under sections 351, 381(a), 721 or 731. There is also a new rule that will allow use of the preformation expenses exception when a person incurs capital expenditures with respect to property, transfers the property to a partnership and, within a two-year period, the partnership interest is transferred to another partnership in a section 721 transaction.

It is interesting to note that, in releasing these regulations, the government comments in the preamble to the regulations that it will continue to study the appropriateness of the exception for preformation capital expenditures, stating that "because the receipt of 'boot' [generally meaning cash] in the context of other non-recognition transactions, for example, transfers of property to corporations in section 351 transactions, is generally taxable to the transferor, [we] are considering whether the exception for preformation capital expenditures is appropriate."[2] With this ominous comment the Treasury and the IRS appear to be signaling their desire that one of the longstanding advantages of partnership taxation, the ability to make distributions from a partnership without gain recognition, be changed so that partners have the same outcome as corporate shareholders with respect to distributions following a contribution of appreciated property.

Qualified Liabilities

As described above, to the extent that a partner, in connection with a contribution of assets, experiences debt relief upon the assumption of the partner's liability by the partnership, the partner will be considered to have received a distribution of cash that is subject to characterization as taxable sale proceeds unless the liability assumed is one of the types of liabilities characterized as a qualified liability. The new regulations add an additional type of qualified liability: a liability that is not incurred in anticipation of the transfer of the property to a partnership but that was incurred in connection with a trade or business in which property transferred to the

[2] T.D. 9787, 12-13.

partnership was used or held, but only if all the assets related to that trade or business are transferred, other than assets that are not material to a continuation of the trade or business. This new type of qualified liability is different than a type that already existed in that the liability, while incurred in connection with the trade or business, need not have been incurred in the ordinary course of the trade or business in which the property is used. The liability cannot have been incurred in anticipation of the transaction, however, which is a restriction that is not applied to qualified liabilities incurred in the ordinary course of a trade or business.

The final regulations also contain a new step-in-the-shoes rule for qualified liabilities. Under this rule, a partner steps into the shoes of a person to the extent that the partner assumed or took property subject to the liability from the person in a non-recognition transaction under Code sections 351, 381(a), 721, or 731. That way, even if the contributing partner did not itself incur the qualified liability, if the partner acquired property subject to a liability that was a qualified liability in the hands of the original partner/debtor, the liability can retain its qualified status.

Allocation of Nonrecourse Debt

Code section 752 addresses the allocation of partnership liabilities among the partners. The new regulations also include some revisions to the rules under section 752 regarding the allocation of partnership nonrecourse debt among partners. Treasury and the IRS abandoned its previous proposal to do away with the significant item method and the expected share of nonrecourse deductions method (also referred to as the alternative method). Any of the three previously available methods may be used: the significant item method, the alternative method, or the additional method. As noted above, however, none of these methods is applicable to determine the share of debt for section 707 disguised sale purposes, which is limited to the partner's interest in the partnership profits.

Bottom-Dollar Guarantees

Bottom-dollar guarantees have been used by some taxpayers to increase the allocation of debt to the partner making the guarantee, thereby increasing the partner's outside basis in order to protect it from gain recognition. The new temporary and proposed regulations continue the effective prohibition on the use of bottom-dollar guarantees seen in the prior proposed regulations. A bottom-dollar guarantee is defined in the new temporary and proposed regulations as a payment obligation other than one in which the partner or related person will be liable up to the full amount of the partner's or related person's payment obligation if and to the extent that any amount of the partnership liability is not otherwise satisfied. Therefore, if the guarantee does not make the guarantor liable for any portion of the first dollar of the debt, the debt cannot be included in the guarantor's basis. However, if the guarantor guarantees a percentage of each dollar of a liability (a "vertical slice" guarantee), then an allocation of the debt to the guarantor is allowed.

The temporary section 752 rules will be effective immediately, with an exception for liabilities that have not yet been incurred but are subject to a written, binding contract entered into before October 5, 2016. There is a seven-year transition rule that grandfathers existing debt allocated under the prior rules as long as there is not a 50 percent or more change in ownership of the partner to whom the debt was allocated.

Economic Risk of Loss Rules Reproposed

Under section 731(a), cash distributions from a partnership to a partner are only taxable to the extent they exceed the partner's basis in the partner's partnership interest (outside basis). Outside basis includes the partner's share of the partnership's recourse liabilities. Under Treas. Reg. section 1.752-2, a partnership's recourse liabilities are allocated among the partners for basis purposes in accordance with the partners' economic risk of loss ("EROL"), which is determined by identifying the partner or partners who would be called upon to pay if all of the partnership's assets were worthless and all partners with payment obligations satisfied their obligations.

The regulations that were previously proposed in 2014[3] regarding the determination of EROL, limited such a finding to situations in which seven payment obligation requirements were satisfied and proposed a new net value requirement as well as an anti-abuse rule. In the new proposed regulations, Treasury and the IRS have revised the previously proposed requirements by putting in place a facts and circumstances test that is designed to look at the totality of the situation by examining a non-exclusive list of factors, rather than the previous rigid, exclusive list of tests that an obligation had to satisfy.

Because the new test for an obligation to attract an allocation of a liability is a weighted, facts-and-circumstances model, taxpayers cannot use the rules affirmatively to opt into nonrecourse treatment simply by intentionally failing one of the factors. Many will be relieved to see that the revised list of factors does not include the previously proposed requirement that consideration be paid to the guaranteeing partner for that partner's guarantee of the partnership liability.

Under the re-proposed regulations, the facts and circumstances test involves the evaluation of the following seven factors (their presence will weigh in favor of disregard of the obligation):

- the partner's obligation to pay is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment;
- the absence of commercially reasonable documentation regarding the partner's financial condition;
- the term of the payment obligation ends before the term of the liability (unless the termination of the obligation occurs upon an event that lessens the risk of loss, such as lease-up of a building);
- the primary obligor (not the partner whose payment obligation is being tested) holds an unreasonable amount of cash or other liquid property exceeding the reasonably foreseeable needs of the obligor, thereby making the partner's payment obligation highly likely to be avoided;
- the payment obligation does not permit the creditor to promptly pursue payment or otherwise delays collection;
- where a guarantee is provided, the terms of the loan would have been substantially the same absent the guarantee;
- the creditor benefiting from the obligation or guarantee did not receive executed documents at the time of execution of the obligation or guarantee.

With respect to the net value of the partner/guarantor, if it is a disregarded entity, the previously proposed regulations provided that the entity would be considered to have EROL only to the extent of the net value of the disregarded entity. That proposal has been withdrawn and the new proposed regulations create a presumption under an anti-abuse rule that any obligation, including an obligation of a disregarded entity, will not be considered a liability if there is not a reasonable expectation that the payment obligor will be able to make the payments when due and payable because, for example, the entity is underfunded.

[3] 79 Fed. Reg. 4826 (Jan. 30, 2014), REG-119305-11.

Conclusion

In summary, the rule changes are expected to have a significant impact on the taxability of transactions designed to move appreciated assets into partnerships followed by a distribution of cash. While some exceptions to gain recognition from cash distributed upon the contribution of appreciated assets are still available, such as the reimbursement of preformation expenditures and debt-financed distributions to the extent of a partner's interest in partnership profits, the ability to use the entire amount of a leveraged partnership's debt to protect the asset-contributing partner from taxation is now gone.

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