

Allocating Partnership Liabilities for Disguised Sales

Cross References

- REG-131186-17, June 19, 2018

The IRS has issued new proposed regulations for allocating partnership liabilities for disguised sale purposes. IRC section 707(a)(2)(B) generally provides that related transfers to and by a partnership that, when viewed together, are more 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. This type of transaction is referred to as a disguised sale. Proposed regulations were issued on January 30, 2014 to amend previous regulations under IRC section 707. Final and temporary regulations were then issued on October 5, 2016 that implemented a new rule concerning the allocation of liabilities for IRC section 707 purposes.

On April 21, 2017, the President issued an Executive Order on identifying and reducing tax regulatory burdens, which directed the IRS to review all significant tax regulations issued on or after January 1, 2016, and to take concrete action to alleviate the burdens of regulations that impose an undue financial burden on taxpayers, add undue complexity to the tax laws, or exceed the statutory authority of the IRS.

As a result of the Executive Order, the IRS is proposing to remove the IRC section 707 temporary regulations that were issued in 2016 and reinstate the prior regulations concerning the allocation of liabilities for disguised sale purposes.

Under the new proposed regulations (based upon the prior regulations), a partner's share of a partnership's recourse liability equals the partner's share of the liability under IRC section 752. A partnership liability is a recourse liability to the extent that the obligation is a recourse liability under Regulation section 1.752-1(a)(1). A partner's share of a partnership's nonrecourse liability is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under Regulation section 1.752-3(a)(3). A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a recourse liability under Regulation section 1.752-1(a)(2).

Author's Comment

The temporary regulations issued in 2016 contained a few extra rules in determining a partner's share of liabilities in a disguised sales transaction, thus making them a bit more complicated.

The new proposed regulations reinstates Examples 2, 3, 7, and 8 under Regulation section 1.707-5(f) of the prior regulations with additional language added to Example 3 to illustrate the application of these regulations:

Example 2

Partnership's assumption of recourse liability encumbering transferred property. Cory transfers property to a partnership. At the time of its transfer to the partnership, the property has a fair market value of \$10,000,000 and is subject to an \$8,000,000 liability that Cory incurred, immediately before transferring the property to the partnership, in order to finance other expenditures. Upon the transfer of the property to the partnership, the partnership assumed the liability encumbering that property. The partnership assumed this liability solely to acquire the property. Under IRC section 752 and the regulations, immediately after the partnership's assumption of the liability encumbering the property, the liability is a recourse liability of the partnership and Cory's share of that liability is \$7,000,000. Under the facts of this example, the liability encumbering the property is not a qualified liability. Accordingly, the partnership's assumption of the liability results in a transfer of consideration to Cory in connection with Cory's transfer of the property to the partnership in the amount of \$1,000,000 [the excess of the liability assumed by the partnership (\$8,000,000) over Cory's share of the liability immediately after the assumption (\$7,000,000)].

Example 3

Subsequent reduction of transferring partner's share of liability. The facts are the same as in Example 2. In addition, the property transferred to the partnership is a fully leased office building. The rental income from the property is sufficient to meet debt service, and the remaining term of the liability is ten years. It is anticipated that, three years after the partnership's assumption of the liability, Cory's share of the liability under IRC section 752 will be reduced to zero because of a shift in the allocation of partnership losses pursuant to the terms of the partnership agreement. Under the partnership agreement, this shift in the allocation of partnership losses is dependent solely on the passage of time. Under the regulations, if the reduction in Cory's share of the liability was anticipated at the time of Cory's transfer, was not subject to the entrepreneurial risks of partnership operations, and was part of a plan that has as one of its principal purposes minimizing the extent of sale treatment under Regulation section 1.707-3 (that is, a principal purpose of allocating a large percentage of losses to Cory in the first three years when losses were not likely to be realized was to minimize the extent to which Cory's transfer would be treated as part of a sale), Cory's share of the liability immediately after the assumption is treated as equal to Cory's reduced share.

Example 7

Partnership's assumptions of liabilities encumbering properties transferred pursuant to a plan.

Pursuant to a plan, Gloria and Helen transfer property 1 and property 2, respectively, to an existing partnership in exchange for interests in the partnership. At the time the properties are transferred to the partnership, property 1 has a fair market value of \$10,000 and an adjusted tax basis of \$6,000, and property 2 has a fair market value of \$10,000 and an adjusted tax basis of \$4,000. At the time properties 1 and 2 are transferred to the partnership, a \$6,000 nonrecourse liability (liability 1) is secured by property 1 and a \$7,000 recourse liability (liability 2) is secured by property 2. Properties 1 and 2 are transferred to the partnership, and the partnership takes subject to liability 1 and assumes liability 2. Gloria and Helen incurred liabilities 1 and 2 immediately prior to transferring properties 1 and 2 to the partnership and used the proceeds for personal expenditures. The liabilities are not qualified liabilities. Assume that Gloria and Helen are each allocated \$2,000 of liability 1 in accordance with Regulation section 1.707-5(a)(2)(ii) (which determines a partner's share of a nonrecourse liability). Assume further that Gloria's share of liability 2 is \$3,500 and Helen's share is \$0 in accordance with Regulation section 1.707-5(a)(2)(i) (which determines a partner's share of a recourse liability). Gloria and Helen transferred properties 1 and 2 to the partnership pursuant to a plan. Accordingly, the partnership's taking subject to liability 1 is treated as a transfer of only \$500 of consideration to Gloria [the amount by which liability 1 (\$6,000) exceeds Gloria's share of liabilities 1 and 2 (\$5,500)], and the partnership's assumption of liability 2 is treated as a transfer of only \$5,000 of consideration to Helen [the amount by which liability 2 (\$7,000) exceeds Helen's share of liabilities 1 and 2 (\$2,000)]. Gloria is treated under the rule in Regulation section 1.707-3 as having sold \$500 of the fair market value of property 1 in exchange for the partnership's taking subject to liability 1 and Helen is treated as having sold \$5,000 of the fair market value of property 2 in exchange for the assumption of liability 2.

Example 8

Partnership's assumption of liability pursuant to a plan to avoid sale treatment of partnership assumption of another liability. The facts are the same as in Example 7, except that:

- Helen transferred the proceeds of liability 2 to the partnership, and
- Helen incurred liability 2 in an attempt to reduce the extent to which the partnership's taking subject to liability 1 would be treated as a transfer of consideration to Gloria (and thereby reduce the portion of Gloria's transfer of property 1 to the partnership that would be treated as part of a sale).

Because the partnership assumed liability 2 with a principal purpose of reducing the extent to which the partnership's taking subject to liability 1 would be treated as a transfer of consideration to Gloria, liability 2 is ignored in applying the regulations of this section. Accordingly, the partnership's taking subject to liability 1 is treated as a transfer of \$4,000 of consideration to Gloria [the amount by which liability 1 (\$6,000) exceeds Gloria's share of liability 1 (\$2,000)]. On the other hand, the partnership's assumption of liability 2 is not treated as a transfer of any consideration to Helen because Helen's share of that liability equals \$7,000 as a result of Helen's transfer of \$7,000 in money to the partnership.