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Déjà Vu All Over Again: New Proposed Disguised Sale Regulations

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In October 2016, the Treasury Department issued regulations that significantly restricted the ways in which a partner can contribute property to a partnership and receive a tax-free distribution of money. In June 2018, proposed regulations were issued that would once again permit some of those transactions.

In general, a contribution of property to a partnership is tax-free, and a distribution of money from a partnership to a partner is only taxable to the extent it exceeds the partner's basis in its partnership interest. However, if a partner contributes property to a partnership and the partnership distributes money to the partner within two years of the contribution, the transaction is generally treated as a disguised sale of property by the partner to the partnership, which is taxable to the partner.

Under an exception to the disguised sale rules, if a partnership borrows money and distributes it to a partner, a portion of the money distributed to the partner corresponding to the partner's share of the partnership's liability is not treated as part of a disguised sale, and therefore can be received by the partner tax-free.

Prior to October 2016, a partner's share of a partnership recourse liability for this purpose was equal to the amount (if any) for which the partner bore the economic risk of loss. A partner's share of a nonrecourse liability was equal to his share of "excess nonrecourse liabilities" under Internal Revenue Code Section 752, which generally was equal to the partner's share of the partnership's profits. Therefore, if a partner guaranteed a partnership liability, he would have been allocated the entire amount of the liability.

In October 2016, the Treasury Department issued temporary regulations (Temp. Treas. Reg. §1.707-5T), which provided that for purposes of the disguised sale rules, a partner's share of any liability, whether recourse or nonrecourse, is equal to the partner's share of partnership profits. However, if one partner bore the economic risk of loss with respect to a liability, the other partners in the partnership had no share of that liability. For example if a partner had a 25 percent interest in a partnership and guaranteed a liability of that partnership, the partner would be allocated 25 percent of the partnership liability for disguised sale purposes. The remaining 75 percent of the liability would be allocated to no one for disguised sale purposes. This rule prompted outrage among tax practitioners (and their clients), both because a partner bearing the economic risk of loss had no impact on the amount of the liability allocated to the partner for disguised sale purposes, and due to the radical new concept that a portion of the debt could not be allocated to anyone for disguised sale purposes. Moreover, this rule was issued as a temporary regulation rather than as a proposed regulation, which did not afford the public the opportunity to comment on it before it became effective. Also in October 2016, the Treasury Department issued regulations addressing the allocation of partnership nonrecourse liabilities for disguised sale purposes and the treatment of bottom-dollar guarantees under Section 752.

On June 19, 2018, the Treasury Department issued new proposed regulations (Prop. Treas. Reg. §1.707-5). The proposed regulations would remove the temporary regulations issued in October 2016 with respect to recourse liabilities and reinstate the final regulations that were in place prior to October 2016. Thus, under the proposed regulations, a partner's share of a recourse liability for purposes of the disguised sale rules is equal to the amount for which he bears the economic risk of loss. Therefore, if a partner guaranteed the entire amount of a partnership liability, the partner would be allocated the full amount of that liability for purposes of the disguised sale rules. The proposed regulations would not change the October 2016 regulations that relate to the allocation of nonrecourse liabilities or to the treatment of bottom-dollar guarantees.

Although the proposed regulations are not effective until finalized, the pre-

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amble to the proposed regulations indicates that taxpayers may apply the new rules for any transaction in which all transfers occur after Jan. 3, 2017, which effectively means that the October 2016 temporary regulations may be ignored.

To illustrate these rules, assume that a partner contributes unencumbered property to a partnership in exchange for a 25 percent interest in the partnership. Immediately thereafter, the partnership borrows $100, which is guaranteed by the contributing partner. The partnership then distributes the $100 of loan proceeds to the contributing partner. Under the temporary regulations issued in 2016, the partner would be allocated $25 of the liability, and the remaining $75 of the liability would not be allocated to any partner. Upon the distribution of the $100 to the contributing partner, he would have an amount realized of $75 from a disguised sale of an interest in the contributed property to the partnership.

In contrast, under both the proposed regulations and pre-2016 law, the contributing partner would be allocated all $100 of the liability because he bears the entire risk of loss with respect to the liability. The contributing partner could therefore receive the entire $100 amount from the partnership tax-free under the "debt-financed distribution" exception to the disguised sale rules.

Because the October 2016 regulations were issued as temporary regulations rather than as proposed regulations, the public was not given a chance to provide comments to them before they became effective. In the preamble to the new proposed regulations, the Treasury Department did not state that it had reconsidered the substantive rule of the 2016 temporary regulations, but rather that it agreed with commentators that such a change should be studied systematically. Thus, it remains to be seen whether these rules will be changed again. For now, though, the proposed regulations are good news for taxpayers in that they will once again open the door to tax planning transactions that were previously restricted.