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Structuring Contributions of Appreciated Property to Partnerships: Avoiding Tax Recognition on Built-in Gain Assets

Navigating Allocation Challenges, the "Seven Year Rule" of Section 737, and New Debt Classification Regs

TUESDAY, DECEMBER 20, 2016

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Structuring Contributions of Appreciated Property to Partnerships: General Nonrecognition Rules; Current Tax Consequences

Strafford CLE
December 20, 2016

Joseph Mandarino
Smith, Gambrell & Russell, LLP

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Overview

1. General Nonrecognition Rules
2. Current Tax Consequences

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Transfers of Property – General Nonrecognition Rule

A. General Rule -- Section 721

B. Property Requirement

C. Assumption of Debt

D. Contribution to Investment Company

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General Rule – Section 721

- The formation of a partnership is generally a tax-free event.
- No gain or loss is recognized upon the contribution of property to a partnership in exchange for a partnership interest.
- There are a number of exceptions to this rule.
- Common exceptions: a transfer to an "investment company;" the assumption by the partnership of the contributing partner's debt; the contribution of services or items that are not treated as property.
- Typically, however, even taxable transfers are taxable only to the contributor and not to the entity

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Property Requirement

- Section 721 only applies to the transfer of property
- A transfer of services can be taxable, but there are numerous ways to address this as discussed above.
- The transfer of a right to use property (as distinguished from ownership of the property itself) is taxable.
- Common examples would be transfers of leaseholds or licenses that are treated as something short of ownership of the underlying property for tax purposes

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Assumption of Debt

- One of the most common instances in which a contribution is treated as taxable is when property is contributed that is subject to debt.
- In general, if the contributed property is subject to a liability at the time of contribution, and the liability is assumed by the partnership (either directly or indirectly), then the net amount by which the contributing partner is relieved is treated as a cash distribution to that partner.
- The first consequence is that the contributor's basis in his or her partnership interest is reduced by the amount of this deemed cash distribution.
- Secondly, the amount of the liability that is treated as assumed by the partnership is then allocated among all the partners and increases the tax basis of their partnership interests .
- Finally, if the amount of the deemed cash distribution exceeds the contributor's basis in his or her partnership interest, the difference is treated as taxable gain.

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Assumption of Debt – Ex. 1

- Smith and Jones form Newco, LLC. Jones contributes $300,000 in cash. Smith transfers raw land that he originally purchased for $400,000, but which now has a value of $1.1 million. The land is subject to a non-recourse loan of $1 million. Smith takes a 25% interest and Jones takes a 75% interest in Newco.
- Assume that under the applicable tax rules, the $1 million liability is allocated between the members 25%-75%. Accordingly, Smith's share of the liability is $250,000. As a result of this allocation of the debt, Smith is treated as receiving a deemed cash distribution equal to the amount by which the liability was reduced (i.e., $750,000).
- Assume that Smith's basis in the raw land is $400,000 and then adds the $250,000 of debt he is allocated, for a total basis in his LLC interest of $650,000. The deemed cash distribution of $750,000, however, reduces his basis to $0 and then triggers a gain of $100,000.

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Assumption of Debt – Ex. 2

- Same facts as Example 1, but Jones contributes only $100,000 in cash. Smith takes back a 50% interest in Newco and Jones takes back a 50% interest.

- Assume that under the applicable tax rules, the $1 million liability is allocated $500,000 to Smith and $500,000 to Jones. Smith, therefore, is treated as receiving a deemed cash distribution equal to the amount by which the liability was reduced (i.e., $1million less $500,000 = $500,000).

- Smith is treated as, initially, taking a $400,000 basis in his LLC interest and adds the allocated debt of $500,000 for a total of $900,000. The deemed cash distribution of $500,000 reduces his basis to $400,00. Because the deemed cash distribution in this instance is less than Smith's tax basis, no gain is triggered.

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Assumption of Debt

- One of the key issues in this type of transaction is how the liability will be allocated to the members. The tax regulations governing this are very complicated and there are techniques that can be used to allocate more of the debt back to the contributing partner. Because the amount of the deemed cash distribution is equal to the net reduction in liability, this is an important planning point.

- Note: The rules discussed above apply to all liabilities. This includes clear obligations like loans and accounts payable, but can also apply to certain contingent liabilities, claims, judgments, etc.

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Transfer to Investment Company

- Another exception to the general rule that contributions to a partnership are not taxable is that a transfer to an "investment company" is a taxable event.

- In general, the Code wants to discourage investors from diversifying risk by varying their investments without paying tax. One frequent technique was to contribute stock or other financial instruments to a large investment pool that included a variety of other positions and instruments. This would have the effect of diversifying risk without triggering any taxable gain on the contributed stock.

- To prevent this, Code section 721 provides that any appreciation inherent in property that is contributed to an "investment company" is immediately taxable after the contribution.

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Transfer to Investment Company

Example:

- Smith forms a tech company which goes public. Smith now holds $50 million in tech company stock, with a tax basis of $0. Smith would like to diversify her stock position and contributes the stock to a pool operated by an investment bank in exchange for a 1% interest. The balance of the pool's assets consist of shares represented in the DJIA and commercial paper. If the pool qualifies as an investment company, Smith has a $50 million tax gain.

- For these purposes, an "investment company" is generally defined as a partnership in which more than 80% of its assets are readily marketable stocks or securities which are held for investment.

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Current Tax Consequences

A. General Rule -- Section 704(c)
B. Aggregation
C. 704(c) Methods

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Section 704(c) Rules -- General

- Assume that Smith and Jones make equal contributions to Newco LLC. Smith contributes land worth $100, but with a basis of $40. Jones contributes cash in the amount of $100. Each takes back a 50% interest in Newco.

- Although they have each made contributions of equal value, the tax basis of each contribution is different.

- If Newco sold its assets the next day for $200, it would have gain of $60.

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Section 704(c) Rules -- General

- If the taxable gain were allocated 50/50, then Smith would be able to avoid a considerable tax bill by contributing his property to an LLC just before it was sold.

- This type of planning is not permitted.

- Code section 704(c) and the regulations under it contain a number of complicated rules that attempt to allocate gain from an appreciated asset back to the contributor.

- In the example above, all $60 of the gain would be allocated back to Smith, and none to Jones. This is because the 704(c) rules allocate income or loss to partner in order to take into account the difference at the time of contribution between the basis of contributed property and its fair market value.

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General Restriction – 704(c)

- Code Section 704(c)(1)(A):
- . . . income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution . . . .

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Application of 704(c) Rules

- These rules apply to (1) property contributed at the start of a partnership, (2) later contributions of appreciated property, and (3) later contributions of any property if the LLC already owns appreciated property.

- Thus, even there are no contributions of appreciated property at the outset of an LLC, if there is a subsequent contribution (i.e., a new member joins), and if the LLC's assets have appreciated by that time (i.e., the value of the LLC's assets is different from the tax basis of the LLC's assets), then the 704(c) rules will be needed to allocate the pre-contribution gain inherent in the LLC's assets back to the founders.

- Typically, a spreadsheet is used to maintain special accounts for LLC members whenever the 704(c) rules apply.

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704(c) Rules and Depreciation

- When the contributed property is depreciable or amortizable, another level of complications arise. Assume that Smith contributes a depreciable asset worth $100, but with a basis of $40. The asset is depreciated on a straight line basis over 10 years. Thus, the asset will generate tax deductions of $4 a year for ten years. If Smith's asset had a tax basis equal to its FMV, then it would general tax deductions of $10 a year for ten years.

- In the case of such deductions, the 704(c) rules require that depreciation deduction must be allocated to take into account the difference between the FMV of an asset and the tax basis of that asset.

- The difference between the actual $4 per year depreciation deduction and the "book" depreciation deduction of $10 per year must be reconciled.

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704(c) Rules and Depreciation

- Note that Jones would ordinarily be allocated half of any depreciation deduction. Therefore, but for the appreciation in Smith's contributed asset, Jones would be entitled to $5 in depreciation deductions a year for ten years. The 704(c) rules will require that all of the actual tax depreciation be allocated to Jones (i.e., the entire $4) in order to minimize the built-in-gain effect.

- Alternative approaches would be to allocate $1 in phantom income to Smith and $5 in depreciation ($1 phantom and $4 actual) to Jones.

- The net result is to minimize the possibility of shifting income or deductions, and to reduce the effect of built-in gain or loss.

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704(c) Amounts

- Section 704(c) only applies to built-in gain or built-in loss as of the date of contribution – the "704(c) layer"
- Section 704(c) is generally applied on a property-by-property basis
- Small disparities between FMV and basis can be ignored as de minimis
  - difference between the adjusted basis and FMV for all properties contributed by a partner is less than 15% of tax basis and the total gross disparity does not exceed $20,000

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704(c) Aggregation

- In some cases, contributed property can be aggregated and only the net 704(c) layer is subject to these rules. Treas. Reg. §1.704-3(e).
  - All depreciable property, other than real property can be aggregated, that is contributed by one partner in one taxable year of the partnership may be aggregated, but only if property so aggregated is included in the same general asset account.
  - Zero basis property may be aggregated, but only if the property is not real property.
  - Inventory items can be aggregated, but securities and similar investments, and inventory determined under a specific identification method cannot be aggregated. (BUT – special rules for "securities partnerships".)
  - Any other contributed items that the IRS permits to be aggregated. For example, in a 1996 PLR, the IRS permitted the aggregation of built-in gains on contributions of certain timber.

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704(c) Methods

- In order to allocate depreciation appropriately, the tax regulations require that a reasonable method be used.
- Three methods are set forth, each of which is deemed to be reasonable:
  - Traditional allocation method
  - Traditional method with curative allocations
  - Remedial allocation method
- Other methods are possible, but these are the most common

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704(c) Methods

- Different methods can be used for different properties provide it is reasonable.
- Generally can't change the method once started.
- If a partner subject to 704(c) sells his or her partnership interest, then a proportionate amount of 704(c) taints the buyer's interest (in the absence of a §754 election).

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Traditional Method – Income/Gain

- Same example as before: Smith and Jones make equal contributions to Newco LLC. Smith contributes land worth $100, but with a basis of $40. Jones contributes cash in the amount of $100. Each takes a 50% interest in Newco.
- Note that at the time of contribution, the land has a §704(c) layer of $60.
- Later, Newco sells the land for $300.
- Newco's gain on the sale is $260 --- i.e., amount received of $300 less tax basis of $40.
- The traditional method requires that the built-in gain amount at the time of contribution – the §704(c) layer – be allocated to Smith. The balance of the gain -- $200 – is split between the partners based on their 50/50 ownership of Newco.

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Traditional Method – Ceiling Rule

- Same example as before: Smith and Jones make equal contributions to Newco LLC. Smith contributes land worth $100, but with a basis of $40. Jones contributes cash in the amount of $100. Each takes a 50% interest in Newco.
- Later, Newco sells the land for $80 (i.e., it has decreased in value).
- The ceiling rule interacts with the traditional method to limit the allocation of the §704(c) layer.
- Specifically, here Newco's gain on the sale is $40 --- i.e., amount received of $80 less tax basis of $40.
- Because the total gain recognized by Newco is less than the 704(c) layer, all of it is allocated to Smith.

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Traditional Method – Ceiling Rule

- After the sale, Smith's tax basis in Newco is $80 ($40 contribution basis plus $40 of gain allocated from the sale of the land).
- Jones' outside basis is still $100.
- After the sale, Newco will have $80 of cash – Jones' contribution of $100 and $80 of sales proceeds from the land.
- If Newco liquidates, then $90 is distributed to Smith and $90 is distributed to Jones.
- Smith recognizes $10 ($90 distribution less $80 outside basis).
- Jones recognizes a loss of $10 ($90 distribution less $100 outside basis).
- Thus, in total, Smith recognizes $50 of gain, which reflects the fact that Smith received $90 on his investment, but started with a $40 basis.
- Jones has a $10 loss, reflecting the fact that he received $90 back on his investment of $100 of cash.

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Traditional Method – Depreciation

- As noted, §704(c) also applies to depreciation and other forms of cost recovery.
- Assume the facts from before: Smith contributes a depreciable asset worth $100, but with a basis of $40. The asset is depreciated on a straight line basis over 10 years. Thus, the asset will generate tax deductions of $4 a year for ten years. If Smith's asset had a tax basis equal to its FMV, then it would general tax deductions of $10 a year for ten years.
- Jones contributes cash of $100 and Smith and Jones share in the LLC on a 50/50 basis.

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Traditional Method – Depreciation

- As noted, Jones is entitled to half of any depreciation deduction.
- Thus, Jones would be entitled to $5 in depreciation deductions a year for ten years – that is, half of the $10 in annual depreciation that would otherwise be generated but for the fact that the asset was contributed with basis different than FMV.
- The traditional method would allocate all of the actual depreciation generated by Newco to Jones to the extent necessary to give him this $5 per year.
- However, in this example the ceiling rule comes into play.
- Thus, because Newco only generates $4 of depreciation for tax purposes, all of it must be allocated to Jones.

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Traditional Method – Depreciation

- Assume now that Newco uses the $100 of cash contributed by Jones to purchase another depreciable asset, which generates $4 of depreciation per year for 10 years.
- Now Newco has a total of $8 of depreciation that can be allocated each year.
- So can Newco allocate $5 to Jones and the balance ($3) to Smith?
- Our goal is to allocate $5 of depreciation to Jones on the first asset (the asset contributed by Smith) and half the depreciation on the new asset purchased by Newco. The new asset generates $4 of depreciation, so $2 would be allocated to Jones.
- Thus, a total of $7 is allocated to Jones and $1 to Smith. The ceiling rule does not trap us in this instance because there is enough depreciation to make up for the §704(c) limitation.

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Traditional Method with Curative Allocations

- The traditional method with curative allocations can be used to overcome problems caused by the ceiling rule.
- This method uses other income and loss items of the partnership to eliminate ceiling rule issues.
- Example: Smith contributes a depreciable asset worth $100, but with a basis of $40. The asset is depreciated on a straight line basis over 10 years. Thus, the asset will generate tax deductions of $4 a year for ten years. If Smith's asset had a tax basis equal to its FMV, then it would general tax deductions of $10 a year for ten years.

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Traditional Method with Curative Allocations

- Jones should be entitled to $5 in depreciation per year. But, due to the ceiling rule there is only $4 to allocate.
- Assume that Newco has $10 of income in the same year. Ordinarily, this would be split $5 to Jones and $5 to Smith.
- The traditional method with curative allocations permits Newco to allocate $6 of the income to Smith and $4 of the income to Jones.
- If Newco had $10 of depreciation and $10 of income, there would be zero net income and Jones and Smith would both be allocated zero.
- In this example Jones is allocate $4 of actual depreciation and $4 of income, for a net of zero. Smith is allocated $6 of income and zero depreciation, for a net of $6.

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Traditional Method with Curative Allocations

- In fact, Newco has a net income of $6, so this works out.
- Note that the key is to allocate items that are similar in character. Thus, Newco could allocate deductible expanses to Jones or ordinary income items.
- Assume, instead, that Newco had $10 of capital gain instead of ordinary income. In this case, the character does not match the depreciation, so curative allocations are not permitted.

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Remedial Method

- With the traditional method, Newco allocates actual amounts in order eliminate the §074(c) layer, but is limited by the ceiling rule.
- Under the traditional method with curative allocations, Newco shifts other items of similar character to eliminate the §704(c) layer.
- Both these methods use actual items. The remedial method equalizes the §704(c) layer by means of fictional allocations.

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Remedial Method

- Example: Smith contributes a depreciable asset worth $100, but with a basis of $40. The asset will generate tax deductions of $4 a year for ten years. If Smith's asset had a tax basis equal to its FMV, then it would general tax deductions of $10 a year for ten years.
- Assume not other items of income, gain, loss or deduction for Newco in the year other than the $4 of depreciation.
- In order to "fix" the §704(c) issue, Jones must be allocated $5 of depreciation, but only $4 is available.
- Solution: Allocate $4 of actual depreciation to Jones, $1 of "fictional" depreciation to Jones, and $1 of fictional income to Smith.

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Remedial Method

- In this fact pattern, the ceiling rule prevents the full allocation of $5 to Jones under the traditional method.
- And because there are no similar items to shift to Smith, the traditional method with curative allocations cannot fix the problem.
- The problem is fixed under the remedial method because Newco can create the missing depreciation and create offsetting income items for Smith.

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Summarizing the Methods

- From Smith's point of view, the traditional method is the best – there are no curative or fictional income allocations to Smith that could increase his tax bill.
- From Jones' point of view, the remedial method is the best because he in fact is allocated the depreciation that he expected.
- The choice of method is frequently negotiated ahead of time if there is a significant §704(c) asset that is contributed to a partnership.

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Cash Issues

- As noted, the parties will have frequently have quite different views on which method to use.
- Sometimes this disagreement can be bridged by means of tax distributions.
- Example: Smith does not want to agree to the remedial method because it will cause income inclusions over the life of Newco.
- Jones is adamant that unless Newco uses the remedial method he will not invest.
- Solution? If Newco's financial projections show liquidity, the parties could agree on tax distributions to cover Smith's remedial allocations.

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Thank You

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ALSTON & BIRD LLP

Structuring Contributions of Appreciated Property to Partnerships: Selected Basis and Distribution Issues

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Basis to Partner on Contribution

- The basis of the partner in a partnership interest acquired by contribution (commonly referred to as "outside" basis) equals the cash contributed plus the adjusted basis of the property contributed (plus any gain recognized on taxable contributions to "investment companies"). Code § 722.
- A partner has one overall basis in its partnership interest even if it holds interests in different "classes" or interests acquired at different times.

Holding Period in Partnership Interest

- *Tacking:* The holding period of the contributor in its partnership interest includes the holding period of the contributor in the property contributed, if the contributed property is a capital asset or "Section 1231" property. Code § 1223(1).
  - "Section 1231" property (sometimes called a "quasi-capital asset") is generally:
    - Depreciable property used in a trade or business, held for more than one year.
    - Real property used in a trade or business, held for more than one year.
- *No tacking*: If the partner contributes cash, non-capital assets, or non-Section 1231 assets, the holding period begins on the date of contribution.
- *Split holding period*: Although basis is unitary, holding period may be divided if:
  - Partner acquires interests at different times.
  - Partner contributes both "tacking" and "nontacking" property.

Example: Split Holding Period

- On Jan. 1, A makes a contribution to a partnership of:
  - $5,000 cash.
  - $10,000 fair market value raw land (with $5,000 basis and two-year holding period). So A had a $5,000 long-term capital gain built in to the land.

- A has a $10,000 basis in the partnership interest; her $5,000 built in gain in the land becomes $5,000 built in gain in the partnership interest.

- But A's holding period in the partnership is split:
  - 1/3 short-term (starting Jan. 1 on the contribution of the $5,000 cash)
  - 2/3 long-term (tacking the two-year holding period of the $10,000 worth of land).

Example: Split Holding Period (cont'd)

- On Dec. 1, A sells the interest for $15,000, and recognizes her $5,000 capital gain. No gain accrued while A held the partnership interest; all $5,000 of gain is attributable to the long-term capital gain built in to the land at the time of contribution.

- However, because A sold the partnership interest rather than the land, and had a short-term holding period in 1/3 of her partnership interest, 1/3 of the $5,000 gain is short-term gain.

- Economically, all the gain is long-term, but the partnership regulations recharacterize 1/3 of it as short-term (taxed at the same rate as ordinary income).

Tax Attributes to Partnership on Contribution

- The partnership's basis ("inside" basis) carries over from the contributor (plus any gain recognized on taxable contributions to "investment companies"). Code § 723.
- The partnership's holding period includes the holding period of the contributing partner. Code § 1223(2).
- If the partner contributes "unrealized receivables" (including depreciation recapture items) to the partnership, the partnership's gain or loss on disposition of the property is ordinary gain or loss. Code § 724(a), (d)(1).

Carryover/Tacking of Attributes Inside Partnership

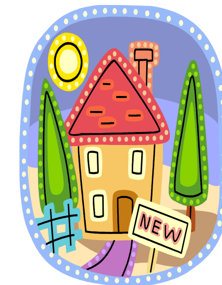
- If the partner contributes inventory items to the partnership, the partnership's gain or loss on disposition of the property is ordinary gain or loss if the disposition takes place within five years. Code § 724(b), (d)(2).
- If the partner contributes capital loss property to the partnership, the partnership's loss on disposition of the property is capital loss if the disposition takes place within five years (to the extent that the loss was built in to the property immediately before the contribution). Code § 724(c).

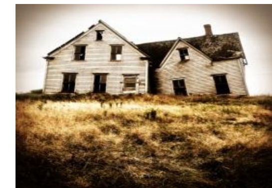
Property Contributions and Property Distributions

- Under Code § 704(c), if the partnership sells property that was contributed to the partnership, the gain that was built in at the time of the contribution is allocated to the partner (subject to possible "burn off" of the gain over time under Code § 704(c) principles).
- Under Code § 731, property distributions are generally tax-free.
- Can the allocation of built-in gain back to the contributor be deferred indefinitely by distributing:
  - The contributed property to another partner?
  - Other partnership property to the contributing partner?
- *Answer:* Yes, but only with great care and patience.
- The effect can be similar to a tax-free exchange of the contributed property for other property (without the limitations of Code § 1031).
- However, the anti-mixing bowl rules are a powerful weapon against such contribution/distribution transactions.

Mixing Bowl Example

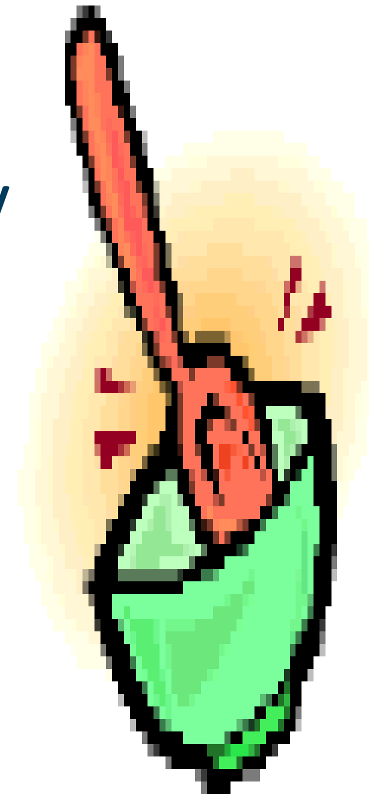
O:	Owner of appreciated property.
I:	Investor.
New Property:	Property that Investor contributes, or that is purchased with the cash that Investor contributes.
Old Property:	Appreciated property that Owner wants to contribute
Newco:	Newly formed LLC (or other business entity classified for tax purposes as a partnership)



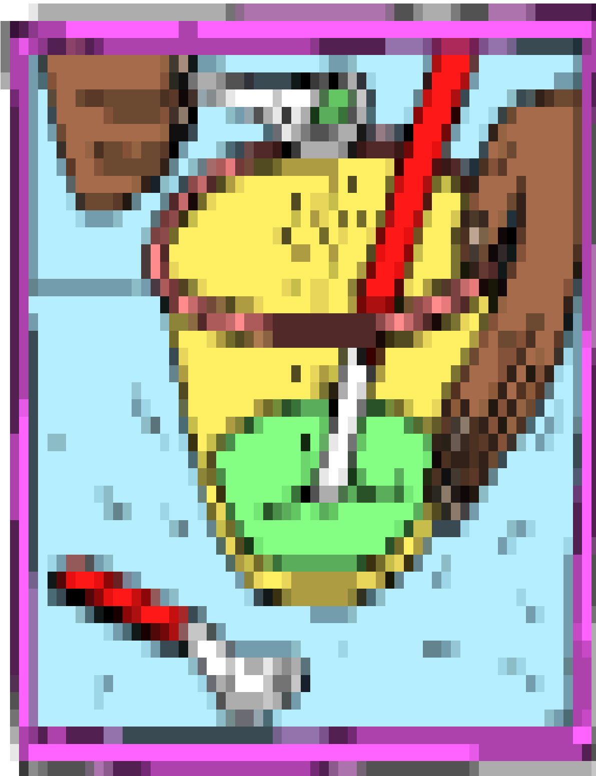


Mixing Bowl Example

- Owner contributes Old Property to Newco.
- Investor contributes either:
  - Cash to Newco, and Newco uses the cash to buy New Property, or
  - New Property to Newco.



Mixing Bowl Example



- Owner receives 90% of the income from New Property; Investor receives 90% of the income from Old Property.
- The effect is similar to a tax-free disposition of most of Owner's interest in Old Property, in exchange for most of the interests in New Property.

Mixing Bowl Example

O

90% in New Property; 10% in Old Property

I

10% in New Property; 90% in Old Property

Old Property

New Property/ Cash

NEWCO

How Long Is the Gain Deferred?

- Even if the mixing bowl partnership succeeds in deferring precontribution gain on Old Property (and deferral is not disallowed entirely under “disguised sale” or “anti-abuse” principles), the built-in precontribution gain in Old Property is not eliminated.
- Events that trigger precontribution gain:
  - Sale of the Old Property at ***any time*** (if Owner is still a member of Newco). *See* Code § 704(c)(1)(A).
  - Distribution of the Old Property to Investor within ***seven years*** of the contribution. *See* Code § 704(c)(1)(B).
  - Redemption of Owner within ***seven years*** of the contribution. *See* Code § 737.

Original Anti-Mixing Bowl Rule

- Old Property is contributed by Owner.
- ***Old Property is later distributed to Investor*.**
  - Contribution is generally tax-free.
  - Distribution is generally tax-free.
  - Has Owner transferred Old Property to Investor and paid no tax?
    - Maybe yes, if the parties can wait 7 years (and there was not a "disguised sale").
    - If the Old Property is distributed to the non-contributing partner (i.e., Investor) within 7 years, Owner recognizes precontribution gain. Code § 704(c)(1)(B).
    - *But after 7 years, the rule is inapplicable.*

Mixing Bowl Partnership: Day One

Note: "A" is added to the example so there will be at least two partners at all times.

O

I

A

New Property/ Cash

Basis: $0
Value: $100

NEWCO

Mixing Bowl Partnership: Old Property Distribution

O

I

A

NEWCO

Old Property/

Basis: $0
Value: $150

Original Anti-Mixing Bowl Rule

- Assume Old Property is distributed to Investor in complete liquidation of Investor's interest.
- If distributed in *Year 6*, Owner recognizes the precontribution gain (the full $100, assuming Old Property is not depreciable).
  - O's original deferral of gain ends.
  - O's basis in the Partnership increases by $100.
- If distributed in *Year 8*, Owner does not recognize gain.
  - Owner's gain continues to be deferred.
  - Owner's basis in the Partnership stays the same.
- In both cases:
  - Investor does not recognize gain.
  - No one recognizes the post-contribution appreciation in Old Property.

Back-Up Anti-Mixing Bowl Rule

- Old Property is contributed by Owner.
- ***New Property later distributed to Owner.***
  - Contribution is generally tax-free.
  - Distribution is generally tax-free.
  - Has Owner transferred Old Property to Investor and paid no tax?
    - Maybe yes, if parties can wait 7 years (and there was not a "disguised sale").
    - If the New Property is distributed to the contributing partner (i.e., Owner) within 7 years, Owner recognizes precontribution gain. Code § 737.
    - *But after 7 years, the rule is inapplicable.*

Mixing Bowl Partnership: Day One

O

I

A

Old Property

New Property/ Cash

NEWCO

Basis: $0
Value: $100

Mixing Bowl Partnership: New Property Distribution

O

I

A

New Property

NEWCO

Back-Up Anti-Mixing Bowl Rule

- Assume New Property is distributed to Owner in complete liquidation of Owner's interest.
- If distributed in *Year 6*, Owner recognizes the precontribution gain (the full $100, assuming Old Property is not depreciable).
  - Owner's original deferral of gain ends.
  - Owner's basis in the New Property increases by $100.
- If distributed in *Year 8*, Owner does not recognize gain.
  - Owner's gain continues to be deferred.
  - Owner's basis in the New Property is the same as Owner' basis in the Partnership.
- In both cases:
  - Investor does not recognize gain.
  - No one recognizes the post-contribution appreciation in Old Property.

Final Separation

- If the parties are able to remain together in Newco for more than seven years, it may be possible for Owner and Investor to go their separate ways without Owner recognizing its precontribution gain.
- If Owner or Investor is going to be redeemed for New Property, the value of the redeemed interest, and the value of the property used for the redemption, ideally should be determined *at the time of the redemption*.
- Although the parties planning an eventual separation may try to "lock in" the value at the time of the original contribution -- so that both parties know with some certainty what Owner or Investor will get when it leaves -- doing so adds greatly to the tax risks.

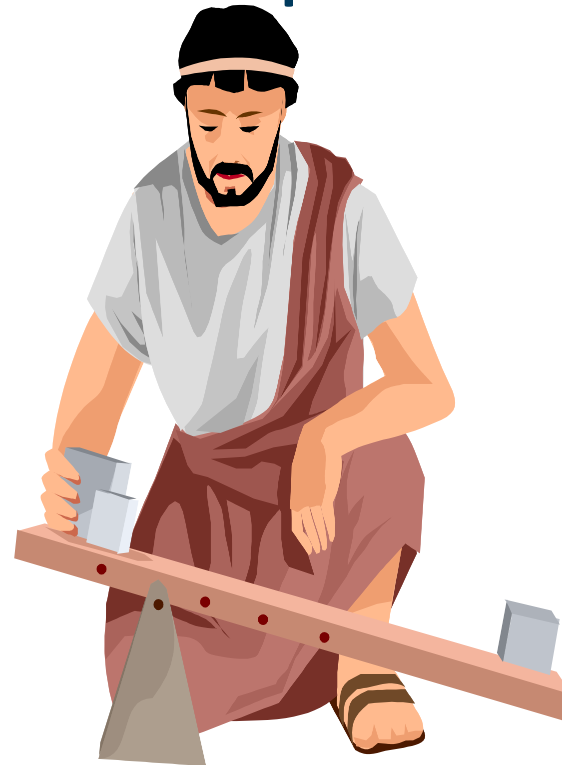
Disguised Sales and Debt Allocations: 2016 Regulations

- In October 2016 (and followed by a "correcting amendment" the next month), the IRS released a complex and controversial package of guidance reshaping the rules on partnership disguised sales and debt allocations. TD 9787 (final regulations); TD 9788 (temporary regulations); REG-122855-15 (reproposed regulations).
- Among other effects, the potential tax benefits of leveraged distributions are vastly reduced.
- The following simplified example of a leveraged distribution illustrates one key change produced by the new regulations.

Leveraged Distribution Example: First Step

First Step

- Owner contributes Old Property to Newco.
- Investor contributes either:
  - Cash to Newco, and Newco uses the cash to buy New Property, or
  - New Property to Newco.



Leveraged Distribution Example: First Step

O

I

10%

Old Property

90%

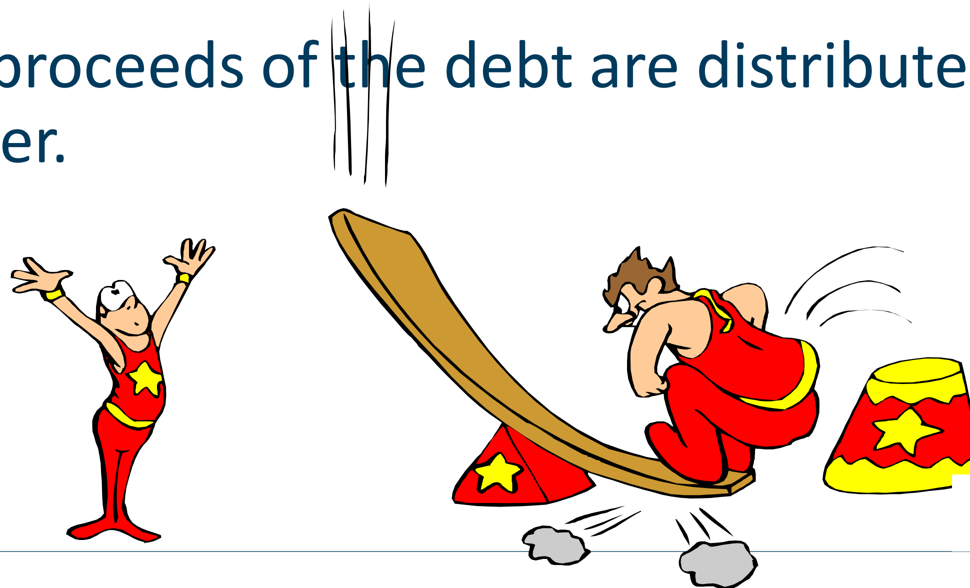
New Property/ Cash

NEWCO

Leveraged Distribution Example: Second Step

Second Step

- Newco borrows money from an unrelated third party on a nonrecourse basis.
- Owner guarantees the debt; consequently 100% of the debt is included in Owner's basis.
- The proceeds of the debt are distributed to Owner.



Leveraged Distribution Example: Second Step

O

I

10%

Debt Proceeds

Debt Guarantee

NEWCO

Loan

Third Party Lender

Are the Debt Proceeds Tax-Free to Owner?

- Old Regulations:
  - Leveraged distributions have been under severe attack under the old rules.
  - But if Owner was adequately capitalized (however that happened to be defined) the distribution might very well have been tax-free).
  - The guaranteed debt would generally be allocated to Owner both for purposes of basis (Code § 752) and disguised sale (Code § 707(a)(2)(B)).
  - A partner's share of a recourse liability for purposes of the disguised sale rules was the same as the partner's share of the recourse liability for basis purposes. Reg. § 1.707-5(a)(2)(i).
  - But a partner's share of a nonrecourse liability for disguised sale purposes was specially defined (but generally based on the partner's share of profits). Reg. § 1.707-5(a)(2)(ii).

Old Regulations (Effective Prior to Jan. 3, 2017)

Reg. § 1.707-5(a):

(2) Partner's share of liability. A partner's share of any liability of the partnership is determined under the following rules:

(i) Recourse liability. A partner's share of a recourse liability of the partnership equals the partner's share of the liability under the rules of section 752 and the regulations thereunder. A partnership liability is a recourse liability to the extent that the obligation is a recourse liability under § 1.752-1(a)(1) or would be treated as a recourse liability under that section if it were treated as a partnership liability for purposes of that section.

Old Regulations
(Effective Prior to Jan. 3, 2017)

Reg. § 1.707-5(a):

(ii) Nonrecourse liability. A partner's share of a nonrecourse liability of the partnership is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under § 1.752-3(a)(3). A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability under § 1.752-1(a)(2) or would be a nonrecourse liability of the partnership under § 1.752-1(a)(2) if it were treated as a partnership liability for purposes of that section.

Are the Debt Proceeds Tax-Free to Owner?

- New Regulations:
  - Bona fides of the guarantee, including capitalization of Owner, is irrelevant.
  - The guaranteed debt may still be allocated to Owner for purposes of basis (Code § 752).
  - However, for disguised sale purposes (Code § 707(a)(2)(B)), a partner's share of any debt is specially defined (but generally based on the partner's share of profits).
  - For this purpose, recourse debt and nonrecourse debt are treated alike.

New Regulations (Effective Jan. 3, 2017):

Reg. § 1.707-5T(a)(2)(i):

> In general. For purposes of § 1.707-5, a partner's share of a liability of a partnership, as defined in § 1.752-1(a) (whether a recourse liability or a nonrecourse liability) is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under § 1.752-3(a)(3) (as limited in its application to this paragraph (a)(2)), [but such share shall not exceed the partner's share of the partnership liability under section 752 and applicable regulations (as limited in the application of § 1.752-3(a)(3) to this paragraph (a)(2)].

- The bracketed language quoted above (sometimes referred to in discussions as "the proviso") reflects the "correcting amendment" promulgated shortly after the new regulations were initially released.

- Because Owner's share of profits is only 10%, only 10% of the debt is allocated to Owner for disguised sale purposes.
- The "proviso" should have no effect here.
  - If Owner's share of the recourse liability for basis purposes had been less than 10%, then for disguised sale purposes Owner's share of the debt would have been less than 10% as well.
  - However, for basis purposes Owner is presumably allocated 100% of the debt, so the proviso does not limit the amount of debt that can be allocated to owner for disguised sale purposes.
- 90% of the debt-financed distribution received by Owner will be treated as proceeds of a disguised sale of Old Property.

Thank You

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