



TaxNewsFlash

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Regulations: Partnerships and disguised sales, treatment of partnership liabilities

The Treasury Department and IRS today released for publication in the Federal Register three packages containing final, temporary, and proposed regulations under sections 707 and 752 relating to: (1) disguised sales of property involving partnerships; (2) allocations of partnership liabilities; and (3) a variety of other partnership-related items.

- **Final regulations** [PDF 246 KB] (T.D. 9787) have been issued under section 707 as guidance concerning disguised sales of property to or by a partnership, and under section 752 as guidance relating to allocations of excess nonrecourse liabilities of a partnership to partners for disguised sale purposes.
- **Final and temporary regulations** [PDF 228 KB] (T.D. 9788) have been issued under section 707 concerning how liabilities are allocated and under section 752 as to when certain obligations are recognized for purposes of determining whether a liability is a recourse partnership liability.
- **Proposed regulations** [PDF 226 KB] (REG-122855-15) incorporate the text of the temporary regulations, withdraw a notice of proposed rulemaking from January 2014 (to the extent the proposed rulemaking was not finalized by the final regulations), and introduce new proposed regulations addressing when certain obligations to restore a deficit balance in a partner's capital account are disregarded under section 704 and when partnership liabilities are treated as recourse liabilities under section 752.

Significantly, the regulations largely eliminate the ability to engage in a leveraged partnership transaction. Also, as in the proposed regulations, the new regulations disregard "bottom dollar payment obligations" for purposes of allocating partnership liabilities. Finally, rather than require the satisfaction of the specific "commercial" characteristics in order for a payment obligation to be respected as provided in the 2014 proposed regulations, the new proposed regulations shift the factors to a non-exclusive facts and circumstances test in an anti-abuse rule.

Final and temporary regulations

Relevant to the determination of whether there is a disguised sale of property, the final and temporary regulations under section 707 and 752 provide the following guidance:

Determining share of liabilities of disguised sale purposes: Importantly, the temporary and final regulations provide that for purposes of the disguised sale rules, **all liabilities are treated as nonrecourse liabilities and must be allocated under Reg. section 1.752-3(a)(3), solely in accordance with the partners' allocable share of partnership profits** (the significant item method, alternative method, and additional method do not apply to disguised sales). This rule is effective for any transaction with respect to which all transfers occur on or after January 3, 2017. Accordingly, a guarantee or other payment obligation will not be taken into account in determining whether a debt financed distribution to a partner exceeds the partner's allocable share of the liability. As a result, any disproportionate leveraged distribution may trigger gain to the extent the liability is incurred in connection with a property contribution to, or distribution from, a partnership.

KPMG observation: The preamble notes that taxpayers may require further guidance regarding reasonable methods for determining a partner's share of partnership profits, and requests comments regarding possible safe harbors and reasonable methods. Until such guidance is issued, it may be difficult to determine a partner's share of profits in many partnership arrangements.

KPMG observation: For any transaction which anticipates using the current rules under section 707 to determine a partner's share of partnership liabilities to determine if a distribution gives rise to proceeds on a sale, it will be important that taxpayers consider whether **all** transfers occur on or after January 3, 2017. To the extent **any** transfer occurs before such date, it appears the old rules continue to apply.

Exception for reimbursement of preformation capital expenditure rule: The final regulations provide a number of changes to the reimbursement for preformation capital expenditure rule (the "Cap Ex Rule"). The regulations provide for:

- **Property-by-property determinations:** Adopting the 2014 proposed regulations' application of the 20% and 120% test on a property-by-property basis, but providing an extremely limited aggregation rule which has the effect of applying when no single aggregated property has a fair market value in excess of \$10,000 and the total of the aggregated property does not exceed the lesser of 10% of all property contributed or \$1 million.
- **Step-in-the-shoes rule:** Providing that a partner steps in the shoes with respect to capital expenditures made by another person (and for determining whether a liability is a qualified liability) when a partner acquires the property in a nonrecognition transaction (under sections 351, 381(a), 721 or 731) and contributes it to a partnership.
- **Tiered partnership rule:** Providing that an upper-tier partnership steps into the shoes of a partner with respect to preformation capital expenditures when the

partner contributes capital expenditure property to a lower-tier partnership and then contributes its interest in the lower-tier partnership to an upper tier partnership. The upper-tier partnership can be reimbursed for the partner's capital expenditures and may reimburse the contributing partner.

- **Double-dip rule:** Providing that money or other consideration transferred to a partner is not treated as a reimbursement for capital expenditures to the extent the expenditure was funded by a qualified liability and exceeds the partner's share of the qualified liability. They also provide an anti-abuse rule for transactions with a principal purpose to avoid this rule.
- **Defining of capital expenditure:** Defining a capital expenditure as having the same meaning as the Code and applicable regulations, except that it includes capital expenditures taxpayer elects to deduct, and does not include deductible expenditures taxpayer elects to treat as capital expenditures.

KPMG observation: The preamble notes that the IRS is considering whether the Cap Ex Rule is appropriate, and requests comments on whether it should be removed from the regulations. The preamble specifically identifies two situations that may be abusive including transactions to effectively refresh the two-year period and the contribution of intangibles such as goodwill.

Anticipated reduction rule: The 2014 proposed regulations provided that if a partner's share of liabilities is reduced due to a decrease in the partner's net value such decrease would be considered as anticipated and thereby reduce the partner's share of liabilities for purposes of the disguised sale rules. The final regulations do not adopt the net value rule but instead add an additional requirement to the existing rules which takes into account a subsequent reduction in a partner's share of liabilities only if the reduction was anticipated, was not subject to the entrepreneurial risks of the partnership operation, and the reduction has as one of its principal purposes, minimizing the amount of proceeds on a sale.

Small amount of nonqualified liabilities: If a transfer of property by a partner to a partnership is treated as part of a sale as a result of the assumption of nonqualified liabilities by the partnership, the assumption by the partnership of the partner's qualified liabilities may also be treated as consideration. The final rules provided limited relief from this rule if the total amount of the nonqualified liabilities the partnership assumes is the lesser of 10% of the total amount of all qualified liabilities or \$1 million.

Qualified liabilities: The final regulations adopt the 2014 proposed regulations' new qualified liability that is not incurred in anticipation of the transfer of property to a partnership, but that were incurred in connection with a trade or business in which the property was transferred but only if all the material assets related to that trade or business are transferred. Transfers are subject to disclosure. The final regulations also treat an upper-tier partnership's share of a lower-tier partnership's liabilities as a qualified liability when the lower-tier interest is contributed to the upper-tier.

Liabilities incurred by another person: The final regulations adopt a step-in-the-shoes rule for a liability assumed by the partner in connection with a nonrecognition transaction under sections 351, 381(a), 721, or 731.

Tiered partnerships: The final regulations provide that an upper-tier partnership's share of lower-tier partnership liabilities is treated as incurred on the same day the liability was incurred by the lower-tier partnership.

Ordering rule: The final regulations adopt the ordering rule contained in the 2014 proposed regulations pursuant to which the debt-financed distribution exception applies before other exceptions under Reg. section 1.707-4. (Note, however, that disproportionate debt-financed distributions in connection with a property contribution to, or distribution from, a partnership will trigger gain after January 3, 2017).

Effective date: The final regulations are effective for transfers occurring on or after the publication in the Federal Register (October 5, 2016).

KPMG observation: The preamble provides that the IRS will continue to study the issue of the effect of contingent liabilities with respect to section 707 as well as other sections of the Code.

Temporary regulations under section 752 and guidance on "bottom dollar" obligations

The temporary regulations under section 752 provide the following guidance with respect to bottom dollar obligations:

Bottom dollar payment obligations disregarded: Most importantly and similar to the 2014 proposed regulations, the section 752 temporary regulations provide that a "bottom dollar payment obligation" is not taken into account as an obligation for purposes of Reg. section 1.752-2, with certain exceptions. The preamble notes that any payment obligation, including a capital contribution obligation and a deficit restoration obligation, may be a bottom dollar payment obligation.

Exception for small rights of reimbursement: The section 752 temporary regulations provide an exception when a partner is liable for 100% of a liability but has up to a 10% reimbursement right. For example, if a partner guarantees 100% of a partnership liability and another partner agrees to indemnify the partner for 10% of that guarantee obligation, the guarantee will be respected.

Exception for vertical slice: The section 752 temporary regulations also provide an exception from the definition of a bottom dollar payment obligation for "vertical slice" payment obligations, pursuant to which the obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates or if there is a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.

Disclosure requirement: To the extent a partner or related person enters into a bottom dollar payment obligation, the partnership must disclose the obligation on a completed Form 8275, *Disclosure Statement*, attached to the return of the partnership for the tax year in which the bottom dollar obligation is undertaken or modified.

KPMG observation: Disclosure is required to be made on Form 8275. A whitepaper attachment is not acceptable under the regulations.

Anti-abuse rule: The section 752 temporary regulations contain an anti-abuse rule that applies to an obligation that is structured as a bottom dollar payment obligation but when the partner actually bears the economic risk of loss. In that case, the IRS may treat such partner as bearing the economic risk of loss if one of the principal purposes of the obligation is to attempt to permit partners other than those who are directly or indirectly liable for the obligation to include a portion of the loan in the basis of their partnership interests.

Effective date: With respect to the changes under Reg. section 1.752-2, the section 752 temporary regulations 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. Consistent with the 2014 proposed regulations, the section 752 temporary regulations provide a transition rule, pursuant to which a partner whose allocable share of partnership liabilities under Reg. section 1.752-2 exceeds its adjusted basis in its partnership interest as of October 5, 2016, can continue to apply the existing regulations. The amount of partnership liabilities subject to transition relief will be reduced for certain 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 the amount realized.

KPMG observation: For certain partners (particularly those with bottom dollar payment obligations in place), it will be important to determine the partner's share of liabilities and basis in its partnership interest as of October 5, 2016, to determine if the partner can avail itself of the favorable transition rule.

Proposed regulations

The proposed regulations under section 752 provide the following guidance.

New anti-abuse rule: The six factors in the 2014 notice of proposed rulemaking that had to be satisfied in order for a payment obligation to be respected under section 752 in determining whether a partner bears the economic risk of loss with respect to partnership liabilities were not adopted, but were instead generally converted into a list of nonexclusive factors in an anti-abuse rule. Under the anti-abuse rule, the factors are weighed to determine whether a payment obligation should be respected. The revised factors are:

- Whether the partner (or related person) is subject to commercially reasonable contractual restrictions that protect the likelihood of payment
- Whether the partner (or related person) is required to provide commercially reasonable documentation regarding the party's financial condition to the benefited party
- 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 or events that increase the risk of economic loss to the guarantor or benefited party
- Whether there exists 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 does not permit 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
- Whether the creditor or other party benefiting from the obligation received executed documents with respect to the payment obligation from the partner (or related person) before, or within a commercially reasonable period of time after, the creation of the obligation

Reasonable expectation of repayment rule: The proposed regulations also remove the net value rules for disregarded entities under Reg. section 1.752-2(k) and instead create a new adverse presumption under the proposed anti-abuse rule when there is evidence of a plan to circumvent or avoid a payment obligation. Such a plan is deemed to exist if the facts and circumstances show that there is not a reasonable expectation that the payment obligor will have the ability to make the required payments if the payment obligation becomes due and payable. This rule would seem to apply to any obligor, including individuals.

Deficit restoration obligations (DROs): The proposed regulations also differentiate DROs under the section 704(b) capital account rules from payment obligations, such as guarantees and indemnities. As a result of their differences, the proposed regulations refine the list of factors in determining whether DROs will be respected for purposes of section 704(b) allocations and allocations of liabilities under section 752. The factors provided are:

- Whether the partner is subject to commercially reasonable provisions for enforcement and collection of the obligation
- Whether the partner is required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership

- Whether 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 as provided in Reg. section 1.704-1(b)(2)(iv) is negative
- Whether the terms of the obligation are provided to all the partners in the partnership in a timely manner

Effective date: The proposed regulations will be effective on the date when regulations finalizing these rules are published in the Federal Register, but partnerships and their partners may rely on the proposed regulations prior to the date they are finalized. However, the rules in the current Reg. section 1.752-2(k) still apply to disregarded entities until the proposed regulations are published as final.

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