2017

Recent Changes to Rules Governing Disguised Sale and Debt Allocations

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I. INTRODUCTION

A. On October 5, 2016, Treasury published final, temporary, and proposed regulations under Code Secs. 707 and 752 (collectively, the "2016 Regulations"),[3] which consist of four basic parts:

1. Final regulations under Code Sec. 707 making certain modifications to, and clarifications of, the disguised sale rules, mainly relating to the treatment of qualified liabilities and reimbursable capital expenditures.

2. Temporary regulations under Code Sec. 752 disregarding "bottom dollar payment obligations."

3. Proposed regulations under Code Sec. 752 broadening the application of anti-abuse rules in determining "economic risk of loss" for partnership liabilities.

4. A temporary regulation revising the allocation of liabilities for purposes of the Code Sec. 707 disguised sale regulations.

B. The major topic of this outline is the allocation of partnership liabilities. This issue is relevant to determining a partner's basis in its partnership interest. It is also relevant to determining the treatment of liabilities for purposes of the disguised sale rules. Both of these issues bear on whether a transaction can be done without causing a partner to recognize gain.

C. The recently issued 2016 Regulations fundamentally change (or propose to change) the treatment of liabilities both for purposes of the disguised sale rules and generally under Code Sec. 752.

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[3]T.D. 9787 and 9788 and REG 122855-15, published in the Federal Register on October 5, 2016.

D. Practitioners and taxpayers will need to adapt to this new regime, which no longer permits what previously constituted standard tax planning techniques for certain transactions and situations.

E. Part II of this outline summarizes the temporary and proposed regulations under Code Sec. 752.

F. Part III of this outline summarizes the temporary regulations under Code Sec. 707 regarding the allocation of liabilities for purposes of the disguised sale rules. This outline does not address the modifications to, and clarifications of, the disguised sale rules, mainly relating to the treatment of qualified liabilities and reimbursable capital expenditures, made pursuant to the final regulations under Code Sec. 707.

II. TEMPORARY AND PROPOSED REGULATIONS UNDER CODE SEC. 752

A. INTRODUCTION AND OVERVIEW

1. For over two decades, taxpayers have relied on a set of rules governing the allocation of partnership liabilities among partners. These rules provided clarity and were both administrable and flexible.

2. The newly issued Code Sec. 752 regulations, in many cases, make it impossible for taxpayers to allocate liabilities with any degree of certainty. In addition, especially with respect to the proposed regulations, they would make it extremely difficult, if not impossible, for taxpayers to transfer property subject to debt in excess of basis to a partnership without triggering gain at the time of the transfer or subsequently.

3. The Code Sec. 752 regulations that were issued in the 1990s (as amended, but for the 2016 Regulations, the "Existing Regulations") embraced the view expressed by the American Law Institute in its landmark, two-volume 1984 study of subchapter K issues and proposals. In that study, the American Law Institute stated:

> Once it is decided to apply relatively strict rules to profit-and-loss allocations … there seem to be no important policies served by a strict rule for allocating liabilities among partners in computing their basis for their partnership interests. This is particularly true when there appears to be more than one justifiable allocation with no single one being clearly correct.[4]

The Code Sec. 704(b) regulations provide strict rules for allocating profits and losses.

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[4]American Law Institute, *Federal Income Tax Project: Subchapter K, Proposals on Taxation of Partners*, at 264 (1984).

4. It is widely understood that the original motivation for changing the Code Sec. 752 regulations was to limit taxpayers' ability to structure a leveraged partnership transaction. Those transactions attempted to comply with the debt-financed distribution exception to the partnership disguised sale rules under Code Sec. 707.[5] As discussed in part III, the recently issued final regulations under Code Sec. 707 address this concern effectively.

5. Temporary Code Sec. 752 Regulations:

   a. The temporary Code Sec. 752 regulations provide that a "bottom dollar payment obligation" ("BDPO") that historically created a recourse liability to the obligor will no longer increase the obligated partner's share of partnership liabilities. The Treasury's justification is that such obligations generally lack a significant non-tax commercial business purpose.[6]

   b. The temporary regulations provide for a seven-year transition period during which some BDPOs may still be taken into account under the existing partnership recourse debt allocation rules.

   c. BDPOs are admittedly not "commercial," but they addressed a policy flaw in the prior regulations that often required taxpayers to enter into BDPOs in order to achieve inoffensive allocations of liabilities that should have been permitted under those regulations.

6. Proposed Code Sec. 752 Regulations:

   a. The proposed Code Sec. 752 Regulations set forth a nonexclusive list of factors that will be considered in determining whether there exists a plan to circumvent or avoid a payment obligation. The proposed regulations will apply prospectively from the date they are published in final form.

   b. The proposed regulations would impose subjective—and in many cases noncommercial—requirements that practitioners must consider in order to conclude that any partnership liability is properly treated as a recourse liability under Code Sec. 752.

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[5]Amy S. Elliott, *Treasury Officials Explain New Bottom-Dollar Guarantee Rules*, 2014 TNT 38-4 (Mar. 3, 2014) (quoting Lisa Zarlenga, Treasury tax legislative counsel, as saying "When we were considering changes in the Code Sec. 752 rules related to [the debt-financed distribution] exception, we determined that certain principles that were being applied for just Code Sec. 707 purposes ought to apply equally in non-disguised sale cases").

[6]*See* the Preamble of the Temporary Regulations.

c. They proposed regulations would create an un-administrable regime and would shift allocations of debt away from partners who bear real economic risk for the debt to those who do not bear any economic exposure.

7. Executive Order 13789 and Subsequent Developments:

a. In Executive Order 13789,[7] the Secretary of the Treasury was directed to immediately review all significant tax regulations issued on or after January 1, 2016, and submit a report identifying regulations that (i) impose an undue financial burden on U.S. taxpayers; (ii) add undue complexity to the Federal tax laws; or (iii) exceed the statutory authority of the IRS.

b. The IRS and Treasury issued Notice 2017-38,[8] identifying regulations as either imposing an undue financial burden on taxpayers or adding undue complexity to the Code, and the Notice included the temporary Section 752 regulations on BDPOs.

c. On October 2, 2017, the Treasury issued the "Second Report to the President on Identifying and Reducing Tax Regulatory Burdens." This report indicates that the Treasury believes the BDPO regulations should be retained and that the Treasury does not plan to propose substantial changes to the regulations.

B. <u>ALLOCATION OF PARTNERSHIP LIABILITIES: GENERAL RULES</u>

1. <u>Background</u>

a. Since at least 1956, the theory underlying the regulations governing the allocation of partnership liabilities has been that liabilities should be allocated to partners who would be required to pay the liability if the partnership were unable to do so because those partners are considered to bear the economic burden for the liability.

b. If a lender would have no recourse to any partner if the partnership were unable to repay the liability, only partnership profits could satisfy the liability. Accordingly, the regulations have allocated

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[7] 82 Fed. Reg. 19317 (Apr. 21, 2017).

[8] 2017-30 I.R.B. 147.

partnership nonrecourse liabilities among the partners in the same way the partnership's profits would be allocated among them.[9]

2. Recourse Liabilities

a. A partnership liability is a recourse liability to the extent that any partner or related person bears the "economic risk of loss" for that liability.[10] In general, recourse liabilities are allocated to the partner who would be responsible for paying them if the partnership were unable to.

b. To determine who bears the economic risk of loss for a recourse liability, the regulations employ a "constructive liquidation" test. Reg. §1.752-2(b)(1) provides that upon a constructive liquidation, all of the following events are deemed to occur simultaneously:

i. All of the partnership's liabilities become payable in full.

ii. With the exception of property contributed to secure a partnership liability, all of the partnership's assets, including cash, have a value of zero.

iii. The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership).

iv. All items of income, gain, loss or deduction are allocated among the partners.

v. The partnership liquidates.

c. A partner bears the economic risk of loss for a liability to the extent that, if the partnership constructively liquidated, the partner (or a related person) would be obligated to either pay a creditor or make a contribution to the partnership because the liability would be due and the partner (or related person) would not be entitled to reimbursement.[11]

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[9]*See* American Law Institute, *Federal Income Tax Project: Subchapter K, Proposals on Taxation of Partners*, at 264 (1984).

[10]Reg. §1.752-1(a) (1).

[11]Reg. §1.752-2(b). In addition, a partner bears the economic risk of loss for a liability to the extent the partner (or a related person) makes (or acquires an interest in) a nonrecourse loan to the partnership and the economic risk of loss for the liability is not borne by another partner. Reg. §1.752-2(c).

d. In circumstances where a partner is entitled to reimbursement, the economic risk of loss is shifted to the obligor under such reimbursement arrangement. Reg. §1.752-2(b)(3) provides that all statutory and contractual obligations relating to the partnership liability are taken into account for purposes of determining which partner bears the risk of loss, including contractual obligations outside the partnership agreement such as

i. guarantees, indemnifications, reimbursement agreements and other obligations running directly to creditors or to other partners, or to the partnership;

ii. obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership; and

iii. payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law, including the governing state partnership statute.

e. Accordingly, an obligation to make a contribution to a partnership pursuant to a capital account deficit restoration obligation ("DRO") is generally taken into account as an obligation of a partner under the regulations, subject to the new rule for BDPOs.

f. For purposes of determining the extent to which a partner or related person has a payment obligation and bears the economic risk of loss for a recourse liability, it is assumed that all partners and related persons actually perform on their obligations, irrespective of their net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.[12]

g. A partner's or related person's obligation to make a payment may be disregarded or treated as an obligation of another person. This can occur if the facts and circumstances indicate that a principal purpose of the arrangement between the parties is to (1) eliminate the partner's economic risk of loss with respect to the obligation or (2) create the appearance that the partner or related person bears the economic risk of loss when, in fact, the substance of the arrangement is otherwise.[13]

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[12]Reg. §1.752-2(b)(6); Reg. §1.752-2(j) (3).

[13]Reg. §1.752-2(j)(1).

3. Nonrecourse Liabilities

a. A partnership liability is a nonrecourse liability if no partner or related person bears the economic risk of loss for that liability.

b. Under Reg. §1.752-3(a), a partner's share of partnership nonrecourse liabilities equals the sum of three tiers of allocations.

i. First, a partner is allocated an amount of a partnership's nonrecourse liabilities equal to the amount of that partner's share of partnership minimum gain determined under Code Sec. 704(b).[14]

a) The partnership minimum gain is generally the excess of the amount of a nonrecourse liability over the Code Sec. 704(b) book value of the property securing the liability.

ii. Second, a partner is allocated an amount of a partnership's nonrecourse liabilities equal to the amount of any taxable gain that would be allocated to the partner under Code Sec. 704(c) (or in the same manner as under Code Sec. 704(c) if partnership property is revalued), if the partnership disposed of all partnership property subject to nonrecourse liabilities for no consideration other than full satisfaction of the liabilities.[15]

a) The second tier amount is often referred to as "Code Sec. 704(c) minimum gain."

iii. Third, a partner's share of the amount of nonrecourse liabilities that is not allocated to partners under the first or second tiers ("excess nonrecourse liabilities") is determined in accordance with the partner's share of partnership profits.

a) The partner's interest in partnership profits is determined by taking into account all facts and circumstances regarding the partners' economic arrangement.

b) The partnership agreement may specify the partner's interest in partnership profits for purposes

[14]Reg. §1.752-3(a)(1).

[15]Reg. §1.752-3(a) (2).

of allocating excess nonrecourse liabilities provided the interest so specified is reasonably consistent with allocations (that have substantial economic effect under the Code Sec. 704(b) regulations) of some significant item of partnership income or gain.

c) Alternatively, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated.

d) Additionally, the partnership may first allocate excess nonrecourse liabilities to a partner up to the amount of built-in gain that is allocable to the partner on Code Sec. 704(c) property or property for which reverse Code Sec. 704(c) allocations are applicable by virtue of a book-up (as described in Reg. §1.704-3(a)(6)(i)) where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the amount of gain taken into account under the Reg. §1.752-3(a)(2) with respect to such property (this last allocation method, the "Additional Method").[16]

iv. The Additional Method was added to Reg. §1.752-3(a)(3) by regulations issued on October 31, 2000. The preamble to the regulations proposing the Additional Method explained the change as follows:

> Under section 731(a), a partner will recognize gain on the distribution of money by the partnership to the extent that the distribution exceeds the partner's adjusted basis in its partnership interest. Section 704(c) generally ensures that any built-in gain on contributed property will be recognized by the contributing partner upon the disposition of the property by the partnership. *The partnership liability allocation rules arguably should not accelerate the contributing partner's recognition of*

[16]In the Final Regulations under Code Sec. 707 adopted as part of the regulations discussed herein, the following language was added to the end of Reg. §1.752-3(a)(3) addressing disguised sale transactions: "The significant item method, alternative method, and additional method do not apply for purposes of §1.707-5(a)(2). To the extent that a partnership uses this additional method and the entire amount of the excess nonrecourse liability is not allocated to the contributing partner, the partnership must allocate the remaining amount of the excess nonrecourse liability under one of the other methods in this paragraph (a)(3)."

that gain when the amount of the partnership's liability attributable to such property is sufficient, if allocated to the contributing partner, to prevent such partner from recognizing gain.

In response to comments received, the proposed regulations modify the third tier to allow a partnership to allocate the portion of a nonrecourse liabilities in excess of the portions allocated in tiers one and two (excess nonrecourse liabilities) based on the excess section 704(c) gain attributable to the property securing the liability. Thus, to the extent a portion of a partnership nonrecourse liability is available to be allocated in the third tier, the partnership may allocate that portion to the contributing partner based on the excess section 704(c) gain inherent in the property.[17] [Emphasis added.]

v. Notwithstanding the intended effect of that amendment to the regulations, the regulations still had certain shortcomings in achieving this identified goal, and taxpayers have used BDPOs to remedy these shortcomings in ways that appear consistent with the intent of the Existing Regulations.

C. TEMPORARY CODE SEC. 752 REGULATIONS

1. BPDOs

a. The temporary regulations provide that in determining whether a partner bears the economic risk of loss for a partnership liability, any BDPO will not be recognized. Specifically, Temporary Reg. §1.752-2T(b)(3)(ii)(C)(1) sets forth the following definition of a BDPO:

i. With respect to a guarantee or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.

[17] The preamble to the notice of proposed rulemaking, 65 FR 2084 (Jan. 13, 2000).

ii. With respect to an indemnity or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation, if, and to the extent that, any amount of the indemnitee's or benefited party's payment obligation that is recognized under this paragraph (b)(3) is satisfied.

iii. An arrangement with respect to 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, based on the facts and circumstances, the liabilities were incurred pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements, and with a principal purpose of avoiding having at least one of such liabilities or payment obligations with respect to such liabilities being treated as a bottom dollar payment obligation as described in paragraph (b)(3)(ii)(C)(1)(i) or (ii) of this section.

b. A bottom guarantee can be illustrated as follows:

i. **Example 1.** Assume that X is a limited partner in a limited partnership and is allocated one percent of partnership profits and losses. The partnership's only debt is a nonrecourse debt of $100 from a third party. X wishes to receive an enhanced allocation of liabilities. X enters into a bottom guarantee of $10 of the debt that is legally enforceable under state law. The bottom guarantee is, in effect, a guarantee of the last dollars of the debt, which is the least risky portion of the debt. The bottom is a guarantee of collection rather than of payment[18] and provides that X shall not be obligated to make any payment under the guarantee until the lender has exhausted its remedies against the borrower and the collateral and has failed to collect at least $10. Thus, in general, X will only have economic exposure under the bottom guaranty to the extent the value of the collateral declines below $10.

[18]A guarantee of collection requires that the lender pursue its remedies against the collateral (*e.g.*, through foreclosure) before pursuing the guarantor for any deficiency. A guaranty of payment does not require the lender to pursue its remedies against the collateral before pursuing the guarantor.

c. The temporary regulations provide that in determining whether a partner or related person has an obligation that will be recognized as such for purposes of Reg. §1.752-2, the facts and circumstances at the time of the determination will be considered and all statutory and contractual obligations relating to the partnership liability will be taken into account, including

i. contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements,

ii. payment obligations imposed by state or local law and other obligations running directly to creditors, to other partners, or to the partnership; and

iii. obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership as described in Reg. §1.704-1(b)(2)(ii)(*b*)(*3*) (taking into account Reg. §1.704-1(b)(2)(ii)(*c*)).[19]

d. The temporary regulations recognize that arrangements tantamount to a BDPO can arise through the use of tiered partnerships, intermediaries, senior and subordinate liabilities or similar arrangements. Thus, the temporary regulations provide that these types of arrangements can create a BDPO if, based on the facts and circumstances, the liabilities were incurred pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements, and with a principal purpose of avoiding having at least one of such liabilities or payment obligations with respect to such liabilities being treated as a BDPO.

i. For example, if a partner's guarantee of the last $50 of a $100 partnership liability is a BDPO, it should not be possible to circumvent this result by splitting the liability into a senior $50 liability and a junior $50 liability and having the partner guarantee all of the former and none of the latter.

e. The temporary regulations include a few exceptions.

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[19]Temporary Reg. §1.752-2T (b)(3)(i).

i. Temporary Reg. §1.752-2T(3)(B)(ii)(c)(2) provides:

> A payment obligation is not a bottom dollar payment obligation merely because a maximum amount is placed on the partner's or related person's payment obligation, a partner's or related person's payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates, or 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.

ii. Thus, it is permissible to place a cap on a partner's payment obligation without turning it into a BDPO.

iii. Also, a payment obligation for a fixed percentage of every dollar, instead of the entire amount, of a partnership liability (a "vertical slice") is not thereby turned into a BDPO.

iv. Moreover, having a right to proportionate contribution among co-obligor partners with respect to a payment obligation, where the partners are jointly and severally liable, does not make the payment obligation a BDPO.

f. Temporary Reg. §1.752-2T(b)(3)(ii)(B) provides that if a partner or related person has a payment obligation that would be recognized but for the effect of an indemnity, reimbursement agreement or similar arrangement, such payment obligation is recognized if, taking into account the indemnity, reimbursement agreement, or similar arrangement, the partner or related person is liable for at least 90 percent of the partner's or related person's initial payment obligation ("90% Obligation").

i. Thus, if a partner's payment obligation would be characterized as a BDPO because of the effect of an indemnity, reimbursement agreement or similar arrangement, but after taking such arrangement into account, the partner is still liable for at least 90 percent of the partner's initial payment obligation, then the obligation is not a BDPO.

g. Temporary Reg. §1.752-2T(b)(3)(iii) provides that "[a]n indemnity, reimbursement agreement, or similar arrangement will be recognized only if, before taking into account the indemnity, reimbursement agreement, or similar arrangement, the indemnitee's or other benefited party's payment obligation is recognized under this paragraph (b)(3), or would be recognized under this paragraph (b)(3) if such person were a partner or related person."

i. In other words, an indemnity is not recognized if it is an indemnity of a payment obligation that is already a BDPO.

2. <u>Anti-Abuse Rule</u>

a. The Existing Regulations contain an anti-abuse rule that deals with situations where

i. a partner enters into a contractual obligation that permits a partnership to obtain or retain a loan,

ii. which significantly reduces the risk to the lender, and

iii. a principal purpose of the obligation is to permit other partners to include a portion of the loan in their outside basis.[20]

b. In those cases, the partner would be treated as bearing the economic risk of loss.

c. The temporary regulations amend this provision to provide that only the IRS is permitted to apply this anti-abuse rule.

d. In addition, the temporary regulations allow the IRS to disregard contractual obligations where one partner enters into a payment obligation and another partner enters into a payment obligation with a principal purpose to cause the former partner's contractual obligation to be disregarded as a BDPO.

3. <u>Disclosure Rules</u>

a. The temporary regulations impose a disclosure obligation on partnerships that have a liability that is subject to a BDPO.

i. The partnership must attach a completed Form 8275, *Disclosure Statement*, with the partnership return for the tax year in which the BDPO is undertaken or modified. Such disclosure must identify the payment obligation,

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[20]Reg. §1.752-2(j)(2).

include the amount of the payment obligation and the parties to the payment obligation.

b. Interestingly, this disclosure requirement applies even though the BDPO is disregarded for purposes of the Code Sec. 752 liability allocation rules.

c. Additionally, to the extent that the partnership is taking the position that the BDPO creates a recourse liability debt allocation pursuant to the 90% Obligation, the partnership must also disclose to the IRS on Form 8275 the facts and circumstances that clearly establish that a partner or related person is liable for up to 90 percent of the partner's or related person's initial payment obligation.[21]

4. <u>Effective Date and Transition Relief</u>

a. The temporary regulations are generally applicable 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, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date.

b. To ease the potential effect of these new rules, the temporary regulations provide for a seven-year transition period. During that period, if a partner (the "transition partner") has a share of recourse liabilities under Reg. §1.752-2(b) of the Existing Regulations, the partnership may choose not to apply the new BDPO rules to an amount of partnership liabilities equal to the excess of (A) the transition partner's share of recourse liabilities over (B) its adjusted basis in the partnership interest.

c. The amount of partnership liabilities to which the transition rule applies is reduced to the extent that the built-in gain attributable to the transition partner's negative tax basis capital account is recognized.

i. Further, if the transition partner is a partnership, S corporation or disregarded entity, a 50 percent or greater change in ownership of the transition partner will terminate the transition period.

[21]Temporary Reg. §1.752-2T(b)(3)(ii)(D).

d. Because the seven-year transition rule applies only if elected by the partnership, partners that have entered into BDPOs for partnership liabilities should take steps to assure that the partnership makes that election.

D. TECHNICAL ISSUES RAISED BY TEMPORARY REGULATIONS

1. DROs and Capital Contribution Obligations

a. The preamble to the temporary regulations states that "any payment obligation under §1.752-2, including an obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership as described in §1.704-1(b)(2)(ii)(*b*)(*3*), may be a bottom dollar payment obligation if it meets the requirements set forth above."[22]

b. Nevertheless, the actual definition of a BDPO provides no guidance as to how to determine whether a DRO or capital contribution obligation is a BDPO. The definition of BDPO that presumably is viewed by Treasury as applicable to DROs and capital contribution obligations is as follows:

> With respect to a guarantee or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.[23]

c. Thus, the definition of a BDPO requires a guarantee or similar arrangement that relates to a particular partnership liability, and a conclusion that the obligor would not be liable for the full amount of the obligor's payment obligation "if, and to the extent that, any amount of *the partnership liability* is not otherwise satisfied." [Emphasis added.]

d. In contrast, a DRO is primarily an invention of the Code Sec. 704(b) regulations, which provide a safe harbor for respecting a partnership's allocations of profit and losses if the partnership agreement imposes a DRO and certain other requirements are met. The relevant Code Sec. 704(b) regulations state:

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[22]T.D. 8788, Preamble at 15.

[23]Temporary Reg. §1.752-2T(b)(3)(ii)(C)(1)(i).

> If such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (*3*)), he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances (in accordance with requirement (*2*) of this paragraph (b)(2)(*ii*)(*b*)).[24]

e. Thus, a DRO does not relate to a particular partnership liability, and in fact the proceeds of the DRO payment may be paid "to creditors of the partnership or distributed to other partners."

f. In our experience, a "bottom" DRO is effectuated by creating a tiered allocation of losses under the partnership agreement so that partners other than the partner entering into the DRO are allocated the first losses on disposition of partnership property, and the partner entering into the DRO is allocated the last losses.[25]

   i. This creates a situation where the DRO is required to be paid only if the partnership's property loses virtually all of its value. The definition of BDPO in the temporary regulations simply has no relevance to or bearing on the determination of whether a particular DRO is a BDPO. Nor does it aid in determining whether a capital contribution obligation (which presumably would apply regardless of whether the partner has a deficit capital account) is a BDPO.

2. Ninety-percent Obligations

   a. As noted above, the 90% Obligation provisions provide relief for a partner whose payment obligation would be characterized as a BDPO because of the effect of an indemnity, reimbursement agreement or similar arrangement, provided that after taking such

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[24]Reg. §1.704-1(b)(2)(ii)(b)(3).

[25]*See* Blake D. Rubin, Andrea M. Whiteway & Jon G. Finkelstein, *Put a 'Bottom' Deficit Restoration Obligation in Your Partnership Liability Allocation Toolkit*, J. PASSTHROUGH ENTITIES, Nov.–Dec. 2014, at 29.

arrangement into account, the partner is still liable for at least 90 percent of the partner's initial payment obligation.

i. While this provision provides some flexibility to taxpayers who enter into these arrangements, there is some question about the extent of relief provided.

b. **Example 2.** If partner A has a payment obligation with respect to the entirety of a $100 partnership liability, the payment obligation is not turned into a BDPO simply because partner B indemnifies partner A for the top $5 of partner A's payment obligation. It would be turned into a BDPO, however, if partner B indemnifies partner A for the top $11 of partner A's payment obligation.

i. Suppose instead that partner B guarantees the first $10 of a borrowing, and partner A guarantees the next $90 of a borrowing, which would result in a similar conclusion as to partner A. Economically, partner A continues to be obligated for the same $90 of the partnership liability. However, a literal reading of Temporary Reg. §1.752-2T seems to require that there exist an arrangement running in favor of partner A in order to permit partner A to rely on the exception.

ii. The preamble to the temporary regulations reinforces this interpretation by explaining that the exception is intended to permit "payment obligation that would be recognized (initial payment obligation) under Temp. Reg. §1.752-2T(b)(3) but for the effect of an indemnity, reimbursement agreement, or similar arrangement … if, taking into account the indemnity, reimbursement agreement, or similar arrangement, the partner or related person is liable for at least 90 percent of the initial payment obligation."

3. <u>Effective Date and Transition Issues</u>

a. While the effective date and transition relief provide some ability for taxpayers to continue to rely on prior law and their pre-existing methodology for allocation of partnership liabilities, the effective date and transition rules leave open many questions.

b. In general, it appears that the temporary regulations would apply to any liability incurred after the effective date, even if that liability refinances a pre-effective-date liability that was subject to a BDPO.

i. It is unclear how the prospective effective date would apply to a BDPO for a term of years entered into before the effective date that contains an elective or automatic extension, subject to the right to terminate the obligation with sufficient notice and satisfaction of specified terms.

ii. Arguably, if those provisions are in a written binding contract, an extended BDPO should continue to be subject to the Existing Regulations. However, if a BDPO is amended on or after October 5, 2016, the BDPO would likely be treated as a new obligation subject to the temporary regulations. The application of the effective date rules is explored in the following examples.

a) **Example 3.** Before the effective date of the Temporary Regulations, a partnership enters into a nonrecourse loan from Bank X with a 10-year term. To maintain A's allocable share of the liability to avoid gain recognition as a result of a deemed distribution under Code Sec. 752(b) in excess of A's basis in the partnership interest, A enters into a bottom guarantee of the liability. A's guarantee provides that it has an initial term of three years and is thereafter automatically extended for successive one-year terms unless A provides six-months prior written notice to Bank X, and the partnership satisfies specified financial requirements. Assume the Temporary Regulations became effective on the second anniversary of the partnership incurring the Bank X debt.

[i] Presumably, A's guarantee would be grandfathered for the balance of the initial term because the liability was incurred, and A's payment obligation was imposed or undertaken, pursuant to a written binding contract entered into before the date the Temporary Regulations became effective.

[ii] Would each automatic one-year extension of A's guarantee also be grandfathered? Arguably, it should be, because it was imposed or undertaken pursuant to a written binding contract entered into before the effective date of the temporary regulations.

b) **Example 4.** The facts are the same as in Example 3, except that the partnership and A also enter into a debt maintenance agreement that obligates the partnership to maintain a specified level of debt that must be guaranteed by A for a 10-year period. A's guarantee of the Bank X liability is for the full 10-year term. Assume the temporary regulations became effective on the second anniversary of the partnership incurring the Bank X liability. On the third anniversary, the partnership refinances the Bank X liability with a loan from Bank Y. Under the debt maintenance agreement, A is required to enter into a similar bottom guarantee of the Bank Y liability.

[i] Is A's guarantee of the Bank Y liability grandfathered and subject to the Existing Regulations because both the Bank Y liability and the guarantee were undertaken pursuant to the debt maintenance agreement, which is a written binding contract entered into before the effective date of the temporary regulations?

c) **Example 5.** The facts are the same as in Example 3, except that A has the right, but not the obligation, to enter into a bottom guarantee of the partnership's debt for a 10-year period under the debt maintenance agreement.

[i] If A enters into a bottom guarantee of the Bank Y liability one year after the temporary regulations became effective, is A grandfathered under the existing Code Sec. 752 regulations because the guarantee was "undertaken pursuant to a written binding contract" entered into before the effective date of the temporary regulations?

iii. The following examples illustrate that some taxpayers may find that the seven-year transition period is not long enough.

a) **Example 6.** Before the effective date of the temporary regulations, A contributed property to a partnership subject to debt in excess of basis. To obtain an enhanced share of partnership liabilities and avoid gain recognition as a result of a deemed distribution under Code Sec. 752(b) in excess of A's basis in the partnership interest, A enters into a bottom guarantee or DRO. The partnership and A also enter into a lockout agreement that generally provides that the partnership will not sell the contributed property (which would trigger A's gain under Code Sec. 704(c)) for a specified period. Also, to further protect A's tax deferral, the lockout agreement contains debt maintenance provisions that obligate the partnership during the same period to maintain a specified level of debt that may be guaranteed by A.

[i] As discussed above, if there is a refinancing of the debt and A wishes to enter into a bottom guarantee or DRO pursuant to the debt maintenance agreement, it is unclear whether that arrangement would be grandfathered under the binding contract exception of Temp. Reg. § 1.752-2T(l)(2).If the specified period extends beyond the seven-year transition period, A will be denied the benefit of its bargain because of a change in the regulations that is not truly prospective only.

[ii] We are familiar with many real-world cases in which the specified lockout and period exceeds seven years, including those in which A is an individual, and the period ends only on A's death (at which time the tax liability is absolved by virtue of the step-up in basis at death).

iv. Other taxpayers may find that the seven-year transition rule is inadequate because it limits relief to an amount equal to the excess of the taxpayer's share of recourse liabilities over basis in the partnership interest immediately before the temporary regulations become effective.

a) **Example 7.** The facts are the same as in Example 6, except that the contributed property is depreciable, and A enters into the bottom guarantee not because A needs an enhanced share of the liabilities at the time of contribution, but because A anticipates needing an enhanced share in the future.

[i] This often occurs with contributions of depreciable property subject to nonrecourse

debt because of the phenomenon known as "Code Sec. 704(c) burn-off." Code Sec. 704(c) burn-off refers to the fact that the amount of Code Sec. 704(c) gain on depreciable property contributed to a partnership declines annually as depreciation deductions are claimed.[26]

(a) As the Code Sec. 704(c) gain declines annually, so does the amount of nonrecourse debt allocated to the contributing partner under the second tier of Reg. §1-752-3(a)(2).

[ii] In the context of the seven-year transition rule, the point is that if A has a sufficient share of nonrecourse liabilities to avoid gain recognition immediately before the effective date of the temporary regulations but, nevertheless, has guaranteed debt to prevent gain recognition in the future from an anticipated reduction of nonrecourse liabilities, seven-year transition relief will be unavailable for the guaranteed liability.[27]

v. Still other taxpayers may find that the rule terminating seven-year transition relief when there is a change in ownership to a transition partner that is a partnership causes them to lose relief as a result of events they cannot control.

a) **Example 8.** A is a 49-percent partner, and B is a 51-percent partner, in an upper-tier partnership (UTP). UTP is a 30-percent partner in a lower-tier partnership (LTP). To maintain an enhanced share of LTP liabilities, UTP has entered into a bottom guarantee of specified LTP liabilities. Further, A

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[26]Reg. §1.704-3(a)(3)(9)(ii). *See generally* Blake D. Rubin & Andrea M. Whiteway, *Making Section 704(c) Sing for You* 66 N.Y.U. FEDERAL TAX INSTITUTE, ch. 9 (2008).

[27]To illustrate, immediately before the effective date of the Temporary Regulations, A might have a negative $100 tax basis capital account, $100 share of nonrecourse liabilities and $20 share of recourse liabilities on account of a guarantee entered into to prevent future gain recognition, as A's Code Sec. 704(c) gain burns off and A's share of nonrecourse liabilities declines. A's tax basis in the interest would be $20, and the seven-year transition rule would be inapplicable because A's $20 share of recourse liabilities does not exceed the basis in its interest. Relief might be available initially under the general effective date rule of Temporary Reg. §1.752-2T(l)(2) but would be lost if the debt subject to the guarantee were refinanced.

and B have each entered into a capital contribution obligation requiring that if UTP must pay on its guarantee, A will contribute 49 percent, and B will contribute 51 percent of the required funds to UTP. B sells its interest to C, which also assumes B's capital contribution obligation.

[i] Under Temp. Reg. §1.752-2T(l)(3)(ii), A loses the benefit of the seven-year transition rule and recognizes gain on account of a deemed distribution under Code Sec. 752(b) that exceeds the basis in A's interest.[28] Thus, A loses the benefit of the seven-year transition rule even though its payment obligation is unchanged, there is no change in the partnership liability, and it has no control over B's sale.

(a) The policy justification for this seems particularly opaque, even under a set of temporary regulations whose policy justification is obscure at best.

c. As illustrated by the examples above, the application of the effective date and transition relief in real world transactions is far from clear, and taxpayers may find themselves in situations where they are losing allocations of partnership liabilities while they continue to bear the real economic risk of loss for such liabilities under the temporary regulations.

E. <u>CODE SEC. 752 PROPOSED REGULATIONS</u>

1. <u>Overview</u>

a. The Existing Regulations set forth an anti-abuse rule pursuant to which an obligation of a partner is not recognized if the facts and circumstances indicate a plan to circumvent or avoid the obligation.[29]

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[28]Even if the arrangement might otherwise be grandfathered under the general effective date rule of Temporary Reg. §1.752-2T(l)(2), it appears that that status would be lost as a result of the technical termination of UTP that would occur under Code Sec. 708(b)(1)(B). New UTP would not have incurred any liability or payment obligation prior to the effective date. The relief for technical terminations provided by the general effective date rule of Temporary Reg. §1.752-2T(l)(3)(B) applies only for purposes of the seven-year transition rule.

[29]Reg. §1.752-2(j)(3).

i. The sole example in the Existing Regulations illustrating the application of this rule involves a corporate subsidiary that is formed with $0 net worth apart from its interest in a partnership to guarantee a partnership liability in order to allow the consolidated tax return group to enjoy losses from the partnership property.

b. Proposed Reg. §1.752-2(j)(3) expands this anti-abuse rule to include a nonexclusive list of factors that may indicate a plan to circumvent or avoid a payment obligation. The proposed regulations provide that the presence or absence of any factor is not necessarily indicative of whether a payment obligation is or is not recognized and the weight to be given to any particular factor depends on the particular case. The factors include the following:

i. The partner or related person is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, including, for example, restrictions on transfers for inadequate consideration or distributions by the partner or related person to equity owners in the partner or related person.

ii. The partner or related person is not 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 to the benefited party.[30]

iii. 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.[31]

iv. There exists a plan or arrangement in which the primary obligor or any other obligor (or a person related to the

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[30]Note that in order to avoid this factor, it appears to be necessary to impose an obligation to provide such documentation *both* at inception of the obligation and periodically thereafter.

[31]Proposed Reg. §1.752-2(j)(3) clarifies that "[t]his factor typically will not be present if the termination of the obligation occurs by reason of an event or events that decrease the risk of economic loss to the guarantor or benefited party (for example, the payment obligation terminates upon the completion of a building construction project, upon the leasing of a building, or when certain income and asset coverage ratios are satisfied for a specified number of quarters)."

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.

v. 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.

vi. 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.

vii. The creditor or other party benefiting from the obligation did not receive 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.[32]

c. Since 2006, Reg. §1.752-2(k) of the Existing Regulations has provided that the owner of a disregarded entity (such as a single-owner LLC) will be treated as bearing the economic risk of loss for a partnership liability only to the extent of the net value of the disregarded entity, as defined in the Existing Regulations.

i. In general, the "net value" of the disregarded entity is equal to fair market value of its assets less its liabilities, disregarding the value of its interest in the partnership whose liabilities are being allocated. The point is to recognize that, although the owner of the disregarded entity is the taxpayer affected by partnership liability allocations, the state law liability shield provided by the disregarded entity effectively precludes the taxpayer from bearing any economic risk of loss beyond the net value of the disregarded entity.

ii. The proposed regulations would eliminate this regime applicable for disregarded entities that are partners and substitute a much broader rule applicable to all partners. Specifically, the proposed regulations provide that:

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[32]Proposed Reg. §1.752-2(j)(3)(ii).

> Evidence of a plan to circumvent or avoid an obligation is deemed to exist if the facts and circumstances indicate 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 ... [33]

2. Issues Raised by Proposed Regulations

   a. The first two factors require commercially reasonable financial documentation and commercially reasonable restrictions on transfer of the obligor's assets.

      i. Although the determination of what is "commercially reasonable" is likely unclear in many situations, as a practical matter taxpayers could likely avoid falling afoul of these factors by inserting "magic language" in the documents creating the obligation.

   b. The third factor looks to whether the term of the payment obligation ends or can be terminated prior to the partnership's obligation payment obligation becoming due and payable, if the purpose of limiting the duration of the payment obligation is to terminate it prior to the occurrence of an event that increases the risk of the obligor.

      i. This is consistent with the view that partners should not be able to eliminate their recourse liability when the likelihood of having to pay increases and should be interpreted to allow early termination of the obligation where the purpose is not to terminate it prior to an event that increases the obligor's risk, such as in the situation described in Example 9.

         a) **Example 9.** A real estate loan is required by the lender to be fully guaranteed by a partner. The partner is allowed to sell his interest in the partnership to a credit-worthy purchaser who guarantees the loan, in which case the original partner-guarantor has the right to be released from the guarantee. This should not fall afoul of the third factor because the purpose is not to terminate the

[33] Proposed Reg. §1.752-2(j)(3)(iii).

obligation prior to an event that increases the obligor's risk.

c. The fourth factor looks to whether the partnership is holding money or other liquid assets in excess of its reasonably foreseeable needs.

   i. Under the Existing Regulations, in applying the constructive liquidation test, all assets including cash held by the partnership are deemed to be worthless.

   ii. Under the proposed regulations, in cases where a partnership holds significant liquid assets, the fourth factor will create the risk of disagreement over whether such holdings are in excess of reasonably foreseeable needs.

d. The fifth factor looks to whether there are limitations on the ability of the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements that indicate a plan to delay collection.

   i. Any guarantee of collection is arguably afoul of this factor. As noted above, a guarantee of collection requires that the creditor pursue its remedies against the borrower and the collateral prior to pursuing the guarantor. These arrangements are commonplace in secured real estate lending transactions that are entered into for non-tax reasons, and the treatment of such arrangements as evidencing a plan or arrangement to avoid the obligation is misguided.

e. Even more troubling is the sixth factor, which looks to whether the loan terms would be "substantially the same" without the payment obligation.

   i. Presumably, avoiding this factor will require the taxpayer to demonstrate that it received better loan terms by virtue of the presence of the payment obligation. Indeed, the language suggests that the loan terms must be "substantially" better. Avoiding this factor will require the taxpayer to demonstrate what the loan terms would be with and without the guarantee, which in many cases will be challenging.

   ii. Moreover, the extent to which the loan terms were or were not improved due to the payment obligation does not seem to have any bearing on whether the taxpayer has a plan or intention to avoid the obligation.[34]

iii. Apparently, any guarantee that is created after the inception of the loan, even though legally enforceable, will be afoul of this factor.

f. The seventh factor is that the creditor or other party benefiting from the obligation did not receive 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.

i. Frankly, we believe that the requirement that the creditor receive executed documents is inherent under existing law and required to conclude that the payment obligation is legally enforceable, which of course is required for it to be taken into account for tax purposes.

g. Unlike the objective and administrable rules of the Existing Regulations, the first, second, fourth and sixth factors require a determination of the meaning of the terms "commercially reasonable," "reasonable needs" and "substantially the same."

i. These amorphous and subjective tests will require partners and partnerships to make difficult, if not impossible, judgments in order to determine whether a particular obligation can be taken into account.

ii. Given the amorphous and subjective nature of these tests, we expect that IRS agents will challenge many payment obligations on the grounds that the commercially reasonable, reasonable needs, or substantially the same factors are not met, if a challenge would result in an increase in tax.

iii. We are particularly disappointed that the proposed regulations would require a subjective analysis of an obligation for it to be taken into account, given the public

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[34]The Preamble to the Proposed Regulations states that the fact that the loan terms were not improved by agreeing to the payment obligation indicates that the guarantee was not required by lender. Of course, it might also indicate that the lender was not willing to make the loan without the guarantee (which might raise issues under *Plantation Patterns Inc.*, 29 TCM 817, Dec. 30,219(M), TC Memo. 1970-182, *aff'd*, CA-5, 72-2 USTC ¶9494, 462 F2d 712). In any case, the presence or absence of this factor does not bear on whether there is a plan to avoid the obligation.

statements by the IRS and Treasury representatives preceding the issuance of the earlier proposed regulations that any new rules concerning such a determination under Code Sec. 752 would be objective and mechanical.[35]

h. Most troubling of all is the *per se* rule in Proposed Reg. §1.752-2(j)(3)(iii) that a plan to circumvent a payment obligation is deemed to exist if the facts and circumstances indicate 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 (the "Reasonable Expectation Requirement").

i. The other factors discussed above are nonexclusive and to be given varying weight depending on the facts and circumstances. In contrast, failure to meet the Reasonable Expectation Requirement automatically results in a deemed plan to circumvent the obligation, which automatically results in the obligation being disregarded.

ii. The Reasonable Expectation Requirement is entirely inconsistent with the so-called presumption of solvency in the Existing Regulations that an obligor will perform on its obligations irrespective of its net worth set forth in Reg. §1.752-2.

a) The proposed regulations do not explicitly amend the presumption of solvency, so it is unclear how the presumption of solvency is intended to co-exist with the Reasonable Expectation Requirement.

b) The Reasonable Expectation Requirement would place an affirmative burden on the obligor to establish that an expectation of satisfaction of a payment obligation is reasonable, which defeats the purpose of and is inconsistent with the presumption of solvency. It is the exception that completely undoes the general rule of the presumption of solvency, rather than proving the general rule.

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[35]*See* Elliott, *Guarantors May Need to Document Net Worth, Katz Says*, TAX NOTES TODAY, Sept. 30, 2013, at 1528 ("Craig Gerson, attorney-advisor, Treasury Office of Tax Legislative Counsel, said the government is designing the test in the regs to be mechanical in nature," and Clifford Warren, senior counsel for the Service's Office of Associate Chief Counsel (Passthroughs and Special Industries), "added that the government is trying to avoid using phrases like 'business purpose' and 'commercially reasonable' in the guidance. 'We want it to be a more objective test, to be frank. We don't want to be litigating about what's right and what's wrong in this area,' he said.").

iii. While failure to meet the Reasonable Expectation Requirement results automatically in disregarding a payment obligation, determining whether the Reasonable Expectation Requirement is met in a particular case could hardly be more uncertain.

a) To begin with, what level of probability or likelihood of payment needs to be present in order to conclude that there is a "reasonable expectation that the payment obligor will have the ability to make the required payments if the payment obligation becomes due and payable"? Lacking any guidance on this point—and there is none—one could argue as plausibly for a 10-percent likelihood of payment as for a 90-percent likelihood, or anywhere in between.

b) Whatever the required likelihood, when is it measured? At the time the payment obligation is entered into? At the end of every year that the payment obligation is taken into account for purposes of Code Sec. 752? At any time that there is a change in expectation?

c) What does it mean to "have the ability to make the required payments if the obligation becomes due and payable"? Does that require an ability to pay all principal in the event of default, or only to pay regular debt service as it comes due? How does one prove the reasonable expectation? Will all guarantors be required to tender to the IRS comprehensive financial statements to demonstrate the ability to pay?

d) The issues are legion, and we foresee that IRS auditors will use the massive uncertainty inherent in the Reasonable Expectation Requirement, together with the draconian consequences of violating it, to hammer taxpayers.

F. CODE SEC. 704(B) PROPOSED REGULATIONS

1. As part of this same regulatory package, Treasury issued proposed regulations under Code Sec. 704(b) (the "Code Sec. 704(b) Proposed Regulations"). While a detailed discussion of these changes is beyond the scope of this outline, some mention is appropriate because of their

relationship to the Code Sec. 752 temporary regulations and proposed regulations.

2. The Code Sec. 704(b) Proposed Regulations would make changes to the Code Sec. 704(b) regulations regarding when a DRO is respected that correspond to the provisions of the temporary regulations and proposed regulations.

   a. The first change, corresponding to the temporary regulations, is that a DRO would not be respected if it is disregarded BDPO.[36]

   b. The second change in the Code Sec. 704(b) Proposed Regulations, corresponding to the Code Sec. 752 proposed regulations, is that a DRO would not be recognized if the facts and circumstances indicate a plan to circumvent or avoid the obligation.

      i. As with the Code Sec. 752 regulations, the Code Sec. 704(b) Proposed Regulations include a nonexclusive list of factors that may indicate a plan to circumvent or avoid the obligation.[37]

      ii. The Code Sec. 704(b) Proposed Regulations provide that the presence or absence of any factor is not necessarily indicative of whether a payment obligation is or is not recognized, and the weight to be given to any particular factor depends on the particular case. Proposed Reg. §1.704-1(b)(2)(ii)(C)(4)(B) includes the following factors:

         a) The partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation.

         b) The partner is not 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.

         c) The obligation ends or could, by its terms, be terminated before the liquidation of the partner's

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[36]Proposed Reg. §1.704-1(b)(2)(ii)(c)(4)(A). As discussed above, unfortunately, the Temporary Regulations do not provide any guidance to determine whether a DRO is a BDPO. Reg. §1.704-2(m), *Example 1(vii)* specifically addresses the consequences of a "bottom" guarantee on the computation of "minimum gain" under the Code Sec. 704(b) regulations, but does not in any way suggest that the "bottom" guarantee is illusory or should be disregarded. Presumably due to a technical oversight, the Code Sec. 704(b) Proposed Regulations would not make any change to that example.

[37]Proposed Reg. §1.704-1(b)(2)(ii)(c)(4)(B).

interest in the partnership or when the partner's capital account as provided in Reg. §1.704-1(b)(2)(iv) is negative.

d) The terms of the obligation are not provided to all the partners in the partnership in a timely manner.

iii. A common provision in partnership agreements that have DROs is that a partner having a DRO can transfer his partnership interest if the transferee agrees to the same DRO. Such a provision would presumably fall afoul of the factor in Proposed Reg. §1.704-1(b)(2)(ii)(C)(4)(B)(iii).

iv. Another concern is that the effective date of the Code Sec. 704(b) Proposed Regulations is that the new rules would "apply on or after the date these regulations are published as final regulations in the Federal Register." Thus, there is no transition relief for binding DROs that were entered into before the date the Code Sec. 704(b) Proposed Regulations were published.

v. Partners who entered into DROs in reliance on the existing Code Sec. 704(b) regulations could find that those DROs cease to be taken into account because the various factors listed in Proposed Reg. §1.704-1(b)(2)(ii)(C)(4)(B) are not met. Putting aside the merits of the proposed changes to the Code Sec. 704(b) regulations, the failure to provide transition relief for pre-existing DROs is entirely inappropriate.

G. CONCLUSION

1. Managing the allocation of partnership liabilities is critical to achieving a partner's tax planning goals. The amendments to the partnership debt allocation rules in the temporary regulations and proposed regulations are among the most significant changes in partnership tax law in more than 20 years. In many cases, the changes would result in the recognition of taxable gain by partners or limit partners' ability to take losses into account as a result of a reduction in their allocable share of partnership liabilities.

2. In contrast to the existing regulations on the allocation of partnership recourse liabilities, which are largely mechanical and administrable, the proposed regulations would impose unclear, subjective, and in some cases, noncommercial requirements on payment obligations commonly entered into by partners in order for those obligations to be taken into account under Code Sec. 752.

3. We suggest that both the temporary regulations and the proposed regulations under Code Sec. 752 be withdrawn. We believe that the changes to the Code Sec. 707 regulations that were published at the same time adequately addressed Treasury's concerns about the use of debt allocations to avoid gain in leveraged partnership and other similar transactions, and that these further changes impose an entirely unworkable, unnecessary and burdensome regime on every partnership and partnership liability that is inconsistent with sound tax policy.

III. TEMPORARY REGULATIONS UNDER CODE SEC. 707

A. BACKGROUND

1. It is widely understood that the original motivation for the revisions to the Code Sec. 752 regulations was to limit taxpayers' ability to structure a so-called "leveraged partnership" transaction that complies with the debt-financed distribution exception to the partnership disguised sale rules under Code Sec. 707.[38]

2. The proposed Code Sec. 752 regulations issued on January 29, 2014[39] (the "2014 Proposed Regulations") actually did little to curtail leveraged partnership transactions, and in response to comments on those proposed regulations, the temporary Code Sec. 707 regulation directly and effectively addresses the issue.

3. The basic rule of the temporary Code Sec. 707 regulation is that a partner's share of a liability for purposes of the disguised sale rules is determined by reference to the partner's share of partnership profits.

    a. This rule applies regardless of whether the liability is a recourse liability for which the partner bears the economic risk of loss under the Code Sec. 752 regulations, which is a major departure from the prior regulations under Code Sec. 707.

B. PARTNERSHIP DISGUISED SALES: IN GENERAL

1. Code Sec. 707(a)(2)(B) provides that, if:

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[38]Amy S. Elliott, *Treasury Officials Explain New Bottom-Dollar Guarantee Rules*, 2014 TNT 38-4 (Mar. 3, 2014) (quoting Lisa Zarlenga, Treasury Tax Legislative Counsel, as saying "When we were considering changes in the Code Sec. 752 rules related to [the debt-financed distribution] exception, we determined that certain principles that were being applied for just Code Sec. 707 purposes ought to apply equally in non-disguised sale cases").

[39]REG-119305-11. For a discussion of the 2014 Proposed Regulations, *see* Blake D. Rubin, Andrea M. Whiteway & Jon G. Finkelstein, *Proposed Partnership Liability Allocation Regulations: An Unworkable Solution in Search of a Problem*, J. PASSTHROUGH ENTITIES, July–August 2014, at 41.

a. There is a direct or indirect transfer of money or other property by a partner to a partnership;

b. There is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner); and

c. The transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property,

such transfers shall be treated either as a transaction occurring between the partnership and one who is not a partner, or as a transaction between two or more partners acting other than in their capacity as members of the partnership.

2. Similarly, the regulations under Code Sec. 707(a)(2)(B) provide:

   a. A transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if based on all the facts and circumstances:

      i. The transfer of money or other consideration would not have been made but for the transfer of property; and

      ii. In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.[40]

3. The regulations under Code Sec. 707(a)(2)(B) also deal with the treatment of liabilities. The Senate Report relating to the disguised sale legislation in 1984 provided direction regarding the treatment of liabilities:

> The disguised sale provision also will apply to the extent (1) the transferor partner receives the proceeds of a loan related to the property to the extent responsibility for the repayment of the loan rests, directly or indirectly, with the partnership (or its assets) or the partners, or (2) the partner has received a loan related to the property in anticipation of the transaction and responsibility for

[40]Reg. §1.707-3(b).

repayment of the loan is transferred, directly or indirectly, to the partnership (or its assets) or the other partners.[41]

4. The Conference Report relating to the disguised sale legislation in 1985 (the "Conference Report") contemplated an analysis of who (or whose assets) bears responsibility for the repayment of a loan for purposes of determining whether (1) a partnership's distribution to a contributing partner of the proceeds of a partnership liability or (2) a partnership's assumption of, or taking subject to a contributing partner's liability, constitutes a disguised sale.

5. Regarding the former case, the Conference Report elaborated:

> The conferees wish to note that when a partner of a partnership contributes property to the partnership and that property is borrowed against, pledged as collateral for a loan, or otherwise refinanced, and the proceeds of the loan are distributed to the contributing partner, there will be no disguised sale under the provision to the extent the contributing partner, in substance, retains liability for repayment of the borrowed amounts (i.e., to the extent the other partners have no direct or indirect risk of loss with respect to such amounts) since, in effect, the partner has simply borrowed through the partnership. However, to the extent the other partners directly or indirectly bear the risk of loss with respect to the borrowed amounts, this may constitute a payment to the contributing partner.[42]

6. The regulations under Code Sec. 707(a)(2)(B) establish a general rule for situations in which a partnership assumes or takes subject to a contributing partner's liability that reflects the framework provided in the Conference Report. Specifically, Reg. §1.707-5(a)(1) provides:

> For purposes of this section and §§1.707-3 and 1.707-4, … if the partnership assumes or takes property subject to a liability of the partner other than a qualified liability, the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes or takes subject to the

[41]S. Rep. No. 98-169 (P.L. 98-369) at 321 (1984).

[42]H.R. Rep. No. 98-861, at 862 (1984).

liability as provided in paragraphs (a)(2), (3) and (4) of this section.[43]

7. Similarly, the regulations under Code Sec. 707(a)(2)(B) implement the "borrowing through the partnership" exception to disguised sale treatment. Specifically, Reg. §1.707-5(b)(2) provides:

> For purposes of §1.707-3, if a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under §1.163-8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner's allocable share of the partnership liability.

8. The language from the Conference Report regarding "responsibility for the repayment of the loan" was incorporated into the regulations under Code Sec. 707(a)(2)(B) through the concept of a partner's "share" of a liability in Reg. §1.707-5(a)(1).

9. The regime for determining a partner's share of a liability was fundamentally revised by the temporary Code Sec. 707 regulation. To understand this change, it is helpful first to review the rules that preceded the temporary Code Sec. 707 regulation.

C. <u>LIABILITIES UNDER THE PRIOR DISGUISED SALE REGULATIONS</u>

1. Under the prior disguised sale regulations, before the temporary Code Sec. 707 regulation, an initial distinction was made between a recourse and a nonrecourse liability by reference to the regulations under Code Sec. 752.

   a. Regarding a recourse liability, the prior disguised sale regulations provided:

   > A partner's share of a recourse liability of the partnership equals the partner's share of the liability under the rules of section 752 and the regulations thereunder. A partnership liability is a recourse liability to the extent that the obligation is a recourse liability under §1.752-1(a)(1) or

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[43]This column does not deal with a partnership's assumption of, or taking subject to "qualified liabilities," which generally are not treated as giving rise to consideration in a disguised sale unless they are assumed or taken subject to, in connection with a transaction otherwise treated as a disguised sale.

would be treated as a recourse liability under that section if it were treated as a partnership liability for purposes of that section.[44]

b. Regarding a nonrecourse liability, the prior disguised sale regulations provided:

> A partner's share of a nonrecourse liability of the partnership is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under §1.752-3(a)(3). A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability under §1.752-1(a)(2) or would be a nonrecourse liability of the partnership under §1.752-1(a)(2) if it were treated as a partnership liability for purposes of that section.[45]

2. As discussed above, under the Code Sec. 752 regulations, a partnership liability is a recourse liability to the extent a partner bears the "economic risk of loss" for the liability, and a recourse liability is allocated to the partner that bears the economic risk of loss.[46] A partnership liability is a nonrecourse liability to the extent no partner is treated as bearing the economic risk of loss for the liability.[47]

3. Also as discussed above, the Code Sec. 752 regulations establish a three-tier system for allocating nonrecourse liabilities.

a. The prior disguised sale regulations provided that a partner's share of a nonrecourse liability was determined by applying the same percentage used to determine the partner's share of the "excess nonrecourse liability" under the Code Sec. 752 regulations (*i.e.,* the excess of the liability that is not allocated pursuant to the first or second tier).[48]

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[44]Prior Reg. §1.707-5(a)(2)(i).

[45]Prior Reg. §1.707-5(a)(2)(ii).

[46]Reg. §1.752-1(a)(1) and Reg. §1.751-2(a).

[47]Reg. §1.752-1(a)(2).

[48]Prior Reg. §1.707-5(a)(2)(ii). The first and second tiers (often referred to as the "minimum gain" tier and the "Section 704(c) minimum gain" tier) generally allocate a portion of the nonrecourse liability to partners that would be allocated gain pursuant to a minimum gain chargeback or Code Sec. 704(c) if the property were disposed of solely in satisfaction of the nonrecourse liability.

4. The general rule for excess nonrecourse liabilities is that they are allocated in accordance with a partner's share of (or interest in) partnership profits (the "General Rule").[49] In general, a partner's interest in partnership profits is determined "by taking into account all facts and circumstances relating to the economic arrangement of the partners."[50]

5. As described above, the Code Sec. 752 regulations also provide certain specific methods for determining a partner's interest in partnership profits.

   a. The partnership agreement may specify a partner's interest in partnership profits in a manner that is "reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain" (the "Significant Item Method").[51]

   b. Also, a partnership may allocate an excess nonrecourse liability "in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated" (the "Alternative Method").

   c. Finally, there is also an "Additional Method," which allows the excess nonrecourse liability to be allocated to a partner up to the amount of built-in gain that would be allocated to the partner under Code Sec. 704(c) (or Code Sec. 704(c) principles if the property has been revalued under the Code Sec. 704(b) regulations) if the property subject to the liability were sold to the extent such built-in gain exceeds the built-in gain taken into account in the second tier.

6. Under the prior Code Sec. 707(a)(2)(B) regulations, the Significant Item Method and the Alternative Method were available for purposes of determining a partner's share of a nonrecourse liability, in addition to the General Rule. The Additional Method was not permitted to be used for purposes of the disguised sale regulations.[52]

7. With this framework, the following is a simplified example of how a leveraged partnership transaction could work under the prior disguised sale regulations, before the temporary Code Sec. 707 regulation:

   a. **Example 10.** A transfers property X, with a fair market value of $100, to partnership AB. B transfers $95 of other property.

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[49]Reg. §1.752-3(a)(3).

[50]*Id.*

[51]*Id.*

[52]Reg. §1.752-3(a)(3).

Immediately after the transfer, AB borrows $95 and distributes the proceeds of the borrowing to A. A guarantees the liability so that only A bears the economic risk of loss for the liability. Because the entire liability is allocable to A, A has not been distributed money in excess of A's allocable share of the liability under the prior Code Sec. 707 regulations. Accordingly, A receives the $95 as a distribution under Code Sec. 731(a) that is not treated as part of a disguised sale and not currently taxable.

i. A similar result could be achieved if A encumbered X immediately prior to transferring X subject to the liability to AB. If A guaranteed the liability so that only A bore the economic risk of loss for the liability, then, under the prior disguised sale regulations, A's share of the liability after the transfer would equal the entire amount of the liability, and accordingly none of the liability would be treated as consideration received by A in a disguised sale.

8. In *Canal Corp.*,[53] the Tax Court analyzed the application of the disguised sale rules to a leveraged partnership transaction. Without going into the facts, the transaction depended on a liability of the partnership being treated as a recourse liability to the partner that received the proceeds of the partnership liability. The IRS successfully challenged the transaction by asserting an anti-abuse rule in the Code Sec. 752 regulations.[54]

a. The anti-abuse rule (discussed above) provided that a partner or related person's payment obligation may be disregarded if facts and circumstances indicate that a principal purpose of the arrangement is to eliminate the partner's or related person's economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise.[55]

9. The preamble to the 2014 Proposed Regulations noted:

> The IRS and the Treasury Department have considered whether the approach of the existing regulations under §1.752-2 is appropriate given that, in most cases, a partnership will satisfy its liabilities

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[53]*Canal Corp.,* 135 TC 199, Dec. 58,298 (2010).

[54]The taxpayer in *Canal Corp.* was in bankruptcy at the time of the Tax Court decision. It did not pursue an appeal of the Tax Court decision, and it entered into a settlement with the IRS to settle the $106.7 million judgment for about $2 million. For a detailed discussion of the *Canal Corp.* case, *see* Blake D. Rubin, Andrea M. Whiteway & Jon G. Finkelstein, *Tax Court Takes Wrong Turn in Canal,* J. PASSTHROUGH ENTITIES, Nov.–Dec. 2010, at 41.

[55]Reg. §1.752-2(j).

> with partnership profits, the partnership's assets do not become worthless, and the payment obligations of partners or related persons are not called upon. The IRS and the Treasury Department are concerned that some partners or related persons have entered into payment obligations that are not commercial solely to achieve an allocation of a partnership liability to such partner.

10. The preamble went on to explain:

> Accordingly, the proposed regulations provide a rule that obligations to make a payment with respect to a partnership liability (excluding those imposed by state law) will not be recognized for purposes of section 752 unless certain factors are present.

11. The 2014 Proposed Regulations would not have upended the basic distinction in the treatment of recourse and nonrecourse liabilities under the disguised sale regulations. Rather, the regulations would have significantly limited the extent to which a liability would be treated as a recourse liability primarily by expanding the situations in which a payment obligation would be disregarded.

D. <u>TEMPORARY CODE SEC. 707 REGULATION</u>

1. The temporary Code Sec. 707 regulation provides the following:

    a. For purposes of §1.707-5, a partner's share of a liability of a partnership, as defined in §1.752-1(a) (whether a recourse liability or a nonrecourse liability) is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under §1.752-3(a)(3) (as limited in its application to this paragraph (a)(2)), but such share shall not exceed the partner's share of the partnership liability under section 752 and applicable regulations (as limited in the application of § 1.752-3(a)(3) to this paragraph (a)(2)).[56]

        i. This provision replaces the prior regulations that provided one rule for recourse liabilities and another for nonrecourse liabilities.

            a) As a result, for purposes of the disguised sale rules, a partner's share of recourse and nonrecourse liabilities is now determined by reference to the partner's share of excess nonrecourse liabilities.

[56]Reg. §1.707-5T(a)(2)(i).

The preamble to the 2016 Regulations under the disguised sale rules explained:

> [T]he Treasury Department and the IRS have concluded that, for disguised sale purposes only, it is appropriate for partners to determine their share of any partnership liability, whether recourse or nonrecourse under section 752, in the manner in which excess nonrecourse liabilities are allocated under Sec. 1.752-3(a)(3), as limited for disguised sale purposes in the 752 Final Regulations.

b. In connection with Temporary Code Sec. 707 Regulation, the IRS also revised the language of the "third tier" in Reg. §1.752-3(a)(3), so that it provides, "The significant item method, alternative method, and additional method do not apply for purposes of §1.707-5(a)(2)."

i. As a result, for purposes of the disguised sale rules, a partner's share of a liability is therefore determined only by reference to the General Rule for excess nonrecourse liabilities (*i.e.*, the Significant Item Method and the Alternative Method are no longer available).[57]

2. The consequences of the temporary Code Sec. 707 regulation can be illustrated by applying it to the same example used above:

a. **Example 11.** A transfers property X, with a fair market value of $100, to partnership AB. B transfers $95 of other property. Immediately after the transfer, AB encumbers X with a $95 liability and distributes the proceeds of the borrowing to A. A guarantees the liability so that only A bears the economic risk of loss for the liability. Assume A's share of partnership profits is 5%. Therefore, A's share of the liability is $5. The remaining $90 is in excess of A's allocable share of the liability. Accordingly, A receives the $90 of taxable consideration as part of a disguised sale of X to AB.

i. In this case, A's guarantee of the liability is not relevant for the disguised sale analysis. Under the same facts, if A had

[57]For a discussion of IRS's concern with the use of these methods in the disguised sale context, *see* Blake D. Rubin & Andrea M. Whiteway, *Here Comes the Kitchen Sink: IRS Throws 'Everything But' at Two Partnership Tax Deferral Structures,* J. PASSTHROUGH ENTITIES, Mar.–Apr. 2003.

not guaranteed the liability, A's allocable share of the liability would still be $5 based on A's 5% share of AB's profits. The result would also be the same if A encumbered X with a $95 liability in anticipation of the contribution, contributed X to AB subject to the liability, and guaranteed the liability.

3. The preamble to the 2014 Proposed Regulations noted that Treasury and the IRS "are aware of the difficulty in determining a partner's interest in partnership profits in other than very simple partnerships and, therefore, recognize the need to have a bright-line measure of a partner's interest in partnership profits."

   a. The 2014 Proposed Regulations proposed looking to a partner's proportionate share of the partnership on a liquidation basis as a bright-line test for measuring a partner's share of partnership profits. Commenters raised numerous and significant problems with the liquidation approach to the allocation of excess nonrecourse liabilities (summarized in the preamble to the 2016 Regulations), and the IRS abandoned this proposal in the 2016 Regulations.

   b. The Treasury did not, however, provide an alternative bright-line test in the 2016 Regulations for determining a partner's interest in partnership profits. The observation in the preamble to the 2014 Proposed Regulations about the difficulty in many circumstances of determining a partner's interest in partnership profits remains valid, and the significance of this determination has been greatly increased by the Temporary Code Sec. 707 Regulation by causing this standard to be applicable to all liabilities for purposes of the disguised sale rules.

4. The regulations under Code Sec. 707(a)(2)(B) take account of a situation in which a partner's share of a liability changes, dealing with a so-called "anticipatory reduction." This rule provides:

   a. For purposes of this section, a partner's share of a liability, immediately after a partnership assumes or takes property subject to the liability, is determined by taking into account a subsequent reduction in the partner's share if:

      i. At the time that the partnership assumes or takes property subject to the liability, it is anticipated that the transferring partner's share of the liability will be subsequently reduced;

      ii. The anticipated reduction is not subject to the entrepreneurial risks of partnership operations; and

iii. The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the assumption of or taking property subject to the liability is treated as part of a sale under §1.707-3.[58]

5. Clause (ii) was added as part of the 2016 Regulations. The 2016 Regulations revise an example in the regulations providing an illustration of the anticipatory reduction rule.[59] The example can be summarized as follows:

a. **Example 12.** C transfers property Y to a partnership in which C has a 50% interest. At the time of its transfer to the partnership, property Y has a fair market value of $10,000,000 and is subject to an $8,000,000 liability. Property Y is a fully leased office building, the rental income from property Y is sufficient to meet debt service, and the remaining term of the liability is 10 years. Under Code Sec. 752, immediately after the partnership's assumption of the liability encumbering property Y, the liability is a recourse liability of the partnership, and C's share of that liability is $8,000,000. For disguised sale purposes, C's share of the liability immediately after the partnership's assumption is $4,000,000 (50% of $8,000,000). It is anticipated that, three years after the partnership's assumption of the liability, C's share of the liability for disguised sale purposes will be reduced to $2,000,000 because of a shift in the allocation of partnership profits pursuant to the terms of the partnership agreement, which provide that C's share of the partnership profits will be 25% at that time.

Under the partnership agreement, this shift in the allocation of partnership profits is dependent solely on the passage of time. Therefore, if the reduction in C's share of the liability was anticipated at the time of C's transfer, was not subject to the entrepreneurial risks of partnership operations, and was part of a plan that has as one of its principal purposes minimizing the extent of sale treatment under Reg. §1.707-3 (that is, a principal purpose of allocating a larger percentage of profits to C in the first three years when profits were not likely to be realized was to minimize the extent to which C's transfer would be treated as part of a sale), C's share of the liability immediately after the partnership's assumption is treated as equal to C's reduced share of $2,000,000. Thus, the amount of consideration to C is $6,000,000 (the excess

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[58]Reg. §1.707-5(a)(3).

[59]Reg. §1.707-5T(f), Example 3.

of the liability assumed by the partnership ($8,000,000) over C's share of the liability for disguised sale purposes immediately after the assumption ($2,000,000)), taking into account the anticipated reduction in C's share of the liability pursuant to the terms of the partnership agreement.

i. This example implies that, in the absence of the anticipatory reduction rule, C's share of partnership profits, and therefore C's share of the liability, would have been 50%. Thus, the example implies that the subsequent reduction in C's profit share is ignored for purposes of determining C's share of profits under the General Rule.

ii. Needless to say, this "snapshot" approach to determining C's share of profits is not the only plausible way to make that determination. For example, commentators have suggested that the determination might be based on the partner's anticipated share of overall partnership profits over the life of the partnership.[60]

6. The temporary Code Sec. 707 regulation generally looks to a partner's share of partnership profits in determining the partner's share of a liability, but there is a limitation at the end of the provision, which provides, "such share shall not exceed the partner's share of the partnership liability under section 752 and applicable regulations (as limited in the application of § 1.752-3(a)(3) to this paragraph (a)(2))" (the "Code Sec. 752 Limitation").[61]

7. The application of the Code Sec. 752 Limitation can be illustrated as follows:

a. **Example 13.** C transfers property X, with a fair market value of $100, to partnership AB. Immediately after the transfer, AB encumbers X with a $50 liability and distributes the proceeds of the borrowing to C. A guarantees all the liabilities of AB,

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[60]*See, e.g.*, William S. McKee, William F. Nelson & Robert L. Whitmire, WARREN, GORHAM & LAMONT, at ¶ 13.03[2][b] (4th ed 2007).

[61]When the Temporary Code Sec. 707 Regulation was initially issued, the Code Sec. 752 Limitation was formulated differently, as follows, " ... without including in such partner's share any amount of the liability for which another partner bears the economic risk of loss for the partnership liability under Sec. 1.752-2." This formulation was criticized on the grounds that excluding liabilities that are recourse to another partner was inconsistent with the stated rationale of the rule that a partner's share of overall partnership profits is a better measure of who really bears the burden of repayment of the debt and also because it gave rise to problems if the contributor and another partner both guaranteed the relevant liability. *See* Amy S. Elliott, *Treasury to Clarify Temporary Disguised Sale Regulations*, 2016 TNT 208-1 (Oct. 27, 2016). A "technical correction" to the Code Sec. 752 Limitation was issued to address the latter concern, but not the former.

including this newly incurred liability. Assume C's share of partnership profits is 10%. C's share of the newly incurred liability under Code Sec. 752 and the regulations thereunder is $0. Therefore, C's share of the liability for disguised sale purposes is $0 as a result of the Code Sec. 752 Limitation. Accordingly, C receives the $50 of taxable consideration as part of a disguised sale of X to AB.

b. **Example 14.** C transfers property X, with a fair market value of $100, to partnership AB. Immediately after the transfer, AB encumbers X with a $50 liability and distributes the proceeds of the borrowing to C. A guarantees all the liabilities of AB, including this newly incurred liability. C indemnifies A for the first $5 that A would have to pay under its guarantee of the newly incurred liability. Assume C's share of partnership profits is 10%. C's share of the newly incurred liability under Code Sec. 752 and the regulations thereunder is $5. Therefore, C's share of the liability for disguised sale purposes is $5 because the Code Sec. 752 Limitation does not result in a lower share than C's share of the liability based on C's share of partnership profits. Accordingly, C receives the $45 of taxable consideration as part of a disguised sale of X to AB.

i. The result in Example 5 would be the same even if C indemnified A for the entire $50 of the newly incurred liability. That is, the Code Sec. 752 Limitation does not lead to a larger share of a partnership liability than the amount based on a partner's share of partnership profits.

ii. It is unclear whether the Code Sec. 752 Limitation takes into account the partners' shares of a partnership nonrecourse liability under tier one and tier two of the allocation rules for nonrecourse liabilities. It is difficult to grasp a rationale for why tier one and tier two would be relevant to the Code Sec. 752 Limitation, although the Code Sec. 752 Limitation, read literally, does not exclude tier one and tier two. A Treasury official has indicated that tier one and tier two are not intended to be included in the Code Sec. 752 Limitation.[62]

c. **Example 15.** A transfers property X, with a fair market value of $100 and basis of $0, to partnership AB. B transfers $5 of cash to AB. Immediately after the transfers, AB encumbers X with a liability of $90 and distributes the proceeds of the borrowing to A.

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[62]Amy S. Elliot, *Clarification to Disguised Sale Rules Causing Confusion,* 2016 TNT 228-2 (Nov. 28, 2016).

B guarantees the top $45 of the liability so that only B bears the economic risk of loss for that portion of the liability. Assume A's share of AB's profits is 66.66%, which would result in a $60 share of the liability but for the Code Sec. 752 Limitation. A's share of the liability under Code Sec. 752, taking into account only the General Rule for excess nonrecourse liabilities, is $30 (*i.e.*, 2/3 × $45 nonguaranteed portion of the debt). A's share of the liability under Code Sec. 752, taking into account tier two, is $45.

i. It is unclear under the Code Sec. 752 Limitation whether A's share of the liability for disguised sale purposes is limited to $30 or $45.

E. <u>CONCLUSION</u>

1. We agree that the prior disguised sale rules were overly generous in allowing taxpayers to use leverage to extract equity from property transferred to a partnership while shifting the burden of repaying the debt to other partners.

   a. Nevertheless, the Conference Report described a "borrowing through the partnership" exception, and the Temporary Code Sec. 707 Regulation does not attempt to preserve that exception at all. The "borrowing through the partnership" exception described in the Conference Report involved a situation in which only contributed property is encumbered by a liability (and, presumably, other partnership property does not secure the liability) and the contributing partner bears the risk of loss with respect to the liability.

   b. In that situation, it appears that the contributing partner is effectively extracting equity from its contributed property that it could have extracted from the property by borrowing outside the partnership.

   c. While the prior disguised sale rules on this point were overly generous, arguably a "borrowing through the partnership" exception should have been preserved where the liability was secured only by the contributed property, consistent with the direction of the Conference Report.

2. The new rule was a significant departure from the approach of the 2014 Proposed Regulations. Because the rule was issued as a temporary and not a proposed regulation, taxpayers were denied the opportunity to provide comments on the rule before it became effective.

   a. In light of the fact that leveraged partnerships had been a feature of the tax law known to the government for many years, the issuance of the regulation in temporary form cannot be justified on grounds of eliminating some new abuse.

b. Moreover, the temporary regulation as originally promulgated was the subject of a prompt "technical correction" relating to the Code Sec. 752 Limitation.

c. Further, as discussed above, the language of the corrected Code Sec. 752 Limitation is still arguably defective, which reinforces the conclusion that the regulation should have been issued in proposed rather than temporary form.

3. Executive Order 13789 and Subsequent Developments:

a. As noted above, in Executive Order 13789, the Secretary of the Treasury was directed to immediately review all significant tax regulations issued on or after January 1, 2016, and submit a report identifying regulations that (i) impose an undue financial burden on U.S. taxpayers; (ii) add undue complexity to the Federal tax laws; or (iii) exceed the statutory authority of the IRS.

b. The IRS and Treasury issued Notice 2017-38, identifying regulations as either imposing an undue financial burden on taxpayers or adding undue complexity to the Code, and the Notice included the temporary Section 707 regulations, regarding the allocation of liabilities for purposes of the disguised sale rules.

c. In its "Second Report to the President on Identifying and Reducing Tax Regulatory Burdens," the Treasury indicated it is considering whether the temporary Section 707 regulations should be revoked, with the prior regulations reinstated.