June 19, 2018

IRS Replaces Proposed Regulations on Disguised Sale Rules and Allocation of Partnership Liabilities

The Proposed Regulations, if Adopted, Would Reverse Prior Temporary and Proposed Regulations, but Bottom-Dollar Guarantees Would Continue to not be Recognized

SUMMARY

Yesterday, the Treasury Department and the Internal Revenue Service (the "IRS") issued proposed regulations (the "New Proposed Regulations") that would reinstate certain prior rules regarding partnership disguised sales and allocation of partnership liabilities. The New Proposed Regulations would no longer effectively treat all partnership liabilities as nonrecourse liabilities for disguised sale purposes. However, the New Proposed Regulations would retain prior regulations that do not recognize "non-commercial" guarantees and similar arrangements (including so-called "bottom-dollar" guarantees).

BACKGROUND

A. PARTNERSHIP DISGUISED SALES

Distributions of cash from a partnership to a partner are generally not taxable unless the cash distributed exceeds the partner's basis in its partnership interest. A partner generally includes its share (as determined under the relevant Treasury regulations) of a partnership's liabilities in the partner's basis. As a result, partnership liabilities can allow a partner to receive a tax-free cash distribution, as long as the partner's basis in the partnership interest (including the partner's share of the partnership's debt) exceeds the amount distributed and the distribution is not part of a "disguised sale."

Under the disguised sale rules, a contribution of property (including cash) by a partner and a related distribution from the partnership are generally treated as a sale, in whole or in part, of the property. For these purposes, a partnership's assumption of a partner's "non-qualified" liability, or a partnership's receipt of property subject to a "non-qualified" liability, is generally treated as a distribution of money to the contributing partner to the extent the non-qualified liability is not allocable to such partner,[1] and such deemed distributions can trigger the disguised sale rules. Under the law in effect before the 2016 Regulations (discussed below), recourse debt was generally allocated only to the partners to which the debt was recourse. As a result, many partners contributing encumbered property to a partnership minimized or eliminated disguised sale treatment by guaranteeing otherwise nonrecourse debt of the partnership through so-called "bottom-dollar" guarantees, in which the contributing partner would guarantee a portion of a partnership liability only to the extent the creditor recovered less than the guaranteed amount, even if the amount of the principal amount of the debt was significantly greater.

B. PRIOR AND CURRENT REGULATIONS

In 2016, the Treasury Department and the IRS issued final, temporary and proposed regulations (the "2016 Final Regulations," the "2016 Temporary Regulations," and the "2016 Proposed Regulations," respectively, and collectively, the "2016 Regulations") addressing bottom-dollar guarantees and the allocation of liabilities for disguised sale purposes.[2] Prior to the 2016 Regulations, the method for allocating partnership liabilities under the regulations (the "Prior Regulations") depended on whether the debt was "recourse" or "nonrecourse" to a partner. Debt that was "recourse" to a partner was generally allocated to partners to which the debt was recourse. Debt that was "nonrecourse" was generally allocated for disguised sale purposes between or among the partners in accordance with one of two safe harbor methods set forth in the Prior Regulations.

The 2016 Temporary Regulations treated almost all partnership liabilities (other than liabilities that are recourse to a non-contributing partner) as nonrecourse liabilities for disguised sale purposes only. The 2016 Final Regulations provided that, for disguised sale purposes, nonrecourse partnership liabilities may not be allocated in accordance with any of the safe harbor methods and instead must be allocated in accordance with the partners' interests in partnership profits, determined by taking into account all facts and circumstances relating to the economic arrangement of the partners.

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1 *See* Section 752(b). Under the current disguised sale rules, a partnership can assume certain "qualified liabilities" in connection with a contribution of property without triggering a disguised sale, including: (i) liabilities encumbering contributed property incurred at least two years before the assumption of the liability or not in anticipation of the contribution, (ii) liabilities allocable to capital expenditures with respect to the contributed property and (iii) liabilities incurred in the ordinary course of a trade or business in which the contributed property was used, provided that all assets material to the continuation of such trade or business are also contributed to the partnership. *See* Treas. Regs. § 1.707-5(a)(6).

2 *See* S&C publication of October 11, 2016, *IRS Issues Regulations on Disguised Sale Rules and Allocation of Partnership Liabilities*, for a detailed description of the 2016 Regulations.

For purposes of determining whether debt is considered recourse to a partner, the 2016 Temporary Regulations largely ignored "bottom dollar payment obligations," a term intended to encapsulate "non-commercial" guarantees, and required that a partnership disclose to the IRS all bottom dollar payment obligations with respect to each partnership liability. Additionally, the 2016 Proposed Regulations would further limit the ability for debt to be classified as recourse to a partner by (i) adding a seven-factor anti-abuse rule, (ii) presuming an avoidance plan if certain net value tests are met, and (iii) adding anti-abuse factors specific to deficit restoration obligations.

THE NEW PROPOSED REGULATIONS

The New Proposed Regulations would remove the rule treating almost all partnership liabilities as nonrecourse liabilities for disguised sale purposes, but would maintain the rule largely ignoring non-commercial guarantees.[3]

As a result, in determining a partner's share of a partnership liability for disguised sale purposes, the New Proposed Regulations would prescribe separate rules for a partnership's recourse and nonrecourse liabilities. A partner's share of a partnership's recourse liability would equal the partner's share of the liability under the general rules for allocating partnership recourse liabilities, except that non-commercial guarantees would continue to not be respected. A partner's share of a partnership's nonrecourse liability would be determined in accordance with the partner's interest in partnership profits. The New Proposed Regulations reinstate various examples in the Prior Regulations illustrating the application of these rules.[4]

Practically, the New Proposed Regulations would, if finalized, reopen the door to limited use of so-called "leveraged partnership contribution transactions" that were effectively ended by the disguised sale rules in the 2016 Temporary Regulations. In a leveraged partnership contribution transaction, a partner contributes appreciated property to a partnership and guarantees debt incurred by the partnership or debt assumed by the partnership in connection with the contribution. The 2016 Temporary Regulations effectively limited partners to their pro rata shares of partnership liabilities for disguised sale purposes and thus generally prevented partners from reducing the proceeds of a disguised sale by the full amount of debt guaranteed by the contributing partner. Under the New Proposed Regulations, a partnership liability

[3] More specifically, the New Proposed Regulations would remove the disguised sale rules in the 2016 Temporary Regulations (but maintain the portions of these regulations relating to non-commercial guarantees), withdraw the 2016 Proposed Regulations incorporating such rules and reinstate the Prior Regulations. The New Proposed Regulations would not change the 2016 Final Regulations.

[4] The New Proposed Regulations add language in one example to reflect an amendment in the 2016 Final Regulations regarding the calculation of a partner's share of a liability assumed by a partnership. For purposes of the disguised sale rules, a partner's share of a liability assumed by a partnership is determined taking into account subsequent reductions that were anticipated when the liability was assumed if the reduction is part of a plan that has a principal purpose of minimizing the extent to which the distribution or assumption of a liability is treated as part of a sale. The 2016 Final Regulations provided that only reductions not subject to the entrepreneurial risks of partnership operations are taken into account under this rule.

would become recourse to the contributing partner to the extent of the partner's qualifying guarantee, including for disguised sale purposes. As a result, the partner's basis in its partnership interest would reflect the full amount of the debt subject to the guarantee, thus allowing the contributing partner to receive, under the "debt-financed distribution exception" to the disguised sale rules, a distribution of cash from the partnership up to the amount of the partner's guarantee without triggering current tax. Unlike under the rules prior to the 2016 Regulations, non-commercial guarantees would not be taken into account in determining whether debt is recourse to a contributing partner.

The New Proposed Regulations also reinstate the rules under the Prior Regulations providing that a contingent liability is a recourse or nonrecourse liability for disguised sale purposes based on the extent that any partner or related person would bear the economic risk for the liability if the liability were treated as a partnership liability. However, the preamble to the New Proposed Regulations states that the Treasury Department and the IRS continue to study the effect of contingent liabilities with respect to disguised sales and believe additional guidance would be helpful in this area.

If finalized, the New Proposed Regulations would apply to any transaction with respect to which all transfers occur on or after the date that is 30 days after the date the New Proposed Regulations are finalized. The disguised sale rules in the 2016 Temporary Regulations would continue to apply to any transaction with respect to which all transfers occurred on or after January 3, 2017 and with respect to which any transfer occurred before the effective date of the New Proposed Regulations. However, the preamble to the New Proposed Regulations provides that taxpayers may apply the New Proposed Regulations in lieu of the disguised sale rules in the 2016 Temporary Regulations to any transaction with respect to which all transfers occur on or after January 3, 2017.

The preamble states that the Treasury Department and the IRS are continuing to consider whether to retain the rules in the 2016 Temporary Regulations that largely ignore bottom dollar payment obligation, and continue to request comments on the rules in the 2016 Proposed Regulations that would limit the ability for debt to be classified as recourse to a partner.

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CONTACTS

New York		
Ronald E. Creamer Jr.	+1-212-558-4665	creamerr@sullcrom.com
David P. Hariton	+1-212-558-4248	haritond@sullcrom.com
Jeffrey D. Hochberg	+1-212-558-3266	hochbergj@sullcrom.com
Andrew S. Mason	+1-212-558-3759	masona@sullcrom.com
David C. Spitzer	+1-212-558-4376	spitzerd@sullcrom.com
Davis J. Wang	+1-212-558-3113	wangd@sullcrom.com
S. Eric Wang	+1-212-558-3328	wangs@sullcrom.com
Isaac J. Wheeler	+1-212-558-7863	wheeleri@sullcrom.com
Michelle H. Lu	+1-212-558-3204	lum@sullcrom.com
London		
Ronald E. Creamer Jr.	+44-20-7959-8525	creamerr@sullcrom.com
S. Eric Wang	+44-20-7959-8411	wangs@sullcrom.com