Final, temporary, and proposed regulations under Section 707 and 752

Presenters

- James Chenoweth, Partner, Gibson Dunn (Houston, TX)
- Jeff Erickson, Principal, EY (Washington, DC)
- Max Pakaluk, Senior Manager, EY (Washington, DC)

Overview

- Section 707/752 – allocation of liabilities for purposes of disguised sale rules
  - Look to partner's interest in partnership profits
- Section 707 – preformation capital expenditures
  - Various clarifications and modifications
- Section 707 – qualified liabilities
  - Various clarifications and modifications
- Section 752 – allocation of liabilities for purposes of determining a partner's outside basis
  - Disregard bottom dollar payment obligations
  - Proposed anti-abuse standard

Review of disguised sale rules

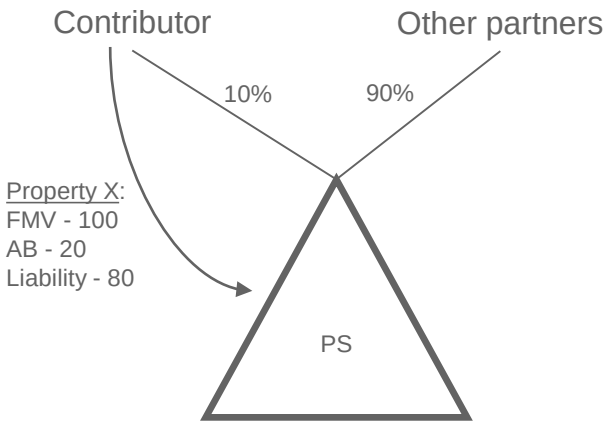
- Disguised sale – transfers between a partnership and partner that are properly characterized as a sale or exchange of property.
- A partnership's assumption of (or taking subject to) a liability is effectively a transfer of consideration to a partner.
- Qualified vs. nonqualified liabilities
  - Consideration allocable to nonqualified liabilities (and in some cases, a qualified liability) depends on partner's share of nonqualified liability
- Various exceptions, including reimbursement of capital expenditures.

Allocation of liability for disguised sales

- Prior rules for allocating a liability:
  - Recourse liabilities allocated under Section 752 regulations for recourse liabilities.
  - Nonrecourse liabilities allocated under Section 752 regulations for nonrecourse liabilities, under the "third tier"
    - Use either the "general rule" (partner's interest in profits), the "significant item method", or the "alternative method" (but not the "additional method").

- New rules for allocating a liability:
  - Look only to third tier
    - A liability that is recourse to the contributing partner is treated as nonrecourse (but a liability that is recourse to a non-contributing partner is treated as recourse to the non-contributing partner). (temporary regulation)
  - Look only to "general rule":
    - Third tier nonrecourse liabilities are allocated only under the general rule of the "third tier" (i.e., based on the partners' interests in partnership profits)
      - Not the "significant item method," the "alternative method," or the "additional method." (final regulation)
    - Notwithstanding the foregoing, a liability is treated as allocable to another partner if recourse to the other partner.

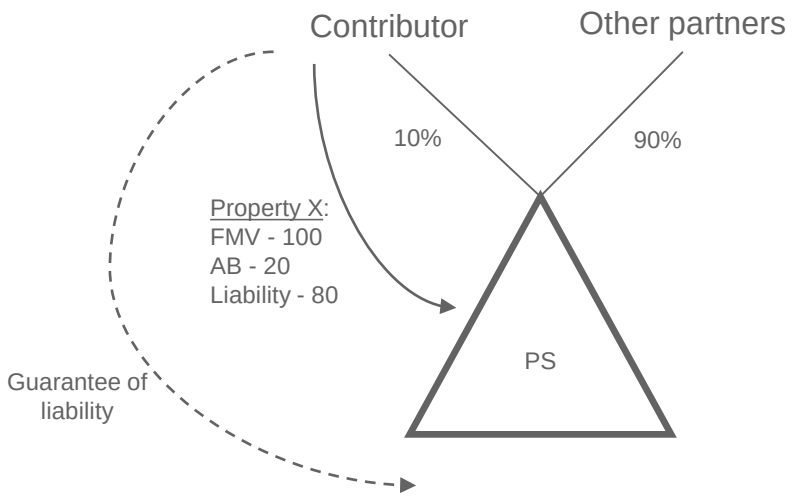
Example: Nonqualified liability (no guarantee)



Contributor borrows $80 and contributes property X to PS subject to the liability.

New rule: Contributor is allocated 10% of liability ($8) for disguised sale rules. Contributor receives $72 of taxable consideration with respect to the liability.

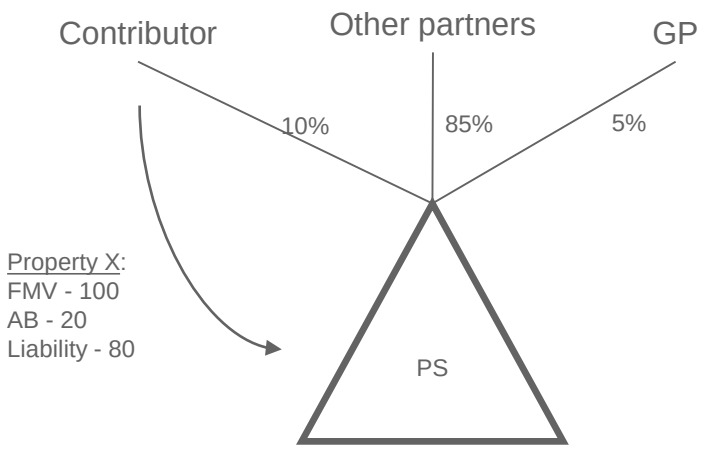
Example: Nonqualified liability (guarantee of liability)



Contributor borrows $80 and contributes property X to PS subject to the liability. Contributor guarantees the $80 liability.

New rule: Contributor is allocated 10% of liability ($8) for disguised sale rules. Contributor receives $72 of taxable consideration with respect to the liability.

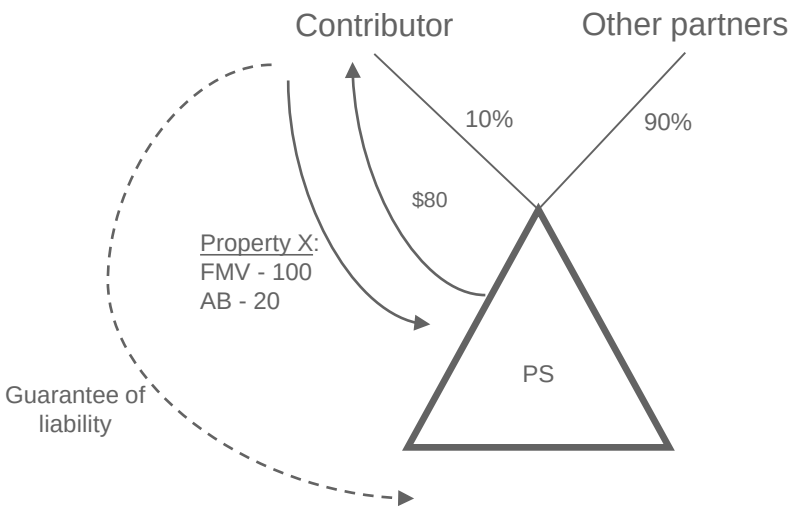
Example: Nonqualified liability (no guarantee) with a general partner



Contributor borrows $80 and contributes property X to PS subject to the liability.

New rule: GP is allocated 100% of liability and contributor is allocated 0% of liability for disguised sale rules. Contributor receives $80 of taxable consideration with respect to the liability.

Example: Debt financed distribution (with guarantee)



Contributor contributes property X to PS.

PS borrows $80. Contributor guarantees the $80 liability.

PS distributes $80 to Contributor.

New rule: Contributor is allocated 10% of liability ($8) for disguised sale rules. Contributor receives $72 of taxable consideration with respect to the liability.

Effective dates for disguised sale liability allocations

- Temporary Regulation: Rule that an assumed (or taken subject to) liability is always treated as nonrecourse to a contributing partner for disguised sale purposes is effective for transactions where all transfers occur on or after January 3, 2017.

- Final Regulation: Requirement that only general rule (partners' interest in profits) be used to allocate nonrecourse liabilities for purposes of disguised sale rules is applicable to liabilities incurred, taken subject to, or assumed by a partnership on or after October 5, 2016, other than liabilities incurred, taken subject to, or assumed by a partnership pursuant to a written binding contract in effect prior to October 5, 2016.

Other changes to disguised sale regulations Changes

- Property-by-property analysis for reimbursement of capital expenditures
- Adoption of new type of Qualified Liability (category “E”)
- Step-in-the-shoes rules
- Tiered-partnership rules
- Other items

Reimbursement of capital expenditures: property-by-property approach

- Exception for reimbursement of preformation capital expenditures:
  - Capital expenditures incurred by the partner with respect to contributed property within the two-year period prior to the contribution.
  - Reimbursement cannot exceed 20 percent of the fair market value of the relevant property (as of the time of its transfer).
    - Limitation not applicable if the fair market value of the property does not exceed 120 percent of the basis of the property.

- New rules:
  - Property-by-property approach: 20 percent limit applies on a property-by-property basis (subject to limited aggregation rule);
  - "Anti-double dipping" rule: Exception is reduced for capital expenditures funded by assumed (or taken subject to) qualified liability, to extent liability is allocated away from contributing partner.

Example: Property-by-property approach

- Partner A contributes Property X and Property Y to PS.

Property X:
- FMV: 50
- AB: 50
- Capex: 40

Property Y:
- FMV: 100
- AB: 80
- Capex: 70

- 20% limit is inapplicable to property X (eligible for reimbursement of 40).
- 20% limit is applicable to Property Y (eligible for reimbursement of 20).
- If test had been applied on an aggregate basis (i.e., AB of 130 and FMV of 150), 20% limit would not have applied, and eligible reimbursement amount would be 110.

Example: “Anti-double dipping” rule

- Partner A contributes Property X and Property Y to PS.
- Property X is subject to liability of 30, used to acquire Property X.
- Property Y is subject to liability of 40, used to acquire Property Y.
- Partner A has 10% share of liability (based on interest in PS profits).

Property X:

- FMV: 50
- AB: 50
- Capex: 40
- Liability: 30

Property Y:

- FMV: 100
- AB: 80
- Capex: 70
- Liability: 40

- Partner A eligible for reimbursement for Property X of 13 (i.e., 40 of Capex less 27 of liability shift (90% of 30).
- In absence of 20% rule, Partner A would be eligible for reimbursement for Property Y of 34 (i.e., 70 of Capex less 36 (90% of 40). 20% rule limits reimbursement to 20.

Initial categories of qualified liabilities

- Under the prior rules, a qualified liability includes:
  - (A) a liability incurred by a partner more than two years prior to the transfer (or date transfer was agreed to in writing) and which has encumbered the transferred property during the two-year period;
  - (B) a liability incurred by a partner within the two-years prior to the transfer (or date transfer was agreed to in writing) and which has encumbered the transferred period during such period, but only if the liability was not incurred in anticipation of the transfer;
  - (C) a liability properly allocable to capital expenditures with respect to the transferred property; and
  - (D) a liability incurred in the ordinary course of the trade or business in which the transferred property was used, but only if all assets related to the trade or business are transferred (other than assets immaterial to the conduct of the trade or business);

New category of qualified liability

- New final regulations include an additional category:
  - (E) a liability incurred in connection with a trade or business in which the transferred property was used, but only if all assets related to the trade or business are transferred (other than assets immaterial to the conduct of the trade or business), and only if the liability was not incurred in anticipation of the transfer.

- Elements of category (E):
  - incurred in connection with a trade or business in which the transferred property was used
  - all assets related to the trade or business are transferred
  - the liability was not incurred in anticipation of the transfer

- Disclosure obligation for categories (B) and (E).

New category of qualified liability: Private Letter Ruling 201714028

Private Letter Ruling 201714028

- Company is a partnership among affiliates of X and Y.
- Company holds interests in Partnership (a PTP/MLP).
- Company transfers all of its material operating assets to Partnership.
- Partnership assumes Liabilities from Company in connection with transfer.
- Description of Liabilities:

> All of the Liabilities were incurred more than [x] years before the proposed Transfer. Some of the Liabilities were originally incurred to make distributions in connection with Company's formation on [date] and have been subsequently refinanced. The remaining balance of the Liabilities have been used to acquire assets, make improvements, pay expenses, and otherwise operate Company's business and that of its subsidiaries, including to refinance other liabilities incurred for the same purposes. Company has also regularly distributed cash to its members in proportion to their ownership interests. Those cash distributions, however, have been less than Company's earnings. The Liabilities (and the liabilities they refinanced) are an integral part of Company's existing and historical capital structure.

New category of qualified liability: Private Letter Ruling 201714028 (cont'd)

Company makes the following representations:

i. None of the Liabilities is in default;

ii. The Liabilities were not incurred in anticipation of the Transfer to Partnership;

iii. The Transfer to Partnership was not being considered at the time the Liabilities were incurred;

iv. Company would have incurred the Liabilities without regard to the Transfer to Partnership; and

v. There will not be a shift in the ownership of the capital of Partnership associated with the Transfer, and the amount of cash deemed to be distributed under § 752(b) (if any) upon the assumption of the Liabilities will not exceed Company's basis in its interests in Partnership, nor will there be a reduction in Company's interests in Partnership's unrealized receivables (within the meaning of § 751(c)) and inventory items (within the meaning of § 751(d)) in connection with the Transfer. For this purpose, a "shift in the ownership of capital" means a change by reason of a partner's giving up any part of his right to be repaid the amount in his capital account (after adjustment under § 1.704-1(b)(2)(iv)(f)) in favor of one or more other partners.

- PLR conclusion:

  Based on the facts submitted and the representations made, we conclude that the Liabilities assumed by Partnership (through DRE) in connection with Company's Transfer to Partnership will constitute qualified liabilities of Company under § 1.707-5(a)(6)(i)(E).

Step-into-the-shoes rules

- Preformation capital expenditures:
  - Partner steps into the shoes of transferor in connection with a nonrecognition transaction under Sections 351, 381(a), 721, or 731.
  - Partnership can step into the shoes of transferor partner.

- Qualified liabilities:
  - Partner steps into the shoes of transferor when the partner acquires property and assumes a liability, or takes property subject to a liability in connection with a nonrecognition transaction under Sections 351, 381(a), 721, or 731.

Tiered partnership rules

- Preformation capital expenditure:
  - If the partner transferred property to a lower-tier partnership ("LTP") with respect to which the exception for reimbursements of preformation capital expenditures was available, and transfers the LTP interest to an upper-tier partnership ("UTP"),
    - the transferring partner is deemed to have transferred the relevant property to UTP and is eligible for the exception for reimbursements of preformation capital expenditures from the UTP to the same extent the partner could have been so reimbursed by LTP;
    - in addition, UTP steps into the shoes of the transferor for purposes of determining its eligibility for the exception for reimbursement of preformation capital expenditures.
- Qualified liabilities:
  - Where a partner transfers its interest in LTP to UTP, the liabilities transferred to UTP are treated as qualified liabilities to the extent they would be qualified liabilities if LTP had transferred them and all of its property to UTP.
    - Regarding the "anticipation" factor in the qualified liabilities definition, the relevant inquiry is whether *the partner* anticipated transferring its interest in LTP to UTP when LTP incurred the liability (and not whether LTP anticipated that the partner would transfer its interest in LTP to UTP).

Other items

- Ordering rule: apply exception for debt-financed distributions before other exceptions (e.g., operating cash flow, reasonable preferred return or guaranteed payment, reimbursement of preformation capital expenditures).
- Clarification of meaning of “capital expenditure.”
- De minimis exception from application of “net equity extraction” rule for qualified liabilities.
- Comments requested regarding appropriateness of exception for reimbursement of preformation capital expenditures.

Effective dates

- Temporary Section 707 Regulation: an assumed (or taken subject to) liability is always treated as nonrecourse to a contributing partner for disguised sale purposes.
  - Effective for transactions where all transfers occur on or after January 3, 2017.
- Final Section 752 Regulation: use only general rule (partners' interest in profits) be used to allocate nonrecourse liabilities for purposes of disguised sale rules.
  - Applicable to liabilities incurred, taken subject to, or assumed by a partnership on or after October 5, 2016, other than liabilities incurred, taken subject to, or assumed by a partnership pursuant to a written binding contract in effect prior to October 5, 2016.
- Final Section 707 Regulations: miscellaneous other changes to preformation capital expenditure exception and qualified liability rules.
  - Apply to any transaction with respect to which all transfers occur on or after October 5, 2016.

Temporary Section 752 Regulations

- Limits the types of obligations that are respected as “payment obligations” resulting in economic risk of loss (i.e., a recourse liability.

- General rule: bottom-dollar payment obligations are not respected

- Bottom-dollar payment obligations: any payment obligation under a guarantee or similar arrangement where the partner (or related person) is not liable up to the full amount of the payment obligation in the event of non-payment by the partnership.

Examples of Bottom Dollar Payment Obligation

- A, B, and C are equal members of an LLC. ABC borrows $1,000 from Bank. A guarantees payment up to $300 if Bank does not recover in full. B guarantees payment of up to $200, but only if Bank otherwise recovers less than $200.

- Same facts, except C agrees to indemnify A up to $100 that A pays with respect to its guarantee, and agrees to indemnify B fully.

Effective dates

- Applies to liabilities assumed or incurred by a partnership and payment obligations imposed or undertaken with respect to a partnership liability on or after October 5, 2016

- Limited seven-year transition rule
  - If a partner has a share of a partnership liability under the rules in effect immediately before October 5, 2016, the partnership may choose not to apply the temporary bottom-dollar payment obligation rules to the extent (1) the partner's share of liabilities for which the partner is treated as bearing the economic risk of loss, immediately prior to October 5, 2016, exceeds (2) the partner's adjusted based in the partnership at such time

Facts and circumstances analysis (proposed regulations)

- The proposed regulations include a non-exclusive list of factors that may indicate such a plan to circumvent or avoid a payment obligation, including
  - lack of commercially reasonable contractual restrictions that protect the likelihood of payment;
  - lack of commercially reasonable documentation regarding financial condition to benefited party;
  - the payment obligation terminates at a specified time or is terminable by the provider, where purpose is to terminate prior to an event that increases the risk of loss to the guarantor or benefited party;
  - the primary obligor (or related person) holds money or other liquid assets in excess of the reasonably foreseeable needs of the primary obligor;
  - No timely remedy to the benefited party in event of payment default;
  - the payment obligation does not result in any substantial change to the terms of the liability; or
  - the creditor or other benefited party does not receive executed documents regarding payment obligation within a commercially reasonable period after obligation's creation.
- Evidence of a plan to avoid or circumvent an obligation is deemed to exist if the facts and circumstances indicate that there is not a reasonable expectation the obligor will have the ability to make the required payments.

Proposed effective dates

- Effective on or after the date the regulations are published as final regulations, 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.

- Taxpayers may rely on the regulations for the period between October 5, 2016 and the date the regulations are published as final regulations.

Questions