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September 30, 2015

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The Honorable William J. Wilkins
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RE: Proposed Regulations (REG-119305-11): Relating to Guidance under Section 707 on Disguised Sales and Section 752 on the Allocation of Partnership Liabilities Issued on January 30, 2014

Dear Messrs. Koskinen, Wilkins, and Burke:

The American Institute of CPAs (AICPA) submits the below comments in response to the proposed regulations (REG-119305-11) published on January 30, 2014, regarding disguised sales to partnerships and the allocation of partnership liabilities. These comments were developed by the AICPA Partnership Taxation Technical Resource Panel and approved by the AICPA Tax Executive Committee.

The proposed regulations under section 707¹ clarify several disguised sale rules. The AICPA commends the Internal Revenue Service (IRS or “Service”) for providing these clarifications and reducing the likelihood that a taxpayer will inadvertently enter into a disguised sale.

The proposed regulations under section 752 recommend a number of significant changes to the existing regulations, which provide how recourse and nonrecourse liabilities are shared by partners. These provisions are intended to prevent abuse of certain liability allocation rules. However, the AICPA believes most of these changes are unnecessary and administratively burdensome.

Specifically, our comments in this letter address the following issues:

¹ All section references in this letter are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.

1. Section 707 – Disguised Sale Rules;
2. Section 752 – Partnership Liability Sharing Rules (Recourse Liabilities); and
3. Section 752 – Partnership Liability Sharing Rules (Nonrecourse Liabilities).

Section 707 – Disguised Sale Rules

A. Recommendation

The AICPA recommends that the IRS amend the proposed regulations to continue to allow the application of the fair market value limitation on an aggregate of qualifying property basis. For legitimate business reasons, some partnerships wish to avoid the expense of valuing each property held by the business and this option should remain permissible.

B. Analysis

Initially, the proposed regulations clarify and continue the concept that borrowing against contributed property after the partnership is formed is treated the same as borrowing against contributed property before the partnership is formed.² That rule is based on the belief that borrowing before or after the partnership formation is substantively the same. This rule allows the partnership to borrow money and distribute it to the property contributor without a disguised sale occurring as long as the contributing partner is allocated the liability under the partnership rules. This debt finance distribution rule³ is clarified by the addition of an example involving multiple liabilities of the partnership. Under the debt financed distribution rule, it is easy for a property contributor to receive money equivalent to sale proceeds but defer the gain until the partnership pays the debt.

The proposed regulations also clarify the preformation expenditure rule,⁴ which allows a property contributor to apply many distributions first to offset basis. The existing disguised sale regulations provide that a transfer of money or other consideration by a partnership to a partner is not treated as part of a disguised sale to the extent that the transfer to the partner is (1) made to reimburse the partner for, and does not exceed the amount of, capital expenditures that are incurred during the two-year period preceding the transfer of property and (2) are incurred by the partner with respect to preformation capital expenditures (with respect to property contributed to the partnership).

² See H.R. Rep. No. 98-861, at 862 (1984), which states: “The conferees wish to note that when a partner of a partnership contributes property to the partnership and that property is borrowed against, pledged as collateral for a loan, or otherwise refinanced, and the proceeds of the loan are distributed to the contributing partner, there will be no disguised sale under the provision to the extent the contributing partner, in substance, retains liability for repayment of the borrowed amounts (i.e., to the extent the other partners have no direct or indirect risk of loss with respect to such amounts) since, in effect, the partner has simply borrowed through the partnership.”

³ Treas. Reg. § 1.707-5(b).

⁴ Treas. Reg. § 1.707-4(d).

To avoid characterization as proceeds received in a disguised sale, the reimbursement by the partnership with respect to property contributed to the partnership by that partner generally cannot exceed 20 percent of the fair market value of the contributed property.⁵ However, Treas. Reg. § 1.707-4(d)(2)(ii) provides that if the fair market value of the contributed property does not exceed 120 percent of the tax basis of that property, the contributing partner can receive reimbursement of 100 percent of the original cost of the preformation capital expenditures without subjecting themselves to the disguised sale rules.

The first clarification to the capital expenditure reimbursement rule relates to the fair market value limitation. The clarification provides that the 120 percent limitation calculation is made separately for each property with qualifying capital expenditures. This proposed rule requires a separate valuation for each property. For legitimate business reasons, some partnerships may wish to avoid the expense of valuing each property held by the partnership. The currently permitted aggregate approach avoids the need for detailed individual property valuations.

Second, the proposed regulations provide that capital expenditures that are already deducted and resulted in tax savings are still reimbursable in full. For example, if \$1,000,000 is used to buy property and 50 percent bonus depreciation is deducted, the full \$1,000,000 is still subject to reimbursement. Further, the preamble to REG-119305-11 states: “For purposes of § 1.707-4 and § 1.707-5, the term ‘capital expenditures’ has the same meaning as the term ‘capital expenditures’ has under the Code and applicable regulations.” Thus, even an expenditure to buy stock within two years of the partnership contribution will qualify for the tax-free expenditure reimbursement by the partnership. Finally, the IRS removed the so-called double dip benefit where a capital expenditure is paid with a loan that is also excluded from disguised sale analysis.⁶

As a result of the changes, it remains more beneficial to have a disguised sale rather than an actual sale. For example, if a developer who has property built within the last two years with a value of \$100,000,000 and a basis of \$60,000,000, wants to sell 20 percent and then join in a partnership with the purchaser, the capital expenditure rule can be used to eliminate the gain. In an actual sale, the seller would recognize and pay tax on $\$20,000,000 - \$12,000,000 = \$8,000,000$. The \$8,000,000 in gain results from an allocation of the basis between the portion sold and the portion retained. If instead the cash is routed through the partnership, there is no gain because under the preformation capital expenditure rule, the basis is only reduced to \$40,000,000 and the gain is deferred. The use of the preformation expenditure rule still requires reporting to the IRS.⁷ Thus, the majority of disguised sales reported to the IRS will remain intentional disguised sales. It remains unlikely that anyone will inadvertently violate the disguised sale rules.

⁵ Treas. Reg. § 1.707-4(d)(2)(ii).

⁶ See generally, PLR 9444004, which had authorized the “double dip.”

⁷ Treas. Reg. § 1.707-3(c) & Treas. Reg. § 1.707-8.

Section 752 – Partnership Liability Sharing Rules (Recourse Liabilities)

A. Recommendations

The IRS and Department of the Treasury (“Treasury”) specifically requested comments regarding (i) whether the final regulations should extend the net value rules to all partners and related persons, and (ii) whether consolidating the net value rules in Treas. Reg. § 1.752-2(k) would provide clarity.

The AICPA recommends that the final regulations should:

1. Consolidate the net value rules within Treas. Reg. § 1.752-2(k), and extend the existing net value rule of Treas. Reg. § 1.752-2(k) to all partners and related parties other than individuals; and
2. Include an anti-avoidance provision similar to Treas. Reg. § 1.705-2(c)(1), or simply expand the anti-abuse rule currently in Treas. Reg. § 1.752-2(j). The anti-avoidance provision should prevent the breaking up of debt into tranches to manipulate the bottom guarantee rule in recommendation number 5 below.

The AICPA recommends that the final regulations should not require:

1. Providing continuous documentation to support the net value of the credit support provider;
2. The payment obligation to exist for the full term of the partnership liability (partners often change responsibility for liabilities and should not face this restriction); and
3. “First dollar” obligations.

We recommend that any obligation that is not restricted to the final 25 percent of a liability is treated as having substance. The IRS should respect a vertical slice liability guarantee if it guarantees more than 25 percent of the liability. We believe that liability exposures greater than 25 percent would generally represent a real risk exposure in the view of third party lenders.

B. Analysis

Treasury Reg. § 1.752-2 provides that in general, a partner’s share of a recourse partnership liability equals the portion of that liability for which the partner or a related person bears the economic risk of loss. Treasury Reg. § 1.752-2(b) utilizes a constructive liquidation test to determine when the partner or a related person bears the economic risk of loss because they are obligated to make a payment on the partnership liability. Under the constructive liquidation test, the following is deemed to occur:

- All of the partnership’s liabilities are considered payable in full;

- With the exception of property contributed to secure a partnership liability, all of the partnership's assets, including cash, have a value of zero;
- The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditors' right to repayment is limited solely to one or more assets of the partnership);
- All items of income, gain, loss, or deduction are allocated among the partners; and
- The partnership liquidates.

If under this constructive liquidation a partner or a related person is obligated to make payment on a liability of the partnership, then that partner is deemed to bear the economic risk of loss related to such liability.

Under current Treas. Reg. § 1.752-2(b)(3), when determining if a partner or a related person has an obligation to make a payment under the constructive liquidation test, various contractual obligations (including guarantees and obligations imposed by the partnership agreement, such as deficit restoration obligations) are taken into account.

Under current Treas. Reg. § 1.752-2(b)(6), a payment obligation is generally deemed satisfied irrespective of the actual net worth of the partner, except in the case of a plan to avoid or circumvent the obligation. This provision of the current regulations could cause recourse obligations to lack economic substance. Under the proposed regulations, the deemed satisfaction rule of the current regulations is replaced with a net value rule. The proposed regulations require that the partner demonstrate that they have sufficient net value to support the payment obligation. Proposed Reg. § 1.752-2(b)(3)(iii)(B) amends and supplements the deemed satisfaction rule of Treas. Reg. § 1.752-2(b)(6) by adding a net value requirement similar to the current rule for disregarded entities under Treas. Reg. § 1.752-2(k) to determine whether the partner bears the risk of loss other than for a trade payable. Under the proposed regulations, except for an individual or a decedent's estate, a payment obligation of a partner or related person is only taken into account as causing the partner to bear the risk of loss to the extent of the partner's net value. Furthermore, the net value requirement will apply to the payment obligation of a disregarded entity owned by an individual or decedent's estate.

Proposed Reg. § 1.752-2(b)(3)(ii) provides that payment obligations of partners or related persons are not recognized for purposes of section 752 unless seven requirements are met. These requirements attempt to determine how much risk a partner can actually bear.

The first five requirements are generally referred to as "commercial requirements" and are designed to ensure that terms of the guaranty or payment obligation has economic substance.

Proposed Reg. § 1.752-2(b)(3)(ii)(A)-(E) sets forth the five commercial requirements:

"A. The partner or related person is:

- (1) Required to maintain a commercially reasonable net worth during the term of the payment obligation; or
- (2) Subject to commercially reasonable restrictions on asset transfers for inadequate consideration.

B. The partner or related person is required periodically to provide commercially reasonable documentation regarding its financial condition.

C. The term of the payment obligation does not end prior to the term of the partnership liability.

D. The payment obligation does not require that the primary obligor or any other obligor with respect to the partnership liability directly or indirectly hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor.

E. The partner or related person received arm's length consideration for assuming the payment obligation."

The remaining two recognition requirements apply to guarantees and indemnities to ensure that any guarantees are "first dollar" obligations.

The AICPA believes most of these changes are unnecessary and administratively burdensome. The liability rules need only minor changes to support their current structure, which is well-reasoned and generally perceived as intuitive.

In determining the extent to which a partner bears the economic risk of loss for a partnership liability, under current Treas. Reg. § 1.752-2(k), a net value rule is imposed on disregarded entity partners. The net value of a disregarded entity partner is the fair market value of the entity's assets, including its enforceable rights to contributions and the fair market value of any other partnership interests (other than the partnership for which net value is determined), reduced by all obligations other than the recourse payment obligations. The valuation date is generally the allocation date which is the earlier of the date when a partner's share of partnership liabilities is determined or the end of the partnership's taxable year in which the requirement to determine the net value arises.

Extending Treas. Reg. § 1.752-2(k), to all partners except individuals should resolve the current payment obligation issues without imposing the more burdensome reporting requirements of the proposed regulations which would require providing documentation "periodically."

Under Prop. Reg. § 1.752-2(b)(3)(iii)(C), a partner treated as bearing the economic risk of loss for a partnership liability, other than an individual or decedent's estate, must provide information regarding its net value that is appropriately allocable to the partnership's liabilities on a timely

basis. The reporting obligation presents many administrative and technical issues as to how often the information is provided and how net value is allocated to a specific partnership liability.

The payment obligation requirements appear to be based on what a third party lender would require of a credit support provider, and in turn, what a credit support provider would require from the obligor. However, rarely does a commercial arrangement among third parties satisfy all of the noted payment obligation requirements. Furthermore, in recent years we have seen drastic, and somewhat sudden, changes in commercial practices. Similar future changes could quickly render the payment obligation requirements out-of-date. We also find the reporting requirements administratively burdensome from the perspective of both the partners and the partnership.

There are further issues raised by the proposal as to the consequences to a partner (and the partnership itself) if a contractual obligation is breached, or if the documentation requirement is not satisfied. Taxpayers seeking to apply the nonrecourse debt allocation rules could intentionally plan to fail one or more of the recognition requirements, even in cases where a partner is providing meaningful credit support.

Section 752 – Partnership Liability Sharing Rules (Nonrecourse Liabilities)

A. Recommendations

The AICPA recommends retaining the existing safe harbors in the current regulations and adding the capital interest safe harbor to the disguised sale regulations.

We believe that the safe-harbor in the proposed regulations is administratively burdensome. Some partnerships will find the cost of compliance unaffordable. Moreover, the valuation necessary to compute liquidation value percentages is, by its very nature, judgmental.

Currently, the section 704(c) determination method does not apply for purposes of the disguised sale rules. Thus, there is a history of having a more restrictive nonrecourse sharing rule for disguised sales. Our suggested approach is to further restrict the allocation of nonrecourse debt for purposes of the disguised sale rules, but otherwise leave the existing nonrecourse rules unchanged except perhaps for a clarification of an “item of partnership income.” The problem with aggressive disguised sales is best addressed directly in the disguised sale regulations.

B. Analysis

Currently, Treas. Reg. § 1.752-3 provides that a partner’s share of excess nonrecourse liabilities are determined in one of several different ways:

- **Profits:** A partner's share of partnership profits taking into account all the facts and circumstances relating to the economic arrangement of the partners;
- **Significant Item:** A partner's interest in the partnership as specified in the partnership agreement assuming such allocation is consistent with allocations of some other significant item of partnership income or gain which has substantial economic effect;
- **Nonrecourse Deductions:** In accordance with the allocation of deductions attributable to the nonrecourse liabilities; or,
- **Section 704(c):** Up to the amount of built-in gain allocable to the partner on section 704(c) property.

The proposed regulations would eliminate the significant item and nonrecourse deductions methods, replacing them with an allocation based on the partner's liquidation value percentage – his or her share of the overall net fair market value of the partnership's assets. Determination of liquidation value would occur on formation and upon any revaluation event – contributions by new or existing partners, distributions of money or other property to retiring or continuing partners, etc. – no matter how insignificant and regardless of whether the partnership actually revalues capital accounts.

Furthermore, the liquidation value percentage safe harbor may not clearly reflect a partner's interest in a service partnership or a profits interest partner's share in other partnerships where the right to share in profits is not dependent on capital. Defining profits interest by reference to capital is confusing and can lead to a wide range of nonrecourse sharing results. Capital and profits are traditionally considered opposites. For example, the profits interest rules define a profits interest as the absence of a capital interest. See Rev. Proc. 93-27, 1993-2 C.B. 343, which states: "A profits interest is a partnership interest other than a capital interest." Further, section 707(b) [related party restrictions] and section 708(b)(1)(B) [partnership terminations] use the terms profit and capital to mean very distinct and different things.

To equate or define a profit interest by reference to capital violates basic partnership tax concepts, can only lead to confusion, and will erode the unique, precise definition of both terms. Similarly, section 954(c)(4)(B) is an example of a rule that operates off of the partner's capital or profit share.

The wide range of options the proposed regulations allows, and the issues they raise, is best illustrated with a simple example. Assume partner A contributes \$100M, partner B contributes services, profits are split 50/50 for every year, and the limited liability company partnership borrows \$5M. The proposed regulations allows a 50/50 split of the liability based on profit share or allows a 100 percent allocation to partner A based upon capital share. Further, these allocation options are allowed even if the nonrecourse liability is secured by just one \$5M asset. The 100 percent allocation is possibly appropriate if the nonrecourse deductions are similarly allocated entirely to partner A, however the proposed regulations eliminate the already existing deduction tracing rule that accommodates those circumstances.

Allocating liabilities in accordance with relative capital accounts, as allowed by the proposed regulations, could give rise to phantom income to partners who previously received distributions or deducted losses. Such partners may have insufficient basis and receive deemed distributions as a result of the required reallocation of liabilities.

One potentially appropriate situation for allocating liabilities in accordance with relative capital accounts are those partnerships with exculpatory liabilities⁸ only, or partnerships where capital is the only income producing factor.

Another potentially appropriate situation for the proposed safe harbor is in leveraged partnerships where the disguised sale rules are also applicable. In this case, it would prevent disproportionate allocations of liabilities to a contributing partner based on a disproportionate allocation of a significant item of income or gain that does not otherwise reflect the partner's interest in the partnership.

Conclusion

The proposed changes to the section 707 regulations should help address any problems which currently exist with regard to disguised sales. However, the AICPA believes that the IRS should continue to allow the application of the fair market value limitation on an aggregate of qualifying property basis.

The proposed changes to the section 752 regulations seemed designed to address a few abusive transactions while creating excessive and unnecessary burdens for all partners who need to share in partnership liabilities. The AICPA believes that the partnership liability rules are more appropriately improved by expanding the net value rule of existing Treas. Reg. § 1.752-2(k) and by eliminating certain extreme bottom liability guarantees. We further believe that the IRS should retain the existing safe harbors in Treas. Reg. § 1.752-3. Finally, we propose consideration of the proposed capital interest safe harbor for inclusion under the section 707 regulations concerning disguised sales.

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⁸ Exculpatory liabilities are liabilities that are recourse to all the assets of the partnership, but nonrecourse with respect to all the partners. This situation is common for limited liability company partnerships.

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We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. Please feel free to contact me at (801) 523-1051, or tlewis@sisna.com; Noel Brock, Chair, AICPA Partnership Taxation Technical Resource Panel, at (619) 300-1207 or noel@noelbrock.com; or Jonathan Horn, AICPA Lead Technical Manager – Tax Advocacy, at (202) 434-9204, or jhorn@aicpa.org.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Troy K. Lewis". The signature is written in a cursive, flowing style.

Troy K. Lewis, CPA
Chair, AICPA Tax Executive Committee

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Mr. Curtis G. Wilson, Associate Chief Counsel for Passthroughs and Special Industries, Internal Revenue Service