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IRS Rules on Qualified Liabilities

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One might think that a contributor of property to a partnership would not need to worry about having gain from a "disguised sale" of property to the partnership as long as the contributor does not receive any cash. However, a transaction as simple as a contribution of property to a partnership subject to a mortgage may be treated as involving a taxable sale of property to the partnership if the debt is not a "qualified" liability.

While the new Treasury Regulations regarding partnership disguised sales that were issued in October 2016 were generally unfavorable for taxpayers, a taxpayer-friendly provision that was included is a new category of debt that constitutes a qualified liability. In a welcome development, the IRS recently issued a private letter ruling that interpreted the new category of qualified liability in a favorable manner.

Background

A contribution of property to a partnership is generally tax-free, and a distribution of cash from 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 Treasury Regulations presume there to be a sale of property by the partner to the partnership (a "disguised sale").

The Regulations provide that where a partner contributes property to a partnership and the partnership assumes or takes subject to a liability, the tax consequences depend on whether or not the liability is a "qualified" liability. If the liability is a qualified liability, then the transaction is generally tax-free. Alternatively, if the liability is not a qualified liability, then the partnership is generally treated as transferring cash to the partner 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)

Until October 2016, the Regulations provided that a liability assumed by a partnership in connection with a transfer of property by a partner to the partnership is a qualified liability if any of the following criteria are met:

(A) The liability (i) was incurred by the partner more than two years prior to transfer and (ii) has encumbered the transferred property throughout that two-year period.

(B) The liability was incurred by the partner within the two-year period prior to the transfer, but (i) was not incurred in anticipation of the transfer and (ii) has encumbered the transferred property since it was incurred.

(C) The liability is allocable to capital expenditures with respect to the transferred property.

(D) The liability (i) was incurred in the ordinary course of the trade or business in which the transferred property was used or held and (ii) all of the material assets related to that trade or business are transferred to the partnership.

In October 2016, the Regulations were modified to add a new category of qualified liability (Reg. § 1.707-5(a)(6)(i)(E)), which applies if the following criteria are met: (i) the liability was not incurred in anticipation of the transfer, (ii) the liability was incurred in connection with a trade or business in which the transferred property was used or held, and (iii) all the material assets related to that trade or business are transferred to the partnership. There is a presumption that a liability incurred within two years of a transfer was incurred in anticipation of the transfer.

PLR 201714028

In a recent private letter ruling (PLR 201714028), the IRS addressed a scenario where an entity (the "Company") transferred all of the material operating assets of a business and cash to a partnership (the "Partnership"), in exchange for an interest in the Partnership. The Partnership assumed liabilities of the Company in connection with the transfer. The liabilities that were assumed by the Partnership included liabilities that had been used to acquire assets, make improvements, pay expenses, and otherwise operate the business of the Company and its subsidiaries. In addition,

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some of the assumed liabilities had originally been incurred by the Company to make distributions to its members in connection with its formation, and had subsequently been refinanced. The ruling stated that the liabilities in question "are an integral part of Company's existing and historical capital structure." The Company represented that the liabilities were not incurred in anticipation of the transfer to the Partnership.

The IRS ruled, without analysis, that all of the liabilities in question were qualified liabilities under the new category of Reg. § 1.707-5(a)(6)(i)(E).

Analysis

The determination of whether a liability constitutes a qualified liability has an increased importance in light of provisions in the October 2016 Regulations that generally have the effect of eliminating the ability of partners to contribute property to a partnership subject to a nonqualified liability tax-free.

Prior to the addition of the new category of qualified liability, in order for a debt to be a qualified liability it had to either (i) encumber property transferred to a partnership, (ii) have been used to fund capital expenditures with respect to property transferred to a partnership, or (iii) have been incurred in the ordinary course of the trade or business in which property transferred to a partnership was used or held. The new category enables a liability that does not meet any of the foregoing criteria to be a qualified liability if it was incurred "in connection with" a trade or business in which property transferred to a partnership was used or held (even if it was not incurred "in the ordinary course of" the trade or business).

The Regulations do not elaborate on what it means for liabilities to be incurred "in connection with" a trade or business. However, the IRS seems to have taken a relatively broad interpretation of that phrase while ruling in PLR 201714028 that liabilities incurred to fund distributions to members were considered to have been incurred in connection with a trade or business. Although one taxpayer cannot rely on a PLR granted to another taxpayer, PLRs can be significant to the extent that they usually reflect the IRS's position on a particular issue. In this case, it remains to be seen how broadly the new category of qualified liability will be construed, but in the meantime PLR 201714028 provides taxpayers with good news in an area where that has recently been in short supply.