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Hot Topics in Partnership Taxation

New York State Bar (Tax Section) Annual Meeting

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Section 704, 707 and 752 Regulations

Risk of Loss

Relevance

Adjusted basis of partnership interest

— Allocation of debt under section 752

Allocation of income/loss under section 704(b)

— Deficit restoration obligation

— Partner nonrecourse deductions

Disguised sale rules

— Debt allocation for purposes of nonqualified liability and debt financed distribution rules

At-risk rules under section 465

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New Section 707-752 Regulations

Three different regulation packages

Final regulations relating to narrow issues under section 707 disguised sale rules (e.g., preformation capital expenditures and qualified liabilities) and allocation of nonrecourse liabilities under section 752

— Effective for transfers on or after October 5, 2016 (for section 707) and liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken with respect to a partnership liability on or after October 5, 2016, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date.

Temporary and proposed regulations addressing debt-financed distributions under section 707 and ignoring "bottom-dollar" guarantees under section 752

— Section 752 regulations are effective for liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken with respect to a partnership liability on or after October 5, 2016, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date, and section 707 regulations are effective for transactions with respect to which all transfers occur on or after 90 days after October 5, 2016.

Proposed regulations defining risk of loss for purposes of classifying liabilities as recourse under section 752

— Proposed to be effective for liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken with respect to a partnership liability on or after the date the regulations are published as final, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date. However, partners can rely on the proposed regulations except with respect to the elimination of the section 752 net value rule for DREs.

Allocating Liabilities under Section 752

Historic "atom bomb" approach for determining risk of loss in allocating partnership liabilities

Except as otherwise provided in this section, a partner bears the economic risk of loss for a partnership liability to the extent that, *<u>if the partnership constructively liquidated, the partner or related person would be obligated to make a payment</u>* to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner. Reg. §1.752-2(b)(1).

Upon a constructive liquidation, all of the following events are deemed to occur simultaneously:

- All of the partnership's liabilities become payable in full;
- With the exception of property contributed to secure a partnership liability, *<u>all of the partnership's assets, including cash, have a value of zero</u>*;
- The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership);
- All items of income, gain, loss, or deduction are allocated among the partners; and
- The partnership liquidates. Reg. §1.752-2(b)(1).

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Allocating Liabilities under Section 752

Historic presumption that obligations will be satisfied

For purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, *unless the facts and circumstances indicate a plan to circumvent or avoid the obligation*. Reg. §1.752-2(b)(6); *see also* Reg. §1.752-2(j)(3).

Allocating Liabilities under Section 752

New regulations under section 752 still reference the "atom bomb" test, but significantly limit the situations when that test will apply.

A bottom dollar guarantee is not recognized for purposes of creating risk of loss for purposes of section 752. Temp. Reg. §1.752-2(b)(3)(ii)(A).

"A plan to circumvent or avoid the obligation" is defined broadly.

- Evidence of a plan to circumvent or avoid an obligation is deemed to exist if the facts and circumstances indicate that there is not a reasonable expectation that the payment obligor will have the ability to make the required payments if the payment obligation becomes due and payable. Prop. Reg. §1.752-2(j)(3)(iii).
- The proposed regulations provide a non-exclusive list of factors that may indicate a plan to circumvent or avoid the payment obligation. Prop. Reg. §1.752-2(j)(3)(ii).
  - The presence or absence of a factor is based on all of the facts and circumstances at the time the partner or related person makes the payment obligation or if the obligation is modified, at the time of the modification. *Id.*
  - The weight to be given to any particular factor depends on the particular case, and the presence or absence of a factor is not necessarily indicative of whether a payment obligation is or is not recognized. *Id.*

Allocating Liabilities under Section 752

The factors considered in determining the existence of a plan to circumvent or avoid payment of the obligation (other than for deficit restoration obligations) are:

There are no commercially reasonable restrictions that protect likelihood of payment (e.g., limit distributions by borrower entity or transfers for inadequate consideration).

Lender-required commercially reasonable documentation of guarantor financial condition.

Termination of guarantor’s liability prior to maturity of loan, except upon occurrence of events that decrease risk of loss (e.g., stabilization of building).

Primary obligor required to hold liquid assets that exceed reasonable foreseeable needs.

Limitations on creditors ability to pursue payment upon default or other arrangements indicating a plan to delay.

Terms of the partnership liability would be substantially the same had the partner not agreed to provide the guarantee.

Lender does not require receipt of guarantee documents. Prop. Reg. §1.752-2(j)(3)(ii).

Allocations Under Section 704 and 752

Proposed regulations would apply a similar, although not identical, analysis to determine whether a deficit restoration obligation will be respected for purposes of supporting loss allocations under section 704(b).

A partner will not be considered obligated to restore a deficit capital account balance if the partner's obligation is a "bottom-dollar payment obligation" that is not recognized under the section 752 rules. Prop. Reg. §1.704-1(b)(2)(ii)(c)(4)(B).

A partner also will not be considered obligated to restore a deficit capital account if the obligation is not legally enforceable or the facts and circumstances otherwise indicate a plan to circumvent or avoid such obligation. *Id*.

- The section 704(b) proposed regulations do not appear to analyze whether there is a reasonable expectation that the payment obligor will have the ability to make the required payments.
- The proposed regulations do, however, apply a factor-based analysis similar to the analysis applied under section 752 to determine whether there is a plan to circumvent or avoid the deficit restoration obligation. *Id*.; *compare* Rev. Rul. 97-38, 1997-2 C.B. 69.

Allocations Under Section 704 and 752

The proposed regulations provide a series of factors that are relevant to determine whether there is a plan to circumvent or avoid the deficit restoration obligation, so that such obligation will be disregarded.

— The partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation.

— The partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership.

— The obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account as provided in Reg. §1.704-1(b)(2)(iv) is negative.

— The terms of the obligation are not provided to all the partners in the partnership in a timely manner. Prop. Reg. §1.704-1(b)(2)(ii)(c)(4)(B).

These factors also would apply in determining whether a deficit restoration obligation will be recognized for purposes of allocating debt under section 752.

— Treasury and the IRS have requested comments as to whether deficit restoration obligations should continue to be recognized. REG-122855-15 (preamble).

Allocations under Section 707

Temporary regulations address the allocation of liabilities for purposes of the disguised sale rules under section 707.

Those regulations provide that risk of loss will no longer be relevant for purposes of allocating liabilities under the section 707 disguised sale rules, and instead, liabilities will be allocated based on a partner's share of profits as determined under Reg. §1.752-3(a)(3) (that is, determined without regard to the significant item, nonrecourse deduction, or excess section 704(c) method). Temp. Reg. §1.707-5T(a)(2)(i).

- The limitation applies to the allocation of liabilities both for purposes the debt-financed distribution rule under Reg. §1.707-5(b)(1) and the rule applicable to shifts of non-qualified liabilities Reg. §1.707-5(a)(1).
- For purposes of this rule, a partner's share of liabilities cannot exceed the partner's share of the partnership liability under section 752 and applicable regulations (as limited in the application of section 1.752-3(a)(3) to section 1.707-5T(a)(2)).
  - Consider application in the context of Reg. §1.707-5(a)(4) relating to transfers of encumbered property to a partnership by more than one partner pursuant to a plan – independently calculates shares of separate liabilities and combines.

Section 465 At-Risk Rules

The new regulations do not address the concept of risk of loss for purposes of section 465.

Under section 465(b)(2), a taxpayer is considered at risk with respect to amounts borrowed for use in an activity to the extent that the person

- *is personally liable for the repayment* of such amounts, or
- has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property).

Under section 465(b)(4), a taxpayer will not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

- Worst case scenario approach illustrated in *Emershaw*, 949 F.2d 841 (6th Cir. 1991), assumes the value of the property that is the subject of the activity becomes worthless, and all parties providing support to back-stop the payment obligation will perform. *See also Melvin*, 88 T.C. 63 (1987); *Tepper*, T.C. Memo. 1991-402 (reference the 752 approach).
- Other circuits apply an “economic realities” approach, looking to whether the transaction is structured to remove any realistic possibility that a taxpayer will suffer an economic loss. *Moreno*, 2014-1 USTC 50,293 (W.D. La. 2014) (summarizing case law).

Section 465 At-Risk Rules

In the case of an activity of holding real property, section 465(b)(6)(A) provides that a taxpayer will be considered "at risk" with respect to the taxpayer's share of any "qualified nonrecourse financing" which is secured by real property used in such activity.

Section 465(b)(6)(B) defines "qualified nonrecourse financing" to mean any financing—

- which is borrowed by the taxpayer with respect to the activity of holding real property,
- which is borrowed by the taxpayer from a qualified person or represents a loan from any Federal, State, or local government or instrumentality thereof, or is guaranteed by any Federal, State, or local government,
- except to the extent provided in regulations, <u>*with respect to which no person is personally liable for repayment*</u>, and
- which is not convertible debt. *See also* Reg. §1.465-27(b)(1).

In the case of a partnership, a partner's share of any qualified nonrecourse financing is determined based on the partner's share of liabilities incurred in connection with the financing (within the meaning of section 752).

It is not clear that a guarantee disregarded under section 752 also would be disregarded for purposes of determining status as qualified nonrecourse financing.

Section 707 - Preformation Capital Expenditures

The final regulations make a number of changes related to preformation capital expenditures.

Exception for preformation capital expenditures is limited to 20% of the fair market value of the contributed property if the fair market value of such property exceeds 120% of the adjusted basis of such property.

— Under new final regulations, the 20% and 120% determinations are made on a property-by-property basis, with a limited permissible aggregation rule. Prop. Reg. §1.707-4(d)(1)(ii)(B).

The term capital expenditures has the same meaning as the term capital expenditures has under the Code and regulations, except that it includes capital expenditures taxpayers elect to deduct, and does not include deductible expenses taxpayers elect to treat as capital expenditures. Prop. Reg. §1.707-4(d)(5).

The regulations provide step-in-the-shoes and tiered partnership rules related to preformation capital expenditures. Prop. Reg. §1.707-4(d)(2) and (3).

— Similar rules are provided for qualified liabilities. Prop. Reg. §1.707-4(d)(4).

— Does specific rule allowing step-in-the-shoes for partnership interest received in exchange for preformation capex asset mean such treatment is not available for stock received in a section 351 contribution?

Preamble indicates that Treasury and IRS are studying the appropriateness of the preformation capex exception. T.D. 9787 (preamble).

Recourse or Nonrecourse Debt

Recourse or Nonrecourse Debt

Treatment of partnership debt as recourse or nonrecourse can be relevant for a number of purposes, including:

Reg. §1.1001-2 and determination as to whether debt gives rise to COD income or amount realized upon a transfer property securing debt to the lender;

Section 108(a)(1)(B) and analysis of debt in determining insolvency; and

Reg. §1.1001-3 and analysis in determining whether modifications are significant and result in a deemed exchange.

Recourse or Nonrecourse Debt

Conflicting authority exists in analyzing partnership debt for purposes of Reg. §1.1001-2.

Great Plains Gasification Associates, 92 T.C.M. (CCH) 534 (2006) (general partnership where debt was secured by “all real or personal property ‘now owned or hereafter acquired’ by the partnership”; court focused on section 752 rules in determining debt was nonrecourse).

In CCA 201525010 (Mar. 6, 2015), the IRS disavowed any relevance of the section 752 rules in determining whether debt is recourse or nonrecourse for purposes of Reg. §1.1001-2.

Recourse or Nonrecourse Debt

The introduction of a disregarded single member LLC can further impact the analysis Reg. §1.1001-2.

IRS Field Attorney Advice 20150301F analyzed whether debt owed by a disregarded LLC for which the owner had no personal liability should be treated as recourse or nonrecourse for purposes of section 1001 and the determination of COD income or sale gain or loss.

— Citing Reg. §1.465-27(b)(6), Ex. 6, the FAA states that "where the disregarded entity is personally liable on the debt, but its sole member is not (i.e., the creditor may proceed only against the assets of the disregarded entity), the debt is treated as nonrecourse with respect to the sole member."

— The taxpayer was required to treat proceeds of debt owed by disregarded LLC as amount realized upon transfer of property in satisfaction of debt.

In PLR 201644018, the IRS also concluded that debt owed by a disregarded entity where the regarded owner does not have personal liability for any portion of the debt would be treated as a nonrecourse liability of the regarded owner.

— As a result, the debt cancelled in exchange for the transfer of the property was treated as amount realized rather than COD income recognized in connection with the transfer.

Recourse or Nonrecourse Debt

If a nonrecourse liability is being discharged, the excess of the nonrecourse liability over the value of the property will be treated as a liability in measuring insolvency to the extent that the excess is discharged. Rev. Rul. 92-53, 1992-2 C.B. 48.

If the nonrecourse debt is not being discharged, treat the debt as a liability only to the extent of the value of the property securing the debt. *Id*.

Under Rev. Rul. 2012-14, in order to properly apply Rev. Rul. 92-53 in a partnership context, the partnership's discharged excess nonrecourse debt should be associated with the partner who in the absence of the insolvency or other § 108 exclusion would be required to pay the tax liability arising from the discharge of that debt

Preamble to final regulations relating to disregarded entities and the application of the bankruptcy and insolvency exceptions indicates that debt of a disregarded LLC generally will be treated as nonrecourse for purposes of measuring insolvency under Rev. Rul. 92-53, absent a guarantee or some other credit support by the regarded owner. T.D. 9771 (preamble).

Recourse or Nonrecourse Debt

The character of debt as recourse or nonrecourse impacts the significant-modification analysis under Reg. §1.1001-3 in the context of a substitution of a new obligor.

The substitution of a new obligor on a recourse debt instrument will give rise to a significant modification, except for limited circumstances (i.e., section 381 transactions, acquisition of substantially all assets together with no change in payment expectations, and certain tax-exempt bond transactions). Reg. §1.1001-3(e)(4)(i).

The substitution of a new obligor on a nonrecourse debt instrument is not a significant modification. Reg. §1.1001-3(e)(4)(ii).

Recourse or Nonrecourse Debt

The character of debt as recourse or nonrecourse also impacts the significant-modification analysis under Reg. §1.1001-3 in the context of an alteration of credit support or collateral with respect to a debt instrument.

A modification that releases, substitutes, adds or otherwise alters the collateral for, a guarantee on, or other form of credit enhancement for a recourse debt instrument is a significant modification if the modification results in a change in payment expectations. Reg. §1.1001-3(e)(4)(iv)(A).

A modification that releases, substitutes, adds or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for a nonrecourse debt instrument generally will give rise to a significant modification. Reg. §1.1001-3(e)(4)(iv)(B).

- A substitution of collateral is not a significant modification, however, if the collateral is fungible or otherwise of a type where the particular units pledged are unimportant (e.g., government securities or financial instruments of a particular type and credit quality). *Id*.
- In addition, the substitution of a similar commercially available credit enhancement contract is not a significant modification, and an improvement to the property securing a nonrecourse debt instrument does not result in a significant modification. *Id*.

Recourse or Nonrecourse Debt

There is limited guidance addressing the treatment of debt of a disregarded LLC as recourse or nonrecourse for these purposes under Reg. §1.1001-3.

The IRS has been somewhat inconsistent in its analysis, sometimes seemingly applying the analysis by reference to the state law debtor and in others arguably analyzing by reference to the regarded owner for tax purposes. *See generally* PLRs 200315001, 200630002, 200709013, 201010015, and AM 2011-003.

The policies that should influence the analysis under Reg. §1.1001-3 would seem to be different than in the contexts considered earlier.

— "The question posed in applying [Reg. §1.1001-3] to a debt modification is whether the debt has changed enough from the holder's perspective to trigger gain or loss. The tests concerning recourse and nonrecourse debt in the debt modification regulations can be understood to be proxies for asking if the economic characteristics of an instrument have changed enough so that the creditor holds something really new." J. Peaslee, *Disregarded Entities and Debt Modifications*, 2016 Tax Notes Today 45-14 (Mar. 8, 2016).

Fractions Rule Proposed Regulations

Fractions Rule

The following issues are addressed in proposed regulations published on November 23, 2016.

Reasonable preferred return

Allocation of partner-specific items/disproportionate management fees

— Interaction with chargeback rule

Unlikely loss exception

— Interaction with chargeback rule

Staged closings

Capital call default

Tiered partnership rule

De minimis rule

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Management Fee Waivers

Management Fee Waiver Guidance

On July 22, 2015, the Treasury Department and Internal Revenue Service issued proposed regulations relating to disguised payments for services.

The proposed regulations imply that, in order for a management fee waiver arrangement to avoid treatment as a fee, there must be positive net profit over the life of the partnership to match the fee waiver or any shortfall amount must be forfeited.

It is uncertain whether a fee waiver profits interest that avoids treatment as a fee under section 707 will be eligible for $0 valuation by reference to liquidation value under Rev. Procs. 93-27 and 2001-43.

— This point could have a significant impact on the viability of fee waiver arrangements going forward.

While the regulations were originally said to be targeted at management fee waivers, to what extent might other arrangements be implicated (e.g., first dollars of gain to equate new entrant to carry entity with other carried interest participants, REIT LTIPs, etc.)?

What questions do you have?

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