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New Regulations Eliminate Leveraged Partnership Transactions, Modify Proposed Rules for Allocation of Partnership Liabilities

On October 5, 2016, the U.S. Department of Treasury and the Internal Revenue Service (together referred to as the "Service") finalized previously proposed regulations regarding the allocation of partnership liabilities and "disguised sales" involving partnerships (in each case, with certain modifications based on comments from practitioners) and published new proposed and temporary regulations addressing the same topics. As was expected, these regulations effectively eliminate the tax benefits related to tax-motivated leveraged partnership transactions.

Disguised Sales and Leveraged Partnership Transactions

In general, a partner may contribute property to a partnership on a tax-deferred basis, and, separately, a partner may receive cash distributions from a partnership up to the amount of the partner's tax basis in its partnership interest without incurring tax. In 1984, in response to taxpayer efforts to use these rules to recast a sale of assets to a partnership for cash as a tax-free contribution and distribution, Congress enacted Section 707(a)(2)(B),[1] which authorizes the Service to prescribe regulations that treat a related contribution and distribution as a sale.

The Service proposed the first version of the regulations under Section 707(a)(2)(B) in 1991 and finalized them in 1992. These regulations included a number of exceptions, including an exception for a transaction in which a partner contributes property to a partnership and receives a debt-financed distribution of cash from the partnership (a "leveraged partnership transaction"). In that case, to the extent the distribution does not exceed the partner's allocable share of the associated liability, the distribution is not treated as a disguised sale.

A common approach for taxpayers trying to take advantage of these rules was to treat the debt as a recourse liability fully allocable to the taxpayer receiving the distribution. Recourse liabilities are allocated to the partner that bears the economic risk of loss. Under the rules in effect before the recent amendments to the regulations, taxpayers took the position that a partner could establish economic risk of loss by providing a so-called bottom-dollar guarantee with respect to otherwise nonrecourse debt. The partner would guarantee the payment of the partnership liability up to the amount of the distribution, but only after all of the equity in the partnership's assets had been applied to the liability, and only with

[1] All Section references herein are to the U.S. Internal Revenue Code of 1986, as amended and the regulations thereunder, as applicable.

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respect to the last dollars of the liability. So for example if a partner guaranteed $10 million of a $100 million partnership debt, he would only be liable under the guarantee after the lender had lost the first $90 million of its investment, and would only be fully liable for $10 million if the partnership's assets proved to be entirely worthless. Using this technique, with only modest risk of actual economic exposure, taxpayers could take the position that a transaction was a debt-financed distribution and thereby defer substantial amounts of gain on a transaction that as a matter of economic substance might be viewed as more akin to a sale.

A second, less commonly employed but still well-known approach was for the debt incurred to fund the distribution to be nonrecourse debt. For purposes of determining whether there was a disguised sale, a partner's share of nonrecourse debt was to be determined in the same manner as his share of excess nonrecourse liabilities. In most partnerships, in the absence of a leveraged partnership transaction, this share is determined by reference to the partner's share of partnership profits. But a special rule permitted allocation based on a partner's share of a "significant item" of income. Accordingly, in some cases, partnerships would allocate, for example, 100% of the income from a particular line of business to the partner receiving the distribution, treating that as a "significant item", and on that basis allocate all of the nonrecourse debt to the partner in question.

While allocation of partnership liabilities to partners is a fundamental feature of partnership tax law that has benefited and will continue to benefit partners in many ordinary course transactions, the specific leveraged partnership techniques described above were used in highly structured transactions to achieve tax deferral that would not otherwise have been available to a taxpayer receiving substantial amounts of cash with respect to an asset with low tax basis. These transactions were especially common in the real estate industry, particularly in connection with exchanges of real estate assets for UPREIT units, coupled with debt-financed cash distributions. However, taxpayers in other industries also made use of these techniques: for example, a conglomerate might have contributed a valuable and long-held business with low tax basis into a leveraged partnership that superficially appeared to be a joint venture, but was primarily a vehicle for a disguised sale to the third party operating the joint venture.[2] Famously, before its bankruptcy, The Tribune Company sold Newsday and the Chicago Cubs using this structure.[3]

The 2014 Proposed Regulations

Concerned that transactions along the lines described above were abusing the intended scope of the 1992 Rules, in 2014 the Service proposed modifications to these regulations intended to curtail or eliminate

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2 Even under the prior regulations, the Service successfully challenged certain leveraged partnership transactions under anti-abuse provisions. *See, e.g.*, Canal Corp. v. Commissioner, 135 T.C. 199 (2010).

3 Tribune has publicly reported that the Service challenged the Newsday and Chicago Cubs transactions on audit, that Tribune recently agreed to report part of the gain on the Newsday transaction as taxable in 2008 and to make related tax payments, and that Tribune and the Service are contesting the tax treatment of the Chicago Cubs transaction in the Tax Court.

these transactions. First, the proposed rules would have disallowed reliance on what the Service viewed as an illusory economic risk of loss in determining that liabilities should be treated as recourse and should be allocated to the partner who had the apparent but not the real economic risk. Second, the proposed regulations would have eliminated the "significant item" method for allocating nonrecourse liabilities for all purposes (in addition to other changes to the permitted methods for allocating nonrecourse liabilities).

New Regulations

The 2014 proposed regulations were generally well received, though particularly with respect to bottom guaranties and other techniques for asserting economic risk of loss, they seemed to rely on multi-factored and, at least in part, subjective determinations. The new regulations take a more direct approach:

- First, solely for purposes of the disguised sale analysis, a partner's share of any partnership liability (whether otherwise a recourse liability or a nonrecourse liability) will be determined as if all liabilities are nonrecourse, but without including in such partner's share any amount of the liability for which another partner bears the economic risk of loss. Thus, economic risk of loss becomes largely irrelevant for purposes of the disguised sale determination.

- Second, again solely for purposes of the disguised sale rules, a partner's share of nonrecourse liabilities will be based on his share of partnership profits—the "significant item" rule will not apply.

These changes, which effectively eliminate the ability to use leveraged partnerships as a tax deferral tool, apply prospectively.

Bottom Guarantees under the New Regulations

While the new regulations render the use of bottom guarantees moot for disguised sale purposes, the Service remained concerned with the use of such arrangements to create partnership basis under the rules more generally applicable to allocation of partnership liabilities. Under the new temporary regulations, a bottom guarantee will not be recognized for purposes of treating a liability as a recourse liability and allocating it to the partner providing the guarantee. In order to be allocated a liability as a result of a guarantee, a partner must guarantee either the entire liability or a vertical slice of the liability (e.g., 25% of each dollar not paid by the partnership to the lender), with no more than 10% of the partner's obligation eliminated by any side agreement with the partnership or other partners. Even a guarantee of the bottom 85% of a partnership liability, although many partners would view this guarantee as economically significant, will not support a liability allocation to the guarantor. Instead, the partnership would allocate this liability among all of the partners under the rules applicable to nonrecourse liabilities.

This change is effective immediately, although it applies only to liabilities incurred or assumed on or after October 5, 2016. Although the temporary regulations will not recharacterize completed transactions and

pre-existing liabilities, the allocation of partnership liabilities (and therefore the tax basis of the partners in their partnership interests) will be adjusted if these liabilities are modified or refinanced. The Service did include a helpful transition rule that permits a partner with a share of a recourse liability under the old rules to continue to apply the old rules for 7 years, but a partner that is a partnership, S corporation or disregarded entity will cease to qualify for the transition rule if the direct or indirect ownership of the partner changes by 50 percent or more.

Proposed Changes to Recourse Liability Rules

The Service also proposed a new set of rules regarding which obligations of a partner will be recognized for purposes of treating the partner as bearing the economic risk of loss with respect to a liability and treating the liability as a recourse liability allocated to the partner. These rules could apply even to a full guarantee of a partnership obligation, or to other arrangements, but will not apply to bottom guarantees, which are excluded from the definition of recourse liabilities under the *per se* rule described above. However, both of the new rules described below will not be effective until finalized, and the Service has solicited comments, which may lead to further changes.

Reasonable Expectation of Payment Rule Would Replace Net Value Rule

Under the new proposed regulations, an obligation would not be recognized if the facts and circumstances indicate that there is not a reasonable expectation that the obligor (including a disregarded entity obligor, where applicable) will have the ability to make the required payments. This rule would replace the "net value" requirement of the prior regulations, which commenters have criticized for its focus on a snapshot of net value at the time of the original allocation, rather than on the ability of the obligor to make future payments.

Flexible Multi-Factor Test Would Replace Previously Proposed All-or-Nothing Requirements

Under the prior proposed regulations, an obligation would not have been recognized unless each of seven specific recognition factors was satisfied. Commenters protested that this previous proposal was too strict and would produce illogical results in many cases. In response, the Service has now proposed a new nonexclusive seven-factor test, which identifies factors that may indicate a plan to circumvent or avoid an obligation. The weight given to any particular factor would depend on the facts and circumstances of the particular case and the presence or absence of any particular factor, in itself, would not necessarily indicate whether an obligation is recognized. The seven factors named in the new proposed regulations are:

- the partner is not subject to contractual restrictions that protect the likelihood of payment to the lender;

- the partner is not required to provide commercially reasonable documentation regarding the partner's financial condition to the lender;
- the term of the partner's obligation ends before the term of partnership obligation, if the purpose is to reduce the risk of loss to the partner (this factor typically will not be present if termination occurs by reason of events that decrease the lender's risk);
- a plan or arrangement exists in which the partnership (or any other obligor or related person) holds money or other liquid assets in an amount that exceeds its reasonably foreseeable needs;
- the lender is not permitted to promptly pursue payment or the arrangements indicate a plan to delay collection;
- the terms of partnership liability would be substantially the same had the partner not provided its guarantee; and
- the lender did not receive executed documents regarding the obligation before or within a reasonable period of time after the creation of obligation.

While the more flexible approach of the new seven-factor test represents an improvement over the prior proposal, the absence of any safe harbor or any indication as to how one should weigh the factors in close cases will generate uncertainty and may produce difficult issues to be resolved through audit and litigation.

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We will continue to track developments in this area and keep our clients informed as these rules develop.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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