New Proposed Regulations Remove Obstacles to Partnership Formation, Debt Capitalization Transactions

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On June 18, 2018, the Internal Revenue Service (IRS) and the Treasury Department (Treasury) released proposed regulations that largely reinstate pre-2017 law regarding the allocation of liabilities under the partnership "disguised sale" rules, thereby restoring taxpayers' ability to form partnerships and establish appropriate ownership and capitalization structures without triggering taxable gain.

The proposed regulations, if finalized, would withdraw controversial temporary regulations that were issued in October 2016 under Section 707 of the Internal Revenue Code and that effectively ended the ability of taxpayers to contribute certain types of leveraged assets to partnerships and engage in certain debt-financed partnership transactions.[1] Importantly, taxpayers are permitted to rely on the new proposed regulations prior to their finalization, meaning that taxpayers can immediately recommence the types of transactions that were quashed by the 2016 temporary Section 707 regulations.

Background

Under the partnership disguised sale rules, when, in connection with a contribution of property to a partnership, the partnership assumes a liability of the contributing partner (other than certain "qualified liabilities"), the portion of the liability that is allocated away from the contributing partner and to other partners is generally treated as disguised sale proceeds that trigger gain in the contributed assets. In addition, if a partner contributes property to a partnership and within two years receives a cash distribution from the partnership, the distributed cash is generally treated as disguised sale proceeds, subject to certain exceptions. Prior to the 2016 regulations, taxpayers had the ability to engage in partnership formation and contribution transactions without triggering gain under the disguised sale rules by retaining (or assuming) the risk of loss with respect to partnership liabilities (for example, by guaranteeing them). Thus, when a partner transferred property subject to nonqualified liabilities to a partnership, the partner could defer phantom gain by guaranteeing those liabilities. Similarly, a partner could receive non-pro rata leveraged distributions (*i.e.*, distributions from the proceeds of the partnership's borrowings) on a tax-deferred basis if it guaranteed those borrowings.

The 2016 temporary Section 707 regulations drastically changed these rules by treating all liabilities, for disguised sale purposes, as "nonrecourse" liabilities that must be allocated among all partners in accordance with their respective interests in partnership profits, thereby ignoring the sharing of economic risk of loss with respect to the liability among the partners. As a result, an assumption by a partnership of nonqualified liabilities in connection with a property contribution, or a non-pro rata leveraged partnership distribution made to a contributing partner within two years of a property contribution, would generally give rise to a disguised sale, even if the partner guaranteed 100 percent of every dollar of the liability.

New Proposed Regulations

On October 2, 2017, Treasury, in response to a presidential executive order directing it to review recent tax regulations, issued a report telegraphing its plan to revoke the 2016 temporary Section 707 regulations and reinstate prior law. The new proposed regulations

[1] For a detailed explanation of the disguised sale rules and the 2016 regulations, see our October 10, 2016, client alert, "New Regulations Dramatically Alter Partnership 'Disguised Sales' and Allocation of Partnership Liabilities."

follow through on that plan and revert to prior law by once again permitting taxpayers to use guarantees and similar mechanisms to defer gain on partnership contributions and leveraged distributions. Although the formal effective date of the proposed regulations is 30 days after they are finalized, the preamble expressly states that taxpayers may immediately apply the new proposed regulations in lieu of the 2016 temporary Section 707 regulations. Taxpayers can thus again pursue opportunities to engage in partnership contribution and distribution transactions in a way that carries out their commercial and capital-structure objectives without triggering phantom gain in connection with the use of certain types of long-standing leveraging techniques.

It is important to note, however, that although the new proposed regulations would withdraw the 2016 temporary Section 707 regulations, they generally do not affect the other temporary and final regulations discussed in our 2016 client alert. Most importantly, the proposed regulations would not affect the 2016 temporary regulations under Section 752, which prohibit tax deferral through the use of so-called "bottom-dollar guarantees" — *i.e.*, guarantees under which the partner-guarantor is liable only if the lender fails to collect a specified minimum amount from the partnership. As a result, taxpayers still need to structure their guarantees in a manner that complies with the 2016 Section 752 regulations.

Conclusion

The 2016 temporary Section 707 regulations were unduly restrictive and have discouraged many legitimate business-driven partnership transactions. By returning to prior law, the new proposed regulations would once again give taxpayers the flexibility to engage in these transactions.