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Approved: August 29, 2016.

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## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

#### 26 CFR Part 1

[TD 9787]

RIN 1545-BK29

#### Section 707 Regarding Disguised Sales, Generally

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations.

**SUMMARY:** This document contains final regulations under sections 707 and 752 of the Internal Revenue Code (Code). The final regulations under section 707 provide guidance relating to disguised sales of property to or by a partnership and the final regulations under section 752 provide guidance relating to allocations of excess nonrecourse liabilities of a partnership to partners for disguised sale purposes. The final regulations affect partnerships and their partners.

**DATES:** *Effective date:* These regulations are effective on October 5, 2016.

*Comment date:* Comments will be accepted until January 3, 2017.

*Applicability dates:* For dates of applicability, see §§ 1.707-9(a)(1) and 1.752-3(d).

**ADDRESSES:** Send submissions to: CC:PA:LPD:PR (REG-122855-15), Room 5203, Internal Revenue Service, P.O. 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-122855-15), 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-122855-15).

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

**SUPPLEMENTARY INFORMATION:** In addition to these final regulations, the Treasury Department and the IRS are publishing temporary regulations

concerning a partner's share of partnership liabilities for purposes of section 707 (the 707 Temporary Regulations) and the treatment of certain payment obligations under section 752 (the 752 Temporary Regulations) in the Rules and Regulations section in this issue of the **Federal Register**, and, in the Proposed Rules section in this issue of the **Federal Register**, proposed regulations (REG-122855-15) that incorporate the text of the temporary regulations, withdraw a portion of a notice of proposed rulemaking (REG-119305-11) to the extent not adopted by the final regulations, and contain new proposed regulations (the 752 Proposed Regulations) addressing (1) when certain obligations to restore a deficit balance in a partner's capital account are disregarded under section 704 and (2) when a partnership's liabilities are treated as recourse liabilities under section 752.

#### Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) and approved by the Office of Management and Budget under control number 1545-0889.

The collection of information in these final regulations under section 707 is in § 1.707-5(a)(7)(ii) (regarding a liability incurred within two years prior to a transfer of property) and is reported on Form 8275, Disclosure Statement. This information is required by the IRS to ensure that section 707(a)(2)(B) of the Code and applicable regulations are properly applied to transfers between a partner and a partnership.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by section 6103.

#### Background

##### 1. Overview

This Treasury decision contains amendments to the Income Tax Regulations (26 CFR part 1) under sections 707 and 752 of the Code related to a notice of proposed rulemaking published on January 30, 2014 in the

**Federal Register** (REG-119305-11, 79 FR 4826) to amend regulations under sections 707 and 752 (the 2014 Proposed Regulations). A public hearing on the 2014 Proposed Regulations was not requested or held, but the Treasury Department and the IRS received written comments. After full consideration of the comments, the final regulations contained in this Treasury decision substantially adopt the 2014 Proposed Regulations under section 707 with revisions to certain proposed rules in response to comments. The revisions to the 2014 Proposed Regulations under section 707 adopted in these final regulations are discussed in the Summary of Comments and Explanation of Revisions section of this preamble. In addition, after considering comments on the 2014 Proposed Regulations under section 752, this Treasury decision adopts as final regulations provisions of the 2014 Proposed Regulations that amend § 1.752-3, revised in response to the comments received. Finally, these final regulations adopt provisions of the 2014 Proposed Regulations revising § 1.704-2(d)(2)(ii) and (m) *Example 1*, to comport with the provisions in the 752 Proposed Regulations and the 752 Temporary Regulations relating to "bottom dollar payment obligations."

However, based on a comment received on the 2014 Proposed Regulations requesting that guidance regarding a partner's share of partnership liabilities apply solely for disguised sale purposes, the Treasury Department and the IRS have 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. Accordingly, in a separate Treasury decision (TD 9788), the Treasury Department and the IRS are also publishing the 707 Temporary Regulations that require 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 partnership liabilities for disguised sale purposes. That Treasury decision also contains the 752 Temporary Regulations providing guidance on the treatment of "bottom dollar payment obligations." Cross-referencing proposed regulations providing additional opportunity for comment are contained in the related notice of proposed rulemaking (REG-122855-15) published in the Proposed Rules section in this issue of the **Federal Register**.

Finally, after considering comments on the 2014 Proposed Regulations under section 752, the Treasury Department

and the IRS are withdrawing § 1.752-2 of the 2014 Proposed Regulations and are publishing the new 752 Proposed Regulations contained in the related notice of proposed rulemaking (REG-122855-15) published in the Proposed Rules section in this issue of the **Federal Register**.

## 2. Summary of Applicable Law

### A. Section 707

Section 707 provides rules concerning “disguised sales” of property to or by a partnership. Section 707(a)(2)(B) generally provides that, under regulations prescribed by the 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 under § 1.707-3, 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 (a disguised sale), 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 property and, for non-simultaneous transfers, the subsequent transfer is not dependent on the entrepreneurial risks of the partnership.

The existing regulations under section 707, however, provide several exceptions. One exception is in § 1.707-4(d) for reimbursements of capital expenditures. Section 1.707-4(d) excepts transfers of money or other consideration from a partnership to reimburse a partner for certain capital expenditures and costs incurred by the partner from being treated as part of a disguised sale of property under § 1.707-3 (exception for preformation capital expenditures). The exception for preformation capital expenditures generally applies only to the extent that the reimbursed capital expenditures do not exceed 20 percent of the fair market value of the property transferred by the partner to the partnership (the 20-percent limitation). The 20-percent limitation, however, 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 120-percent test).

Another exception is in § 1.707-5(b), which generally provides that if a partner transfers property to a

partnership, the partnership incurs a liability and all or a portion of the proceeds of that liability are traceable to a transfer of money or other consideration to the partner, the transfer of money or other consideration is taken into account for purposes of § 1.707-3 only to the extent that the amount of money or the fair market value of other consideration exceeds the partner’s allocable share of the partnership liability (the debt-financed distribution exception).

In addition to the exception for preformation capital expenditures and the debt-financed distribution exception, the disguised sale rules generally exclude certain types of liabilities from disguised sale treatment. Generally under § 1.707-5(a)(5), a partnership’s assumption of a qualified liability, or a partnership’s taking property subject to a qualified liability, in connection with a transfer of property by a partner to the partnership is not treated as part of a disguised sale. Section 1.707-5(a)(6) of the existing regulations defines four types of liabilities that are qualified liabilities. One type of qualified liability is a liability that is allocable under the rules of § 1.163-8T to capital expenditures with respect to the property transferred to the partnership. Another type is one incurred in the ordinary course of the 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. The other two types of qualified liabilities are liabilities incurred more than two years before the transfer of property to the partnership and liabilities incurred within two years of the transfer of the property to the partnership, but not in anticipation of transfer to the partnership. In order to qualify as one of these types of liabilities, it is required that the liability encumber the transferred property.

### B. Determining a Partner’s Share of Liability for Disguised Sale Purposes

In determining a partner’s share of a partnership liability for disguised sale purposes, the existing regulations under section 707 prescribe separate rules for a partnership’s recourse liability and a partnership’s nonrecourse liability. Under § 1.707-5(a)(2)(i), 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 under section 707 to the extent that the obligation is a recourse liability under § 1.752-1(a)(1). Under § 1.707-

5(a)(2)(ii), 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 liabilities under § 1.752-3(a)(3). Generally, a partner’s share of excess nonrecourse liabilities is determined in accordance with the partner’s share of partnership profits taking into account all facts and circumstances relating to the economic arrangement of the partners. A partnership liability is a nonrecourse liability under section 707 to the extent that the obligation is a nonrecourse liability under § 1.752-1(a)(2). Also for purposes of the rules under section 707, 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 under an anticipated reduction rule.

### C. Section 752 Allocation of Excess Nonrecourse Liabilities

Section 1.752-3(a)(3) provides various methods to determine a partner’s share of excess nonrecourse liabilities. Under one method, a partner’s share of excess nonrecourse liabilities of the partnership is determined in accordance with the partner’s share of partnership profits, which takes into account all facts and circumstances relating to the economic arrangement of the partners. For this purpose, the partnership agreement may specify the partners’ interests in partnership profits so long as the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain (the significant item method). Alternatively, excess nonrecourse liabilities may be allocated among partners in a manner that deductions attributable to those liabilities are reasonably expected to be allocated (alternative method). Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property (as defined under § 1.704-3(a)(3)(ii)) or property for which reverse section 704(c) allocations are applicable (as described in § 1.704-3(a)(6)(i)) where such property is subject to the nonrecourse liability, to the extent that such built-in gain exceeds the gain described in § 1.752-3(a)(2) with respect to such property (additional method). This additional method does not apply in determining a partner’s share of a liability for disguised sale purposes.

### 3. The 2014 Proposed Regulations

As discussed in greater detail in the Summary of Comments and Explanation of Provisions section of this preamble, the 2014 Proposed Regulations, as they pertained to section 707, were intended to address certain deficiencies and ambiguities under existing regulations §§ 1.707-3, 1.707-4, and 1.707-5. The 2014 Proposed Regulations, among other things, provided rules that (1) clarified that in the case of multiple property contributions to a partnership, the exception for preformation capital expenditures applies on a property-by-property basis, (2) clarified the definition of capital expenditures for the purpose of the exception for preformation capital expenditures, (3) coordinated the exception for preformation capital expenditures and the rules regarding liabilities traceable to capital expenditures, (4) added a new type of qualified liability, (5) prescribed an ordering rule for applying the debt-financed distribution exception where other exceptions also potentially applied, (6) specified that a reduction that is subject to the entrepreneurial risks of the partnership is not an anticipated reduction for purposes of the rule taking into account an anticipated reduction in a partner's share of a liability, (7) clarified, with respect to tiered partnerships, the application of the debt-financed distribution exception and the application of the rules for qualified liabilities, and (8) extended the principles of § 1.752-1(f) providing for netting of increases and decreases in a partner's share of liabilities resulting from a single transaction to the disguised sale rules.

#### Summary of Comments and Explanation of Revisions

##### 1. Preformation Capital Expenditures

As explained above, § 1.707-4(d) excepts transfers of money or other consideration from a partnership to reimburse a partner for certain capital expenditures and costs incurred by the partner from being treated as part of a disguised sale of property under § 1.707-3, subject to the 20 percent limitation and the 120 percent test.

The 2014 Proposed Regulations under section 707 provided that the determination of whether the 20 percent limitation and the 120 percent test apply to reimbursements of capital expenditures is made, in the case of multiple property transfers, separately for each property that qualifies for the exception (property-by-property rule). Commenters generally supported the property-by-property rule but noted that

in some circumstances the approach may be burdensome and recommended limited aggregation of certain property. After considering the comments, the Treasury Department and the IRS have determined that limited aggregation of property is warranted in certain cases to reduce the burden of separately accounting for each property under the property-by-property rule. Thus, the final regulations adopt the proposed rule but permit aggregation to the extent: (i) The total fair market value of the aggregated property (of which no single property's fair market value exceeds 1 percent of the total fair market value of such aggregated property) is not greater than the lesser of 10 percent of the total fair market value of all property, excluding money and marketable securities (as defined under section 731(c)), transferred by the partner to the partnership, or \$1,000,000; (ii) the partner uses a reasonable aggregation method that is consistently applied; and (iii) the aggregation of property is not part of a plan a principal purpose of which is to avoid §§ 1.707-3 through 1.707-5. Additionally, the final regulations add an example to illustrate the application of the property-by-property rule when a partner transfers both tangible and intangible property to a partnership.

In addition to the property-by-property rule, the 2014 Proposed Regulations provided a rule coordinating the exception for preformation capital expenditures with a rule regarding one type of qualified liability (within the meaning of § 1.707-5(a)(6)) under § 1.707-5(a)(6)(i)(C). Under § 1.707-5(a)(6)(i)(C), a liability that is allocable under the rules of § 1.163-8T to capital expenditures with respect to the property transferred to the partnership by the partner is a qualified liability (capital expenditure qualified liability). Generally under § 1.707-5(a)(5), a partnership's assumption of a qualified liability, or a partnership's taking property subject to a qualified liability, in connection with a transfer of property by a partner to the partnership is not treated as part of a disguised sale. To coordinate the exception for preformation capital expenditures and the capital expenditure qualified liability rule under § 1.707-5(a)(6)(i)(C), the 2014 Proposed Regulations provided that to the extent a partner funded a capital expenditure through a capital expenditure qualified liability and economic responsibility for that borrowing shifts to another partner, the exception for preformation capital expenditures would not apply because

there is no outlay by the partner to reimburse.

A commenter suggested that the final regulations broaden this proposed rule to include any qualified liability under § 1.707-5(a)(6) used to fund capital expenditures, not just a capital expenditure qualified liability under § 1.707-5(a)(6)(i)(C). The final regulations adopt the suggestion and provide that to the extent any qualified liability under § 1.707-5(a)(6) is used by a partner to fund capital expenditures and economic responsibility for that borrowing shifts to another partner, the exception for preformation capital expenditures does not apply. Under the final regulations, capital expenditures are treated as funded by the proceeds of a qualified liability to the extent the proceeds are either traceable to the capital expenditures under § 1.163-8T or are actually used to fund the capital expenditures, irrespective of the tracing requirements under § 1.163-8T. However, under an anti-abuse provision, if capital expenditures and a qualified liability are incurred under a plan a principal purpose of which is to avoid the requirements of this coordinating rule, the capital expenditures are deemed funded by the qualified liability.

Finally, it has come to the attention of the Treasury Department and the IRS that some partners have taken the position that the disclosure requirements of § 1.707-3(c)(2) are not applicable to situations in which the partners believe that one or more of the exceptions for disguised sale treatment are applicable, including the exception for preformation capital expenditures. The Treasury Department and the IRS remind taxpayers that disclosure is required whenever money or other consideration is transferred by a partnership to a partner within two years of the transfer of property by the partner to the partnership, except in the limited situations described in § 1.707-3(c)(2)(iii).

Notwithstanding the final regulations, the Treasury Department and the IRS continue to study the appropriateness of the exception for preformation capital expenditures. Specifically, because the receipt of "boot" in the context of other nonrecognition transactions, for example, transfers of property to corporations in section 351 transactions, is generally taxable to the transferor, the Treasury Department and the IRS are considering whether the exception for preformation capital expenditures is appropriate and request comments on whether the regulations should continue to include the exception, including any policy justifications for keeping the

exception, and on the effects that removing the exception may have. In addition, the Treasury Department and the IRS are concerned that partners and partnerships may be attempting to apply the exception in an unintended manner such that the exception may be subject to potential abuses in certain circumstances that could effectively refresh expenditures not incurred within the two-year period preceding a contribution to a partnership (for example, where an entity treats as a capital expenditure an issuance of its own interest in exchange for property contributed to it in a nonrecognition transaction). Also, the Treasury Department and the IRS are aware that a contribution to a partnership of an intangible such as goodwill, may, in certain circumstances, give rise to an unintended benefit under the exception. The Treasury Department and the IRS are studying the potential for abuse under the exception for preformation capital expenditures, including any unintended benefits with respect to intangibles, for which the final regulations reserve a section under the exception.

## 2. Partner's Share of Partnership Liabilities

As is discussed in the preamble to the 707 Temporary Regulations, after considering the comments on the 2014 Proposed Regulations under both sections 707 and 752, the Treasury Department and the IRS have determined that, for disguised sale purposes only, it is appropriate for partners to determine their share of any liability, whether recourse or nonrecourse, in the manner in which excess nonrecourse liabilities are allocated under § 1.752-3(a)(3). Accordingly, under the 707 Temporary Regulations a partner's share of any partnership liability for disguised sale purposes is determined using the same percentage used to determine the partner's share of the partnership's excess nonrecourse liabilities under § 1.752-3(a)(3) based on the partner's share of partnership profits. Thus, the 707 Temporary Regulations treat all partnership liabilities, whether recourse or nonrecourse, as nonrecourse liabilities solely for disguised sale purposes under section 707. These final regulations, however, provide limitations on the available allocation methods under § 1.752-3(a)(3), applicable solely for disguised sale purposes under section 707, for determining a partner's share of excess nonrecourse liabilities.

For purposes of allocating excess nonrecourse liabilities under § 1.752-

3(a)(3), proposed § 1.752-3(a)(3) removed the significant item method and the alternative method, but provided a new approach based on a partner's liquidation value percentage. Under the 2014 Proposed Regulations, a partner's liquidation value percentage was a ratio (expressed as a percentage) of the liquidation value of the partner's interest in the partnership to the liquidation value of all of the partners' interests in the partnership. The liquidation value of a partner's interest in a partnership was defined as the amount of cash the partner would receive with respect to the interest if, immediately after formation of the partnership or the occurrence of an event described in § 1.704-1(b)(2)(iv)(f)(5), as the case may be, the partnership sold all of its assets for cash equal to the fair market value of such property (taking into account section 7701(g)), satisfied all of its liabilities (other than those described in § 1.752-7), paid an unrelated third party to assume all of its § 1.752-7 liabilities in a fully taxable transaction, and then liquidated.

Commenters expressed concerns with the scope of changes to § 1.752-3(a)(3) in the 2014 Proposed Regulations and suggested that such changes should be adopted, if at all, for disguised sale purposes only. Additionally, one commenter noted that in all but the simplest of partnerships the liquidation value percentage may have little or no relationship to the partners' share of profits and therefore is inconsistent with the general rule for allocating excess nonrecourse liabilities. Another commenter thought the liquidation value percentage approach could be subject to manipulation. Partially in response to commenters' concerns about both the liquidation value percentage and the relationship between the methods and certain rules under § 1.704-2, the final regulations under § 1.752-3 retain the significant item method and the alternative method, but do not adopt the liquidation value percentage approach for determining partners' interests in partnership profits. However, the Treasury Department and the IRS have concluded that the allocation of excess nonrecourse liabilities in accordance with the significant item method and the alternative method has been abused by partnerships and their partners for disguised sale purposes under section 707. Therefore, as suggested by some commenters, the final regulations under § 1.752-3 provide that, along with the additional method, the significant item method and the alternative method do

not apply for purposes of determining a partner's share of a partnership liability for disguised sale purposes.

In addition to the changes to § 1.752-3, the final regulations revise *Example 1* under § 1.707-5(f) and *Example 2* under § 1.707-6(d) to update some of the cross references to the liability allocation rule in the 707 Temporary Regulations. The final regulations also revise *Examples 5* and *6* under § 1.707-5(f) and *Examples 10* and *12* under proposed § 1.707-5(f) to remove the assumption that the liability is a recourse liability.

Finally, because, under the 707 Temporary Regulations, a partner's share of a partnership liability for disguised sale purposes is based on the partner's share of partnership profits, a partner cannot be allocated 100 percent of the liabilities for purposes of section 707. As a result, some amount of the liabilities, both qualified liabilities and nonqualified liabilities, may shift among partners. The shifting of even a minimal amount of a nonqualified liability that triggers a disguised sale can cause a portion of the qualified liability to be treated as consideration under § 1.707-5(a)(5). Section 1.707-5(a)(5) provides a special rule when a partnership's assumption of, or taking property subject to, a qualified liability is treated as a transfer of consideration made pursuant to a sale due solely to the partnership's assumption of, or taking property subject to, a liability other than a qualified liability. To mitigate the effect of the allocation method for disguised sales, the final regulations include a rule under § 1.707-5(a)(5) that does not take into account qualified liabilities as consideration in transfers of property treated as a sale when the total amount of all liabilities other than qualified liabilities that the partnership assumes or takes subject to is the lesser of 10 percent of the total amount of all qualified liabilities the partnership assumes or takes subject to, or \$1,000,000.

## 3. Step-in-the-Shoes Rule Regarding Preformation Capital Expenditures and Liabilities Incurred by Another Person

For purposes of applying the exception for preformation capital expenditures and determining whether a liability is a qualified liability under § 1.707-5(a)(6), commenters suggested that the final regulations clarify how the rules under §§ 1.707-4(d) and 1.707-5 apply if the transferor partner acquired the transferred property in a nonrecognition transaction, assumed a liability in a nonrecognition transaction, or took property subject to a liability in a nonrecognition transaction from a

person who incurred the preformation capital expenditures or the liability. Commenters noted that Rev. Rul. 2000–44 (2000–2 CB 336) allowed “step-in-the-shoes” treatment when a corporation that acquires assets in a transaction described in section 381(a) succeeds to the status of the transferor corporation for purposes of applying the exception for preformation capital expenditures and determining whether a liability is a qualified liability under § 1.707–5(a)(6). Similar to a corporation that acquires assets in a section 381(a) transaction, a partner that acquires property, assumes a liability, or takes property subject to a liability from another person in connection with certain other nonrecognition transactions should succeed to the status of the other person for purposes of applying the exception for preformation capital expenditures and determining whether a liability is a qualified liability under § 1.707–5(a)(6). Thus, the final regulations provide a “step-in-the-shoes” rule for applying the exception for preformation capital expenditures and for determining whether a liability is a qualified liability under § 1.707–5(a)(6) when a partner acquires property, assumes a liability, or takes property subject to a liability from another person in connection with a nonrecognition transaction under section 351, 381(a), 721, or 731. As a result, Rev. Rul. 2000–44, relating to preformation capital expenditures and qualified liabilities involved in a transaction described in section 381(a), is superseded by these final regulations.

#### 4. Anticipated Reduction

Under the existing regulations, for purposes of the rules under section 707, 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. See § 1.707–5(a)(3) and (b)(2)(iii). The 2014 Proposed Regulations provided that if, within two years of the partnership assuming, taking property subject to, or incurring a liability, a partner's share of the liability is reduced due to a decrease in the partner's or a related person's net value, then the reduction will be presumed to be anticipated and must be disclosed under § 1.707–8, unless the facts and circumstances clearly establish that the decrease in the net value was not anticipated. Because the 707 Temporary Regulations provide that a partner's share of any liability for disguised sale purposes is determined in accordance with the partner's interest in partnership profits under § 1.752–3(a)(3), net value is not relevant in

determining a partner's share of partnership liabilities for disguised sale purposes. Accordingly, the final regulations do not retain the net value component of the anticipated reduction of share of liabilities rule.

#### 5. Tiered Partnerships

The existing regulations in § 1.707–5(e), and § 1.707–6(b) by applying rules similar to § 1.707–5(e), provide only a limited tiered-partnership rule for cases in which a partnership succeeds to a liability of another partnership. The 2014 Proposed Regulations added additional rules regarding tiered partnerships. One rule related to the characterization of liabilities attributable to a contributed partnership interest. Under that proposed rule, 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 the liability 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 final regulations retain this proposed rule but, in response to comments, address whose intent, the partner's or the lower-tier partnership's, is relevant when applying the anticipated transfer of property rule in § 1.707–5(a)(6) for purposes of determining whether a liability constitutes a qualified liability. The comments suggested that it should be the intent of the partner as to whether the partner anticipated transferring its interest in the lower-tier partnership to the upper-tier partnership at the time the lower-tier partnership incurred the liability.

The Treasury Department and the IRS agree that the intent of the partner is the appropriate inquiry in applying the anticipated transfer of property rule under § 1.707–5(a)(6) in the context of contributions of a partnership interest. Thus, the final regulations provide that in determining whether a liability would be a qualified liability under § 1.707–5(a)(6)(i)(B) or (E), 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.

Commenters also requested that the final regulations allow for the application of the exception for preformation capital expenditures when

a person incurs capital expenditures with respect to property, transfers the property to a partnership (lower-tier partnership), and then transfers an interest in the lower-tier partnership to another partnership (upper-tier partnership) within the two-year period in which the person incurred the capital expenditures. The Treasury Department and the IRS have determined that such a rule is warranted, subject to certain limitations. Therefore, the final regulations provide that, in such circumstances, and provided such expenditures are not otherwise reimbursed to the person, the upper-tier partnership “steps in the shoes” of the person with respect to the property for which the capital expenditures were incurred and may be reimbursed for the capital expenditures by the lower-tier partnership to the same extent that the person could have been reimbursed by the lower-tier partnership. In addition, the person is deemed to have transferred the property, rather than the partnership interest, to the upper-tier partnership for purposes of the exception for preformation capital expenditures and, accordingly, may be reimbursed by the upper-tier partnership to the extent the person could have been previously reimbursed by the lower-tier partnership. The aggregate reimbursements for capital expenditures under this rule cannot exceed the amount that the person could have been reimbursed for such capital expenditures under § 1.707–4(d)(1).

#### 6. Treatment of Liabilities in Assets-Over Merger

The 2014 Proposed Regulations extended the netting principles of § 1.752–1(f) in a provision for determining the effect of an assets-over merger or consolidation under the disguised sale rules. Although comments were generally favorable, they did request clarification on the specific rule provided.

Upon further consideration of the area, the Treasury Department and the IRS have determined that no rule on the treatment of liabilities in an assets-over merger is needed in § 1.707–5. In many instances, liabilities involved in such a merger will constitute qualified liabilities, especially given that the final regulations adopt a “step-in-the-shoes” rule for liabilities acquired by a partner from another person in certain nonrecognition transactions. In cases in which liabilities involved in an assets-over merger do not constitute qualified liabilities, the facts and circumstances test in § 1.707–3 should reach the proper result. Thus, the final regulations do not retain the proposed rule for

partnership assets-over mergers or consolidations.

7. *Disguised Sales of Property by a Partnership to a Partner*

Under § 1.707-6, rules similar to those provided in § 1.707-3 apply in determining whether a transfer of property by a partnership to a partner and one or more transfers of money or other consideration by that partner to the partnership are treated as a disguised sale of property, in whole or in part, to the partner. The Treasury Department and the IRS requested in the preamble to the 2014 Proposed Regulations comments on whether, for purposes of § 1.707-6, it is inappropriate to take into account a transferee partner's share of a partnership liability immediately prior to a distribution if the transferee partner did not have economic exposure with respect to the partnership liability for a meaningful period of time before appreciated property is distributed to that partner subject to the liability. Commenters suggested that § 1.707-6 should be amended to take into account the transitory nature of a partner's share of nonqualified liabilities.

Because under the 707 Temporary Regulations a partner's share of all liabilities is determined for disguised sale purposes in accordance with the partner's interest in partnership profits under § 1.752-3(a)(3), the transitory nature of a partner's share of nonqualified liabilities is no longer an issue. Under that allocation method, an allocation of a 100 percent share of a liability to a partner immediately before a transfer of property by the partnership to the partner in which the transferee partner assumes the liability will not be taken into account. Therefore, the final regulations do not make any changes to the rules under § 1.707-6, other than revising *Example 2* under § 1.707-6(d) to update a cross reference to the liability allocation rule in the 707 Temporary Regulations.

**Effective/Applicability Dates**

With respect to amendments to §§ 1.707-3 through 1.707-6, the final regulations under section 707 apply to any transaction with respect to which all transfers occur on or after October 5, 2016.

With respect to amendments to § 1.752-3, the final regulations under section 752 apply to liabilities that are incurred by a partnership, that a partnership takes property subject to, or that are assumed by a partnership on or after October 5, 2016, other than liabilities incurred by a partnership, that a partnership takes property subject to,

or that are assumed by a partnership pursuant to a written binding contract in effect prior to that date.

**Effect on Other Documents**

The following publication is superseded on October 5, 2016: Rev. Rul. 2000-44 (2000-2 CB 336).

**Special Analyses**

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the amount of time necessary to report the required information will be minimal in that it requires partners to provide information they already maintain or can easily obtain to the IRS. Moreover, it should take a partner no more than 1 hour to satisfy the information requirement in these regulations. Accordingly, a Regulatory Flexibility Analysis under 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.

**Drafting Information**

The principal authors of these regulations are Deane M. Burke and Caroline E. Hay of the Office of the Associate Chief Counsel (Passthroughs & Special Industries), IRS. 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 \* \* \*

Sections 1.707-2 through 1.707-9 also issued under 26 U.S.C. 707(a)(2)(B).

**§ 1.704-2 [Amended]**

■ **Par. 2.** Section 1.704-2 is amended by:

- 1. Removing the language “and (vii)” in paragraph (d)(2)(ii).
  - 2. Removing the language “*Example* (1)(viii) and (ix)” in paragraph (i)(2) and adding the language “*Example* (1)(vii) and (viii)” in its place.
  - 3. Removing the language “*Example* (1)(viii)” in paragraph (i)(5) and adding the language “*Example* (1)(vii)” in its place.
  - 4. Removing *Example* (1)(vii) in paragraph (m) and redesignating *Examples* (1)(viii) and (ix) as *Examples* (1)(vii) and (viii) respectively.
  - 5. Removing the language “*Example* (1)(viii)” in newly redesignated *Example* (1)(viii) in paragraph (m) and adding the language “*Example* (1)(vii)” in its place.
- **Par. 3.** Section 1.707-0 is amended by:
- 1. Adding entries for §§ 1.707-4(d)(1), (d)(2) through (4), (d)(4)(i) and (ii), (d)(5) and (6), and (f).
  - 2. Adding entries for §§ 1.707-5(a)(8) and (b)(3).

The additions read as follows:

**§ 1.707-0 Table of contents.**

\* \* \* \* \*

**§ 1.707-4 Disguised sales of property to partnership; special rules applicable to guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures.**

\* \* \* \* \*

- (d) \* \* \*
- (1) In general.
- (2) Capital expenditures incurred by another person.
- (3) Contribution of a partnership interest with capital expenditures property.
- (4) Special rule for qualified liabilities.
  - (i) In general.
  - (ii) Anti-abuse rule.
- (5) Scope of capital expenditures.
- (6) Example.

\* \* \* \* \*

- (f) Ordering rule cross reference.

\* \* \* \* \*

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

- (a) \* \* \*
- (8) Liability incurred by another person.
- (b) \* \* \*
- (3) Ordering rule.

\* \* \* \* \*

■ **Par. 4.** Section 1.707-4 is amended by:

- 1. Redesignating the text of paragraph (d) introductory text after its subject heading as paragraph (d)(1) and adding a paragraph (d)(1) subject heading.
- 2. Redesignating paragraph (d)(1) as paragraph (d)(1)(i).
- 3. Redesignating paragraph (d)(2) introductory text as paragraph (d)(1)(ii).
- 4. Redesignating paragraph (d)(2)(i) as paragraph (d)(1)(ii)(A).
- 5. Redesignating paragraph (d)(2)(ii) as paragraph (d)(1)(ii)(B) and revising it.
- 6. Adding reserved paragraph (d)(1)(ii)(C) and paragraphs (d)(2) through (6) and (f).

The additions and revisions read as follows:

**§ 1.707-4 Disguised sales of property to partnership; special rules applicable to guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures.**

\* \* \* \* \*

(d) \* \* \*

(1) *In general.* \* \* \*

(ii) \* \* \*

(B) Property transferred to the partnership by the partner, but only to the extent the reimbursed capital expenditures do not exceed 20 percent of the fair market value of such property at the time of the transfer (the 20-percent limitation). However, the 20-percent limitation of this paragraph (d)(1)(ii)(B) 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 transferred property at the time of the transfer (the 120-percent test). This paragraph (d)(1)(ii)(B) shall be applied on a property-by-property basis, except that a partner may aggregate any of the transferred property under this paragraph (d)(1) to the extent—

(1) The total fair market value of such aggregated property (of which no single property's fair market value exceeds 1 percent of the total fair market value of such aggregated property) is not greater than the lesser of 10 percent of the total fair market value of all property, excluding money and marketable securities (as defined under section 731(c)), transferred by the partner to the partnership, or \$1,000,000;

(2) The partner uses a reasonable aggregation method that is consistently applied; and

(3) Such aggregation of property is not part of a plan a principal purpose of which is to avoid §§ 1.707-3 through 1.707-5.

(C) [Reserved].

(2) *Capital expenditures incurred by another person.* For purposes of

paragraph (d)(1) of this section, a partner steps in the shoes of a person (to the extent the person was not previously reimbursed under paragraph (d)(1) of this section) with respect to capital expenditures the person incurred with respect to property transferred to the partnership by the partner to the extent the partner acquired the property from the person in a nonrecognition transaction described in section 351, 381(a), 721, or 731.

(3) *Contribution of a partnership interest with capital expenditures property.* If a person transfers property with respect to which the person incurred capital expenditures (capital expenditures property) to a partnership (lower-tier partnership) and, within the two-year period beginning on the date upon which the person incurred the capital expenditures, transfers an interest in the lower-tier partnership to another partnership (upper-tier partnership) in a nonrecognition transaction under section 721, the upper-tier partnership steps in the shoes of the person who transferred the capital expenditures property to the lower-tier partnership with respect to the capital expenditures that are not otherwise reimbursed to the person. The upper-tier partnership may be reimbursed by the lower-tier partnership under paragraph (d)(1) of this section to the extent the person could have been reimbursed for the capital expenditures by the lower-tier partnership under paragraph (d)(1) of this section. In addition, for purposes of paragraph (d)(1) of this section, the person is deemed to have transferred the capital expenditures property to the upper-tier partnership and may be reimbursed by the upper-tier partnership under paragraph (d)(1) of this section to the extent the person could have been reimbursed for the capital expenditures by the lower-tier partnership under paragraph (d)(1) of this section and has not otherwise been previously reimbursed. The aggregate reimbursements for capital expenditures under this paragraph (d)(3) shall not exceed the amount that the person could have been reimbursed for such capital expenditures under paragraph (d)(1) of this section.

(4) *Special rule for qualified liabilities—(i) In general.* For purposes of paragraph (d)(1) of this section, if capital expenditures were funded by the proceeds of a qualified liability defined in § 1.707-5(a)(6)(i) that a partnership assumes or takes property subject to in connection with a transfer of property to the partnership by a partner, a transfer of money or other consideration by the partnership to the partner is not treated

as made to reimburse the partner for such capital expenditures to the extent the transfer of money or other consideration by the partnership to the partner exceeds the partner's share of the qualified liability (as determined under § 1.707-5(a)(2), (3), and (4)). Capital expenditures are treated as funded by the proceeds of a qualified liability to the extent the proceeds are either traceable to the capital expenditures under § 1.163-8T or were actually used to fund the capital expenditures, irrespective of the tracing requirements under § 1.163-8T.

(ii) *Anti-abuse rule.* If capital expenditures and a qualified liability are incurred under a plan a principal purpose of which is to avoid the requirements of paragraph (d)(4)(i) of this section, the capital expenditures are deemed funded by the qualified liability.

(5) *Scope of capital expenditures.* For purposes of this section and § 1.707-5, the term *capital expenditures* has the same meaning as the term *capital expenditures* has under the Internal Revenue Code and applicable regulations, except that it includes capital expenditures taxpayers elect to deduct, and does not include deductible expenses taxpayers elect to treat as capital expenditures.

(6) *Example.* The following example illustrates the application of paragraph (d) of this section:

*Example. Intangible treated as separate property.* (i) Z transfers to a partnership a business the material assets of which include a tangible asset and goodwill from the reputation of the business. At the time Z transfers the business to the partnership, the tangible asset has a fair market value of \$550,000 and an adjusted basis of \$450,000. The goodwill is a section 197 intangible with a fair market value of \$100,000 and an adjusted basis of \$0. Z incurred \$130,000 of capital expenditures with respect to improvements to the tangible asset (which amount is reflected in its adjusted basis) one year preceding the transfer. Z would like to be reimbursed by the partnership for the capital expenditures with an amount that qualifies for the exception for reimbursement of preformation expenditures under paragraph (d)(1) of this section.

(ii) Under paragraph (d)(1)(ii)(B) of this section, the 20-percent limitation on reimbursed capital expenditures applies on a property-by-property basis. The 120-percent test also applies on a property-by-property basis. Accordingly, the tangible asset and the goodwill each constitutes a separate property. Z incurred the capital expenditures with respect to the tangible asset only. The \$550,000 fair market value of the tangible asset exceeds 120 percent of Z's \$450,000 adjusted basis in the asset at the time of the transfer (120 percent × \$450,000 = \$540,000). Thus, the 20-percent limitation applies so that the reimbursement of Z's \$130,000 of

capital expenditures is limited to 20 percent of the fair market value of the tangible asset, or \$110,000 (20 percent × \$550,000).

\* \* \* \* \*

(f) *Ordering rule cross reference.* For payments or transfers by a partnership to a partner to which the rules under this section and § 1.707–5(b) apply, see the ordering rule under § 1.707–5(b)(3).

■ **Par. 5.** Section 1.707–5 is amended by:

- 1. Revising paragraph (a)(3).
- 2. Adding paragraph (a)(5)(iii).
- 3. Revising paragraph (a)(6)(i)(C).
- 4. Removing “and” at the end of paragraph (a)(6)(i)(D) and adding “or” in its place.
- 5. Adding paragraph (a)(6)(i)(E).
- 6. Revising paragraph (a)(7)(ii).
- 7. Adding paragraph (a)(8).
- 8. Adding a sentence at the end of paragraph (b)(1).
- 9. Removing the word “property” in paragraph (b)(2)(i)(A) and adding the word “consideration” in its place.
- 10. Revising paragraph (b)(2)(iii).
- 11. Adding paragraph (b)(3).
- 12. Designating the text of paragraph (e) after its subject heading as paragraph (e)(1) and adding paragraph (e)(2).
- 13. Revising *Examples 1, 5, 6, and 10* in paragraph (f).
- 14. Redesignating *Example 11* in paragraph (f) as *Example 13* and adding new *Examples 11 and 12*.

The additions and revisions read as follows:

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

(a) \* \* \*

(3) *Reduction of partner’s share of liability.* For purposes of this section, a partner’s share of a liability, immediately after a partnership assumes or takes property subject to the liability, is determined by taking into account a subsequent reduction in the partner’s share if—

(i) At the time that 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 reduced;

(ii) The anticipated reduction is not subject to the entrepreneurial risks of partnership operations; and

(iii) 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 extent to which the assumption of or taking property subject to the liability is treated as part of a sale under § 1.707–3.

\* \* \* \* \*

(5) \* \* \*

(iii) Notwithstanding paragraph (a)(5)(i) of this section, in connection

with a transfer of property by a partner to a partnership that is treated as a sale due solely to the partnership’s assumption of or taking property subject to a liability other than a qualified liability, the partnership’s assumption of or taking property subject to a qualified liability is not treated as a transfer of consideration made pursuant to the sale if the total amount of all liabilities other than qualified liabilities that the partnership assumes or takes subject to is the lesser of 10 percent of the total amount of all qualified liabilities the partnership assumes or takes subject to, or \$1,000,000.

(6) \* \* \*

(i) \* \* \*

(C) A liability that is allocable under the rules of § 1.163–8T to capital expenditures (as described under § 1.707–4(d)(5)) with respect to the property;

\* \* \* \* \*

(E) A liability that was not incurred in anticipation of the transfer of the property to a partnership, but that was incurred in connection with a trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business (see paragraph (a)(7) of this section for further rules regarding a liability incurred within two years of a transfer presumed to be in anticipation of the transfer); and

\* \* \* \* \*

(7) \* \* \*

(ii) *Disclosure of transfers of property subject to liabilities incurred within two years of the transfer.* A partner that treats a liability assumed or taken subject to by a partnership in connection with a transfer of property as a qualified liability under paragraph (a)(6)(i)(B) of this section or under paragraph (a)(6)(i)(E) of this section (if the liability was incurred by the partner within the two-year period prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership) must disclose such treatment to the Internal Revenue Service in accordance with § 1.707–8.

(8) *Liability incurred by another person.* Except as provided in paragraph (e)(2) of this section, a partner steps in the shoes of a person for purposes of paragraph (a) of this section with respect to a liability the person incurred or assumed to the extent the partner assumed or took property subject to the liability from the person in a

nonrecognition transaction described in section 351, 381(a), 721, or 731.

(b) \* \* \*

(1) \* \* \* For purposes of paragraph (b) of this section, an upper-tier partnership’s share of the liability of a lower-tier partnership as described under § 1.707–5(a)(2) that is treated as a liability of the upper-tier partnership under § 1.752–4(a) shall be treated as a liability of the upper-tier partnership incurred on the same day the liability was incurred by the lower-tier partnership.

(2) \* \* \*

(iii) *Reduction of partner’s share of liability.* For purposes of paragraph (b)(2) of this section, a partner’s share of a liability immediately after a partnership incurs the liability is determined by taking into account a subsequent reduction in the partner’s share if—

(A) At the time that the partnership incurs the liability, it is anticipated that the partner’s share of the liability that is allocable to a transfer of money or other consideration to the partner will be reduced subsequent to the transfer;

(B) The anticipated reduction is not subject to the entrepreneurial risks of partnership operations; and

(C) 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 extent to which the partnership’s distribution of the proceeds of the borrowing is treated as part of a sale.

(3) *Ordering rule.* The treatment of a transfer of money or other consideration under paragraph (b) of this section is determined before applying the rules under § 1.707–4.

\* \* \* \* \*

(e) \* \* \*

(2) If an interest in a partnership that has one or more liabilities (the lower-tier partnership) is transferred to another partnership (the upper-tier partnership), the upper-tier partnership’s share of any liability of the lower-tier partnership that is treated as a liability of the upper-tier partnership under § 1.752–4(a) is treated as a qualified liability under paragraph (a)(6)(i) of this section to the extent the liability would be a qualified liability under paragraph (a)(6)(i) of this section had the liability 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. For purposes of determining whether the liability constitutes a qualified liability under paragraphs (a)(6)(i)(B) and (E) of this



section, a determination that the liability was not 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 its interest in the lower-tier partnership to the upper-tier partnership at the time the liability was incurred by the lower-tier partnership.

(f) \* \* \*

*Example 1. Partnership's assumption of nonrecourse liability encumbering transferred property.* (i) A and B form partnership AB, which will engage in renting office space. A transfers \$500,000 in cash to the partnership, and B transfers an office building to the partnership. At the time it is transferred to the partnership, the office building has a fair market value of \$1,000,000, has an adjusted basis of \$400,000, and is encumbered by a \$500,000 nonrecourse liability, which B incurred 12 months earlier to finance the acquisition of other property and which the partnership assumed. No facts rebut the presumption that the liability was incurred in anticipation of the transfer of the property to the partnership. Assume that this liability is a nonrecourse liability of the partnership within the meaning of section 752 and the regulations thereunder. The partnership agreement provides that partnership items will be allocated equally between A and B, including excess nonrecourse liabilities under § 1.752-3(a)(3). The partnership agreement complies with the requirements of § 1.704-1(b)(2)(ii)(b).

(ii) The nonrecourse liability secured by the office building is not a qualified liability within the meaning of paragraph (a)(6) of this section. B would be allocated 50 percent of the excess nonrecourse liability under the partnership agreement. Accordingly, immediately after the partnership's assumption of that liability, B's share of the liability as determined under paragraph (a)(2) of this section is \$250,000 (B's 50 percent share of the partnership's excess nonrecourse liability as determined in accordance with B's share of partnership profits under § 1.752-3(a)(3)).

(iii) The partnership's assumption of the liability encumbering the office building is treated as a transfer of \$250,000 of consideration to B (the amount by which the liability (\$500,000) exceeds B's share of that liability immediately after the partnership's assumption of the liability (\$250,000)). B is treated as having sold \$250,000 of the fair market value of the office building to the partnership in exchange for the partnership's assumption of a \$250,000 liability. This results in a gain of \$150,000 (\$250,000 minus \$250,000/\$1,000,000 multiplied by \$400,000).

\* \* \* \* \*

*Example 5. Partnership's assumption of a qualified liability as sole consideration.* (i) F purchases property Z in 2012. In 2016, F transfers property Z to a partnership. At the time of its transfer to the partnership, property Z has a fair market value of \$165,000 and an adjusted tax basis of

\$75,000. Also, at the time of the transfer, property Z is subject to a \$75,000 nonrecourse liability that F incurred more than two years before transferring property Z to the partnership. The liability has been secured by property Z since it was incurred by F. Upon the transfer of property Z to the partnership, the partnership assumed the liability encumbering that property. The partnership made no other transfers to F in consideration for the transfer of property Z to the partnership. Assume that immediately after the partnership's assumption of the liability encumbering property Z, F's share of that liability for disguised sale purposes is \$25,000 in accordance with § 1.707-5(a)(2).

(ii) The \$75,000 liability secured by property Z is a qualified liability of F because F incurred the liability more than two years prior to the partnership's assumption of the liability and the liability has encumbered property Z for more than two years prior to F's transfer. See paragraph (a)(6) of this section. Therefore, since no other transfer to F was made as consideration for the transfer of property Z, under paragraph (a)(5) of this section, the partnership's assumption of the qualified liability of F encumbering property Z is not treated as part of a sale.

*Example 6. Partnership's assumption of a qualified liability in addition to other consideration.* (i) The facts are the same as in *Example 5*, except that the partnership makes a transfer to F of \$30,000 in money that is consideration for F's transfer of property Z to the partnership under § 1.707-3.

(ii) As in *Example 5*, the \$75,000 liability secured by property Z is a qualified liability of F. Since the partnership transferred \$30,000 to F in addition to assuming the qualified liability under paragraph (a)(5) of this section, assuming no other exception to disguised sale treatment applies to the transfer of the \$30,000, the partnership's assumption of this qualified liability is treated as a transfer of additional consideration to F to the extent of the lesser of—

(A) The amount that the partnership would be treated as transferring to F if the liability were not a qualified liability (\$50,000 (that is, the excess of the \$75,000 qualified liability over F's \$25,000 share of that liability)); or

(B) The amount obtained by multiplying the qualified liability (\$75,000) by F's net equity percentage with respect to property Z (one-third).

(iii) F's net equity percentage with respect to property Z equals the fraction determined by dividing—

(A) The aggregate amount of money or other consideration (other than the qualified liability) transferred to F and treated as part of a sale of property Z under § 1.707-3(a) (\$30,000 transfer of money); by

(B) F's net equity in property Z (\$90,000 (that is, the excess of the \$165,000 fair market value over the \$75,000 qualified liability)).

(iv) Accordingly, the partnership's assumption of the qualified liability of F encumbering property Z is treated as a transfer of \$25,000 (one-third of \$75,000) of consideration to F pursuant to a sale. Therefore, F is treated as having sold \$55,000 of the fair market value of property Z to the

partnership in exchange for \$30,000 in money and the partnership's assumption of \$25,000 of the qualified liability. Accordingly, F must recognize \$30,000 of gain on the sale (the excess of the \$55,000 amount realized over \$25,000 of F's adjusted basis for property Z (that is, one-third of F's adjusted basis for the property, because F is treated as having sold one-third of the property to the partnership)).

\* \* \* \* \*

*Example 10. Treatment of debt-financed transfers of consideration by partnership.* (i) K transfers property Z to partnership KL in exchange for a 50 percent interest therein on April 9, 2016. On September 13, 2016, the partnership incurs a nonrecourse liability of \$20,000. On November 17, 2016, the partnership transfers \$20,000 to K, and \$10,000 of this transfer is allocable under the rules of § 1.163-8T to proceeds of the partnership liability incurred on September 13, 2016. The remaining \$10,000 is paid from other partnership funds. Assume that on November 17, 2016, for disguised sale purposes, K's share of the \$20,000 liability incurred on September 13, 2016, is \$10,000 in accordance with § 1.707-5(a)(2).

(ii) Because a portion of the transfer made to K on November 17, 2016, is allocable under § 1.163-8T to proceeds of a partnership liability that was incurred by the partnership within 90 days of that transfer, K is required to take the transfer into account in applying the rules of this section and § 1.707-3 only to the extent that the amount of the transfer exceeds K's allocable share of the liability used to fund the transfer. K's allocable share of the \$20,000 liability used to fund \$10,000 of the transfer to K is \$5,000 (K's share of the liability (\$10,000) multiplied by the fraction obtained by dividing—

(A) The amount of the liability that is allocable to the distribution to K (\$10,000); by

(B) The total amount of such liability (\$20,000)).

(iii) Therefore, K is required to take into account \$15,000 of the \$20,000 partnership transfer to K for purposes of this section and § 1.707-3. Under these facts, assuming no other exception applies and the within-two-year presumption is not rebutted, this \$15,000 transfer will be treated under the rule in § 1.707-3 as part of a sale by K of property Z to the partnership.

*Example 11. Treatment of debt-financed transfers of consideration and transfers characterized as guaranteed payments by a partnership.* (i) The facts are the same as in *Example 10*, except that the entire \$20,000 transfer to K is allocable under the rules of § 1.163-8T to proceeds of the partnership liability incurred on September 13, 2016. In addition, the partnership agreement provides that K is to receive a guaranteed payment for the use of K's capital in the amount of \$10,000 in each of the three years following the transfer of property Z. Ten thousand dollars of the transfer made to K on November 17, 2016, is pursuant to this provision of the partnership agreement. Assume that the guaranteed payment to K constitutes a reasonable guaranteed payment within the meaning of § 1.707-4(a)(3).

(ii) Under these facts, the rules under both § 1.707-4(a) and § 1.707-5(b) apply to the

November 17, 2016 transfer to K by the partnership. Thus, the ordering rule in § 1.707-5(b)(3) requires that the § 1.707-5(b) debt-financed distribution rules apply first to determine the treatment of the \$20,000 transfer. Because the entire transfer made to K on November 17, 2016, is allocable under § 1.163-8T to proceeds of a partnership liability that was incurred by the partnership within 90 days of that transfer, K is required to take the transfer into account in applying the rules of this section and § 1.707-3 only to the extent that the amount of the transfer exceeds K's allocable share of the liability used to fund the transfer. K's allocable share of the \$20,000 liability used to fund the transfer to K is \$10,000 (K's share of the liability (\$10,000) multiplied by the fraction obtained by dividing—

(A) The amount of the liability that is allocable to the distribution to K (\$20,000); by

(B) The total amount of such liability (\$20,000)).

(iii) The remaining \$10,000 amount of the transfer to K that exceeds K's allocable share of the liability is tested to determine whether an exception under § 1.707-4 applies. Because \$10,000 of the payment to K is a reasonable guaranteed payment for capital under § 1.707-4(a)(1)(ii), the \$10,000 transfer will not be treated as part of a sale by K of property Z to the partnership under § 1.707-3.

*Example 12. Treatment of debt-financed transfers of consideration by partnership made pursuant to plan.* (i) O transfers property X, and P transfers property Y, to partnership OP in exchange for equal interests therein on June 1, 2016. On October 1, 2016, the partnership incurs two nonrecourse liabilities: Liability 1 of \$8,000 and Liability 2 of \$4,000. On December 15, 2016, the partnership transfers \$2,000 to each of O and P pursuant to a plan. The transfers made to O and P on December 15, 2016 are allocable under § 1.163-8T to the proceeds of either Liability 1 or Liability 2. Assume that under § 1.707-5(a)(2), O's and P's share of Liability 1 is \$4,000 each and of Liability 2 is \$2,000 each on December 15, 2016.

(ii) Because the partnership transferred pursuant to a plan a portion of the proceeds of the two liabilities to O and P, paragraph (b)(1) of this section is applied by treating Liability 1 and Liability 2 as a single \$12,000 liability. Pursuant to paragraph (b)(2)(ii)(A) of this section, each partner's allocable share of the \$12,000 liability equals the amount obtained by multiplying the sum of the partner's share of Liability 1 and Liability 2 (\$6,000) (\$4,000 for Liability 1 plus \$2,000 for Liability 2) by the fraction obtained by dividing—

(A) The amount of the liability that is allocable to the distribution to O and P pursuant to the plan (\$4,000); by

(B) The total amount of such liability (\$12,000).

(iii) Therefore, O's and P's allocable share of the \$12,000 liability is \$2,000 each. Accordingly, because a portion of the

proceeds of the \$12,000 liability are allocable under § 1.163-8T to the \$2,000 transfer made to each of O and P within 90 days of incurring the liability, and the \$2,000 transfer does not exceed O's or P's \$2,000 allocable share of that liability, each is required to take into account \$0 of the \$2,000 transfer for purposes of this section and § 1.707-3. Under these facts, no part of the transfers to O and P will be treated as part of a sale of property X by O or of property Y by P.

\* \* \* \* \*

■ **Par. 6.** Section 1.707-6 is amended by revising *Example 2*(i) in paragraph (d) to read as follows:

**§ 1.707-6 Disguised sales of property by partnership to partner; general rules.**

\* \* \* \* \*

(d) \* \* \*

*Example 2. Assumption of liability by partner.* (i) B is a member of an existing partnership. The partnership transfers property Y to B. On the date of the transfer, property Y has a fair market value of \$1,000,000 and is encumbered by a nonrecourse liability of \$600,000. B takes the property subject to the liability. The partnership incurred the nonrecourse liability six months prior to the transfer of property Y to B and used the proceeds to purchase an unrelated asset. Assume that under § 1.707-5(a)(2), B's share of the nonrecourse liability immediately before the transfer of property Y was \$100,000.

\* \* \* \* \*

■ **Par. 7.** Section 1.707-9 is amended by revising paragraph (a)(1) to read as follows:

**§ 1.707-9 Effective dates and transitional rules.**

(a) \* \* \*

(1) *In general.* Except as otherwise provided in this paragraph (a), §§ 1.707-3 through 1.707-6 apply to any transaction with respect to which all transfers occur on or after October 5, 2016. For any transaction with respect to which all transfers that are part of a sale of an item of property occur after April 24, 1991, but before October 5, 2016, §§ 1.707-3 through 1.707-6 as contained in 26 CFR part 1 revised as of April 1, 2016, apply.

\* \* \* \* \*

■ **Par. 8.** Section 1.752-3 is amended by:

■ 1. Revising the third, fourth, fifth, and sixth sentences in paragraph (a)(3).

■ 2. Adding paragraph (d).

The revisions and addition read as follows:

**§ 1.752-3 Partner's share of nonrecourse liabilities.**

(a) \* \* \*

(3) \* \* \* The partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain (significant item method). Alternatively, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated (alternative method). Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property (as defined under § 1.704-3(a)(3)(ii)) or property for which reverse section 704(c) allocations are applicable (as described in § 1.704-3(a)(6)(i)) where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the gain described in paragraph (a)(2) of this section with respect to such property (additional method). The significant item method, alternative method, and additional method do not apply for purposes of § 1.707-5(a)(2). \* \* \*

\* \* \* \* \*

(d) *Effective/applicability dates.* The third, fourth, fifth, and sixth sentences of paragraph (a)(3) of this section apply to liabilities that are incurred, taken subject to, or assumed by a partnership on or after October 5, 2016, other than liabilities incurred, taken subject to, or assumed by a partnership pursuant to a written binding contract in effect prior to October 5, 2016. For liabilities that are incurred, taken subject to, or assumed by a partnership before October 5, 2016, the third, fourth, fifth, and sixth sentences of paragraph (a)(3) of this section as contained in 26 CFR part 1 revised as of April 1, 2016, apply.

**John Dalrymple,**

*Deputy Commissioner for Services and Enforcement.*

Approved: August 29, 2016.

**Mark M. Mazur,**

*Assistant Secretary of the Treasury (Tax Policy).*

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