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Recently Proposed Treasury Regulations Regarding the Allocation of Partnership Recourse and Nonrecourse Liabilities Contain Significant Changes for Many Routine Partnership Transactions

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On January 29, 2014, the Internal Revenue Service ("IRS") and the Treasury Department issued proposed regulations[1] (the "Proposed Regulations") modifying the rules under Section[2] 752 regarding the allocation of recourse and nonrecourse partnership liabilities and clarifying some aspects of the disguised sale rules of Section 707. The Proposed Regulations would make significant changes to the rules for allocating partnership liabilities among partners, including imposing a "net value" requirement on partners to whom liabilities are allocated and ignoring "bottom-dollar" guarantees in determining whether debt is recourse to the guarantor. In addition, the proposed regulations eliminate two of the alternative methods of allocating certain nonrecourse liabilities and replace those with a new method focusing on the partners' relative liquidation values in the partnership. Although some aspects of the Proposed Regulations are helpful, the provisions regarding bottom-dollar guarantees and allocations of recourse and nonrecourse liabilities, if enacted as proposed, represent a significant change from current law and could create significant challenges for many common partnership structures.

Overview of Allocations of Recourse and Nonrecourse Liabilities under Current Law

General Rules

Section 752(a) treats any increase in a partner's share of partnership liabilities as a contribution of money by such partner to the partnership. Conversely, a decrease in a partner's share of partnership liabilities is treated as a distribution of money to the partner by the partnership. Partnership liabilities are subject to different allocation rules depending on whether they are treated as recourse or nonrecourse liabilities. In general, recourse liabilities are allocated to the partner(s) that bear the risk of loss while nonrecourse liabilities are allocated among all partners based on how they share profits.

Treasury Regulations Section 1.752-1 generally defines a recourse liability as any partnership liability to the extent that any partner bears the economic risk of loss for that liability. A partnership liability is generally treated as nonrecourse liability to the extent that no party bears the economic risk of loss for that liability.

Under Treasury Regulations Section 1.752-2, a partner's share of recourse partnership liability is generally an amount equal to the portion of the liability for which the partner bears the economic risk of loss. A partner generally bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner

[1] *See* REG-119305-11, which is available at http://www.ofr.gov/OFRUpload/OFRData/2014-01637_PI.pdf.
[2] All references to "Section" in this client alert refer to Sections of the Internal Revenue Code unless otherwise specified.

would be obligated to make a payment to any person (or a contribution to the partnership) and would not be entitled to reimbursement from another partner. For purposes of determining whether a partner has a payment obligation and the economic risk of loss, Treasury Regulation Section 1.752-2 assumes that all partners who have obligations to make payments will actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate otherwise.

Nonrecourse liabilities on the other hand are allocated among partners based on a three-tier structure under Treasury Regulations Section 1.752-3. First, each partner is allocated nonrecourse liability in an amount equal to his share of partnership minimum gain. Second, each partner is allocated nonrecourse liabilities in an amount equal to the taxable gain (if any) that would be allocated to the partner under Section 704(c) if the partnership were to dispose of all partnership property that is subject to nonrecourse liability in full satisfaction of the nonrecourse liabilities and for no other consideration. Third, any excess amount of nonrecourse liability is allocated among the partners in accordance with their shares of partnership profits. Under the current rule, an allocation of nonrecourse liabilities generally is treated as consistent with a partner's share of partnership profits if it is in accordance with allocations of some other significant item of partnership income (the so-called "significant item method") or in accordance with the allocation of deductions with respect to the nonrecourse liabilities. Accordingly, if the allocation conforms to the allocation of another single significant item, it should be respected.

Certain IRS Concerns In Connection with Current Debt Allocation Rules

One motivation for the proposed changes in the allocation of recourse and nonrecourse liabilities has been the perceived abuses of certain leveraged partnership transactions which involve guarantees of partnership debt by undercapitalized taxpayers.[3] Taxpayers owning real estate and other property with large built-in gains have used leveraged partnership transactions to get some liquidity with respect to their investments. In these transactions, a newly-formed partnership to which the taxpayer contributes property will borrow against the equity in the appreciated property and then distribute all or a portion of the amount borrowed to the contributing partner. If properly structured, these transactions may permit the taxpayer to monetize its investment in the property without the recognition of the built-in gain. For the leveraged partnership structure to be respected, the loan must be properly allocable to the partner benefiting from the debt so that it is treated as a debt financed transfer under Treasury Regulations Section 1.707-5(b)(1). Under the current Treasury Regulations, if the contributor guarantees the debt, the debt will be treated as recourse to the contributor, the contributor's tax basis in its partnership interest will be increased by the amount of the debt guaranteed and the contributor will not recognize gain in connection with the distribution. One of the primary concerns of the IRS regarding leveraged partnership transactions has been the use of guarantees by entities with little net worth to avoid gain recognition while bearing little effective risk of loss.

The IRS has also been critical of "bottom-dollar" loan guarantees, in which a partner guarantees only the least risky portion of the debt (*i.e.*, the last dollar or dollars), claiming that such guarantees are used inappropriately for tax planning to shift economic risk of loss for partnership liabilities to a partner who needs the basis. A "bottom-dollar" guarantee usually provides that the guarantor is not obligated to make any payments until all attempts to collect from the borrower have failed to produce gross proceeds to the lender of a specified minimum amount. Thus, the guarantor will have

[3] *See, e.g.*, *Canal Corp. v. Comm'r*, 135 T.C. 199 (2010) (Court held that guarantee should not be respected based on the undercapitalization of the taxpayer, the low likelihood of the taxpayer being required to make an indemnity payment, and the fact that the lender did not request the taxpayer to guarantee the debt); CCA 201324013 (Jun. 14, 2013).

economic exposure under the guaranty only to the extent the value of the collateral declines below such specified amount.

Bottom-dollar guarantees are routinely used in real estate and other partnerships to prevent unintended gain recognition for tax purposes. For example, where a partner contributes significantly depreciated property to an operating partnership in an UPREIT structure and the property is secured by a mortgage, the partner can avoid gain recognition that would otherwise result from the liabilities securing the contributed property being shifted to the other partners by guaranteeing a portion of this debt. By structuring the guarantee as a bottom-dollar guarantee, the partner is taking on real economic risk but the amount of this risk is mitigated by the limited nature of the guarantee.

Summary of the Proposed Regulations

Recourse Liabilities

Although the Proposed Regulations do not alter the basic rule for determining a partner's share of a partnership recourse liability based on the extent to which the partner bears the economic risk of loss, the Proposed Regulations would significantly alter the status quo by imposing a number of additional requirements that a partner must satisfy in order to establish that it actually bears the economic risk of loss for a particular partnership liability.

The Proposed Regulations require that partner guarantees, indemnifications and reimbursement agreements, as well as any obligations to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership, satisfy a multi-factor test designed to ensure that the partner has a bona fide payment obligation with respect to the liability, if they are to be taken into account for these purposes.[4] First, a partner must maintain a "commercially reasonable" net worth throughout the term of the payment obligation or, alternatively, be subject to restrictions that would limit transfers of assets for "inadequate consideration."[5] Second, a partner must periodically provide commercially reasonable documentation regarding its, or a related person's, financial condition.[6] Third, the term of the partner's payment obligation may not end prior to the term of the liability.[7] Fourth, the primary obligor cannot be required to hold cash or other liquid assets that exceed an amount reasonably necessary to service the liability.[8] Fifth, the partner must receive an arm's length payment for assuming the payment obligation.[9] Sixth, in the case of a guarantee, the partner must be liable for the full amount of the partnership liability if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. Accordingly, bottom-dollar guarantees would not be respected for purposes of determining whether debt is recourse to a partner.

With respect to the sixth requirement, where the partner has a right to be reimbursed or indemnified for any portion of that guarantee, no matter how small, the partner cannot be treated as bearing the economic risk of loss for *any* portion of the liability guaranteed by the partner.[10] If an indemnity or other reimbursement agreement by a partner is itself subject to a further indemnity or right of reimbursement (whether or not the secondary indemnity or right of reimbursement otherwise meets the payment obligation requirements), then the partner also cannot be treated as bearing the economic risk of loss for any portion of the liability.[11] There is a limited exception from this rule for rights of contribution running between

[4] Prop. Treas. Reg. § 1.752-2(b)(3)(i)(A), (B).
[5] Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(A).
[6] Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(B).
[7] Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(C).
[8] Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(D).
[9] Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(E).
[10] Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F); Prop. Treas. Reg. § 1.752-2(f), Example 11.
[11] Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(G).

partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.

The Proposed Regulations also add a "net value" requirement for partners other than individuals or a decedent's estate. Under the net value rule, a partner's payment obligation will be recognized only to the extent of that partner's net value as of the date the partnership liability is first allocated as well as on any subsequent "testing date." The definition of net value is linked to the existing rules applicable to disregarded entities under Treasury Regulations Section 1.752-2(k) and generally is defined as the fair market value of all assets that may be subject to creditors' claims under local law, less obligations of the partner that do not constitute payment obligations.[12]

Finally, the Proposed Regulations provide transitional rules for a partner whose allocable share of the partnership recourse liabilities exceeds its adjusted basis in its partnership interest on the date the proposed regulations are finalized.[13] Under this transition rule, a partner can continue to apply the existing regulations for a seven-year period to the extent of such excess.[14] In addition, the amount of partnership liabilities that may be grandfathered will be reduced for certain reductions in the amount of liabilities allocated to that partner under the transition rules.[15]

Nonrecourse Liabilities

The Proposed Regulations significantly limit the manner in which third-tier, excess nonrecourse liabilities may be allocated. Under the proposal, excess nonrecourse liabilities may only be allocated based upon the partner's interest in partnership profits, because, according to the IRS and the Treasury Department, other methods may not properly reflect the overall economic arrangement of the partners.[16]

The Proposed Regulations provide a "safe harbor" where a partnership agreement provides that the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities are calculated in accordance with the partners' "liquidation value percentages."[17] A partner's liquidation value percentage is the ratio of the liquidation value of the partner's interest in the partnership to the liquidation value of all of the partners' interests in the partnership.[18] The Proposed Regulations also provide that the liquidation value of a partner's interest in a partnership is the amount of cash the partner would receive if, immediately after formation of the partnership or the occurrence of certain revaluations of property, the partnership sold all of its assets for cash equal to the fair market value of the property, satisfied all of its liabilities, paid an unrelated third party to assume certain liabilities in a fully taxable transaction and then liquidated.[19]

Technical Amendments to "Disguised Sales" Rules:

The Proposed Regulations also provide certain amendments, largely technical in nature, to the "disguised sales" rules under Section 707. Specifically, the Proposed Regulations clarify various aspects of the "disguised sales" rules relating to debt-financed distributions, preformation expenditures, qualified liabilities in a trade or business, anticipated reductions in liabilities, tiered partnerships, treatment of liabilities in an assets-over merger and disguised sales of property by a

[12] Treas. Reg. § 1.752-2(k)(2).
[13] Prop. Treas. Reg. § 1.752-2(l)(2).
[14] Prop. Treas. Reg. § 1.752-2(l)(2).
[15] Prop. Treas. Reg. § 1.752-2(l)(2).
[16] Prop. Treas. Reg. § 1.752-3(a)(3).
[17] Prop. Treas. Reg. § 1.752-3(a)(3).
[18] Prop. Treas. Reg. § 1.752-3(a)(3).
[19] Prop. Treas. Reg. § 1.752-3(a)(3).

partnership to a partner.

Potential Issues under the Proposed Regulations

Net Value Requirement

The Proposed Regulations move away from the presumption that a partner's "economic risk of loss" is determined assuming that "all partners and related persons who have obligations to make payments actually perform those obligations." Instead, the Proposed Regulations provide that a partner will only be deemed to have a risk of loss if it has sufficient net worth to be able to pay the guarantee. In determining "net value," the Proposed Regulations require periodic valuations at the time of, among other events, a contribution, distribution or sale of property by the guarantor based on a complicated set of rules already in existence for determining the "net value" of disregarded entities. As a result, if adopted, the net value requirement will impose significant costs and administrative burdens upon partners and will require partners to provide potentially sensitive or confidential information to the partnerships in which they invest.

Elimination of Bottom-Dollar Guarantees

The Proposed Regulations disregard any "bottom-dollar" guarantee and contain a broad view of the definition of a bottom-dollar guarantee in that they treat any guarantee other than a guarantee of 100% of the relevant liability as a prohibited "bottom-dollar" guarantee. Strangely, the Proposed Regulations also treat as an impermissible guarantee, a guarantee of 100% of the partnership's liability where there are other arrangements that effectively split the economic risk of loss arising from the guarantee among multiple parties. As a result, having another partner agree to reimburse the guarantor for a portion of the amount it guarantees results in the entire guarantee being disallowed even though the guarantor is unconditionally liable for the portion of the debt for which it is not entitled to reimbursement. It is not clear that having such a broad prohibition makes sense in light of the fact that such guarantees are commonly used in ordinary non-abusive commercial transactions with partners negotiating at arms' length. Moreover, many customary loan transactions not involving partnerships involve bottom-dollar guarantees or guarantees by multiple guarantors. If the Proposed Regulations are adopted in their current form, this is one area in which the 7-year transition rule in the Proposed Regulations could be very important.

Change in Rules for Allocating Nonrecourse Liabilities

The changes in the Proposed Regulations with respect to the allocation of nonrecourse liabilities are of significant concern. Having a "safe harbor" based on liquidation value that must be updated upon the occurrence of certain events, including certain issuances of additional partnership interests to new or existing partners or certain redemptions of partnership interests, is administratively challenging, particularly given the complexity of running through the liquidation value analysis. As a result, the safe harbor may be unavailable for many partnerships that cannot bear the compliance costs. By removing the alternative methods for determining partnership liabilities, the Proposed Regulations create significant uncertainty with respect to whether allocations of third-tier nonrecourse liabilities will be respected.

Moreover, it is not at all clear that the use of liquidation value as the safe harbor test for allocating excess nonrecourse liabilities is a proper surrogate for reflecting partners' interests in the partnership. For example, in a partnership that has issued profits interests, a partner with a profits but no capital interest will have a right to share in the partnership's profits even though it would not receive anything under a liquidation value analysis at the time the interest is granted. In addition, it is not clear how to apply this rule if the partnership uses a "forced allocation" regime. As a result, since the liquidation value may be inappropriate as a proxy for determining a partner's interest in the partnership, it is unclear why it should be utilized as the sole safe harbor for purposes of the nonrecourse debt allocation rules.

Requiring Payment for Providing a Guarantee

Among the factors that must be present in order for a payment obligation with respect to a partnership liability to be respected are that a partner must receive arm's length consideration in exchange for assuming the payment obligation. This rule stems from a concern that under current rules related parties enter into payment obligations that are not commercial in order to achieve a particular allocation of a partnership liability. However, in normal commercial practice, related parties (such as affiliated corporations) regularly enter into payment guarantee arrangements without requiring compensation to be paid to the issuer of the guarantee for reasons wholly unrelated to tax consequences. A requirement that all payment obligations be compensated with arm's length consideration will result in the tax laws distorting otherwise generally accepted commercial practices.

Transition Rules

The Proposed Regulations apply to liabilities incurred or assumed by a partnership and to payment obligations imposed or undertaken with respect to a partnership liability after the Proposed Regulations become final. Once the Proposed Regulations become effective, partners will have some transitional relief under Proposed Treasury Regulations Section 1.752-2, which allows partners to apply the prior Treasury Regulations for a period of seven years in respect of any partner whose allocable share of partnership liabilities exceeds its adjusted basis in its partnership as of the effective date of the Proposed Regulations. This rule permits the partnership to apply the old Regulations to each partner only with respect to the "grandfathered amount" – the amount that the partner's allocable share of partnership liabilities exceeds its adjusted tax basis as of the effective date of the Proposed Regulations. The grandfathered amount can be reduced by tax gain allocated to the partner as well as decreases in the partner's allocated share of liabilities.

The transitional rule under the Proposed Regulations may be difficult to administer in practice because of its complexity. In addition, seven years likely will prove to be an insufficient relief period for many classes of taxpayers, including publicly traded REITs and UPREITs.

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