

AN ALERT FROM THE BDO NATIONAL TAX PRACTICE

# BDO KNOWS:

## PARTNERSHIP TAXATION



### SUBJECT

## SIGNIFICANT CHANGES TO DISGUISED SALE RULES UNDER SECTIONS 707 AND 752

### SUMMARY

On October 5, 2016, the IRS published final and temporary regulations (TD 9787 and TD 9788) under sections 707 and 752 of the Internal Revenue Code ("Code"). The new regulations provide guidance relating to disguised sales of property to or by a partnership under section 707, and special rules for allocating liabilities under section 752 for purposes of the section 707 disguised sale rules.

### DETAILS

#### *General Rule under Section 707*

Section 707(a)(2)(B) provides that, under regulations prescribed by the Secretary, related transfers to and by a partnership that, when viewed together, are properly characterized as a sale or exchange of property, will be treated either as a transaction between the partnership and one who is not a partner, or between two or more partners acting other than in their capacity as partners. Under section 1.707-3, a transfer of property by a partner to a partnership and a transfer of money or other consideration from the partnership to the partner will generally be treated as a sale of property by the partner to the partnership, if based on all the facts and circumstances, the transfer of money or other consideration would not have been made but for the transfer of property and, for non-simultaneous transfers, the subsequent transfer is not dependent on the entrepreneurial risks of the partnership.

The existing disguised sale regulations provide several exceptions, including one related to reimbursements of capital expenditures (the "Preformation Expenditure Exception") and another for distributions of certain debt-financed proceeds (the "Debt-Financed Distribution Exception"). Additionally, existing regulations exclude certain liabilities from disguised sale treatment

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(the “Qualified Liability Exclusion”). TD 9787 and TD 9788 contain final and temporary regulations, respectively, impacting these exceptions and exclusion.

### **Preformation Expenditure Exception**

**General Rule:** In general, transfers of money or other consideration from a partnership to reimburse a partner for certain capital expenditures and costs incurred by the partner are not treated as part of a disguised sale of property. Capital expenditures include partnership organization and syndication costs, and costs capitalized to the basis of contributed property. The exception for preformation capital expenditures generally applies only to the extent that the reimbursed capital expenditures do not exceed 20 percent of the fair market value (“FMV”) of the property transferred by the partner to the partnership (the 20-percent limitation). The 20-percent limitation, however, does not apply if the FMV of the transferred property does not exceed 120 percent of the partner’s adjusted basis in the property at the time of the transfer (the 120-percent test).

**New Rule - Aggregation of Assets:** The final regulations clarify that the preformation expenditure exception applies on a property-by-property basis.<sup>1</sup> However, aggregation is permitted to the extent that:

1. The total FMV of the aggregated property (of which no single property’s FMV exceeds one percent of the total FMV of the aggregated property) is not greater than the lesser of 10 percent of the total FMV of all property transferred by the partner to the partnership (excluding money) or one million dollars;
2. The partner uses a reasonable aggregation method that is consistently applied; and
3. The aggregation of property is not part of a plan in which the principal purpose is to avoid sections 1.707-3 through 1.707-5.<sup>2</sup>

**New Rule - Step-in-the-Shoes Transaction:** Under the final regulations, a partner “steps in the shoes” of a person (to the extent the person was not previously reimbursed) with respect to capital expenditures incurred by the person with respect to the property transferred to the partnership. This rule applies to the extent the partner acquired the property in a non-recognition transaction under sections 351, 381(a), 721, or 731.<sup>3</sup>

**New Rule - Tiered Partnerships:** In certain situations, an upper-tier partnership is eligible to apply the preformation expenditure exception to capital expenditures incurred by another person.<sup>4</sup> This rule applies where:

1. A person incurred eligible capital expenditures with respect to property;
2. Such property is contributed by the person who incurred the capital expenditures to a partnership (lower-tier partnership); and
3. Within two years from the date the capital expenditures were originally incurred, the person transfers an interest in the lower-tier partnership to another partnership (upper-tier partnership).

Under this rule, the upper-tier partnership may be reimbursed by the lower-tier partnership to the extent the person could have been reimbursed for the capital expenditures by the lower-tier partnership.<sup>5</sup> In addition, the person is deemed to have transferred the capital expenditures property to the upper-tier partnership and may be reimbursed by the upper-tier partnership of this section to the extent the person could have been reimbursed for the capital expenditures by the lower-tier partnership and has not otherwise been previously reimbursed.<sup>6</sup> The aggregate reimbursements for capital expenditures may not exceed the amount that the person could have been reimbursed for such capital expenditures.

<sup>1</sup> Section 1.707-4(d)(1)(ii)(B).

<sup>2</sup> Section 1.707-4(d)(1)(ii)(B)(1), (2), & (3).

<sup>3</sup> Section 1.707-4(d)(2).

<sup>4</sup> Section 1.707-4(d)(3).

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

**New Rule - Coordination with Qualified Liability Rules:** Special rules apply if capital expenditures were funded by the proceeds of a qualified liability that is assumed by a partnership in connection with a transfer of property to the partnership.<sup>7</sup> Under these rules, to the extent any qualified liability is used by a partner to fund capital expenditures, and economic responsibility for that borrowing shifts to another partner, the exception for preformation capital expenditures does not apply.<sup>8</sup>

Further, capital expenditures are treated as funded by the proceeds of a qualified liability to the extent the proceeds are either traceable to the capital expenditures under section 1.163-8T or were actually used to fund the capital expenditures, irrespective of the tracing requirements under section 1.163-8T.<sup>9</sup> However, if capital expenditures are incurred under a plan in which the principal purpose is to avoid the requirements of these rules, the capital expenditures are deemed funded by the qualified liability.<sup>10</sup>

**New Rule - Definition of Capital Expenditures:** For purposes of the preformation expenditure exception and qualified liability exclusion, the term capital expenditures has the same meaning as the term capital expenditures has under the Code and applicable regulations, except that it includes capital expenditures taxpayers elect to deduct, and does not include deductible expenses taxpayers elect to treat as capital expenditures.<sup>11</sup>

**Additional Notes:** The IRS continues to study the appropriateness of the exception for preformation capital expenditures. Specifically, the IRS is considering whether the exception for preformation capital expenditures is appropriate and requests comments on whether the regulations should continue to include the exception, including any policy justifications for keeping the exception, and on the effects that removing the exception may have.

### ***Debt-Financed Distribution Exception***

**General Rule:** In certain situations, distributions funded with partnership liabilities that are made to a partner who transfers property to a partnership may be excluded from the disguised sale rules. A debt-financed distribution exception applies where the partnership incurs a liability and all or a portion of the proceeds of that liability are traceable to a transfer of money or other consideration to the contributing partner. However, this exception only applies to the extent that the amount of money or FMV of other consideration is does not exceed the partner's allocable share of the partnership liability. Thus, to the extent the partner receives a distribution of debt-financed proceeds and is not allocated a portion of the liability, application of this exception is limited. Determination of a partner's allocable share of the partnership liability is therefore critical in applying the debt-financed distribution exception.

<sup>7</sup> A qualified liability of the partner exists only to the extent the liability is:

- a. A liability that was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property throughout that two-year period;
- b. A liability that was not incurred in anticipation of the transfer of the property to a partnership, but that was incurred by the partner within the two-year period prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property since it was incurred;
- c. A liability that is allocable under the rules of §1.163-8T to capital expenditures with respect to the property;
- d. A liability that was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business; or
- e. A liability that was not incurred in anticipation of the transfer of the property to a partnership, but that was incurred in connection with a trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business; and

If the liability is a recourse liability, the amount of the liability does not exceed the FMV of the transferred property (less the amount of any other liabilities that are senior in priority and that either encumber such property or are liabilities described in paragraph (a)(6)(i)(C) or (D) of this section) at the time of the transfer.

<sup>8</sup> Section 1.707-4(d)(4)(i)

<sup>9</sup> *Id.*

<sup>10</sup> Section 1.707-4(d)(4)(ii)

<sup>11</sup> Section 1.707-4(d)(5)

**New Rule - Determination of Share of Liabilities under Section 707:** Under the temporary regulations, a partner's share of any partnership liability for disguised sale purposes is the same percentage used to determine the partner's share of the partnership's excess nonrecourse liabilities.<sup>12</sup> This rule applies regardless of whether the liability is recourse or nonrecourse. For purposes of the disguised sale rules, a partner's share of partnership excess nonrecourse liabilities will be based on the partner's share of partnership profits.<sup>13</sup> The temporary regulations also provide that, for disguised sale purposes, if another partner bears economic risk of loss ("EROL") with respect to a liability, then no portion of that liability can be allocated to the contributing partner.<sup>14</sup>

**New Rule - Qualified Liability Ordering Rule:** The final regulations clarify that an amount excludable as a debt-financed distribution is determined prior to applying the preformation expenditure exception under section 1.707-4.<sup>15</sup>

**Effective Date:** Section 707-5T(a)(2) is effective for any transaction with to which all transfers occur on or after January 3, 2017.<sup>16</sup> The temporary regulations are scheduled to expire on October 4, 2019.<sup>17</sup>

### **Qualified Liability Exclusion**

**General Rule:** Provided that a transaction is not otherwise treated as a disguised sale, and the partnership's assumption of a qualified liability, or a partnership's taking property subject to a qualified liability, is not treated as part of a sale. Where the transaction is otherwise treated as a sale, however, the qualified liability gives rise to additional disguised sale consideration in an amount equal to the lesser of:

1. The consideration the partnership would have been treated as transferring to the partner if the liability had been a nonqualified liability; or
2. An amount equal to the amount of the liability multiplied by the partner's net equity percentage with respect to the property.<sup>18</sup>

**New Rule - Anticipated Reduction in Partner's Share of Liability:** The existing rules provide that an anticipated reduction in a partner's share of liability must be taken into consideration in determining the partner's share of a liability.<sup>19</sup> The final regulations expand this rule to include the requirement that the anticipated reduction is not subject to the entrepreneurial risks of partnership operations.<sup>20</sup>

<sup>12</sup> Section 1.707-5T(a)(2)(i)

<sup>13</sup> Section 1.752-3(a)(3) provides that the partner's share of the excess nonrecourse liabilities of the partnership as determined in accordance with the partner's share of partnership profits. The partner's interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. In addition to allocations based on profits, partnerships may allocate excess nonrecourse liabilities under one of the following methods:

1. **Significant Item Method:** The partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities, provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain.
2. **Alternative Method:** Excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated.
3. **Additional Method:** The partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property (as defined under section 1.704-3(a)(3)(ii)) or property for which reverse section 704(c) allocations are applicable (as described in section 1.704-3(a)(6)(i)) where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the gain described in paragraph (a)(2) of this section with respect to such property.

The significant item method, alternative method, and additional method do not apply for purposes of the debt-financed distribution rules under section 1.707-5.

<sup>14</sup> Section 1.707-5T(a)(2)(i)

<sup>15</sup> Section 1.707-5(b)(3).

<sup>16</sup> Section 1.707-9T(a)(5)

<sup>17</sup> Section 1.707-5T(g)

<sup>18</sup> Section 1.707-5(a)(5)(i)

<sup>19</sup> Under the pre-existing regulations, a partner's share of a liability, immediately after a partnership assumes or takes property subject to the liability, is determined by taking into account a subsequent reduction in the partner's share if (i) at the time that the partnership assumes or takes property subject to the liability, it is anticipated that the transferring partner's share of the liability will be subsequently reduced, and (ii) the anticipated reduction is not subject to the entrepreneurial risks of partnership operations.

<sup>20</sup> Section 1.707-5(a)(3)(iii)

**New Rule - Exception Related to Certain Liability Shifts:** As described above, a partner's share of a partnership liability for disguised sale purposes is based on the partner's share of partnership profits. Consequently, a partner cannot be allocated 100 percent of the liabilities for purposes of section 707. As a result, some amount of the liabilities will shift among partners. The shifting of a nonqualified liability that triggers a disguised sale can cause a portion of the qualified liability to be treated as consideration under the disguised sale rules as well. In order to mitigate the impact of the general rules, the final regulations include an exception in certain circumstances. Specifically, the partnership's assumption of or taking property subject to a qualified liability is not treated as a transfer of consideration made pursuant to the sale, if the total amount of all liabilities other than qualified liabilities that the partnership assumes or takes subject to is the lesser of 10 percent of the total amount of all qualified liabilities the partnership assumes or takes subject to, or \$1,000,000.<sup>21</sup>

**New Rule - Addition to Qualified Liability Definition:** The final regulations expand the definition of qualified liability to include certain liabilities not incurred in anticipation of the property transfer. Under the final regulations, qualified liabilities will also include liabilities incurred in connection with a trade or business in which property transferred to the partnership was used or held, providing all the assets related to that trade or business are transferred to the partnership.<sup>22</sup> Assets that are not material to a continuation of the trade or business do not need to be included in the contribution. In meeting the definition of a qualified liability, the final regulations also provide that if the liability is a recourse liability, the amount of the liability may not exceed the FMV of the transferred property at the time of the transfer.<sup>23</sup>

**New Rule - Step-in-the-Shoe Transaction:** The final regulations provide a rule similar to the rule described above in connection with the preformation expenditure exception. Specifically, a partner "steps in the shoes" of a person for purposes of the qualified liability rules with respect to a liability the person incurred or assumed to the extent the partner assumed or took property subject to the liability from the person in a non-recognition transaction described in sections 351, 381(a), 721, or 731.<sup>24</sup>

**New Rule - Tiered Partnerships:** The pre-existing regulations provided only a limited tiered-partnership rule for cases in which a partnership succeeds to a liability of another partnership. Under the final regulations, a contributing partner's share of a liability from a lower-tier partnership is treated as a qualified liability to the extent the liability would be a qualified liability had it been assumed or taken subject to by the upper-tier partnership in connection with a transfer of all of the lower-tier partnership's property to the upper-tier partnership by the lower-tier partnership.<sup>25</sup> Further, the final regulations provide that in determining whether a liability would be a qualified liability, the determination of whether the liability was incurred in anticipation of the transfer of property to the upper-tier partnership is based on whether the partner in the lower-tier partnership anticipated transferring the partner's interest in the lower-tier partnership to the upper-tier partnership at the time the liability was incurred by the lower-tier partnership.<sup>26</sup>

## BDO INSIGHTS

- ▶ While the regulations clarify that the preformation expenditure exception must be applied on an asset-by-asset basis, the ability to aggregate assets in certain situations should alleviate the administrative burden associated with contributions of numerous assets. Careful attention to the aggregation exception should be paid in order to ensure the ability to maximize potential benefits.
- ▶ The rule coordinating the preformation expenditure exception and liability allocations effectively eliminates so-called "double-dip" transactions, where the partnership both reimburses the contributing partner's preformation expenditures and assumes the liability used by the contributing partner to finance the capitalized expenditures.

<sup>21</sup> Section 1.707-5(a)(5)(iii).

<sup>22</sup> Section 1.707-5(a)(6)(i)(E).

<sup>23</sup> Section 1.707-5(a)(6)(ii).

<sup>24</sup> Section 1.707-5(a)(8).

<sup>25</sup> Section 1.707-5(e)(2).

<sup>26</sup> *Id.*

- ▶ Leveraged partnership transactions in which newly-obtained liabilities are used to fund distributions to property-contributing partners are severely impacted by these rules. For purposes of calculating the amount of debt-financed distribution exception, a contributing partner's share of liabilities is based solely on such partner's interest in partnership profits (excluding liabilities for which another partner bears the EROL).
- ▶ While it is critical to consider the final and temporary regulations addressing disguised sales, it is important to bear in mind that the determination of a disguised sale transaction is inherently driven by facts and circumstances.<sup>27</sup> Consequently, careful consideration should be given to the overall facts and circumstances to determine whether the transaction should be considered a disguised sale.<sup>28</sup>

<sup>27</sup> Section 1.707-3(b)(1) provides transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if based on all the facts and circumstances:

- (i) The transfer of money or other consideration would not have been made but for the transfer of property; and
- (ii) In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

<sup>28</sup> Section 1.707-3(b)(2) provides that the determination of whether a transfer of property by a partner to the partnership and a transfer of money or other consideration by the partnership to the partner constitute a sale, in whole or in part, is made based on all the facts and circumstances in each case. The weight to be given each of the facts and circumstances will depend on the particular case. Generally, the facts and circumstances existing on the date of the earliest of such transfers are the ones considered in determining whether a sale exists. Among the facts and circumstances that may tend to prove the existence of a sale are the following:

- (i) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;
- (ii) That the transferor has a legally enforceable right to the subsequent transfer;
- (iii) That the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;
- (iv) That any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;
- (v) That any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;
- (vi) That the partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);
- (vii) That the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);
- (viii) That partnership distributions, allocations, or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;
- (ix) That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and
- (x) That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

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