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Unmasking disguised sales

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Learning objectives

1

Define key characteristics of a disguised sale under Section 707

2

Identify the implications of the proposed regulations on your partnership

Agenda

- 1 Disguised sales and exchanges - Background
- 2 Disguised sales and exchanges - Recent developments
- 3 Disguised sales and exchanges – Identifying potential disguised sale transactions

Disguised sales and exchanges - background

Poll 1

How many times have you encountered a disguised sale transaction?

- A. Never
- B. I've seen one once, long ago, in a transaction far away
- C. I generally see one or two a year
- D. These things are coming out of the woodwork



Disguised sales and exchanges - background

Historically, Subchapter K has generally allowed partners to contribute property and receive distributions without recognizing gain. (Sections 721 and 731)

- This flexibility presented an opportunity for abuse

A disguised sale of property is one of the most common exceptions to the nonrecognition treatment afforded upon the contribution of property to a partnership by a partner

What is or what could be a disguised sale?

- Transfer of property by a partner to a partnership and a corresponding transfer of cash or other property by a partnership to the partner
 - Includes certain situations in which a partnership assumes a partner's liabilities

Disguised sales and exchanges - background

Section 707(a)(2)(B)

- **Section 707(a)(1)** - Partner not acting in Capacity as Partner – In General - If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner
- **Section 707(a)(2)(B)** -- Treatment of Certain Property Transfers – If -
 - (i) there is a direct or indirect transfer of money or other property by a partner to a partnership,
 - (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and
 - (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated either as a transaction described in [Section 707(a)(1)] or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership

Disguised sales and exchanges - background

Section 707(a)(2)(B)

Reg. Sec. 1.707-3(b)(1) lays out a facts and circumstances based two-part test; a transfer of money and other property between a partner and partnership is treated as a sale if:

- One transfer would not have been made but for the other, and
- If transfers are not simultaneous, the later transfer is not dependent upon the entrepreneurial risks of partnership operations

2-year rebuttable presumptions (Reg. Sec. 1.707-3(c) & (d)):

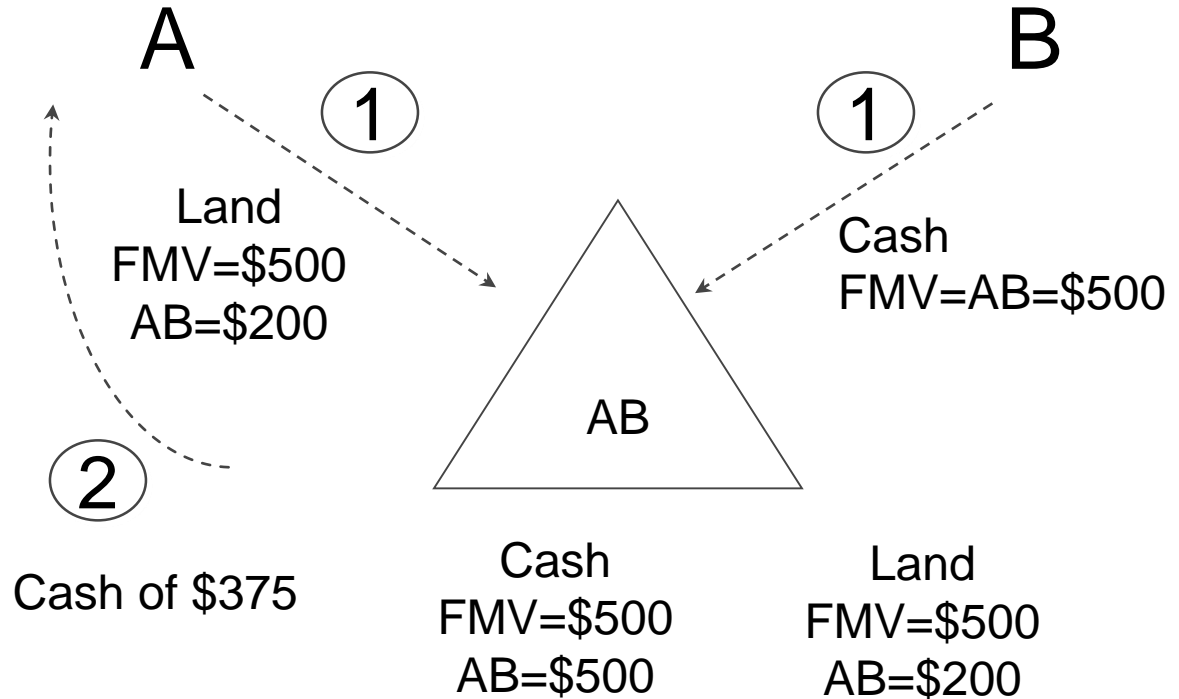
- Transfers made within 2 years of each other: presumed part of a sale
- Transfers made more than two years apart: presumed not to be part of a sale
- Presumptions can be rebutted only if the relevant facts and circumstances clearly establish the contrary

Disguised sales and exchanges - background

Section 707(a)(2)(B) - Example

After formation, AB distributes \$375 to A

A is potentially treated as selling 75% of the land to AB



Disguised sales and exchanges - background exceptions

Although many transfers between partnerships and partners can potentially fall under Section 707(a)(2)(B), Reg. Sec. 1.707-4 contains several **exceptions to disguised sale treatment**

Certain distributions from the partnership are presumed not to be part of a disguised sale:

- **Guaranteed payments and preferred returns** presumed not to be part of disguised sale if “reasonable”
 - Reasonableness measured by multiplying unreturned capital by safe harbor interest rate (150% of AFR)
- **Operating cash flow distributions** presumed not part of disguised sale if amount does not exceed partnership’s net operating cash flow for year; multiplied by lesser of partner’s percentage interest in overall partnership profits for year or for life of partnership

Disguised sales and exchanges - background exceptions (cont'd.)

Distributions from a partnership that are presumed not to be part of a disguised sale (cont'd):

Reimbursements of preformation capital expenditures – subject to certain limitations:

- Must be incurred in the 2-year period preceding the transfer to the partnership, and
- Must be incurred with respect to partnership organization and syndication costs OR be incurred with respect to the **property contributed**
 - If incurred with respect to property contributed, cannot exceed 20% of FMV, but the 20% limitation does not apply if the FMV of the contributed property does not exceed 120% of the partner's adjusted basis in the property (generally applied on a property by property basis)

Poll 2

Which one of the following is an exception to disguised sale treatment?

- A. Asset Contribution Unit Buybacks
- B. Partner Entertainment Expenditures Reimbursement
- C. Reimbursement of Preformation Capital Expenditures
- D. Guaranteed Partner Buyout Repayments



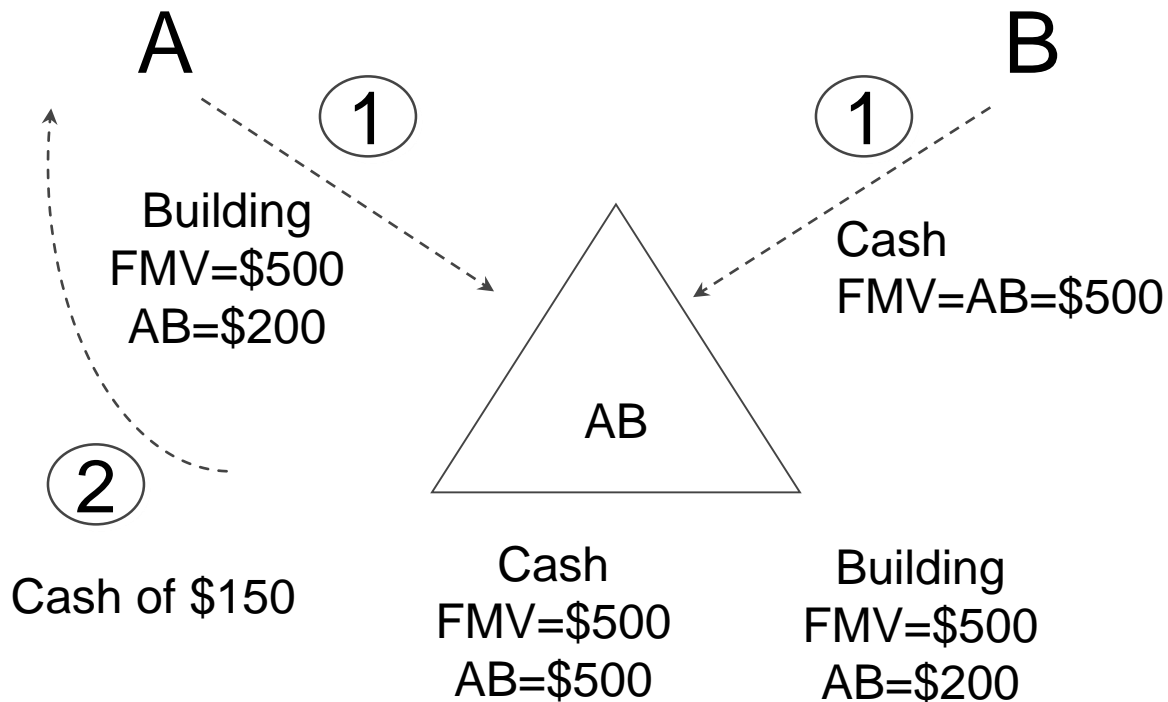
Disguised sales and exchanges - background preformation capital expenditure exception - example

In the 2 years prior to the transfer, A incurs \$150 of capital expenditures with respect to the building.

After formation, AB distributes \$150 to A

\$100 is shielded from disguised sale treatment

What if A's basis in the building is \$425?



Disguised sales and exchanges - background liabilities

Liabilities must be considered in the disguised sale analysis

- Under Reg. Sec. 1.707-5(a)(1), the disguised sale consequences depend on whether a liability is a "qualified liability"
- Relief of qualified liabilities generally is not considered sales proceeds
 - It does not matter if partnership pays the liability
 - **This rule applies only if the transaction isn't otherwise considered a disguised sale; there is a special rule for treating part of a qualified liability as part of a disguised sale where partner receives other disguised sale consideration**
- Relief of other liabilities (nonqualified liabilities) is considered sales proceeds to the extent that the amount of the liability exceeds the partner's share of the liability after the partnership assumes the liability

Disguised sales and exchanges - background qualified liabilities

Types of qualified liabilities (Reg. Sec. 1.707-5(a)(6)(i))

- **Old and cold:** Incurred more than 2 years prior and has encumbered property during 2-year period before transfer
- **Not in anticipation:** Incurred within 2 years, was not incurred in anticipation of transfer and has continuously encumbered property (requires disclosure)
- **Capital expenditure:** Traced to contributed property under Temp. Reg. section 1.163-8T
- **Ordinary course:** Incurred in ordinary course of trade or business and all material assets of the trade or business are transferred
- **Connected with a trade or business:** Not incurred in anticipation of transfer and incurred in connection with the trade or business transferred and all material assets of the trade or business are transferred (requires disclosure)

Disguised Sales and Exchanges - Background

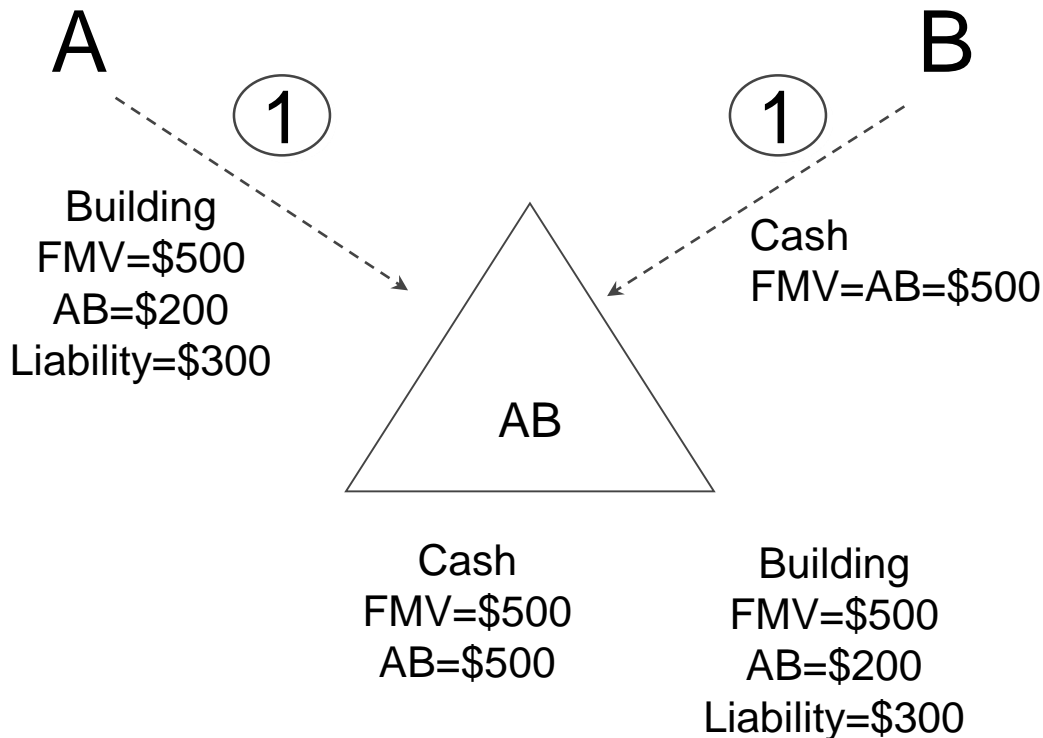
Qualified vs. Nonqualified Liabilities - Example

A transfers property subject to a \$300 liability to AB. After the transfer, A's share of the liability is \$150.

If the liability is a qualified liability, no disguised sale results.

If the liability is a nonqualified liability, A may have \$150 of disguised sale proceeds.

What if only \$150 of the total liability is a qualified liability?



Disguised sales and exchanges - background debt financed distributions

Under Reg. Sec. 1.707-5(b), if a partner receives a **debt financed distribution** from a partnership, the distribution is subject to recharacterization as part of a sale only to the extent it **exceeds** an allocable portion of **the partner's share of the liability** that is used to fund the distribution. This rule applies if:

- All or a portion of the proceeds of the liability are allocable to the transfer of money or other consideration to the partner under Temp. Reg. Sec. 1.163-8T, and
- The transfer is made within ninety days of the date the liability is incurred.

So if a partner receives a debt financed distribution and all of the debt is allocable to the distribution AND all of the debt is allocated to the distributee partner, then the partner is not treated as receiving any disguised sale consideration

- The debt financed distribution rule is applied before any of the other exceptions to disguised sale treatment

Disguised sales and exchanges - background allocation of liabilities

In order to evaluate the impact of a partnership's assumption of a partner's liabilities, it is necessary to determine the partner's post-transfer share of the assumed liabilities

Prior to October 5, 2016, Reg. Sec. 1.707-5(a)(2) provided separate approaches for determining a partner's share of recourse and nonrecourse liabilities for the disguised sale rules

- Recourse liabilities: generally equal to the amount determined pursuant to the general liability allocation rules under Section 752
- Nonrecourse liabilities: computed using the percentage used to determine the partner's share of excess nonrecourse liabilities under Reg. Sec. 1.752-3(a)(3); generally a partner's interest in partnership profits

Because the disguised sale rules only potentially treat a net decrease in a partner's share of partnership liabilities as disguised sale proceeds, **partners that were allocated recourse liabilities under Section 752 were effectively shielded from the disguised sale rules**

Disguised sales and exchanges - background

2016 temporary regulations

On October 5, 2016, the Treasury Department and the IRS issued final and temporary regulations implementing new rules that adopted an approach that required partners to treat all partnership liabilities as nonrecourse liabilities for disguised sale purposes, i.e., allocated solely in accordance with the partner's share of partnership profits

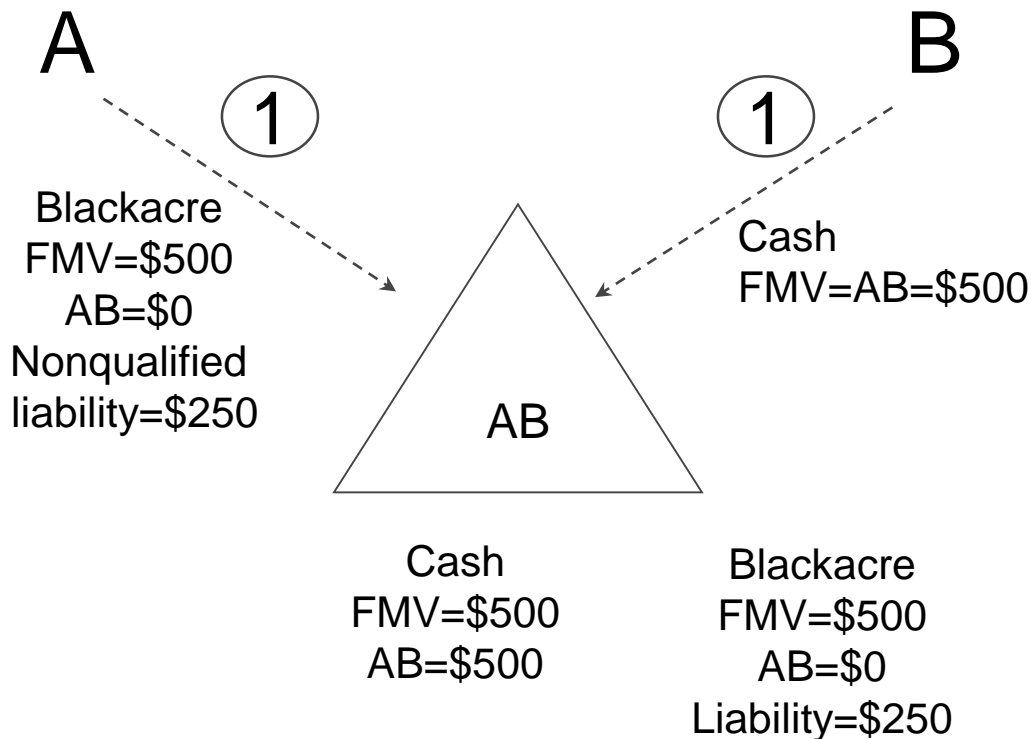
- Under a correction to T.D. 9788 that was published in November 2016, the partner's share of partnership liabilities for this purpose could not exceed the partner's share of the partnership's liabilities under the general rules of Section 752 and the applicable regulations

The temporary regulations made it far more likely that a partnership's assumption of a partner's recourse liability would result in a disguised sale

The 2016 regulations were among eight regulations that the IRS recognized as burdensome and identified for potential removal in response to President Trump's Executive Order 13789, which called for the review of all significant tax regulations issued after January 1, 2016

Disguised sales and exchanges - background allocation of liabilities - example

A transfers Blackacre subject to a \$250 liability to ABC in exchange for a 10% interest in the profits of ABC. A also guarantees the liability encumbering Blackacre.



Disguised sales and exchanges - background allocation of liabilities – example (Cont'd.)

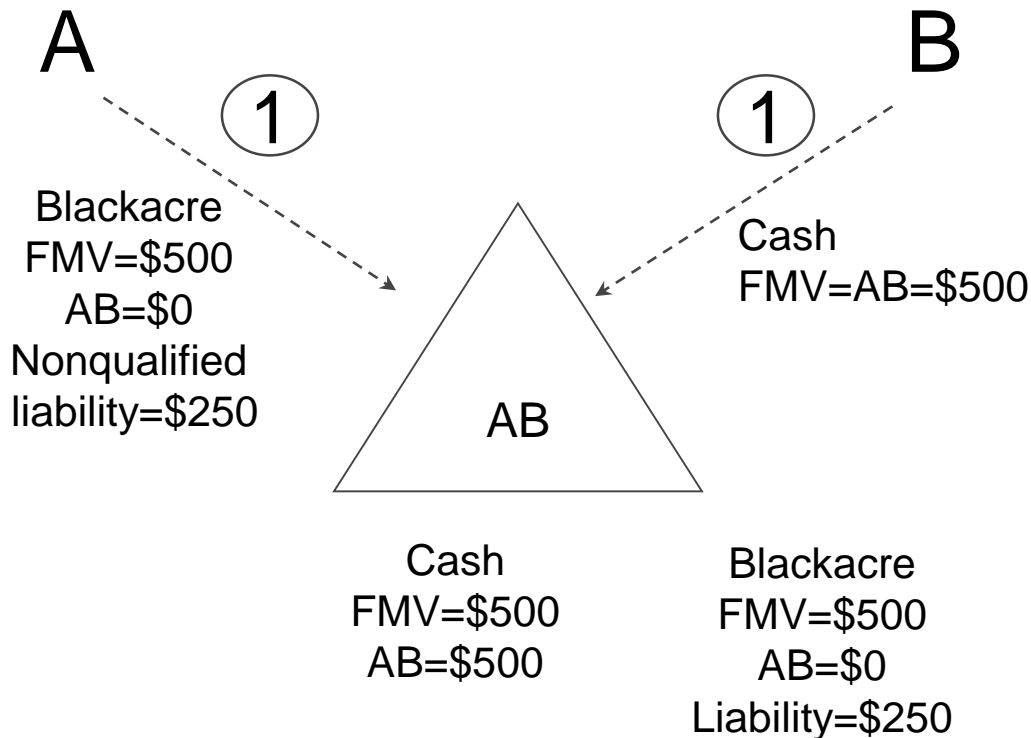
Under the prior regulations, A is allocated the full \$250 liability

- No disguised sale proceeds from transfer of the nonqualified liability

Under the 2016 temporary regulations, A is only allocated \$25 of the liability

- \$225 of potential disguised sale proceeds from transfer of nonqualified liability
- This result is proposed to change as discussed next

The results are the same if A contributes Blackacre to AB unencumbered, then AB borrows \$250 and distributes the proceeds to A



Disguised sales and exchanges - recent developments

Disguised sales and exchanges - recent developments

2018 proposed regulations

On June 19, 2018, the IRS issued proposed regulations that would remove the liability allocation approach for disguised sales contained in the 2016 temporary regulations and reinstate the liability allocation rules contained in the final regulations prior to the 2016 temporary regulations

- The proposed regulations would apply to any transaction that occurs 30 days after the proposed regulations are finalized

However, the IRS provides that a partnership and its partners may apply all the rules in the proposed regulations in lieu of the 2016 regulations to any transaction with respect to which all transfers occur on or after January 3, 2017

- **Thus, partnerships are effectively not required to use the approach that was set forth in the 2016 regulations**

Poll 3

As of August 14, 2018, is the classification of a liability as recourse vs. nonrecourse considered in determining the partner's share of liabilities for disguised sale purposes.

A. Yes

B. No

C. It was, then it wasn't, then maybe, then... not quite sure.



Disguised sales and exchanges – identifying potential disguised sale transactions

Disguised sales and exchanges – summary

- Disguised sales can arise from a variety of transactions and, without proper planning, can result in unpleasant surprises from an economic or tax perspective following the transaction!
 - Not limited to contributions of property/distribution of cash – **Watch out for shifts in liabilities!**
- Once a potential disguised sale transaction has been identified, taxpayers need to evaluate and document the various exceptions to disguised sale treatment that may apply.
- Proactive modeling can provide transparency of the desired transaction(s) to partnership investors, planners, and other involved parties to determine the most favorable tax consequences.

Disguised sales and exchanges – identifying potential disguised sale transactions

Common disguised sale triggers:

1. A partner's contribution of property to a partnership and the partnership's distribution of cash or other consideration to that partner within 2 years.
2. A partnership's distribution of property to a partner and the partner's contribution of cash or other consideration to the partnership within 2 years.
3. Contribution is subject to liabilities
4. Leveraged distribution (exchange of liabilities)
5. Partnership mergers with liability assumptions
6. Partnership divisions
7. Partnership forms applying the Revenue Ruling 99-5, Situation 2 analysis, including partnerships formed through S Corporation F Reorganization
8. Corporate conversions to partnership

Disguised sales and exchanges – identifying potential disguised sale transactions

Who should be on the lookout for potential disguised sales?

1. Partnerships considering distributions and contributions within a 2-year period
2. Partnerships considering mergers and/or divisions
3. Partnerships considering redemptions following a contribution
4. Partnerships considering debt financed distributions as part of a desired transaction(s)
5. Partnerships considering formation by applying Revenue Ruling 99-5, Situation 2 analysis, including partnerships formed through S Corporation F Reorganization
6. Corporations considering a conversion to a partnership

Poll 4

Do you feel comfortable you could identify a situation in which the disguised sale rules might be implicated after this training?

- A. Yes; best training ever
- B. Not quite; I'd like to review some additional resources
- C. No; but the training was great
- D. No; we have advisors to catch these issues



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