



DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-131186-17]

RIN 1545-BO05

Proposed Removal of Temporary Regulations on a Partner's Share of a Partnership Liability for Disguised Sale Purposes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; public hearing; partial withdrawal of notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations concerning how partnership liabilities are allocated for disguised sale purposes. The proposed regulations, if finalized, would replace existing temporary regulations with final regulations that were in effect prior to the temporary regulations. This document also partially withdraws proposed regulations cross-referencing the temporary regulations. These regulations affect partnerships and their partners. Finally, this document provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by **[INSERT DATE 30 DAYS AFTER DATE OF PUBLICATION IN THE *FEDERAL REGISTER*]**.

A public hearing will be held at 10:00 am on August 21, 2018. Outlines of topics to be discussed at the public hearing must be received by **[INSERT DATE 45 DAYS AFTER DATE OF PUBLICATION IN THE *FEDERAL REGISTER*]**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-131186-17), Room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-131186-17), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the Federal eRulemaking Portal site at <http://www.regulations.gov> (indicate IRS and REG-131186-17). The public hearing will be held in the IRS Auditorium, Internal Revenue Service Building, 1111 Constitution Ave, NW., Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Caroline E. Hay or Deane M. Burke at (202) 317-5279; concerning the submission of comments, the hearing, or to be placed on the building access list to attend the hearing, Regina L. Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document proposes amendments to the Income Tax Regulations (26 CFR part 1) under section 707 of the Internal Revenue Code (Code) regarding allocations of partnership liabilities for disguised sale purposes. Section 707(a)(2)(B) generally provides that, under regulations prescribed by the Secretary of the Treasury (Secretary), related transfers to and by a partnership that, when viewed together, are more properly characterized as a sale or exchange of property, will be treated either as a transaction between the partnership and one who is not a partner or between two or

more partners acting other than in their capacity as partners (generally referred to as “disguised sales”).

The Department of the Treasury (Treasury Department) and the IRS published a notice of proposed rulemaking (REG-119305-11) in the *Federal Register* (79 FR 4826) on January 30, 2014, to amend the then-existing regulations under section 707 relating to disguised sales of property to or by a partnership and under section 752 concerning the treatment of partnership liabilities (2014 Proposed Regulations). The 2014 Proposed Regulations provided certain technical rules intended to clarify the application of the disguised sale rules under section 707 and also contained rules regarding the sharing of partnership recourse and nonrecourse liabilities under section 752. A public hearing on the 2014 Proposed Regulations was not requested or held, but the Treasury Department and the IRS received written comments. Based on a comment received on the 2014 Proposed Regulations requesting that guidance under section 752 regarding a partner’s share of partnership liabilities apply for disguised sale purposes, the Treasury Department and the IRS reconsidered the rules under §1.707-5(a)(2) of the 2014 Proposed Regulations for determining a partner’s share of partnership liabilities for purposes of section 707.

On October 5, 2016, the Treasury Department and the IRS published in the *Federal Register* (81 FR 69282) final and temporary regulations (T.D. 9788) implementing a new rule concerning the allocation of liabilities for section 707 purposes. On November 17, 2016, the Treasury Department and the IRS published in the *Federal Register* (81 FR 80993 and 81 FR 80994) two correcting amendments to T.D. 9788 (the temporary regulations as so corrected, 707 Temporary Regulations). T.D. 9788 also

contained rules concerning the treatment of “bottom dollar payment obligations” (752 Temporary Regulations). The 707 Temporary Regulations were incorporated by cross reference in a notice of proposed rulemaking (REG-122855-15) published on October 5, 2016, in the *Federal Register* (81 FR 69301) (707 Proposed Regulations). That notice of proposed rulemaking also incorporated by cross reference the 752 Temporary Regulations and included new proposed regulations under sections 704 and 752 (752 Proposed Regulations). Also on October 5, 2016, the Treasury Department and the IRS published final regulations under section 707 and §1.752-3 (T.D. 9787) in the *Federal Register* (81 FR 6929). T.D. 9787 was the subject of a correction notice published in the *Federal Register* (81 FR 80587) on November 16, 2016 (the final regulations as so corrected, 707 Final Regulations).

The 707 Temporary Regulations, in response to the comment received on the 2014 Proposed Regulations, adopted an approach that requires a partner to apply the same percentage used to determine the partner’s share of excess nonrecourse liabilities under §1.752-3(a)(3) (with certain limitations) in determining the partner’s share of all partnership liabilities for disguised sale purposes. Also in response to the comment, the 707 Temporary Regulations provide that a partner’s share of a partnership liability for section 707 purposes shall not exceed the partner’s share of the partnership liability under section 752 and applicable regulations. The 707 Temporary Regulations reserve on the treatment, for disguised sale purposes, of an obligation that would be treated as a recourse liability under §1.752-1(a)(1) or a nonrecourse liability under §1.752-1(a)(2) if the liability was treated as a partnership liability for purposes of section 752. The Treasury Department and the IRS received comments supporting the

approach taken in the 707 Temporary Regulations, but also received comments expressing concern that a new approach was adopted by temporary regulations rather than in proposed regulations, which denied taxpayers the ability to provide comment prior to the 707 Temporary Regulations being effective.

On April 21, 2017, the President issued Executive Order 13789 (E.O. 13789), “Executive Order on Identifying and Reducing Tax Regulatory Burdens” (82 FR 19317, April 26, 2017), which directed the Secretary to review all significant tax regulations issued on or after January 1, 2016, and to take concrete action to alleviate the burdens of regulations that (i) impose an undue financial burden on U.S. taxpayers; (ii) add undue complexity to the Federal tax laws; or (iii) exceed the statutory authority of the IRS. E.O. 13789 further directed the Secretary to submit to the President within 60 days an interim report identifying regulations that meet these criteria. Notice 2017-38 (2017-30 IRB 147 (July 24, 2017)) included the 707 Temporary Regulations in a list of eight regulations identified by the Secretary in the interim report as meeting at least one of the first two criteria specified in E.O. 13789.

E.O. 13789 further directed the Secretary to submit to the President and publish in the *Federal Register* a report recommending specific actions to mitigate the burden imposed by regulations identified in the interim report. On October 16, 2017, the Secretary published this second report in the *Federal Register* (82 FR 48013), “Second Report to the President on Identifying and Reducing Tax Regulatory Burdens” (Second Report). The Second Report stated that, while the Treasury Department and the IRS believe that the 707 Temporary Regulations’ novel approach to addressing disguised sale treatment merits further study, the Treasury Department and the IRS agree with

commenters that such a change should be studied systematically. The second report further stated that the Treasury Department and the IRS therefore would consider whether the 707 Temporary Regulations and the 707 Proposed Regulations should be removed and withdrawn, respectively, and the prior regulations reinstated. After further consideration, the Treasury Department and the IRS are withdrawing the 707 Proposed Regulations and proposing to remove the 707 Temporary Regulations and reinstate the regulations under §1.707-5(a)(2) as in effect prior to the 707 Temporary Regulations and as contained in 26 CFR part 1 revised as of April 1, 2016 (Prior 707 Regulations).

The Second Report also stated that the Treasury Department and the IRS believe that the 752 Temporary Regulations concerning bottom dollar payment obligations should be retained because, consistent with the view of a number of commenters, the 752 Temporary Regulations are needed to prevent abuses and do not meaningfully increase regulatory burdens for the taxpayers affected. The Treasury Department and the IRS will continue to consider these issues and continue to request comments concerning the 752 Proposed Regulations. The Second Report did not identify the 707 Final Regulations, which are not affected by this notice of proposed rulemaking.

Explanation of Provisions

In addition to withdrawing the 707 Proposed Regulations, this notice of proposed rulemaking proposes to remove the 707 Temporary Regulations and reinstate the Prior 707 Regulations concerning the allocation of liabilities for disguised sale purposes. In determining a partners' share of a partnership liability for disguised sale purposes, §1.707-5(a)(2) of the Prior 707 Regulations prescribed separate rules for a partnership's

recourse liability and a partnership's nonrecourse liability. This notice of proposed rulemaking adopts those same rules.

Under §1.707-5(a)(2)(i) of the Prior 707 Regulations and, if finalized, these proposed regulations, a partner's share of a partnership's recourse liability equals the partner's share of the liability under section 752 and the regulations thereunder. A partnership liability is a recourse liability to the extent that the obligation is a recourse liability under §1.752-1(a)(1).

Under §1.707-5(a)(2)(ii) of the Prior 707 Regulations and, if finalized, these proposed regulations, a partner's share of a partnership's nonrecourse liability is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under §1.752-3(a)(3). A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability under §1.752-1(a)(2).

The 707 Final Regulations limited the available methods for determining a partner's share of an excess nonrecourse liability under §1.752-3(a)(3) for disguised sale purposes. Under the 707 Final Regulations, a partner's share of an excess nonrecourse liability for disguised sale purposes is determined only in accordance with the partner's share of partnership profits and by taking into account all facts and circumstances relating to the economic arrangement of the partners. Thus, the significant item method, the alternative method, and the additional method as defined in §1.752-3(a)(3) do not apply for purposes of determining a partner's share of a partnership's nonrecourse liability for disguised sale purposes.

In addition, §1.707-5(a)(2)(i) and (ii) of the Prior 707 Regulations provided that a partnership liability is a recourse or nonrecourse liability to the extent that the obligation would be a recourse liability under §1.752-1(a)(1) or a nonrecourse liability under §1.752-1(a)(2), respectively, if the liability was treated as a partnership liability for purposes of section 752 (§1.752-7 contingent liabilities). This notice of proposed rulemaking reinstates these rules concerning §1.752-7 contingent liabilities. However, as noted in the preamble to T.D. 9788, the Treasury Department and the IRS continue to believe additional guidance would be helpful in this area. The preamble to T.D. 9788 explained that, in many cases, §1.752-7 contingent liabilities may constitute qualified liabilities that would not be taken into account for purposes of determining a disguised sale. Some commenters on the 2014 Proposed Regulations noted that there may be circumstances in which certain transfers of §1.752-7 contingent liabilities to a partnership may be abusive. The Treasury Department and the IRS continue to study the issue of the effect of contingent liabilities with respect to section 707, as well as other sections of the Code.

Finally, this notice of proposed rulemaking reinstates Examples 2, 3, 7, and 8 under §1.707-5(f) of the Prior 707 Regulations. However, language is added to Example 3 to reflect an amendment to §1.707-5(a)(3) in the 707 Final Regulations regarding an anticipated reduction in a partner's share of a liability that is not subject to the entrepreneurial risks of partnership operations.

Proposed Applicability Date

The 707 Temporary Regulations are proposed to be removed thirty days following the date these regulations are published as final regulations in the *Federal*

Register. The amendments to §1.707-5 are proposed to apply to any transaction with respect to which all transfers occur on or after thirty days following the date these regulations are published as final regulations in the *Federal Register*. However, a partnership and its partners may apply all the rules in these proposed regulations in lieu of the 707 Temporary Regulations to any transaction with respect to which all transfers occur on or after January 3, 2017.

Special Analyses

These proposed regulations are not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Department of the Treasury and the Office of Management and Budget regarding review of tax regulations. These proposed regulations are expected to be an Executive Order 13771 deregulatory action. Details on the estimated cost savings of these proposed regulations will be provided in the final regulations.

Because these proposed regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Comments Concerning These Proposed Regulations

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "ADDRESSES" heading. The Treasury

Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at <http://www.regulations.gov> or upon request.

A public hearing has been scheduled for August 21, 2018, beginning at 10:00 am in the IRS Auditorium of the Internal Revenue Service Building, 1111 Constitution Avenue, NW., Washington, DC 20224. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit a signed original and eight (8) copies of written or electronic comments by **[INSERT DATE 30 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]** and an outline of the topics to be discussed and the time to be devoted to each topic by **[INSERT DATE 45 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Comments Concerning Approach in the 707 Temporary Regulations

As discussed in the Second Report, the Treasury Department and the IRS believe that the 707 Temporary Regulations' novel approach (treating all liabilities as

nonrecourse and allocating in accordance with §1.752-3(a)(3) for disguised sale purposes) merits further study. The 707 Temporary Regulations explained that this approach reflects the overall economic arrangements of the partners as, in most cases, a partnership will satisfy its liabilities with partnership profits, the partnership's assets do not become worthless, and the payment obligations of partners or related persons are not called upon. The Treasury Department and the IRS continue to study this issue and request comments on the approach adopted in the 707 Temporary Regulations. The request for comments in this paragraph on the approach of the 707 Temporary Regulations is not the subject of the scheduled public hearing.

Drafting Information

The principal authors of these proposed regulations are Caroline E. Hay and Deane M. Burke, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income Taxes, Reporting and recordkeeping requirements.

Partial Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, §§1.707-5 and 1.707-9 of the notice of proposed rulemaking (REG-122855-15) that was published in the *Federal Register* on October 5, 2016 (81 FR 69301) are withdrawn.

Proposed Amendments to the Regulations

For the reasons stated in the preamble, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.707-5 is amended by revising paragraph (a)(2) and Examples 2, 3, 7, and 8 in paragraph (f) to read as follows:

§1.707-5. Disguised sales of property to partnership; special rules relating to liabilities.

(a) * * *

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

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

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

* * * * *

(f) * * *

Example 2. Partnership's assumption of recourse liability encumbering transferred property. (i) C transfers property Y to a partnership. 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, 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. The partnership assumed this liability solely to acquire property Y. 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 \$7,000,000.

(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 in the amount of \$1,000,000 (the excess of the liability assumed by the partnership (\$8,000,000) over C's share of the liability immediately after the assumption (\$7,000,000)). See paragraphs (a)(1) and (2) of this section.

Example 3. Subsequent reduction of transferring partner's share of liability. (i) The facts are the same as in Example 2. In addition, property Y is a fully leased office building, the rental income from property Y is sufficient to meet debt service, and the remaining term of the liability is ten years. It is anticipated that, three years after the partnership's assumption of the liability, C's share of the liability under section 752 will be reduced to zero because of a shift in the allocation of partnership losses pursuant to the terms of the partnership agreement. Under the partnership agreement, this shift in the allocation of partnership losses is dependent solely on the passage of time.

(ii) Under paragraph (a)(3) of this section, if the reduction in C's share of the liability was anticipated at the time of C's transfer, was not subject to the entrepreneurial risks of partnership operations, and was part of a plan that has as one of its principal purposes minimizing the extent of sale treatment under §1.707-3 (that is, a principal purpose of allocating a large percentage of losses to C in the first three years when losses were not likely to be realized was to minimize the extent to which C's transfer would be treated as part of a sale), C's share of the liability immediately after the assumption is treated as equal to C's reduced share.

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Example 7. Partnership's assumptions of liabilities encumbering properties transferred pursuant to a plan. (i) Pursuant to a plan, G and H transfer property 1 and property 2, respectively, to an existing partnership in exchange for interests in the partnership. At the time the properties are transferred to the partnership, property 1 has a fair market value of \$10,000 and an adjusted tax basis of \$6,000, and property 2 has a fair market value of \$10,000 and an adjusted tax basis of \$4,000. At the time

properties 1 and 2 are transferred to the partnership, a \$6,000 nonrecourse liability (liability 1) is secured by property 1 and a \$7,000 recourse liability of F (liability 2) is secured by property 2. Properties 1 and 2 are transferred to the partnership, and the partnership takes subject to liability 1 and assumes liability 2. G and H incurred liabilities 1 and 2 immediately prior to transferring properties 1 and 2 to the partnership and used the proceeds for personal expenditures. The liabilities are not qualified liabilities. Assume that G and H are each allocated \$2,000 of liability 1 in accordance with §1.707-5(a)(2)(ii) (which determines a partner's share of a nonrecourse liability). Assume further that G's share of liability 2 is \$3,500 and H's share is \$0 in accordance with §1.707-5(a)(2)(i) (which determines a partner's share of a recourse liability).

(ii) G and H transferred properties 1 and 2 to the partnership pursuant to a plan. Accordingly, the partnership's taking subject to liability 1 is treated as a transfer of only \$500 of consideration to G (the amount by which liability 1 (\$6,000) exceeds G's share of liabilities 1 and 2 (\$5,500)), and the partnership's assumption of liability 2 is treated as a transfer of only \$5,000 of consideration to H (the amount by which liability 2 (\$7,000) exceeds H's share of liabilities 1 and 2 (\$2,000)). G is treated under the rule in §1.707-3 as having sold \$500 of the fair market value of property 1 in exchange for the partnership's taking subject to liability 1 and H is treated as having sold \$5,000 of the fair market value of property 2 in exchange for the assumption of liability 2.

Example 8. Partnership's assumption of liability pursuant to a plan to avoid sale treatment of partnership assumption of another liability. (i) The facts are the same as in Example 7, except that—

(A) H transferred the proceeds of liability 2 to the partnership; and

(B) H incurred liability 2 in an attempt to reduce the extent to which the partnership's taking subject to liability 1 would be treated as a transfer of consideration to G (and thereby reduce the portion of G's transfer of property 1 to the partnership that would be treated as part of a sale).

(ii) Because the partnership assumed liability 2 with a principal purpose of reducing the extent to which the partnership's taking subject to liability 1 would be treated as a transfer of consideration to G, liability 2 is ignored in applying paragraph (a)(3) of this section. Accordingly, the partnership's taking subject to liability 1 is treated as a transfer of \$4,000 of consideration to G (the amount by which liability 1 (\$6,000) exceeds G's share of liability 1 (\$2,000)). On the other hand, the partnership's assumption of liability 2 is not treated as a transfer of any consideration to H because H's share of that liability equals \$7,000 as a result of H's transfer of \$7,000 in money to the partnership.

* * * * *

§1.707-5T [Removed]

Par. 3. Section 1.707-5T is removed.

Par. 4. Section 1.707-9 is amended by revising paragraph (a)(4) and removing paragraph (a)(5). The revisions read as follows:

§1.707-9. Effective dates and transitional rules.

(a) * * *

(4) Section 1.707-5(a)(2) and (f) Examples 2, 3, 7, and 8. (i) Section 1.707-5(a)(2) and (f) Examples 2, 3, 7, and 8, as contained in 26 CFR part 1 revised as of April 1, 2016, apply to any transaction with respect to which any transfers occur before January 3, 2017.

(ii) For any transaction with respect to which all transfers occur on or after January 3, 2017, and any of such transfers occurs before the date that is thirty days after the date these regulations are published as final in the *Federal Register*, see §1.707-9T(a)(5) as contained in 26 CFR part 1 revised as of April 1, 2017.

(iii) Section 1.707-5(a)(2) and (f) Examples 2, 3, 7, and 8 apply to any transaction with respect to which all transfers occur on or after the date that is thirty days after the date these regulations are published as final in the *Federal Register*.

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§1.707-9T [Removed]

Par. 5. Section 1.707-9T is removed.

Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

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