Federal Bar Association Section on Taxation

2015 Tax Law Conference

Partnerships: Recent Developments

March 6, 2015

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Agenda: Proposed Regulations under Section 751(b)
Proposed Regulations under Sections 707 and 752
Update on Section 706 Regulations
Update on Section 7704 Guidance
Other Recent Developments

Section 751(b) Proposed Regulations

FBA

March 6, 2015

Section 751(b) – Overview

An otherwise nontaxable distribution can be recast as a taxable exchange under section 751(b) to the extent the partner receives hot assets in exchange for all or any part of its interest in cold assets or cold assets in exchange for all or any part of its interest in hot assets.

Section 751(b) – Overview

Hot assets include "unrealized receivables" and "inventory items which have appreciated substantially in value" (assets that would generate ordinary income if sold by the partnership).

Section 751(b) – New Proposed Regulations

The new proposed regulations

- establish an approach for measuring partners' interests in section 751 property,
- provide new rules under section 704(c) to help partnerships compute partner gain in section 751 property more precisely, and
- describe how basis adjustments under sections 734(b) and 743(b) affect the computation of partners' interests in section 751 property.

Section 751(b) – Lack of Guidance

- Section 751(b) and the underlying regulations provide no guidance regarding how to measure a partner’s interest in a partnership’s hot and cold assets.

Section 751(b) – Gross Value Approach

- The examples in the regulations, however, illustrate ways the provisions of section 751 "may" be applied and use an exchange table to account for each partner's share of partnership properties before and after the distribution.
- The exchange table assumes that the partners share in each partnership asset in the same proportions as their capital accounts. The exchange table also focuses on the FMV of each asset and ignores its built-in gain.

Section 751(b) – Gross Value Approach

Gross Value Approach:

Compare

(i) the distributee partner's undivided interest in the gross value of each partnership asset before a distribution

to

(ii) to the partner's undivided interest in the same assets after the distribution (including the distributed assets).

Criticism of the Gross Value Approach

Section 751(b) was enacted in 1954 and has remained almost unchanged while many other provisions of Subchapter K have undergone significant transformation. In combination with other Code sections, it can create unanticipated results.

Criticism of the Gross Value Approach

Section 704(b): Treasury regulations issued under section 704(b) provide that a partnership's allocations will be respected if they have substantial economic effect.

- Relying on this safe harbor, it is common for partnerships to specially allocate items of partnership income and loss other than in accordance with the partner's relative fair market value capital accounts.
- This common arrangement is not consistent with the gross value approach, which assumes a partner's interest in the partnership's property is based on the partner's relative fair market value capital account.

Criticism of the Gross Value Approach

- The gross value approach is unclear on whether, and to what extent, section 704(c) (forward and reverse) is properly taken into account in determining a partner's share of assets.
- Section 704(c)(1)(A) provides that income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take into account the variation between the basis of the property to the partnership and its FMV at the time of contribution.

Criticism of the Gross Value Approach

Under Treas. Reg. § 1.704-3(a)(6), the principles of section 704(c) apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(f).

Is the Distribution a Section 751(b) Transaction?

- Current Regs: Gross Value Approach (not exclusive interpretation of regs)
  - Based on share of hot or cold assets; measured by gross value
- Proposed Regs: Hypothetical Sale that takes 704(c) into account
  - Based on OI (or OL) that would be recognized in a hypothetical sale for fmv
  - Mandatory bookup if partnership owns hot assets immediately after the distribution; permissive bookup otherwise.
  - Reverse 704(c) layers taken into account

Example 1:
Current Distribution of Cold Asset

- A, B, and C contribute $120 to ABC in exchange for a 1/3 interest
- ABC purchases land for $100 in year 1

Example 1:
Current Distribution of Cold Asset

Balance sheet three years later

Assets	Tax	Book	Capital	Tax	Book
Cash	$260	$260	A	$120	$150
Unrealized receivable	$0	$90	B	$120	$150
Real Property	$100	$100	C	$120	$150
Totals	$360	$450		$360	$450

Example 1:
Current Distribution of Cold Asset

ABC distributes $50 cash to C in a current distribution, reducing C's interest to 1/4

Example 1 (Gross Value Approach)

Exchange Table

	C's post-distribution share	(+) Property distributed	(-) C's pre-distribution share	= Change in Interest
Unrealized receivable	$22.50	$0	$30.00	($7.50)
Cash	$52.50	$50	$86.66	$15.84
Real Property	$25.00	$0	$33.34	($8.34)

Example 1 (Gross Value Approach)

- C’s interest in hot assets has decreased by $7.50 and while her interest in cold assets has increased by $7.50
- Distribution is a section 751(b) transaction

Example 1 (Proposed Regs)

- Compare each partner's share of OI before the distribution with each partner's share of OI after the distribution
- Decrease in share of OI = "Section 751(b) amount"
- When there is a Section 751(b) amount, Section 751(b) applies.

Example 1 (Proposed Regs)

- Balance sheet is booked up before distribution
- Each partner has $30 of net unrealized OI

Assets	Tax	Book	Capital	Tax	Book
Cash	$260	$260	A	$120	$150
Unrealized receivable	$0	$90	B	$120	$150
Real Property	$100	$100	C	$120	$150
Totals	$360	$450		$360	$450

Example 1 (Proposed Regs)

- Net unrealized OI before = net unrealized OI after
- Section 751(b) amount = $0
- The distribution is not a section 751(b) distribution
- Different result than gross value approach

Tax Consequences of Section 751(b) Distribution – Current Regs

Asset Exchange Approach

- Distributee is deemed to receive a current distribution of the type of asset, and in the amount in which, her interest decreases
- She is then deemed to exchange the property received in the hypothetical distribution for an equal amount of the type of asset in which her interest increases
- Balance of distribution treated under normal rules

Tax Consequences of Section 751(b) Distribution – Proposed Regs

- Must recognize Section 751(b) amount as ordinary income and make “appropriate adjustments” to basis
- No specific method specified
- Must pick a “reasonable method” that is consistent with the purpose of section 751(b)
- Examples: Deemed Gain Approach and Hot Asset Sale Approach
- Bound by approach adopted until the approach becomes unreasonable
  - Must reevaluate for each distribution

Example 2 (Proposed Regs)

- Assume same facts in Example 1, except ABC distributes $150 cash to C in liquidation of C's interest
- ABC has 754 election in place
- In hypothetical sale before the distribution, each partner has $30 of section 751 gain

Example 2 (Proposed Regs)

Balance sheet before the distribution

Assets	Tax	Book	Capital	Tax	Book
Cash	$260	$260	A	$120	$150
Unrealized receivable	$0	$90	B	$120	$150
Real Property	$100	$100	C	$120	$150
Totals	$360	$450		$360	$450

Example 2 (Proposed Regs)

Apply hypothetical sale approach after distribution

- Determine tax consequences without regard to 751(b) regs
- C recognizes $30 of gain
- Section 734(b) adjustment of $30 to basis of real property

Example 2 (Proposed Regs)

Balance sheet after distribution

Assets	Tax	Book	Capital	Tax	Book
Cash	$110	$110	A	$120	$150
Unrealized receivable	$0	$90	B	$120	$150
Real Property	$130	$100	C	$0	$0
Totals	$240	$300		$240	$300

Example 2 (Proposed Regs)

- C has no share of unrealized OI after the distribution
- Section 751(b) amount = $30 - $0 = $30
- C must recognize $30 of ordinary income using a reasonable approach, and appropriate basis adjustments must be made

Example 2 (Proposed Regs)

- A different way of recognizing gain
- Deemed Gain Approach
  - C must recognize $30 of ordinary income
  - ABC deemed to recognize $30 of its OI and allocate that OI to C. Immediately before the distribution:
    - C increases her outside basis by $30.
    - ABC increases its basis in unrealized receivables to $30

Example 2 (Proposed Regs)

Modified balance sheet immediately prior to distribution

Assets	Tax	Book	Capital	Tax	Book
Cash	$260	$260	A	$120	$150
Unrealized receivable	**$30**	$90	B	$120	$150
Real Property	$100	$100	C	**$150**	$150
Totals	$390	$450		$390	$450

Example 2 (Proposed Regs)

Then the normal distribution rules apply. C recognizes no gain on distribution. No 734(b) basis adjustment. Balance sheet after distribution:

Assets	Tax	Book	Capital	Tax	Book
Cash	$110	$110	A	$120	$150
Unrealized receivable	$30	$90	B	$120	$150
Real Property	$100	$100	C	$0	$0
Totals	$240	$300		$240	$300

Example 2 (Proposed Regs) – Hot Asset Sale Approach

- C is deemed to:
  - Receive a distribution of ABC's unrealized receivable w/ FMV = $30, basis = $0
  - Sell unrealized receivable to ABC, recognize $30 of OI (ABC takes cost basis in unrealized receivable)
  - Contribute the $30 to ABC
- Then the normal distribution rules apply. C recognizes no gain on distribution. No 734(b) basis adjustment.

Capital Gain Recognition

- Distributee's basis in distributed assets cannot exceed distributee's outside basis
- This limitation can increase the distributee's unrealized OI
- That additional OI duplicates OI that the other partners recognize
- Distributee can avoid this result by recognizing capital gain
- Capital gain recognition is sometimes elective and sometimes mandatory

Example 3: Capital Gain Recognition

Balance sheet before distribution:

Assets	Tax	Book	Capital	Tax	Book
Unrealized receivable 1	$0	$90	A	$0	$100
Unrealized receivable 2	$0	$30	B	$0	$100
Real Property	$0	$180	C	$0	$100
Totals	$0	$300		$0	$300

Example 3: Capital Gain Recognition

- ABC distributes unrealized receivable 1 to C in a current distribution.
- ABC does not have a sec. 754 election

Example 3: Capital Gain Recognition

- Net section 751 unrealized gain before distribution:
  - A = $40, B = $40, and C = $40
- Net section 751 unrealized gain after distribution:
  - A = $10, B =$10, and C = $100
- 751(b) distribution
- A and B each have a Section 751(b) amount of $30

Example 3: Capital Gain Recognition

- A and B must recognize $30 of ordinary income (before distribution of unrealized receivable 1).
- Deemed to be A & B's share of ABC's OI in unrealized receivable 1.
  - A & B increase their outside basis by $30
  - ABC increases its basis in unrealized receivable 1 by $60

Example 3: Capital Gain Recognition

Modified balance sheet before distribution:

Assets	Tax	Book	Capital	Tax	Book
Unrealized receivable 1	$60	$90	A	$30	$100
Unrealized receivable 2	$0	$30	B	$30	$100
Real Property	$0	$180	C	$0	$100
Totals	$60	$300		$60	$300

Example 3: Capital Gain Recognition

- C’s outside basis is $0, so C receives unrealized receivable 1 with a $0 basis
  - $60 of basis will be lost in unrealized receivable 1
- C will therefore recognize $90 of OI upon disposition
  - $60 of this OI duplicates the OI previously picked up by A and B
- C retains its $10 share of OI in unrealized receivable 2 and its $60 of CG in the real property
  - If ABC sold its assets (unrealized receivable 2 and real property) for cash, the sale would generate a $60 built-in loss in C’s partnership interest (FMV = $10)

JA4 and liquidated?
Alexander, Jennifer, 1/10/2015

Example 3: Capital Gain Recognition

After the distribution:

- C holds unrealized receivable 1 with $90 of unrealized OI
- Balance sheet is as follows:

Assets	Tax	Book	Capital	Tax	Book
			A	$30	$100
Unrealized receivable 2	$0	$30	B	$30	$100
Real Property	$0	$180	C	$0	$10
Totals	$0	$210		$60	$210

Example 3: Capital Gain Recognition

C may avoid the duplicated $60 of OI by electing to recognize $60 of capital gain (effectively C’s share of the gain in the real property)

- ABC increases its basis in the real property by $60 (thereby eliminating C’s reverse 704(c) gain in the real property)
- C’s outside basis increases by $60
- C receives unrealized receivable 1 with a basis of $60, so will have only $30 of OI from that asset

Example 3: Capital Gain Recognition

Modified balance sheet prior to distribution

– takes into account the $60 of OI and the $60 of CG

	Tax	Book	Capital	Tax	Book
Unrealized receivable 1	$60	$90	A	$30	$100
Unrealized receivable 2	$0	$30	B	$30	$100
Real Property	$60	$180	C	$60	$100
Totals	$120	$300		$120	$300

Example 3: Capital Gain Recognition

Balance sheet after distribution:

	Tax	Book	Capital	Tax	Book
			A	$30	$100
Unrealized receivable 2	$0	$30	B	$30	$100
Real Property	$60	$180	C	$0	$10
Totals	$60	$210		$60	$210

Example 3: Capital Gain Recognition

Mandatory recognition of capital gain when partnership has a Section 754 election

- If ABC had a sec. 754 election, distribution of unrealized receivable 1 results in a Section 734(b) adjustment of $60 to unrealized receivable 2.
- This adjustment (if taken into account) would have altered each partner's share of net unrealized OI immediately prior to the distribution.
- Regs require capital gain to be recognized in order to prevent such a Section 734(b) adjustment from arising.

Example 3: Capital Gain Recognition

Mandatory recognition of capital gain (cont'd)

- C must recognize $60 of capital gain immediately prior to the distribution of unrealized receivable 1 to eliminate 734(b) adjustment
- ABC increases its basis in the real property by $60 (thereby eliminating C's reverse 704(c) gain in the real property)
- C's outside basis increases by $60
- C receives unrealized receivable 1 with a basis of $60

Tiered Partnerships

- Unclear what is "reasonable" when you have tiered partnerships
- When UTP makes a distribution and LTP holds hot assets:
  - LTP must book up when UTP holds more than 50% of LTP
  - UTP must allocate its share of LTP items as if LTP had booked up when UTP does not hold more than 50% of LTP
- Rule requiring mandatory book-up in LTP is written very broadly. As written, requires mandatory book-up in situations other than what is described above (and suggested in Preamble).

Anti-Abuse Rules

- Purpose of section 751: to prevent a partner from converting its share of OI into CG
  - Including when a partner monetizes most of the value of its partnership interest and uses 704(c) to defer OI
- If a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 751, the Service may recast the transaction

Anti-Abuse Rules

- 6 situations in which a transaction is presumed to be inconsistent with the purpose of 751
- 5 of them arise when 704(c) is the reason that a transaction avoids being subject to 751(b)

Anti-Abuse Rules

Presumption of abuse when 704(c) applies and

- Partner's interest in net section 751 unrealized gain is at least four times greater than the partner's capital account after the distribution;
- Distribution reduces a partner's interest such that partner has little exposure to losses and does not meaningfully participate in partnership profits;
- Net value of partner becomes less than its potential tax liability from section 751 property;

Anti-Abuse Rules

Presumption of abuse when 704(c) applies and (cont.)

- Partner transfers a portion of its partnership interest to tax-indifferent party w/in 5 years; or
- Partnership transfers section 751 property to a corporation in a nonrecognition transaction other than pursuant to a transfer of all Trade or Business assets.

Anti-Abuse Rules

Presumption of abuse when partners change the manner in which they share any item or class of items of income, gain, loss, deduction or credit and that change reduces a partner's net section 751 unrealized gain

Anti-Abuse Rules

When a presumption of abuse applies, must disclose the transaction on Form 8275-R.

Effective Date

May rely on these rules on or after November 3, 2014, provided that all parties apply the proposed regulations consistently for all partnership distributions and sale or exchanges, including those that occur after a technical termination

Section 752/707(a)(2)(B) Proposed Regulations

Federal Bar Association
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Background

- Section 707(a)(2)(B)
  - Contains rules addressing related transfers of money or other property between a partnership and one or more of its partners. If the transfers, when viewed together, are more properly characterized as a sale or exchange of property, they will be so treated. The legislative history of Section 707(a)(2)(B) indicates that the provision was enacted to prevent taxpayers from characterizing what were, in substance, sales of property as contributions and distributions.
- Section 752
  - Addresses the manner by which partnership recourse and nonrecourse liabilities are allocated to partners.

Overview of Proposed Regulations

- The proposed regulations contain amendments to both the disguised sale of property regulations and the partnership debt allocation regulations.
- These are (generally) two distinct sets of regulations.
  - Killing two birds with two stones (in one proposed regulation package).

Issues Addressed

Section 707 – Disguised Sales of Property

- Rules clarifying the exception for debt-financed distributions.
- Rules clarifying the exception for reimbursement of preformation expenditures.
- New category of qualified liabilities incurred in connection with the conduct of a trade or business.
- Rules clarifying the consequences of an anticipated reduction of a partner's share of a partnership liability.
- Additional rules with respect to tiered partnerships.
- Rules clarifying the treatment of liabilities in an assets-over merger.

Issues Addressed

Section 752 – Debt Allocations

- Recourse Liabilities
  - New requirements relating to payment obligations with respect to partnership liabilities.
  - Rules addressing bottom-dollar guarantees.
  - Extension of the net value requirement previously applicable only to disregarded entities.
- Nonrecourse Liabilities
  - Amendment to permissible methods of allocating nonrecourse liabilities.
  - New approach to determining a partner's interest in partnership profits.

Debt-Financed Distributions

Existing Regulations

- The existing disguised sale of property regulations provide a number of exceptions from disguised sale treatment.

- One such exception is found in Reg. Section 1.707-5(b):
  - In general, a partnership distribution of money to a partner is not taken into account for disguised sale purposes to the extent it is traceable to a recent partnership borrowing and does not exceed the partner's allocable share of the liability incurred to fund the distribution (the "**Debt-Financed Distribution Exception**").
  - The existing regulations provide that, if a partnership transfers all or a portion of the proceeds of one or more liabilities to more than one partner, the Debt-Financed Distribution Exception is applied by treating all of the liabilities incurred pursuant to the plan as a single liability. Thus, partners who are allocated shares of multiple liabilities are treated as being allocated a share of a single liability, to which any distributee partner's distribution of debt proceeds relates, rather than a share of each separate liability.

Debt-Financed Distributions

Proposed Regulations

- The proposed regulations add an example to the existing disguised sale of property regulations to clarify the Debt-Financed Distribution Exception. The example illustrates that if more than one partner receives all or a portion of the proceeds of multiple liabilities that are treated as a single liability under the special rule, the debt proceeds will not be treated as consideration in a disguised sale to the extent of each partner's allocable share of the single liability.
- The proposed regulations also include an ordering rule, which would first test a transfer to a partner under the Debt-Financed Distribution Exception. Any amount not excluded under the Debt-Financed Distribution Exception would then be tested under other exceptions to disguised sale treatment, such as the exception for reimbursements of preformation expenditures in Reg. Section 1.707-4.

Preformation Expenditures

Existing Regulations

- Reg. Section 1.707-4(d) provides an exception to disguised sale treatment for reimbursements of preformation expenditures when a transfer is made to a partner to reimburse the partner for certain capital expenditures made and costs incurred by the partner with respect to the contributed property (the "**Preformation Capital Expenditures Exception**"). This exception limits the reimbursement to 20% of the fair market value of such property at the time of the contribution. This 20% limitation does not apply, however, if the fair market value of the contributed property does not exceed 120% of the partner's adjusted basis in the property.

Preformation Expenditures

Proposed Regulations

- The proposed regulations amend the Preformation Capital Expenditures Exception in three ways:
  - First, in the case of multiple property transfers, the proposed regulations provide that the determination of whether the fair market value limitation and the exception to the fair market value limitation apply is made separately for each property.
  - Second, the proposed regulations specify that the term "capital expenditures" has the same meaning as in other Code sections, except that it includes capital expenditures taxpayers elect to deduct and does not include deductible expenses taxpayers elect to treat as capital expenditures.
  - Third, the proposed regulations coordinate the Preformation Capital Expenditures Exception and the rules regarding qualified liabilities traceable to capital expenditures under Reg. Section 1.707-5. The proposed regulations provide that, to the extent a partner funded a capital expenditure through a borrowing, then shifted the economic responsibility for that borrowing to another partner, the preformation capital expenditure exception would not apply because there is no outlay by the partner to reimburse.

Qualified Liabilities

Existing Regulations

- To the extent property is contributed subject to a "qualified liability," the debt generally does not constitute consideration provided to the contributor unless, as part of the transaction, other property is distributed to the partner or a liability other than a qualified liability is transferred to the partnership.
- The existing disguised sale of property regulations list the following four categories of qualified liabilities. The first two types of liabilities must “encumber” the transferred property to be treated as qualified.
  - A liability incurred more than two years before the transfer (or written agreement to transfer).
  - A liability incurred by a partner within two years of the transfer (or written agreement to transfer), but not in anticipation of the transfer.
  - A liability traceable to capital expenditures with respect to the encumbered property.
  - A liability incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held, but only if all the assets that are material to that trade or business are transferred to the partnership.

Qualified Liabilities

Proposed Regulations

- Fifth Category of Qualified Liability
  - The proposed regulations add a fifth category of qualified liability to account for a liability that is incurred in connection with the conduct of a trade or business, provided that the liability was not incurred in anticipation of the transfer and that all of the assets material to that trade or business were transferred to the partnership.
  - In other words, if a trade or business liability was not incurred <u>in the ordinary course of a trade or business</u> and thus cannot be a qualified liability under existing Reg. Section 1.707-5(a)(6)(i)(D), the liability may nonetheless be a qualified liability under the proposed regulations if it was incurred <u>in connection with the conduct of a trade or business</u>, provided that the liability was not incurred in anticipation of the transfer and that all of the assets material to that trade or business were transferred to the partnership. In contrast to the requirements of Reg. Section 1.707-5(a)(6)(i)(B), the liability need not "encumber" the property transferred.
  - As under the existing Section 707(a)(2)(B) regulations regarding liabilities other than capital expenditure and ordinary course qualified liabilities, if the partner incurred the liability within two years of the transfer of property to the partnership, the liability is presumed to have been incurred in anticipation of its transfer (unless the facts and circumstances clearly establish otherwise) and the treatment of the liability as qualified must be disclosed in accordance with the existing disguised sale of property regulations.

Anticipated Reduction Rule

Existing Regulations

- The existing disguised sale of property regulations provide that a partner's share of a liability is determined by taking into account certain subsequent reductions in the partner's share of such liability.
- Specifically, if, at the time the partnership incurs, assumes, or takes property subject to a liability, it is anticipated that the partner's share of such liability will be reduced, and the reduction is part of a plan that has a principal purpose of minimizing the extent to which the distribution or assumption of (or taking property subject to) the liability is treated as part of a sale, the partner's share of such liability must take into account the anticipated reduction in the partner's liability share.

Anticipated Reduction Rule

Proposed Regulations

- Acknowledging that all debt at some point will be satisfied, the proposed regulations clarify that a reduction in a partner's share of a liability is not considered an anticipated reduction, provided that the reduction is subject to the entrepreneurial risks of partnership operations.
- In addition, the proposed regulations provide that if, within two years of the partnership incurring, assuming or taking property subject to the liability, a partner's share of the liability is reduced due to a decrease in such partner's (or related person's) net value (described further below), the liability reduction will be presumed to be anticipated, unless the facts and circumstances clearly establish otherwise. Any such reduction is required to be disclosed in accordance with the existing disguised sale of property regulations.

Tiered Partnerships

Existing Regulations

- The existing disguised sale of property regulations provide that if a lower-tier partnership succeeds to a liability of an upper-tier partnership, the liability in the lower-tier partnership retains the same characterization, as a qualified or nonqualified liability, that it had in the upper-tier partnership.
- A similar rule applies where an upper-tier partnership succeeds to a liability of a lower-tier partnership.

Tiered Partnerships

Proposed Regulations

- The proposed regulations provide additional rules with respect to tiered partnerships.
  - First, they clarify that the Debt-Financed Distribution Exception applies in a tiered-partnership setting.
  - Second, the proposed regulations treat a lower-tier partnership as an aggregate for purposes of determining whether an upper-tier partnership's share of lower-tier partnership liabilities are qualified liabilities. In other words, a partner that contributes an interest in a lower-tier partnership to an upper-tier partnership would treat its share of liabilities from the lower-tier partnership as qualified to the extent they would be qualified had they been assumed or taken subject to by the upper-tier partnership in connection with a transfer by the lower-tier partnership of all of its property to the upper-tier partnership.

Liabilities in Assets-Over Merger

Existing Regulations

- Reg. Section 1.752-1(f) provides for a netting of increases and decreases in a partner's share of liabilities resulting from a single transaction, including a merger or consolidation of partnerships.

Liabilities in Assets-Over Merger

Proposed Regulations

- The proposed regulations extend the principles of the Reg. Section 1.752-1(f) netting rule for purposes of determining the effect of a partnership merger under the existing disguised sale regulations.

Effective Date

- The changes to the Section 707 regulations are proposed to apply to transactions in which all transfers occur on or after the date final regulations are published.

Recourse Liabilities

Existing Regulations

- The existing partnership debt allocation regulations provide that a partner's share of recourse liabilities equals the portion of the liability, if any, for which the partner, or a related person, bears the economic risk of loss ("**EROL**").
- A partner generally bears the EROL for a partnership liability to the extent the partner (or a related person) would be obligated to make a payment if the partnership's assets became worthless and the liability became due and payable.
- Subject to an anti-abuse rule and certain net value rules that apply to disregarded entities under Reg. Section 1.752-2(k), Reg. Section 1.752-2(b)(6) currently assumes that all partners and related persons with a payment obligation will satisfy such obligations, irrespective of their actual net worth.

Recourse Liabilities

Proposed Regulations

- Respecting Payment Obligations – Generally
  - The proposed regulations provide that an obligation to make a payment with respect to a partnership liability will not be recognized for purposes of Section 752 unless certain factors are present. The six factors are intended to establish that the terms of a payment obligation are commercially reasonable and not designed solely to obtain tax benefits.
  - Thus, under the proposed regulations, a payment obligation would not be respected (and the party with the obligation would not be treated as bearing the EROL for the liability) unless each of the six factors were satisfied.

Six Factors

a) Commercially reasonable net worth or commercially reasonable restrictions on transfer of assets;
b) Periodic commercially reasonable documentation of financial conditions;
c) Term of obligation equal to term of the liability;
d) No requirement that the primary obligor set aside money or assets to pay liability;
e) Arm's length consideration for assuming payment obligation;
f) No bottom guarantees or indemnities.

Recourse Liabilities

Proposed Regulations

- Bottom-Dollar Guarantees (one of the six factors)
  - The proposed regulations would also prevent the use of so-called “bottom-dollar guarantees” from being recognized for Section 752 purposes. In this regard, the existing anti-abuse rule under Section 1.752-2(j) would be modified to prevent the use of intermediaries, tiered partnerships or similar arrangements to avoid the bottom-dollar guarantee restrictions.
- Deemed Satisfaction Presumption
  - The proposed regulations would also disregard the Reg. Section 1.752-2(b)(6) deemed satisfaction presumption by extending the Reg. Section 1.752-2(k) net value requirement currently applicable only to disregarded entities to all partners (or related persons), other than individuals and certain estates. To the extent the satisfaction presumption is disregarded, the partner's (or related person's) payment obligation would be recognized only to the extent of such person's net value as of the liability allocation date.
- Payment Obligations with Right to Reimbursement from Any Person
  - Finally, the proposed regulations would modify Reg. Section 1.752-2(b)(1) to reduce a partner's payment obligation by the amount of any right to reimbursement from any person. The existing rule takes into account a reimbursement right only from another partner or related person.

Nonrecourse Liabilities

Existing Regulations

- Existing Reg. Section 1.752-3 provides rules for determining a partner's share of a partnership nonrecourse liability.
- In that regard, Reg. Section 1.752-3(a)(3) provides for various methods of determining a partner's share of excess (or "**Tier 3**") nonrecourse liabilities (i.e., liabilities that are not allocated based on the partners' shares of Section 704(b) and (c) minimum gain).
  - Under one method, a partner's share of excess nonrecourse liabilities is determined in accordance with the partner's share of partnership profits. For this purpose, the existing regulations provide that the partnership agreement may specify the partners' interests in partnership provided the interests specified are reasonably consistent with allocations (that have substantial economic effect) of some other significant item of partnership income or gain (the "**Significant Item Method**").
  - Alternatively, such liabilities may be allocated among the partners in the manner that deductions attributable to those liabilities are reasonably expected to be allocated (the "**Alternative Method**").

Nonrecourse Liabilities

Proposed Regulations

- Removal of Significant Item Method and Alternative Method for Allocating Tier 3 Nonrecourse Liabilities
  - Removal is due to a belief that such methods may not properly reflect a partner's share of partnership profits that are generally used to repay such liabilities.
- Addition of Liquidation Value Approach for Partner's Interest in Partnership Profits
  - For purposes of this proposed rule, the liquidation value of a partner's interest in a partnership is the amount of cash the partner would receive with respect to the interest if, immediately after formation of the partnership or the occurrence of a Section 704(b) revaluation event, the partnership sold all of its assets for cash equal to their fair market value (taking into account Section 7701(g)), satisfied all of its liabilities (other than certain Section 1.752-7 — i.e., contingent — liabilities), paid an unrelated person to assume all of its Section 1.752-7 liabilities in a fully taxable transaction, and then liquidated.

Effective Dates

In General

- The changes to Reg. Section 1.752-2 are proposed to apply to liabilities incurred or assumed by a partnership and to payment obligations imposed or undertaken with respect to a partnership liability on or after the date final regulations are published, 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.
- Similarly, the changes to Reg. Section 1.752-3 are proposed to apply to liabilities incurred or assumed by a partnership on or after the date final regulations are published, other than liabilities incurred or assumed by a partnership pursuant to a written binding contract in effect prior to that date.
- It is anticipated that a partnership will be permitted to apply the final regulations to all of its liabilities as of the beginning of the first tax year of the partnership ending on or after the date final regulations are published.

Effective Dates

Transitional Relief

- In addition, the proposed regulations provide transitional relief for any partner whose allocable share of partnership liabilities under Reg. Section 1.752-2 exceeds its adjusted basis in its partnership interest on the date the proposed regulations are finalized.
  - Under the transitional rule, if a partner has a share of a recourse partnership liability under the existing Reg. Section 1.752-2 rules immediately before the effective date of final regulations (a "**Transition Partner**"), the partnership (a "**Transition Partnership**") may choose not to apply the new Reg. Section 1.752-2 provisions to the extent the amount of the Transition Partner's share of liabilities under the existing Reg. Section 1.752-2 regulations immediately prior to the effective date exceeds the amount of the Transition Partner's adjusted basis in its partnership interest at such time (the "**Grandfathered Amount**").
  - The Transition Partnership may continue to apply the existing Reg. Section 1.752-2 regulations to a Transition Partner to the extent of the Transition Partner's adjusted Grandfathered Amount for a seven-year period beginning with the issuance of final regulations.
  - A Transition Partner's Grandfathered Amount is reduced (but never increased) for certain reductions in the amount of liabilities allocated to that partner under the transition rules and, upon the sale of any partnership property, for the excess of any tax gain allocated to the partner (including Section 704(c) gain) less the partner's share of amount realized.