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IRS Introduces Long-Awaited Proposed Regulations Addressing the Allocation of Partnership Liabilities and Partnership Disguised Sales

On January 29, 2014, the Internal Revenue Service (the IRS) and the Treasury Department (Treasury) introduced a long-awaited package of proposed regulations (the Proposed Regulations) that would significantly change the rules for allocating partnership liabilities among partners and address a number of issues under the partnership disguised sale rules. Of particular note, the Proposed Regulations would modify the rules that apply to partner guarantees of partnership liabilities, including so-called “bottom-dollar guarantees.” Among other things, the Proposed Regulations would require most partner-guarantors to maintain a net worth equal to the amount of any payment obligation for its guarantee to be respected in full. According to the preamble to the Proposed Regulations, the IRS and Treasury are concerned about partners entering into guarantee or indemnity arrangements “that are not commercial solely to achieve an allocation of a partnership liability to such partner.” The Proposed Regulations also would significantly reduce the flexibility that exists for allocating so-called “nonrecourse liabilities” and clarify certain technical issues under the disguised sales rules that previously had been uncertain. The Proposed Regulations only would apply prospectively from the date that they are finalized, and the IRS and Treasury have made it clear that they will welcome comments on all aspects of the Proposed Regulations.

The Current Regulations

A comprehensive set of regulations currently addresses the allocation of the liabilities of a partnership to its partners. In general, an increase in the allocation of liabilities to a partner results in a deemed capital contribution by the partner to the partnership and a corresponding increase in the partner’s basis in its partnership interest. A decrease in the allocation of liabilities to a partner results in a deemed distribution by the partnership to the partner and a corresponding reduction in the partner’s basis in its partnership interest and/or the recognition gain to the extent the deemed distribution exceeds such partner’s tax basis. Accordingly, the allocation of the liabilities of a partnership to its partners can have significant consequences to partners in a partnership, including the recognition of phantom taxable gain.

The current disguised sale regulations (together with the current partnership liability allocation regulations, the Current Regulations) treat property contributions by a partner to a partnership and distributions by the partnership to the partner as taxable sales if such transactions are in substance sales of property by a partner to a partnership, rather than separate (potentially tax-deferred) contributions and distributions. The regulations include a comprehensive facts-and-circumstances test for making such a determination, including a presumption that if a partner contributes assets to a partnership and receives a distribution of cash from the partnership within two years of the contribution, the transaction represents a taxable sale of the contributed assets, unless the facts and circumstances indicate otherwise. The disguised sale regulations also address issues relating to a partnership’s assumption of partner debt in connection with a property contribution by the partner to the partnership. In general, debt assumed by the partnership that was incurred more than two years prior to the property contribution or that was otherwise incurred in the ordinary course of business constitutes a "qualified liability" and does not implicate the disguised sale rules.[1] Alternatively, partner debt assumed by the partnership in connection with a property contribution that does not constitute a qualified liability will result in a disguised sale to the extent that the amount of such liability exceeds the partner's allocable share of the partnership liability under the partnership liability allocation rules, with certain modifications. Similarly, among the exceptions to the general two-year presumption for contributions and distributions referenced above, there is a rule for certain debt-financed distributions by a partnership to a partner, which provides that the proceeds of a newly incurred partnership liability received by a partner from the partnership only are taken into account as sale proceeds for purposes of the disguised sale rules to the extent the distribution exceeds the partner's allocable share of the partnership liability under the partnership liability allocation rules. In general, to the extent the debt-financed distribution rule applies and the entire amount of the relevant partnership liability is allocated to the contributing partner, the partner can defer recognizing taxable gain as a result of the distribution until the liability is repaid, the partner sells its interest in the partnership or the partnership sells the contributed property.

The disguised sale rules also apply similar principles to determine whether property distributions by a partnership to a partner and related contributions by the partner to the partnership should be characterized as taxable sales by the partnership, rather than (potentially tax-deferred) distributions and contributions. In this regard, the Current Regulations provide that if, in connection with a partnership's transfer of property to a partner, the partner assumes, or takes the property subject to, a liability that is not a qualified liability, the partnership will be treated as receiving taxable consideration to the extent the amount of such liability exceeds the partner's share of the liability immediately before the transfer.

The Current Regulations generally divide partnership liabilities into "recourse" and "nonrecourse" liabilities. A liability is considered "recourse" to a partner and is accordingly allocated to the partner to the extent the partner bears the "economic risk of loss" with respect to the liability. This determination is based upon whether the partner would be obligated to make a nonreimbursable payment to any person (or contribute money to the partnership) to satisfy the liability in the event the partnership's assets became worthless and the liability became due in full. Subject to an anti-abuse rule and an exception for disregarded entities lacking sufficient net worth, a partner is deemed to satisfy its obligation with respect to a guaranteed liability, regardless of its actual net worth.

In the IRS' and Treasury's view, the allocation regime that applies to recourse liabilities allows partners to enter into guarantees of (and other similar arrangements relating to) partnership liabilities that lack commercial reality and are entered into solely to achieve a liability allocation to the partner that qualifies for the debt-financed distribution exception to the disguised sale rules or otherwise avoids current gain recognition, while minimizing the partner's actual economic risk of loss with respect to the liability.[2] These arrangements have included a thinly capitalized partner providing a guarantee, or as a condition to guaranteeing a partnership liability, a partner requiring the partnership to maintain cash or liquid securities with a value in excess of the liability. In addition, partners frequently enter into so-called

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1 A "qualified liability" generally includes a liability that (i) was incurred more than two years prior to the contribution and has encumbered the contributed property throughout the two-year period prior to the contribution, (ii) was not incurred in anticipation of the contribution but was incurred within two years of the contribution, (iii) is allocable to capital expenditures made with respect to the property or (iv) was incurred in the ordinary course of the trade or business in which the property contributed to the partnership was used, but only if all assets related to the trade or business are contributed to the partnership other than assets that are not material to the continuation of the business. Treas. Reg. § 1.707-5(a)(6). The Proposed Regulations also include certain technical changes to the definition of qualified liability.

2 *See, e.g., Canal Corporation v. Comm'r,* 135 T.C. 199 (2010) (Tax Court held that a partner's guarantee in the context of a so-called "leveraged partnership" transaction should not be respected where the partner-guarantor was undercapitalized vis-a-vis the liability and had no contractual requirement to maintain a minimum net worth).

"bottom-dollar guarantees," where a partner-guarantor is not obligated to make a payment to a lender (or other indemnitee) unless it first fails to collect from the partnership a specified minimum amount, which might be a fraction of the full amount of the partnership liability to a third party. For example, a partner could agree to guarantee up to $25 of a $100 partnership liability (which is secured by $150 of assets) and such a guarantee only would apply if the lender failed to collect at least $25 from the partnership in the case of a default. Under the Current Regulations, a partner is generally allocated the full guaranteed amount of the liability, even if the economic risk being borne is quite remote.

If no partner bears the economic risk of loss with respect to a partnership liability under the "economic risk of loss" test described above, the liability is considered "nonrecourse." Nonrecourse liabilities are allocated among the partners under a three-tier waterfall.[3] Under the Current Regulations, the third tier in the waterfall generally is intended to allocate so-called "excess nonrecourse liabilities" in the same manner in which partnership income is allocated, however, the regulations provide significant flexibility by allowing partners to allocate such liabilities in the same manner as "some other significant item of partnership income or gain" or alternatively in accordance with the manner in which deductions attributable to the liability are reasonably expected to be allocated. This flexibility to allocate nonrecourse liabilities among partners, including the ability to match the liability allocation to a special allocation of an item of partnership income or gain, even if such a special allocation represents a relatively small portion of the partnership's overall operations, can provide partners with the ability to allocate excess nonrecourse liabilities in a manner that is not entirely consistent with their interests in the partnership.

The Proposed Regulations

Recourse Liabilities

The Proposed Regulations would significantly modify the rules for determining whether a partner bears the economic risk of loss with respect to a partnership liability and, therefore, can be allocated such liability. Specifically, the Proposed Regulations would impose six new requirements, each of which must be satisfied for a partner's (or related person's) guarantee of a partnership liability to be recognized and respected. In addition, partners (notably, other than individuals and estates) would be required to maintain a minimum net value during the entire term of the payment obligation. The stated impetus behind the approach taken in the Proposed Regulations is the IRS' and Treasury's concern that some partners (or related persons) have entered into guarantee arrangements that are not commercial solely to achieve an allocation of partnership debt. In certain respects, the Proposed Regulations could be viewed as a codification of certain of the positions asserted by the IRS, and accepted by the Tax Court, in *Canal*.

1. The partner (or related person) must maintain a commercially reasonable net worth for the entire term of the payment obligation or must be subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration.

2. The partner (or related person) must periodically document its financial condition.

3. The term of the partner's (or related person's) payment obligation must not end prior to the term of the guaranteed partnership liability.

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3 In general, the three tiers are (i) the partner's share of partnership "minimum gain" attributable to the liability, (ii) the amount of gain that would be allocated to the partner under Section 704(c) if the partnership made a taxable disposition of all partnership property subject to the nonrecourse liability in exchange for no consideration other than relief from the nonrecourse liability, and (iii) the partner's share of partnership profits or the items of deduction expected to be attributable to the nonrecourse liability.

4. The partner's payment obligation must not require that the partnership or any other obligor under the partnership liability hold money or other liquid assets in an amount that exceeds that person's reasonable needs.

5. The partner must receive arm's-length consideration in exchange for assuming the payment obligation.

6. The partner must be liable for no less than the full amount of the payment obligation. This last requirement effectively requires that the partner be liable for any losses incurred by the lender or indemnitee up to the amount of the partner's guarantee and would prevent the use of a bottom guarantee (referred to above) and a "vertical slice" guarantee, where a partner guarantees only a portion of each dollar of the partnership liability.

In addition, the Proposed Regulations would largely eliminate the sometimes unrealistic presumption under the Current Regulations that a partner will satisfy its payment obligations regardless of its actual net worth, and instead provide that a partner is presumed to satisfy its payment obligation only to the extent of the partner's net value. The net value of the partner for these purposes equals (i) the fair market value of all assets owned by the partner that may be subject to creditors' claims under local law (excluding the partner's interest in the partnership for which the net value is being determined and the net fair market value of any property pledged to secure a liability of the partnership), less (ii) all of the obligations of the partner that do not constitute payment obligations under the existing liability allocation rules. Unlike the six requirements discussed above, this net value requirement does not take an "all or nothing" approach, but instead a partner's failure to meet the net value requirement generally will result in a reduction in the partner's debt allocation only to the extent of the amount by which the guaranteed or indemnified liability exceeds the partner's net value. The determination of a partner's share of partnership liabilities must generally be made whenever necessary to determine the taxable income of the partners, including the end of the partnership's taxable year. The net value requirement would not apply to partners (or related persons) that are individuals or estates "because of the nature of personal guarantees," although the IRS and Treasury has requested comments on whether this requirement should be extended to cover individuals and estates in final regulations.

Nonrecourse Liabilities

The Proposed Regulations also would modify the manner in which nonrecourse liabilities are allocated. As discussed above, under the Current Regulations nonrecourse liabilities are allocated among the partners through a three-tier waterfall where a partnership and its partners have significant flexibility to allocate excess nonrecourse liabilities. Under the Proposed Regulations, the allocation of excess nonrecourse liabilities generally would be made in accordance with the partners' "liquidation value percentages," and the option to allocate these liabilities in accordance with a "significant item" or under the alternative method relating to deductions resulting from the liability would be eliminated. A partner's liquidation value percentage is the ratio (expressed as a percentage) of (i) the amount the partner generally would be entitled to receive from the partnership in the event the partnership sold all of its assets for their fair market values, satisfied all outstanding liabilities and liquidated, to (ii) the aggregate amounts all partners would be entitled to receive under this deemed sale and liquidation approach. A partner's liquidation value percentage would need to be redetermined upon the occurrence of a "book-up" (*i.e.*, revaluation) event under the Section 704(b) regulations (regardless of whether the partnership chooses to actually book-up capital accounts). The IRS believes that this liquidation model better reflects a partner's share of partnership profits that are used to repay partnership liabilities than the allocation of a significant item of income or gain or the alternative method, which may not reflect the overall economic arrangement of the partners.

Disguised Sales of Appreciated Property by Partnership to Partners

The IRS and Treasury indicated that they are studying whether it may be inappropriate to take into account a transferee partner's share of a partnership liability immediately prior to a distribution of appreciated property subject to such partnership liability (or where such liability is otherwise assumed by the partner) if such partner "did not have economic exposure with respect to the partnership liability for a meaningful period of time" prior to such distribution. For example, assume a partner holding a partnership interest worth $100 negotiates with the partnership to be redeemed out of the partnership for appreciated property with a value of $200, subject to $100 of partnership debt, which was incurred by the partnership in contemplation of, and shortly before, the redemption of the partner. Under the Current Regulations, if the partner guarantees the entire amount of such debt (or existing nonqualified partnership debt that it ultimately assumes in connection with the redemption) shortly before the distribution, all of the debt would be allocated to the partner and there arguably would be no partnership-to-partner disguised sale because the partner's share (*i.e.*, 100 percent) of the liability immediately prior to the distribution equaled the amount of the liability assumed by the partner in the transaction. The IRS and Treasury indicated that they are considering a rule that would look to "the partner's lowest share of the liability within some meaningful time, for example, 12 months."

Certain Other Technical Changes to the Disguised Sale Rules

The Proposed Regulations also would clarify certain technical issues under the disguised sales rules that had previously been uncertain. For example, the Proposed Regulations would clarify that the exception from disguised sale treatment for certain reimbursements of preformation capital expenditures that do not exceed 20 percent of the fair market value of the property contributed to the partnership is applied on a "property-by-property" basis, to the particular property for which the expenditures were made, and thus the values of all "property contributed to the partnership" are not aggregated for purposes of this exception. In addition, the Proposed Regulations would introduce an ordering rule, pursuant to which the exception to the disguised sale rules for debt-financed distributions is applied before applying certain other exceptions to the disguised sale rules.

Observations

Recourse Liabilities

The Proposed Regulations, if finalized in their current form, would be a dramatic departure from the Current Regulations and would have a significant impact on, and create significant uncertainties with respect to, a wide range of partnerships and partnership transactions, including so-called "leveraged partnerships," which rely upon an allocation of recourse debt to a partner that contributes appreciated property to a partnership and receives a related debt-financed cash distribution. In the context of leveraged partnership transactions where a contributing partner is converting a substantial portion of its equity in contributed property into cash, prudent planning without regard to the Proposed Regulations, particularly in light of the *Canal* case, would generally dictate using a well-capitalized guarantor with meaningful net worth in order to achieve the requisite degree of tax comfort that the guarantee would not be disregarded.

The Proposed Regulations would, however, appear to create unnecessary uncertainties for taxpayers trying to determine whether a guarantee arrangement will be recognized and respected by, among other things, focusing on the "commerciality" of the arrangement, requiring the payment of an arm's-length guarantee fee and limiting the guarantor's ability to ensure that the partnership (or other primary obligor) acts prudently in retaining a cash or other liquid asset cushion (which might arguably exceed the reasonable needs of the business), particularly because of the proposed all or nothing approach in which the entire guarantee would be disregarded if any of the six requirements described above is not satisfied.

The focus of the commerciality standards in the Proposed Regulations should be on the ability of the guarantor to satisfy its obligations as well as arrangements intended to artificially reduce or eliminate the guarantor's risk under the guarantee as opposed to whether a guarantee provides quantifiable credit enhancement to a lender or whether the guarantee would have been entered into absent tax considerations. In other words, as long as the guarantor maintains net worth that at least approximates the amount of debt that is guaranteed throughout the term of the partnership liability, this should constitute commercially reasonable net worth (and also should satisfy the net value requirement), regardless of whether a partnership default and/or possible enforcement action under the guarantee is quite remote because, for example, of the strong financial position of the partnership at the time the guarantee is entered into or whether the guarantee itself might not be demanded by the lender or provide quantifiable credit enhancement. Any other approach would be extremely difficult to administer with certainty and would be inconsistent with the approach of the Current Regulations, which assumes that the partnership's assets are worthless. In addition, guarantees are frequently provided in commercial settings where they provide no quantifiable credit enhancement.

Moreover, the Proposed Regulations do not provide any guidance on how to determine whether a guarantee fee is arm's-length.[4] Taxpayers may wish to retain a financial advisor to advise on the commercial terms of a partner guarantee, but it is unclear whether financial advisors would be willing to undertake such an assignment, whether comparables would be available and whether a taxpayer's determination would in any event be susceptible to challenge by the IRS. Moreover, the cost incurred and timing considerations in obtaining any such guidance may render the notion of retaining a financial advisor impractical. In any case, the IRS should consider including safe harbors when the regulations are finalized that would respect any reasonable determination by a financial advisor.

These concerns would be particularly acute in ordinary course partnership/joint venture arrangements where certainty and compliance considerations are paramount. The burden of complying with the approach of the Proposed Regulations and the vagueness of a number of the concepts would likely adversely impact the certainty that the Current Regulations promote. In this regard, it may be appropriate for the IRS to limit the scope of the six-factor test in circumstances involving ordinary course business transactions (*e.g.,* not involving a significant debt-financed distribution) where the issues which concern the IRS and Treasury are less apparent.

Another common structure, particularly in the real estate context, that effects the allocation of partnership liabilities, is for a partner to execute a bottom-dollar guarantee in favor of a lender or the partnership. Under a bottom-dollar guarantee, which generally should be respected under the Current Regulations, the partner-guarantor only is responsible to the extent the lender fails to recover from the partnership a specific minimum amount. Under the Proposed Regulations, however, any bottom-dollar guarantee, even for up to 99 percent of the amount of the liability, would not be respected and the entire amount of the liability would be treated as nonrecourse, notwithstanding a partner-guarantor's potentially significant exposure. The IRS and Treasury should consider whether

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4 In addition, guidance on the pricing of related-party guarantee fees under Section 482 is still pending, leaving taxpayers without any official guidance. *See* TD 9456 (July 31, 2009) ("The Treasury Department and the IRS intend to issue future guidance [under Section 482] regarding financial guarantees.").

it would be appropriate to limit this restrictive approach to cases where the bottom-dollar guarantee exposes the guarantor to a *de minimis* amount of risk or where the disguised sale rules otherwise would apply, but otherwise retain the rules under the Current Regulations.

Nonrecourse Liabilities

The proposed changes to the allocation of excess nonrecourse liabilities would eliminate the significant degree of compliance certainty that exists under the Current Regulations and is likely to create compliance burdens as well as unintended, adverse consequences, such as phantom gain to partners, as the relative capital accounts (and shares of partnership nonrecourse debt) of partners shift in the ordinary course of business. This is particularly likely to be the case with certain ongoing partnerships where there are multiple book-up events that could create changes in the relative liquidation value percentages of the partners over time.

On the other hand, it is at least arguable that, in the leveraged partnership context where the disguised sale rules generally apply, determining the contributing partner's allocable share of debt by reference to its relative capital account (which should be readily determinable at the time the transaction is entered into) should address many of the IRS' and Treasury's concerns with the Current Regulations where liabilities could be disproportionately allocated to a contributing partner based on some disproportionate allocation of a significant item of income or gain that does not reflect the partner's overall interest in the partnership. Accordingly, an approach that limits the significant changes referred to above to situations in which the disguised sale rules are implicated would serve the goal of protecting against perceived abuses and promote the certainty and flexibility of the Current Regulations in most ordinary course partnership transactions.

The full text of the Proposed Regulations is available at http://www.gpo.gov/fdsys/pkg/FR-2014-01-30/pdf/2014-01637.pdf.