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Rock Bottom: Proposed Partnership Regulations Would Have Significant Impact

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So-called "bottom guarantees" can be an important tax planning tool for partners of a partnership in certain circumstances. The term "bottom guarantee" is used to refer to a guarantee by a partner of the repayment of the "last dollars" of a partnership liability. For example, if a partnership has a property with a value of $10 million subject to $6 million of mortgage debt, a partner might make a bottom guarantee of the last $3 million of the debt. This would mean that the partner should not need to make any payments on its guarantee unless the value of the property declines from $10 million to less than $3 million.

To illustrate the potential significance of a bottom guarantee, consider a partner that contributes to a partnership property subject to mortgage debt that exceeds the partner's tax basis in the property. Despite this mortgage in excess of basis in the contributed property, the partner would generally be allocated sufficient nonrecourse liabilities of the partnership such that the transaction would be tax-free. However, suppose that the partnership subsequently repays the debt secured by the property that this partner had contributed. The repayment of this debt could potentially result in the partner recognizing gain from a deemed distribution in excess of basis as a result of a reduction in its share of the nonrecourse liabilities of the partnership if its share of other partnership liabilities is insufficient. Under the Treasury Regulations currently in effect, the partner could avoid recognizing any gain by making a bottom guarantee of other debt of the partnership, which would cause the guaranteed debt to be allocated to the partner as a recourse liability.

The Treasury Department released proposed regulations earlier in 2014 under which partnership debt that is guaranteed by a partner would be allocated to the partner making the guarantee as a recourse liability only under very limited circumstances. If finalized in their current form, these regulations would have a profound impact on the ability of many partners to defer gain.

Background

Under section 752 of the Internal Revenue Code, an increase in a partner's share of the liabilities of a partnership is considered as a contribution of money by the partner to the partnership (which increases the partner's basis in its partnership interest). A decrease in a partner's share of the liabilities of a partnership is considered as a distribution of money to the partner by the partnership (which reduces the partner's basis in its partnership interest and triggers gain recognition to the extent the deemed distribution exceeds the partner's basis in its partnership interest).

The method by which liabilities of a partnership are allocated to its partners depends on whether the liabilities are recourse liabilities (i.e., liabilities for which a partner bears the economic risk of loss) or nonrecourse liabilities (i.e., liabilities for which no partner bears the economic risk of loss). In general, a partner is considered to bear the economic risk of loss for a partnership liability to the extent that the partner or a related person would be required to make a payment under a constructive liquidation scenario where (1) all of the partnership's liabilities become due and payable and (2) all of the partnership's assets (including cash) have a value of $0.

Under Treasury Regulation section 1.752-2, a recourse liability of a partnership (i.e., a partnership liability for which a partner bears the economic risk of loss) is allocated to a partner to the extent (if any) that the partner or a related person bears the economic risk of loss for the liability. The net worth of the partner making the guarantee of partnership debt generally has no impact on the extent to which a partner is considered to bear the economic risk of loss. However, a guarantee made by an entity that is disregarded for Federal income tax purposes (e.g. a wholly owned LLC) is taken into account only to the extent of the net value of the disregarded entity. Treasury Regulation section 1.752-3 provides a different set of rules for

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allocating nonrecourse liabilities of a partnership.

In the 2010 Tax Court case of *Canal Corporation v. Commissioner*,[1] the taxpayer was a corporation that contributed property to an LLC with a value of $775 million. The LLC incurred a $755 million liability which was guaranteed by the other member, but the taxpayer indemnified the other member for any obligations it might have under the guarantee. The LLC distributed the $755 million of borrowed funds to the taxpayer. This distribution was reported as a tax-free "debt-financed distribution" (an exception to the partnership disguised sale rules under which a contribution of property to a partnership and a distribution of money by the partnership to the partner within two years would generally be treated as a sale of property by the partner to the partnership). The taxpayer transferred the $755 million that it received to its corporate parent and, after the transaction, was left with only an intercompany note that could be forgiven at any time and a $6 million corporate jet. The Tax Court agreed with the IRS that the taxpayer's payment obligation should be disregarded under an anti-abuse rule. Therefore, the contribution of property by the taxpayer and the distribution of cash to the taxpayer were treated as a disguised sale of property to the partnership.

In the aftermath of *Canal Corporation*, the IRS and the Treasury Department made it known that they intended to issue regulations that would alter the rules with respect to bottom guarantees, and proposed regulations were issued earlier in 2014.

Proposed Regulations

The proposed regulations would impose numerous requirements that must be satisfied in order for a partner to be considered to bear the economic risk of loss for a liability guaranteed by the partner for purposes of the partnership recourse debt allocation rules. One of these requirements is that the partner or related person making the guarantee must be liable up to the full amount of the payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. Thus, the proposed regulations go well beyond disregarding only bottom guarantees—they would disregard the full amount of any guarantee except to the extent that the guarantor is liable for the first amounts not otherwise recovered (i.e., only "top guarantees" would be respected).

To illustrate, suppose that a partner guarantees a $3 million portion of a $6 million partnership debt such that the partner would be required to pay up to the full $3 million to the extent that that any portion of the debt is not otherwise repaid. This guarantee would be respected under the proposed regulations if it meets the other requirements described below. However, suppose that the partner is indemnified by a third party for the first $500,000 that it would be required to pay under its payment obligation. As a result of this partial indemnification, the partner's guarantee would no longer be a "top guarantee," and the partner would be considered to bear the economic risk of loss for *no portion* of the guaranteed debt. In addition, this approach of the proposed regulations would totally disregard "vertical slice" guarantees, where the guarantor is responsible for a certain percentage of each dollar not otherwise collected up to the full amount of the guarantee.

In addition to rejecting bottom guarantees, the proposed regulations would also require that each of the following requirements must be satisfied in order for a guarantee made by a partner or related person to be respected:

1. The partner or related person must be required to maintain a "commercially reasonable" net worth throughout the term of the payment obligation and must be subject to "commercially reasonable" contractual restrictions on transfers of assets for inadequate consideration.
2. The partner or related person must be required periodically to provide "commercially reasonable" documentation regarding its financial condition.
3. The term of the guarantee may not end prior to the term of the partnership liability.
4. The guarantee may not require that any obligor with respect to the liability hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor.
5. The partner or related person must receive arm's length consideration for assuming the guarantee.

For a partner or related person other than an individual or a decedent's estate, the proposed regulations would also provide for a guarantee to be respected only to the extent of the net value of the partner or related person (similar to the rules that currently apply to a guarantee made by a disregarded entity). This net value requirement would not apply to a guarantee made by a partner that is an individual or a decedent's estate. However, it appears that a guarantee made by an individual or decedent's estate would still be subject to the requirement to maintain a commercially reasonable net worth.

In terms of effective date, the regulations are proposed to apply to either (1) liabilities incurred or assumed by a partnership on or after the date the regulations are finalized or (2) to payment obligations imposed or undertaken with respect to a partnership liability on or after the date the regulations are finalized. Thus, if a partner guarantees a partnership liability prior to the effective date, the guarantee would not be subject to the proposed regulations for as long as the debt remains outstanding. In addition, there would be a transition rule under which a taxpayer could continue to be allocated debt under the current regulations for seven years in certain circumstances.

Conclusion

That the Treasury Department issued proposed regulations regarding the allocation of partnership recourse liabilities was of little surprise. However, many were expecting that the proposed regulations would be more limited in scope and targeted at abusive arrangements such as the one in *Canal Corporation* where the entity making the guarantee deliberately stripped out substantially all of its assets. Instead, the proposed regulations would completely eliminate bottom guarantees as well as vertical slice guarantees, and indemnification for the first $1 of an otherwise qualifying guarantee would cause the guarantor to be considered to bear the risk of loss for no portion of the debt.

Although IRS and Treasury Department officials have spoken of specifically targeting "tax lawyer motivated guarantees," the proposed regulations would disregard many guarantees that are given for business purposes and without any tax-related motivation (for example, where the guarantor is not a paid a fee for making the guarantee). In a twist that demonstrates just how distortive the impact of the proposed regulations can be, they could disregard a guarantee made by a partner for business purposes which, under the current regulations, would have had the undesirable effect of shifting the liability allocation and causing another partner to have a deemed distribution in excess of basis—thereby *helping* the taxpayer!

Moreover, the proposed regulations would impose requirements that seem to be difficult for anyone to quantify. For example, how does one determine what is a "commercially reasonable" net worth for a guarantor to be required to maintain? What is "arms length" consideration for making a guarantee?

If implemented, the proposed regulations would have a profound impact on many partners by radically shifting partnership debt allocations. In light of resounding criticism from many commentators, though, it remains to be seen whether the proposed regulations will be finalized in anything close to their current form.

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[1] 135 T.C. 199 (2010).