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Structuring Contributions of Appreciated Property to Partnerships: Avoiding Tax Recognition on Built-In Gain Assets

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Smith Gambrell Russell

Structuring Contributions of Appreciated Property to Partnerships: General Nonrecognition Rules and Section 704(c) Consequences

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Overview

1. General Nonrecognition Rules
2. Section 704(c) Tax Consequences

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General Nonrecognition Rules

A. General Rule -- Section 721
B. Property Requirement
C. Assumption of Debt
D. Contribution to Investment Company

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General Rule – Section 721

- The formation of a partnership is generally a tax-free event.
- No gain or loss is recognized upon the contribution of property to a partnership in exchange for a partnership interest.
- There are a number of exceptions to this rule.
- Common exceptions: a transfer to an “investment company;” the assumption by the partnership of the contributing partner’s debt; the contribution of services or items that are not treated as property.
- Typically, however, even taxable transfers are taxable only to the contributor and not to the entity

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Property Requirement

- Section 721 only applies to the transfer of property
- A transfer of services can be taxable, but these transfers often implicate the rules on issuances of profits interests.
- The transfer of a right to use property (as distinguished from ownership of the property itself) is taxable.
- Common examples would be transfers of leaseholds or licenses that are treated as something short of ownership of the underlying property for tax purposes

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Assumption of Debt

- One of the most common instances in which a contribution is treated as taxable is when property is contributed that is subject to debt.
- In general, if the contributed property is subject to a liability at the time of contribution, and the liability is assumed by the partnership (either directly or indirectly), then the net amount by which the contributing partner is relieved is treated as a cash distribution to that partner.

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Assumption of Debt

- The first consequence is that the contributor's basis in his or her partnership interest is reduced by the amount of this deemed cash distribution.
- Secondly, the amount of the liability that is treated as assumed by the partnership is then allocated among all the partners and increases the tax basis of their partnership interests .
- Finally, if the amount of the deemed cash distribution exceeds the contributor's basis in his or her partnership interest, the difference is treated as taxable gain.

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Assumption of Debt – Ex. 1

- Smith and Jones form Newco, LLC. Jones contributes $300,000 in cash. Smith transfers raw land that he originally purchased for $400,000, but which now has a value of $1.1 million. The land is subject to a non-recourse loan of $1 million. Smith takes a 25% interest and Jones takes a 75% interest in Newco.
- Assume that under the applicable tax rules, the $1 million liability is allocated between the members 25%-75%. Accordingly, Smith's share of the liability is $250,000. As a result of this allocation of the debt, Smith is treated as receiving a deemed cash distribution equal to the amount by which the liability was reduced (i.e., $750,000).

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Assumption of Debt – Ex. 1

- Assume that Smith's basis in the raw land is $400,000 and then adds the $250,000 of debt he is allocated, for a total basis in his LLC interest of $650,000. The deemed cash distribution of $750,000, however, reduces his basis to $0 and then triggers a gain of $100,000.

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Assumption of Debt – Ex. 2

- Same facts as Example 1, but Jones contributes only $100,000 in cash. Smith takes back a 50% interest in Newco and Jones takes back a 50% interest.

- Assume that under the applicable tax rules, the $1 million liability is allocated $500,000 to Smith and $500,000 to Jones. Smith, therefore, is treated as receiving a deemed cash distribution equal to the amount by which the liability was reduced (i.e., $1million less $500,000 = $500,000).

- Smith is treated as, initially, taking a $400,000 basis in his LLC interest and adds the allocated debt of $500,000 for a total of $900,000. The deemed cash distribution of $500,000 reduces his basis to $400,000. Because the deemed cash distribution in this instance is less than Smith's tax basis, no gain is triggered.

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Assumption of Debt

- One of the key issues in this type of transaction is how the liability will be allocated to the members. The tax regulations governing this are very complicated and there are techniques that can be used to allocate more of the debt back to the contributing partner. Because the amount of the deemed cash distribution is equal to the net reduction in liability, this is an important planning point.

- Note: The rules discussed above apply to all liabilities. This includes clear obligations like loans and accounts payable, but can also apply to certain contingent liabilities, claims, judgments, etc.

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Transfer to Investment Company

- Another exception to the general rule that contributions to a partnership are not taxable is that a transfer to an "investment company" is a taxable event.

- In general, the Code wants to discourage investors from diversifying risk by varying their investments without paying tax. One frequent technique was to contribute stock or other financial instruments to a large investment pool that included a variety of other positions and instruments. This would have the effect of diversifying risk without triggering any taxable gain on the contributed stock.

- To prevent this, Code section 721 provides that any appreciation inherent in property that is contributed to an "investment company" is immediately taxable after the contribution.

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Transfer to Investment Company

Example:

- Smith forms a tech company which goes public. Smith now holds $50 million in tech company stock, with a tax basis of $0. Smith would like to diversify her stock position and contributes the stock to a pool operated by an investment bank in exchange for a 1% interest. The balance of the pool's assets consist of shares represented in the DJIA and commercial paper. If the pool qualifies as an investment company, Smith has a $50 million tax gain.

- For these purposes, an "investment company" is generally defined as a partnership in which more than 80% of its assets are readily marketable stocks or securities which are held for investment.

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Section 704(c) Tax Consequences

A. General Rule – Section 704(c)
B. Aggregation
C. 704(c) Methods

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Section 704(c) Rules -- General

- Assume that Smith and Jones make equal contributions to Newco LLC. Smith contributes land worth $100, but with a basis of $40. Jones contributes cash in the amount of $100. Each takes back a 50% interest in Newco.
- Although they have each made contributions of equal value, the tax basis of each contribution is different.
- If Newco sold its assets the next day for $200, it would have gain of $60.

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Section 704(c) Rules -- General

- If the taxable gain were allocated 50/50, then Smith would be able to avoid a considerable tax bill by contributing his property to an LLC just before it was sold.
- This type of planning is not permitted. Code section 704(c) and the regulations under it contain a number of complicated rules that attempt to allocate gain from an appreciated asset back to the contributor.
- In the example above, all $60 of the gain would be allocated back to Smith, and none to Jones. This is because the 704(c) rules allocate income or loss to partners as necessary to take into account the difference at the time of contribution between the basis of contributed property and its fair market value.

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General Restriction – 704(c)

Code Section 704(c)(1)(A):

- ". . . income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution . . . ."

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Application of 704(c) Rules

- These rules apply to (1) property contributed at the start of a partnership, (2) later contributions of appreciated property, and (3) later contributions of any property if the LLC already owns appreciated property.

- Thus, even if there are no contributions of appreciated property at the outset of an LLC, if there is a subsequent contribution (i.e., a new member joins), and if the LLC's assets have appreciated by that time (i.e., the value of the LLC's assets is different from the tax basis of the LLC's assets), then the 704(c) rules will be needed to allocate the pre-contribution gain inherent in the LLC's assets back to the founders.

- Typically, a spreadsheet is used to maintain special accounts for LLC members whenever the 704(c) rules apply.

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704(c) Rules and Depreciation

- When the contributed property is depreciable or amortizable, another level of complications arise. Assume that Smith contributes a depreciable asset worth $100, but with a basis of $40. The asset is depreciated on a straight line basis over 10 years. Thus, the asset will generate tax deductions of $4 a year for ten years. If Smith's asset had a tax basis equal to its FMV, then it would general tax deductions of $10 a year for ten years.

- In the case of such deductions, the 704(c) rules require that depreciation deduction must be allocated to take into account the difference between the FMV of an asset and the tax basis of that asset.

- The difference between the actual $4 per year depreciation deduction and the "book" depreciation deduction of $10 per year must be reconciled.

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704(c) Rules and Depreciation

- Note that Jones would ordinarily be allocated half of any depreciation deduction. Therefore, Jones would be entitled to $5 in depreciation deductions a year for ten years. The 704(c) rules will require that all of the actual tax depreciation be allocated to Jones (i.e., the entire $4) in order to minimize the built-in-gain effect.

- Alternative approaches would be to allocate $1 in phantom income to Smith and $5 in depreciation ($1 phantom and $4 actual) to Jones.

- The net result is to minimize the possibility of shifting income or deductions, and to reduce the effect of built-in gain or loss.

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704(c) Amounts

- Section 704(c) only applies to built-in gain or built-in loss as of the date of contribution – the “704(c) layer”
- Section 704(c) is generally applied on a property-by-property basis
- Small disparities between FMV and basis can be ignored as de minimis
  - difference between the adjusted basis and FMV for all properties contributed by a partner is less than 15% of tax basis and the total gross disparity does not exceed $20,000

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704(c) Aggregation

- In some cases, contributed property can be aggregated and only the net 704(c) layer is subject to these rules. Treas. Reg. §1.704-3(e).
- All depreciable property, other than real property, that is contributed by one partner in one taxable year of the partnership may be aggregated, but only if property so aggregated is included in the same general asset account.
- Zero basis property may be aggregated, but only if the property is not real property.
- Inventory items can be aggregated, but securities and similar investments, and inventory determined under a specific identification method cannot be aggregated. (BUT – special rules for "securities partnerships".)
- Any other contributed items that the IRS permits to be aggregated. For example, in a 1996 PLR, the IRS permitted the aggregation of built-in gains on contributions of certain timber.

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704(c) Methods

- In order to allocate depreciation appropriately, the tax regulations require that a reasonable method be used.
- Three methods are set forth, each of which is deemed to be reasonable:
  - Traditional allocation method
  - Traditional method with curative allocations
  - Remedial allocation method
- Other methods are possible, but these are the most common

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704(c) Methods

- Different methods can be used for different properties provide it is reasonable.
- Generally can't change the method once started.
- If a partner subject to 704(c) sells his or her partnership interest, then a proportionate amount of 704(c) taints the buyer's interest (in the absence of a §754 election).

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Traditional Method – Income/Gain

- Same example as before: Smith and Jones make equal contributions to Newco LLC. Smith contributes land worth $100, but with a basis of $40. Jones contributes cash in the amount of $100. Each takes a 50% interest in Newco.
- Note that at the time of contribution, the land has a §704(c) layer of $60.
- Later, Newco sells the land for $300.
- Newco's gain on the sale is $260 --- i.e., amount received of $300 less tax basis of $40.
- The traditional method requires that the built-in gain amount at the time of contribution – the §704(c) layer – be allocated to Smith. The balance of the gain -- $200 – is split between the partners based on their 50/50 ownership of Newco.

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Traditional Method – Ceiling Rule

- Same example as before: Smith and Jones make equal contributions to Newco LLC. Smith contributes land worth $100, but with a basis of $40. Jones contributes cash in the amount of $100. Each takes a 50% interest in Newco.
- Later, Newco sells the land for $80 (i.e., it has decreased in value).
- The ceiling rule interacts with the traditional method to limit the allocation of the §704(c) layer.
- Specifically, here Newco's gain on the sale is $40 --- i.e., amount received of $80 less tax basis of $40.
- Because the total gain recognized by Newco is less than the 704(c) layer, all of it is allocated to Smith.

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Traditional Method – Ceiling Rule

- After the sale, Smith's tax basis in Newco is $80 ($40 contribution basis plus $40 of gain allocated from the sale of the land). Jones' outside basis is still $100.
- After the sale, Newco will have $80 of cash – Jones' contribution of $100 and $80 of sales proceeds from the land.
- If Newco liquidates, then $90 is distributed to Smith and $90 is distributed to Jones.
- Smith recognizes $10 ($90 distribution less $80 outside basis). Jones recognizes a loss of $10 ($90 distribution less $100 outside basis).

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Traditional Method – Ceiling Rule

- Thus, in total, Smith recognizes $50 of gain, which reflects the fact that Smith received $90 on his investment, but started with a $40 basis.
- Jones has a $10 loss, reflecting the fact that he received $90 back on his investment of $100 of cash.

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Traditional Method – Depreciation

- As noted, §704(c) also applies to depreciation and other forms of cost recovery.
- Assume the facts from before: Smith contributes a depreciable asset worth $100, but with a basis of $40. The asset is depreciated on a straight line basis over 10 years. Thus, the asset will generate tax deductions of $4 a year for ten years. If Smith's asset had a tax basis equal to its FMV, then it would general tax deductions of $10 a year for ten years.
- Jones contributes cash of $100 and Smith and Jones share in the LLC on a 50/50 basis.

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Traditional Method – Depreciation

- As noted, Jones is entitled to half of any depreciation deduction.
- Thus, Jones would be entitled to $5 in depreciation deductions a year for ten years – that is, half of the $10 in annual depreciation that would otherwise be generated but for the fact that the asset was contributed with basis different than FMV.
- The traditional method would allocate all of the actual depreciation generated by Newco to Jones to the extent necessary to give him this $5 per year.
- However, in this example the ceiling rule comes into play.
- Thus, because Newco only generates $4 of depreciation for tax purposes, all of it must be allocated to Jones.

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Traditional Method – Depreciation

- Assume now that Newco uses the $100 of cash contributed by Jones to purchase another depreciable asset, which generates $4 of depreciation per year for 10 years.
- Now Newco has a total of $8 of depreciation that can be allocated each year.
- So can Newco allocate $5 to Jones and the balance ($3) to Smith?

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Traditional Method – Depreciation

- Our goal is to allocate $5 of depreciation to Jones on the first asset (the asset contributed by Smith) and half the depreciation on the new asset purchased by Newco. The new asset generates $4 of depreciation, so $2 would be allocated to Jones.
- Thus, a total of $7 is allocated to Jones and $1 to Smith. The ceiling rule does not trap us in this instance because there is enough depreciation to make up for the §704(c) limitation.

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Traditional Method with Curative Allocations

- The traditional method with curative allocations can be used to overcome problems caused by the ceiling rule.
- This method uses other income and loss items of the partnership to eliminate ceiling rule issues.
- Example: Smith contributes a depreciable asset worth $100, but with a basis of $40. The asset is depreciated on a straight line basis over 10 years. Thus, the asset will generate tax deductions of $4 a year for ten years. If Smith's asset had a tax basis equal to its FMV, then it would general tax deductions of $10 a year for ten years.

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Traditional Method with Curative Allocations

- Jones should be entitled to $5 in depreciation per year. But, due to the ceiling rule there is only $4 to allocate.
- Assume that Newco has $10 of income in the same year. Ordinarily, this would be split $5 to Jones and $5 to Smith.
- The traditional method with curative allocations permits Newco to allocate $6 of the income to Smith and $4 of the income to Jones.
- If Newco had $10 of depreciation and $10 of income, there would be zero net income and Jones and Smith would both be allocated zero.
- In this example Jones is allocated $4 of actual depreciation and $4 of income, for a net of zero. Smith is allocated $6 of income and zero depreciation, for a net of $6.

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Traditional Method with Curative Allocations

- In fact, Newco has a net income of $6, so this works out.
- Note that the key is to allocate items that are similar in character. Thus, Newco could allocate deductible expanses to Jones or ordinary income items.
- Assume, instead, that Newco had $10 of capital gain instead of ordinary income. In this case, the character does not match the depreciation, so curative allocations are not permitted.

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Remedial Method

- With the traditional method, Newco allocates actual amounts in order eliminate the §074(c) layer, but is limited by the ceiling rule.
- Under the traditional method with curative allocations, Newco shifts other items of similar character to eliminate the §704(c) layer.
- Both these methods use actual items. The remedial method equalizes the §704(c) layer by means of fictional allocations.

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Remedial Method

- Example: Smith contributes a depreciable asset worth $100, but with a basis of $40. The asset will generate tax deductions of $4 a year for ten years. If Smith's asset had a tax basis equal to its FMV, then it would general tax deductions of $10 a year for ten years.
- Assume no other items of income, gain, loss or deduction for Newco in the year other than the $4 of depreciation.
- In order to "fix" the §704(c) issue, Jones must be allocated $5 of depreciation, but only $4 is available.
- Solution: Allocate $4 of actual depreciation to Jones, $1 of "fictional" depreciation to Jones, and $1 of fictional income to Smith.

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Remedial Method

- In this fact pattern, the ceiling rule prevents the full allocation of $5 to Jones under the traditional method.
- And because there are no similar items to shift to Smith, the traditional method with curative allocations cannot fix the problem.
- The problem is fixed under the remedial method because Newco can create the missing depreciation and create offsetting income items for Smith.

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Summarizing the Methods

- From Smith's point of view, the traditional method is the best – there are no curative or fictional income allocations to Smith that could increase his tax bill.
- From Jones' point of view, the remedial method is the best because he in fact is allocated the depreciation that he expected.
- The choice of method is frequently negotiated ahead of time if there is a significant §704(c) asset that is contributed to a partnership.

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Cash Issues

- As noted, the parties will have frequently have quite different views on which method to use.
- Sometimes this disagreement can be bridged by means of tax distributions.
- Example: Smith does not want to agree to the remedial method because it will cause income inclusions over the life of Newco.
- Jones is adamant that unless Newco uses the remedial method he will not invest.
- Solution? If Newco's financial projections show liquidity, the parties could agree on tax distributions to cover Smith's remedial allocations.

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Thanks

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Structuring Contributions of Appreciated Property to Partnerships: Selected Basis and Distribution Issues

January 27, 2022

Presented By:
Kate Mathieu
and
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Skadden

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Basis to Partner on Contribution

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- The basis of the partner in a partnership interest acquired by contribution (commonly referred to as “outside” basis) equals the cash contributed plus the adjusted basis of the property contributed (plus any gain recognized on taxable contributions to “investment companies”). § 722.
- A partner has one unitary basis in its partnership interest even if it holds interests in different “classes” or interests acquired at different times. *See* Rev. Rul. 84-53.

Holding Period in Partnership Interest

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- Tacking: If the contributed property is a capital asset or section 1231 property, the holding period of the contributor in its partnership interest includes the holding period of the contributor in the property contributed. § 1223(1).
  - Section 1231 property includes:
    - Depreciable property used in a trade or business, held for more than one year.
    - Real property used in a trade or business, held for more than one year.
- No tacking: If the contributed property is cash or a non-capital, non-section 1231 asset (e.g., inventory), the holding period begins on the date of contribution.
- Split holding period: Although a partner's outside basis is unitary, the partner's holding period may be divided if:
  - The partner acquires interests at different times.
  - The partner contributes both "tacking" and "nontacking" property.
    - Regulations provide for the fragmentation (solely for holding period purposes) of an interest acquired in exchange for both types of property by comparing the FMV of the interest acquired in exchange for particular property to the FMV of the holder's entire partnership interest.

Example: Split Holding Period

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- Example: On January 1, A makes a contribution to a partnership of:
  - $5,000 cash.
  - Land with $10,000 fair market value, $5,000 basis, and a two-year holding period.
    - The land has a $5,000 built-in gain.
- A has a $10,000 basis in the partnership interest; her $5,000 built-in gain in the land becomes a $5,000 built-in gain in the partnership interest.
- A's holding period in the partnership is split:
  - 1/3 short-term (starting Jan. 1, when the $5,000 cash is contributed)
  - 2/3 long-term (tacking the two-year holding period of the land worth $10,000).
- If A sells the partnership interest for $15,000 on Dec. 1 and recognizes a $5,000 capital gain, 1/3 of the $5,000 gain is short-term (taxed at ordinary income rates).
  - Economically, the entire $5,000 of gain is attributable to the long-term capital gain built into the land at the time of contribution; no gain accrued while A held the partnership interest.
  - However, because A sold the partnership interest, rather than the land, and had a short-term holding period in 1/3 of her partnership interest, 1/3 of the $5,000 gain is short-term gain.

Tax Attributes to Partnership on Contribution

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- The partnership's basis in contributed property ("inside" basis) carries over from the contributor (and is increased by any gain recognized on taxable contributions to "investment companies" and section 721(c) gain). § 723.
- The partnership's holding period in contributed property includes the holding period of the contributing partner. § 1223(2).
- If a partner contributes "unrealized receivables" (including depreciation recapture items) to a partnership, the partnership's gain or loss on disposition of the property is ordinary gain or loss. § 724(a), (d)(1).
- If the partner contributes inventory items to the partnership, the partnership's gain or loss on disposition of the property is ordinary gain or loss if the disposition takes place within 5 years. § 724(b), (d)(2).
- If the partner contributes a capital asset to the partnership, any loss recognized by the partnership on disposition of the property is capital loss if the disposition takes place within 5 years (to the extent of any built-in loss immediately prior to the contribution). § 724(c).

Section 704(c) Anti-Mixing Bowl Rule

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- As discussed, section 704(c) applies when a partner contributes property with built-in gain or built-in loss to a partnership.
- Section 704(c) Anti-Mixing Bowl Rule: If section 704(c) property is distributed (directly or indirectly) by the partnership (other than to the contributing partner) within 7 years of being contributed, the contributing partner is treated as recognizing gain or loss (as the case may be) from the sale of such property in an amount equal to the gain or loss which would have been allocated to such partner by reason of section 704(c) if the property had been sold at its fair market value at the time of the distribution. § 704(c)(1)(B).
  - Character of the gain or loss is the same as the character of the gain or loss that would have resulted if the property had been sold by the partnership to the distributee.
  - Appropriate adjustments are made to the adjusted basis of the contributing partner's interest in the partnership and to the adjusted basis of the property distributed to reflect any gain or loss recognized.

Section 704(c) Anti-Mixing Bowl Rule (cont.)

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- There are several notable regulatory exceptions to the application of section 704(c)(1)(B):
  - Certain liquidating distributions in which the contributing partner receives only an interest in the section 704(c) property contributed by that partner and the built-in gain or loss in such interest, determined immediately after the distribution, is equal to or greater than the built-in gain or loss on the property that would have been allocated to the contributing partner under section 704(c)(1)(A) on a sale of the contributed property to an unrelated party immediately before the distribution.
  - Transfers of all of a partnership's assets and liabilities to a second partnership (transferee partnership) in a section 721 contribution, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement.
  - Certain partnership incorporations.
  - Distributions of an undivided interest in property to the extent that the undivided interest does not exceed the undivided interest, if any, contributed by the distributee partner in the same property.
- See generally Treas. Reg. § 1.704-4(c).

Section 704(c) Anti-Mixing Bowl Rule: Example

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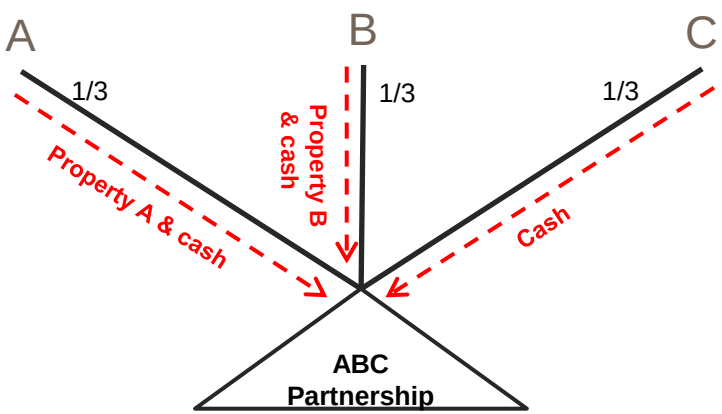
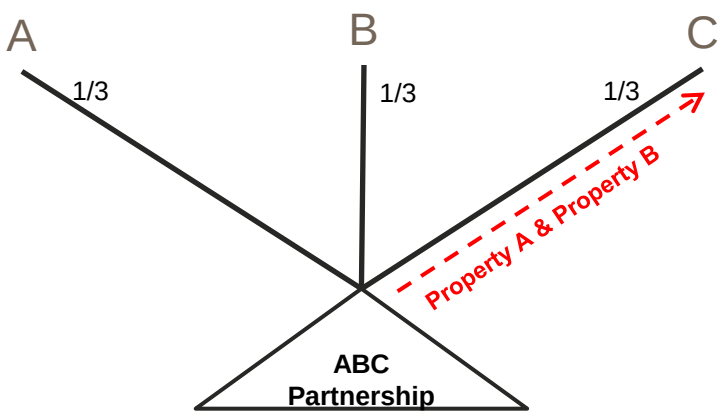
- **Facts**
  - On 1/1/95, A, B, and C form partnership ABC as equal partners.
    - » A contributes $10,000 cash and Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $4,000.
    - » B contributes $10,000 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of $10,000.
    - » C contributes $20,000 cash.
  - On 12/31/98, Property A and Property B are distributed to C in complete liquidation of C's interest in the partnership.

Formation: 1/1/95



Distribution: 12/31/98



Section 704(c) Anti-Mixing Bowl Rule: Example

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- **Tax Treatment**
  - A would have recognized $6,000 of gain under section 704(c)(1)(A) on the sale of Property A at the time of the distribution ($10,000 fair market value less $4,000 adjusted tax basis). As a result, A must recognize $6,000 of gain on the distribution of Property A to C.
  - B would not have recognized any gain or loss under section 704(c)(1)(A) on the sale of Property B at the time of distribution because Property B was not section 704(c) property. As a result, B does not recognize any gain or loss on the distribution of Property B.
  - *See* Treas. Reg. § 1.704-4(a)(5) Ex. 1.

Section 704(c) Anti-Mixing Bowl Rule: Section 737

Skadden

- Section 737 applies a back-stop to section 704(c)(1)(B) in the event the contributing partner receives certain distributions of non-contributed property during the 7-year period.
  - Section 704(c)(1)(B) would not otherwise apply in this situation because the section 704(c) property has not itself been distributed, but the end result may be economically similar.
- Section 737 requires recognition of gain equal to the lesser of (i) the excess (if any) of (A) the fair market value of property (other than money) received in the distribution over (B) the adjusted basis of such partner's interest in the partnership immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution, or (ii) the “net precontribution gain” of the partner.
  - “Net precontribution gain” is the hypothetical section 704(c)(1)(B) gain that would have been allocated to the contributing partner were all the contributed section 704(c) property still held by the partnership distributed to non-contributing partners.

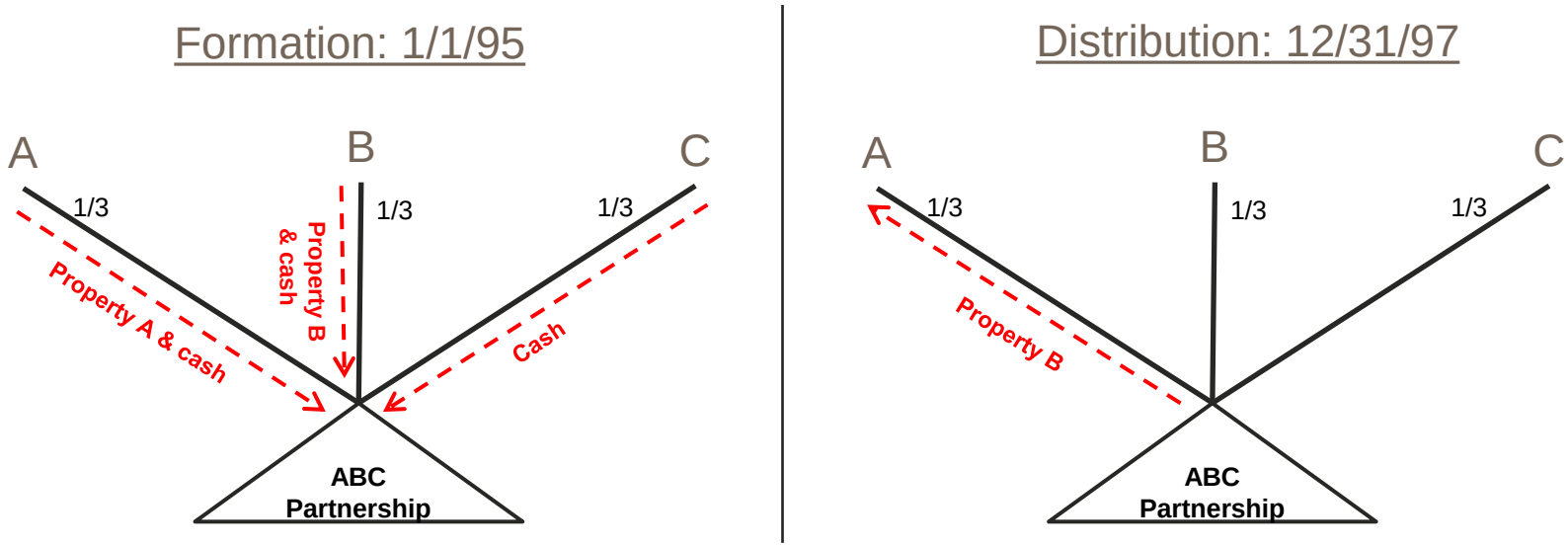
Section 737 Example

Skadden

- **Facts**
  - On 1/1/95, A, B, and C form partnership ABC as equal partners.
    - A contributes Property A, depreciable real property with a fair market value of $30,000 and an adjusted tax basis of $20,000. Property A has 10 years remaining on its cost recovery schedule and is depreciated using the straight-line method.
    - B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of $30,000.
    - C contributes $30,000 cash.
    - The partnership uses the traditional method.
  - At the end of 1997, the book value of Property A is $21,000 ($30,000 initial book value less $9,000 aggregate book depreciation) and its adjusted tax basis is $14,000 ($20,000 initial tax basis less $6,000 aggregate tax depreciation).
  - On 12/31/97, Property B is distributed to A in complete liquidation of A's partnership interest. The adjusted tax basis of A's partnership interest at that time is $20,000.

Section 737 Example (cont.)

Skadden



- **Tax Treatment**
  - The amount of the excess distribution is $10,000, the difference between the fair market value of the distributed Property B ($30,000) and A's adjusted tax basis in A's partnership interest ($20,000).
  - A's net precontribution gain is $7,000, the difference between the book value of Property A ($21,000) and its adjusted tax basis at the time of the distribution ($14,000).
  - A recognizes gain of $7,000 on the distribution, the lesser of the excess distribution and the net precontribution gain.
  - *See* Treas. Reg. § 1.737-1(e) Ex. 1.

Section 704(c)(1)(A) Anti-Abuse Rule

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- An allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the (direct or indirect) partners in a manner that substantially reduces the present value of the (direct or indirect) partners' aggregate tax liability. Treas. Reg. § 1.704-3(a)(10).
  - In exercising its authority under the anti-abuse rule, the IRS will not require a partnership to use the remedial allocation method or any other method involving the creation of notional tax items.
  - There are also specific anti-abuse rules for sections 704(c)(1)(B) and 737.
- FAA 20204201 (Apr. 22, 2020)
  - Taxpayer contributed zero-basis amortizable intangibles to a partnership.
  - Partnership used the traditional method (with a limited curative gain-on-sale allocation provision) to account for the built-in gain under section 704(c).
  - The contribution and use of the traditional method were certain to shift the pre-contribution gain in the property to a related foreign partner.
  - Taxpayer received two opinion letters; neither referred to the existence of the section 704(c)(1)(A) anti-abuse rule.
  - The taxpayer acted "with a view" to shifting the built-in gain, even though the transactions may also have been motivated in part by non-tax business purposes.
  - The Service may exercise its authority under the section 704(c)(1)(A) anti-abuse rule to place the partnership on the curative method with respect to the contributed intangible assets.

Overview of Disguised Sale Rules

Skadden

- Generally, cash and other property may be contributed by a partner to a partnership or distributed by a partnership to a partner without tax at either the partnership or partner level.
  - Contributions to and distributions from corporations sometimes require the recognition of taxable income or gain by the corporation or the shareholder, or both.
- Congress was concerned that taxpayers deferred or avoided tax on sales of property (including partnership interests) by characterizing sales as contributions of property (including money) followed (or preceded) by a related partnership distribution.
  - IRS lost in court attempting to re-characterize such transactions as sales.

Overview of Disguised Sale Rules (cont.)

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- In 1984 and 1986, Congress enhanced section 707 and granted Treasury broad authority to issue regulations that would re-characterize such transactions as taxable sales if the transactions "when viewed together, are properly characterized as a sale or exchange of property."
  - A similar directive was given with respect to the performance of services or transfer of property by a partner to a partnership accompanied by an allocation and distribution of income to that partner.
- In 1991, Treasury proposed regulations on disguised sales under Section 707 of the Internal Revenue Code. The regulations were finalized in 1992.
  - Though targeted at abusive transactions, the regulations are not so narrowly tailored in their wording.
    - May capture even innocuous, ordinary course transactions.
    - May result in unexpected tax liability for partners, including partners that did not participate in the transaction.
  - Even diligent taxpayers may not attain certainty as to whether their transactions could be re-characterized as disguised sales.
    - Lack of bright-line rules.
    - Series of presumptions and facts-and-circumstances tests.

Disguised Sale from Partner to Partnership

Skadden

- This presentation will discuss partner-to-partnership disguised sales. Similar rules apply for transfers of partnership property to a partner with transfers of money/consideration by partner to partnership.
- Partner-to-Partnership Disguised Sale: A transfer of property (other than money) by a partner to a partnership and a transfer of money (or other consideration, including the assumption of or the taking subject to a liability) by the partnership to the partner, if, based on all of the facts and circumstances:
  - The transfer of money or other consideration would not have been made but for the transfer of property; and
  - In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

Disguised Sale from Partner to Partnership (cont.)

Skadden

- The regulations provide that if a contribution and related distribution are treated as a disguised sale, the contribution and distribution will be treated as a sale or exchange for all purposes of the Code.
  - Moreover, if the consideration treated as transferred to a partner is less than the FMV of the property transferred to the partnership, the transfer will be treated as a sale in part and a contribution in part.
  - The sale is considered to take place on the date that, under general U.S. tax principles, the partnership is considered the owner of the property.
    - If the transfer of consideration from the partnership to the partner occurs after the transfer of property, the transaction is treated as a sale in exchange for an obligation to transfer the consideration to the partner.

Disguised Sale from Partner to Partnership (cont.)

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- The following are among the facts and circumstances that may tend to prove the existence of a disguised sale (all references to money include other consideration):
  - Timing / amount of subsequent transfer are reasonably certain at time of earlier transfer.
  - Transferor has legally enforceable right to subsequent transfer.
  - Partner's right to receive money is secured.
  - A person makes contributions to partnership in order to permit partnership to transfer the money.
  - A person loans money to the partnership required to enable it to make transfer.
  - Partnership holds money, beyond reasonable needs of the business, that is expected to be available to make the transfer.
  - Partnership distributions, allocations or operational control is designed to effect an exchange of burdens and benefits of ownership of property.
  - Transfer of money by partnership to partner is disproportionately large relative to partner's interest in profits.
  - Partner has no obligation to return or repay the money to the partnership, or the obligation is so far in the future that its present value is relatively small.

Disguised Sale from Partner to Partnership (cont.)

Skadden

- Presumptions
  - If partner's transfer of property to partnership occurs **within 2 years** of the partnership's transfer of money (or other consideration) to the partner, regardless of the order of the transfers, transfers are **presumed to be a disguised sale** unless the facts and circumstances **clearly establish** otherwise.
    - Burden is on taxpayer to prove transaction is **not** a disguised sale.
      - Prudent taxpayers are advised to contemporaneously document relevant facts and circumstances and discuss with their tax advisors.
    - **All** transfers within 2 years of each other that the taxpayer does not treat as a sale are required to be disclosed to the IRS.
      - Unless the transfer of money is a guaranteed payment for capital, a reasonable preferred return, or an operating cash flow distribution (outside the scope of this presentation).
      - Disclosure obligation applies even if facts and circumstances clearly establish that there is no disguised sale.
  - If the transfers are **more than 2 years apart**, transfers are presumed not to be a disguised sale unless the facts and circumstances clearly establish otherwise.
    - Burden is on the IRS to prove transaction is a disguised sale.
    - However, taxpayers are not in the clear! This rule is only a presumption that the IRS may rebut.
      - Prudent taxpayers are still advised to contemporaneously document relevant facts and circumstances and discuss with their tax advisors.

Disguised Sale from Partner to Partnership: Example

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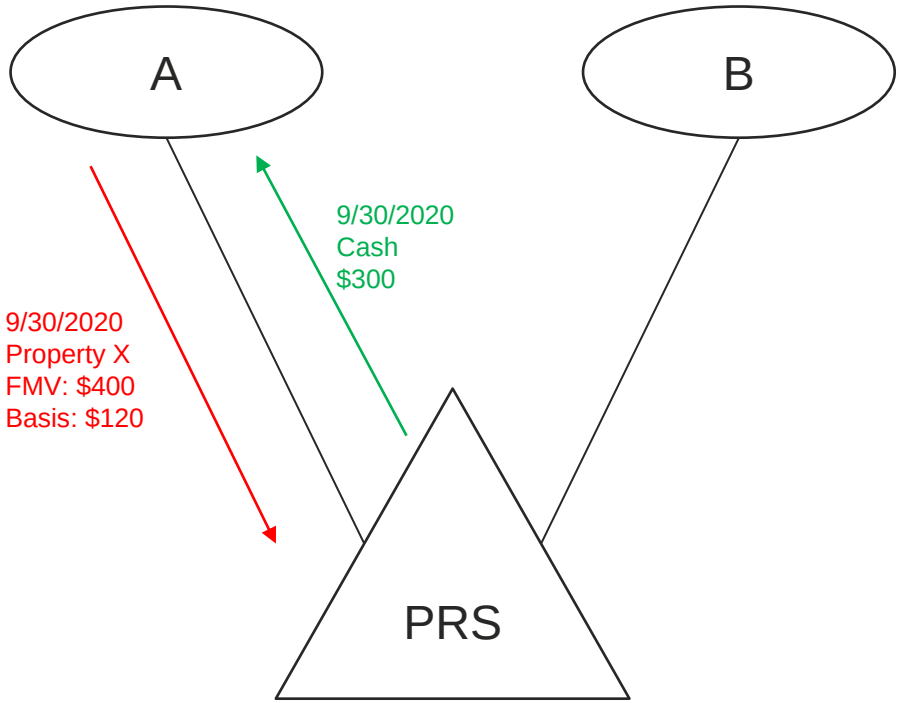
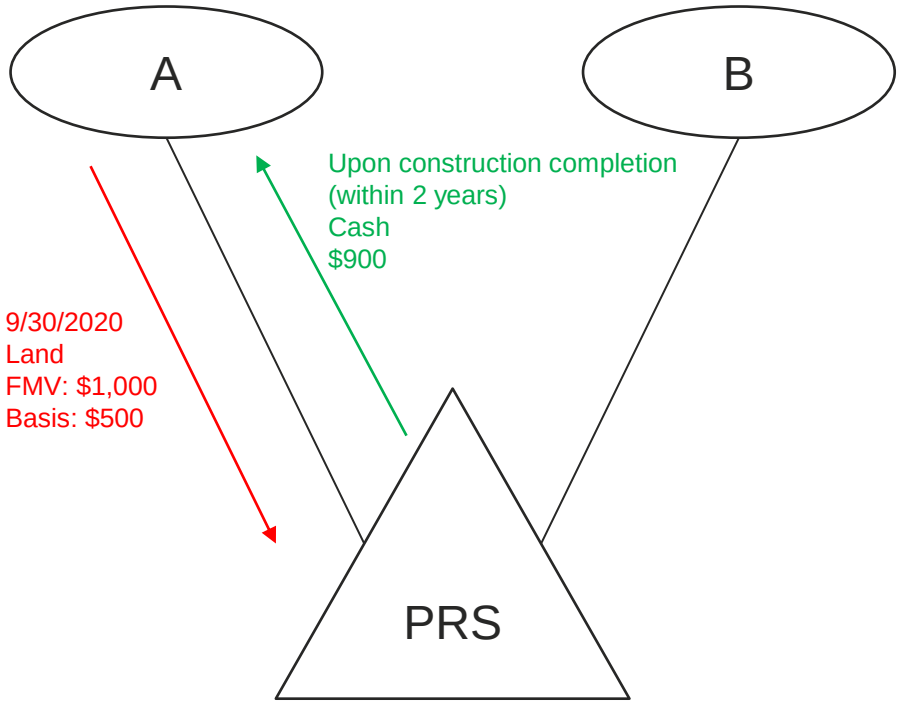


- A transfers Property X to PRS and PRS simultaneously transfers cash to A.
- Assume transfers treated as sale.
- A treated as selling portion of Property X with value of $300 to PRS for cash.
  - Gain recognized = $300 realized - $90 basis* = $210.
    - *$90 basis = $120 total basis x ($300/$400).
- A treated as contributing portion of Property X with value of $100 to PRS with basis of $30 (which built-in gain is subject to section 704(c)).

Source: Reg. § 1.707-3(f) Ex. 1

Disguised Sale from Partner to Partnership: Example

Skadden



Source: Reg. § 1.707-3(f) Ex. 3

- A contributes undeveloped land to PRS.
- Upon completing construction of building on land (within 2 years), PRS pays cash to A.
- Transfers presumed to be a disguised sale because less than 2 years apart.
- A may rebut presumption if facts clearly establish that:
  - Cash transfer would have been made regardless of land transfer; or
  - PRS's obligation to transfer cash depended, at time of transfer, on entrepreneurial risk.
    - E.g., PRS will have excess loan proceeds to transfer only if construction costs end up significantly less than reasonable budget amount.
    - E.g., PRS will not have access to loan proceeds needed to be able to fund cash transfer unless building is successfully leased.
    - E.g., at the time land was transferred, no lender had committed to providing loan to fund cash transfer.
- Facts opposing sale treatment may be offset by other facts.
  - E.g., loan that will fund cash transfer is recourse to partners and loan conditions are likely to be waived.
  - E.g., partners obligated to attempt to obtain loan and are likely to obtain it regardless of successful completion.
  - E.g., PRS has other source of funding for cash transfer.

Exceptions to Partner to Partnership Disguised Sale Treatment

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- A guaranteed payment for capital is not treated as part of a disguised sale of property.
  - A guaranteed payment for capital is any payment to a partner by a partnership that is determined without regard to partnership income and is for the use of that partner's capital.
  - Presumed to be a guaranteed payment for capital, unless facts and circumstances clearly establish otherwise, if:
    - Characterized by parties as guaranteed payment for capital;
    - Determined without regard to income of partnership; and
    - Is reasonable (as determined under regulations).
  - If payment is not reasonable, is presumed **not** to be a guaranteed payment for capital unless facts and circumstances clearly establish otherwise.
- A preferred return is not treated as part of a disguised sale of property.
  - Preferred return:
    - Preferential distribution of partnership cash flow to partner with respect to capital contributed, and
    - Will be matched, to the extent available, by allocation of income/gain.
  - Presumed to be a preferred return, unless facts and circumstances clearly establish otherwise, if:
    - Characterized by parties as preferred return; and
    - Is reasonable (determined under same test as guaranteed payments for capital).
  - Facts and circumstances include likelihood and expected timing of subsequent allocation of income/gain to support preferred return.

Exceptions to Partner to Partnership Disguised Sale Treatment (cont.)

Skadden

- A distribution of operating cash flow is presumed not to be part of a disguised sale of property, unless facts and circumstances clearly establish otherwise.
  - Operating cash flow distributions:
    - Not guaranteed payments for capital.
    - Not reasonable preferred returns.
    - Not characterized by parties as non-partner transaction.
    - Do not exceed product of:
      - Net partnership cash flow from operations for year (as determined under regulations)
      - Multiplied by the lesser of (i) partner's % interest in profits for year, or (ii) partner's % interest in profits for life of partnership.
  - Safe Harbor: To determine operating cash flow distributions, may use partner's smallest % interest in any material item of income/gain that may be realized by partnership in 3-year period.
- Reimbursement for preformation capital expenditures not treated as part of a disguised sale of property.
  - Capital expenses must be incurred during 2-year period before transfer by partner and incurred with respect to:
    - Partnership organization and syndication costs, or
    - Property transferred to partnership, up to 20% of FMV of such property (20% limit does not apply if FMV of property does not exceed 120% of partner's basis in such property).
      - Generally applied on property-by-property basis, but may be aggregated for certain small properties up to $1 million.
- Exception does not apply if expenses were funded using proceeds of a qualified liability that partnership assumes, to extent consideration transferred to partner exceeds partner's share of the qualified liability.

Liabilities and Disguised Sale Determinations

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- Additional rules govern a partnership assuming a partner's liability or taking property subject to a liability.
- Qualified Liabilities:
  - Incurred more than 2 years prior and has encumbered transferred property throughout 2-year period.
  - Not incurred in anticipation of transfer of property, but incurred within 2 years of transfer, and has encumbered transferred property since incurred.
    - Presumed to be in anticipation of transfer unless facts and circumstances clearly establish otherwise.
    - Must be disclosed to IRS if treated as qualified liability.
  - Allocable to capital expenditures with respect to the property (under rules of Reg. § 1.163-8T).
  - Incurred in ordinary course of business in which transferred property was used or held, if all assets of that business are transferred (other than immaterial assets).
  - Not incurred in anticipation of transfer of property, but incurred in connection with business in which transferred property was used or held, if all assets of that business are transferred (other than immaterial assets).
    - If within 2 years of transfer, presumed to be in anticipation of transfer unless facts and circumstances clearly establish otherwise.
    - Must be disclosed to IRS if treated as qualified liability.
  - Recourse liabilities: Can be qualified liability only if amount does not exceed FMV of transferred property, less any senior liabilities on the property.

Liabilities and Disguised Sale Determinations (cont.)

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- Non-Qualified Liability
  - Partnership treated as transferring consideration to extent liability exceeds partner's share of liability immediately after assumption.
- Qualified Liability
  - By itself, assumption of qualified liability cannot result in a disguised sale.
  - If qualified liability is assumed in connection with a transaction that is otherwise a disguised sale, amount of liability treated as consideration is lesser of:
    - Extent to which liability assumed exceeds partner's share of liability immediately after assumption; or
    - Amount of qualified liability × partner's net equity percentage.
      - Partner's net equity percentage = other consideration received / (FMV of property – qualified liability encumbering or allocable to property)
  - Exception: If qualified liability is assumed in connection with a transaction that is otherwise a disguised sale *solely due to assumption of non-qualified liability*, qualified liabilities assumed are not treated as consideration if non-qualified liabilities assumed are lesser of 10% of qualified liabilities assumed or $1 million.

Determining Liabilities

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- In October 2016, IRS issued temporary regs for allocating liabilities for purposes of the disguised sale rules.
  - Required partnership to allocate ALL liabilities (not just nonrecourse liabilities) based on partner's share of excess nonrecourse liabilities under § 1.752-3(a)(3) (with certain limitations).
    - Rationale was that lenders, borrowers, and credit support providers generally expect a partnership borrower to satisfy its liabilities with partnership profits.
- Temporary regs proposed to be withdrawn in June 2018, and were finally withdrawn in October 2019 and replaced with regs that were in effect prior to October 2016.
  - The current rules prescribe separate rules for recourse liabilities and nonrecourse liabilities (described on next slide).
  - Effective for transactions in which all transactions occur on or after October 4, 2019, and partnerships/partners may elect to apply to transactions in which all transactions occurred on or after January 3, 2017.

Determining Liabilities (cont.)

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- "Partner's Share of Liability"
  - Recourse liability:
    - Liability for which any partner or related person bears economic risk of loss.
    - Partner's share is determined under section 752.
      - Generally, the extent to which that partner bears economic risk of loss.
  - Nonrecourse liability:
    - Liability for which no partner or related person bears economic risk of loss.
    - Partner's share is generally determined in accordance with partner's share of partnership profits.
      - Taking into account all facts and circumstances of parties' economic arrangement.
      - Not aligned with partner's share of excess non-recourse liabilities for purposes of section 752 if the "significant item," "alternative," or "additional" method is used for purposes of section 752.
      - Reflects that a nonrecourse liability would often be paid off through partnership profits.
  - Partner's share is reduced if:
    - At time of transfer, it is anticipated that transferring partner's share of liability will be subsequently reduced;
    - Anticipated reduction is not subject to entrepreneurial risk; and
    - Part of plan with principal purpose to minimize disguised sale gain.

Liabilities and Disguised Sale Determinations: Example

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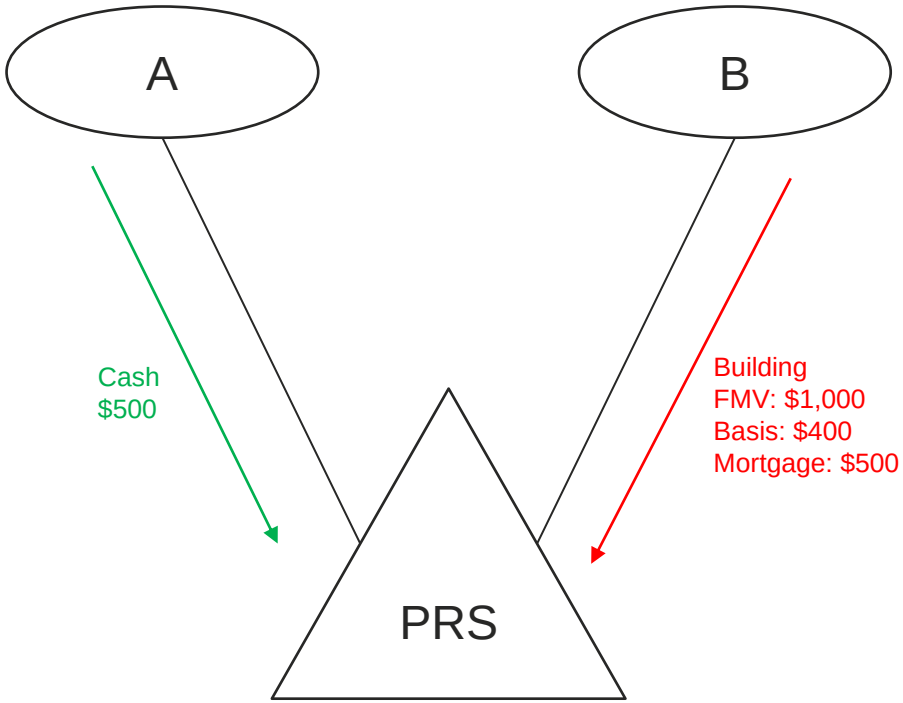

- A contributes $500 to PRS, and B contributes a building (FMV $1,000; basis $400) encumbered by $500 nonrecourse mortgage
  - Mortgage incurred 12 months earlier to finance acquisition of other property
- Partnership agreement allocates all items equally
- Mortgage is presumed to have been incurred in anticipation of transfer
  - No rebutting facts
- Mortgage is a nonqualified liability
  - B allocated 50% of the mortgage, and thus B's share of mortgage immediately after transfer is $250
- Treated as transfer of $250 to B in exchange for $250 of the value of the building
  - Gain = $250 – (($250/$1,000) * $400) = $150

Source: Reg. § 1.707-5(f) Ex. 1

Liabilities and Disguised Sale Determinations: Example

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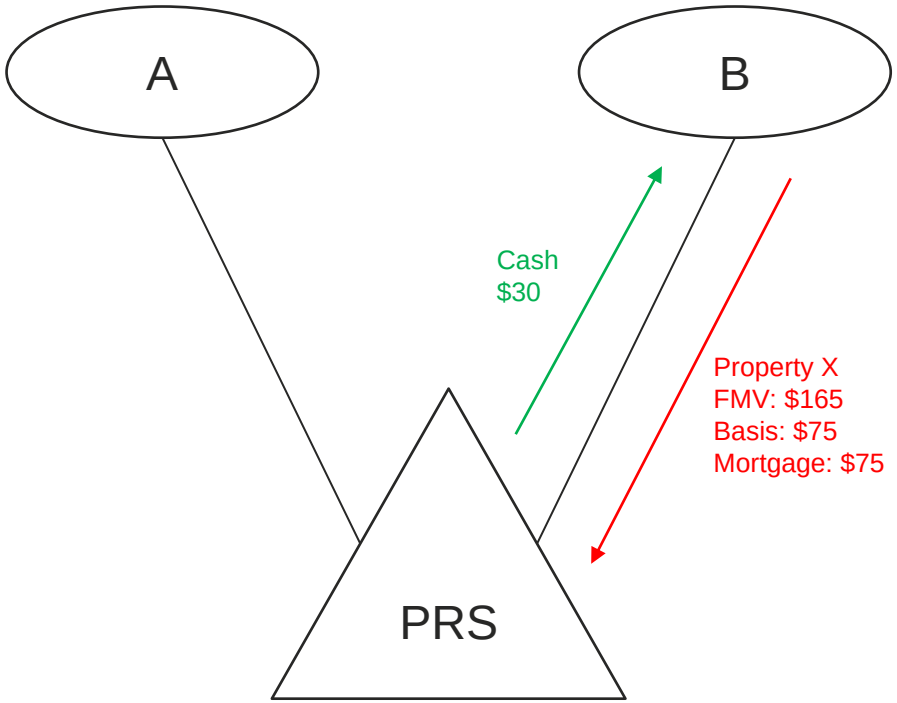

- B transfers Property X (FMV $165; basis $75) to PRS, and PRS assumes a $75 nonrecourse mortgage on Property X.
  - Mortgage was incurred 5 years before transfer, and has been secured by Property X since it was incurred.
- PRS also transfers $30 cash to B.
- B's share of mortgage immediately after transfer is $25.
- Mortgage is a qualified liability because it was incurred more than 2 years prior to assumption by PRS, and mortgage has encumbered Property X for more than 2 years prior to transfer to PRS.
- Because other consideration was transferred, PRS's assumption of mortgage is treated as consideration to extent of lesser of:
  - Difference between liability ($75) and B's share of liability ($25) = $50; or
  - Liability ($75) * B's net equity percentage (1/3) = $25.
    - B's net equity percentage = Other consideration transferred ($30) / B's net equity in Property X ($165 - $75 = $90) = $30/$90 = 1/3.
- Thus, treated as transfer of $25 of liability assumption + $30 cash to B in disguised sale for $55 of Property X.
  - Gain = $55 – ($75 x 1/3) = $30.

Source: Reg. § 1.707-5(f) Ex. 6

Recent Developments re: Guarantees

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- Disguised sale treatment may be mitigated or avoided by increasing the partner's share of partnership liabilities.
  - Often accomplished by having partner guarantee the liability, which increases partner's economic risk of loss and thus partner's share of liability.
- IRS was concerned that partners and partnerships were abusing this rule by having contributing partners (or related persons) enter into payment obligations that are "not commercial" to avoid disguised sale treatment.
  - E.g., "bottom-dollar guarantees" that IRS believes generally lack a significant non-tax commercial business purpose.
- Under final regulations promulgated in the Fall of 2019, "bottom dollar payment obligations" (BDPOs) are disregarded.
  - A BDPO is any payment obligation other than one in which partner is or would be liable up to the full amount of partner's payment obligation if, and to the extent that:
    - (A) for guarantee: any amount of partnership liability is not otherwise satisfied, or
    - (B) for indemnity: any amount of indemnitee's payment obligation is satisfied.
  - A BDPO also includes an arrangement that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, liabilities were incurred with principal purpose of avoiding having at least one of such liabilities/obligations treated as a BDPO.

Recent Developments re: Guarantees (cont.)

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- A payment obligation is not a BDPO merely because it is subject to a cap, as long as a partner (or related person) is or would be liable for full amount of payment obligation.
  - I.e., payment obligation is for a portion, rather than 100% of each dollar of partnership liability (a “vertical slice”).
- Capital contributions and deficit restoration obligations (DROs):
  - BDPO includes any capital contribution or DRO other than one in which the partner is or would be required to (i) make the full amount of the partner’s capital contribution or (ii) restore the full amount of the partner’s deficit capital account.

Recent Developments re: Guarantees (cont.)

Skadden

- Exception: What otherwise would be a BDPO can be distinguished in a situation where the partners have allocated the risk among themselves, and person with payment obligation is liable for at least 90% of person's payment obligation.
  - Not entitled to indemnification/reimbursement for more than 10% of payment obligation.
  - E.g., Partner A guarantees 100% of PRS's liability, and Partner B indemnifies A for first 1% of A's obligation.
    - Because A is still liable for 99% of A's initial obligation, arrangement is not treated as a BDPO under this exception.
- Anti-Abuse Rule: If a partner actually bears economic risk of loss, partners cannot create a BDPO in order to have liability treated as nonrecourse.
  - Such arrangements will continue to be treated as recourse obligation of partner that bears economic risk of loss.
- BDPOs are required to be disclosed to IRS, whether they meet exception or not.

For Further Information

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