

AN ALERT FROM THE BDO NATIONAL TAX PRACTICE

# BDO KNOWS:

## PARTNERSHIP TAXATION



### SUBJECT

## PROPOSED REMOVAL OF TEMPORARY REGULATIONS ON A PARTNER'S SHARE OF LIABILITY FOR DISGUISED SALE PURPOSES

### SUMMARY

Proposed regulations [REG-131186-17] issued by the IRS on June 18, 2018, would remove temporary regulations that were issued on October 5, 2016, (TD 9788) under Sections 707 of the Internal Revenue Code (Code). The proposed regulations, if finalized, would replace the existing Temporary Regulations Sections 1.707-5T and 1.707-9T,<sup>1</sup> and replace them with final regulations that were in effect prior to the temporary regulations. Temporary Regulations Sections 1.707-5T and 1.707-9T provided special rules solely for purposes of the Section 707 disguised sale rules, which required all liabilities to be allocated using the partner's share of partnership profits under regulation Section 1.752-3(a)(3) regardless of whether the liability was recourse or nonrecourse. Although these regulations have not been finalized, the IRS and Treasury have indicated that the proposed changes can be applied in lieu of the temporary regulations to any transaction of which all transfers occur on or after January 3, 2017.

### DETAILS

#### **General Rule under Section 707**

Section 707(a)(2)(B) generally provides that 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. Regulation Section 1.707-5 provides special rules related to the treatment of liabilities in a disguised sale.

### CONTACT

#### JULIE ROBINS

National Tax Office Managing Director  
512-391-3534 / jrobins@bdo.com

#### JEFFREY N. BILSKY

Partnerships Technical Practice Leader  
and National Tax Office Partner  
404-979-7193 / jbilsky@bdo.com

#### JOSEPH SCHLUETER

National Tax Office Managing Director  
612-367-3097 / jschlueter@bdo.com

#### REBECCA LODOVICO

National Tax Office Managing Director  
412-315-2484 / rlodovico@bdo.com

#### WILLIAM HODGES

National Tax Office Senior Manager  
404-942-2937 / whodges@bdo.com

#### KATIE PENDZICH

National Tax Office Senior Manager  
414-615-6782 / kpendzich@bdo.com

<sup>1</sup> REG-131186-17 also withdraws the related proposed regulations issued concurrently with these temporary regulations.

### Section 707 Temporary Regulations

T.D. 9788 contained temporary regulations Sections 1.707-5T and 1.707-9T (the "Section 707 Temporary Regulations"), which provide that 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>2</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 is based on the partner's share of partnership profits.<sup>3</sup> The Section 707 Temporary Regulations also provide that, for disguised sale purposes, if another partner bears economic risk of loss with respect to a liability, then no portion of that liability can be allocated to the contributing partner.<sup>4</sup> Therefore, if another partner guarantees the liability, the entire liability is allocated away from the cash-receiving partner under the Section 707 Temporary Regulations, even though a guarantee by the cash-receiving partner does not change the requirement to allocate the liability based on that partner's share of partnership profits.

The Section 707 Temporary Regulations were designed to restrict so-called leveraged partnership transactions, as the IRS believed taxpayers were using the disguised sale liability rules to avoid gain recognition on transactions that should have been properly treated as sales. The Section 707 Temporary Regulations were effective for any transaction with respect to which all transfers occur on or after January 3, 2017,<sup>5</sup> and were scheduled to expire on October 4, 2019.<sup>6</sup>

### New Proposed Regulations

On April 21, 2017, the President issued Executive Order 13789, "Executive Order on Identifying and Reducing Tax Regulatory Burdens" (82 FR 19317, April 26, 2017), which directed the Secretary to review all significant tax regulations issued on or after January 1, 2016.<sup>7</sup> As a result, these proposed regulations were issued recommending to withdraw Section 707 Temporary Regulations and to replace them with the regulations as in effect prior to the temporary regulations.<sup>8</sup>

The rules that were in effect prior to the enactment of the Section 707 Temporary Regulations treated recourse and nonrecourse liabilities differently for purposes of the Section 707 disguised sale rules. Under the prior Section 707 regulations, a partner's share of a nonrecourse liability was required to be allocated using the partner's share of partnership profits under regulation Section 1.752-3(a)(3), as was also required under the Section 707 Temporary Regulations. However, a partner's share of a recourse liability was equal to that partner's share of the liability under regulation Section 752-2 and was, therefore, allocated to the partner who bore the economic risk of loss for that liability. As such, a partner that had guaranteed or agreed to indemnify another partner or related party for an otherwise nonrecourse liability would be allocated that liability for purposes of the Section 707 disguised sale rules.

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

<sup>3</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:

- a. **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.
- b. **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.
- c. **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>4</sup> Section 1.707-5T(a)(2)(i).

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

<sup>6</sup> Section 1.707-5T(g).

<sup>7</sup> E. O. 13789 required the Secretary to take concrete action to alleviate the burdens of regulations that (i) impose an undue financial burden on U.S. taxpayers; (ii) add undue complexity to the Federal tax laws; or (iii) exceed the statutory authority of the IRS. Notice 2017-38 (2017-30 IRB 147 (July 24, 2017)) included the Section 707 Temporary Regulations in a list of eight regulations identified by the Secretary in the interim report as meeting at least one of the first two criteria specified in E.O. 13789. E.O. 13789 further directed the Secretary to submit to the President and publish in the Federal Register a report recommending specific actions to mitigate the burden imposed by regulations identified in the interim report. On October 16, 2017, the Secretary published this second report in the Federal Register (82 FR 48013), "Second Report to the President on Identifying and Reducing Tax Regulatory Burdens" (Second Report). The Second Report stated that, while the Treasury Department and the IRS believe that the Section 707 Temporary Regulations' novel approach to addressing disguised sale treatment merits further study, the Treasury Department and the IRS agree with commenters that such a change should be studied systematically. The second report further stated that the Treasury Department and the IRS therefore would consider whether the Section 707 Temporary Regulations should be removed and withdrawn, respectively, and the prior regulations reinstated.

<sup>8</sup> T.D. 9788 also contained rules concerning the treatment of "bottom dollar payment obligations." The proposed regulations do not propose withdrawing the bottom dollar payment obligations regulations as the Treasury and the IRS believe they should be retained because they believe they are needed to prevent abuses and do not meaningfully increase regulatory burdens for the taxpayers affected. The Treasury Department and the IRS have indicated that they will continue to consider these issues and have requested comments concerning these rules.

This allocation of recourse liabilities can have the effect of deferring gain by reducing the portion of the transaction treated as a disguised sale. These so-called leveraged partnership transactions have been used to defer gain in what would have otherwise been a sale transaction.

In the preamble to these proposed regulations, the Treasury Department and the IRS stated that they believe that the Temporary Regulations' novel approach (treating all liabilities as nonrecourse and allocating in accordance with Section 1.752-3(a)(3) for disguised sale purposes) merits further study.<sup>9</sup> In addition, in the preamble to the Section 707 Temporary Regulations, the IRS stated that they believed that this approach reflected the overall economic arrangements of the partners as, in most cases, a partnership will satisfy its liabilities with partnership profits, the partnership's assets do not become worthless, and the payment obligations of partners or related persons are not called upon. The Treasury Department and the IRS have indicated that they will continue to study this issue and requested comments on the approach that was adopted in the Section 707 Temporary Regulations.

## EFFECTIVE DATE

The amendments to regulation Section 1.707-5 are proposed to apply to any transaction with respect to which all transfers occur on or after thirty days following the date these regulations are published as final regulations in the Federal Register. However, the proposed regulations provide that a partnership and its partners may apply all the rules in these proposed regulations in lieu of the Section 707 Temporary Regulations to any transaction with respect to which all transfers occur on or after January 3, 2017.

## BDO INSIGHTS

- ▶ The Section 707 Temporary Regulations severely limited the ability of partners to use leveraged partnership transactions in order to defer gain on appreciated property contributed to a partnership.
- ▶ The repeal of the Section 707 Temporary Regulations means that leveraged partnership transactions are again a valid planning tool. Care should be taken in planning new transactions as the IRS and Treasury have indicated they are still reviewing the issue. Additionally, authorities such as *Canal Corp.*<sup>10</sup> and CCA 201324013 need to be considered when planning transactions. These authorities looked to the anti-abuse rules under regulation Section 1.752-2(j) to disregard indemnities in leveraged transactions.
- ▶ Partnerships that have had a disguised sale transaction with respect to which all transfers occurred on or after January 3, 2017, should review their transactions and see if a more favorable result could be obtained by applying these proposed regulations rather than the Section 707 Temporary Regulations.

<sup>9</sup> This approach was suggested by the New York State Bar Association in comments related to the proposed Section 707 regulations issued on January 30, 2014 [REG-119305-11]. The Treasury and the IRS adopted the approach in the Section 707 Temporary Regulations instead of in new proposed regulations which commentators have expressed concern that it denied taxpayers the ability to comment on the approach prior to the Section 707 Temporary Regulations being effective.

<sup>10</sup> 135 TC 199 (2010).

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, and advisory services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through more than 60 offices and over 550 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multi-national clients through a global network of 67,700 people working out of 1,400 offices across 158 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information please visit: [www.bdo.com](http://www.bdo.com).

Material discussed is meant to provide general information and should not be acted on without professional advice tailored to your needs.

© 2018 BDO USA, LLP. All rights reserved.