The Final Partnership Debt Allocation Regulations

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Overview

► Final regulations under sections 704 and 752 (T.D. 9877)
  ► Bottom dollar payment obligations (including deficit restoration obligations)
  ► Determining “economic risk of loss”

► Final regulations under section 707 (T.D. 9876)
  ► Allocation of liabilities for disguised sale purposes
  ► Beyond the scope of this panel
Background

- 1991 final regulations (allocation of partnership liabilities)
- 2006 final regulations (anti-abuse rule for disregarded entities)
- 2014 proposed regulations (determination of economic risk of loss)
- 2016 temporary regulations (allocation of liabilities for disguised sale purposes)
- 2016 temporary regulations (bottom dollar payment obligations)
- 2016 proposed regulations (anti-abuse factors for determination of economic risk of loss)
- 2018 proposed regulations (allocation of liabilities for disguised sale purposes)
- 2019 final regulations (allocation of liabilities for disguised sale purposes)
- 2019 final regulations (bottom dollar payment obligations and anti-abuse factors for determination of economic risk of loss)
Background on Bottom Dollar Guarantees (BDG)

- Historically, partners with “negative tax capital accounts” have often looked to the recourse liability allocations in order to avoid triggering their negative tax capital.

- For example, in order to obtain a larger partner liability share, a partner historically may have increased its EROL through a guarantee (including a BDG), a contribution agreement, a DRO, an indemnification agreement or some other payment obligation.
By increasing its liability share, the partner would generate additional tax basis in its interest and thereby potentially avoid either recognizing gain under Section 731(a) or disguised sale gain under Section 707.
Bottom Dollar Guarantee Example

- Partner A needs $80x in additional basis in its partnership interest to avoid gain under Section 731 as a result of an expected distribution.

- To obtain this additional basis while minimizing its economic risk, Partner A guarantees the $80x “bottom portion” of a $1,000x nonrecourse LLC liability. In other words, Partner A agrees that, if the value of the property securing the $1,000x liability falls below $80x, A can be called on its guarantee to the extent of the difference between the value of the property and $80x.

- Under pre-2016 Treas. Reg. §1.752-2, LLC would have treated $80x of its $1,000x liability as recourse and then allocated $80x of additional recourse liabilities to Partner A for basis purposes.
A Vertical Slice Guarantee (VSG) is excepted from the definition of a BDG. In a VSG, the guarantor is liable for the same percentage of each dollar of loss. Thus a $100 VSG causes guarantor in this example to be liable for $20 of the first $200 of decrease in value of the property below the loan amount.
Key highlights of section 752 regulations

- Finalizes definition of “bottom dollar payment obligation” from 2016 temporary regulations and provides additional rules specific to deficit restoration obligations (DROs)

- Generally effective for partnership liabilities incurred or assumed by a partnership, and payment obligations imposed or undertaken with respect to a partnership liability, in each case on or after October 5, 2016

- Exception for liabilities incurred or assumed or payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date

- Transitional relief provided for certain partners with negative tax capital accounts immediately prior to October 5, 2016, who applied section 752 regulations effective prior to October 5, 2016 to determine economic risk of loss. If such liability is modified or refinanced partnership may choose not to apply new bottom dollar rules to the extent of the partner’s negative tax capital immediately prior to October 5, 2016. Generally transition period extends until October 5, 2023.
Bottom Dollar Payment Obligations

- Bottom dollar payment obligations are not recognized for purposes of determining economic risk of loss under Treas. Reg. §1.752-2(b).

- All statutory and contractual obligations are taken into account when analyzing whether bottom dollar payment obligations exist, including:
  - Contractual obligations outside of the partnership agreement, such as guarantees, indemnities, reimbursement agreements, and other obligations running directly to creditors or partners.
  - Obligations imposed by the partnership agreement, such as an obligation to contribute capital or restore a deficit capital account upon liquidation of the partnership (a DRO).
  - Payment obligations imposed by state or local law.

- A bottom dollar payment obligation is recognized if, taking into account an indemnity, reimbursement agreement, or similar or arrangement, the partner or related person is still liable for at least 90 percent of the partner or related person’s initial payment obligation.
Bottom Dollar Payment Obligations

- Bottom-dollar payment obligations are defined as arrangements that are “the same as or similar to”:
  - 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 or related person’s payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied
  
  - 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 amount of such partner 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 the section 752 regulations is satisfied
  
  - with respect to a DRO or similar arrangement, 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
Bottom Dollar Payment Obligations

Bottom-dollar payment obligations are defined as arrangements that are “the same as or similar to” (cont.):

- An arrangement that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert a single liability to multiple liabilities if based on facts and circumstances the principal purpose of the plan, transaction, arrangement, or series thereof was to avoid having at least one liability or payment obligation avoid being treated as a bottom dollar payment obligation
Bottom Dollar Payment Obligations

- Even if a person’s indemnity, reimbursement agreement, or similar arrangement is not itself a bottom dollar payment obligation, it will not be recognized for purposes of section 752 if the indemnitee’s or other benefitted party’s payment obligation is not recognized.

- A payment obligation is not a bottom dollar payment obligation merely because:
  - A maximum amount is placed on the partner’s payment obligation,
  - The payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which the obligation relates (i.e., a “vertical slice” guarantee), or
  - There is a right of proportionate contribution running between partners or related persons who are co-obligors for an obligation for which each is jointly and severally liable.
Bottom Dollar Payment Obligations Disclosure

- Partnership must disclose a bottom dollar payment obligation on a Form 8275 attached to the partnership return for the year in which the obligation is undertaken or modified.

- The disclosure is required even if a partner’s bottom dollar payment obligation is respected because of the “90% Rule” in Treas. Reg. § 1.752-2(b)(3)(ii)(B).
Deemed Satisfaction

In determining whether a partner has economic risk of loss, it is generally assumed that all partners and related persons who have payment obligations perform those obligations, regardless of actual net worth, unless facts and circumstances indicate:

- A plan to circumvent or avoid the obligation under Treas. Reg. §1.752-2(j), or
- That 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 as described in Treas. Reg. §1.752-2(k)

- The “commercially reasonable expectation” rule replaces the net value rule applicable to disregarded entities, and applies to all partners, including disregarded entities
Commercially Reasonable Expectation

► The 752 Final Regulations elaborate that the facts and circumstances to consider in determining a commercially reasonable expectation of payment include factors a third-party creditor would take into account when determining whether to grant a loan.

► When is this tested? The 752 Final Regulations state the you test at the time that you determine a partner’s share of partnership liabilities under §§1.705-1(a) and 1.752-4(d).

► Determine whether 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.
Example 3 – No Commercially Reasonable Expectation

► Single-member LLC is a general partner in LP, a limited partnership, which has $300,000 of state law recourse debt.

► LLC has no other assets other than its LP interest, and has no right of contribution from its owner, which is the partner for tax purposes in LP. The LP agreement provides that LLC has an obligation to restore any deficit in its capital account.

► LLC is disregarded as separate from its owner, and Treas. Reg. §1.752-2(k) (regarding commercially reasonable expectation of payment) is applied to LLC instead of its owner for purposes of determining whether LLC could satisfy its payment obligation. LLC has no assets other than its interest in LP, and has no right of contribution from its owner. As a result, there is no commercially reasonable expectation that LLC would satisfy its payment obligation, so LLC’s obligation to restore its deficit capital account balance is disregarded.

► As a result, the $300,000 of state law recourse debt is allocated among the partners of LP under Treas. Reg. §1.752-3.
Example 4 – Commercially Reasonable Expectation

- Same facts as Example 3, except that LLC also holds real property worth $475,000 subject to a $200,000 liability. LLC also reasonably projects to earn $20,000 of net rental income per year from the real property it owns in addition to its LP interest.

- LLC is disregarded as separate from its owner, and Treas. Reg. §1.752-2(k) (regarding commercially reasonable expectation of payment) is applied to LLC instead of its owner for purposes of determining whether LLC could satisfy its payment obligation. As a result of LLC’s ownership of the rental property, there is a commercially reasonable expectation that LLC will be able to satisfy its payment obligation, so its DRO is recognized under Treas. Reg. §1.752-2(b).

- As a result, the $300,000 of state law recourse debt is allocated to LLC’s owner under Treas. Reg. §1.752-2.
Plan to Circumvent or Avoid an Obligation

Regulations finalize a non-exclusive list of seven factors that may indicate a plan to circumvent or avoid a payment obligation:

(A) The partner or related person is not subject to **commercially reasonable contractual restrictions that protect the likelihood of payment**, including, for example, restrictions on transfers for inadequate consideration or distributions by the partner or related person to equity owners in the partner or related person.

(B) The partner or related person 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, including, for example, balance sheets and financial statements.
Plan to Circumvent or Avoid an Obligation

- (C) 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 limiting the duration of the payment obligation is to terminate such payment obligation prior to the occurrence of an event or events that increase the risk of economic loss to the guarantor or benefited party (for example, termination prior to the due date of a balloon payment or a right to terminate that can be exercised because the value of loan collateral decreases).

- This factor typically will not be present if the termination of the obligation occurs by reason of an event or events that decrease the risk of economic loss to the guarantor or benefited party (for example, the payment obligation terminates upon the completion of a building construction project, upon the leasing of a building, or when certain income and asset coverage ratios are satisfied for a specified number of quarters).
Plan to Circumvent or Avoid an Obligation

(D) There exists a plan or arrangement in which the primary obligor or any other obligor (or a person related to the obligor) with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonably foreseeable needs of such obligor (but not taking into account standard commercial insurance, for example, casualty insurance).

(E) 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.
Plan to Circumvent or Avoid an Obligation

► (F) 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.

► (G) The creditor or other party benefiting from the obligation did not receive executed documents 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.
Anti-Abuse Rules

► In 2020, A, B, and C form LLC, and LLC receives a loan from a bank. Neither A, B, nor C bear EROL with respect to the liability, and the liability is treated as nonrecourse for purposes of section 752.

► 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 did not require any restrictions on asset transfers by A and no such restrictions exist.

► Example concludes that the guarantee is not recognized and the liability continues to be treated as nonrecourse for purposes of section 752.
Key highlights of section 704 regulations

► Any bottom dollar deficit restoration obligations that are disregarded under the final section 752 regulations are also disregarded for section 704(b) purposes.

► DROs are also disregarded if they are not legally enforceable or if the facts and circumstances indicate a plan to circumvent or avoid the obligation based on a list of four non-exclusive factors.

► The rule providing that DROs disregarded under section 752 are also disregarded under section 704(b) is effective for DROs entered into on or after October 5, 2016.

► The rules disregarding DROs where not legally enforceable or based on facts and circumstances are effective for partnership tax years beginning after 2019.
Bottom Dollar DROs

► The Section 752 regulations provide that, in the case of a DRO or similar arrangement, a bottom-dollar payment obligation includes:

   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.

► Any bottom dollar DRO under the above rule is disregarded for purposes of section 704(b) in addition to section 752.
DROs are disregarded for purposes of section 704(b) if the facts and circumstances indicate a plan to circumvent or avoid the obligation.

The following, non-exclusive list of factors that may indicate such a plan:

- The partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation.

- 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.

- 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 is negative other than when a transferee partner assumes the obligation.

- The terms of the obligation are not provided to all partners in the partnership in a timely manner.
Example 1 – Top and Bottom Dollar Guarantees

- A, B, and C are equal partners in ABC. ABC borrows Liability of $1,000 from Bank. A guarantees $300 of Liability if any amount of Liability is not recovered by Bank. B guarantees $200 of Liability, but only if Bank otherwise recovers less than $200.

- B’s liability is a bottom dollar payment obligation and disregarded.

- A’s liability is not a bottom dollar payment obligation, and is regarded, so $300 of Liability is allocable to A under Treas. Reg. §1.752-2 and $700 of Liability is allocated among A, B, and C under Treas. Reg. §1.752-3.
Example 2 – Top and Bottom Dollar Guarantees

► Same facts as Example 1, but C indemnifies A up to $100 that A pays under its guarantee and agrees to indemnify B fully with respect to its guarantee.

► Because C indemnifies any amount that A is required to pay, it effectively converts A’s “top dollar” guarantee with respect to Liability to a bottom dollar payment obligation. As a result, A’s guarantee is disregarded for purposes of section 752.

► Since C’s indemnity in respect of A is for 33.33% of A’s guarantee, A’s guarantee does not qualify for the 90% exception.

► C’s indemnity of A’s guarantee is not a bottom-dollar payment obligation and so is recognized under Treas. Reg. § 1.752-2(b)(3).

► Because B’s guarantee is not recognized under Treas. Reg. § 1.752-2(b)(3) independent of C’s indemnity of B’s guarantee, C’s indemnity of B’s guarantee is not recognized under Treas. Reg. § 1.752-2(b)(3).

► Thus, $100 of Liability allocable to C under Treas. Reg. §1.752-2 and $900 is allocable among A, B and C under Treas. Reg. §1.752-3.