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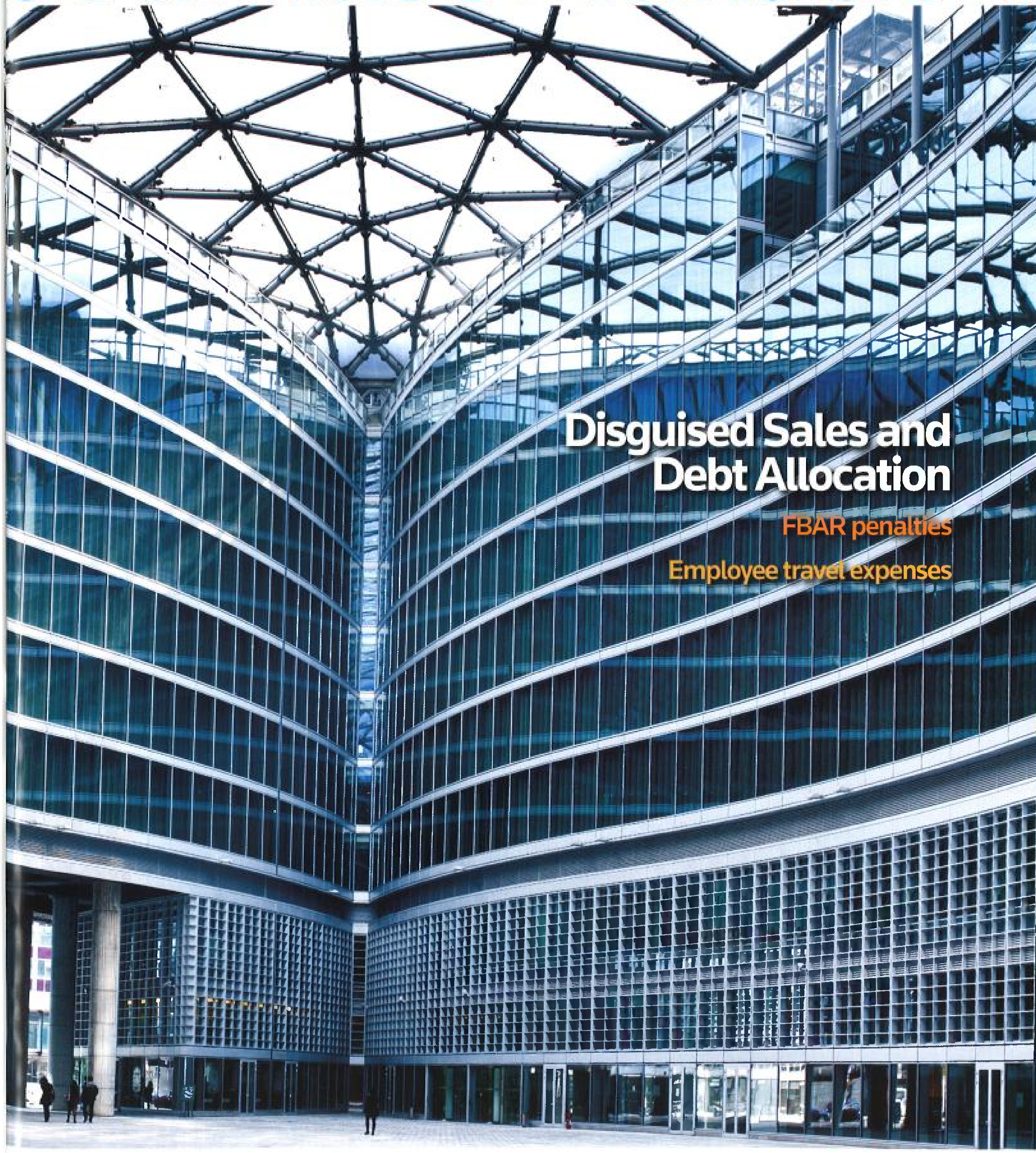

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New Regulations on Partnership Debt and Disguised Sales: Is the Road to Hell Paved with Good Intentions? (Part 2)

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The 2016 Temporary Regulations, which address bottom-dollar guarantees and debt allocation, are seriously flawed, and their adoption on a temporary basis appears to violate IRS authority, so challenges to their validity are certain.

This is the second part of a two-part article addressing the recently-issued final, temporary, and proposed regulations concerning the allocation of partnership debt and disguised sales. The first part of this article, which addressed the Disguised Sale Final Regulations and the 2016 Proposed Debt Regulations, appeared in last month's issue of the Journal. This second part of the article will focus on the 2016 Temporary Regulations addressing so-called bottom-dollar guarantees (BDGs) and the allocation of debt for disguised sale purposes. These regulations, which are effective immediately, raise multiple levels of problems.

BACKGROUND

Prior to the issuance of the 2016 Temporary Regulations, the regulations concerning allocation of partnership debt for tax purposes followed Congress's basic mandate, issued in response to the Federal Circuit's decision in *Raphan*, 759 F.2d 879, 55 AFTR2d 85-1154 (CA-F.C., 1985) that debt should be allocated by a partnership to the partner(s) who bear the economic risk of loss (EROL) with respect to such debt. Specifically, Reg. 1.752-2 provided that a partner's share of a recourse partnership liability equals the portion of the liability, if any, for which the partner or related person bears the EROL. A partner generally bears the EROL for a partnership liability to the extent the partner, or a related person, would be obligated to make a payment if the partnership's assets were worthless and the liability became due and payable. Subject to an anti-abuse rule and the disregarded entity net value requirement of Reg. 1.752-2(k), Reg. 1.752-2(b)(6) assumes that all partners and related persons will actually satisfy their payment obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.

Thus, for purposes of allocating partnership liabilities, Reg. 1.752-2 adopts an ultimate liability test under a worst-case scenario. Under this test, the regulations generally would allocate an otherwise nonrecourse liability of the partnership to a partner that guarantees the liability even if the lender and the partnership reasonably anticipate that the partnership will be able to satisfy the liability with either partnership profits or capital.

The rules concerning debt allocation within a partnership were mirrored on the rules concerning whether a debt-financed distribution by a partnership gave rise to a disguised sale. Reg. 1.707-3 generally provided that a transfer of property by a partner to a partnership followed by a transfer of money or other consideration from the partnership to the partner will 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 the property. In the case of non-simultaneous transfers, a subsequent transfer of money or other consideration not dependent on the entrepreneurial risks of the partnership operations is treated as a sale. Notwithstanding this general rule, the existing regulations provide several exceptions.

One such exception, in Reg. 1.707-5(b), generally provided that a distribution of money to a partner is not taken into account for purposes of Reg. 1.707-3 to the extent the distribution is traceable to a partnership borrowing and the amount of the distribution does not exceed the partner's allocable share of the liability incurred to fund the distribution. For purposes of applying these rules, the determination of whether a partnership debt was to be treated as a recourse liability to a partner was made using the same rules that applied under Section 752, i.e., the debt was allocated to the partner who bore the risk of loss if the partnership's assets became totally worthless.

REASONS FOR CHANGE

The 2016 Temporary Regulations are aimed at two types of transactions that the IRS did not like and labelled "abusive," even though such transactions were clearly appropriate under settled partnership tax principles. First, with respect to disguised sales, the IRS expressed its dislike for so-called "leveraged partnerships" in which a partnership borrows money to make a debt-financed distribution to its partners. The IRS stated that the regulations were "abused through leveraged partnership transactions in which the contributing partners or related persons enter into payment obligations that are not commercial solely to achieve an allocation of the partnership liability to the partner, with the objective of avoiding a disguised sale."[1] Amusingly, the IRS supported this argument by referring to *Canal Corp.*, 135 TC 199 (2010), in which the Tax Court used the then-existing anti-abuse rules to thwart an attempt to allocate liabilities which, arguably, lacked sufficient economic reality. Ironically, the IRS justified its attack on its existing regulations by pointing to a case concluding that the regulations worked!

The IRS recognized in the preamble to the 2016 Temporary Regulations that its approach to liabilities for purposes of the disguised sale rules, which is discussed in more detail below, lacked any direct support in the Code and appeared to be contrary to the statutory rules found in Section 752. To address these concerns, the IRS contends that Congress had focused solely on Section 752 when it passed legislation requiring debt to be allocated to a partner who bears the EROL with respect to that debt. The IRS attempts to create this distinction in order to justify providing different rules for allocating liabilities within other sections of subchapter K. In other words, even though Congress had enacted specific legislation concerning debt allocation for partnerships, the drafters of the 2016 Temporary Regulations somehow convinced themselves that such rules were inapplicable to another provision of the Code which was enacted after Congress had laid out the framework for the manner in which liabilities are to be allocated. This contravenes the expected-meaning canon regarding related statutes. "Statutes *in pari materia* are to be interpreted together, as though they were one law...Hence laws dealing with the same subject–being *in pari materia* (translated as "in a like matter")—should if possible be interpreted harmoniously."[2] The Supreme Court has made it clear: "We generally presume that Congress is knowledgeable about existing law pertinent to the legislation it enacts."[3]

The rules concerning debt allocation vis-à-vis potential disguised sales in the 2016 Temporary Regulations, and especially the rules concerning BDGs, directly flout Congress's mandate. Specifically, the IRS stated in the Preamble to the 2016 Temporary Regulations that it remained concerned that partners and persons related to partners were able to enter into payment obligations that are not commercial solely to achieve an allocation of a partnership liability. The IRS recognized in its discussion of the allocation of liabilities for disguised sale purposes that Congress had mandated that liabilities must be allocated to the partner who bears the EROL, but the IRS concluded in the 2016 Temporary Regulations that with respect to certain guarantees, the potential EROL to a partner should be disregarded, even if the liability incurred by the partner was real.

THE 2016 TEMPORARY REGULATIONS

The 2016 Temporary Regulations significantly alter rules on allocation of partnership liabilities under Section

1 TD 9788, 10/5/16.

2 Scalia and Garner, *Reading Law: The Interpretation of Legal Texts* (West, 2012), p. 252.

3 *Goodyear Atomic Corp. v. Miller*, 486 U.S. 174, 184-185 (1988) (per Marshall, J.).

752 and on disguised sales of property to or by a partnership under Section 707. Together, these rules function to defer taxation when monetizing assets using a partnership. The 2016 Temporary Regulations, however, have a substantial impact on bottom-dollar guarantees and partnership debt allocations and do so in a flawed manner.

Bottom Dollar Guarantees

As noted above, under the prior regulations, debt had to be allocated to a partner who bore the EROL with respect to a liability, assuming that all of the assets of a partnership were worthless. The 2016 Temporary Regulations essentially turn this rule upside down, and provide that a payment obligation with respect to a liability is *not* recognized under the new rules for BDGs. This rule is a sweeping one, because all payment obligations are treated as BDGs unless the obligation satisfies one of three requirements.

Specifically, Temp. Reg. 1.752-2T(b)(3)(ii)(a) provides that a bottom dollar payment obligation is not recognized as a payment obligation for purposes of determining whether a partner has the EROL with respect to a partnership liability. Under Temp. Reg. 1.752-2T(b)(3)(ii)(C)(1), a bottom dollar payment obligation is every payment obligation except:

1. A payment obligation in which the partner or a related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, *any* amount of the partnership liability is not otherwise satisfied.
2. A payment obligation in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if and to the extent that *any* amount of the indemnitee's or benefit partner's obligation is satisfied.

In other words, a partner's or related person's liability is recognized for purposes of Section 752 only if the partner or related person would be required to pay every dollar lost by the lender, subject to the two exceptions below.

The first exception to this general rule is contained in Temp. Reg. 1.752-2T(b)(3)(ii)(B), which creates a de minimis exception (the "90% Exception"). Under this exception, if a partner has a non-bottom dollar payment obligation to a lender except for an indemnity, reimbursement agreement, or similar agreement, the obligation is not treated as a bottom dollar payment obligation if the partner or related person is liable for at least 90% of the partner's initial payment obligation. Thus, a lender could agree that a partner is required to pay only 90% of the amount otherwise due and not cause a shift of the liability.

Second, the 2016 Temporary Regulations permit a partner to guarantee a "vertical slice" of a liability. Specifically, under Temp. Reg. 1.752-2T(b)(3)(ii)(C)(2), a payment obligation is not a bottom dollar payment obligation merely because a maximum amount is placed on the partner's or related person's payment obligation, a partner's or related person's payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such payment obligation relates, or there is a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.

For example, assume that partnership ABCD borrows $1 million, and partner A wants to be certain that A is allocated 50% of the liability, even though A is only a 25% partner in the partnership. If A were to provide a guarantee of 50% of any loss incurred by the lender, this would be a "vertical slice," which is recognized under these rules, provided that it applies to the first dollar lost by the lender (subject to the de minimis rule mentioned above). A would be on the hook for half of that first dollar lost. Alternatively, A could provide a full 100% guarantee, which is limited to $500,000. This would also not be a bottom dollar payment obligation, but it would expose A to all of the risk of loss on the first dollars lost by the lender. It is not entirely clear, but it does appear that A could provide both a guarantee of 50% of the liability and limit the total guarantee to $300,000. Although this would not be a complete "vertical slice" of the entire liability, A still bears EROL that appears to be recognized under these rules.

An example provided in the 2016 Temporary Regulations illustrates the basic premises of these rules:

> Example 10. <u>Guarantee of first and last dollars.</u> (i) A, B, and C are equal members of a limited liability company, ABC, that is treated as a partnership for federal tax purposes. ABC borrows $1,000 from Bank. A guarantees payment of up to $300 of the ABC liability if any amount of the full $1,000 liability is not recovered by Bank. B guarantees payment of up to $200, but only if the Bank otherwise recovers less than $200. Both A and B waive their rights of contribution against each other.
>
> (ii) Because A is obligated to pay up to $300 if, and to the extent that, any amount of the $1,000 partnership liability is not recovered by Bank, A's guarantee is not a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section. Therefore, A's payment obligation is recognized under paragraph (b)(3) of this section. The amount of A's economic risk of loss under § 1.752-2(b)(1) is $300.
>
> (iii) Because B is obligated to pay up to $200 only if and to the extent that the Bank otherwise recovers less than $200 of the $1,000 partnership liability, B's guarantee is a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section and, therefore, is not recognized under paragraph (b)(3)(ii)(A) of this section. Accordingly, B bears no economic risk of loss under § 1.752- 2(b)(1) for ABC's liability.
>
> (iv) In sum, $300 of ABC's liability is allocated to A under § 1.752-2(a), and the remaining $700 liability is allocated to A, B, and C under § 1.752-3.

A special rule is provided in the 2016 Temporary Regulations with respect to indemnities and reimbursement obligations in Temp. Reg. 1.752-

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2T(b)(3)(iii). Under this rule, an indemnity, reimbursement agreement or similar arrangement will be recognized only if, before taking into account the indemnity, reimbursement agreement, or similar arrangement, the indemnitee's or other benefited party's payment obligation is recognized and not treated as a bottom dollar payment obligation. This limitation is also illustrated with a simple example:

> Example 11. Indemnification of guarantees. (i) The facts are the same as in Example 10, except that, in addition, C agrees to indemnify A up to $100 that A pays with respect to its guarantee and agrees to indemnify B fully with respect to its guarantee.
>
> (ii) The determination of whether C's indemnity is recognized under paragraph (b)(3) of this section is made without regard to whether C's indemnity itself causes A's guarantee not to be recognized. Because A's obligation would be recognized but for the effect of C's indemnity and C is obligated to pay A up to the full amount of C's indemnity if A pays any amount on its guarantee of ABC's liability, C's indemnity of A's guarantee is not a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section and, therefore, is recognized under paragraph (b)(3) of this section. The amount of C's economic risk of loss under § 1.752-2(b)(1) for its indemnity of A's guarantee is $100.
>
> (iii) Because C's indemnity is recognized under paragraph (b)(3) of this section, A is treated as liable for $200 only to the extent any amount beyond $100 of the partnership liability is not satisfied. Thus, A is not liable if, and to the extent, any amount of the partnership liability is not otherwise satisfied, and the exception in paragraph (b)(3)(ii)(B) of this section does not apply. As a result, A's guarantee is a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section and is not recognized under paragraph (b)(3)(ii)(A) of this section. Therefore, A bears no economic risk of loss under § 1.752-2(b)(1) for ABC's liability.
>
> (iv) Because B's obligation is not recognized under paragraph (b)(3)(ii) of this section independent of C's indemnity of B's guarantee, C's indemnity is not recognized under paragraph (b)(3)(iii) of this section. Therefore, C bears no economic risk of loss under § 1.752-2(b)(1) for its indemnity of B's guarantee.
>
> (v) In sum, $100 of ABC's liability is allocated to C under § 1.752-2(a) and the remaining $900 liability is allocated to A, B, and C under § 1.752-3.

The above example illustrates how the construct of these rules can easily result in an illogical outcome. In Example 10, A's $300 of EROL is recognized, but it is completely ignored under these rules in Example 11 as a result of another partner taking the first $100 of A's risk. You would have thought that the result is that A and C would split the $300 top dollar EROL, $200 allocated to A and $100 allocated to C. However, even though two partners in the aggregate make a $300 top dollar guarantee, which would be respected if made by one partner, this example concludes that $200 of such EROL is instead completely ignored for debt allocation purposes. This is the wrong result!

The IRS recognized that the broad definition of a bottom dollar payment obligation would make it easy (indeed, simple) for a partnership to cause a liability to be treated as nonrecourse for tax purposes in situations in which a partner or related person bore real EROL. To address this possibility, the IRS included in the 2016 Temporary Regulations a "heads we win, tails you lose" anti-abuse rule under which the IRS can disregard its own rules on bottom dollar payment obligations and treat a partner as bearing EROL for a loan. Specifically, under Temp. Reg. 1.752-2T(j)(2)(i), irrespective of the form of a contractual obligation, the IRS (but *not* the taxpayer) may treat a partner as bearing the EROL with respect to a partnership liability, or a portion thereof, to the extent that:

1. The partner or a related person undertakes one or more contractual obligations so that the partnership may obtain or retain a loan;
2. The contractual obligations of the partner or related person significantly reduce the risk to the lender that the partnership will not satisfy its obligations under the loan or a portion thereof; and
3. Either (i) one of the principal purposes of using the contractual obligation is to attempt to permit partners (other than those directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests or (ii) another partner or person related to another partner enters into a payment obligation and a principal purpose of the arrangement is to cause the payment obligation to be disregarded under the bottom dollar payment obligation rules.

Thus, as long as the IRS concludes that a principal purpose of the structure of the obligation was to cause a shifting of the liability for tax purposes, the IRS may choose to disregard the new rules that treat the obligation as nonrecourse and recast the obligation as recourse (as it would have been treated under the old rules).

The 2016 Temporary Regulations are aimed at two types of transactions that the IRS did not like and labelled "abusive," even though such transactions were clearly appropriate under settled partnership tax principles.

Moreover, the IRS wanted to make certain that partners could not somehow shift economic responsibility for a debt in a manner that did not involve a debt instrument. Therefore, for purposes of applying Temp. Reg. 1.752-2T(j)(2), partners are considered to bear the EROL for a liability in accordance with their relative economic burdens for the liability pursuant to contractual obligations. For example, a lease between a partner and a partnership that is not on commercially reasonable terms may be tantamount to a guarantee by the partner of the partnership liability. Thus, to determine how debt is allocated, the IRS can look not only at debt instruments, but to any other arrangement between the partners to reach a conclusion to reallocate debt in a manner that is not otherwise prescribed by the applicable regulations.

Also, what is in essence an anti-abuse rule is baked into the definition of a bottom dollar payment obligation. An arrangement using tiered partnerships, intermediaries, tranches of liabilities, or similar arrangements to convert a single liability into multiple liabilities pursuant to a plan with a principal purpose of avoiding the bottom dollar payment obligation non-recognition rule for a liability or payment obligation is still treated as within the scope of the definition.[4]

The IRS is seemingly concerned (justifiably so!) that it does not understand the broad impact of its hastily issued regulations. Such concern is one of the main reasons why the APA mandates notice and comment procedures for new regulations. The anti-abuse rules are the IRS's attempt to limit this risk and ensure that the rules are not causing unintended consequences (presumably to the fisc; the detrimental consequences to the integrity of the tax system have already had permanent effect), which the IRS may not have fully thought through. The IRS will sort through the pieces later, and apply this murky and vague regime ex-post facto to any arrangement it does not like.

As part of this "we will figure out the particulars later approach," under Temp. Reg. 1.752-2T(b)(3)(ii)(D), a partnership must disclose to the IRS any bottom dollar payment obligation, including any bottom dollar payment obligation that is not treated as such under the 90% Exception discussed above, on a Form 8275. A more detailed explanation is required in any situation in which the 90% Exception applies. Thus, there will be a reporting burden imposed on every partnership in which a partner is not obligated to bear all, or a vertical slice, of any partnership obligation. This burden will apply for the tax year in which the bottom dollar payment obligation is entered into or modified, and, presumably, will include the first year to which the 2016 Temporary Regulations apply. In short, the IRS has set forth an uncertain set of rules regarding debt allocation, given themselves broad power to attack what they arbitrarily do not think is the "right" answer, and then required taxpayers to tell the IRS everything they have done!

Disguised Sales

The 2016 Temporary Regulations also completely change the treatment of debt instruments for purposes of determining whether a partner received consideration that results in a disguised sale due to the use of leverage. As noted above, under prior law, the regulations under Section 707 incorporated the principles of Section 752 to determine whether debt should be allocated to a partner, and a partner who transferred property to a partnership was allowed to receive a distribution up to such partner's share of the debt allocated to that partner. Note, however, that previously, Reg. 1.707-5(a) specifically provided that a partner's allocable share of a partnership nonrecourse liability for purposes of the partnership disguised sale rules is determined by solely applying the allocation rules applicable to excess nonrecourse liabilities under Reg. 1.752-3(a)(3). The allocation of partnership nonrecourse liabilities under Regs 1.752-3(a)(1) and (2) was disregarded for this purpose. This approach was wholly consistent with the legislative history of Section 707, which indicated that the disguised sale rules were not intended to limit a partner's ability to borrow money through a partnership.

The 2016 Temporary Regulations take a different approach based primarily on one comment received from the New York State Bar Association in response to the 2014 Disguised Sale Proposed Regulations. Under the original version of the 2016 Temporary Regulations, for purposes of determining the tax consequences of a distribution received by a person who contributed property to a partnership under Reg. 1.707-5, a partner's share of a partnership liability (whether such obligation is recourse or nonrecourse) is determined by treating the obligation as a nonrecourse liability, and allocating to the partner only such partner's share of the liability that relates to the partner's share of partnership profits. Yet, the amount of a liability that can be allocated to a partner is reduced by any amount of the liability for which another partner bears EROL for such liability.

> **The IRS is seemingly concerned (justifiably so!) that it does not understand the broad impact of its hastily issued regulations.**

The 2016 Temporary Regulations contain an example that illustrates how this rule works:

> Example 2. Partnership's assumption of recourse liability encumbering transferred property. (i) C transfers property Y to a partnership in which C has a 50 percent interest. At the time of its transfer to the partnership, property Y has a fair market value of $10,000,000 and is subject to an $8,000,000 liability that C incurred and guaranteed, immediately before transferring property Y to the partnership, in order to finance other expenditures. Upon the transfer of property Y to the partnership, the partnership assumed the liability encumbering that property. Under section 752 and the regulations thereunder, immediately after the partnership's assumption of the liability encumbering property Y, the liability is a recourse liability of the partnership and C's share of that liability is $8,000,000.
>
> (ii) Under the facts of this example, the liability encumbering property Y is not a qualified liability. Accordingly, the partnership's assumption of the liability results in a transfer of consideration to C in connection with C's transfer of property Y to the partnership. Notwithstanding C's share of the liability for section 752 purposes, for disguised sale purposes, C's share of the liability immediately after the partnership's assumption is $4,000,000 (50 percent of $8,000,000) under paragraph (a)(2) of this section (which determines a partner's share of a liability using

[4] Temp. Reg. 1.752-2T(b)(3)(ii)(C)(1).

the percentage under § 1.752-3(a)(3)). Therefore, the amount of consideration to C is $4,000,000 (the excess of the liability assumed by the partnership ($8,000,000) over C's share of the liability for purposes of § 1.707-5(a) immediately after the assumption ($4,000,000)). See § 1.707-5(a)(1) and paragraph (a)(2) of this section.

As noted, this aspect of the original version of the 2016 Temporary Regulations, which will become effective within 90 days of promulgation, was adopted without any notice and comment—it was a suggestion from a commentator within the New York State Bar Association that, itself, was not subject to review. Example 2 illustrates how this commentator's suggestion results in the wrong answer; there was no sale in economic substance, but this rule causes C to have a taxable recognition event.

Even more so, the fundamental flaw in this rule is illustrated with a simple example. Assume that Cliff, David, and Marc each contribute a property with a FMV of $100 and a tax basis of $0 to a partnership, and each becomes an equal 1/3 partner in the CDM partnership. CDM then borrows $180 and distributes the debt proceeds pro rata to all three partners. So far, there is no issue, because Cliff, David, and Marc would each be allocated one-third of the non-recourse debt and receive one-third of the debt proceeds.

However, what if the lender insists that each of the partners in CDM guarantee their *pro rata* share of the debt? Cliff, David, and Marc each has EROL for $60 of the debt. It appears that as a result of the proviso at the end of the original version of Temp. Reg. 1.707-5T(a)(2)(i) ("without including in such partner's share any amount of the liability for which another partner bears the economic risk of loss for the partnership liability"), $120 of the debt is not included in each partner's share, because, with respect to each partner, $120 of the economic risk of loss for the debt is borne by another partner. Only $60 of the $180 partnership liability is not excluded under the aforesaid plain language of this proviso with respect to each partner. However, this $60 piece of the debt is allocated in proportion to each partner's interest in partnership profits, a third to each partner, under Temp. Reg. 1.707-5T(a)(2)(i).

In other words, with respect to Cliff, it appears that $120 of the debt is not eligible to be included in Cliff's basis because David and Marc each bear $60 of the economic risk of loss for the debt (even though the guaranteed pieces are not taken into account for David and Marc for disguised sale purposes). With respect to Cliff, the debt is now treated as a nonrecourse liability of $60 and a debt that is recourse to the other partners in the amount of $120. Cliff is allocated, for purpose of applying Temp. Reg. § 1.707-5T, only $20 of the remaining $60 of the debt. This would mean that only $20 of the $180 debt is allocated to Cliff. Accordingly, it appears that if Cliff receives the same $60 debt-financed cash distribution from CDM as in the initial part of this example, the $40 in excess of the debt allocated to Cliff is considered a taxable distribution to Cliff. This distribution consists of $20 for which Cliff bears the EROL and $40 for which David and Marc bear the EROL. The same result appears to follow for David and Marc. Since only $20 of the debt is allocated to each partner, for a total of $60, under the plain language of the original version of Temp. Reg. 1.707-5T(a)(2)(i), it appears that $120 of the partnership liability disappears and is not allocated to any of the partners. That notion is very difficult to reconcile with established partnership taxation principles. Debt should be allocated to a partner, not ignored entirely.

Even though Cliff is liable for $60 of the debt, at most he could receive a distribution of $20 without triggering a disguised sale because $40 of the debt is allocated to other partners and $120 of the debt is ignored. It appears that a $60 nontaxable distribution to each of Cliff, David, and Marc was rendered a $40 taxable distribution to each because each partner guaranteed a pro rata portion of the $180 partnership liability. This is obviously a nonsensical result. This result conflicts with every fundamental concept of partnership taxation and evidences a serious flaw in the original version of the regulation. It runs directly contrary to Congress's stated intention that a partner should be able to receive, on a tax-free basis, the partner's share of a borrowing through the partnership.

In an attempt to address the deficiencies inherent in the premise of the original version of Temp. Reg. 1.707-5T(a)(2)(i), the IRS and Treasury "doubled down" and issued a corrective amendment on 11/17/16 (the "Attempted Correction"), which did not solve the problem. The provision at issue now provides:

> 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 Reg. § 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 Attempted Correction replaces the originally drafted language with a disorienting reference to Section 752. This reference is confusing because the conceptual framework asserted by the IRS for the new temporary regulation was that partnership debt allocation under Section 707 for purposes of disguised sales should be separate and distinct from partnership debt allocation under Section 752 for other purposes. With the inclusion of this reference to partnership debt allocation under Section 752, it is unclear the extent to which the rules under Section 752 are relevant and required to be incorporated relative to disguised sales. The parenthetical limitation in the Attempted Correction is subject to multiple inconsistent interpretations, two of which are as follows:

1. A partner's share of the debt should be determined under Section 752 and Regs. 1.752-2 and -3, except that profit shares should be used with respect to the so-called third tiers, Reg. 1.752-3(a)(3) (which

means that Regs. 1.752-3(a)(1) and (a)(2) are relevant); or

2. A partner's share of the debt should be determined under Section 752 and Regs. 1.752-2 and -3, except that profit shares should be used to allocate all portions of any nonrecourse debt (and thus Regs. 1.752-3(a)(1) and (a)(2) are not relevant). The conflicting interpretations of the Attempted Correction results solely from the reference to Reg. 1.752-3(a)(3) in the second parenthetical.

The Attempted Correction is just that, an endeavor that fails to correct one of the fundamental flaws in the original draft of the temporary regulations. Using the example above with Cliff, David, and Marc, assume all three each contribute property with a basis of zero and a fair market value of $100, *each subject to a pre-existing nonqualified $60 liability that each partner had personally guaranteed prior to contribution*, to CDM partnership for a one-third interest in the partnership. Temp. Reg. 1.707-5T(a)(2)(i) appears to operate on a liability-by-liability basis ("For purposes of § 1.707-5, a partner's share of a liability of a partnership…"). Here, as a result of the Attempted Correction, Cliff's share of both $60 partnership liabilities with respect to properties contributed by David and Marc is capped at zero. Remember, under Section 752, no portion of the debts guaranteed by David and Marc are allocated to Cliff despite the disregard of personal guarantees by David and Marc for disguised sale purposes. Thus, only $20 of the $60 debt with respect to the property contributed by Cliff and only $20 of CDM partnership's total $180 aggregate debt is allocated to him. Cliff is deemed to receive $40 in disguised sale proceeds under the Attempted Correction. The same result follows for David and Marc.

Unfortunately, under the Attempted Correction, David's and Marc's guarantees increase the amount of the distribution treated as a disguised sale to Cliff. Initially, what started as a $60 *nontaxable* distribution to each of Cliff, David, and Marc was transformed into $40 of *taxable* disguised sale proceeds to each of Cliff, David, and Marc because each personally guaranteed a separate $60 liability—a result which defies all logic and could not have been intended by Congress. Such a result under Temp. Reg. 1.707-5T(a)(2)(i), as revised by the Attempted Correction, completely contravenes Section 707(a)(2)(B) and effectively nullifies Section 721(a) because a fact pattern that should not be treated as a sale of property (pro rata contributions of appreciated property to a partnership subject to pro rata guaranteed liabilities) is transformed into a taxable transaction.

These simple examples illustrate what can happen when regulations do not go through full notice and comment. The IRS and Treasury issued temporary regulations (in a non-emergency situation) based primarily on one comment from the New York State Bar Association that entirely confuses the premise underlying Section 707. Temporary regulations were not appropriate with respect to this issue and the need for jerry-rigged "corrections" drives this point home. By following the appropriate notice and comment period as required under the APA, the obvious flaws in the proposed rules could have been highlighted and addressed. The regulations concerning the allocation of liabilities for disguised sale purposes (Reg. § 1.707-5) have been in place for decades. The transactions of concern to the IRS have also been around for decades and have been reviewed by the IRS national office on multiple occasions.

There was no "abuse" vis-à-vis these transactions that had not been addressed by the courts. The law requires that Treasury and the IRS show good cause for dispensing with notice and comment rulemaking and issuing force-of-law regulations in temporary form.[5] Section 7805(e) does not provide independent authority to issue temporary regulations. Instead, it merely harmonizes the rulemaking provisions in the Code with those in the APA, and imposes an additional requirement on the IRS to sunset temporary regulations after three years.[6] The IRS took a proposal from the New York State Bar Association, which was never discussed with anyone other than that bar association, and turned it into a force-of-law temporary regulation. This is a troubling practice, particularly when that regulation is so deeply flawed. The proper course of action here is for the IRS to withdraw the temporary regulation and issue corrected proposed regulations for notice and comment.

Effective Date and Transition Rules. The portion of the 2016 Temporary Regulations related to the allocation of debt for purposes of Section 707 apply to any transfer that occurs 90 days after 10/5/16, i.e., for all transfers on or after 1/3/17.

The new rules concerning bottom dollar payment obligations bear an immediate effective date, i.e., they apply to all liabilities incurred or assumed by a partnership on or after 10/5/16, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date. Nonetheless, if a partner ("Transition Partner") in a partnership ("Transition Partnership") was allocated a portion of a liability prior to 10/5/16, the Transition Partner may elect to continue to apply the prior rules to the extent of the amount of the liability that exceeds the Transition Partner's adjusted basis in its partnership interest in the Transition Partnership as of that date. Thus, a Transition Partner is not required to recapture its nega-

NOTES

5 5 U.S.C. section 553(b)(3)(B).

6 See Hickman, "Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements," 82 Notre Dame L. Rev. 1727 (2007), pp.1738-39; see also *Burks*, 633 F.3d 347, 107 AFTR2d 2011-824, 360 n.9 (CA-5, 2011) ("Here, the government issued the Temporary Regulations without subjecting them to notice and comment procedures. This is a practice that the Treasury apparently employs regularly. . . . That the government allowed for notice and comment after the final Regulations were enacted is not an acceptable substitute for pre-promulgation notice and comment.").

tive capital account with respect to any liability existing as of 10/5/16 (a "Grandfathered Amount"), for as long as such liability remains in place.

This special rule for pre-existing liabilities of Transition Partners, however, ceases to apply if the direct or indirect ownership of the Transition Partner in the Transition Partnership changes by 50% or more. A Transition Partnership may continue to apply prior law with respect to a Transition Partner for payment obligations to the extent of the Transition Partner's adjusted Grandfathered Amount for a seven-year period. The foregoing transition rule applies only as long as debt—that existed prior to 10/5/16—remains in place and is not modified. In light of the fact that most debt instruments have a limited term and are often modified, the transition rules may not provide the protection that taxpayers would expect once the complicated grandfathering gobbledygook is actually applied to the taxpayer's particular facts.

In addition, a Transition Partner's Grandfathered Amount is reduced (but not below zero and never increased), upon the sale of any property by the Transition Partnership, by an amount equal to the excess of any gain allocated to the Transition Partner (including amounts allocated under Section 704(c)) over the product of the total amount realized by the Transition Partner from the property sale and multiplied by the Transition Partner's percentage interest in the partnership, and an amount equal to any decrease in the Transition Partner's share of liabilities to which these regulations (other than the prior clause) applies.

The Attempted Correction also does not address the overlap and potential areas of conflict between the seven-year transition period espoused in the new rules concerning bottom dollar payment obligations and Reg. 1.704-2(g)(3) related to partnership minimum gain. Reg. 1.704-2(g)(3) references Reg. 1.704-1(b)(2)(iii)(c) in testing whether there is a deficit in a partner's capital account and the latter regulation requires the use of book value of the property if the property is reflected on the partnership's books using its book basis and a book-tax difference exists. Without overly complicating the discussion, if there is a decrease, but not below the amount of nonrecourse debt, in a partner's capital account (i.e., a "book down") due to a decrease in the book value of the property, the partner's basis in the property should be equal to the amount of the debt and no minimum gain chargeback would occur for Reg. 1.704-2 purposes. Under Reg. 1.752-3(a), the partner is subject to Section 752 "Tier 2" allocations and the seven-year transition rule would be unnecessary as the book basis should be sufficient to support any deficit in the partner's tax capital account. Accordingly, when Reg. 1.704-3(g) is applicable, Reg. 1.752-3(a)(1) is also applicable. The former regulation creates minimum gain for any deficiency in a partner's capital account due to the transformation of the debt from recourse to nonrecourse, which, ultimately, creates outside basis under Reg. 1.752-3(a)(1). Consequently, no issue exists when the debt is transformed from recourse to nonrecourse; however, this begs the question as to how the seven-year transition rule should be applied. Said another way, Reg. 1.704-2(g) creates minimum gain which increases a partner's capital account to reflect the same result as if nonrecourse debt deductions had always existed. The gain is now deferred because the partner has its share of minimum gain so what use is the seven-year transition period?

Moreover, this transition relief is significantly limited in a number of ways. The Grandfathered Amount does not apply to the entire liability, but includes only the share of liabilities in excess of adjusted basis. The relief does not apply to all partners of a Transition Partnership, but only to Transition Partners. Any modification of existing debt or refinancing creates a significant risk of the loss of grandfathered status, as does ownership changes of Transition Partners. Lastly, seven years is a tight time-frame for addressing these arrangements. Practically, the authors expect that taxpayers will come to find the transition rules to be overly limiting of their future ability to act, even within the seven-year grandfather period. Even worse, some taxpayers will be surprised to find that they inadvertently triggered recognition of gain!

Liability allocation is one of the fundamental pillars of subchapter K, together with the rules concerning allocation of income and the tax treatment of contributions and distributions. The 2016 Temporary Regulations muddle and unsettle partnership taxation at its core.

DISCUSSION

The 2016 Temporary Regulations are flawed on numerous levels and they run directly contrary to Congress's stated intent in Sections 752 and 707. The rules can lead to results that are difficult to justify, and most importantly, they display what can happen when an administrative agency effectively ignores the comments that it receives in response to proposed regulations. Moreover, the IRS utterly failed to provide any valid reason why the 2016 Temporary Regulations were adopted on a temporary basis, except to refer to its determination that the pre-existing regulations, which had been in existence for decades, did not produce the "right" result in certain situations. The adoption of these regulations on a temporary basis appears to be a clear violation of the IRS's authority under the APA and challenges to their validity are inevitable.

Turning first to the aspect of the 2016 Temporary Regulations concerning the allocation of debt for purposes of applying the disguised sale rules, one of the flaws in these rules was illustrated above, i.e., a guarantee of any portion of the debt by another partner can lead to absurd results. Moreover, the rule is completely contrary to the fundamental premise underlying the new regulations on bottom dollar payment obligations that a partner should be allocated the portion of any debt instrument for which the partner bears economic responsibility.

For example, assume that Terry and Jane form the TJ partnership, to which each contributes appreciated property worth $1 million. A potential lender is willing to make a loan to TJ of $1.5 million, but the loan will be based solely on Terry's credit rating—Jane's credit rating is abysmal. This is the "classic" situation in which the 2016 Temporary Regulations require the entire loan to be allocated to Terry—as it should under the legislative history to Section 752. So the loan is made, and, because Terry had guaranteed the loan, the entire debt proceeds are distributed to him under Section 752. Yet, despite that Terry was the sole partner to guarantee the loan, and that there would have been no loan without Terry's guarantee, the loan is allocated $750,000 to each partner for purposes of applying Section 707, so that Terry is deemed to receive $750,000 in excess of his share of the debt of the partnership—even if the entire loan was allocated to Terry for purposes of Section 752!

The foregoing result is completely inconsistent with all aspects of the theory that underlies partnership taxation and runs contrary to all of the rules adopted by Congress, but it is mandated by the 2016 Temporary Regulations. Moreover, this result appears to directly repudiate the concern that the IRS enunciated about bottom dollar payment obligations not reflecting economic reality, because here a payment obligation that unquestionably reflects economic reality is simply being ignored.

What makes this treatment even more inappropriate is that Terry and Jane could easily avoid this result without substantially altering the economics. Terry is liable on the debt, and the loan was made solely based on Terry's credit rating. So, instead of distributing the $1.5 million to Terry, the TJ partnership could lend that amount to him, and then allocate all of the interest Terry pays on that loan back to him. The economic result is exactly the same as a distribution of the loan proceeds to Terry, except now there would be no disguised sale treatment to Terry. In other words, economically-identical transactions can lead to different results, thereby illustrating that this aspect of the 2016 Temporary Regulations is flawed.

The significant problems with the rules concerning disguised sales in the 2016 Temporary Regulations are overshadowed by the rules concerning bottom dollar payment obligations—the worst type of "heads we win, tails you lose" regulations. The prior regulations had an internal logic and consistency and, most importantly, all partnerships could immediately determine how debt would be allocated and the consequences thereof. Because of the expansion of the anti-abuse rules, it will be very difficult for a partnership to have any certainty regarding how a liability will be allocated.

For example, assume that Todd, Pat, and Steve form the TPS partnership. Todd is wealthy; Pat and Steve have significant assets, but not to the extent of Todd. A lender to the TPS partnership receives guarantees on its loan from all three partners, but the lender's internal documentation shows that it was relying solely on Todd's credit rating in making the loan. Given this fact, should Pat and Steve be allocated any of the debt, notwithstanding that they have the economic resources to perform on their guarantees? Realistically, the lender will simply present any claims to Todd—therefore, are Pat's and Steve's guarantees illusory? Under prior law, it was clear in this situation that the debt is allocated one-third to each partner; this result is not as clear under the 2016 Temporary Regulations.

These issues are exacerbated whenever a partner is able to reduce its risk of loss and enters into a bottom dollar payment obligation with a lender. Assume that in the Tom, Anne, and Martin partnership, the lender asks Anne to guarantee the bottom 60% of the debt; the lender is willing to accept risk on the top 40%, but does not want to bear catastrophic risk. Anne agrees to do so, but under the 2016 Temporary Regulations, her guarantee would be a bottom dollar payment obligation that is disregarded. Accordingly, the liability would be allocated to the partners in accordance with their partnership interests.

There is no assurance of this treatment, however. Of course, Anne will have considered the applicable tax matters prior to entering into that obligation; even somewhat-financially astute individuals usually consider the tax aspects of their financial transactions. Now, the consideration of the tax aspects of the arrangement, however, would place the partner in "tax hell" because, under these rules, the taxpayer is subject to the whim of the IRS. If the IRS determines that it prefers a different result, the obligation would be treated as a recourse loan to Anne. As a result, the partners would never have any certainty as to the tax consequences of their partnership and its borrowings.

Liability allocation is one of the fundamental pillars of subchapter K, together with the rules concerning allocation of income and the tax treatment of contributions and distributions. The 2016 Temporary Regulations muddle and unsettle partnership taxation at its core.