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There's No Guarantee: Proposed Regulations on Wholly-Owned LLCs

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Although most people endeavor to avoid liabilities, partners frequently worry that they have too small a share of liabilities. This is because a decrease in a partner's share of partnership liabilities is deemed to be a cash distribution under the partnership taxation rules, and if the deemed distribution is in excess of basis, gain results to the partner. Thus, there is a lively interest by each partner in its share of liabilities. Frequently, in order to obtain sufficient liability shares, partners must guarantee partnership debt. On August 12, 2004, the Internal Revenue Service (IRS) issued proposed regulations governing the treatment of guarantees by partners that are "disregarded entities" for tax purposes.

Background

Under Section 752 of the Internal Revenue Code, a partner's basis in its partnership interest includes its share of partnership liabilities. Treasury Regulations under Section 752 of the Code provide rules relating to the determination of a partner's share of partnership liabilities. Which rules apply depends on whether the liability is characterized as recourse or nonrecourse for purposes of Section 752. Under the regulations, a partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability and a partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability.

In general, a partner bears the economic risk of loss for a partnership liability to the extent that the partner or a related person would have an obligation to make a payment to any person, including a contribution to the partnership, on account of the partnership liability if, hypothetically, the partnership were to liquidate. For this purpose, all statutory and contractual obligations relating to the partnership liability and reimbursement rights are taken into account in determining whether a partner or related person has a payment obligation. Moreover, for purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss for a partnership liability, it is presumed that all partners and related persons which have obligations to make payments actually perform those obligations irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. Typically, when a partner guarantees debt that is otherwise nonrecourse to the partnership (and the partners), the debt is transformed into a recourse liability and is allocated to the guarantor.

Under regulations governing the classification of entities, a limited liability company in which a single member owns 100% of the member interests is, for tax purposes, disregarded as an entity separate from its owner.

The proposed regulations provide that in determining the extent to which a partner bears the economic risk of loss for a partnership liability, payment obligations of a disregarded entity are taken into account for purposes of Section 752 only to the extent of the net value of the disregarded entity.

Net Value

Under the proposed regulations, the net value of a disregarded entity generally equals (A) the fair market value of all assets owned by the disregarded entity that may be subject to creditors' claims under local law, including the disregarded entity's enforceable rights to contributions from its owner, but excluding the disregarded entity's interest in the partnership (if any) less (B) obligations of the disregarded entity that are senior, or of equal priority, to the partnership payment obligations of the disregarded entity. After the net value of a disregarded entity is initially determined under the rules of the proposed regulations, the net value of the disregarded entity is not redetermined unless the obligations of the disregarded entity that do not constitute, and are senior or of equal priority to, the partnership payment obligations of the disregarded entity change by more than a de minimis amount or there is more than a de minimis contribution to or distribution from the disregarded entity.

In connection with the issuance of the proposed regulations, the Internal Revenue Service and Treasury Department requested comments on whether other events (such as a sale of substantially all of a disregarded entity's assets) should be specified as revaluation events and whether a partner should be able to make an election to revalue a disregarded entity annually regardless of the occurrence of a revaluation event.

The proposed regulations also provide that the net value of a disregarded entity is determined by taking into account a subsequent reduction in the net value of the entity if the subsequent reduction is anticipated and is part of a plan that has as one of its principal purposes the creation of the appearance that a partner bears the economic risk of loss for a partnership liability. In addition, under the proposed regulations, if one or more disregarded entities have payment obligations with respect to one or more partnership liabilities, or liabilities of more than one partnership, the partnership must allocate the net value of each disregarded entity among partnership liabilities in a reasonable and consistent manner, taking into account priorities among partnership liabilities.

To facilitate the partnership's determination of the net value of a disregarded entity, the proposed regulations provide that a partner that may be treated as bearing the economic risk of loss for a partnership liability based upon a payment obligation of a disregarded entity must provide information to the partnership as to the entity's tax classification and net value on a timely basis.

The scope of these proposed regulations is not limited to situations where disregarded entities guarantee partnership debt. They will commonly apply in the case of a disregarded entity which is a general partner. Usually, general partners bear the risk of loss (and receive liability allocations) with respect to liabilities of the partnership, since they are secondarily liable for these debts under local law.

In addition, the IRS and Treasury Department announced they are considering and request comments regarding whether the rules of the proposed regulations should be extended to the payment obligations of other entities, such as entities that are capitalized with nominal equity.

This request for comments raises the specter of the IRS' opening a Pandora's Box in this area. As mentioned above, the current regulatory scheme for partnership liability allocation assumes generally that partners will make good on their obligations. A rule of this sort is necessary to avoid burdening taxpayers with a full-blown underwriting analysis every time it is necessary to allocate partnership debt. The proposed regulations deal with the narrow case of a disregarded entity, which presents a particularly compelling case for an exception to this rule. For tax purposes, the entity is ignored and the entity owner is treated as the partner. Since the owner is not liable on the guaranty, he does not bear the risk of loss; accordingly, the definition of partnership recourse liability is not met. However, if other entities are swept into the purview of these proposed regulations, it will be difficult to draw lines without changing the current system entirely and creating tremendous uncertainty and heavy compliance burdens. We sincerely hope that the final regulations will not expand the scope of the proposed regulations.