October 21, 2016

Recently Issued Final, Temporary and Proposed Treasury Regulations Regarding the Allocation of Partnership Liabilities and Disguised Sales

By Michelle Jewett, Shane Shelley, Joy MacIntyre, Craig Phillips, Shiukay Hung, David Goett, Brennan Young, Nicole Humphrey and Adam Nguyen

On October 5, 2016, the Internal Revenue Service ("IRS") and Treasury Department published final regulations (the "Final Regulations"), temporary regulations (the "Temporary Regulations") and new proposed regulations (the "Proposed Regulations")[1] addressing (1) the allocation of partnership liabilities under Section 752, (2) the allocation of partnership liabilities in connection with partnership disguised sales under Section 707 and (3) certain other partnership-related items. The IRS and the Treasury Department previously issued proposed regulations (the "2014 Proposed Regulations") on January 29, 2014.[2] As discussed below, this new package of regulations largely adopts the concepts regarding allocations of partnership liabilities under Section 752 contained in the 2014 Proposed Regulations, with certain significant changes in response to comments. As a significant departure from prior law, the new regulations for disguised sales also flatly prevent a contributing partner from increasing its share of partnership liabilities through a guarantee of (or other arrangement with respect to) partnership indebtedness for purposes of determining whether and to what extent a disguised sale has occurred. Among other things, the new regulations thus substantially limit the ability to receive cash tax-free in leveraged partnership transactions by preventing a contributing partner from increasing its share of partnership liabilities (and tax-free distributions) through guarantees or other arrangements. The new regulations also modified the anti-abuse rule proposed in the 2014 Proposed Regulations, initially based on a list of factors, to one based on facts and circumstances. We anticipate the new package of regulations will have a significant impact on real estate and other partnership transactions.

DISGUISED SALE RULES

Allocation of Liabilities and Leveraged Partnership Transactions

Section 707 provides rules treating the contribution of property to a partnership followed by a distribution of cash by the partnership to the contributor as a "disguised sale" for U.S. tax purposes. Under certain circumstances, Section 707 also treats the assumption of a liability of, or the receipt of encumbered property from, a contributing partner as a disguised sale. One significant exception to the disguised sale rules is the so-called "debt financed distribution" rule, which provides an exception for distributions financed by a partnership borrowing to the extent

[1] *See* TD 9787, TD 9788 and REG-122855-15, available at https://www.gpo.gov/fdsys/pkg/FR-2016-10-05/pdf/2016-23387.pdf, https://www.gpo.gov/fdsys/pkg/FR-2016-10-05/pdf/2016-23388.pdf and https://www.gpo.gov/fdsys/pkg/FR-2016-10-05/pdf/2016-23390.pdf.
[2] *See* Morrison & Foerster LLP's Client Alert "Recently Proposed Treasury Regulations Regarding the Allocation of Partnership Recourse and Nonrecourse Liabilities Contain Significant Changes for Many Routine Partnership Transactions" for a discussion of the 2014 Proposed Regulations.

the partner to whom the distribution is made is allocated a share of the borrowing. As a result, a distribution of money to a partner by a partnership is not considered a disguised sale to the extent the distribution is traceable to a partnership borrowing and the amount of the distribution does not exceed the partner's allocable share of the liability incurred to fund the distribution.

Prior to the Temporary Regulations, for purposes of the disguised sale rules, a partnership liability was allocated among the partners in a manner consistent with the general allocation rules of Section 752, which depend significantly on whether a liability is "recourse" (because one or more partners bears the "economic risk of loss," *e.g.*, by providing a guarantee of the partnership liability) or "nonrecourse." A partner contributing appreciated assets and receiving a leveraged distribution in a single transaction could thus avoid current gain recognition by guaranteeing the debt used to fund the distribution. For example, under the prior regulations, gain recognition by a partner contributing appreciated property to a partnership, in exchange for a 50% interest in the partnership and a leveraged distribution, generally would be deferred if the partner (or its affiliate) personally guaranteed the loan used to fund the distribution, such that the partner was treated as bearing the "economic risk of loss" with respect to the loan. In such a case, the loan would be considered "recourse" under Treasury Regulation Section 1.752-1(a), and the partner would be allocated 100% of the loan for purposes of the disguised sale rules.

The Temporary Regulations now deem all partnership loans to be "nonrecourse" for purposes of the disguised sale rules so that the partner-guarantor is no longer able to increase its liability allocation by entering into a guarantee or other arrangement. Under the Temporary Regulations, a partner’s share of a liability now is determined, for disguised sale purposes, in the manner in which "excess nonrecourse liabilities" are allocated under Treasury Regulation Section 1.752-3(a)(3). The Temporary Regulations thus disregard any "economic risk of loss" borne by a contributor-guarantor and, for disguised sale purposes, allocate liabilities solely based on the partner's share of partnership profits. Under the new rule, the partner in the example above would be allocated only 50% of the liability; thus, the excess of the amount distributed to the partner over 50% of the liability may be treated as proceeds from the disguised sale of the contributed property.

The Temporary Regulations also exclude from a partner’s share of partnership labilities any portion of the liability for which another partner bears the economic risk of loss and reserve with respect to the treatment of Section 1.752-7 contingent liabilities for disguised sale purposes.

The Temporary Regulations under Section 707 are effective for any transaction with respect to which all transfers occur on or after January 3, 2017 (the date which is 90 days after the Temporary Regulations were published).

Additional Changes to Disguised Sale Rules

Separate and apart from the exception for debt financed distributions, Section 1.707-4(d) continues to exclude from the disguised sale rules transfers of consideration from a partnership to reimburse a partner for certain amounts of partnership-related capital expenditures incurred by the partner. These amounts are excluded to the extent that the reimbursed capital expenditures do not exceed 20% of the fair market value of the property transferred. This 20% limitation does not apply, however, if the fair market value of the contributed property does not exceed 120% of the partner’s adjusted basis in the property at the time of the transfer. The Final Regulations have made changes to clarify how this exception is applied.

As in the 2014 Proposed Regulations, the Final Regulations provide that the 20% limitation and the 120% test are applied on a property-by-property basis. However, unlike the 2014 Proposed Regulations, the new regulations permit aggregation in certain instances, namely if: (i) the total fair market value of the aggregated property is not greater than the lesser of
(a) 10% of the total fair market value of all property, excluding money and marketable securities, transferred by the partner to the partnership, or (b) $1,000,000; (ii) the partner uses a reasonable aggregation method that is consistently applied; and (iii) the aggregation of property is not part of a plan the principle purpose of which is to avoid application of the disguised sale rules.

Other changes include:

- A rule for coordinating the exception for preformation capital expenditures with the rules regarding capital expenditure qualified liabilities. The exception for preformation capital expenditures is disallowed to the extent a partner funds a capital expenditure through a "capital expenditure qualified liability" and the economic responsibility for that borrowing shifts to another partner.
- Clarification that a partner that acquires property in a nonrecognition transaction from a person who incurred capital expenditures with respect to the transferred property, steps into the shoes of the transferor and succeeds to the status of the transferor for purposes of applying the preformation capital expenditures exception and determining whether a liability is a qualified liability.
- Finally, in the context of an upper tier partnership that assumes a liability from a lower tier partnership in connection with a transfer of all the lower tier partnership's property to the upper tier partnership, the Final Regulations add that for purposes of determining whether a liability constitutes a qualified liability it is the intent of the partner that is the relevant inquiry not the upper-tier partnership.

The Final Regulations under Section 707 are effective for transactions with respect to which all transfers occur on or after October 5, 2016.

BOTTOM DOLLAR GUARANTEES

As was the case with the 2014 Proposed Regulations, the Temporary Regulations provide new rules that address so-called "bottom dollar guarantees" and similar indemnity obligations where a partner guarantees only the least risky portion of partnership debt. While the Temporary Regulations jettison the recourse/nonrecourse distinction for disguised sale purposes, Section 752 continues to apply this distinction for purposes of allocating partnership liabilities, taking into account guarantees, indemnities and reimbursement obligations between the partners, partnership and creditors. Under the Temporary Regulations, however, a "bottom dollar payment obligation" is not taken into account for these purposes.

A bottom dollar payment obligation with respect to a partnership liability includes any payment obligation other than one in which the partner is liable up to the full amount of such partner's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. For example, a bottom dollar payment obligation includes a guarantee to creditors that can only be called on if the creditors receive less than a specified portion of the liability. A bottom dollar payment obligation also includes a partnership liability that uses tiered partnerships, intermediaries, senior and subordinate liabilities or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if the liabilities were incurred pursuant to a common plan with a principal purpose of avoiding the bottom dollar payment obligation definition. A payment obligation is generally not a bottom dollar payment obligation merely because (1) the partner's payment obligation is subject to a maximum amount, (2) the partner is liable only for a specified percentage of any partnership liability (a so-called "vertical slice" guarantee) or (3) there is a proportionate right of contribution among the partners.

In recognition of the fact that some bottom dollar arrangements may be economically meaningful, the Temporary Regulations provide that a bottom dollar payment obligation is recognized for purposes of the liability allocation rules, despite an indemnity, reimbursement agreement or similar arrangement, if the partner is ultimately liable for at least 90 percent of the liability. It should be noted that these arrangements are still classified as "bottom dollar payment obligations" and, therefore, are still subject to the disclosure requirement discussed below.

The Temporary Regulations have an anti-abuse rule that applies to contractual obligations structured as bottom dollar payment obligations when a partner bears the economic risk of loss. Under those facts, the Temporary Regulations state that if one of the principal purposes of the contractual obligation is to attempt to allow partners other than those partners that are directly or indirectly liable for the obligation to include a portion of the loan in the basis of their partnership interest, the IRS may treat the partner making the contractual obligation as bearing the economic risk of loss.

In addition to the anti-abuse rules for bottom dollar payment obligations, the Temporary Regulations contain a disclosure requirement for such obligations. Specifically, to the extent a partner or related person enters into a bottom dollar payment obligation, the partnership must disclose such guarantee on IRS Form 8275. This form is to be attached to the tax return of the partnership for the tax year in which the bottom dollar payment obligation is undertaken or modified. The form must identify the payment obligation for which the disclosure is made, including the amount of the payment obligation and the parties to the payment obligation. If the bottom dollar payment obligation meets the exception described above, the partnership must disclose on IRS Form 8275 the facts and circumstances that establish that (1) a partner or related person is liable for up to 90 percent of the partner's or related person's initial payment obligation and (2) but for an indemnity, reimbursement agreement or similar arrangement, the partner's or related person's payment obligation would have been recognized.

The Temporary Regulations for bottom dollar guarantees are effective and apply to liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken with respect to a partnership liability on or after October 5, 2016. However, the Temporary Regulations provide for a transition rule, under which a partner whose allocable share of partnership liabilities exceeds its adjusted basis in its partnership interest as of October 5, 2016, can continue, for seven years, to apply the existing regulations to the extent of that excess. The amount of partnership liabilities subject to transitional relief will be reduced by any reductions in the amount of liabilities allocated to that partner under the transition rules and, upon the sale of any partnership property, for any tax gain (including Section 704(c) gain) allocated to the partner less that partner's share of amount realized.

The Proposed Regulations would extend the concept of a "bottom dollar payment obligation" to capital accounts and allocations of partnership profits and losses by preventing a partner from relying on a deficit restoration obligation (or "DRO") to support allocations of losses in excess of the partner's adjusted capital account balance if the DRO constitutes a bottom dollar payment obligation. The Proposed Regulations also address DROs by expanding upon the provision, under current law that disregards a DRO if the facts and circumstances indicate a plan to avoid or circumvent the DRO. The Proposed Regulations would provide a non-exhaustive list of factors that indicate a plan to avoid or circumvent a deficit restoration obligation, including (1) the partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation, (2) the partner is not required to provide commercially reasonable documentation regarding the partner's financial condition to the partnership, (3) the obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account is negative and (4) the terms of the obligation are not provided to all the partners in the partnership in a timely manner.

REVISED ECONOMIC RISK OF LOSS RULES

In determining whether a partner bears the economic risk of loss with respect to partnership liabilities, the 2014 Proposed Regulations provided six factors that had to be satisfied for a payment obligation to qualify as a recourse liability under Section 752 and required that the guarantor satisfied a net value requirement. Although this six-factor test and the net value requirement was not adopted in the Final Regulations or the Temporary Regulations in response to comments, the Proposed Regulations contain a new facts and circumstances anti-abuse rule with similar, nonexclusive factors for determining when a plan to circumvent or avoid an obligation exists. The determination of whether a factor is present or absent is based on the facts and circumstances at the time the partner or a related person makes the payment obligation, or if an obligation is modified, at the time of such modification. Notably absent from these factors is the requirement that the partnership pay an arm's length fee to the guarantor as compensation for the guarantee. The anti-abuse rule weighs the following factors in determining whether a payment obligation by a partner should be respected:

- whether the partner or a related person is subject to commercially reasonable contractual restrictions that protect the likelihood of payment;
- whether the partner or a related person is required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition;
- whether the term of the payment obligation ends prior to the term of the partnership liability, or the partner or related person has a right to terminate its payment obligation, if the purpose of limiting the duration of the payment obligation is to terminate such payment obligation prior to the occurrence of an event that will increase the risk of economic loss to the guarantor or benefited party;
- whether there is a plan or arrangement in which the primary obligor or any other obligor (or a person related to the obligor) with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonable foreseeable needs of such obligor;
- whether the payment obligation permits the creditor to promptly pursue payment following a payment default on the partnership liability or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection;

- whether, in the case of a guarantee or similar arrangement, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee; and
- whether the creditor or other party benefiting from the obligation receives executed documents with respect to the payment obligation from the partner or related person before, or within a commercially reasonable time after, the creation of the obligation.

The Proposed Regulations will become effective on the date they are finalized and published in the Federal Register, but taxpayers can rely on the Proposed Regulations between October 5, 2016 and the date the Final Regulations are published.

CONCLUSION

Parties that regularly deal with the disguised sale rules, leveraged partnerships and allocations of recourse liabilities will need to reevaluate current and future tax planning with the new regulations, particularly in industries where significant value is embedded in durable, depreciable assets with a significant difference between tax basis and fair market value (such as real estate). Partnership contributions and distributions have long been a favored mechanism for extracting
tax-deferred cash from low-basis assets in these contexts, but the new regulations present significant new obstacles and traps. Taxpayers employing transactions involving an allocation of partnership liabilities in connection with a property contribution should consult with their tax counsel to address the consequences of the new regulations on their operations.

Contacts:

Michelle Jewett
(212) 336-4154
mjewett@mofo.com

Shane Shelley
(858) 720-5169
sshelley@mofo.com

Joy MacIntyre
(415) 268-6270
jmacintyre@mofo.com

Craig Phillips
(212) 336-4419
cphillips@mofo.com

Shiukay Hung
(212) 336-4331
shung@mofo.com

David Goett
(212) 336-4337
dgoett@mofo.com

Brennan Young
(212) 336-4243
byoung@mofo.com

Nicole Humphrey
(213) 336-4234
nhumphrey@mofo.com

Adam Nguyen
(415) 268-6278
anguyen@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer*'s A-List for 13 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.