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Memorandum

IRS Publishes New Regulations on the Disguised Sale Rules and the Allocation of Partnership Liabilities

October 13, 2016

Summary

Last week, the IRS and Treasury Department released final, temporary and proposed regulations regarding the partnership "disguised sale" rules under section 707 of the Internal Revenue Code (the "Code") and the partnership debt allocation rules under section 752 of the Code. These regulations, which modify regulations proposed in January 2014 (the "2014 Proposed Regulations"), limit a partner's ability to contribute property to a partnership in exchange for a debt-financed distribution or liability assumption on a tax-deferred basis. Under prior rules, contributors of property to partnerships could avoid sale treatment in some circumstances by issuing low-risk "bottom-dollar guarantees" or taking other steps to cause partnership debt to be allocated to the contributor. Such arrangements have become common in MLP, UPREIT, UP-C and other partnership transactions, and the new rules will require changes to practices in those areas. The new rules are designed to ensure that a partner's allocable share of partnership debt accurately reflects the partner's economic risk of loss with respect to such debt. Most notably, the temporary regulations seek to limit the application of the exception to the disguised sale rules for debt-financed distributions. In addition, the temporary regulations provide that, subject to limited exceptions, bottom-dollar guarantees will no longer cause partnership obligations to be allocated to the guarantor partner, thereby reducing the amount of cash that may be distributed or deemed distributed to a contributing partner on a tax-deferred basis.

Background – Disguised Sales of Property Prior to the New Regulations

The disguised sale rules under section 707(a)(2)(B) of the Code seek to recharacterize contributions of property to or by a partnership that are more properly characterized as taxable sales or exchanges. These rules generally treat a transaction as a sale of property by a partner to the partnership if the partner contributes property to the partnership and receives a related distribution of money or other consideration from the partnership that is not tied to the entrepreneurial risks of the partnership's operations. There are, however, several important exceptions to this rule, including the debt-financed distribution exception. This exception provides that if a partner contributes property to a partnership in exchange for cash from a loan to the partnership, that distribution will only be taken into account for purposes of the disguised sale rules to the extent that the amount of the distribution exceeds the partner's "allocable share" of the loan. Under prior law, a partner could be allocated the full amount of debt by agreeing to guarantee the loan, even if the guarantee was a so-called bottom-dollar guarantee. A bottom-dollar guarantee is a guarantee of a certain amount of the loan, but is only payable to the extent that the lender collects less than the guaranteed amount from the partnership borrower. The debt-financed distribution exception, in conjunction with the prior method for allocating recourse partnership liabilities for purposes of the disguised sale rules, enabled partners to use leveraged partnerships to contribute appreciated property in exchange for debt-financed distributions on a tax-deferred basis, while taking on only limited economic risk by means of the bottom-dollar guarantee.

Modifications to the Disguised Sale Rules

Partners' Share of Partnership Liabilities

The temporary regulations provide that a partner's share of partnership liabilities for disguised sale purposes will be determined in accordance with the partner's share of partnership profits, effectively treating all partnership liabilities as nonrecourse liabilities for purposes of these rules. A partner's allocable share, however, will not include any amount of liability for which another partner bears the economic risk of loss. Under the new regulations, partnerships will have less discretion in allocating partnership liabilities. If a partner contributes appreciated property encumbered by nonqualified debt to a partnership (i.e. debt not meeting the exception to the disguised sale rules for "qualified" liabilities) or receives a debt-financed distribution in exchange for appreciated property, that partner's share in the liability will now be equal to that partner's profit sharing percentage, possibly causing that partner to be allocated a smaller amount of the liability and reducing the potential for tax deferral with respect to the cash distribution or liability assumption.

In addition, because a partner's share of a partnership liability is based on the partner's share of partnership profits for purposes of the disguised sale rules, a partner cannot be allocated more than that share of partnership liabilities for such purposes. Therefore, the new allocation rule may produce shifting of qualified and nonqualified liabilities among existing partners, potentially resulting in increased gain recognition. There is, however, a special rule that seeks to mitigate this effect by excluding qualified liabilities from being treated as consideration in a disguised sale if the total amount of nonqualified liabilities assumed by the partnership is less than ten percent of all qualified liabilities assumed by the partnership or one million dollars.

The temporary regulations under section 707 of the Code are effective for any transaction for which all contributions occur on or after January 3, 2017, meaning that with the exception of bottom-dollar payment obligations (which, effective immediately, will no longer cause the liability to become recourse), all other recourse liabilities will continue to receive the current allocation treatment for disguised sale purposes until January 3, 2017.

Preformation Capital Expenditures

The final regulations under section 707 of the Code implement the approach of the 2014 Proposed Regulations and provide that, in the case of multiple property contributions, reimbursement for preformation capital expenditures will be tested on a property-by-property basis to determine whether the contribution qualifies for the reimbursement of preformation capital expenditures exception to the disguised sale rules. However, the final regulations add an exception that permits the aggregation of properties in the limited instances where a property-by-property analysis would be overly burdensome.

Step-In-The-Shoes Rule & Tiered Partnerships

The final regulations provide greater flexibility and clarity in a few areas than did the 2014 Proposed Regulations. First, the "step-in-the-shoes" rule allows partners who received property in connection with a nonrecognition transaction to step into the original contributor's shoes for purposes of applying the preformation capital expenditure and qualified liability exceptions to the disguised sale rules. Second, in the case of tiered partnerships, the determination of whether a liability is qualified is based on whether the lower-tier partner anticipated making the transfer to the upper-tier partnership at the time the lower-tier partnership incurred the liability. With respect to preformation capital expenditures, if a partner incurs capital expenditures on property, contributes that property to a partnership, and then transfers an interest in that partnership to an upper-tier partnership within a two-year period, the upper-tier partnership steps into the lower-tier partner's shoes for purposes of receiving a preformation capital expenditure reimbursement.

The final regulations under both sections 707 and 752 of the Code are effective immediately.

Bottom-Dollar Guarantees

The temporary regulations provide that bottom-dollar guarantees are no longer recognized as payment obligations that cause liabilities to become recourse and thus allocable to a specific partner because the IRS generally views such arrangements as "lack[ing] significant non-tax commercial business purpose." In addition to traditional bottom-dollar guarantees, this new rule applies to a broad category of similar arrangements (renamed "bottom-dollar payment obligations"), including "tiered partnerships, intermediaries, senior and subordinate liabilities," and other obligations involving multiple liabilities if the liabilities were incurred as part of a common plan to avoid having at least one of the liabilities be treated as a bottom-dollar payment obligation. Therefore, it is possible that guaranteeing a senior piece of tranched debt could constitute a bottom-dollar payment obligation under the new rules.

The new rules provide that bottom-dollar payment obligations are ignored, and the underlying partnership debt is allocated under the rules for nonrecourse liabilities (i.e. in accordance with a partner's share of partnership profits) unless another respected guarantee causes the debt to be treated as recourse under section 752 of the Code. By ignoring bottom-dollar payment obligations, there is a greater likelihood that a distribution of cash to a partner will exceed such partner's tax basis. The temporary regulations also require disclosure to the IRS of all bottom-dollar payment obligations that are incurred or modified, which may further discourage the use of these arrangements.

There are, however, a few exceptions to the new bottom-dollar payment obligation rules:

1. the temporary regulations permit the recognition of a "vertical slice" of a partnership liability, i.e. guaranteeing a certain percentage of each dollar of debt; and

2. the temporary regulations permit recognition of certain indemnification or reimbursement agreements, so long as the obligor is liable for at least ninety percent of the payment obligation.

The temporary regulations under section 752 of the Code are effective immediately for liabilities incurred or assumed, or payment obligations imposed or undertaken with respect to a partnership liability, after October 5, 2016, although they provide transition relief for up to seven years for a partner whose allocable share of partnership liabilities in place on that date exceeds the partner's adjusted basis in its partnership interest. Further, any partnership liabilities or payment obligations that are modified or refinanced will be subject to the new temporary regulations, including any pre-modification and pre-refinancing liabilities or obligations.

Proposed Anti-Abuse Rule under Section 752 of the Code

The proposed regulations amend the list of factors in the 2014 Proposed Regulations' anti-abuse rule for determining whether to recognize a partner's payment obligation for purposes of allocating recourse liabilities. Unlike the 2014 Proposed Regulations' "all-or-nothing" approach, which required that each of six specified factors be met in order to obtain recognition for purposes of section 752 of the Code, the new anti-abuse rule is a non-exclusive list of facts and circumstances factors, to be assessed in totality. If, on the whole, these factors suggest that the obligor would be unable to make payment if the obligation were to become due and payable, evidence of a plan to avoid a payment obligation will be presumed, and the payment obligation will not be recognized.

The proposed regulations also include substantive changes to the factors included in the 2014 Proposed Regulations. They propose removing the factor requiring the partner to have received "arm's length consideration for assuming the payment obligation" on the basis that requiring arm's length consideration is not commercial. The rationale is that a partner will often be willing to provide a guarantee or other payment obligation due to the benefit the liability affords the guarantor in his or her capacity as partner. The proposed regulations also intend to provide two additional factors believed to be indicative of a plan to avoid payment: (1) whether, "in the case of a guarantee or similar arrangement, the terms of the liability would be substantially the same had the partner or related person not agreed to provide the guarantee"; and (2) "whether the creditor or other party benefiting from the obligation received executed documents with respect to the payment obligation from the partner or related person before, or within a commercially reasonable time after, the creation of the obligation."

The proposed regulations will not become effective until they are published in final form.

Conclusion

In several areas, the new regulations are an improvement over the 2014 Proposed Regulations, offering additional guidance and clarity in response to certain comments that were received. However, the new regulations also provide significantly less flexibility regarding the allocation of partnership liabilities than under prior law, which may effectively end the use of bottom-dollar guarantees and substantially curtail the use of leveraged partnerships as techniques to achieve tax deferral in partnership transactions.

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