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New Regulations on Debt Share for Partnership Disguised Sales

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The Treasury Department issued new regulations in October 2016 that modify a number of the partnership debt allocation rules. One important aspect of these regulations, discussed in our last column, disregards so-called "bottom guarantees" for purposes of allocating partnership liabilities among the partners of a partnership. The new regulations take an even more drastic approach, though, with respect to determining a partner's share of partnership liabilities for purposes of the "disguised sale" rules—and in a surprising twist cause some partnership liabilities to not be included in any partner's share.

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, there is generally presumed to be a sale of property by the partner to the partnership (a "disguised sale"). The contribution of property to a partnership subject to debt can also result in a disguised sale under certain circumstances.

One exception to the partnership disguised sale rules applies where a partner contributes property to a partnership and the partnership distributes proceeds from a new borrowing to the partner. In that case, a portion or all of the distribution to the partner is excluded from the disguised sale rules, with the amount determined based on the partner's share of the liability and the percentage of the debt proceeds that are distributed to the partner.

Prior to the October 2016 regulations, a partner's share of a partnership recourse liability (i.e., for which a partner bears the economic risk of loss) and a partnership nonrecourse liability (i.e., for which no partner bears the economic risk of loss) was determined as follows:

- For a partnership recourse liability, a partner's share was the amount (if any) for which the partner bears the economic risk of loss.
- For a partnership nonrecourse liability, a partner's share was generally based on the allocation of "excess nonrecourse liabilities" under Internal Revenue Code section 752—which is generally equal to the partner's "share of partnership profits," but can also be based on other methods including a "significant item" of partnership income or gain. (For a partnership with a waterfall that includes multiple "tranches," there has been uncertainty regarding whether the manner in which profits are allocated in each tranche constitutes a "significant item" for this purpose.)

Under the rules that were in effect prior to the October 2016 regulations, a partner that contributes property to a partnership was able to receive a distribution of debt proceeds entirely tax-free if it had a 100% share of the liability (either by bearing the economic risk of loss for the full liability, or by having a 100% share of a "significant item" of partnership income or gain.)

October 2016 Regulations

In October 2016, the Treasury Department issued final and temporary regulations that change the manner in which a partner's "share" of a partnership liability is determined for disguised sale purposes. Under the new final regulations (Treas. Reg. § 1.752-3(a)(3)), a partner's "share" of a nonrecourse liability for disguised sale purposes is always determined based on the partner's "share of partnership profits," regardless of the manner in which the nonrecourse liability is allocated for other purposes. These final regulations apply to liabilities incurred or assumed by a partnership on or after October 5, 2016.

In addition, the Treasury Department issued new temporary regulations (Temp. Treas. Reg. § 1.707-5T(a)(2)) under which a partner's share of a liability for disguised sale purposes is equal to the partner's share of partnership profits even if the partner bears the economic risk of loss for the liability (e.g., by mak-

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ing a guarantee). Moreover, if one partner bears the economic risk of loss for a partnership liability, every other partner's share of that liability is $0.

To illustrate, suppose that a 25% partner guarantees a $100 partnership liability and is therefore considered to bear the economic risk of loss for the liability. The full $100 amount of this liability would be allocated to the partner under section 752 (and would be included in the partner's basis in its partnership interest). However, for purposes of the disguised sale rules, (i) that partner's share of the liability would be only $25 (i.e., 25% of $100) and (ii) each other partner's share of the liability would be $0. These temporary regulations apply to disguised sale transactions where all of the transfers are made on or after January 3, 2017.

Analysis

A big (and unwelcome) surprise in the new regulations is that if one partner bears the economic risk of loss for a liability, that partner's share of the liability for disguised sale purposes is equal to only its share of partnership profits (and not the full amount for which the partner bears the economic risk of loss). Even more surprising is the counterintuitive concept that if one partner bears the economic risk of loss for a partnership liability, each other partner's share of that liability is $0 despite the fact that the guarantor partner's share is equal to only its share of partnership profits. These provisions were not included in the proposed regulations from 2014 (which likely explains why their effective date was delayed until 2017).

Now that a partner's share of any recourse or nonrecourse liability for disguised sale purposes is based on the partner's "share of partnership profits," the critical question becomes how to determine a partner's share of partnership profits. There is no clear answer to this question for a partnership with a typical multi-tier waterfall. The preamble to the new regulations does acknowledge this uncertainty, and requests comments regarding safe harbors and reasonable methods (although it is unfortunate that the new regulations were issued before this was worked out). In the meantime, it is clear that the new regulations eliminate certain planning opportunities involving disguised sales, but it remains to be seen what their full impact will be.