# New Partnership Disguised Sale Regulations

By William E. Sigler, Esq.

On October 5, 2016, the Treasury Department and the Internal Revenue Service issued final, temporary and proposed regulations relating to the partnership disguised sales and debt allocation rules. These new regulations will significantly impact the partnership industry because they limit the ways that certain cash distributions can be made to partners without incurring a current income tax.

Generally, 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 is treated as a “disguised sale” of property by the partner to the partnership. Therefore, the cash or other consideration received may be taxable to the partner if the transfer of money or other consideration would not have been made but for the transfer of property. There are a few exceptions to the disguised sale rules that allow cash to be paid by the partnership to the partner without incurring a current income tax.

For example, under the debt-financed distribution exception a distribution of cash to a partner in connection with a property contribution by the partner is not treated as a taxable sale to the extent that the cash is traceable to a partnership liability incurred within 90 days of the distribution, and the amount of the distribution does not exceed the partner’s allocable share of the liability incurred to fund the distribution. Many leveraged partnerships took advantage of this exception by contributing built-in gain property to the partnership, having the partnership incur debt and distributing the borrowed money to the partner. To the extent that the partner is allocated the debt (e.g., the partner guarantees the partnership debt), the cash was not treated as proceeds from a sale and thus was not currently taxable.

The new regulations make numerous changes to the application of the debt-financed distribution exception. Most importantly, the temporary regulations provide that all partnership liabilities, whether recourse or nonrecourse, will be treated as nonrecourse liabilities allocable to the transferor partner based on the partner’s share of partnership profits. This means that a guarantee can no longer

be used to treat an otherwise nonrecourse debt as “recourse” to the guarantor partner in order to increase the partner’s allocable share of partnership liabilities to shelter debt-financed cash distributions.

Under the capital expenditure reimbursement exception, when a partner contributes property to the partnership and the partnership reimburses the contributing partner for certain capital expenditures and costs incurred by the partner, cash received by the partner as a “reimbursement of capital expenditures” is not taxable. This exception generally applies only to the extent that the reimbursed capital expenditures do not exceed 20 percent of the fair market value of the transferred property. However, the 20 percent limitation does not apply if the fair market value of the transferred property does not exceed 120 percent of the partner’s adjusted basis in the property at the time of the transfer. The final regulations provide that the 20 percent limitation and the 120 percent test are to be applied on a property-by-property basis. In addition, the taxpayers are prohibited from “double-dipping” in connection with a capital expenditure reimbursement and also shifting the economics of the borrowing used to fund the capital expenditures to another partner.

These new regulations impact both existing partnerships and partners, as well as future investment transactions involving partnerships. If you have any questions, please do not hesitate to contact us.