American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

June 5, 2013

Mr. Daniel I. Werfel
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, Room 3000
Washington, DC 20024

**Re: Comments on Revenue Ruling 99-5**

Dear Mr. Werfel:

The American Institute of Certified Public Accountants (AICPA) is pleased to provide you with comments on Revenue Ruling 99-5 related to the conversion of disregarded entities to partnerships.

The AICPA is the world's largest member association representing the accounting profession, with nearly 386,000 members in 128 countries and a 125-year heritage of serving the public interest. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

Our comments address issues common to the transactions described in the ruling that are not addressed in the ruling or other guidance. The issues addressed in these comments are related to the treatment of liabilities upon conversion of a disregarded entity to a partnership and the treatment of nonrecognition transactions that result in the conversion of a disregarded entity to a partnership.

We respectfully request that you consider issuing additional guidance on these issues. If you have any questions about these comments, please contact me, at (304) 522-2553, or jporter@portercpa.com; William O'Shea, AICPA Chair of the Partnership Taxation Technical Resource Panel, at (202) 758-1780, or woshea@deloitte.com; or Eileen Sherr, Senior Technical Manager, at (202) 434-9256 or esherr@aicpa.org.

Sincerely,

Jeffrey A. Porter, CPA
Chair, Tax Executive Committee

cc: Craig Gerson, Treasury Attorney-Advisor
Curt Wilson, IRS Associate Chief Counsel (CC:PSI)
Charlotte Chyr, IRS Senior Technical Reviewer (CC:PSI:B02)

## THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

## COMMENTS ON REVENUE RULING 99-5 WITH RESPECT TO THE CONVERSION FROM A DISREGARDED ENTITY TO A PARTNERSHIP

### OVERVIEW – Additional Guidance Needed

The AICPA believes that additional guidance is needed on the conversion of an entity limited liability company ("LLC") that is disregarded from its owner for U.S. federal income tax purposes (a "disregarded entity") to a partnership in transactions covered by Revenue Ruling 99-5.[1] We request guidance in the following areas:

- The amount of the disregarded entity's liabilities that is included in the seller's amount realized on the deemed asset sale that occurs under Rev. Rul. 99-5, Situation 1.
- The treatment of the disregarded entity's liabilities to its single owner upon the formation of the partnership in Rev. Rul. 99-5, Situations 1 and 2.
- The treatment of certain transactions that are not described in Rev. Rul. 99-5 Situations 1 and 2, but which result in the conversion of a disregarded entity to a partnership.

### SUMMARY – AICPA Recommendations

To promote uniform tax results to similarly situated taxpayers, the AICPA suggests one approach generally be adopted. The following recommendations are listed in the order of priority:

1 The amount realized by the owner of a disregarded entity upon the sale of an interest in such entity (i.e., a transaction described in Rev. Rul. 99-5, Situation 1) should be no different than the sales proceeds that would be recognized if the disregarded entity were treated as a partnership and the seller sold a portion of its partnership interest. In other words, the seller should recognize sales proceeds equal to the sum of the cash received and the portion of the disregarded entity's liabilities that are allocable to the purchaser by the partnership as determined generally under section 752.

2 Loans between a disregarded entity and its owner that are disregarded for U.S. federal income tax purposes prior to the disregarded entity becoming a partnership should not be deemed to be newly issued under Rev. Rul. 99-5. Instead, such loan should be treated as "springing into existence" for tax purposes immediately prior to the conversion of the disregarded entity to a partnership, and the new partnership should be treated as assuming the liability from the disregarded entity's owner as part of the contribution of assets to the partnership.

3 The tax treatment of transfers of interests in an LLC that are not described in Rev. Rul. 99-5 (*e.g.*, nonrecognition transfers), and that result in such entity converting to a partnership, should be the same as the transfer described in Rev. Rul. 99-5, Situation 1 (i.e., the deemed

[1] 1999-1 C.B. 434 (Feb. 8, 1999).

transfer of a portion of the assets of the disregarded entity to the person acquiring an interest in the disregarded entity followed by the formation of a partnership).

## SPECIFIC COMMENTS

### A. Liabilities Included in Seller's Amount Realized

#### *1. Deemed Assumption of Liabilities by Buyer – Related Party Liabilities*

Rev. Rul. 99-5, Situation 1, involves an LLC that is disregarded as an entity separate from its owner, A, for federal income tax purposes that is converted to a partnership when an unrelated person, B, purchases a 50 percent interest in the LLC from A. B's purchase of 50 percent of A's ownership interest in the LLC is treated as if A, who is treated as the owner of the assets at the time of purchase for federal tax purposes, sold a 50 percent interest in each of the LLC's assets to B. Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a new partnership in exchange for interests in the partnership. The ruling states that under section 1001[2], A recognizes gain or loss from the deemed sale of a 50 percent interest in each asset of the LLC to B.

The ruling describes the amount of tax basis that each partner has in its interest in the partnership under section 722, as well as the tax basis of the contributed assets to the partnership under section 723. However, the facts of the ruling posit only that the LLC holds assets, and does not address a fact pattern where the LLC also has liabilities. As such, the ruling does not address the treatment of liabilities of the LLC and whether the purchaser, B, is treated as assuming any liabilities in the deemed purchase of assets. If the LLC had liabilities on its books at the time of purchase, those liabilities would become liabilities of the new partnership that is formed by operation of Rev. Rul. 99-5.

The AICPA requests guidance on the treatment of liabilities of a disregarded entity that becomes a partnership in a transaction governed by Rev. Rul. 99-5. Specifically, guidance is requested on the impact of liabilities on the amount realized by the seller in Rev. Rul. 99-5, Situation 1. For purposes of the following discussion, we assume that the percentage of assets deemed sold in the Rev. Rul. 99-5 transaction is determined by reference to the seller's amount realized, rather than cash received.[3]

To illustrate the need for additional guidance, assume the following facts:

**Example 1**: B, a corporation, purchases a 50 percent interest in an LLC from its sole owner, corporation A, for $30. At the time of the sale, the LLC has assets worth $160 that have an adjusted basis of $50. Assume further that the LLC has a $100 note payable to P that has been outstanding for more than two years and that the assets of LLC have been subject to such

[2] All references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder.

[3] Treas. Reg. § 1.1001-2(a)(1); Treas. Reg. § 707-3(f), Example 1.

liability since it was incurred. Assume further that P owns all of the stock of A, and that B is not related to either A or to P, and neither B nor any person related to B bears any risk of loss (within the meaning of section 752) with respect to the liability to P. Under Rev. Rul. 99-5, Situation 1, when B purchases 50 percent of A's interest in the LLC, B is treated as purchasing an undivided interest in the LLC assets from A, and then A and B are treated as contributing their respective undivided interests in the assets to a new partnership in exchange for interests in the partnership. Rev. Rul. 99-5 does not address the treatment of liabilities and, therefore, provides no guidance on how much, if any, of the $100 note payable is included in A's amount realized.

Two approaches are commonly applied by practitioners to determine the amount of liabilities that are included in the seller's amount realized. The first approach is the "Pro Rata Approach," where the buyer is treated as acquiring a pro rata share of all assets and assuming a pro rata portion of all liabilities of the disregarded entity, with such pro rata share computed by reference to the cash consideration paid by the buyer as compared to the fair market value, net of liabilities, of the disregarded entity's assets. The second approach is the "Section 752 Approach," where the buyer is treated as acquiring assets, but assuming only an amount of liabilities of the disregarded entity equal to the amount of liabilities that would be allocated to the buyer under the Section 752 regulations immediately following the formation of the partnership. The tax results of each approach are illustrated below.

*a) The Pro Rata Approach*

Using the facts of Example 1, under the Pro Rata Approach, B is treated as purchasing a 50 percent undivided interest in each of the disregarded entity's assets from A, subject to 50 percent of the LLC's $100 note payable to P. Under section 1001, A is treated as selling such assets for $30 cash consideration subject to 50 percent of the note payable ($50), and recognizes gain based upon an $80 amount realized[4] less its adjusted basis in the assets sold. The tax basis of the assets A sells to B is $25, which is the 50 percent sale percentage[5] multiplied by A's $50 tax basis in the assets. Accordingly, A should recognize tax gain of $55 upon the sale of assets to B.[6] Under section 1012, B would take an $80 cost basis in the assets it is treated as purchasing from A.

Immediately thereafter, A and B would be treated as contributing to a new partnership their respective interests in the assets subject to each person's share of the LLC's liabilities. Section 721(a) provides that A should recognize no gain or loss on the contribution of its share of the assets. Under the Pro Rata Approach, the fair market value of the assets deemed contributed by A would be $80[7] and the tax basis of the assets would be $25. Thus, A's deferred gain on the contribution of assets would be $55. Since these assets have a fair market value that is different from their adjusted tax basis, the LLC's allocation of partnership items with respect to the

[4] $30 cash received plus $50 debt assumed by B.

[5] $80 amount realized by A divided by $160 gross asset value. This computation of basis is also consistent with the disguised sale regulations, specifically Treas. Reg. § 1.707-3(f) Ex 1.

[6] $80 amount realized less $25 tax basis of assets sold.

[7] $160 fair market value of all of the assets, less $80 amount realized from the sale.

contributed property should be subject to section 704(c).[8] Section 704(c) will cause A to generally recognize the built-in gain in the contributed property as the assets are depreciated or amortized, or when the property is sold. The fair market value and tax basis of the property contributed by B should be equal to $80.

Under section 723, the basis of property contributed to the partnership is equal to the adjusted basis of the property in the hands of the contributor immediately prior to the contribution. The adjusted basis of the property contributed by A is equal to the basis of the LLC property that was not sold to B, or $25 ($50 total tax basis less $25 applied to the sale). The tax basis in the assets contributed by B is equal to $80. Thus, the LLC's total basis in the contributed assets is $105.

Under section 722 and the section 752 netting rule, A's and B's basis in their partnership interests should be equal to the tax basis of the assets contributed by each partner respectively, reduced by the liabilities deemed assumed by the partnership from each partner, and increased by each partner's share of the partnership's liabilities immediately following the contribution.[9] Any net reduction in liabilities is treated as a cash distribution under section 752(b), and any net increase in liabilities is treated as a cash contribution under section 752(a). The net increase or decrease is equal to the difference between the total liabilities assumed by the LLC from that member and that member's share of the liabilities immediately following the contribution, as determined under the section 752 regulations.

Under the section 752 regulations and the facts of this Example 1, immediately after the partnership formation, A should be allocated the entire amount of the $100 note payable to P, since the loan was made by a person related to A and no other partner or person related to a partner bears the economic risk of loss for the debt.[10] Pursuant to section 752(a), A is treated as making an additional contribution of money equal to the net increase in A's share of partnership liabilities ($50, the liabilities assumed by LLC from B) [11] and A's post-distribution tax basis in the LLC should be $75.[12] Conversely, B's share of the note payable following the partnership formation is zero, and under section 752(b), B receives a deemed distribution of money equal to the net reduction in its share of partnership liabilities ($50). Accordingly, B's post-distribution tax basis in the LLC should be $30.[13]

The computation of A's amount realized under the Pro Rata Approach is consistent with the amount that would be realized by A if A had sold a 50 percent interest in the LLC assets to an unrelated buyer subject to 50 percent of the LLC debt. However, as discussed below, the amount

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[8] Section 704(c) provides that 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.
[9] Treas. Reg. § 1.752-1(f).
[10] Treas. Reg. § 1.752-2(a) and (c).
[11] *See* Treas. Reg. § 1.752-1(f).
[12] $25 carryover basis of assets deemed contributed plus $50 net increase in liability share.
[13] $80 carryover basis of assets deemed contributed less $50 net decrease in liability share.

of gain recognized by A in this example is greater under the Pro Rata Approach than it would be under the Section 752 Approach.

Treas. Reg. § 1.1001-2(a)(1) provides that the amount realized by the seller includes the amount of liabilities from which the seller is discharged as a result of the transfer. When the LLC's assets are subject to recourse liabilities[14] the seller's amount realized includes the liabilities actually assumed by the buyer. Treas. Reg. § 1.1001-2(a)(4)(ii) provides when property subject to a recourse liability is sold, the sale discharges the transferor from liability if another person agrees to pay the liability (whether or not the transferor is, in fact, released from the liability). If a 50 percent interest in the assets of the LLC were sold, and 50 percent of the recourse obligations of the LLC were assumed by the buyer, the gain recognized by A from the direct sale of the LLC's assets should be the same as the gain recognized by A under the Pro Rata Approach in the Rev. Rul. 99-5 transaction.[15]

*b) Section 752 Approach*

Under the Section 752 Approach, B is treated as assuming an amount of LLC liabilities equal to B's share of the LLC's liabilities immediately following the formation of the partnership, as determined under the section 752 regulations. As previously discussed, under the facts of Example 1, all of the partnership's liabilities (i.e., the note payable to P) would be allocated to A immediately following its formation because, under section 752, A is treated as having economic risk of loss with respect to the liability to P. Under the Section 752 Approach, because B is not allocated any partnership liabilities, it is not treated as acquiring assets from A subject to any liabilities. Correspondingly, A's amount realized is limited to $30[16] and A is treated as selling an 18.75 percent[17] interest in the LLC's assets to B. The tax basis of the assets A is treated as selling to B is $9,[18] and A's gain recognized on the sale is $21. In this case, the Section 752 Approach results in a lower gain to A than the Pro Rata Approach.

Thereafter, A and B are treated as contributing to the new partnership their respective shares of the assets and liabilities of the LLC. Thus, B is treated as contributing $30 of assets with a cost basis of $30. A is treated as contributing the remaining $130 of assets with an adjusted basis of

[14] Treas. Reg. § 1.1001-2(a)(4). For purposes of this discussion, we assume that the liabilities incurred by the LLC would be a state law recourse loan and that the liabilities would be viewed as recourse liabilities for section 1001 purposes, since the creditor may look to all of the assets of the LLC for payment.
[15] The purchaser of an interest in an LLC does not legally assume the recourse liabilities of the LLC. It appears that the result would be the same if B acquired an interest in an LLC that is taxed as a partnership which had liabilities that are nonrecourse for section 752 purposes. However, as discussed below, if the LLC were taxed as a partnership and the LLC's liabilities were owed to A or an owner of A, it appears that A's amount realized from the sale of a 50 percent interest in the LLC would not include 50 percent of the liabilities, and A's gain would be different.
[16] Treas. Reg. § 1.1001-2(a)(1).
[17] The percentage is computed by dividing the amount realized ($30) by the total value of the gross assets ($160).
[18] This amount is the sale percentage (18.75 percent) multiplied by the total tax basis of the assets ($50). This assumes the computation set forth in Example 1 in Treas. Reg. § 1.707-3(f) are applied under the Section 752 Approach as well.

$41,[19] subject to the entire $100 note payable. Under section 721, the $89 built-in gain in the assets contributed by A is generally not recognized.[20] Section 704(c) should generally cause A to recognize this built-in gain in the property contributed as the asset is depreciated or amortized, or when the asset is sold.

Under section 723, the basis of property contributed to the partnership is equal to the adjusted basis of the property in the hands of the contributor immediately prior to contribution. Thus, the partnership would have a total tax basis in its property of $71.

Under section 722, the basis of A and B in their partnership interests would equal the adjusted basis of the assets contributed by each to the partnership, reduced by the net liabilities assumed from each by the partnership upon formation. Since B assumed no liabilities from A under the Section 752 Approach, the assumption of debt by the new partnership should not affect B's tax basis in its partnership interest. B's tax basis in its partnership interest should be its $30 cost basis of the property it was deemed to contribute. The allocation of 100 percent of the note payable to A should not affect A's basis in its partnership interest either (*i.e.*, the net increase to A's share of liabilities is zero). A's tax basis in its partnership interest is $41, which is equal to A's $41 adjusted tax basis in the contributed assets, decreased by the $100 liability deemed assumed by the partnership under section 752(b), and increased by A's $100 post-formation share of the partnership's liabilities under section 752(a).

The Section 752 Approach provides a result that is consistent with other transactions that are economically similar to the sale of 50 percent of the units of a disregarded entity. Under the facts of Example 1, the amount realized by A under the Section 752 Approach is generally the same as the amount A would realize under the section 707(a)(2)(B) disguised sale of property rules if the transaction had been structured differently, or upon the sale of a partnership interest if LLC had instead been a partnership.

**Example 2**: Assume the same facts as in Example 1 above, except that B does not pay A directly for an interest in the LLC. Instead, B makes a cash contribution of $30 to the LLC in exchange for interests in the LLC and that LLC then distributes the contributed cash to A. Rev. Rul. 99-5, Situation 2, describes the tax consequences of the contribution by B. In Situation 2, B is treated as contributing cash and A is treated as contributing the LLC's assets to a new partnership. In the facts of this second example, A receives an immediate cash distribution from the new partnership that was related to A's contribution of assets. As such, A is treated as selling a portion of property to the partnership under the section 707 disguised sale rules.[21] Because A is treated as receiving consideration in a disguised sale, A's amount realized from the disguised sale may also include some or all of the qualified liabilities the partnership assumes from A (tainted qualified liabilities).[22] The amount of tainted qualified liabilities included in A's amount realized is equal to the lesser of the qualified liabilities multiplied by the net equity percentage,

[19] $50 tax basis in all of the assets, less $9 tax basis allocated to the sale.
[20] $130 fair market value of assets deemed contributed by A less $41 adjusted tax basis.
[21] Treas. Reg. §1.707-3.
[22] Treas. Reg. § 1.707-5(a)(1).

or the amount of qualified liabilities that would be allocated to B under section 752 (*i.e.*, the "debt shift").[23]

In this case, since the loan was made by P, who is related to A, the entire amount of loan would be allocated to A under section 752, and none would be allocated to B. Accordingly, A's amount realized would be limited to the $30 cash consideration.[24] Consistent with Example 1 using the Section 752 Approach, A is treated as selling an 18.75 percent interest in the LLC's assets to a new partnership for $30 and contributing the remaining 81.25 percent interest in the LLC's assets to the partnership. The tax basis of the assets A is treated as selling to the partnership would be $9.[25] A's gain on the sale of assets to the partnership would be $21.[26] The tax basis in the assets A is treated as contributing to the partnership would be $41, and A's and B's tax basis in their partnership interests would be $41 and $30, respectively. Thus, the amount realized by A, the gain recognized by A, the partnership's tax basis in its assets, and the partners' tax bases in their partnership interests under the disguised sale rules, is the same as a direct sale of LLC interests under the Section 752 Approach.

If, instead, A sold part of its interest in an existing partnership (as opposed to an interest in a disregarded LLC), A's amount realized would also be limited to the $30 cash received. To illustrate this point, consider a modification to the facts in Example 1 above.

**Example 3**: Assume that A owned an interest in an existing partnership that is worth $60 and that A's tax basis in such partnership is $50, which includes $100 of basis resulting from the allocation of liabilities – all of which are liabilities owed to P, who is related to A. Assume further that B pays $30 cash directly to A for half of A's interest in the partnership. As discussed previously, the entire $100 loan from P is allocable to A before and after the sale under Treas. Reg. § 1.752-2(a), so A is not discharged from any liabilities on the sale to B**.** Treas. Reg. § 1.1001-2(a)(4)(v) provides that A's amount realized is equal to the amount of cash received plus the amount of debt from which A is "discharged." A's share of P's loan is not "discharged," so it is not included in A's amount realized.[27] Thus, A's amount realized on the sale of a 50 percent interest in the LLC is limited to $30. Under Rev. Rul. 84-53,[28] A's basis in the interest sold is $0, the amount derived by prorating the basis of A's entire interest, $50, by the ratio that the liabilities discharged (zero) bears to A's share of total liabilities ($100).[29] A's gain on the sale of the partnership interest is $30 ($30 amount realized less zero of tax basis). Note that the gain recognized here is different than the $21 gain recognized under the Section 752 Approach, which is due to the manner in which Rev. Rul. 84-53 works when the amount of liabilities allocated to the partnership interest exceeds the partner's tax basis in the partnership interest.

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[23] Treas. Reg. §§ 1.707-5(a)(1); 1.707-5(a)(2); 1.707-5(a)(5)(i)(A)-(B).
[24] The amount of tainted qualified liabilities would be equal to the debt shift (zero).
[25] This amount is computed by multiplying the sale percentage (18.75 percent) by the tax basis of the assets ($50). Treas. Reg. § 1.707-3(f), example 1.
[26] $30 amount realized less $9 adjusted tax basis.
[27] *See also* Treas. Reg. §§ 1.752-2(a) and 1.1001-2(a).
[28] 1984-1 C.B. 159.
[29] Rev. Rul. 84-53, Situation 4.

### 2. *Deemed Assumption of Liabilities by Buyer - Third Party Liabilities*

The uncertainty over the seller's amount realized and the amount of assets that the buyer is deemed to purchase also exists when the LLC has liabilities that are nonrecourse for purposes of section 752.[30]

**Example 4.** Assume the same facts as in Example 1 above, except that LLC owes $100 to an unrelated bank (instead of to P) and that no partner is treated as having economic risk of loss with respect to the debt under section 752. Under the Pro Rata Approach, B would be treated as assuming $50 of liabilities from A (*i.e.*, a pro-rata portion of the $100 third party loan). Accordingly, A's amount realized would include the $50 of liabilities assumed by B, and A would recognize $55 of gain,[31] consistent with the results under the Pro Rata Approach when the liability was owed to related party P.

Under the Section 752 Approach, A's amount realized is equal to the amount of cash received by A plus the portion of the liabilities allocated to B under section 752 immediately following the formation of the partnership. Because the liability to the bank is exculpatory, the liability is a nonrecourse liability for purposes of section 752 that is allocable among the partners pursuant to section 1.752-3.[32] However, the calculation of the debt allocation to B becomes circular if one attempts to allocate the nonrecourse liability using all of operative provisions of section 1.752-3 (the Treas. Reg. §1.752-3 Approach). The circularity occurs because the rules for allocating nonrecourse liabilities depend in part on the amount of section 704(c) gain in the partnership assets that are subject to the liabilities, and the amount of assets deemed contributed (and, therefore, the amount of section 704(c) gain in such contributed assets) depends in part on the amount of the liability that the buyer is treated as assuming from the seller. The calculation of the debt shift is not circular if the amount of the nonrecourse liabilities from which the seller is treated as discharged is determined using an approach that does not take into account the section 704(c) gains in the partnership assets, similar to the approach used for the section 707(a)(2)(B) disguised sale rules (the "Disguised Sale Approach").

Under Treas. Reg. § 1.707-5(a)(2)(ii), a partner's share of a partnership nonrecourse liability is determined using the partner's share of partnership profits, in accordance with the excess nonrecourse liability allocation rule of Treas. Reg. § 1.752-3(a)(3), determined without regard to any excess section 704(c) gain. Under this method, in Example 4 above, A and B would each be allocated $50 of the partnership's nonrecourse liability. This approach results in the assumption of $50 of liabilities by B and the recognition of $55 of gain by A, which is the same result as under the Pro Rata Approach.

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[30] Other tax issues may arise when liabilities are involved that are not included in this letter.

[31] This is equal to the amount realized of $80 ($30 cash received plus B's assumption of $50 debt), less $25 of tax basis allocated to B's interest.

[32] A liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability under Treas. Reg. Sec. § 1.752-2. Treas. Reg. Sec. § 1.752-1(a)(2).

We believe that allocating nonrecourse liabilities (within the meaning of section 752) using the approach outlined in Treas. Reg. § 1.707-5(a)(2)(ii) in applying the Section 752 Approach is a reasonable way to allocate such liabilities among the partners in a transaction covered by Rev. Rul. 99-5, Situation 1. The principles of the regulations under section 752 should be applied to prevent A from prematurely recognizing gain where it receives a share of the partnership liabilities following the assumption of the liability by the partnership. The preamble to the notice of proposed rulemaking on the allocation of partnership liabilities[33] explains that the partnership liability allocation rules arguably should not accelerate the partner's recognition of the gain when the amount of the partnership's liability attributable to such property is sufficient to prevent such partner from recognizing gain.

***Recommendations***

The AICPA recommends that Treasury and the IRS publish guidance to address the issues that arise from the assumption of liabilities on the formation of a partnership in a Rev. Rul. 99-5, Situation 1 transaction. Specifically, we recommend the Section 752 Approach be adopted to determine the amount of liabilities included in the seller's amount realized, and to determine the amount of assets deemed purchased by the buyer. Under this approach, the seller's taxable proceeds are limited to the sum of the cash received and liabilities discharged.

We believe that the Section 752 Approach more accurately reflects the amount realized by the seller in connection with the sale. The amount realized by the seller in a transaction covered by Rev. Rul. 99-5, Situation 1, should be no different than in Rev. Rul. 99-5, Situation 2, or if the interest in the disregarded entity was an interest in an existing partnership. As discussed above, A's amount realized in either a disguised sale of assets or a sale of a partnership interest is generally limited to the cash received plus the liabilities assumed by the buyer, as determined under section 752 principles.[34]

Although the amount of gain recognized by the seller currently on the sale of the interest in the disregarded entity is lower under the Section 752 Approach than under the Pro Rata Approach (where there are debts that are recourse to the seller under section 752), [35] the difference is only a timing difference. The seller's deferred gain should be higher under the Section 752 Approach. Sections 704(c) and 752 cause the seller to be taxed on the remaining built-in gain or loss in the assets when the assets are sold or depreciated, when the liabilities are repaid, or when the partnership interest is sold. The amount of section 704(c) gain recognized by the seller under the Section 752 Approach should exceed the amount of gain recognized under the Pro Rata Approach.[36]

[33] 65 FR 2081-01, Allocation of Partnership Debt (Jan. 13, 2000).

[34] In example 2, the amount realized in the disguised sale is $30. In example 3, the amount realized upon the sale of partnership interests is $30.

[35] In example 1, under the Pro Rata Approach, the gain recognized by A was $55. Under the Section 752 Approach, the gain recognized by A was $21.

[36] In example 1, under the Pro Rata Approach, the deferred gain subject to section 704(c) was $55. Under the Section 752 Approach, the deferred gain subject to section 704(c) was $89.

Further, the government can rely on other provisions in Subchapter K when appropriate, rather than relying on the Pro Rata Approach to Rev. Rul. 99-5, to ensure that the seller is taxed on the correct amount of gain. Specifically, the government can apply the disguised sale rules to prevent the seller from deferring gain when the seller is clearly extracting more equity than the cash received. For example, if in Example 1 above, A borrowed against a portion of the disregarded entity's assets, kept the cash, and sold a portion of its interest in the disregarded entity to B, the new partnership is deemed to assume the entire amount of the new liability. Under the disguised sales rules, A should be taxed immediately on the portion of the nonqualified liability that is allocated to B. Thus, abusive attempts to manipulate liability assumptions in connection with a sale of an interest in a disregarded entity can be resolved under section 707.

The AICPA recommends that taxpayers be permitted to apply the Section 752 Approach to the assumption of nonrecourse liabilities in any reasonable manner, provided that the principles of section 752 are applied to determine the seller's amount realized. These comments describe two approaches that may be used - the Treas. Reg. § 1.752-3 Approach or the Disguised Sale Approach. We believe that either approach can be used for nonrecourse liabilities because both approaches reasonably estimate the amount of liabilities from which the seller is discharged.

These recommendations are not intended to override existing rules governing liability allocations. For example, the Treas. Reg. § 1.752-3 Approach illustrated here assumes that the partnership agreement provides that excess nonrecourse liabilities are first allocated in accordance with excess section 704(c) gain. Of course, if the partnership agreement provides for a different method (*e.g*., an allocation based on general share of profits or a significant item of partnership income), that method must be applied instead.

### B. <u>Springing Liabilities</u>

Rev. Rul. 99-5 also does not address the treatment of liabilities of the disregarded entity to its owner that "spring" into existence for tax purposes when the disregarded entity becomes a partnership. Liabilities between a disregarded entity and its owner are disregarded for federal income tax purposes until the disregarded entity becomes a separate entity for income tax purposes. When a second person purchases an interest in the disregarded entity such that it becomes a partnership for federal income tax purposes, the loan becomes a regarded liability for tax purposes - it springs into existence.

**Example 5.** Assume the following additional facts to Example 1 above: the disregarded entity issued the $100 note payable to A, instead of to P, in the ordinary course of the disregarded entity's business. B purchases 50 percent of A's interest in the disregarded entity for $30. Under Rev. Rul. 99-5, Situation 1, B is treated as purchasing assets from A, and both A and B are treated as transferring their respective interests in the assets to a new partnership, in exchange for ownership interests in the partnership. Prior to B's purchase of 50 percent of A's interest, the LLC is disregarded for federal tax purposes and A's loan to the LLC is also disregarded. Upon

B's acquisition of a 50 percent interest in the LLC and the formation of the partnership, A's loan to the LLC would become an obligation of the new partnership to A.

Rev. Rul. 99-5 does not address the treatment of such springing liabilities. There are several different potential tax constructs that may apply to the creation of such obligations. These include: (1) a deemed installment sale of assets to the new partnership by the partner; (2) a deemed issuance of debt by the single owner to the LLC that is respected as a liability prior to the formation of the partnership; and (3) a deemed contribution of assets followed by a distribution of a partnership note. These constructs are discussed briefly below.

*1. Installment Sale to Partnership*

Under the facts of Example 5 above, A is deemed to contribute assets to a new partnership in exchange for a partnership interest and a note receivable. As such, the partnership may be viewed as issuing the debt to A, and A could be viewed as selling part of its assets to the new partnership in exchange for the issued note. As such, it appears that A could be viewed as engaging in an installment sale with the partnership.

Support for this view may be found in the section 721 regulations. Treas. Reg. § 1.721-1(a) states that "if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange under section 707 rather than as a contribution under section 721."

Additional support may be found in corporate authorities. For example, in Rev. Rul. 80-228,[37] the IRS ruled on the issue of a springing liability in a section 351 transaction and determined that the assumption of liabilities caused the transferor to receive taxable consideration for the assets (*i.e.*, "boot"). In exchange for the transfer of an intercompany account payable to a newly formed corporation, the transferor was treated as receiving "other property" within the meaning of section 351(b) and had to recognize gain on the exchange.

*2. Debt Respected as Issued Immediately Prior to Transaction*

In the case of an exchange with a newly formed partnership where the contributing partner continues to bear the economic risk of loss for the partnership liability after the liability springs to life, it is not clear that a deemed sale is the appropriate result. Rather, in this situation, because the contributing partner is not relieved of any obligation, it arguably should have no taxable consideration.[38] Instead, the note payable could be viewed as springing to life

[37] 1980-2 C.B. 115.

[38] This result is arguably consistent with the disguised sale rules. In many cases, A's loan should be viewed as a "qualified liability" under Treas. Reg. § 1.707-5(a)(6), to the extent it was incurred in the ordinary course of business of the LLC. Under those facts, the assumption of the liability should not be viewed as disguised sale proceeds. However, *even if* A's loan were considered a nonqualified liability, the entire amount of the liability would be allocated to A under Treas. Reg. §§ 1.752-2(a) and 1.707-5(a)(2)(i) following the partnership formation.

immediately before it is contributed to the partnership by A and thereafter allocated to A under Treas. Reg. § 1.752-2(a), since A still bears the economic risk of loss for the partnership liability, without implicating a sale or exchange of assets to the partnership. This result can be supported by the assertion that the business of the disregarded entity has just continued in partnership form, with A maintaining its risk of loss with respect to the liability.

### 3. *Distribution of a Partnership Note*

It can also be argued that the contribution by A to the partnership is made simultaneously with the distribution of, rather than the issuance of, a note payable from the partnership. For purposes of maintaining capital accounts, and for partner retirements, a distribution of a promissory note from a partnership to a partner is generally treated as an open transaction.[39] The distribution does not reduce the partner's section 704(b) capital account until the partnership makes principal payments on the note or the partner disposes of the note in a taxable disposition. Thus, the distribution of a promissory note by a partnership to a partner is generally disregarded and is not treated as either a distribution of property or cash to the partner.

Additional support for this position can be found in Treas. Reg. § 1.752-1(a)(4), which provides that the term "liability of a partnership" includes an obligation only if and to the extent that incurring the liability creates or increases the basis of any of the partnership's assets, gives rise to an immediate deduction to the partnership, or under section 705(a)(2)(B), currently decreases the basis in the partner's partnership interest. It appears that based on a literal interpretation of this regulation, a distribution of a partnership note payable to a partner may not be treated as the partnership incurring a liability for tax purposes. If no liability is created for tax purposes at the time of the partnership formation, the contributing partner should not be treated as selling assets for an installment note.

### ***Recommendations***

The AICPA recommends that Treasury publish guidance describing the proper tax treatment of a springing liability in a transaction covered by Rev. Rul. 99-5. We respectfully request that Treasury treat the partnership as assuming a liability from the owner of the disregarded entity that springs into existence immediately prior to the assumption by the partnership, rather than treating the partnership as issuing a promissory note to the owner. We believe that the owner should not be treated as receiving taxable consideration when a new partnership assumes a liability from an owner who continues to bear the economic risk of loss for the liability. The rules of Subchapter K, including sections 752 and 707, can work together to ensure that the owner of the disregarded entity has the appropriate amount realized on the transfer of assets to

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As such, A may not be considered to have any disguised sale consideration under Treas. Reg. § 1.707-5(a)(1) because A is not discharged of any part of the liability.

[39] Treas. Reg. § 1.704-1(b)(2)(iv)(e)(2). There is an exception to this general rule for notes that are readily tradable on an established securities market or that are negotiable. *See also* Treas. Reg. § 1.736-1(a)(6) (providing that a retiring partner that is to receive fixed payments in liquidation of his interest continues to hold such partnership interest until the final payment is made).

the partnership. In most cases, the owner would not be "discharged" from any portion of the liability because the owner continues to bear the economic risk of loss on the loan.

### C. Transfers Not Described in Rev. Rul. 99-5

Rev. Rul. 99-5 describes two types of transfers of interests in LLCs classified as disregarded entities that cause the disregarded entity to become a partnership for U.S. federal income tax purposes: a taxable purchase of an interest in the LLC (Situation 1), and a contribution of cash to the LLC in exchange for interests in such entity (Situation 2). There are, however, many other transactions whereby the single owner of an LLC can transfer all or part of the interests therein such that, after the transfer, the disregarded entity has more than one owner for U.S. federal income tax purposes. The AICPA recommends that the Treasury expand the guidance provided in Rev. Rul. 99-5 to apply to other types of transfers that result in a conversion of the disregarded entity to a partnership under the section 301.7701-3 entity classification regulations due to the change in the number of owners.

Other types of transfers that are not covered by Rev. Rul. 99-5 include, for example: distributions of the interests in a disregarded entity by a partnership or corporation resulting in the disregarded entity having multiple owners; contributions of some of the interests in a disregarded entity to a corporation in a transaction governed by section 351 or to a partnership in a transaction governed by section 721; transfers of interests in a disregarded entity as part of a tax-free reorganization under section 368 resulting in the disregarded entity having more than one owner; gifts of interests in a disregarded entity to another person; bequests of interests in a disregarded entity to two or more beneficiaries, transfers of interests in a disregarded entity as a part-sale, part-gift; and a like-kind exchange of part of the interests by the owner of a disregarded entity for other like-kind property.

A detailed analysis of the tax consequences of each such transfer is beyond the scope of this comment letter. The AICPA believes that guidance should generally adopt the same construct that is applied to the transactions in Rev. Rul. 99-5, Situation 1, *i.e.*, a transfer of an undivided interest in the assets of the disregarded entity to the transferee, followed by a deemed contribution of undivided interests in assets by the transferor and transferee to a newly formed partnership. The general tax principles governing the type of transfer - whether it be gift, bequest, contribution, distribution etc. – should determine the transferor's tax consequences and be used to determine the transferee's basis in the undivided interest in the assets deemed acquired. For example, the rules of Subchapter C should apply in the case of a distribution of an interest in a disregarded entity by a corporation to determine the gain, if any, recognized by the transferor and the basis and holding periods that the transferee shareholder(s) obtain in the distributed property. If a corporation makes a non-liquidating distribution of an interest in a disregarded entity to a shareholder, the gain recognized by the transferor corporation should be determined under section 311(b) with respect to the assets deemed distributed, and the transferee shareholder's basis in their share of such assets deemed distributed should be determined under section 358. The transferee shareholder's basis in the assets as determined under section 358 should be used to determine the basis of the assets deemed contributed by the transferee shareholder to the new partnership that is created by operation of Rev. Rul. 99-5.

***Recommendations***

The AICPA requests guidance describing the tax consequences of the conversion of a disregarded entity to a partnership, which results from transfers of interests in the disregarded entity that are not described in Rev. Rul. 99-5, Situation 1 or 2. The AICPA recommends that the Treasury adopt the same construct for basis and holding period purposes as it adopts for the types of transfers addressed in Rev. Rul. 99-5, Situation 1. The AICPA believes that the rules of Subchapter C or Subchapter K or other relevant provisions of the Code, as appropriate, should determine the tax consequences to the transferor member, and the basis and holding period of the assets deemed acquired by the transferee.