A Brave New World for Leveraged U.S. Real Estate Partnerships

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By Adam S. Wallwork

Adam S. Wallwork is an attorney in the U.S. tax department of Osler, Hoskin & Harcourt LLP in New York.

In this report, Wallwork explores how inbound U.S. real estate investments will be affected by the Obama administration's final partnership tax rules on bottom-dollar obligations and disguised sales. He proposes modifications, short of full repeal, that President Trump's Treasury Department could enact to clarify the regulations and promote foreign investment in U.S. real estate without much loss in tax collection.

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Saving taxes is often an overriding concern for Canadian entities in choosing the form in which to invest in the United States. Increasingly, Canadian multinationals have elected to structure their U.S. investments, especially in U.S. real estate, through U.S. limited liability companies, U.S. limited liability partnerships, and other limited liability entities classified as partnerships for U.S. tax purposes (collectively referred to as "partnerships"). The number of Canadian partners in U.S. partnerships has increased 1,800 percent since 1990, largely on the strength of tax-efficient partnership structures for holding U.S. real estate.[1]

Canadian entities seeking access to the booming U.S. real estate market or seeking simply to diversify their global real estate holdings often realize significant tax benefits by holding interests

in domestically controlled (50 percent U.S.-owned) real estate investment trusts through leveraged partnerships. Canadian corporations can own U.S. real estate indirectly through a domestically controlled REIT without being subject to net-basis U.S. tax at maximum rates of 35 percent under the 1980 Foreign Investment in Real Property Tax Act.[2] Structuring these REIT investments through leveraged operating partnerships (OPs) in which the Canadian real estate investor is a limited partner can add the benefit of U.S. tax deferral as long as the structure does not cause the partner to recognize gain from any disguised sale, mixing bowl transaction, or deemed distribution of net liabilities assumed from the partner by the partnership, among other pitfalls of subchapter K.

Over the past two years, the Obama administration worked on rules for disguised sales and bottom-dollar payment obligations, which were intended to curb abuse by taxpayers who have used guarantees and indemnities to defer gains on transactions that the U.S. government views as sales. Treasury and the IRS first proposed rules on January 30, 2014, with seven requirements, including net-worth and documentation requirements similar to those under Treasury's new section 385 regulations.[3] Fortunately, Treasury's temporary and final regulations under sections 752 and 707(a)(2)(B), which were issued on October 5, 2016, and corrected on November 17, 2016, dispense with those seven factors in favor of two basic rules, which (1) disregard for U.S. partnership tax purposes any partner's guarantee of partnership debt for which that partner or a related person is not liable from the first dollar of default (the bottom-dollar payment regulations) and (2) allocate all debt according to partners' profits interests for purposes of applying the disguised sale rules under section 707(a)(2)(B). These new rules, summarized below, will transform the nature of risks from Canadian investments in any U.S. real estate partnership.

I. REIT Partnership Structures

Well-advised Canadian taxpayers do not typically invest in U.S. real estate or infrastructure through traditional U.S. corporations because of FIRPTA. Canadian residents who acquire a U.S. real property interest (USRPI), including U.S. land, buildings, and structures, are taxed upon disposition of the interest at maximum U.S. graduated rates of 35 percent for corporations and 39.6 percent for individuals, which rates are not reduced by the Canada-U.S. tax treaty.[4] FIRPTA taxes are also imposed on a foreign person's sale of the stock of a current or former U.S. real-property-holding corporation that at any time in the five years before the disposition held USRPIs that exceeded 50 percent of the total value of that corporation's worldwide real property and business assets.[5] Foreign owners of that stock are generally not entitled to nonrecognition that would otherwise be available under U.S. tax law for transfers in subsidiary liquidations and in corporate reorganizations and incorporations unless they receive another USRPI in exchange.

A. Domestically Controlled REITs

While Canadian pension plans that qualify as foreign government investors under section 892 or as "qualified foreign pension funds" under section 897(l) may be exempt from U.S. tax on gain from minority investments in U.S. real property holding corporations, other private entities, which are not qualified foreign pension funds, generally recognize gain from the sale of the holding corporation's stock.[6] One elegant solution to a Canadian company's ownership of

USRPIs or U.S. real property holding corporations has been the use of domestically controlled REITs, which must be more than 50 percent owned by U.S. persons to qualify for a FIRPTA exemption and treaty-reduced rates on dividends paid to Canadian residents.[7] REITs were originally developed by Congress as a means for public shareholders to own portfolios of U.S. real estate assets without incurring double-level corporate tax. REITs are treated for most purposes as corporations, but they must distribute at least 90 percent of their income to shareholders and are allowed deductions for distributions.[8] This has the effect of subjecting shareholders' distributed earnings to only one level of tax rather than two under subchapter C. REITs must also meet quarterly real estate assets tests and annual real estate investment income tests that Congress has established to ensure that REITs are primarily used as vehicles for holding real estate investments and distributing proceeds to investors.[9] Although most REITs were originally publically traded, private domestically controlled REITs have become increasingly popular tools for international investors because REITs offer one of the only remaining vehicles for foreigners to invest in U.S. real estate without incurring significant U.S. tax, withholding, and filing obligations under FIRPTA.

If U.S. investors own more than 50 percent in value of a REIT's stock, the domestically controlled REIT qualifies for an exemption from FIRPTA under section 897(h) so that its stock can be bought and sold by foreign investors without attracting U.S. graduated taxes. In fact, no U.S. tax would be imposed since foreign sellers are generally exempt from U.S. tax on capital gains. Dividends paid by a domestically controlled REIT (except for those attributable to a sale of USRPIs) to foreign investors are also exempt from FIRPTA and generally qualify for treaty benefits in the hands of Canadian corporations, pension funds, and other residents. Thus, maximum U.S. corporate tax rates of 35 percent and individual rates of 39.6 percent on foreign investment in U.S. real estate are reduced to 5 percent for Canadian owners of more than 10 percent of a domestically controlled REIT's stock and to 15 percent for all other Canadian residents. Compared with a regular REIT or U.S. corporation, that's a potential tax savings of between 20 cents and 35 cents for every dollar earned by eligible Canadian residents under the Canada-U.S. tax treaty.

Even Canadian tax-exempt entities are not necessarily exempt from FIRPTA. Article XXI of the Canada-U.S. income tax treaty, which generally precludes U.S. taxation of dividends and interest paid by U.S. persons to Canadian tax-exempt entities, does not apply to the sale of stock of a U.S. real property holding corporation.[10] Importantly, Canadian tax-exempt non-governmental organizations generally fail to qualify for statutory exemptions from FIRPTA available under section 897(l) for qualified foreign pension funds and under section 892 for integral parts or controlled entities of a foreign sovereign.[11] For this reason, domestically controlled REIT structures often provide an efficient means for Canadian tax-exempt and taxable entities to hold U.S. real property and infrastructure without incurring multiple layers of U.S. corporate tax and filing obligations upon the disposition of the holding company's stock.

On the other hand, domestically controlled REITs are not a panacea as foreign shareholders are subject to FIRPTA on both current and liquidating distributions from a REIT (including one that is domestically controlled) that are attributable to the REIT's sale, disposition or transfer of a direct interest in USRPIs.[12] For that reason, Canadian pension funds and government entities otherwise exempt from FIRPTA's tax payment and return filing obligations may avoid the structural tax risks and transaction costs traditionally associated with domestically controlled REITs. Given the narrow purview of section 897(l)'s exemption for qualified foreign pension funds, enacted in 2015, including concerns regarding its availability to multi-member Canadian

master trusts, there remains substantial demand for domestically controlled REIT structures in the Canadian marketplace.

However, direct REIT investments may be impracticable for many Canadian real estate investors, because shareholders who contribute appreciated or encumbered property to REITs in exchange for REIT stock are generally denied the benefits of tax-free incorporation under section 351(e). Although debt relief is generally a taxable event for U.S. federal income tax purposes, sections 351 and 721 generally protect taxpayers from taxable gain when they contribute encumbered property for interests in corporations and partnerships, respectively. But section 351 does not protect REIT shareholders, which means that foreign investors who contribute appreciated or mortgaged real estate directly to a domestically controlled REIT are often subject to tax in the United States.[13] Moreover, even if section 351(e) can be overcome, a foreign investor who transfers a USRPI in exchange for a non-FIRPTA asset, such as domestically controlled REIT stock, generally recognizes gain under section 897(h).

These features of domestically controlled REITs make partnerships an especially attractive holding structure for foreign investors in U.S. real estate because gains that would be recognized by investors in a domestically controlled REIT can often be avoided under section 721(a)'s nonrecognition rule for partnership contributions. For instance, a partner who contributes U.S. real estate assets in exchange for an interest in a partnership continues to own an allocable share of the partnership's FIRPTA assets so that FIRPTA taxes may be avoided on the exchange if the partner's allocable share of the partnership's USRPIs immediately after the exchange is no less than that partner's share of U.S. real property contributed to the partnership. Also, despite the recent disguised sale and bottom-dollar payment regulations, partnership tax rules still offer partners greater flexibility for deferring gain from contributions of mortgaged property than those available to domestically controlled REIT shareholders. Subchapter K's rules for allocating contributing partners' shares of recourse and nonrecourse debt are specifically designed to maximize deferral and minimize potential gains, whereas discharge of indebtedness rules for REIT shareholders under subchapter C generally take the opposite approach.

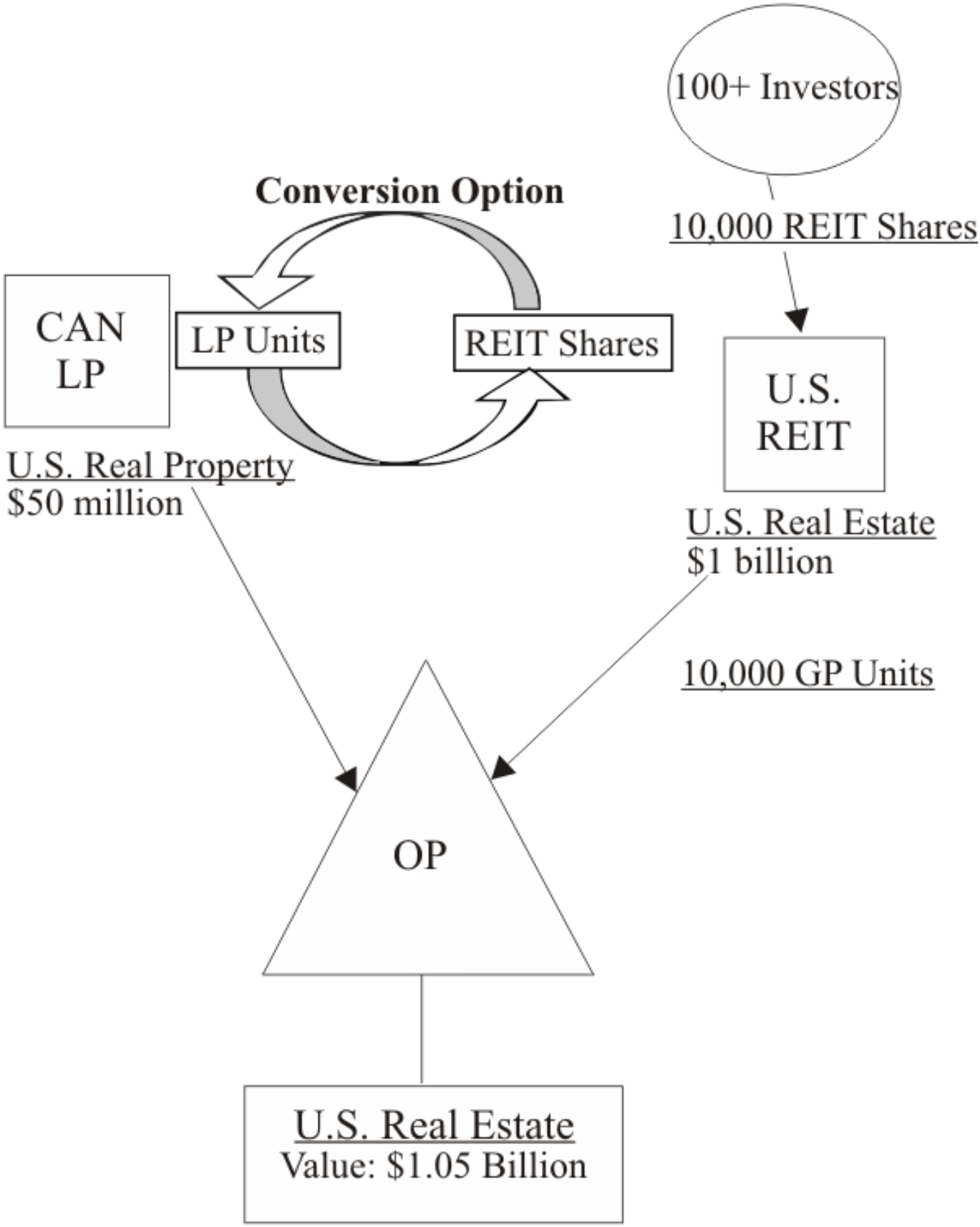
The new disguised sale and bottom-dollar payment rules do place additional pressure on contributions to REIT umbrella partnerships, however, in order to ensure real estate investors recognize no gain in so-called UPREIT and DownREIT structures. But for those who can navigate these rules, subchapter K continues to offer foreign partners the most powerful tools available in U.S. tax law for avoiding immediate gains from leveraged U.S. real estate investments.

B. UPREITs and DownREITs

Practitioners estimate that approximately 75 percent of U.S. REITs are owned through one of two types of leveraged partnership structures. The first type, known as an UPREIT, involves the contribution of real estate assets by limited partners to an operating partnership (OP) in which the general partner is a REIT. The REIT contributes its U.S. real estate assets to the OP in exchange for general partnership interests. The REIT's general partnership interests equal the number of outstanding REIT shares, and the REIT continues to pay dividends to its shareholders. The OP's limited partners contribute money or property for their partnership interests, which track the number of shares and liquidation and distribution rights that the limited

partners would have received from a direct contribution to the REIT. Generally, these limited partnership interests are convertible on a one-to-one basis into REIT shares, which, by definition, must be relatively liquid.

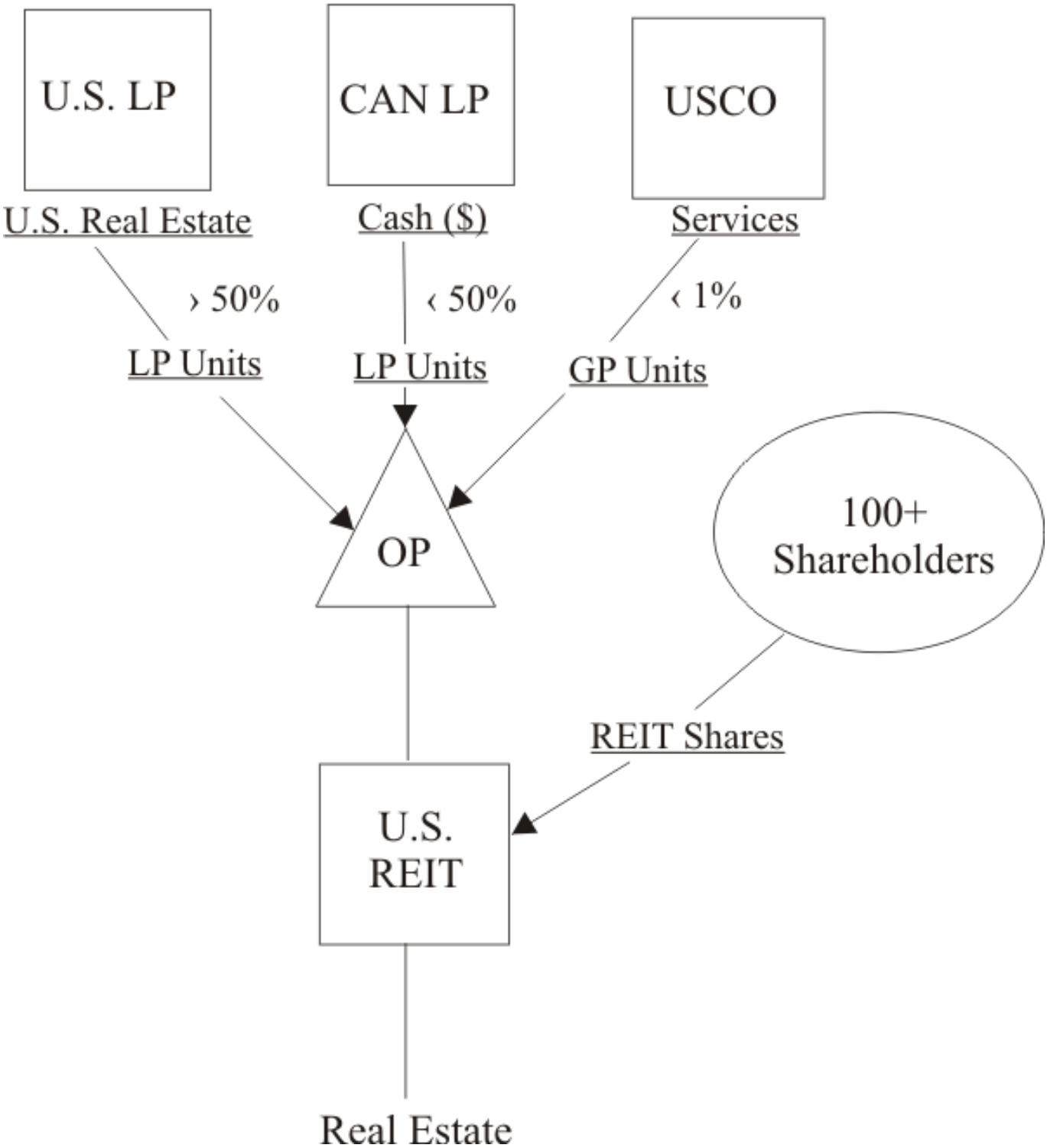
Figure 1. UPREIT Structure



Most tax practitioners consider UPREIT partnerships structurally sound because the IRS has endorsed them in an example under the partnership antiabuse regulations and in a private letter ruling.[14] Moreover, the REIT may guarantee the limited partners that none of their contributed

assets will be exchanged or distributed to other partners within seven years of their contribution in a manner that triggers gain under the mixing bowl transaction rules in section 704(c)(1)(B). Limited partners may also guarantee some portion of the partnership's debt in order to prevent immediate recognition of pre-contribution gains from a net discharge of liabilities under section 731(a). Finally, limited partners may seek protection against actions by the REIT, as general partner of the OP, that may trigger a disguised sale from partnership distributions under section 707(a)(2)(B).

Figure 2. Domestically Controlled DownREIT

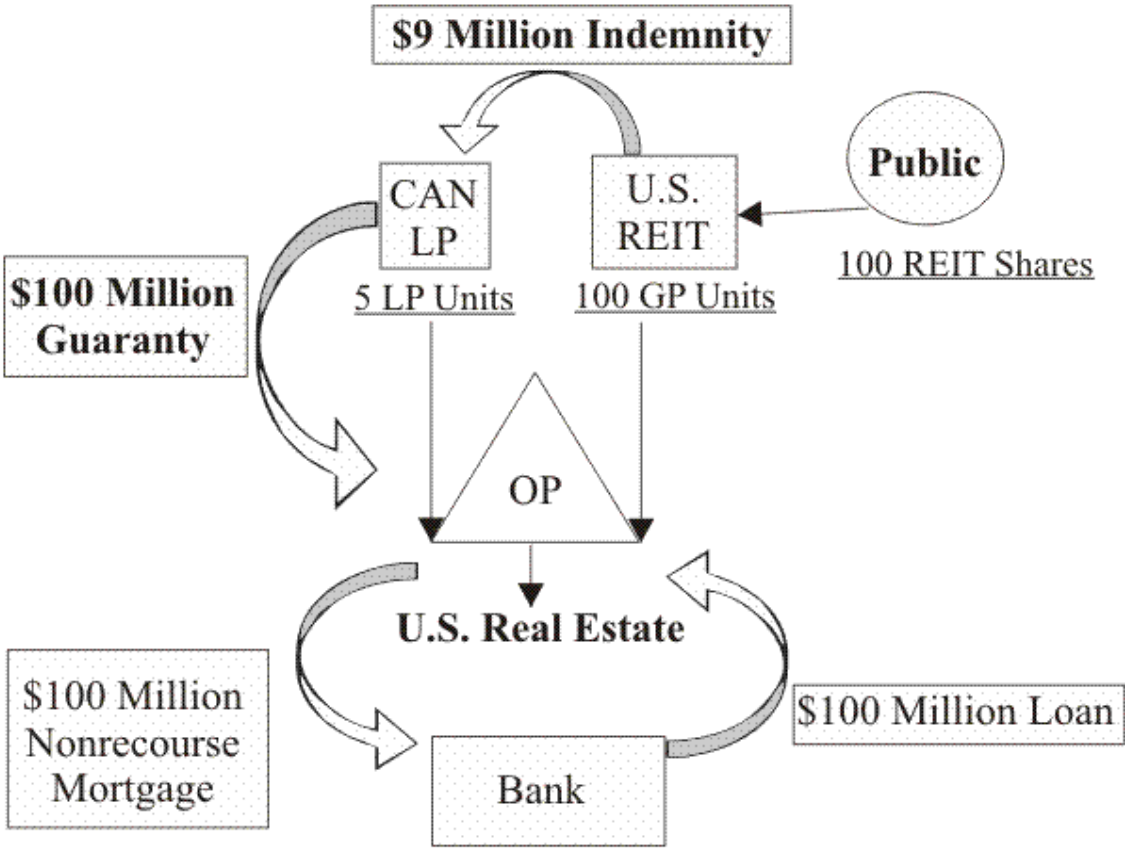


Under an alternative DownREIT structure, foreign real estate investors contribute property or cash to an OP in which a U.S. real estate developer is the other member. The developer contributes U.S. real estate assets to the OP, which elects to be treated as a REIT for federal income tax purposes. The general partner may be a U.S. corporation jointly owned by the U.S. and foreign real estate investors. When the REIT is newly formed, as is often the case in privately held REITs, the REIT must issue shares to at least 100 persons, which is often satisfied by issuing preferred shares that do not materially participate in corporate growth. For the REIT to be considered domestically controlled, more than 50 percent of the OP must be

owned by U.S. persons.

Figure 3. Bottom-Dollar Safe Harbor Example

- OP's Partners are CAN LP (4.8 percent) and Public REIT (95.2 percent). OP holds cash and other property worth $1 billion.
- OP secures a $100 million of nonrecourse financing from a bank: (1) CAN LP unconditionally guarantees payment of all $100 million to the bank and (2) U.S. REIT agrees to indemnify CAN LP for the first $9 million of loss from OP's default.



- CAN LP's $100 million Guaranty of OP's nonrecourse debt is a bottom-dollar payment obligation because of U.S. REIT's $9 million First-Dollar Indemnity. But because that Indemnity is less than 10 percent of CAN LP's obligation ($9 million/$100 million = 9 percent), CAN LP's obligation will be recognized under the Safe Harbor.
- For purposes of section 752, $91 million will be allocated to CAN LP as recourse debt and $9 million will be allocated to U.S. REIT as recourse debt.
- However, CAN LP must file Form 8275, reporting a bottom-dollar payment obligation as well as facts making that obligation cognizable.

The OP's limited partners receive allocations under the partnership agreement to match dividends that would be paid on REIT stock. But the DownREIT limited partner's shares are not typically convertible on a one-to-one basis into REIT stock, which somewhat reduces their liquidity for public REITs. Instead, payments are made to the DownREIT limited partners *as if* they had received dividends on phantom REIT stock. Thus, there will sometimes be a requirement in the DownREIT partnership's operating agreement that requires the REIT to contribute sufficient assets to the partnership to make distributions to the limited partners even if the REIT has insufficient assets to spare. The major difference between this DownREIT structure and UPREITs is that limited partners in the DownREIT partnership each have separate preferred units of the OP, which are based on the amount of their contribution but are not necessarily convertible into REIT stock.

A real estate investor who contributes appreciated property to an UPREIT or DownREIT partnership is generally entitled to nonrecognition under section 721(a). Sections 722 and 723 preserve the partner's built-in gain by transferring his tax basis in appreciated property to the partner's outside basis in partnership interests and to the partnership's inside basis in the assets. Under section 752(b), however, a partner's contribution of encumbered property, including virtually all residential and commercial real estate, may cause gain to be recognized under section 731(a) or 707(a)(2)(B). Section 752(b) treats the partner's decrease in liabilities from a contribution of encumbered property as a distribution of cash from the partnership, and section 752(a) treats the partner's increase in liabilities assumed from the partnership as a contribution of cash to the partnership. A partner whose overall share of liabilities decreases after partnership contributions may be subject to U.S. tax under section 731(a) to the extent that his net decrease in liabilities exceeds his outside basis in OP units received in the exchange. Further, when a partner contributes appreciated property to a partnership subject to an encumbrance that has been incurred within two years of that contribution, there is a risk that the contribution will result in gain under section 707(a)(2)(B)'s disguised sale rules. Partners have historically used practically riskless bottom-dollar guarantees to avoid these rules, but that practice came to an end on October 5, 2016.

II. Bottom-Dollar Guarantees and Indemnities

Under U.S. partnership tax rules, taxpayers receive different allocations of partnership debt under section 752 based on whether debt is recourse or nonrecourse. A recourse liability is debt of the partnership for which at least one partner bears the economic risk of loss.[15] Nonrecourse liabilities of a partnership are those for which no partner bears that economic risk.[16] When a partner assumes a share of the partnership's nonrecourse debt through a guarantee of the partnership's obligation or indemnification of another partner, the guarantor or indemnitor becomes entitled to a portion of that debt for tax purposes.[17] As a result, the partner's outside basis increases by the amount for which the partner is economically at risk, which increases the amount of money or other property that can be distributed (or deemed distributed) to the partner tax free.[18]

Although nonrecourse debt is generally shared among the partners under a three-tiered method designed to reduce gain for partners, recourse debt is allocated only to partners who bear the economic risk of loss.[19] Who bears the economic risk of loss for this purpose is determined under an apocalyptic scenario in which all the partnership's assets, including cash, become worthless and all the partnership's debts become due and payable. In this scenario, all partners

are assumed to satisfy their obligations in full, regardless of their actual net worth.[20]

When a debt is nonrecourse to any of the partners — when no partner would be personally liable for repayment of that debt beyond the value of property forfeited — a partner's guarantee of the partnership's debt generally changes its character for tax and economic purposes. For example, if a partnership borrows $100 from a bank in exchange for a $100 note secured only by the partnership's real estate (currently worth $100), only the bank is economically at risk for a decline in the property's value below the amount of the mortgage. If the property's value declines to $90 before the partnership repays any of the loan's $100 principal, the bank's foreclosure will leave the lender $10 short, and no partner will be liable for the difference. But a partner's guarantee of the partnership's otherwise nonrecourse $100 debt up to the full amount of the shortfall genuinely shifts the economic burden from the bank to the partner for making up the $10 that remains due and owing after the property is sold for $90 to pay a $100 debt.

It makes sense under these circumstances that the partner's tax basis would reflect this additional $100 "investment" in the partnership through the guarantee of its $100 bank loan, which is achieved by treating the debt as recourse to the extent of the guarantee and allocating that amount to the guarantor-partner's basis. If the partner had only guaranteed $90 of the debt, only $90 would have been allocated to the partner's basis. The remaining $10 of the partnership's mortgage for which the bank bears the ultimate economic risk of loss is split among the partners according to a three-tier method for allocating nonrecourse liabilities: first, to the extent of each partner's allocable share of the partnership's potential debt-cancellation income from a taxable disposition of property secured by a nonrecourse loan with an outstanding balance that exceeds the property's basis (partnership minimum gain); then, to the extent of any contributing partner's allocable share of pre-contribution debt-cancellation income and built-in gain from property contributed to the partnership with nonrecourse liabilities in excess of the property's basis (section 704(c) minimum gain); and, finally, according to the partners' profit shares or the way they share nonrecourse deductions for any "excess nonrecourse liabilities."

For section 752 purposes, equal partners in a 50-50 partnership that had not taken any deductions or made any distributions allocable to nonrecourse financing would likely split the $10 nonrecourse liability $5 each in calculating their tax basis, which is half of what the guarantor-partner would have received by guaranteeing the debt. For disguised sale purposes, however, the rules under section 752 have always required partners to split the partnership's nonrecourse debt according to the third-tier method for sharing excess nonrecourse liabilities.

Bottom-dollar guarantees and indemnities arise when partners attempt to achieve the tax treatment for recourse liabilities described above by guaranteeing only the least risky portion of the partnership's nonrecourse debt.[21] For instance, instead of guaranteeing the bank against the first dollar of loss it suffers from its $100 nonrecourse loan to the partnership, some contributing partners in UPREIT and DownREIT partnerships might guarantee the partnership's payment of up to $20, but only if the bank otherwise recovers less than $20 from foreclosing on the partnership's property.[22] Alternatively, the contributing partner could guarantee repayment of all $100 of the partnership's debt while the REIT general partner simultaneously agrees to indemnify the contributing partner for the first $80 of loss from the partnership's default. Either way, the contributing partner's purportedly recourse debt will become due and payable only if the OP's $100 asset loses 80 percent of its value.[23] Because banks typically do not lend money on a nonrecourse basis without adequate assurances that the partnership's operating income

and assets will be sufficient to pay interest and principal on the debt, the bottom-dollar guarantor's "assumption" of the most secure portion of the liability typically has no commercial purpose beyond the allocation of tax basis credit to partners who need it to avoid gains.

A. Scope of Section 752 Regulations

For the reasons explained above, the IRS thought it inappropriate to recognize bottom-dollar payment obligations for federal income tax purposes and generally disregards them for transactions entered into on or after October 5, 2016 (2016 bottom-dollar payment regulations). The regulations define the term "bottom-dollar payment obligation" to mean:

> 1. any partner's or related person's guarantee or other similar arrangement regarding a partnership's liability for which the partner or related person is not or would not be liable up to the full amount of that partner's or related person's payment obligation if and to the extent that any amount of the partnership liability is not otherwise satisfied (bottom-dollar guarantee);
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> 2. any partner's or related person's indemnity or other similar arrangement for the benefit of another person (indemnitee) for which the partner or related person is not or would not be liable up to the full amount of the indemnitee's payment obligation if and to the extent that the obligation is satisfied (bottom-dollar indemnity); or
>
> 3. any common plan or arrangement that uses tiered partnerships, intermediaries, or senior and subordinated liabilities to achieve results similar to a bottom-dollar guarantee or indemnity with a principal purpose of avoiding having at least one of the arrangements treated as a bottom-dollar payment obligation.[24]

Unlike proposed regulations issued in 2014 (REG-119305-11), which imposed various net-worth requirements on guarantors and indemnitors, the 2016 bottom-dollar payment regulations apply mechanically whenever a partner claims tax basis credit for a guarantee of partnership debt for which neither the partner nor a related person (generally an 80 percent affiliate) is responsible from the first dollar of default. The 2016 bottom-dollar payment regulations do not apply to vertical slices of a partnership's nonrecourse liabilities, which partners use to guarantee different parts of a single debt, or to liabilities for which partners are co-obligors.

If each of two limited partners (A and B) in limited partnership LP unconditionally guarantee a bank's payment of up to $10 million of LP's $100 million nonrecourse mortgage, each partner would be entitled to $10 million of basis credit ($20 million total) under the 2016 bottom-dollar payment regulations because each partner would owe the bank $10 million if foreclosure on LP's mortgaged property yielded only $80 million. The $80 million of LP's debt would remain nonrecourse debt and would be allocated accordingly to A, B, and LP's other partners (including a REIT general partner in an UPREIT structure).[25] If, however, B had separately agreed to indemnify A for the first $5 million that A has to pay the bank on its guarantee of LP's debt, only B would be considered at risk of loss for $15 million ($10 million from its own guarantee and $5 million from its unconditional indemnification of A for A's first $5 million of loss).

B. Safe Harbor for 90 Percent Obligors

In response to criticism of the 2014 proposed regulations, which voided bottom-dollar guarantees and indemnities regardless of actual default risk, the IRS adopted a safe harbor rule in the final and temporary regulations that permits taxpayers to take account of specified bottom-dollar payment obligations as long as the taxpayer is responsible for at least 90 percent of the obligation.[26] In other words, if no more than 10 percent of the partner's guarantee is offset by a right to indemnification or reimbursement, the regulations recognize the partner's "recourse" obligation on the unreimbursable portion of the guarantee. If, in the example above, limited partner B had indemnified only $9 of partner A's guarantee of payment to the bank of up to $100 of the partnership's nonrecourse debt, A would be considered at risk of loss for $91 of the debt, and B would be considered at risk of loss for the remaining $9. None of the partnership's $100 debt would be considered nonrecourse under the section 752 rules.[27]

C. Transition Relief

Although the 2016 bottom-dollar payment rules generally apply to payment obligations undertaken for partnership debt on or after October 5, 2016, the IRS and Treasury provide seven years of transition relief to some partners. Under the transition rule, a partnership may choose not to apply the new bottom-dollar payment rules if and to the extent that at least one partner's allocable share of partnership *recourse liabilities* on October 4, 2016, exceeded his adjusted basis in his partnership interest on that date (the grandfathered amount).[28]

In general, transition partners continue to receive tax basis credit for the grandfathered amount of their recourse liabilities until October 4, 2023, reduced by any decrease in the partner's allocable share of partnership liabilities from sales of property during that period.[29] Moreover, a change of more than 50 percent in the ownership of any partner classified as a partnership, disregarded entity, or S corporation for U.S. tax purposes will terminate the partner's eligibility for seven years' transition relief under the bottom-dollar payment rules.[30]

D. Filing Obligations

All partners whose guarantees, indemnities, and other arrangements are classified as bottom-dollar payment obligations, including those whose obligations are recognized under the safe harbor rule, must file Form 8275 with the U.S. government for the tax year in which the payment obligation arose, disclosing the nature of the obligation and any facts establishing the existence of the safe harbor.[31]

III. Disguised Sale Rules for Leveraged Partnerships

Although the Obama administration's regulations under section 752 impose serious restraints on Canadian partners in U.S. REIT partnerships, these bottom-dollar payment rules are hardly traps for the unwary. Guarantees and indemnities are still generally valid for purposes of allocating recourse debt, as long as the taxpayer seeking tax basis credit agrees to become liable for some greater or lesser vertical slice of the liability.

But Treasury's regulations on disguised sales go further by leveling the effect of guarantees, indemnities, and other arrangements on the determination of whether a transfer of appreciated property encumbered by debt will result in gain recognition for the transferor. These rules combat perceived abuse in cases like *Canal Corp.* by eliminating taxpayers' ability to avoid gain recognition from a disguised sale under section 707(a)(2)(B) by guaranteeing debt.[32] The new disguised sale rules treat all debt as nonrecourse debt allocated according to each partner's profits interest, no matter how the debt is treated under section 752. For real estate investors in UPREIT and DownREIT structures who might otherwise avoid the bottom-dollar payment rules, the new disguised sale rules could present serious obstacles.

Section 707(a)(2)(B) grants Treasury broad authority to identify transactions that are structured in the form of tax-free partnership contributions and distributions but are more properly treated as sales between independent parties. Congress enacted section 707(a)(2)(B) in direct response to *Otey*,[33] which effectively allowed a taxpayer to sell his property through a partnership without recognizing gain.

In *Otey*, the taxpayer owned property with a basis and value of approximately $18,500 and $65,000, respectively (that is, a $46,500 built-in gain). Knowing that a direct sale of his property would incur a steep graduated tax on his $46,500 gain, John Otey contributed his property to an equal partnership with the prospective purchaser, who contributed only nominal consideration. The partnership then borrowed $870,000 in recourse debt from a bank, raising each partner's outside basis by $435,000 and Otey's to $453,500 ($18,500 transferred basis from the contributed property plus the $435,000 increase in basis from his share of the partnership debt). The partnership then distributed $65,000 to Otey, who recognized no gain under section 731 because his basis in his partnership interest (including his share of recourse debt) far exceeded his $65,000 cash distribution. In the end, Otey had cashed out his interest in the appreciated property without recognition of gain.

Congress concluded that such partnership transfers were properly characterized as sales that terminate rather than continue the partner's investment in the partnership's assets. It directed Treasury and the IRS to issue rules under section 707(a)(2)(B) reversing the result in *Otey*.

Treasury's disguised sale rules generally apply when a partner contributes appreciated property to a partnership and receives a reciprocal transfer from the partnership in the form of cash, property, or debt relief, which would not have been made but for the partner's contribution and does not depend "on the entrepreneurial risks of partnership operations."[34] For these purposes, simultaneous transfers between a partnership and partners are not considered subject to the partnership's entrepreneurial risks, so those transfers (including the partnership's assumption of a partner's debt incurred immediately before the contribution) will generally result in disguised sales. Moreover, partnership distributions to a contributing partner made within two years of the partner's contribution are generally presumed to be disguised sales unless the partner "clearly establishes" that the payment depended on the partnership's business risks.[35] In cases in which partners receive distributions more than two years after their contributions, however, the IRS must "clearly" demonstrate that a disguised sale has occurred because the payment was never subject to serious doubt.[36] Similar rules apply in the context of leveraged contributions to and distributions from a partnership, such as the debt-financed distribution at issue in *Otey*.[37]

A. Concern Over *Canal Corp.*

Otey was at the heart of Treasury's 1993 promulgation of special rules concerning liabilities for disguised sale purposes. Under those rules, disguised sales may result from (1) a partnership's distribution of loan proceeds to a contributing partner or (2) a partnership's assumption of a partner's liabilities regarding contributed property. Because liabilities incurred before and after the partner's contribution are economically equivalent, it makes sense to treat them similarly for U.S. tax purposes. Leveraged partnership distributions are taken into account for disguised sale purposes to the extent the distribution exceeds the partner's allocable share of the partnership liability used to fund the transfer (the debt-financed distribution rule).[38] Since the old disguised sale regulations treated partners' shares of recourse liabilities according to section 752 principles, Otey's 50 percent allocable share of the $65,000 recourse debt incurred to finance his distribution was $32,500, which would have left Otey's $32,500 distribution in excess of his allocable share ($65,000 leveraged distribution less his $32,500 share of the recourse liability under section 752) as an amount realized from a disguised sale. After October 4, 2016, a taxpayer like Otey would still be deemed to have sold 50 percent of his property for the $32,500 leveraged partnership distribution he received in excess of his 50 percent share of partnership profits.[39]

More recently, in *Canal Corp.*,[40] PwC designed and was ultimately sanctioned for a transactional structure that used a thinly financed subsidiary's indemnification to avoid a $755 million disguised sale from a partnership's leveraged distribution. In the transaction, publically traded Chesapeake Corp. caused its largest division, Wisconsin Paper Mills Inc. (WISCO), to contribute appreciated assets worth $775 million to a partnership in exchange for a 5 percent interest in the partnership. Georgia Pacific, a prospective purchaser, also contributed $376 million for a 95 percent partnership interest. On the same day as the partners' contributions, the partnership made a $755 million leveraged distribution to WISCO from nonrecourse loan proceeds borrowed from a bank, which would have caused a disguised sale only to the extent that WISCO's distribution exceeded its allocable share of the partnership's nonrecourse loan that funded the distribution.

To avoid that result, WISCO agreed to repay any amount of potential loss from the nonrecourse financing under a reciprocal guaranty-indemnification agreement with Georgia Pacific, even though its total assets were worth about $550 million less than the principal amount of the loan. Nevertheless, WISCO claimed a $755 million share of the partnership's recourse liabilities from its indemnification of Georgia Pacific for purposes of section 707(a)(2)(B), which, at the time, tracked section 752's rules for allocating recourse debt.[41] Thus, WISCO argued that none of its $755 million leveraged distribution from the partnership constituted a disguised sale of its business assets to Georgia Pacific.

Both the IRS and the Tax Court disagreed with that position and imposed a $183 million tax deficiency on WISCO's parent, Chesapeake, from a $755 million disguised sale. But the Tax Court's rationale was based entirely on section 752's antiabuse rule and not on any provision of the disguised sale rules.

Because WISCO's technique, if undertaken by a better-financed subsidiary, might have successfully avoided a disguised sale under prior law, Treasury and the IRS decided to change the rules. After considering net income requirements for all partners' guarantees and indemnities under section 752, Treasury and the IRS retreated from those requirements in their temporary and final regulations because of the rules' uncertain impact on other U.S. tax provisions, such as at-risk limitations on a partner's deductions under section 465, that

incorporate subchapter K's rules for allocating recourse debt to partners. As discussed above, Treasury and the IRS made relatively modest changes to section 752's rules and focused instead on rules that transform the way debt is allocated for purposes of disguised sales.

Treasury's new disguised sale rules use a simpler method, which is less taxpayer-friendly, for allocating all debt (whether recourse or nonrecourse) according to the partners' profits interests for transactions occurring on or after January 3, 2017.[42] Under these new rules, WISCO's indemnification of Georgia Pacific in *Canal Corp.* would have had no effect on its 5 percent allocation of nonrecourse *and* recourse liabilities for disguised sale purposes since WISCO had only a 5 percent interest in the partnership's profits. Ninety-five percent of WISCO's distribution, or approximately $717 million, would have been proceeds of a disguised sale under the new disguised sale rules even if the transaction had otherwise been respected under section 752.

B. Sharing Debt by Profits Share

The new disguised sale rules for leveraged partnership transactions reflect concerns over transactions like those in *Canal Corp*. They create a general rule and a proviso that apply in determining whether a debt-financed distribution or a contribution of encumbered property or subsequent transfer causes some portion of the partner's or partnership's liability to be considered proceeds of a disguised sale. Under the general rule, a partner's share of a partnership liability for purposes of the disguised sale rules is determined as if the liability is nonrecourse and in accordance with the partner's share of partnership profits. In other words, even if a partner bears the economic risk of loss for a liability so that the liability is allocated to that partner for purposes of section 752, that liability will be allocated according to the partner's profits interest for disguised sale purposes.

Second, despite the general rule, under the proviso, if a liability of a partnership is a recourse liability, a partner's share of the liability may not exceed his share of the liability determined under section 752. Thus, one partner's first-dollar guarantee of partnership debt may prevent any of the other partners from claiming any portion of that debt for disguised sale purposes when the debt obligations are incurred by the partners according to a plan. But the guarantee will have no effect on the first partner's allocation for disguised sale purposes.

C. Leveraged Contributions

When a partner transfers appreciated property to a partnership and receives a distribution of money or other property from the partnership within two years of that transfer, the disguised sale rules generally treat the partner as having sold part of the contributed property for an amount realized equal to the distribution. If, for instance, a partner contributes a $100 million building (with $80 million of unrealized appreciation and no mortgage) in exchange for a 50 percent partnership interest and immediately receives a $50 million distribution from the partnership, $50 million of the partner's $100 million building (50 percent) is treated as having been sold, and half of the partner's $80 million built-in gain ($40 million) will be recognized for federal income tax purposes unless an exception applies.

To prevent unfair surprise, the regulations recognize exceptions for reasonable preferred returns on the partner's capital (equal to 150 percent of the highest applicable federal rate in effect at any time after the right to such returns is first established), reimbursements for a

partner's preformation capital expenditures (generally, not exceeding 20 percent of the fair market value of contributed property), and distributions from the partnership's operating income. However, under the new disguised sale regulations' ordering rules, these exceptions are generally applied *after* the rules for determining whether a partner's leveraged contributions and distributions constitute a disguised sale.

Treasury and the IRS recognized the fungibility of money when they drafted rules for disguised sales, so that debt relief no less than cash consideration may cause a deemed sale of appreciated assets. Thus, if Otey had used his $65,000 asset (with a $46,500 built-in gain) as collateral to secure a $65,000 recourse loan, which he spent on personal items immediately before contributing the property to a 50-50 general partnership, Otey would have effectively caused the other partner to pay for half his personal expenses since each partner would be liable in the event of default for 50 percent of the loan's unpaid amount. For that reason, the current and prior disguised sale rules treat 50 percent of Otey's asset as having been sold unless his liability was a qualified liability (which most debt incurred within two years of a contribution is not). Otey would have an amount realized of $32,500 on the disguised sale, with a recognized gain of $23,250 (50 percent of his pre-contribution gain) under section 1001. The taxpayer would be treated as contributing the other half of the property with a basis of $9,250 and a value of $32,500 to the partnership.[43]

For disguised sale purposes, the regulations generally apply when a partner contributes property encumbered by any liability other than a qualified liability to a partnership. Qualified liabilities, which can be transferred with property without triggering disguised sales, include (1) any liability that was incurred by a partner more than two years before the transfer and has encumbered the property throughout the two-year period (old and cold debt); and (2) liabilities incurred within two years of the transfer (a) if the proceeds were used to purchase or improve the property (cap ex debt), or (b) if the debt was incurred in the ordinary course of the trade or business in which business assets transferred to the partnership were also used, but only if all material assets of the business have been transferred to the partnership (ordinary course debt).[44] Debt incurred as part of a partner's business, reinvested in contributed property, or incurred more than two years before a transfer does not lend itself to cashing out the partner, so a partner's discharge of that qualified debt is generally not treated as a disguised sale of the encumbered property for U.S. tax purposes.[45]

When a partner contributes property to a partnership encumbered by a nonqualified liability, such as nonbusiness debt that was incurred within two years of the transfer and was not reinvested in the property, the partnership's assumption of the liability may be treated as a disguised sale.[46] The partner realizes gain from a disguised sale equal to the excess of the liability over the partner's share of that liability immediately after the partnership assumes the liability.

Under prior law, a partner's share of a partnership's nonqualified liabilities, and hence the amount realized for tax purposes, depended on whether the liability was recourse or nonrecourse. A partner's share of recourse liabilities depended on section 752's determination of whether that partner bore the economic risk of loss. Thus, before October 5, 2016, a partner's guaranty or indemnity for a partnership's otherwise nonrecourse liabilities could be used to avoid disguised sales. Nonrecourse debt generally had to be allocated for disguised sale purposes under the partnership's method for allocating excess nonrecourse liability, which typically calls for sharing based on the partners' profit shares or nonrecourse deductions. Under

the new rules, all recourse and nonrecourse liabilities are allocated for disguised sale purposes to each partner according to each partner's interest in partnership profits so that partners cannot escape a disguised sale by guaranteeing debt.

Although taxpayers may contribute property encumbered by qualified liabilities to a partnership without recognizing gain, subsequent distributions may cause a portion of the original liability to be treated as proceeds from a disguised sale. Consider, for example, an UPREIT umbrella partnership into which a limited partner contributes a fully depreciated apartment building worth $1 billion (that is, a $1 billion built-in gain), which is subject to a $200 million nonrecourse mortgage that was incurred to purchase the property. In exchange, the contributing partner receives limited partnership units in the umbrella partnership entitled to 5 percent of the partnership's profits. Regardless of the limited partner's share of the partnership's debt after the exchange, no gain will be recognized from the contribution, because the property's purchase money mortgage is cap ex debt that is a qualified liability.

If soon after the exchange, the REIT general partner contributes proceeds from a public offering that are used to fund a $100 million distribution to the limited partner, the partner will be treated as selling part of the building for $100 million under section 707(a)(2)(B). In this scenario, because the partnership's distribution triggers a $100 million disguised sale, independently of the partner's qualified liability, some portion of that liability will be treated as additional consideration exchanged in the building's partial sale. That additional consideration accounts for the fact that the partner's $100 million disguised sale price reflects money received net of liabilities encumbering the property.

Thus, the partner's total amount realized will include the $100 million distribution, plus the lesser of (1) the excess of the qualified liability over the distributee's share of that liability immediately after the partnership assumes the debt ($190 million, which is the $200 million less the 5 percent partner's $10 million share), or (2) the amount of the liability ($200 million) multiplied by the partner's net equity percentage, which is a fraction (-1/8), the numerator of which is the distribution ($100 million) and the denominator of which is the building's net value of qualified liabilities ($800 million, which is the building's $1 billion gross value less the $200 million qualified mortgage).[47] The partner's net equity percentage yields only $25 million of additional consideration from the liability, which is added to the $100 million distribution, for a total disguised sale of $125 million, all of which is recognized as gain under section 1001.

Treasury's new regulations limit minority partners' ability to avoid these rules by claiming a larger share of post-contribution qualified liabilities than their share of partnership profits otherwise entails.

D. Leveraged Distributions

Treasury and the IRS also revamped the leveraged distribution rules at issue in *Canal Corp*. Under the disguised sale rules, a partnership's leveraged distributions from loan proceeds made within 90 days of incurring the debt are treated as disguised sales by a partner only if and to the extent that those distributions exceed the partner's allocable share of those liabilities. Moreover, debt-financed distributions made according to a plan are treated as disguised sales only to the extent a partner's distribution exceeds his aggregate share of all partnership liabilities assumed in the exchange, which makes it somewhat less likely that those distributions will be treated as

disguised sales (unless they are abusive). Both these rules have been changed by the new disguised sale rules' general rule and proviso.

Under the old regulations, a partner's allocable share of liabilities for purposes of the debt-financed distribution rule was equal to the proportion of the partner's distribution that was properly allocable to debt financing (which in WISCO's case was 100 percent), multiplied by the distributee partner's allocable share of recourse liabilities under section 752 and nonrecourse debt allocated in accordance with section 752's excess nonrecourse liabilities method. Thus, although a distributee partner's share of nonrecourse deductions was limited under prior law to the partner's share of partnership profits or nonrecourse deductions, recourse liabilities like those at issue in *Canal Corp*. would (absent abuse) still be allocated to the distributee partner even though that partner had no immediate means of repaying the debt.

Since WISCO's first-dollar indemnification of Georgia Pacific for $755 million of loss gave WISCO a $755 million share of the partnership's recourse debt for purposes of section 707(a)(2)(B), under the old disguised sale rules, WISCO's $755 million debt-financed distribution would not have generated a deemed sale, except that the court determined that WISCO's share of partnership recourse debt equaled zero under section 752's antiabuse rule. The IRS promulgated the new disguised sale rules in part so that it does not have to rely on the highly subjective antiabuse rule in the future.

Today, those allocations must be made in accordance with the partners' relative share of partnership profits. So, however a court came out on the viability of WISCO's debt for section 752 purposes, WISCO, which owned only a 5 percent interest in the partnership, could be allocated no more than 5 percent of the partnership's recourse or nonrecourse liabilities under the new general rule for disguised sales.[48] Moreover, if WISCO's indemnification of Georgia Pacific were successful in shifting the partnership's recourse debt to the distributee partner, the shift would hurt Georgia Pacific's allocation of liabilities under the new disguised sale rules, since under the proviso, no partner's share of liabilities for disguised sale purposes includes any portion of a recourse liability for which another partner bears the economic risk of loss under section 752.[49]

If a court determined that WISCO's indemnification of Georgia Pacific was legitimate, Georgia Pacific could not have included in its share of liabilities for disguised sale purposes any portion of WISCO's $755 million share of recourse liabilities under section 752 and would have been more likely to suffer immediate U.S. tax consequences as a result. Thus, under the new rules, one partner's guaranty or indemnity must be carefully calibrated with other partners' potential disguised sale risks under the proviso to the disguised sale rules to avoid multiple deemed sales, which might exceed the aggregate amount of consideration that would actually be paid for a direct sale of the partnership's encumbered assets.

IV. The Future of the Disguised Sale Rules

It is clear that the Obama administration's October and November 2016 regulations on bottom-dollar payment obligations and disguised sales disadvantage real estate investors. Treasury's 2014 proposed regulations on partnership debt and disguised sales met substantial resistance from the U.S. real estate lobby, which submitted numerous comments criticizing their breadth and subjectivity. Although the Obama administration's 2016 bottom-dollar payment and

disguised sale rules scaled back the partnership debt regulations under section 752, IRS officials have acknowledged that their final regulations target guarantees by real estate investors in REIT umbrella partnerships that keep tax-deferred investments alive after cashing out their profits interest.[50] One IRS attorney portrayed those transactions as unfair loopholes that allowed wealthy taxpayers and multinationals to skirt tax liabilities that middle America has to pay. It's safe to say that the Trump administration, with the country's first real-estate-mogul-in-chief at the helm, will bring different policy priorities to the taxation of real estate partnerships.

But neither President Trump nor any member of his cabinet or the congressional Republican leadership has identified the Treasury's bottom-dollar payment and disguised sale rules as a target for repeal, and there is much to like about them. They generally target noncommercial guarantees and indemnities that in light of the bottom-dollar safe harbor and transition relief, provide taxpayers clear, objective standards for avoiding disguised sales. Therefore, although Treasury Secretary Steven Mnuchin is expected to consider several modifications to clarify the disguised sale regulations, I do not expect wholesale repeal, even though the rules were finalized at the 11th hour of an opposing administration.

A. Deficit Restoration Obligations

Tax practitioners have generally welcomed the IRS and Treasury's scaled-back regulations under section 752, including the new bright-line safe harbor for partners whose first-dollar obligation to fund a debt is offset by no more than 10 percent of another person's indemnity or reimbursement obligation. At the same time, however, there has been some consternation over the breadth of the bottom-dollar payment rules and their apparent tension with other regulations that sanction deficit restoration obligations (DROs).

DROs have previously been considered safe methods for allocating partnership obligations to foreign limited partners in UPREIT structures when the REIT is a general partner. In a DRO, limited partners, who are not otherwise liable for partnership debt, agree to become liable for a portion of that debt and to contribute funds if the partnership is liquidated without adequate resources to repay its debts. For example, if a partnership borrows money on a recourse basis to purchase real estate, the limited partners might agree under a DRO to cover a specified proportion of partnership losses that they would not otherwise be obligated to incur under local limited partnership laws.

Although Treasury regulations under section 704 expressly authorize the allocation of debt-financed partnership deductions according to a DRO, the new bottom-dollar payment rules target DROs. For example, section 704 would generally respect a DRO in a partnership agreement between a limited partner and a REIT general partner in an UPREIT OP that allocates the first $50 of losses to the REIT general partner and the next $50 of losses to the limited partner. But since those allocations to the limited partner require 50 percent of the loss to first be allocated to the REIT general partner, it could be disregarded as a bottom-dollar payment obligation under Treasury's new section 752 regulations.

Because DROs are truly essential, and generally legitimate, means for partners in real estate partnerships to allocate losses to avoid recognition of gain while also remaining fully liable for losses, future regulations under the bottom-dollar payment rules might exempt allocations of recourse debt to limited partners whose allocations otherwise have substantial economic effect

under section 704 and its regulations. Otherwise, I do not expect substantial revisions to the Bottom-Dollar Payment Rules, which went into effect on October 5, 2016.

B. The Disguised Sale Rules' Proviso

Although the U.S. tax bar's response to the withdrawn proposed regulations on disguised sales and bottom-dollar indemnities and guarantees was overwhelmingly negative for their uncertainty and overbreadth, the new targeted regulations on disguised sales have been well received, with the exception of confusing language in the rules' proviso. As discussed above, the proviso generally provides that when partners' liabilities are assumed or incurred by a partnership according to a plan, no partner's share of a partnership liability can exceed that partner's share of the liability for section 752 purposes.

The proviso's current language was revised on November 17, 2016, after an earlier draft appeared to prevent jointly liable partners from taking any credit for partnership debt under the disguised sale rules promulgated on October 5, 2016. But the proviso's revised language, which limits partners' shares of debt for disguised sale purposes based on other partners' share of liabilities under section 752, also appears overbroad because its plain language would override the disguised sale rules' special method for allocating nonrecourse debt whenever the partner's profits share is less than the partner's allocable share of recourse or liabilities under section 752.

While Treasury and the IRS clearly intended to prevent partners from receiving credit for disguised sale purposes from another partner's recourse liability, they also clearly intended other liabilities under the disguised sale rules to be allocated based on partners' profit interests. But the proviso's language undermines that purpose by appearing to make a partner's share of nonrecourse liabilities under the disguised sale rules depend on section 752's other methods for allocating nonrecourse liabilities (for example, according to pre-contribution gains or partnership allocations for nonrecourse deduction), even though the new section 752 regulations clearly state that those methods do not apply for disguised sale purposes. The IRS should issue regulations or rulings under the new disguised sale rules that clarify that the proviso only limits a partner's share of the partnership's *recourse liabilities* for which another partner bears the economic risk of loss under section 752.

In other respects, however, the disguised sale rules reflect a measured response to the perceived abuse in cases like *Canal Corp.* that gives taxpayers welcome standards for determining when their partnership contributions and distributions will cause them to recognize gain from a deemed sale or exchange under section 707(a)(2)(B). In that sense the regulations' objectivity improves on the uncertainty created by the Tax Court's vague standard for identifying disguised sales in *Canal Corp.* from transactions that met none of the regulatory criteria. For this reason alone, the Trump administration might hesitate before repealing the bottom-dollar and disguised sale rules, which went into effect for all partnership transactions occurring on or after January 3, 2017.

FOOTNOTES

[1] *See* IRS, "SOI Tax Stats — Foreign Recipients of U.S. Partnership Income Statistics," data on

Form 8805, "Foreign Partner's Information Statement of Section 1446 Withholding Tax" for 1990 and 2005-2013, *available at* https://www.irs.gov/uac/soi-tax-stats-foreign-recipients-of-u-s-partnership-income-statistics.

[2]FIRPTA is codified in section 897.

[3]*See* reg. section 1.385-2(c)(2)(iii) (for a U.S. corporation's purported debt instrument to a related party to be respected, (1) there must be written document of a legally binding obligation to repay a sum certain and (2) a reasonable expectation of the debtor's repayment, including evidence drawn from the issuer's financial statements).

[4]*See* Canada-U.S. income tax treaty, articles IV(1)-(3) (defining U.S. real property), X(7)(c) (taxing dividends attributable to sales of property by conventional REITs), and XIII(1)-(3) (subjecting to U.S. taxes gains from the sale of U.S. real property and U.S. real property holding corporations).

[5]Section 897(c)(2) (defining stock of U.S. real property holding corporations as FIRPTA assets).

[6]*See* sections 892(a)(2)(B) and 897(l)(1); reg. section 1.892-3T(a)(1).

[7]Section 897(h)(3).

[8]*See* sections 857(b) and 561.

[9]*See* section 856(c).

[10]*See* Canada-U.S. income tax treaty, Article XIII(1), XIII(3)(a).

[11]Reg. section 1.892-3T(a)(1).

[12]*See* Notice 2007-55, 2007-27 IRB 1.

[13]*See* section 351(e)(1) (denying section 351's nonrecognition provisions for transfers of REIT interests).

[14]Reg. section 1.701-2(d), Example 4; and LTR 200450018.

[15]Reg. section 1.752-2(a).

[16]Reg. section 1.752-3.

[17]Reg. section 1.752-2(b)(1).

[18]*See* section 731(a) (providing for nonrecognition from partners' distributions from the partnership, except to the extent cash received or liabilities discharged exceed their outside basis).

[19]Reg. section 1.752-3(a)(1)-(3) (allocating nonrecourse debt according to (1) each partner's share of partnership minimum gain, (2) each partner's share of section 704(c) minimum gain, and (3) each partner's share of excess nonrecourse liabilities, allocated by profits interest or share of nonrecourse deductions).

[20]Reg. section 1.752-2(b).

[21]T.D. 9788, section 2(A).

[22]New York State Bar Association Tax Section, "Report on the Proposed Regulations on the Allocation of Partnership Liabilities and Disguised Sales," at 41-46 (May 30, 2014).

[23]Reg. section 1.752-2T(f), Example 11 (disregarding cross-cutting guarantees and indemnitees between partners).

[24]Reg. section 1.752-2T(b)(3)(ii)(C) (defining bottom-dollar payment obligations).

[25]T.D. 9788, section 2(A) (describing the scope of bottom-dollar payment rules).

[26]Reg. section 1.752-2T(b)(3)(ii)(B).

[27]T.D. 9788, section 2(A) (providing that a partner's payment obligation would be respected if the partner was indemnified for only the first $1 out of $100 guaranteed).

[28]Reg. section 1.752-2T(l)(2).

[29]Reg. section 1.752-2T(l)(3).

[30]*Id.*

[31]Reg. section 1.752-2T(b)(3)(ii)(D).

[32]*See* T.D. 9788, section 1 (citing *Canal Corp. v. Commissioner*, 135 T.C. 199 (2010), as a motivation for the new rules under reg. section 1.707-5T).

[33]*Otey v. Commissioner*, 634 F.2d 1046 (6th Cir. 1980).

[34]Reg. section 1.707-3(b)(1).

[35]Reg. section 1.707-5(a)(7)(i).

[36]Reg. section 1.707-5(a)(6)(i)(A).

[37]*See* reg. section 1.707-5(b).

[38]Reg. section 1.707-5(b)(1), (2).

[39]Reg. section 1.707-5(f), Example 11 (requiring gain to be recognized by a partner similarly situated to *Otey*).

[40]In *Otey*, a 50 percent partner in a general partnership received a $65,000 debt-financed distribution out of proceeds from a recourse loan incurred by the partnership immediately before the distribution.

[41]*See* reg. section 1.752-2(b)(1). *But see* reg. section 1.752-2T(b)(3) (disregarding bottom-dollar payment obligations of the partner for all partnership tax purposes).

[42]Reg. section 1.707-5T(a)(2)(i).

[43]Reg. section 1.707-5(f), examples 10-11 (illustrating how debt-financed distributions can be treated as partial sales under the disguised sale rules).

[44]Reg. section 1.707-5(a)(6)(i)(A)-(E).

[45]Laura A. Cunningham and Noel B. Cunningham, *The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships* 237-238 (4th ed. 2011) (discussing the policy behind the old rules for disguised sales of property).

[46]Reg. section 1.707-5(a)(1) (treating the discharge of any partner's liability "other than a qualified liability" as subject to the disguised sale rules).

[47]*See* reg. section 1.707-5(a)(5).

[48]*See* reg. section 1.707-5T(f), examples 7-8 (illustrating how the new rules work in the context of partners' contributions according to a plan and under the antiabuse rules).

[49]*See* reg. section 1.707-5T(a)(2).

[50]Amy S. Elliott, "Saying Goodbye to the Bottom-Dollar Guarantee," *Tax Notes*, Jan. 2, 2017, p. 17.

END FOOTNOTES