Legal Alert: A New Way to Unwind (Leveraged Partnership Structures): Treasury and IRS Propose Draconian Changes to the Partnership Liability Allocation Rules

February 4, 2014

On January 29, Treasury and the IRS issued proposed regulations that would dramatically change the manner in which partnership liabilities are allocated among the partnership's partners under IRC § 752 (the Proposed Regulations). In brief, the allocation of liabilities under IRC § 752 impacts, among other things, a partner's ability to receive cash distributions (including debt-financed distributions) from a partnership without the recognition of gain and a partner's ability to utilize partnership losses. In view of the effects of IRC § 752, the changes contemplated by the Proposed Regulations have the potential to significantly alter the anticipated federal income tax consequences associated with partnerships that maintain even moderate amounts of leverage.

Sutherland Observation. As described in greater detail below, the Proposed Regulations offer what might best be described as a sea change in the rules governing the allocation of partnership liabilities among the partners of a partnership. On review, a not-so-subtle theme underlying the Proposed Regulations is that the ability of a partner to gain outside basis in the partner's interest in the partnership on account of obligating itself to satisfy some portion of the partnership's liabilities is somehow abusive. In succumbing to this shift in policy under IRC § 752, the Proposed Regulations dispense of an area of well-established law in one overly broad stroke.

The Proposed Regulations also address certain aspects of the disguised sale regulations under IRC § 707. The discussion below, however, focuses solely on the provisions of the Proposed Regulations pertaining to allocations of partnership liabilities under IRC § 752.

Proposed Changes to the Rules Governing Allocation of Recourse Liabilities

In general, a partnership liability is recourse to the extent that a partner or related person bears the economic risk of loss (EROL) and nonrecourse to the extent that no partner or related person bears the EROL. Under the existing regulations, a partner bears the EROL for a partnership liability to the extent the partner or a related person would be obligated to pay the liability without reimbursement from another partner or a person related to another partner if, in connection with a constructive liquidation of the partnership, all of the partnership's assets were worthless and all liabilities of the partnership became due and payable.

For purposes of determining whether a partner bears the EROL, all state law and contractual obligations of the partner, including guarantees, indemnities, and reimbursement obligations, generally are taken into account. Moreover, the existing regulations generally assume that all partners and related persons actually will satisfy their payment obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation (the satisfaction presumption).

Sutherland Observation. For purposes of determining and allocating partnership recourse

Related People/Contributors

- Reginald J. Clark
- Daniel R. McKeithen
- William R. Pauls
- David A. Roby, Jr.
- H. Karl Zeswitz
- William E. Sheumaker

Related Practices/Industries

- Federal Tax
- Insurance Taxation
- Tax

liabilities, the existing regulations adopt a test that seeks to determine which, if any, partner ultimately would be liable for the liability in a worst-case scenario. Under this test, an otherwise nonrecourse liability of the partnership that is guaranteed by a partner generally would be considered a recourse liability allocable to the guarantor-partner. Because the test assumes a worst-case scenario, this result generally follows regardless of whether the partner's guarantee is a top-dollar guarantee (i.e., a guarantee of the first dollar of the liability) or a bottom-dollar guarantee (i.e., a guarantee of the last dollar of the liability).

In the context of recourse liabilities, the Proposed Regulations would change the existing regulations in three significant respects:

- First, in determining and allocating partnership recourse liabilities, the Proposed Regulations recognize a contractual payment obligation of a partner (e.g., a guaranty, indemnity, reimbursement obligation, or other obligation) only if the obligation is "commercial," as determined based on a multi-factor test (described below).
- Second, for all partners or related persons other than individuals and decedent's estates, the Proposed Regulations eliminate the satisfaction presumption for payment obligations associated with liabilities other than trade payables and, in such circumstances, recognize a partner's or related person's payment obligation only to the extent of the partner's or related person's "net value" as of the allocation date.
- Third, under the Proposed Regulations, the payment obligation of a partner is disregarded if the partner has a right of reimbursement or contribution from any another person, as opposed to merely another partner or a person related to another partner.

A. Contractual Obligations Must Be "Commercial"

The preamble to the Proposed Regulations (the Preamble) makes it clear that Treasury and the IRS are concerned that, in some cases, a partner or related person may enter into a payment obligation (e.g., a guaranty, indemnity, reimbursement obligation, or other obligation) that is not "commercial" solely to achieve an allocation of a partnership liability to that partner. To address this concern, the Proposed Regulations provide a new rule under which obligations to make a payment with respect to a partnership liability (excluding obligations imposed by state law) will not be recognized unless the following seven factors are met:

- The partner or related person (i) is required to maintain a commercially reasonable net worth throughout the term of the payment obligation or (ii) is subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration.
- The partner or related person is required periodically to provide commercially reasonable documentation regarding the partner's or related person's financial condition.
- The term of the payment obligation does not end prior to the term of the partnership liability.

- The payment obligation does not require that the primary obligor or any other obligor with respect to the partnership liability directly or indirectly hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor.
- The partner or related person received arm's-length consideration for assuming the payment obligation.
- In the case of a guarantee or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. For this purpose, the terms of the guarantee or similar arrangement will be treated as modified by any right of indemnity, reimbursement, or similar arrangement regardless of whether that arrangement would be recognized by satisfying all of the requisite factors.
- In the case of an indemnity, reimbursement agreement, or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the indemnitee's or other benefitted party's payment obligation is satisfied. This factor can be satisfied only if—before taking into account the indemnity, reimbursement agreement, or similar agreement—the obligation that is subject to the indemnity, reimbursement agreement, or similar agreement itself satisfies all of the requisite factors (or would satisfy all of the factors if the obligation was an obligation of a partner or related person). Moreover, for purposes of this factor, the terms of the indemnity, reimbursement agreement, or similar arrangement will be treated as modified by any further right of indemnity, reimbursement, or similar arrangement regardless of whether that further arrangement would be recognized by satisfying all of the requisite factors.

Sutherland Observation. The intended purpose of the sixth and seventh factors is to prevent bottom-dollar guarantees and similar arrangements from being recognized for purposes of causing a partner to bear the EROL. As illustrated by the following examples, in applying the sixth and seventh factors, a slight change in the relevant facts can produce vastly different results.

Example 1: Assume that a partnership AB borrows $1,000 on a nonrecourse basis and that partner A guarantees up to $900 of the entire liability (i.e., A has a $900 top-dollar guarantee). Assume further that each of factors one through six is satisfied. In this case, $900 of the liability would be considered a recourse liability allocated to A.

Example 2: Assume the same facts as in Example 1, except that partner A's guarantee applies only if the bank recovers less than $900 (i.e., A has a $900 bottom-dollar guarantee). In this case, A's guarantee would fail the sixth factor. Consequently, A's guarantee would not be recognized for purposes of the EROL analysis, which means that none of the liability would be considered recourse as to A.

Example 3: Assume the same facts as in Example 1, except that partner B agrees to indemnify

A for up to $5 that A pays with respect to its guarantee. Assume further that each of factors one through six is satisfied in respect of B's indemnity obligation. In this case, B's indemnity satisfies the seventh factor because A's obligation under the guaranty would be recognized but for the effect of B's indemnity and B is obligated to pay A up to the full amount of B's indemnity if A pays any amount on its guarantee. Accordingly, $5 of the liability would be considered a recourse liability allocated to B. However, B's obligation is treated as modifying A's guarantee such that A is treated as liable for $895 only to the extent that any amount beyond $5 of the partnership's liability is not satisfied (i.e., B's indemnity effectively converts A's guarantee from a $900 top-dollar guarantee into an $895 bottom-dollar guarantee). As a result, A's guarantee does not meet the requirements of the sixth factor and, correspondingly, would not be recognized for purposes of the EROL analysis. Therefore, none of the liability would be considered recourse as to A.

To prevent taxpayer's from using structures to circumvent the rules with respect to bottom-dollar guarantees, the Proposed Regulations also amend the EROL anti-abuse rule in the existing regulations to address the use of intermediaries, tiered partnerships, or similar arrangements to avoid the bottom-dollar guarantee rules. In this regard, Treasury and the IRS have requested comments on other structures that may be used for this purpose and whether the final regulations should broaden the anti-abuse rules further.

B. Satisfaction Presumption Limited and Net Value Requirement Extended

Under the existing regulations, subject to an anti-abuse rule and a limited exception related to disregarded entities, the satisfaction presumption assumes that all partners and related persons actually will satisfy their payment obligations, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. In the case of a disregarded entity, the existing regulations modify this general rule by providing that the payment obligation of the disregarded entity is taken into account only to the extent of the net value of such disregarded entity. Thus, the single-member owner of a disregarded entity is treated as bearing the EROL for any payment obligation of such disregarded entity only to the extent of the net value of such disregarded entity (with the net value of the disregarded entity being determined without regard to the disregarded entity's interest in the partnership).

The Proposed Regulations eliminate the satisfaction presumption for all partners or related persons, except for individuals and decedent's estates, for payment obligations associated with liabilities that are not trade payables. In situations in which the satisfaction presumption is eliminated, the Proposed Regulations provide that the partner's or related person's payment obligation is recognized only to the extent of the partner's or related person's net value as of the allocation date. For this purpose, a partner or related person that is not a disregarded entity is treated as a disregarded entity in determining net value under the Proposed Regulations.

According to the Preamble, Treasury and the IRS considered further extending the net value requirement to partners and related persons that are individuals and decedent's estates, but decided not to do so because of the nature of personal guarantees. The Preamble acknowledges, however, that applying this less restrictive standard to individuals and decedent's estates may disadvantage other

entities that enter into partnerships with individuals or decedent's estates. Accordingly, Treasury and the IRS have requested comments on whether the final regulations should extend the net value requirement to all partners and related persons. Moreover, comments have been requested on the application of the net value requirement to tiered partnership structures.

C. Third-Party Reimbursement Rights

Under the existing regulations, a partner's payment obligation is disregarded if the partner has a right of reimbursement or contribution from another partner or a person related to another partner. The Proposed Regulations expand this rule so that a partner's payment obligation is disregarded if the partner has a right of reimbursement or contribution from any another person, as opposed to merely another partner or a person related to another partner.

Proposed Changes to the Rules Governing Allocation of Nonrecourse Liabilities

The existing regulations contain rules for determining a partner's share of a nonrecourse liability of a partnership, including the partner's share of excess nonrecourse liabilities under Treas. Reg. § 1.752-3(a)(3), which provides various methods to determine a partner's share of excess nonrecourse liabilities. Under one method, a partner's share of excess nonrecourse liabilities is determined in accordance with the partner's share of partnership profits. For this purpose, the partnership agreement may specify the partners' interests in partnership profits so long as the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the IRC § 704(b) regulations) of some other significant item of partnership income or gain (the significant item method). Alternatively, excess nonrecourse liabilities may be allocated among the partners in the manner that deductions attributable to those liabilities are reasonably expected to be allocated (the alternative method).

According to the Preamble, the allocation of excess nonrecourse liabilities in accordance with the significant item method or the alternative method "may not properly reflect a partner's share of partnership profits that are generally used to repay such liabilities because the allocation of the significant item may not necessarily reflect the overall economic arrangement of the partners." For this reason, the Proposed Regulations eliminate the significant item method and the alternative method.

The Proposed Regulations continue to allow the partnership agreement to specify the partners' interests in profits for purposes of allocating excess nonrecourse liabilities, provided that the interests so specified are in accordance with the partners' liquidation value percentages. For this purpose, a partner's liquidation value percentage generally is the ratio (expressed as a percentage) 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. Under this method, the partners' liquidation value percentages and the partners' allocable shares of excess nonrecourse liabilities are required to be redetermined upon any event that would permit the partnership to revalue its assets under Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5), even if no such revaluation actually occurs. These revaluation events include:

- A contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership;

- The liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership;
- The grant of an interest in the partnership (other than a de minimis interest) as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner;
- The issuance by the partnership of a noncompensatory option (other than an option for a de minimis partnership interest); and
- A revaluation under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

While the Preamble acknowledges that the liquidation value approach may not precisely measure a partner's interest in partnership profits, it states that the approach "is a better proxy than the significant item and alternative methods and is still administrable."

Sutherland Observation. The partners' liquidation value percentages generally are <u>not</u> a good proxy for the partners' interests in partnership profits except in very simple partnerships. For example, in any partnership involving any kind of profits interest, the partners' interests in partnership profits may be significantly different than their liquidation value percentages. Similarly, liquidation value percentages generally will not align with the partners' profits interests where the partners do not share equally in all activities of the partnership.

<u>Proposed Applicability Dates</u>

In respect of both recourse and nonrecourse liabilities, the Proposed Regulations would apply to liabilities incurred or assumed by a partnership on or after the date that they are published as final regulations in the Federal Register. In other words, it is anticipated that any final regulations would be applied prospectively, as opposed to the date starting with the issuance of the Proposed Regulations. The preamble states that Treasury and the IRS anticipate that the final regulations will permit a partnership to apply the provisions contained in the final regulations to all of its liabilities as of the beginning of the first taxable year of the partnership ending on or after the date the regulations are published as final regulations in the Federal Register.

The Proposed Regulations offer transitional relief for any partner whose allocable share of partnership liabilities treated as recourse under the existing regulations exceeds the partner's adjusted basis in its partnership interest on the date that the Proposed Regulations are finalized. Under this transitional relief, the partner can continue to apply the existing regulations for a 7-year period to the extent that the partner's allocable share of partnership liabilities exceeds the partner's adjusted basis in its partnership interest on the date that the Proposed Regulations are finalized.

Sutherland Observation. The transitional relief offered in the Proposed Regulations should provide taxpayers time to unwind transactions (e.g., leveraged partnerships) in which the taxpayer may have relied on a contractual payment obligation, such as a bottom-dollar guarantee, to support an allocation of recourse liabilities under the existing regulations.

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed or the Sutherland attorney with whom you regularly work.