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New Regulations Disregard Partnership "Bottom Guarantees"

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Partners have long enjoyed the ability to influence a partnership's allocation of its liabilities by making a "bottom guarantee" of partnership debt. The term "bottom guarantee" or "bottom dollar guarantee" is used to refer to a guarantee by a partner of the repayment of the "last dollars" of a partnership liability. For example, suppose that a partnership has a property with a value of $10 million subject to $6 million of mortgage debt. A $3 million bottom guarantee made by a partner of this debt would mean that the partner would not need to make any payments unless the value of the property declines from $10 million to less than $3 million.

We have known that the end was coming for bottom guarantees since the issuance of proposed regulations by the Treasury Department in 2014. That expectation has now become a reality, as temporary regulations regarding bottom guarantees were issued earlier this month.

Background

The allocation of partnership liabilities is often important, since a partner's share of the liabilities is included in the basis of its partnership interest (which can determine the extent to which a partner is able to receive a tax-free distribution or to receive an allocation of losses from the partnership). In certain circumstances, a reduction in a partner's share of partnership liabilities can cause the partner to recognize gain from a deemed distribution in excess of basis.

Under Reg. §1.752-2, a "recourse liability" of a partnership is generally allocated to a partner to the extent (if any) that the partner or a related person bears the economic risk of loss ("EROL") for the liability. In general, a partner is considered to bear the EROL 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. 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 EROL (except for a special rule that applies where the guarantor is a disregarded entity). Reg. §1.752-3 has a different set of rules for allocating nonrecourse liabilities of a partnership (i.e., partnership liabilities for which no partner bears the EROL).

New Temporary Regulations

The Treasury Department recently issued new temporary regulations (Temp. Reg. §1.752-2T(b)(3)) pursuant to which a "bottom dollar payment obligation" is not recognized for purposes of determining whether a partner or related person bears the EROL for a liability of a partnership. A "bottom dollar payment obligation" generally includes any payment obligation other than one in which the payment obligor would 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." However, a payment obligor is considered to bear the EROL where it makes a "vertical slice" guarantee, pursuant to which the payment obligor would be liable for a fixed percentage of every dollar of the partnership's liability.

In addition, a payment obligation that would otherwise be respected under the new rules will not be disqualified on account of the payment obligor being indemnified for 10% or less of the payment obligation. However, such a payment obligation would still be subject to a new disclosure requirement that is imposed on a partnership where a bottom dollar payment obligation is entered into or modified.

These temporary regulations generally apply to liabilities incurred or assumed by a partnership and to payment obligations undertaken on or after October 5, 2016. There is a transition rule pursuant to which the old regulations will continue to apply for a seven-year period in certain circumstances. The temporary regulations expire on October 5, 2019.

The temporary regulations also contain special rules regarding the impact of

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payment obligations on partnership disguised sales, which are beyond the scope of this article.

New Proposed Regulations

In addition to disregarding bottom guarantees, the 2014 proposed regulations also contained a number of additional criteria that had to each be satisfied in order for a partner to be considered to bear the EROL for a partnership liability. Commentators noted that many "real" non-tax motivated guarantees do not satisfy all of these criteria.

In response to the criticism from commentators, the new temporary regulations do not include these additional criteria. However, the Treasury Department issued new proposed regulations (Prop. Reg. §1.752-2(j)(3)) that would create an anti-abuse rule that would apply even if a payment obligation is not a "bottom dollar payment obligation." Specifically, a payment obligation would be disregarded for purposes of determining whether a partner bears the EROL for a partnership liability if "the facts and circumstances evidence a plan to circumvent or avoid the obligation."

The new proposed regulations provide a "non-exclusive list of factors that may indicate a plan to circumvent or avoid the payment obligation." Included in this list (among others) are the following: (1) the payment obligor is not subject to restrictions on transfers for inadequate consideration, (2) the partnership holds money or other liquid assets in excess of its foreseeable needs, (3) the terms of the partnership liability would be substantially the same without the payment obligation, and (4) limitations imposed on the creditor indicate a plan to delay collection from the payment obligor. A payment obligation would also be disregarded if "the facts and circumstances indicate that there is not a reasonable expectation" that the payment obligor would be able to make the required payments.

These new proposed regulations would apply to liabilities incurred or assumed by a partnership and to payment obligations undertaken after the proposed regulations are finalized.

Conclusions

Under the new temporary regulations, new bottom guarantees will be disregarded for purposes of liability allocation. The ability of partners to use guarantees as a tax-planning tool would be further inhibited if the new proposed regulations are finalized. The good news for taxpayers is that the anti-abuse rule in the new proposed regulations should be less rigid than the list of criteria from the withdrawn proposed regulations—and since it was included in proposed regulations it is not yet in effect at all. Stay tuned for further developments.