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Replacing Certainty with Uncertainty-IRS Fumbles with the Final Regulations on Partnership Debt Guarantees

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The IRS has drafted a rule that contains a “factor test” which is completely contrary to common commercial practice.

On October 4, 2019, the IRS issued the final regulations concerning the treatment of partnership debt guarantees, including bottom dollar guarantees (BDGs). The final regulations were consistent with the temporary regulations that have been in place since 2016 and, to that extent, were anti-climactic. However, the IRS included in the final
regulations the provisions of the regulations that were proposed in 2016 concerning a "facts and circumstances" test which is to be applied in order to determine whether a guarantee would be respected for tax purposes (the "Factors Test"). The Factors Test had been severely criticized when it was proposed, but the IRS essentially included it unchanged in the final regulations.

It's football season, and the final regulations remind your authors of a long pass play in which the receiver catches the ball, avoids several tackles and sprints to the goal line, only to turn around a few steps before scoring to start his celebration and manages, as a result, to fumble the ball short of the end zone. The finalization of the temporary regulations concerning BDGs would be the pass completion-they were controversial in their own right, but this step was fully expected. The inclusion of the Factors Test in the final regulations, however, was the fumble at the goal line, because the inclusion of this rule in the final regulations was completely unexpected in light of their controversial nature and because the Factors Test is arguably contrary to Congress' intent.

Most importantly, as a limited example in the final regulations illustrates, the Factors Test will eliminate certainty concerning how debt is to be allocated if there is a guarantee with respect to the debt. Indeed, commercial guarantees that are otherwise approved by the regulations, such as a top-dollar guarantee or a pro-rata guarantee of a vertical slice of the loan, would fail to satisfy a majority of the factors set forth in the Factors Test, meaning that the IRS has drafted a rule that is completely contrary to common commercial practice. This is particularly problematic for partnerships which are required, on the one hand, to issue a K-1 to each partner indicating the amount of the recourse and nonrecourse debt allocated to such partner while, on the other hand, having no way to know how the Factors Test will be applied in any particular situation.

Background

On January 30, 2014, the Department of the Treasury (Treasury Department) and the IRS published a notice of proposed rulemaking in the Federal Register (REG-119305-11, 79 Fed. Reg. 4826) to amend the then-existing regulations under Section 707 relating to disguised sales of property to or by a partnership and under Section 752 concerning the treatment of partnership liabilities (2014 Proposed Regulations). The 2014 Proposed Regulations provided certain technical rules intended to clarify the application of the disguised sale rules under Section 707 and also contained rules regarding the sharing of partnership recourse and nonrecourse liabilities under Section 752.

The Treasury Department and the IRS received written comments on the 2014 Proposed Regulations. On October
5, 2016, after consideration of, and in response to, the comments on the 2014 Proposed Regulations, the Treasury Department and the IRS published in the Federal Register (81 Fed. Reg. 69,291) final regulations under Section 707 concerning disguised sales and under Section 752 regarding the allocation of excess nonrecourse liabilities of a partnership to a partner for disguised sale purposes (TD 9787). Also, on October 5, 2016, the Treasury Department and the IRS published in the Federal Register (81 Fed. Reg. 69,282) final and temporary regulations under Sections 707 and 752 (TD 9788) implementing a new rule concerning the allocation of liabilities for Section 707 purposes (707 Temporary Regulations) and rules concerning the treatment of “bottom dollar payment obligations” (752 Temporary Regulations). Finally, in the Federal Register (81 Fed. Reg. 69,301) on October 5, 2016, the Treasury Department and the IRS withdrew the 2014 Proposed Regulations under Reg. 1.752-2 and published new proposed regulations (REG-122855-15) cross-referencing the 707 Temporary Regulations (707 Proposed Regulations) and the 752 Temporary Regulations and addressing (1) when certain obligations to restore a deficit balance in a partner’s capital account are disregarded under Section 704, and (2) when partnership liabilities are treated as recourse liabilities under Section 752 (752 Proposed Regulations). On November 17, 2016, the Treasury Department and the IRS published in the Federal Register (81 Fed. Reg. 80,993 and 81 Fed. Reg. 80,994) two correcting amendments to TD 9788 (the temporary regulations as so corrected, 707 Temporary Regulations). The Treasury Department and the IRS received comments on the 752 Proposed Regulations (including comments from your authors).

In the Federal Register (83 Fed. Reg. 28,397) on June 19, 2018, the Treasury Department and the IRS subsequently withdrew the 707 Proposed Regulations, and published proposed regulations (REG-131186-17) proposing to reinstate the regulations under Section 707 concerning how partnership liabilities are allocated for disguised sale purposes that were in effect prior to the 707 Temporary Regulations.

This lengthy history of the 752 Proposed Regulations and the 752 Temporary Regulations is included here because these regulations were controversial, to say the least. The 752 Proposed Regulations and the 752 Temporary Regulations adopted an approach to liabilities that was contrary to the underlying “fabric” of the rules concerning allocation of liabilities in order to address a perceived potential abuse in determining whether a liability was a recourse liability or a nonrecourse liability for purposes of Section 752.

Section 752 separates partnership liabilities into two categories: recourse liabilities and nonrecourse liabilities. Reg. 1.752-1(a)(1) provides that a partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss (EROL) for that liability under Reg. 1.752-2. Reg. 1.752-1(a)(2) provides that a partnership liability is a nonrecourse liability to the extent that no partner or related person bears
the EROL for that liability under Reg. 1.752-2.

A partner generally bears the EROL for a partnership liability if the partner or related person has an obligation to make a payment to any person within the meaning of Reg. 1.752-2(b). For purposes of determining the extent to which a partner or related person has an obligation to make a payment, an obligation to restore a deficit capital account upon liquidation of the partnership under the Section 704(b) regulations is taken into account (deficit restoration obligation). Further, for this purpose, Reg. 1.752-2(b)(6) of the prior regulations presumes that partners and related persons who have payment obligations actually perform those obligations, irrespective of their net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation (the satisfaction presumption). However, the satisfaction presumption is subject to an anti-abuse rule in Reg. 1.752-2(j) pursuant to which a payment obligation of a partner or related person may be disregarded or treated as an obligation of another person if facts and circumstances indicate that a principal purpose of the arrangement is to eliminate the partner’s EROL with respect to that obligation or create the appearance of the partner or related person bearing the EROL when the substance is otherwise. Under these rules, the satisfaction presumption is also subject to a disregarded entity net value requirement under Reg. 1.752-2(k) pursuant to which, for purposes of determining the extent to which a partner bears the EROL for a partnership liability, a payment obligation of a disregarded entity is taken into account only to the extent of the net value of the disregarded entity as of the allocation date that is allocated to the partnership liability.

The Temporary Regulations

The final regulations mostly follow the 752 Temporary Regulations which were issued on October 5, 2016. The 752 Temporary Regulations provided that a bottom dollar payment obligation is not recognized as a payment obligation for purposes of Reg. 1.752-2. The 752 Temporary Regulations provided that a bottom dollar payment obligation is the same as or similar to one of the following three types of payment obligations or arrangements: (1) with respect to a guarantee or similar arrangement, any payment obligation other than one in which 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; (2) with respect to an indemnity or similar arrangement, any payment obligation other than one in which 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 benefited party’s payment obligation is recognized; and (3) an arrangement with respect to a partnership liability that uses tiered partnerships,
intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements, and with a principal purpose of avoiding having at least one of such liabilities or payment obligations with respect to such liabilities being treated as a bottom dollar payment obligation.

A payment obligation is not a bottom dollar payment obligation merely because a maximum amount is placed on the partner’s or related person’s payment obligation, a partner's or related person's payment obligation is stated as a fixed percentage of every dollar of the partnership liability, or there is a right of proportionate contribution running between 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 752 Temporary Regulations also provided an exception to the non-recognition rule of bottom dollar payment obligations. That is, a bottom dollar payment obligation is recognized when a partner or related person is liable for at least 90 percent of the partner's or related person's initial payment obligation despite an indemnity, a reimbursement agreement, or a similar arrangement.

Treasury received comments concerning the 752 Temporary Regulations, including comments from one of your authors, stating that the 752 Temporary Regulations are conceptually flawed, result in inconsistent answers, and are directly contrary to congressional intent. Your authors argued that the prior regulations appropriately followed Congress’s mandate that debt is allocated by a partnership to the partners who bear the EROL with respect to the debt. See section 79 of the Deficit Reduction Act of 1984 (Pub. L. No. 98-369) overruling the decision in *Raphan v. United States*, 3 Cls. Ct. 457 (1983) (holding that a guarantee on a partnership liability by a general partner did not require that partner to be treated as personally liable for that liability and did not preclude the other partners who did not guarantee the loan from sharing in the step up in basis on account of the debt). The preamble to the final regulations rejected this argument, stating that the 752 Temporary Regulations and these final regulations implement congressional intent. According to the IRS, bottom dollar payment obligations do not represent real EROL because those payment obligations are structured to insulate the obligor from having to pay their obligations. Moreover, bottom dollar guarantees are not relevant to loan risk underwriting generally. These obligations generally lack a significant non-tax commercial business purpose. Therefore, bottom dollar payment obligations should not be recognized as payment obligations.

Thus, the final regulations provide a definition for a bottom dollar obligation which is not recognized for purposes of allocating liabilities. A bottom dollar payment obligation is defined in Reg. 1.752-2(b)(3)(ii)(C) as:
(i) With respect to a guarantee or similar arrangement, any payment obligation other than one in which 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.

(ii) With respect to an indemnity or similar arrangement, any payment obligation other than one in which 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 benefited party's payment obligation that is recognized under this paragraph (b)(3) is satisfied.

(iii) With respect to an obligation to make a capital contribution or to restore a deficit capital account upon liquidation of the partnership as described in Reg. 1.704-1(b)(2)(ii)(b)(3) (taking into account Reg. 1.704-1(b)(2)(ii)(c) ), any payment obligation other than one in which the partner is or would be required to make the full amount of the partner's capital contribution or to restore the full amount of the partner's deficit capital account.

(iv) An arrangement with respect to a partnership liability that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements, and with a principal purpose of avoiding having at least one of such liabilities or payment obligations with respect to such liabilities being treated as a bottom dollar payment obligation as described in paragraph (b)(3)(ii)(C)(1)(i), (ii), or (iii) of this section.

A payment obligation is not a bottom dollar payment obligation merely because a maximum amount is placed on
the partner’s or related person’s payment obligation, a partner’s or related person’s payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates, or there is a right of proportionate contribution running between 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 following example in the final regulations makes clear the distinction between a BDG and other guarantees.

(10) Example 10. Guarantee of first and last dollars. (i) A, B, and C are equal members of a limited liability company, ABC, that is treated as a partnership for federal tax purposes. ABC borrows $1,000 from Bank. A guarantees payment of up to $300 of the ABC liability if any amount of the full $1,000 liability is not recovered by Bank. B guarantees payment of up to $200, but only if the Bank otherwise recovers less than $200. Both A and B waive their rights of contribution against each other.

(ii) Because A is obligated to pay up to $300 if, and to the extent that, any amount of the $1,000 partnership liability is not recovered by Bank, A’s guarantee is not a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section. Therefore, A’s payment obligation is recognized under paragraph (b)(3) of this section. The amount of A’s economic risk of loss under §1.752-2(b)(1) is $300.

(iii) Because B is obligated to pay up to $200 only if and to the extent that the Bank otherwise recovers less than $200 of the $1,000 partnership liability, B’s guarantee is a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section and, therefore, is not recognized under paragraph (b)(3)(ii)(A) of this section. Accordingly, B bears no economic risk of loss under §1.752-2(b)(1) for ABC’s liability.

(iv) In sum, $300 of ABC’s liability is allocated to A under §1.752-2(a), and the remaining $700 liability is allocated to A, B, and C under §1.752-3.
The 752 Temporary Regulations further required taxpayers to disclose bottom dollar payment obligations by filing Form 8275, Disclosure Statement, or any successor form, with the return of the partnership for the taxable year in which a bottom dollar payment obligation is undertaken or modified. These final regulations clarify that identifying the payment obligation with respect to which disclosure is made includes stating whether the obligation is a guarantee, a reimbursement, an indemnity, or deficit restoration obligation.

Concerning this final disclosure point, the 752 Temporary Regulations did not specifically address deficit restoration obligations (a DRO). Generally, the regulations under Section 752 provide a description of obligations recognized as payment obligations under Reg. 1.752-2(b)(1). The 752 Temporary Regulations provided that all statutory and contractual obligations relating to the partnership liability are taken into account for purposes of applying Reg. 1.752-2, including obligations to the partnership that are imposed by the partnership agreement, such as the obligation to make a capital contribution and a deficit restoration obligation. (See Reg. 1.752-2T(b)(3).)

Under the 752 Temporary Regulations, although it was clear that a capital contribution obligation and a DRO are types of payment obligations to which Reg. 1.752-2 applies, the definition of a bottom dollar payment obligation provided no guidance as to how to determine whether a capital contribution obligation or a DRO is a bottom dollar payment obligation. For example, a DRO does not relate to a particular partnership liability and the proceeds of the DRO may be paid to creditors of the partnership or distributed to other partners. (See Reg. 1.704-1(b)(2)(ii)(b)(3).) The final regulations revised the definition of a bottom dollar payment obligation to specifically address capital contribution obligations and DROs. Reg. 1.752-2(b)(3)(ii)(C)(1)(iii) in the final regulations provides that a bottom dollar payment obligation includes, with respect to a capital contribution obligation and a DRO, any payment obligation other than one in which the partner is or would be required to make the full amount of the partner's capital contribution or to restore the full amount of the partner's deficit capital account.

The expansion of the BDG rule to cover DROs raised additional corollary problems. The regulations under Section 752 concerning the allocation of liabilities include a specific anti-abuse rule, Reg. 1.752-2(j)(2), under which the Commissioner may treat a partner as bearing the EROL with respect to a partnership liability, or portion thereof, to the extent that: (1) the partner or related person undertakes one or more contractual obligations so that the partnership may obtain or retain a loan; (2) the contractual obligations of the partner or related person...
significantly reduce the risk to the lender that the partnership will not satisfy its obligations under the loan, or
portion thereof; and (3) with respect to the contractual obligations described in (1) or (2), (i) one of the principal
purposes of using the contractual obligation is to attempt to permit partners (other than those who are directly
or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests, or
(ii) another partner, or person related to another partner, enters into a payment obligation and a principal
purpose of the arrangement is to cause the payment obligation to be disregarded. (See Reg. 1.752-2T(j)(2).)

However, this rule does not apply to a DRO. To address this problem, 752 Proposed Regulations added a list of
factors to Reg. 1.704-1(b)(2)(ii)(c) that are similar to the factors in the anti-abuse rule under Reg. 1.752-2(j)
discussed below), but specific to DROs, to indicate when a plan to circumvent or avoid an obligation exists. If a
plan to circumvent or avoid an obligation exists, the obligation is disregarded for purposes of Sections 704 and
752. Under proposed Reg. 1.704-1(b)(2)(ii)(c), the following factors (the DRO Factors Test) indicate a plan to
circumvent or avoid an obligation: (1) the partner is not subject to commercially reasonable provisions for
enforcement and collection of the obligation; (2) the partner is not required to provide (either at the time the
obligation is made or periodically) commercially reasonable documentation regarding the partner’s financial
condition to the partnership; (3) the obligation ends or could, by its terms, be terminated before the liquidation
of the partner’s interest in the partnership or when the partner’s capital account as provided in Reg.
1.704-1(b)(2)(iv) is negative; and (4) the terms of the obligation are not provided to all the partners in the
partnership in a timely manner.

The inclusion of these factors in determining whether a DRO is respected leads to the major problem in the final
regulations-the Factors Test. The Factors Test is applied to determine whether or not an obligation is respected.
In other words, if a partner guarantees a loan and the guarantee is not a BDG, so it is otherwise respected as
creating a recourse liability, the 2014 Proposed Regulations included a list of factors to determine whether a
partner’s or related person’s obligation to make a payment with respect to a partnership liability (excluding those
imposed by state law) would be recognized for purposes of Section 752.

In response to comments, the 752 Proposed Regulations moved the list of factors to an anti-abuse rule in Reg.
1.752-2(3)(j). Under the anti-abuse rule in the 752 Proposed Regulations, the following non-exclusive factors are
weighed to determine whether a payment obligation should be respected: (1) the partner or related person is not
subject to commercially reasonable contractual restrictions that protect the likelihood of payment, (2) the
partner or related person is not required to provide commercially reasonable documentation regarding the
partner’s or related person’s financial condition to the benefited party, (3) the term of the payment obligation
ends prior to the term of the partnership liability, or the partner or related person has a right to terminate its payment obligation, (4) there exists a plan or arrangement in which the primary obligor or any other obligor with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonable foreseeable needs of such obligor, (5) the payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection, (6) in the case of a guarantee or similar arrangement, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee, and (7) the creditor or other party benefiting from the obligation did not receive executed documentation with respect to the payment obligation from the partner or related person before, or within a commercially reasonable period of time after, the creation of the obligation. The weight to be given to any particular factor depends on the particular case and the presence or absence of any particular factor, in itself, is not necessarily indicative of whether or not a payment obligation is recognized under Reg. 1.752-2(b).

Commenters to the 752 Proposed Regulations criticized the proposed Factors Test on the grounds that it was unlikely that any debt would satisfy all seven factors (including particularly the somewhat ridiculous sixth factor that the terms of the loan changed because of the guarantee). The IRS rejected all of these comments, stating that because the Factors Test was simply part of an anti-abuse rule in determining whether a plan to circumvent or avoid an obligation exists, they should not be of concern in most situations. The final regulations also clarified that (1) with respect to the fourth factor, amounts are not held in excess of the reasonably foreseeable needs of an obligor if the partnership purchases standard commercial insurance, such as casualty insurance and (2) with respect to the second factor, certain types of commercially reasonable documentation (balance sheets and financial statements) are examples of documents a lender would typically require.

Notwithstanding the foregoing attempt by the IRS to make the Factors Test somewhat reasonable, the final regulations also include an example in Reg. 1.752-2(j)(4) which shows the potential scope of the Factors Test. In this example:

(i) In 2020, A, B, and C form a domestic limited liability company (LLC) that is classified as a partnership for federal tax purposes. Also in 2020, LLC receives a loan from a bank. A, B, and C do not bear the economic risk of loss with respect to that partnership liability, and, as a result, the liability is treated as nonrecourse under §1.752-1(a)(2) in 2020. In 2022, A guarantees the entire
amount of the liability. The bank did not request the guarantee and the terms of the loan did not change as a result of the guarantee. A did not provide any executed documents with respect to A’s guarantee to the bank. The bank also did not require any restrictions on asset transfers by A and no such restrictions exist.

(ii) Under paragraph (j)(3) of this section, A’s 2022 guarantee (payment obligation) is not recognized under paragraph (b)(3) of this section if the facts and circumstances evidence a plan to circumvent or avoid the payment obligation. In this case, the following factors indicate a plan to circumvent or avoid A’s payment obligation: (1) the partner is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, such as restrictions on transfers for inadequate consideration or equity distributions; (2) the partner is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner’s or related person’s financial condition to the benefited party; (3) in the case of a guarantee or similar arrangement, the terms of the liability are the same as they would have been without the guarantee; and (4) the creditor did not receive executed documents with respect to the payment obligation from the partner or related person at the time the obligation was created. Absent the existence of other facts or circumstances that would weigh in favor of respecting A’s guarantee, evidence of a plan to circumvent or avoid the obligation exists and, pursuant to paragraph (j)(3)(i) of this section, A’s guarantee is not recognized under paragraph (b) of this section. As a result, LLC’s liability continues to be treated as nonrecourse.

This example is obviously somewhat unrealistic because A is attempting to rely upon a guarantee that was not provided to the lending institution. However, the example does not treat that factor as dispositive, raising the question whether the guarantee would have been respected if it had been provided to the bank but no documentation of the obligor’s net worth was provided. The example also does not address whether A, an individual, had somehow limited the scope of his guarantee or whether all of A’s assets, including his home and personal belongings, were available to the bank as a potential creditor. Thus, the example failed to address many of the important facts and focused mostly on factors which are not meaningful, such as whether A was subject to
commercially reasonable contractual restrictions on transfers of assets (ignoring that such transfers could result in an individual bankruptcy).

The problems with the Factors Test (and the DRO Factors Test) are discussed in more detail below.

Another issue addressed in the final regulations was that a guarantor had to have a reasonable expectation of being able to satisfy an obligation in order for the guarantee to be treated as creating a recourse liability. This rule was consistent with the disregarded entity net value requirement under existing Reg. 1.752-2(k). The 2014 Proposed Regulations expanded the scope of the net value requirement and provided that, in determining the extent to which a partner or related person other than an individual or a decedent’s estate bears the EROL for a partnership liability other than a trade payable, a payment obligation is recognized only to the extent of the net value of the partner or related person that, as of the allocation date, is allocated to the liability, as determined under Reg. 1.752-2(k). The 2014 Proposed Regulations also required a partner to provide a statement concerning the net value of a person with a payment obligation (a payment obligor) to the partnership. The preamble to the 2014 Proposed Regulations requested comments concerning whether the net value rule should also apply to individuals and estates and whether the regulations should consolidate these rules under Reg. 1.752-2(k).

Comments on the 2014 Proposed Regulations suggested that if the net value rule is retained, Reg. 1.752-2(k) should be extended to all partners and related persons other than individuals. A commenter expressed concerns that a partner who may be treated as bearing the EROL with respect to a partnership liability would have to provide information regarding the net value of a payment obligor, which is unnecessarily intrusive. Another commenter believed that if the rules requiring net value were extended to all partners in partnerships, the attempt to achieve more realistic substance would be accompanied by a corresponding increase in the potential for manipulation.

The preamble to the 752 Proposed Regulations explained that the Treasury Department and the IRS remain concerned with ensuring that a partner or related person be presumed to satisfy its payment obligation only to the extent that such partner or related person would be able to pay the obligation. After consideration of the comments to the 2014 Proposed Regulations, however, the Treasury Department and the IRS agreed that expanding the application of the net value rules under Reg. 1.752-2(k) may lead to more litigation and may unduly burden taxpayers. Furthermore, net value as provided in Reg. 1.752-2(k) may not accurately take into account future earnings of a business entity, which normally factor into lending decisions. Therefore, the 752 Proposed Regulations proposed to remove Reg. 1.752-2(k) of the existing regulations and instead create a new
presumption under the anti-abuse rule in Reg. 1.752-2(j).

Under the presumption in the 752 Proposed Regulations, evidence of a plan to circumvent or avoid an obligation is deemed to exist if the facts and circumstances indicate that there is not a reasonable expectation that the payment obligor will have the ability to make the required payments if the payment obligation becomes due and payable (Presumed Anti-abuse Rule). A payment obligor includes disregarded entities (including grantor trusts). If evidence of a plan to circumvent or avoid the obligation exists or is deemed to exist, the obligation is not recognized under Reg. 1.752-2(b) and therefore the partnership liability is treated as a nonrecourse liability under Reg. 1.752-1(a)(2).

The IRS received adverse comments to this proposed change as well, including comments suggesting that the existing rules provided more clarity and certainty. In response to comments, the final regulations provide that all payment obligors actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate that at the time the partnership determines a partner’s share of partnership liabilities under Regs. 1.705-1(a) and 1.752-4(d) there is not a commercially reasonable expectation that the payment obligor will have the ability to make the required payments under the terms of the obligation if the obligation becomes due and payable. A partner or related person’s ability to pay may be based on documents such as, but not limited to, balance sheets, income statements, cash flow statements, credit reports, and projected future financial results.

The final regulations apply to liabilities incurred or assumed by a partnership and to payment obligations imposed or undertaken on or after October 5, 2019, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect before that date.

Discussion

The adoption of the final regulations on BDGs, to the extent that such final regulations merely followed the approach of the temporary regulations which had been in effect since 2016, was fully expected by tax practitioners. Indeed, if the final regulations had simply taken that step, there would have been little controversy.

Although there are theoretical problems with the BDG limitation, in that it runs contrary to the presumption that all of a partnership’s assets (including cash) are worthless in order to determine whether a partner bears any risk with respect to a liability, the fact is that most partnerships have been applying these rules for the past three
years and were now accustomed to them. Specifically, most partners who previously had made or wanted to
make a BDG changed to a vertical slice guarantee (VSG) in which the partner was liable for a percentage of the
debt. Thus, if a partnership had $100 of nonrecourse debt that was secured by Blackacre (which was worth $200),
and a partner wanted to be allocated $10 of that debt, under a BDG the partner would have guaranteed the
bottom $10, meaning that there was no liability as long as Blackacre had a value of at least $10. In other words, in
order for the guarantor to have any loss under the BDG, Blackacre would have had to lose 95% of its value.

Under a VSG, the partner who guaranteed a 10% slice would bear $1 of liability for each $10 lost by the lender.
However, because the loan-to-value ratio was 50%, the guarantor under the VSG would not suffer any loss as
long as Blackacre was worth at least $100. And even if Blackacre declined in value to $90, the guarantor would, in
that case, lose only $1. The risk under a VSG is real and begins with the first dollar of risk born by the lender, but
is still modest as long as the debt is adequately collateralized, as this example shows. Thus, in the "real world,"
these VSGs are a good replacement to the BDGs while still including the "first dollar" risk sharing with the lender.

If the final regulations had stopped there, the adoption of the final regulations to replace the temporary
regulations would have resulted in a workable solution for both the IRS and tax practitioners—these rules
concerning BDGs have already been internalized by the tax community and are a part of routine transaction
planning. However, the inclusion of the Factors Test in the final regulations is a horse of a completely different
color.

The Factors Test is the worst type of tax guidance because it adds both complexity and uncertainty. Every
partnership is required to annually provide every partner with a statement concerning that partner’s share of the
liabilities of the partnership, including a statement about the partner’s share of the recourse and nonrecourse
liabilities of the partnership. To make that determination, the partnership needs to know whether a liability is a
recourse liability or a nonrecourse liability, since the rules for allocating such liabilities are different. Prior to the
adoption of the Factors Test, this was always a straightforward determination because the operating rules were
completely clear. The temporary regulations concerning BDGs did nothing to alter this certainty, because the BDG
rules provided clear guidance when a liability must be treated as nonrecourse (instead of recourse) because a
BDG would be disregarded.

The Factors Test completely alters this reality. The Factors Test sets forth seven individual points, but does not
make clear whether any of these factors are more important than the others. Many of the factors have major
problems.
To illustrate the problems, let's use a simple example (taken from a current transaction in which your authors are involved). A financial investor is contributing 80% of the equity to a new construction project, and the individual developer is contributing 20% of the equity; the development will be undertaken by an LLC formed for that purpose. The parties have engaged in multiple similar transactions over the past few decades. There will be a loan from either a third-party lender or, alternatively, the financial investor will make a loan to the LLC; if the lender is a third party, it might require a guarantee from the financial investor. In any event, the parties want to have the developer, which has put up 20% of the equity, also share in 20% of all deductions and credits from the project, so the developer will guarantee 20% of the loan, without regard to whom the lender is. The guarantee is in the form of a VSG, so the developer is responsible for 20% of all losses to the lender; a copy of the guarantee is always provided to the lender. However, the developer does not provide an annual financial statement to the financial investor (or the lender) because they all know him and do not require it.

The first negative factor is the partner or related person is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, including restrictions on transfers for inadequate consideration or distributions by the partner to equity owners in the partner. As noted above, the developer in this example is an individual who did not provide a balance sheet to the lender. But what if an individual guarantor provides the lender with a copy of the guarantee and a balance sheet, but the guarantor does not promise he won't take vacations, does not promise not to send his kids to college, and also does not promise that he won't buy any jewelry for his wife? Does this mean that the guarantor has not agreed to "commercially reasonable contractual restrictions to protect the likelihood of payment" of the liability (whatever those are)? The regulations imply that any of these actions might be suspect, because they are all transfers for inadequate consideration by the partner who made the guaranty.

The second negative factor is if the partner or related person is not required to provide commercially reasonable documentation regarding the partner's or related person's financial condition to the benefitted party, including balance sheets and financial statements. Even though the developer/guarantor furnishes a copy of that guarantee to the lender, because the lender does not require a financial statement, the guarantee could be disregarded. This seems an odd result given that the lender knows it is better off with the guarantee than without it (without regard to the net worth of the guarantor).

The third factor applies if the term of the payment obligation ends prior to the term of the partnership liability, or the partner or related person has a right to terminate its payment obligation if the purpose of such limitation is to terminate such payment obligation prior to the occurrence of an event that increases the risk of economic loss to
the guarantor or the benefitted party, although this factor is not present if the termination occurs because of an event that decreases the risk of loss, such as completion of construction or satisfaction of a coverage ratio. This factor is not as problematic as the others, because the termination of a guarantee makes the guarantee less worthwhile unless it is terminated for one of the specified events. In other words, the third factor is consistent with commercial reality.

The fourth factor applies if there exists a plan or arrangement in which the primary obligor or any other related person directly or indirectly holds money or other liquid assets in an amount that exceeds reasonably foreseeable needs of such obligor. Implicit in this factor is that if a lender makes a loan to a financially healthy obligor which has significant cash flow, any guarantee of that loan could be disregarded. Does this mean that the tax return preparer will need to examine the cash flow of every partnership which has a guaranteed loan in order to determine whether or not to respect a guarantee? And what if the guarantee is made in year one, when the venture has limited cash flow, but the venture is a success and by year two the partnership is rolling in cash—is the guarantee then disregarded because it is superfluous?

This factor is problematic in our example because the parties fully expect that there will be significant profits from this development—after all, they have done deals together for years, and they keep doing them together because they are profitable. There is a fully recourse VSG, but it might be disregarded because there was no financial need for the guarantee.

The fifth factor applies if the payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability. This factor does not recognize the commercial reality that most guarantees address ultimate loss to the lender. A lender usually cannot pursue the guarantor of a loan unless and until the primary obligor has failed to pay and all remedies against the primary obligor have been exhausted, but the Factors Test states that a payment obligation must allow the creditor to promptly pursue payment from the guarantor upon a default—and without requiring the creditor to first seek payment from the primary obligor. No well-represented guarantor would ever agree to this request; your authors have been involved in hundreds of transactions in which third-party lenders have required guarantees, and the guarantees have always been of ultimate collection and not initial payment. This is a commercially unreasonable standard.

The most absurd provision in the Factors Test is the sixth factor, which is that in the case of a guarantee, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee. This determination can NEVER be made. Your authors have never, in decades of
experience working with lenders, seen a loan term sheet where the interest rate is x% with a guarantee and y% without it. Instead, lenders may require a guarantee in order to make a loan, or make the loan without a guarantee, but in each case, the loan terms are what they are. There will never be a way for a partnership to establish in hindsight that the terms of the loan would have been different if the guarantee had not been made. So, the final regulations include a factor that can NEVER be satisfied.

Turning to the example, as noted previously, the parties have worked together for years. The lender might be an unrelated bank, or it could be the financial investor itself, but in no circumstances would there be a term sheet setting forth the terms of the financing with or without the guarantee from the developer. Thus, there is no possibility that the sixth factor will ever be satisfied even in a completely arms' length commercial setting.

The seventh factor provides the creditor or other party benefiting from the obligation did not receive executed documents with respect to the payment obligation from the partner or a related person before, or within a commercially reasonable time after, the creation of the obligation. This may be the most reasonable of the factors—it is appropriate for the guarantor to notify the lender of the guarantee. As noted above, in the hypothetical transaction, this requirement will be satisfied.

So two of the factors are reasonable—the others are all commercially unrealistic. A "standard" transaction such as described above will likely fail to meet four or five of the factors, which means there will be significant doubt as to the manner in which the guaranteed liability should be allocated.

The application of the Factors Test to loan guarantees is contrary to commercial reality. This problem is magnified by the IRS's inclusion of a similar test (the DRO Factors Test) in the final regulations to determine whether a DRO is respected. As noted above, the IRS could determine that there was a plan to circumvent an obligation if (1) the partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation; (2) the partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership; (3) the obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account as provided in Reg. 1.704-1(b)(2)(iv) is negative; and (4) the terms of the obligation are not provided to all the partners in the partnership in a timely manner.

Notwithstanding that comments urged the IRS not to go down this path, the inclusion of the DRO Factors Test in the final regulations will again lead to uncertainty. Your authors have written or reviewed partnership or LLC agreements with DROs (they are not common, but they do happen), and not a single one would satisfy all four of
these tests. Indeed, most partners refuse to sign an agreement that includes a DRO because of the economic risk which a DRO creates, yet the regulations do not recognize this reality. If a partner (including particularly an individual) is willing to sign a DRO that is included in the partnership agreement, that should be the end of the inquiry—the DRO should be respected because of the risk entailed. If the partner is not an individual, then the "net value" rule still would serve to address the IRS's concern that the DRO may be illusory. In other words, the DRO Factors Test creates uncertainty for a partnership which needs to determine how to allocate losses, and the partnership needs to take any DRO into account in making this determination.

The inclusion of the Factors Test and the DRO Factors Test in the final regulations is an example of poorly thought out regulatory rulemaking. Because these rules do not appear to take fully into account all of the comments which were made, and because they are arguably inconsistent with Congress's purpose when it provided in Section 752 that a liability must be allocated to the partner who bears the risk of loss, the validity of this aspect of the final regulations could be questioned. However, any argument that a regulation is invalid will usually be an uphill battle, and it would be better for the tax system (and the IRS's reputation) if it were to reconsider these rules. It would have been appropriate for the IRS to require that a loan guarantee (or a DRO) had to be provided to a lender (or the other partners) and could not be terminated at will—these are objective facts which are consistent with commercial reality. The remaining factors should be moved to the dustbin in which they belong.