February 22, 2017

Regulations Address Partner Reimbursements

By: Ezra Dyckman and Daniel W. Stahl

Partners that contribute property to a partnership are often interested in receiving tax-free distributions of money. However, this objective necessitates fitting within an exception to the partnership "disguised sale" rules. As we discussed in our last column, certain transactions involving partners receiving tax-free debt-financed distributions are no longer viable in light of recently issued Treasury Regulations. This development may increase the focus on other avenues for monetizing equity in the joint venture context, including the exception for certain tax-free reimbursements of capital expenditures. The new Regulations have made important changes to this rule as well.

Background

A contribution of property to a partnership is generally tax-free, and a distribution of money by a partnership to a partner is generally tax-free to the extent of 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 a two-year period, the Regulations presume there to be a sale of property by the partner to the partnership (a "disguised sale").

Where a partner contributes property to a partnership subject to debt, the treatment of the transaction under the disguised sale rules depends on whether the debt is a "qualified" liability. The Regulations provide for several categories of qualified liabilities, including (i) liabilities that are allocable to capital expenditures with respect to the contributed property and (ii) liabilities that are secured by the contributed property and have been outstanding for at least two years. Contribution of property to a partnership subject to a qualified liability is generally tax-free if the transaction would not otherwise be treated as a disguised sale. Contribution of property to a partnership subject to a nonqualified liability is generally considered to constitute a disguised sale of property by the partner to the partnership to the extent of the decrease in the partner's "share" of the nonqualified liability (as specifically defined for purposes of the disguised sale rules).

An exception to the disguised sale rules can apply where a partnership distributes money to a partner as a reimbursement of capital expenditures made by the partner in the previous two years with respect to property contributed to the partnership. The amount of the tax-free reimbursement of capital expenditures is generally limited to 20% of the fair market value of the contributed property (the "20% Limitation"). However, the 20% Limitation does not apply if the fair market value of the contributed property does not exceed 120% of its tax basis (the "120% Safe Harbor").

New Treasury Regulations

Suppose that a partner contributes property to a partnership subject to a qualified liability, the proceeds of which had been used to fund capital expenditures with respect to the contributed property in the previous two years. Contribution of the property to a partnership subject to this qualified liability would generally be tax-free. Should the partner also be able to receive a tax-free distribution as a reimbursement of the capital expenditures? Since the partnership is in effect already reimbursing the partner for its capital expenditures by taking the contributed property subject to the liability, a distribution of money to the partner could be viewed as a second reimbursement of the same capital expenditures (a "double dip"). Until recently, the Regulations were silent on this point, although many tax practitioners were doubtful that such a distribution representing a "double dip" could qualify as a tax-free reimbursement of capital expenditures.

New Regulations that were issued on October 5, 2016 (Treas. Reg. § 1.707-4(d)(4)(i)) address this scenario, and provide that the amount that can be distributed to the partner as a tax-free reimbursement of capital expenditures is limited to the partner's share of the qualified liability (generally the partner's share of partnership profits). To illustrate, suppose that a partner contributes a property with a value of $10 mil-

***Ezra Dyckman** and **Daniel W. Stahl** are partners in the law firm of Roberts & Holland LLP*

lion to a partnership, subject to a $2 million qualified liability that was used to fund capital expenditures with respect to the property in the previous two years. Assume that the partner receives a $1 million distribution from the partnership, and will have a 25% share of partnership profits. In this example, the contribution of the property to the partnership subject to the qualified liability would be tax-free. Then, the partner would be able to receive a distribution of $500,000 as a tax-free reimbursement of capital expenditures (i.e., the product of (i) the $2 million amount of the liability and (ii) the partner's 25% share of the liability after the contribution). The remaining $500,000 portion of the distribution to the partner would be part of a taxable disguised sale of property by the partner to the partnership.

Another important clarification in the new Regulations is that the 20% Limitation and the 120% Safe Harbor generally must be applied on a property-by-property basis. This prevents a partner that contributes multiple properties to a partnership from comparing the amount of capital expenditures incurred with respect to one property against the value of all of the contributed properties for purposes of the 20% Limitation.

In addition, the preamble to the new Regulations reminds taxpayers that (i) there is generally a disclosure requirement if a partner contributes property to a partnership and receives a distribution of money or other property within two years, but does not treat the transaction as a disguised sale and (ii) this disclosure requirement applies even if a partner receives a distribution that is tax-free as a reimbursement of capital expenditures.

Conclusion

Aside from tinkering with some details with respect to how the reimbursement of capital expenditures exception to the disguised sale rules works, the preamble to the new Regulations states that the Treasury Department and the IRS are reviewing the appropriateness for this exception altogether. The preamble notes that there is no analogous exception involving contribution of property to a corporation, and requests comments regarding whether the exception is appropriate in the partnership context. While it remains to be seen what the Treasury Department and the IRS will ultimately decide regarding these Regulations, for now they provide one of the remaining opportunities for a partner that contributes property to a partnership to get tax-free cash.