TAX SECTION
State Bar of Texas

OFFICERS:

Elizabeth A. Copeland, Chair
Strasburger Price Oppenheimer Blend
711 Navarro, Suite 600
San Antonio, Texas 78205-1796
(210) 250.6121
(210) 258.2732 (fax)
elizabeth.copeland@strasburger.com

Andrius R. Kontrimas (Chair-Elect)
Norton Rose Fulbright
1301 McKinney, Suite 5100
Houston, Texas 77010-3095
713-651-5482
713-651-5246 (fax)
akontrimas@nortonrosefulbright.com

Alyson Outenreath (Secretary)
Texas Tech University
School of Law
1802 Hartford Ave.
Lubbock, Texas 79409-0004
806-742-3990 Ext. 238
806-742-1629 (fax)
alyson.outenreath@ttu.edu

David E. Colmenero (Treasurer)
Meadows, Collier, Reed, Cousins,
Crouch & Ungerman, LLP
901 Main Street, Suite 3700
Dallas, Texas 75202
214-744-3700
214-747-3732 (fax)
dcolmenero@meadowscollier.com

June 20, 2014

Via U.S. Mail

Mr. John Koskinen, Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20024

CC:PA:LPD:PR (REG-119305-11)
Courier's Desk
Internal Revenue Service
1111 Constitution Av,e NW
Washington, DC 20044

RE: Comments on Proposed Regulations Regarding Disguised Sales and the Allocation of Liabilities

Dear Commissioner Koskinen:

On January 29, 2014, the Department of the Treasury ("***Treasury***") and the Internal Revenue Service (the "***Service***") published proposed Treasury regulations (the "***Proposed Regulations***") under Sections 707 and 752 of the Internal Revenue Code [REG-119305-11] and requested comments on the proposed rules. On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the following comments on the Proposed Regulations.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend Treasury and the Service for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Elizabeth Copeland

Elizabeth Copeland
Chair, Tax Section
State Bar of Texas

COMMENTS ON PROPOSED TREASURY REGULATIONS SECTION 1.707-4, AS PUBLISHED IN THE FEDERAL REGISTER ON JANUARY 29, 2014

Principal responsibility for drafting these comments was exercised by David S. Peck and Gary R. Huffman. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these comments. Robert Phillpott reviewed the comments and made substantive suggestions on behalf of COGS. Robert Probasco, the Co-Chair of COGS, also reviewed the comments on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact Person: David S. Peck
dpeck@velaw.com
(214) 220-7937

Date: June 20, 2014

The Proposed Regulations address a number of deficiencies and technical ambiguities in the existing regulations under Section 707(a)(2)(B)[1] (relating to disguised sales of property to or by a partnership) and under Section 752 (relating to the treatment of partnership liabilities). These preliminary comments are limited to recommending expansion of the guidance provided in the Proposed Regulations concerning the reimbursements of certain preformation capital expenditures (the "**exception for preformation capital expenditures**"). This should not be construed as implying that we agree with other aspects of the Proposed Regulations. The Tax Section of the State Bar of Texas anticipates submitting comments regarding the treatment of partnership liabilities at a later date.

We respectfully recommend that final regulations include (1) specific guidance regarding the application of the exception for preformation capital expenditures in certain common circumstances involving tiered partnerships and (2) additional guidance regarding the meaning of the term "property" for purposes of the exception for preformation capital expenditures. Each recommendation is discussed in detail below.

I. Application of the Exception for Preformation Capital Expenditures in Tiered Partnership Transactions.

A. Recommended Clarification

We respectfully recommend that final regulations include specific guidance regarding the application of the exception for preformation capital expenditures in two common circumstances involving tiered partnership structures. First, we recommend that any final regulations clarify that if a partner (the "***Contributing Partner***") makes capital expenditures (as defined in the Proposed Regulations) with respect to property that is contributed to a partnership ("***Upper Tier Partnership***") and the Upper Tier Partnership subsequently contributes that property to another partnership ("***Lower Tier Partnership***"), that the Upper Tier Partnership can receive a distribution from the Lower Tier Partnership that qualifies for the exception for preformation capital expenditures to the same extent that a distribution from the Upper Tier Partnership to the Contributing Partner would qualify for the exception.

For example, assume that Contributing Partner owns Property X, which has a fair market value of $1,000 and a tax basis of $200. Contributing Partner has made capital expenditures of $100 with respect to Property X within the past two years. Contributing Partner contributes Property X to Upper Tier Partnership ("***Upper Tier Contribution***"), which then contributes Property X to Lower Tier Partnership ("***Lower Tier Contribution***"). Lower Tier Partnership makes a $100 transfer to Upper Tier Partnership, which then makes a $100 transfer to Contributing Partner as a reimbursement of preformation capital expenditures with respect to Property X.

Absent the recommended clarification, there would be a question regarding whether the $100 transfer received by Upper Tier Partnership from Lower Tier Partnership in the Lower Tier Contribution is treated as disguised sale proceeds or a distribution under the exception for

[1] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "***Code***"), or a section of the Treasury Regulations, unless otherwise indicated.

preformation capital expenditures. If the $100 transfer were treated as disguised sales proceeds, Contributing Partner would be allocated the resulting gain by the Upper Tier Partnership under Section 704(c) even though the Upper Tier Contribution would qualify for the exception for preformation capital expenditures.

Similarly, we recommend that any final regulations clarify that if a Contributing Partner makes capital expenditures (as defined in the Proposed Regulations) with respect to property contributed to a Lower Tier Partnership and the Contributing Partner subsequently contributes her interest in Lower Tier Partnership to Upper Tier Partnership, that the Contributing Partner can receive a distribution from the Upper Tier Partnership that qualifies for the exception for preformation capital expenditures to the same extent that a distribution from the Lower Tier Partnership to the Contributing Partner would have qualified for the exception.

For example, assume that Contributing Partner owns Property X, which has a fair market value of $1,000 and a tax basis of $200. Contributing Partner has made capital expenditures of $100 with respect to Property X within the past two years. Contributing Partner contributes Property X to Lower Tier Partnership in exchange for an interest therein. Contributing Partner then contributes her interest in Lower Tier Partnership to Upper Tier Partnership in exchange for a partnership interest plus a transfer of $100.

Absent the recommended clarification, there would be a question regarding whether the $100 transfer by Upper Tier Partnership to Contributing Partner qualifies for the exception for preformation capital expenditures.

B. Background and Analysis

Section 1.707-4(d) of the existing regulations provides that a transfer of money or other consideration by a partnership to a partner is not treated as part of a sale of property by the partner to the partnership under Section 1.707-3(a) to the extent that the transfer to the partner by the partnership is made to reimburse the partner for, and does not exceed the amount of, capital expenditures that—

> (1) Are incurred during the two-year period preceding the transfer by the partner to the partnership; and
>
> (2) Are incurred by the partner with respect to—
>
> > (i) Partnership organization and syndication costs described in Section 709; or
> >
> > (ii) Property contributed to the partnership by the partner, but only to the extent the reimbursed capital expenditures do not exceed 20% of the fair market value of such property at the time of the contribution. However, the 20% of fair market value limitation of this Paragraph (d)(2)(ii) does not apply if the fair market value of the contributed property does not exceed 120% of the partner's adjusted basis in the contributed property at the time of contribution.

The preamble to the Proposed Regulations states that "the purpose of the exception for preformation capital expenditures is to permit a partnership to reimburse a contributing partner for expenditures incurred with respect to contributed property."

There are several authorities, including the Proposed Regulations, that address the application of other exceptions to the disguised sale rules in tiered partnership transactions. However, there are no authorities that address the application of the exception for preformation capital expenditures in circumstances involving tiered partnerships. Our recommended clarifications are consistent with the purpose of the exception for preformation capital expenditures and also consistent with authorities, including the Proposed Regulations, which address the application of other exceptions to the disguised sale rules in tiered partnership and other circumstances. These authorities are described briefly below.

Treasury Regulation Section 1.707-5(e) provides that if a lower-tier partnership succeeds to a liability of an upper-tier partnership, the liability in the lower-tier partnership retains the characterization as qualified or nonqualified that it had in the upper-tier partnership.

The Proposed Regulations would clarify that the debt-financed distribution exception of Treasury Regulation Section 1.707-5(b) applies in a tiered partnership setting by providing that "an upper-tier partnership's share of the liabilities of a lower-tier partnership that are treated as a liability of the upper-tier partnership under Section 1.752-4(a) shall be treated as a liability of the upper-tier partnership incurred on the same day the liability was incurred by the lower-tier partnership." Similarly, the Proposed Regulations adopt an aggregate approach for purposes of determining whether (in a contribution of an interest in a lower-tier partnership to an upper-tier partnership) the contributing partner's share of the liabilities of the lower-tier partnership are qualified liabilities.

In Rev. Rul. 2000-44,[2] a corporation incurred capital expenditures to acquire property and subsequently liquidated into its corporate parent in a transaction which met the requirements of Section 332. Within two years of the time the liquidating corporation had made its capital expenditures on the property, the parent corporation contributed such property in exchange for partnership interests and a reimbursement for preformation expenditures in an amount equal to the capital expenditures made by the liquidating corporation. The Service observed that:

> Where a corporation incurs preformation expenses or undertakes a borrowing, and another corporation acquires assets of the corporation in a Section 381 transaction, the transfer does not alter the circumstances under which the expenditures or indebtedness were originally incurred <u>or otherwise raise concerns that would justify not treating the transferee corporation as having incurred the expenditures or undertaken the liabilities at the time they were incurred or undertaken by the predecessor corporation</u>.[3]

The theme of the authorities applying exceptions to the disguised sale rules to persons other than a partner directly incurring a liability or expenditure is that the rules should be extended to cases where application is consistent with the underlying purpose of the exception

[2] 2000-2 C.B. 336.
[3] Emphasis added.

and does not raise concern regarding abuse. The clarifications recommended above are consistent with the policy underlying the exception for preformation capital expenditures and provide little (if any) opportunity for abuse. Because these types of tiered partnership transactions occur with some frequency, we recommend that final regulations include our proposal.

II. Definition of "Property" for Purposes of the Exception for Preformation Capital Expenditures under Section 1.707-4(d).

A. Recommended Clarification

We respectfully recommend that any final regulations include a flexible standard regarding the term "property" for purposes of applying the exception for preformation capital expenditures. Specifically, for the reasons discussed below, we recommend that final regulations state that in appropriate circumstances, the term "property" is broader than each separate capitalized asset contributed by a partner.

B. Background and Analysis

The Proposed Regulations clarify that the references in the exception for preformation capital expenditures to "such property" and "contributed property" are intended to refer "to the single property for which the expenditures were made." The preamble to the Proposed Regulations states that "in the case of multiple property contributions, the proposed regulations provide that the determination of whether the fair market value limitation and the exception to the fair market value limitation apply to the reimbursements of capital expenditures is made separately for each property that qualifies for the exception."

Under this clarified rule, the meaning of each separate "property" is critical. The Proposed Regulations, however, do not provide a definition. In order to eliminate potential disputes between taxpayers and the Service over the meaning of "property" for this purpose, and in recognition of the practical difficulties inherent in valuing various components of integrated facilities, we recommend that final regulations acknowledge that the term "property" has, in appropriate circumstances, a broader meaning than each separate capitalized asset.

The issue is best illustrated by example. Suppose that a taxpayer owns and operates an oil refinery. A refinery consists of various components that perform different parts of the refining process (e.g., a distillation unit, catalytic cracker, separator, pumps, condensers, alkylation units, etc.). Even though each of the individual components is part of a larger facility designed to accomplish the refining of crude oil, each component may constitute a separate depreciable asset under Section 167. For example, assume that a taxpayer constructs a refinery and places it in service in 2008. In 2014, the taxpayer has to replace the catalytic cracker and is required to treat the new catalytic cracker as a separately depreciable asset.[4] If the taxpayer contributes the refinery to a partnership in 2015, the question is whether, in applying the

[4] *See, e.g.*, Treas. Reg. §§ 1.162-4, 1.263(a)-3. Pursuant to those regulations, the taxpayer may have to account for the catalytic cracker as a separate capital expenditure and depreciate it separately from the refinery.

exception for preformation capital expenditures, the "property" is the refinery as a whole, or instead, whether the new catalytic cracker must be treated as separate "property."

Viewing the catalytic cracker as a separate property poses difficulties arising principally from the fact that it is part of a functionally integrated facility. As such, it will be difficult, as a practical matter, and unusual, as a factual matter, to determine a separate fair market value for the catalytic cracker.

We understand that providing a highly specific and comprehensive definition of "property" by regulation may be difficult. However, we believe that guidance should be provided clarifying that the definition of "property" for purposes of the exception for preformation capital expenditures will not necessarily correspond to the determination of whether a property is a separate asset for depreciation purposes. We believe such guidance would help to avoid unnecessary disputes and prevent the imposition of limitations on the exception for preformation capital expenditures that would render it useless as a practical matter in many common cases involving contributions of integrated property consisting of multiple properties.

From: (210) 250-6121
Elizabeth Copeland
strasburger and price
2301 Broadway

SAN ANTONIO, TX 78215

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