New Regulations Dramatically Alter Partnership 'Disguised Sales' and Allocation of Partnership Liabilities

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Introduction

On October 4, 2016, the Internal Revenue Service and the Treasury Department issued a sweeping package of proposed, temporary and final regulations under the Internal Revenue Code that, among other things, significantly changes the rules related to the allocation of partnership liabilities and partnership "disguised sales." These rules eliminate the ability of taxpayers to defer taxable gain through the use of "bottom guarantee" structures and cut back sharply on the ability of taxpayers to execute tax-deferred "leveraged partnership" transactions.[1]

The new regulations will have an immediate and adverse impact on nearly all investors that use partnerships to carry out their business objectives, including many real estate investment trusts, private equity funds and public companies. In particular, the regulations will require a wholesale re-evaluation of all existing partnership structures, including a careful examination of existing guarantees and debt maintenance obligations. In addition, investors will have only until January 3, 2017, to initiate partnership contributions or leveraged partnership transactions with existing or soon-to-be-formed partnerships. Once this narrow window closes — or in some cases, even before it closes — the new regulations effectively preclude the ability of taxpayers to engage in debt-financed, leveraged partnership transactions. As a result, many taxpayers will be forced to choose between forgoing a business-driven transaction such as a joint venture or engaging in a transaction that triggers phantom taxable gain, even where the taxpayer is obligated to repay a debt.

Allocation of Partnership Liabilities Under Section 752, Elimination of 'Bottom Guarantees'

The regulations significantly modify the rules for determining whether a partnership liability is properly allocable to a partner. These rules are important because an allocation of liabilities to a partner can allow the partner to defer taxable income, while allocation of liabilities away from a partner gives rise to deemed cash distributions that can cause the partner to recognize taxable phantom income.

Partnership liabilities are generally divided 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.

Under prior law, a partner could guarantee a partnership liability and achieve an allocation of the guaranteed partnership liability to the partner-guarantor. Partners frequently entered into so called "bottom-dollar guarantees," which are commonplace in real estate lending transactions. The bottom-dollar guarantee would obligate a partner-guarantor to make a payment to a lender (or other indemnitee) if the lender failed to collect from the partnership a specified minimum amount. For example, a partner could agree to guarantee up to $25 of a $100 partnership liability (which was secured by $150 of assets),

[1] The new rules follow a set of proposed regulations that were issued on January 29, 2014, and discussed in our client alert "IRS Introduces Long-Awaited Proposed Regulations Addressing the Allocation of Partnership Liabilities and Partnership Disguised Sales."

The new regulations also address several other important partnership issues that are not addressed here in detail, including the treatment of preformation capital expenditures, the allocation of liabilities in tiered partnership structures and the allocation of recourse liabilities to partners.

meaning that the guarantee could be called upon by the lender only to the extent the lender failed to collect at least $25 from the partnership in the case of a default; if the lender collected $30 from the partnership, the partner would have no liability under the guarantee, and if the lender collected $20 from the partnership, the partner would be liable only for $5. Under prior law, a partner was generally allocated the liability to the extent of the guaranteed amount, even if the economic risk being borne was unlikely as a practical matter. Thus, in this example, the partner-guarantor would be allocated the $25 of guaranteed liability as well as some portion of the remaining $75 liability under the rules for allocations of nonrecourse liabilities (discussed below).

Under the new temporary regulations, partner-guarantors that use bottom-dollar guarantees (including certain economically similar arrangements, such as certain deficit restoration obligations) are generally not allocated any amount of the relevant partnership liability as a result of the guarantee, even where the partner-guarantor bears real economic risk. For example, in the scenario described above, the partner-guarantor will not be allocated any amount of the $25 of guaranteed liability as a result of the guarantee. Instead, the allocation regime for nonrecourse liabilities, discussed below, will generally apply to allocate the liability to the partners.

A liability is generally considered nonrecourse if no partner bears the economic risk of loss with respect to the liability. Nonrecourse liabilities are allocated among the partners under a three-tier waterfall. Under current law, the third tier is generally intended to allocate so-called "excess nonrecourse liabilities" in the same manner in which partnership profits are allocated. Nevertheless, the regulations retain significant flexibility by allowing partnerships to allocate such liabilities in the same manner as a "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. In the example above, assuming the partner-guarantor owned a 10 percent interest in partnership profits, the partner would generally be allocated only $10 of the $100 liability in the absence of the partnership's election to allocate liabilities under one of the alternative methods.

"First-dollar guarantees" (*i.e.*, guarantees on which a lender can seek payment of the guaranteed amount to the full extent of its failure to collect from the partnership) as well as "vertical-slice guarantees" (*i.e.*, where a partner guarantees only a portion of each dollar of the partnership liability) generally continue to result in an allocation of the guaranteed debt to the partner-guarantor. In addition, the new regulations continue to respect certain bottom-dollar indemnification arrangements where the full amount of the debt is guaranteed but up to the top 10 percent is indemnified and the partner-guarantor remains liable for at least 90 percent of the original obligation. But partner-guarantors that do not satisfy the foregoing exceptions to the new general rule for guarantees will be subject to a dramatically different allocation of liabilities than under prior law.

In addition, under proposed regulations issued in connection with the new final and temporary regulations, even first-dollar, vertical-slice and other guarantees exempted from the rules for bottom-dollar guarantees may in certain cases be disregarded under an anti-abuse rule. Under the proposed regulations' anti-abuse rule, which is similar but not identical to the anti-abuse rule contained in the 2014 proposed regulations and will be effective when finalized, factors are weighed to determine whether a payment obligation should be respected. Those factors include whether:

- the payment obligation is commercially reasonable;
- the partner is required to provide commercially reasonable documentation regarding its financial condition;
- the term of the payment obligation ends prior to the term of the partnership liability;
- the partnership holds money or liquid assets that exceed reasonably foreseeable needs;
- creditors are permitted to promptly pursue payment following default;
- the terms of the partnership liability would be substantially similar in the absence of the payment obligation; and
- the creditor received executed documents from the partner with respect to the payment obligation within a commercially reasonable period of time after the creation of the obligation.

The temporary regulations that disregard bottom-dollar guarantees are effective for liabilities incurred on or after October 5, 2016, with an exception for liabilities that have not yet been incurred but are subject to a written, binding contract entered into prior to October 5, 2016. Partners that executed bottom-dollar guarantees in the past will benefit from a transition rule that expires upon the earlier of the maturity date of the existing debt or seven years. Under the transition rule, to the extent a partner's allocable share of partnership liabilities exceeds its adjusted basis in its partnership interest on October 5, 2016, a partner may continue to apply the liability allocation rules under prior law for seven years, until the maturity date of the existing debt or until the partner zeroes out its negative capital account. Importantly, however, given that the most common term for real estate debt is 10 years, the benefits of the transition rule will expire before many current real estate loans mature. Partners eligible for transition relief should begin to plan for the expiration of the transition relief for all existing debt.

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Partnership Disguised Sales

The regulations also make sweeping changes to the congressionally sanctioned treatment of partnership liabilities specifically for purposes of the disguised sale rules.

Under the partnership disguised sale rules, when, in connection with a contribution of property to a partnership, the partnership assumes a liability (other than a "qualified liability" described below) of the contributing partner, the portion of the liability that is allocated away from the contributing partner and to other partners is generally treated as disguised sale proceeds that cause the contributing partner to recognize some portion of the gain in the contributed assets. In addition, if a partner contributes property to a partnership and within two years receives a cash distribution from the partnership, the distributed cash is also generally treated as disguised sale proceeds, subject to certain exceptions. Under the prior regulations, one of the primary exceptions to the disguised sale rules allowed contributing partners to defer phantom gain on the transfer of nonqualified liabilities to the partnership and to receive tax-deferred leveraged partnership distributions (*i.e.*, where a partnership borrows to fund a distribution to a partner) so long as, in each case, the contributing partner guaranteed the relevant liability.

The new temporary regulations drastically change these rules by treating all liabilities as nonrecourse liabilities for disguised sale purposes, even if the partner guarantees 100 percent of every dollar of the liability and is economically liable for repayment of the debt. As a result, an assumption by a partnership of nonqualified liabilities in connection with a property contribution will generally give rise to a disguised sale. In addition, non-*pro rata* leveraged partnership distributions made to a contributing partner within two years of a property contribution will, absent some other exception to the disguised sale rules, similarly give rise to a disguised sale without regard to any guarantee of the related liability, thus largely curbing the ability of taxpayers to achieve tax deferral through traditional leveraged partnership transactions.

The new regulations also affect the treatment of qualified liabilities that are transferred by a contributing partner to a partnership. Generally speaking, under the prior disguised sale rules, qualified liabilities — such as liabilities that were incurred more than two years prior to the contribution, liabilities attributable to capital expenditures on the contributed property and liabilities arising in the ordinary course of a contributed business — were given preferential treatment because the assignment of these liabilities by a contributing partner to a partnership were viewed as inherently nonabusive. Thus, these liabilities were subject to a pro-taxpayer general rule and a limited exception. Under the general rule, the shifting of a qualified liability by a contributing partner to a partnership did not create disguised sale proceeds. Under the exception, if the contributing partner also received additional consideration in the transaction — such as a cash distribution or a shifting of nonqualified liabilities — then a portion of the contributing partner's qualified liabilities would be treated as additional disguised sale proceeds. In practice, the exception rarely came into play, as parties would typically ensure that any cash distributions qualified for an exception to disguised sale treatment and that any nonqualified liabilities were fully guaranteed by the contributing partner.

Because the new regulations ignore guarantees of nonqualified liabilities for purposes of the disguised sale rules, taxpayers will face phantom taxable gain on every partnership contribution that involves the assignment of nonqualified liabilities, even if those liabilities are fully guaranteed by the contributing partner. Although the regulations provide a safe harbor that mitigates qualified liability gain recognition, the safe harbor is limited to situations in which the amount of nonqualified liabilities assumed is equal to or less than the lesser of 10 percent of the total amount of qualified liabilities assumed or $1 million. Practically speaking, in most large joint venture or property contribution transactions, taxpayers should assume that any transfer of nonqualified liabilities by the contributing partner to the partnership will trigger phantom gain recognition not only with respect to the nonqualified liabilities but also with respect to a portion of the qualified liabilities.

The temporary regulations related to the partnership disguised sale rules have a delayed effective date and are applicable to transactions where all transfers occur on or after January 3, 2017. Accordingly, investors intending to engage in partnership contributions or leveraged partnership transactions still have a window — albeit a narrow one — to initiate those transactions and avail themselves of the benefits of a guarantee, but only if the guarantee is a first-dollar or other guarantee that is respected under the new Section 752 regulations.

Implications

Although the new regulations apply to all partnerships regardless of their size or business model, the impact of the regulations is likely to be most adverse to businesses and public companies that grow through joint venture transactions and operate in sectors that involve long-lived assets, such as real estate, energy, natural resources and infrastructure. Simply put, for these businesses, the new regulations will require a fundamental re-evaluation of, and potential changes to, the structure underlying every acquisition and financing transaction, including joint ventures, roll-ups, UPREITs (umbrella partnership real estate investment trusts), "Up-Cs," MLP (master limited partnership) acquisitions and routine asset financings. These changes are likely to include the following:

- In recent years, many taxpayers have migrated significant portions (and in some cases, all) of their debt capital layers from secured, asset-level financing to secured or unsecured entity-level financings. The new regulations will prompt many businesses to consider a partial or complete return to the use of secured asset-level financing, as those types of arrangements will provide more flexibility to partners that wish to guarantee partnership debt and enter into joint venture transactions.
- When developing the structure of a business that holds multiple assets or lines of business, taxpayers are likely to consider holding assets through subsidiary partnerships rather than "disregarded entities" in order to increase operational and transactional flexibility, particularly if those assets or lines of business are likely to be contributed to a joint venture at some point in the future.
- If a taxpayer concludes that a particular asset or line of business will be debt financed and contributed to a joint venture in the future, the taxpayer is likely to leverage the asset or line of business on a secured basis as early in the business evaluation process as possible in order to maximize the opportunities for a future tax-deferred joint venture transaction.
- When structuring joint ventures or partnership contributions, parties are likely to consider using a combination of partnership-preferred interests, partner-level mezzanine financing and deferred distribution mechanics to replicate, in an admittedly second-best and less cost-efficient fashion, some of the results that could be achieved under prior law.

Additional Information

While it is impossible to predict all of the coming changes, the new regulations will undoubtedly alter the way leverage is used in partnership transactions. Please contact us if you would like additional information regarding any aspect of the new regulations.