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PARTNERSHIPS, S CORPORATIONS & LLCs

53 New regulations on partnership debt and disguised sales: Is the road to hell paved with good intentions? (Part 1)
RICHARD M. LIPTON, SAMUEL P. GRILLI, AND NICOLE D. RENCHEN

ACCOUNTING

61 Third Circuit reverses the Tax Court's analysis of the all-events test
CLINT LOCKE, EDWARD J. SCHNEE, AND W. EUGENE SEAGO

PERSONAL

68 Tax treatment of post-employment payments
JOHN M. MALLOY, CRAIG J. LANGSTRAAT, AND ELANA J. PUGH

EXEMPT

75 Colleges and universities: Investing for impact
ALEXANDER L. REID

NEWSLINE

51 Late-breaking developments

IRS RULINGS

81 IRS to add two foreign tax credit splitting events to Section 909 regulations

82 Incremental sales associated with taxpayer's print advertising was not advertising income under Section 199

83 IRS determines that termination fee paid by acquiring corporation is capital loss

84 IRS issues first Life PBR guidance

85 Deferred compensation with matching component held subject to 'substantial risk of forfeiture'

SHOP TALK

88 Should lump sum damage awards that 'bunch up' taxable income be grossed up for taxes?

IN FUTURE ISSUES

FBAR penalties

Employee travel expenses

New Regulations on Partnership Debt and Disguised Sales: Is the Road to Hell Paved with Good Intentions? (Part 1)

RICHARD M. LIPTON, SAMUEL P. GRILLI, AND NICOLE D. RENCHEN

The 2016 proposed debt regulations reverse and replace the prior rules, an internally-consistent set of tests focused on economic risk of loss, with a facts-and-circumstances test in which the result is uncertain and open to IRS manipulation.

In January 2014, the IRS issued proposed regulations addressing (1) how the disguised sale rules under Section 707 operate, including, particularly, how partnership debt is treated for purposes of the disguised sale rules ("2014 Disguised Sale Proposed Regulations"), and (2) whether debt guaranteed by a partner is treated as a recourse or nonrecourse liability for purposes of Section 752 ("2014 Proposed Debt Allocation Regulations"). The disguised sale portion of the proposed regulations received generally favorable comments, while the portion of the proposed regulations concerning the treatment of partnership debt was widely criticized.[1]

Two and a half years later, on 10/5/16, the IRS released final, temporary, and proposed regulations addressing these topics. The final regulations ("Disguised Sale Final Regulations") generally follow the outline of the favorably-received 2014 Disguised Sale Proposed Regulations. In contrast, the new proposed regulations ("2016 Proposed Debt Regulations") adopt a new approach to determine whether debt is treated as a recourse or nonrecourse liability for purposes of Section 752. The 2016 Proposed Debt Regulations will likely be almost as controversial as their 2014 predecessors, even though some of the more obvious flaws in the 2014 Proposed Debt Allocation Regulations were eliminated.

The astounding aspect of the new regulations, however, is the temporary regulations, which the IRS issued to address bottom dollar guarantees (BDG) and the treatment of recourse debt for purposes of the disguised sale regulations ("2016 Temporary Regulations").[2] Although the IRS sought notice and comment on these rules by also issuing the regulations in pro-

posed form, the IRS effectively neutered the Administrative Procedure Act (APA) by issuing temporary regulations with essentially immediate effective dates. The 2016 Temporary Regulations were immediately effective with respect to bottom dollar guarantees, and the rules concerning disguised sales were effective 90 days after their publication. Both of these rules (which will be in effect long before regulations are finalized) suffer from a lack of public notice and comment, and it appears that both sets of rules are seriously flawed (as were the 2014 Proposed Debt Allocation Regulations).

This is a two-part article addressing the three sets of regulations. The first part of this article will address the Disguised Sale Final Regulations, as well as the 2016 Proposed Debt Regulations, with an emphasis on how these two sets of regulations will interact and their impact on customary transactions. The second part of this article will focus on the 2016 Temporary Regulations, with an emphasis on how this guidance would not have been flawed if the IRS had addressed these topics through new proposed regulations. In its haste to address "concerns" which have been present in partnership taxation for almost 30 years, the IRS did not follow the APA legal requirements and issued flawed rules.

BACKGROUND AND 2014 REGULATIONS

Section 707 is intended to recharacterize certain contributions and distributions between partners and partnerships as a sale or exchange (i.e., a "disguised sale" transaction). Specifically, the applicable regulations provide ten factors that are to be taken into account for purposes of determining whether a transfer of property to a partnership, and a subsequent transfer of property or money to a partner, is properly characterized as a sale.[3] These factors are:

1. That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer.
2. That the transferor has a legally enforceable right to the subsequent transfer.
3. That the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured.
4. That any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration.
5. That any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations.
6. That the partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt).
7. That the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets).
8. That partnership distributions, allocations or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property.
9. That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits.
10. That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.[4]

The general rule is that a disguised sale exists if, based on all the facts and circumstances, the distribution would not have been made but for the contribution and there was not an intervening sharing of entrepreneurial risk.[5] The existing regulations provide a rebuttable presumption that contributions and distributions within two years are recast as a disguised sale; however, the more important aspect of the regulations concerning disguised sales may be the exceptions that are provided in the regulations. Under Reg. 1.707-4, certain transfers–including reasonable preferred returns, reasonable guaranteed payments, receipt of partnership cash flow, and reimbursement of preformation expenditures–are not treated as part of a disguised sale. These exceptions were modified by the 2016 Temporary Regulations.

Exception Related to Preformation Expenditures

The existing Reg. 1.707-4(d) provides that transfers to reimburse a partner for certain capital expenditures and costs incurred are not treated as part of a sale of property under Reg. 1.707-3 for purposes of the disguised sale rules (the "RFPE Exception"). The RFPE Exception applies, however, only to distributions not exceeding 20% of the fair market value (FMV) of the contributed property. The 20% limitation is inapplicable if the FMV of the contributed property does not exceed 120% of the partner's adjusted basis in the contributed property at the time of contribution.

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The 2014 Disguised Sale Proposed Regulations contained three amendments to the existing regulations. First, under multiple property contributions, the 2014 Disguised Sale Proposed Regulations applied the limitation on a property-by-property basis, such that the 20% limitation and 120% exception would have been applied separately for each property. Additionally, the scope of the term "capital expenditures" was clarified and given the same meaning the term generally receives under the Code, with the exception that the term includes expenditures otherwise able to be capitalized that the taxpayer elects to deduct and excludes otherwise deductible expenses the taxpayer elects to capitalize.[6] Finally, the 2014 Disguised Sale Proposed Regulations also addressed the coordination of the RFPE Exception with capital expenditures funded by "qualified liabilities." Specifically, under existing Reg. 1.707-5(a)(1), a partnership can assume certain "qualified liabilities" in connection with a partner's transfer of property to the partnership and it will not be considered a disguised sale if the liability meets one of the four definitions of qualified liabilities under Reg. 1.707-5(a)(6). Under the 2014 Disguised Sale Proposed Regulations, special rules are provided for capital expenditures funded by a qualified liability and that are traceable to capital expenditures. The 2014 Disguised Sale Proposed Regulations provided that if the partner financed the capital expenditure through a qualified liability assumed by the partnership and the EROL (defined below) of such liability was shifted to another partner, any reimbursement of the capital expenditure would not qualify for the RFPE Exception.

As discussed below, the 2014 Disguised Sale Proposed Regulations were finalized substantially in the same form as they were proposed in the Disguised Sale Final Regulations.

The astounding aspect of the new regulations, however, is the temporary regulations, which the IRS issued to address bottom dollar guarantees and the treatment of recourse debt for purposes of the disguised sale regulations.

Contributions With Qualified/Non-Qualified Liabilities

Additionally, when a partner contributes property to a partnership and the contributing partner receives no cash or other consideration in the transaction, and in situations where only qualified liabilities are assumed or encumber the contributed property, the liabilities are disregarded for disguised sale purposes.[7] Alternatively, if the contributing partner receives any other cash or consideration or if, in addition to a qualified liability, the partnership assumes or takes property subject to a non-qualified liability, a portion of the qualified liability would be taken into account for purposes of Section 707. Accordingly, under the 2014 Disguised Sale Proposed Regulations, even a *de minimis* amount of non-qualified liabilities could result in subjecting the contribution to the disguised sale rules.

Qualified Trade or Business Liabilities

Under existing regulations, assumptions of qualified liabilities generally are excluded from disguised sale treatment. The current regulations treat as a qualified liability any liability incurred in the ordinary course of a trade or business in which property transferred to the partnership was used or held, but only if all of the assets that are material to that trade or business are transferred to the partnership.[8] Additionally, liabilities incurred more than two years before the transfer, or within two years of the transfer but not in anticipation thereof, that encumber the transferred property throughout that period are considered qualified liabilities, but there is limited guidance regarding the meaning of "encumbrance."

The 2014 Disguised Sale Proposed Regulations provided rules that added a new type of qualified liability. Specifically, any liability incurred in connection with a trade or business, provided the liability was not incurred in anticipation of the transfer and all of the assets material to that trade or business are also transferred to the partnership, is a qualified liability.

Anticipated Reductions

The existing regulations under Section 707 provide that a partner's share of a liability assumed or taken subject to by a partnership is determined by taking into account certain subsequent reductions in the partner's share of the liability.[9] A later reduction in a partner's share of a liability is considered if: (1) at the time the partnership incurs, assumes, or takes property subject to the liability, it is anticipated that the partner's share of the liability will be subsequently reduced, and (2) the reduction is part of a plan that has a principal purpose of minimizing the extent to which the distribution or assumption of a liability is treated as part of a sale.

The 2014 Disguised Sale Proposed Regulations retain the existing regulations, but clarify certain aspects. Specifically, a partner's share of a liability immediately after a partnership

NOTES

1 See, for example, Lipton, "Proposed Regulations on Debt Allocations: Controversial, and Deservedly So," 120 JTAX 156 (April 2014); Rubin, Whiteway, and Finkelstein, "A 'Guaranteed' Debacle: Proposed Partnership Liability Regulations," 143 Tax Notes 219 (2014).

2 Temp. Regs. 1.707-5T and 1.752-2T.

3 Regs. 707-3(b)(2)(i)-(x).

4 *Id.*

5 Reg. 1.707-3.

6 Reg. 1.707-4(d)(5).

7 Reg. 1.707-5(a)(5)(i).

8 Reg. 1.707-5(a)(6)(i)(D).

9 Reg. 1.707-5(a)(3).

assumes or takes property subject to the liability is determined by considering a subsequent reduction in the partner's share of the liability if: (1) at the time the partnership assumes or takes property subject to the liability, it is anticipated that the transferring partner's share of the liability will be subsequently reversed, (2) the anticipated reduction is not subject to the entrepreneurial risks of partnership operations, and (3) the reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the impact of Reg. 1.707-3. This treatment by the 2014 Disguised Sale Proposed Regulations necessarily anticipates that all liabilities will be repaid.

Tiered Partnerships

Existing Regs. 1.707-5(e) and 1.707-6(b) provide only a limited tiered-partnership rule for situations in which a partnership succeeds to a liability of another partnership. Under these rules, if a lower-tier partnership succeeds to a liability of an upper-tier partnership or if an upper-tier partnership succeeds to the liability of a lower-tier partnership, the liability retains its characterization as a qualified or nonqualified liability that it had as a liability of the initial partnership.

The 2014 Disguised Sale Proposed Regulations initially clarify that the Debt-Financed Exception (defined below) applies to tiered partnerships. Additionally, the regulations provided that, in the case of a contribution of a partnership interest, the contributing partner's share of liabilities from a lower-tier partnership would be treated as qualified liabilities to the extent that the liabilities would be qualified liabilities in connection with a transfer of all of the lower-tier partnership's property to the upper-tier partnership, thereby treating the lower-tier partnership as an aggregate.

Debt-Financed Distribution Exception

More significantly, under Reg. 1.707-5, certain debt-financed distributions are not taken into account in determining whether a partner has engaged in a disguised sale with a partnership (the "Debt-Financed Exception"). The Debt-Financed Exception is commonly used in leveraged partnerships when a partner contributes appreciated property to a partnership and guarantees debt incurred by the partnership. The regulations also provide rules for determining whether a partnership has sold property to a partner.[10]

As discussed above, existing Reg. 1.707-3 provides 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 and, for nonsimultaneous transfers, the later transfer is independent of the entrepreneurial risks of the partnership. Under a special rule, a transfer by the partnership to more than one partner, pursuant to a plan, of all or a portion of the proceeds of one or more liabilities results in the Debt-Financed Exception treating all of the liabilities incurred pursuant to the plan as one liability. Said another way, partners allocated shares of multiple liabilities are treated as being allocated a share of a single liability rather than a share of each separate liability.

The 2014 Disguised Sale Proposed Regulations clarify what the existing regulations lacked, i.e., whether the amount of the distribution qualifying for the Debt-Financed Exception to the disguised sale rules is reduced by any other exception. Specifically, the 2014 Disguised Sale Proposed Regulations provided an "ordering rule" whereby the Debt-Financed Exception is applied first, and only the portion of a distribution not excluded under this rule is subject to, *inter alia*, guaranteed payments, the RFPE Exception, and preformation expenditures.

Excess Nonrecourse Liabilities

Section 752 dictates how partnership-level debt is allocated among the partners. As a general rule, nonrecourse debt is allocated in accordance with the way partners share profits, but for several special rules designed to specially allocate debt to partners to the extent necessary to protect certain partners with low tax basis (often referred to as "negative tax capital"). In contrast, recourse debt is generally allocated to partners with the economic risk of loss (EROL) on the debt. Partners often seek allocations of recourse and nonrecourse debt both to avoid triggering negative tax capital and to avoid disguised sales that can occur when debt is allocated away from a partner who contributed property to a partnership subject to debt.

Existing Reg. 1.752-3 contains rules for determining a partner's share of a nonrecourse liability of a partnership, including the partner's share of excess nonrecourse liabilities. Where a nonrecourse liability for which no partner has guaranteed the liabilities, and no partner bears the EROL, existing regulations allocate such liabilities among partners first in accordance with the partners' shares of "partnership minimum gain" and then in accordance with the amount of built-in gain that would be allocated to each partner if

The most significant rule in the Disguised Sale Final Regulations is the elimination of what the IRS viewed as "double dipping" for preformation expenditures financed by debt.

[10] Reg. 1.707-6.

the partnership disposed of all property subject to one or more nonrecourse liabilities for the amount of such liabilities.[11] Any leftover unallocated nonrecourse liabilities are "excess nonrecourse liabilities."

Under existing regulations, one method for allocating excess nonrecourse liabilities to a partner is determined in accordance with the partner's share of partnership profits. Under this method, the partner's interest in partnership profits must be reasonably consistent with allocations of some other significant item of partnership income or gain (the "Significant Item Method"). Excess nonrecourse liabilities may also be allocated in the manner that deductions attributable to those liabilities are reasonably expected to be allocated (the "Alternative Method"). A third allocation method is used to the extent an excess nonrecourse liability is allocable to property subject to a nonrecourse liability. In this instance, the partnership may first allocate the excess nonrecourse liability to any partner to the extent that the partner has Section 704(c) built-in gain that is not otherwise allocated to that partner under Reg. 1.752-3(a)(2) (the "Built-in Gain Method").

The 2014 Proposed Debt Allocation Regulations eliminated both the Significant Item Method and the Alternative Method for allocating excess nonrecourse liabilities. Additionally, the regulations created another allocation method based on the partner's liquidation value percentage (the "Liquidation Value Method").

Additionally, a partner guarantee, or some other payment obligation to the partnership, that results in EROL should be recognized for debt allocation purposes and cause a higher allocation of debt to the guarantor or obligor. Under existing Section 752 regulations, there is a presumption that a partner has an EROL with regard to a payment obligation except to the extent the facts and circumstances evidence a plan to circumvent or avoid the obligation. The 2014 Proposed Debt Allocation Regulations, decried by the tax community, displaced the facts-and-circumstances test with six hard requirements. Any payment obligation not satisfying all six requirements would be disregarded for purposes of determining whether a partner bore EROL when allocating debt basis. These six requirements applied to all payment obligations, even so-called deficit restoration obligations (DRO) where a partner promises to repay a deficit in its capital account.

The 2016 Proposed Debt Regulations are intended to address the glaring deficiencies and ambiguities found in the 2014 Proposed Debt Allocation Regulations. Nevertheless, the 2016 Proposed Debt Regulations still extend the non-recognition concept of bottom dollar payment obligations to capital accounts and allocations of partnership profits and losses by preventing reliance on a DRO to provide support for loss allocations in excess of a partner's adjusted capital account balance. This is accomplished in the 2016 Proposed Debt Regulations by classifying the DRO as a bottom dollar payment obligation that does not result in EROL for debt allocation purposes.

THE 2016 DISGUISED SALE FINAL REGULATIONS

The Disguised Sale Final Regulations apply to any transactions or transfers that occur on or after 10/5/16. They also apply to liabilities that are incurred by a partnership, that a partnership takes property subject to, or that are assumed by the partnership on or after 10/5/16. Liabilities that were incurred or assumed pursuant to a written binding contract in effect prior to 10/5/16 are not subject to the Disguised Sale Final Regulations.

The Disguised Sale Final Regulations generally adopt the 2014 Disguised Sale Proposed Regulations. The most significant rule in the Disguised Sale Final Regulations is the elimination of what the IRS viewed as "double dipping" for pre-formation expenditures financed by debt. Many of the remaining rules in the Disguised Sale Final Regulations are housekeeping-type changes to the mechanics of the disguised sale exceptions.

Exception Related to Preformation Expenditures

Prior to the Disguised Sale Final Regulations, a partner might contribute built-in gain property subject to a "qualified liability" used to finance property capital expenditures and avail itself of both the qualified liability exception and the RFPE Exception to disguised sales. This was perceived by the IRS as "double dipping" because the partner excluded from disguised sale proceeds both: (1) the cash received as reimbursement of certain preformation capital expenditures with respect to the property, and (2) the qualified liability assumed by the partnership. The Disguised Sale Final Regulations eliminate this so-called "double dipping" by providing that to the extent a partner funded a capital expenditure through a qualified liability and economic responsibility for that borrowing shifts to another partner, the RFPE Exception will not apply because there is no outlay by the partner to reimburse. Additionally, the regulations adopt the property-by-property rule in the 2014 Disguised Sale Proposed Regulations for calculating the RFPE Exception, subject to aggregation in certain cases where separate accounting would be burdensome.[12] Finally, the Disguised Sale Final Regulations adopt the definition of "capital expenditures" as provided in the 2014 Disguised Sale Proposed Regulations.

Contributions With Qualified/Non-Qualified Liabilities

The Disguised Sale Final Regulations eliminate the risk of a *de minimis* non-qualified liability resulting in dis-

[11] Regs. 1.752-3(a)(1) and (2).

[12] Aggregation of multiple properties is possible under the Disguised Sale Final Regulations to the extent (1) the total FMV of the aggregated property is not more than the lesser of 10% of the FMV of all property, excluding money and Section 731(c) marketable securities transferred by the partner to the partnership, or $1 million, (2) the partner uses a reasonable aggregation method that is consistently applied, and (3) the aggregation of property is not part of a plan, a principal purpose of which is to avoid Reg. 1.707-3 through -5.

guised sale treatment for the contributing partner. Specifically, the Disguised Sale Final Regulations exclude qualified liabilities as consideration for disguised sale purposes when the total amount of all liabilities other than qualified liabilities that the partnership assumes or takes subject to is the lesser of (1) 10% of the total amount of all qualified liabilities the partnership assumes or takes subject to, or (2) $1 million.[13]

Qualified Trade or Business Liabilities

The 2016 Disguised Sale Final Regulations provide that a qualified liability is one that was incurred in connection with a trade or business where property transferred to the partnership was used or held (1) if the partnership assumes the liability in connection with the contribution of property, (2) all of the assets related to the trade or business are contributed to the partnership, and (3) it was not incurred in anticipation of the contribution.[14] Similar to the 2014 Disguised Sale Proposed Regulations, a liability is presumed to be incurred in anticipation of the transfer of property to the partnership if incurred less than two years before the transfer, unless the facts and circumstances indicate an alternate intent. Additionally, the new qualified liability rules do not require the liability to encumber the transferred property, but requires only that the liability be "in connection with," rather than "in the ordinary course of" the trade or business.

Anticipated Reductions

The Disguised Sale Final Regulations remedy the issue within the 2014 Disguised Sale Proposed Regulations that presumed all liabilities would be repaid. Instead, the Disguised Sale Final Regulations provide that only reductions not subject to the entrepreneurial risks of partnership operations are to be considered.

Tiered Partnerships

With respect to tiered-partnership situations, the Disguised Sale Final Regulations provide that a contributing partner's share of a liability from a lower-tier partnership is treated as a qualified liability to the extent the liability would be a qualified liability had it been assumed or taken subject to by the upper-tier partnership in connection with a transfer of all of the lower-tier partnership's property to the upper-tier partnership by the lower-tier partnership. The rules make clear that it is the intent of the partner, and not the lower-tier partnership, that is relevant in determining whether a liability was incurred in anticipation of the transfer. Thus, the determination of whether the liability was incurred in anticipation of the transfer of property to the upper-tier partnership is based on whether the partner in the lower-tier partnership anticipated transferring the partner's interest in the lower-tier partnership to the upper-tier partnership at the time the liability was incurred by the lower-tier partnership. The Disguised Sale Final Regulations also provide that an upper-tier partnership is considered to "step into the shoes" of a person who incurs capital expenditures with respect to a property, transfers the property to a lower-tier partnership, and then transfers an interest in the lower-tier partnership to an upper-tier partnership for purposes of the RFPE exception.

Debt-Financed Distribution Exception

As noted previously, the most important aspect of the regulations under Section 707 may be the rules concerning debt-financed distributions. The Debt-Financed Exception is significant because, to the extent a partner is allocated a sufficient amount of the debt funding a distribution, the partner's distribution may avoid application of the disguised sale rules, depending on how the other exceptions apply. Accordingly, the Disguised Sale Final Regulations clarify the ordering and adopt the ordering rule from the 2014 Disguised Sale Proposed Regulations. Specifically, the Debt-Financed Exception applies before the exceptions for preferred returns, guaranteed payments, operating cash flow distributions, and preformation expenditures.[15]

Excess Nonrecourse Liabilities

In coordination with the 2016 Temporary Regulations, the Disguised Sale Final Regulations provide limitations on the available allocation methods for nonrecourse liabilities under Reg. 1.752-3(a)(3). Specifically, the Disguised Sale Final Regulations retain the "significant item" method and "alternative method," but do not adopt the "liquidation value percentage" approach for determining partners' interests in partnership profits found in the 2014 Disguised Sale Proposed Regulations. Moreover, to mitigate the effect of the allocation method for disguised sales, the Disguised Sale Final Regulations provide a rule that does not take into account qualified liabilities as consideration in transfers of property treated as a sale when the total amount of non-qualified liabilities that the partnership assumes or takes subject to is the lesser of 10% of the total amount of all qualified liabilities the partnership assumes or takes subject to, or $1 million. Additionally, the Significant Item Method and the Alternative Method are unavailable allocation methods for purposes of Section 707. The Disguised Sale Final Regulations also provide a "step-in-the-shoes" rule for applying the RFPE Exception and for determining whether a liability is a qualified liability.[16]

THE 2016 PROPOSED DEBT REGULATIONS

The 2016 Proposed Debt Regulations create significant uncertainty as to whether guarantees result in EROL for allocating debt. Previously, payment obligations were disregarded *ab initio* if the facts and circumstances evidenced a plan to circumvent or avoid a payment obligation. The 2014 Proposed Debt Allocation Regulations added a list of six requirements which had to be satisfied in order for debt to be treated as a recourse obligation;

[13] Reg. 1.707-5(a)(5)(iii).

[14] Reg. 1.707-5(a)(6)(i)(E).

[15] Reg. 1.707-5(b)(3).

[16] Reg. 1.707-5(a)(6).

failure to meet any factor resulted in nonrecourse characterization.

In response to vehement criticism of the 2014 Proposed Debt Allocation Regulations, the 2016 Proposed Debt Regulations eliminate the all-or-nothing approach of the six requirements, but essentially repackage these requirements as factors in a facts-and-circumstances test. This still creates the same taxpayer concerns.

The 2016 Proposed Debt Regulations now include a list of seven nonexclusive factors which the IRS views as evidencing a plan to circumvent or avoid an obligation. The major problem is that this test eliminates any certainty in the treatment of payment obligations. All obligations–even those with irrefutable economic substance and reality, e.g. top-dollar guarantees, vertical slice guarantees, or run-of-the-mill commercial "real-world" guarantees–are unlikely to satisfy all of the proposed factors. Five of the seven factors are identical to five of the requirements found in the 2014 Proposed Debt Allocation Regulations. The remaining two factors, together, are substantially the same as the sixth requirement in the 2014 Proposed Debt Allocation Regulations. The proposed factors are as follows:

1. The partner is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment.
2. The partner is not required to provide commercially reasonable documentation regarding the partner's financial condition.
3. The term of the payment obligation ends or is terminable by the partner before the partnership liability term.
4. There exists a plan where the primary obligor directly or indirectly holds money or other liquid assets that exceeds the reasonable foreseeable needs of the primary obligor.
5. The terms of the payment obligation do not permit the creditor to promptly pursue payment on default or there exist arrangements that otherwise work to delay payment;
6. In the case of a guarantee by a partner, the terms of the partnership liability do not differ with or without such guarantee.
7. The creditor does not receive executed documents with respect to the partner's payment obligation.[17]

A major deficiency in these proposed factors is that they were drafted as part of an ill-conceived crusade against bottom-dollar guarantees, which is expressed in the privative phrasing of the factors. The factors are drafted for an obligation to fail. For example, instead of providing that "contractual restrictions to protect the likelihood of payment" evidence a real obligation, the first proposed factor stains any guarantee "not subject to commercially reasonable contractual restrictions." If a billionaire guarantees a $100,000 debt in a situation where it would greatly damage her business and reputation to not make good on her promise, she still fails the first factor. Without really considering the facts and circumstances, an IRS agent will likely just tick off the boxes. Worse yet, because the 2016 Proposed Debt Regulations are drafted as a facts-and-circumstances test, the IRS has the ability to take inconsistent positions as the situation suits it.

The 2016 Proposed Debt Regulations create significant uncertainty as to whether guarantees result in economic risk of loss for allocating debt.

Due to drafting in the negative, a plan to circumvent or avoid an obligation is, in practice, presumed unless the partner takes steps to affirmatively refute the so-called factors. This means that in reality and practice, these proposed factors are still much more akin to hard requirements. The IRS makes this clear in an example provided: in the absence of evidence that the partner is subject to commercially reasonable contractual restrictions under factor 1, for example, the IRS would take the position that no such restriction exists. Arguably, the IRS would apply similar reasoning with respect to factors (2), (5), (6), and (7) to find a plan to circumvent or avoid the obligation in the absence of countervailing evidence.

Moreover, many of the factors require partners to provide evidence to demonstrate something inherently difficult to prove and/or lead to a speculative inquiry. The most egregious factor is perhaps factor (6), because it requires a partner to prove the counter-factual. To satisfy this factor, a partner must show that terms of a partnership liability would have been different in the alternate universe where the partner made no such guarantee. This factor requires partners to crank up the DeLorean time machine! Unless a partner can go with the IRS agent back in time, where the partner retracts the guarantee to see what the terms of the partnership liability would have been, nearly all instances of partner guarantees will routinely be unable to satisfy this factor. Similarly, factor (4) would require the partner to predict future risk precisely, since any conservatism would be punished.

Presumption of Satisfaction

The 2016 Proposed Debt Regulations also eviscerate the presumption that a payment obligor will satisfy its obligation. This is especially true for partners who make guarantees through disregarded entities (DREs). Under the 2016 Proposed Debt Regulations, if the ability of the payment obligor to pay is less than certain, the IRS may deem such fact as evidence of a plan to circumvent or avoid an obligation. The 2016 Proposed Debt Regulations would add a collateral analysis of a DRE's ability to pay an obligation. This new provision captures not only business entities that

17 Reg. 1.752-2(j).

are DREs, but all DREs–including grantor trusts–that hold partnership interests and bear EROL with respect to a payment obligation.

Ultimately, the 2016 Proposed Debt Regulations disregard any payment obligation and allocate the debt on a nonrecourse basis, if, under the facts and circumstances, the obligor could not pay the full amount of the obligation were the obligation to come due. In practice, an obligor frequently is able only to make debt service payments and is illiquid to a point that repayment of the full amount of the obligation were the obligation to come due would be impractical. This anti-abuse rule would ostensibly displace the more straightforward net value test in the existing regulations wherein payment obligations of a DRE owned by a partner would be respected only to the extent of the DRE's net value.

The preamble to the 2016 Proposed Debt Regulations makes clear, however, that the net value of the DRE would continue to be relevant under the facts-and-circumstances test of the anti-abuse rule, and, indeed, the example in the 2016 Proposed Debt Regulations illustrates that the net value test would survive within the anti-abuse rule. Moreover, this embedded net value factor no longer explicitly excludes individuals. Thus, it appears that the anti-abuse rule would not so much as displace the net value test, but expand upon it and, in the process, dissolve the satisfaction presumption.

Lack of Certainty

Perhaps the most disturbing aspect of these proposed regulations, however, is the lack of certainty that they will create for taxpayers and tax return preparers. Every partnership tax return, and every Schedule K-1, must set forth each partner's share of the debt of the partnership and a determination about whether the debt is a recourse or a nonrecourse obligation. This determination has been very clear and straightforward for more than 25 years, and the rules are well understood by taxpayers and return preparers. By switching to a facts-and-circumstances test, the 2016 Proposed Debt Regulations replace certainty with uncertainty.

Why is such a change being made? As will be discussed in the second part of this article, this revision appears to be part of the attack on so-called bottom dollar guarantees, which were inherent in the framework of the existing regulations under Section 752. The existing regulations are both theoretically sound and follow the legislative history. Unfortunately, the drafters of the 2016 Proposed Debt Regulations decided that their understanding of the manner in which partnership debt should be allocated was somehow superior to a logical, internally-consistent, and orderly set of rules. If finalized, the 2016 Proposed Debt Regulations will lead to uncertainty, disputes, and much litigation.

Moreover, the impact of the 2016 Proposed Debt Regulations is, effectively, to switch the presumption in the existing regulations that debt is a recourse allocation when a partner bears EROL to a presumption that all debt is nonrecourse–now, taxpayers must take active steps to establish debt is truly a recourse obligation. Additionally, the seven factors are an open invitation for a taxpayer who desires nonrecourse debt treatment. Indeed, the IRS included yet another anti-abuse rule, i.e., the special rules for arrangements tantamount to a guarantee, in order to be able to remove from the taxpayers' realm any possibility to elect either recourse or nonrecourse debt treatment simply by addressing or ignoring the factors set forth in the 2016 Proposed Debt Regulations.

This inclusion of the "heads we win, tails you lose" anti-abuse rule arguably establishes the inconsistency in the tax policy surrounding the 2016 Proposed Debt Regulations. By reversing and replacing the prior rules, an internally-consistent set of tests focused on EROL, with a facts-and-circumstances test in which the result is uncertain and open to manipulation –and second-guessing by the IRS–the IRS has taken a significant step backwards in its pursuit of sound tax administration. Unless amended or rescinded, the 2016 Proposed Debt Regulations would be effective once final and published in the Federal Register. Taxpayers may rely on the 2016 Proposed Regulations, however, between 10/5/16 and the final publication date. ●