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IRS Publishes Final Regulations on Disguised Sales

The Treasury Department has issued final regulations (T.D. 9787, https://www.gpo.gov/fdsys/pkg/FR-2016-10-05/pdf/2016-23387.pdf) under Section 707 relating to disguised sales of property to or by a partnership and under Section 752 relating to the treatment of partnership liabilities, substantially adopting the 2014 proposed regulations (79 FR 4826, https://www.gpo.gov/fdsys/pkg/FR-2014-01-30/pdf/2014-01637.pdf) with revisions to certain proposed rules. A few changes to the 2014 proposed regulations are highlighted below. Section references are to the Internal Revenue Code of 1986, as amended.

Most commenters supported the property-by-property rule with respect to reimbursements of capital expenditures, but suggested that the approach could be burdensome in certain situations. The Treasury Department and the IRS have determined that limited aggregation of property is warranted in certain cases and will permit aggregation to the extent: (i) the total fair market value of the aggregated property (of which no single property's fair market value exceeds 1 percent of the total fair market value of such aggregated property) is not greater than the lesser of 10 percent of the total fair market value of all property, excluding money and marketable securities (as defined under Section 731(c)), transferred by the partner to the partnership, or $1 million; (ii) the partner uses a reasonable aggregation method that is consistently applied; and (iii) the aggregation of property is not part of a plan of which a principal purpose is to avoid Treasury Regulations Section 1.707-3 through 1.707-5. Additionally, the final regulations add an example to illustrate the application of the property-by-property rule when a partner transfers both tangible and intangible property to a partnership.

The final regulations provide limitations on the available methods under Treasury Regulations Section 1.752-3(a)(3), applicable solely for disguised sale purposes under Section 707, for determining a partner's share of excess nonrecourse liabilities. The final regulations under Treasury Regulations Section 1.752-3 retain the significant item method and the alternative method, but do not adopt the liquidation value percentage approach for determining partners' interests in partnership profits. However, the Treasury Department and the IRS have concluded that the allocation of excess nonrecourse liabilities in accordance with the significant item method and the alternative method has been abused by partnerships and their partners for disguised sale purposes under Section 707. Therefore, as suggested by some commenters, the final regulations provide that, along with the additional method, the significant item method and the alternative method do not apply for purposes of determining a partner's share of a partnership liability for disguised sale purposes.

The final regulations remind taxpayers that disclosure is required, whenever money or other consideration is transferred by a partnership to a partner, within two years of the transfer of property by the partner to the partnership, except in the limited situations described in Treasury Regulations Section 1.707-3(c)(2)(iii).

With respect to amendments to Treasury Regulations Sections 1.707-3 through 1.707-6, the final regulations under Section 707 apply to any transaction with respect to which all transfers occur on or after Oct. 5, 2016. With respect to amendments to Treasury Regulations Section 1.752-3, the final regulations under Section 752 apply to liabilities that are incurred by a partnership, that a partnership takes property subject to, or that are assumed by a partnership on or after Oct. 5, 2016, other than liabilities incurred by a partnership, that a partnership takes property subject to, or that are assumed by a partnership pursuant to a written binding contract in effect prior to that date.

In a separate Treasury decision (T.D. 9788, https://www.gpo.gov/fdsys/pkg/FR-2016-10-05/pdf/2016-23388.pdf), the Treasury Department and the IRS also published the Section 707 Temporary Regulations that require a partner to apply the same percentage used to determine the partner's share of excess nonrecourse liabilities under Treasury Regulations Section 1.752-3(a)(3) (with certain limitations) in determining the partner's share of partnership liabilities for disguised sale purposes. The Treasury decision also contains the Section 752 Temporary Regulations providing guidance on the treatment of "bottom dollar payment obligations."

IRS Provides Information for Treatment of RICs and RIC Shareholders

In redacted field attorney advice (https://www.irs.gov/pub/irs-lafa/20164001f.pdf), the IRS provided information on numerous topics related to RICs and RIC shareholders. For example, the burden of proper reporting of the dividends received deduction (DRD) is on the RIC shareholders, regardless of whether the amounts reported by the RIC are correct or incorrect. The IRS noted that the source of DRD-eligible dividend distributions to a corporate RIC shareholder must be dividend income received by the RIC that would be deductible by the RIC if it were taxed as a regular corporation. Additionally, a short-term gain recognized by a RIC is not a DRD-eligible dividend in the hands of the RIC. Further, individual shareholders of the RIC who are United States persons may apply designations to the dividends they receive from the RIC that differ from designations applied by shareholders who are nonresident alien individuals.

Subsidiary Denied Dividends Received Deduction for Amount Received From RIC Subsidiary

In Legal Memorandum 201640018 (https://www.irs.gov/pub/irs-wd/201640018.pdf?_ga=1.168712998.665444381.1445536580), the IRS concluded that a subsidiary was not eligible for the Section 245 dividends received deduction with respect to funds distributed from a RIC to the subsidiary via another subsidiary. The common parent corporation of the subsidiaries and RIC caused certain members of its U.S. consolidated group to deconsolidate with the stated principal goal of increasing the U.S. group's after-tax return on certain business investments by claiming an 80 percent dividends received deduction with respect to income attributable to the interest and capital gain derived from the investments. After a series of steps, a subsidiary of the parent corporation ("upper-tier subsidiary") wholly owned a foreign subsidiary ("lower-tier subsidiary") which wholly owned a second foreign subsidiary ("foreign subsidiary"). The foreign subsidiary made an election to be disregarded as an entity for federal income tax purposes ("foreign subsidiary"). The foreign subsidiary owned the RIC. The RIC bought the business investments and made distributions on its earnings to the foreign subsidiary, which in turn distributed the earnings to the lower-tier subsidiary, and the lower-tier subsidiary distributed its shares in the foreign subsidiary to the upper-tier subsidiary. The taxpayer asserted that it met the statutory requirements of Section 245, but the IRS disagreed by applying the economic substance doctrine and the substance-over-form doctrine (including the step transaction doctrine and the conduit theory). The IRS found that the taxpayer failed to satisfy the economic substance test with respect to its funneling investment funds and its investment returns through a foreign corporation. Under the application of the step transaction doctrine, the IRS found that the upper-tier subsidiary is treated as directly acquiring stock in the RIC and receiving distributions from the RIC with respect to such stock. Accordingly, the upper-tier subsidiary does not qualify for a dividends received deductions under Section 245 or Section 243. Under a conduit theory, the IRS found that the lower-tier subsidiary should be disregarded as that of a conduit.

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Liquidation Sale of Assets Will Not Be Prohibited REIT Transaction

In Private Letter Ruling 201640007 (https://www.irs.gov/pub/irs-wd/201640007.pdf?_ga=1.227497498.665444381.1445536580), the IRS ruled that sales of a REIT's assets pursuant to a plan of liquidation will not constitute prohibited transactions within the meaning of Section 857(b)(6).

Change of Asset Valuation Method Permitted

In Private Letter Ruling 201640012 (https://www.irs.gov/pub/irs-wd/201640012.pdf?_ga=1.164535992.665444381.1445536580), the IRS ruled that a common parent of a group of affiliated corporations may change from the fair market value method to the tax book value method of asset valuation for purposes of apportioning interest expense.

NYSBA Submits Report Requesting Guidance on New Exemptions Under FIRPTA

The New York State Bar Association has submitted a report (http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2016/Tax_Section_Report_1354.html) to the IRS regarding the new requirements for investors to qualify as qualified foreign pension funds or qualified shareholders under changes made to the Foreign Investment in Real Property Tax Act of 1980 by the Protecting Americans from Tax Hikes Act of 2015. In its report, the NYSBA requested guidance with respect to the interpretation of the new laws so that investors, as well as their legal advisers, may accurately determine whether they qualify for a new exemption.

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