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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9876]

RIN 1545-BO05

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

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations concerning how partnership liabilities are allocated for disguised sale purposes. The regulations replace existing temporary regulations with final regulations that were in effect prior to the temporary regulations. These regulations affect partnerships and their partners.

DATES: Effective date: These regulations are effective on **[INSERT DATE 30 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability date: For date of applicability, see §1.707-9(a)(4).

FOR FURTHER INFORMATION CONTACT: Caroline E. Hay at (202) 317-5279 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains 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, related transfers of money or other property 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").

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 certain burdens imposed by the regulations. In response to E.O. 13789, the Secretary issued an interim report which identified the final and temporary regulations (T.D. 9788) (707 Temporary Regulations) concerning the allocation of partnership liabilities for section 707 purposes as meeting some of the regulatory burdens specified in E.O. 13789, and later issued a second report recommending specific actions to mitigate the burdens. See Notice 2017-38 (2017-30 IRB 147 (July 24, 2017)) and Second Report to the President on Identifying and Reducing Tax Regulatory Burdens (82 FR 48013, October 16, 2017).

Following the issuance of the interim and second reports, on June 19, 2018, the Department of the Treasury (Treasury Department) and the IRS published a notice of proposed rulemaking (REG-131186-17) in the **Federal Register** (83 FR 28397) (2018 Proposed Regulations) proposing to withdraw the 707 Temporary Regulations. The

2018 Proposed Regulations also proposed reinstating 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). Finally, the 2018 Proposed Regulations withdrew a notice of proposed rulemaking (REG-122855-15) that incorporated by cross reference the 707 Temporary Regulations. The Treasury Department and the IRS did not receive any written public comments in response to the 2018 Proposed Regulations. A scheduled public hearing on the 2018 Proposed Regulations was cancelled because no one requested to speak.

Therefore, the 2018 Proposed Regulations proposing to withdraw the 707 Temporary Regulations and reinstate the Prior 707 Regulations are adopted by this Treasury decision without change, except the applicability date has been revised. To avoid a lapse in rules for allocating partnership liabilities for disguised sale purposes, these final regulations apply to any transaction with respect to which all transfers occur on or after October 4, 2019, the date that the 707 Temporary Regulations expire. Preventing a lapse in rules benefits the Treasury Department, the IRS, and taxpayers by providing certainty regarding the applicable rules. These final regulations continue to provide that partnerships and their partners may apply these regulations to any transaction with respect to which all transfers occur on or after January 3, 2017, the applicability date of the 707 Temporary Regulations.

Special Analyses

These final 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 Treasury Department and the Office of Management and Budget regarding review of tax

regulations. Because these final 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, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

Ongoing Study of Liability Rule for Disguised Sales

The 707 Temporary Regulations withdrawn by this Treasury decision adopted an approach requiring a partnership to apply the same percentage used to determine a 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. As was noted in the preamble to the 2018 Proposed Regulations, some commenters supported this approach, but also expressed concern that it was adopted in temporary regulations rather than proposed regulations that would allow for further comment. The Treasury Department and the IRS continue to study the merits of the approach in the 707 Temporary Regulations and other approaches, including these final regulations, to determine which results in the most appropriate treatment of liabilities in the context of disguised sales.

Drafting Information

The principal author of these regulations is 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.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is 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:

1. Revising paragraph (a)(2).

2. Designating Examples 1 through 13 of paragraph (f) as paragraphs (f)(1) through (f)(13), respectively.

3. Revising newly designated paragraphs (f)(2) and (3).

4. Removing the language "Example 5" in newly designated paragraph (f)(6)(i) and paragraph (f)(6)(ii) introductory text and adding the language "paragraph (f)(5) of this section (Example 5)" in its place.

5. Revising newly designated paragraphs (f)(7) and (8).

6. Removing the language "Example 10" in newly designated paragraph (f)(11)(i) and adding the language "paragraph (f)(10) of this section (Example 10)" in its place.

The revisions 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 in this part under section 752. 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) * * *

(2) 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 in this part under section 752, 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 paragraph (f)(2)(i) of this section (Example 2), 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.

(3) Example 3. Subsequent reduction of transferring partner's share of liability. (i) The facts are the same as in paragraph (f)(2) of this section (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.

* * * * *

(7) 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 paragraph (a)(2)(ii) of this section (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 paragraph (a)(2)(i) of this section (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.

(8) 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 paragraph (f)(7) of this section (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.

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§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 revision reads as follows:

§1.707-9 Effective dates and transitional rules.

(a) * * *

(4) Applicability date of §1.707-5(a)(2) and (f)(2), (3), (7), and (8). (i) Section 1.707-5(a)(2) and (f)(2), (3), (7), and (8) apply to any transaction with respect to which

all transfers occur on or after October 4, 2019. However, a partnership and its partners may apply §1.707-5(a)(2) and (f)(2), (3), (7), and (8) to any transaction with respect to which all transfers occur on or after January 3, 2017.

(ii) For any transaction with respect to which any transfers occur before January 3, 2017, §1.707-5(a)(2) and (f), as contained in 26 CFR part 1 revised as of April 1, 2016, apply.

(iii) For any transaction with respect to which all transfers occur on or after January 3, 2017, and any of such transfers occurs before October 4, 2019, see §1.707-9T(a)(5) as contained in 26 CFR part 1 revised as of April 1, 2019.

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§1.707-9T [Removed]

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

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Sunita Lough

Deputy Commissioner for Services and Enforcement.

Approved: October 1, 2019.

David J. Kautter

Assistant Secretary of the Treasury (Tax Policy).

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