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Client Alert Commentary

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IRS Proposes Significant Changes to Rules for Allocating Partnership Liabilities

Proposed Regulations seek to curtail perceived abuses, including the use of "bottom-dollar" guarantees and some indemnity arrangements.

On January 29, 2014, the Internal Revenue Service (IRS) proposed regulations that would significantly amend the rules under Internal Revenue Code (IRC) Section 752 relating to the allocation of partnership liabilities. In reaction to perceived abuses of leveraged partnership structures, the proposed regulations aim to prevent the use of certain guarantee and indemnity arrangements (including so-called "bottom dollar guarantees") for tax planning purposes by imposing certain "commercially reasonable" standards and a net value requirement in order for such arrangements to be recognized under the recourse debt allocation rules. The proposed regulations also include coordinating revisions and other clarifications of the partnership disguised sales rules under IRC Section 707.

The proposed regulations raise significant tax planning considerations for existing and future partnerships (including limited liability companies (LLCs) taxed as partnerships, master limited partnerships (MLPs), and umbrella partnership real estate investment trusts (UPREITs)), and particularly those structures involving partnerships with "recourse" indebtedness. Although the proposed regulations generally would be effective prospectively from the date they are finalized, it is important to consider and understand the impact of the proposed changes on existing structures and pending and future transactions. The proposed regulations are subject to further revision and significant public comment is expected.

Leveraged Partnerships

Under existing tax rules, each partner generally is entitled to include its share of a partnership's liabilities in the tax basis of its partnership interest. These rules effectively permit a partner to claim deductions and defer taxation on distributions in excess of its investment, with the expectation that eventually the partner will bear the associated economic and tax cost. In some cases, these rules have been used to defer taxation on transactions that might otherwise be taxable as sales. Under current regulations, the manner of allocating partnership liabilities depends in part on whether the liability is considered "recourse" or "nonrecourse" to the partners. As such, one hallmark of these transactions is the use of guarantees and indemnity arrangements to create a "recourse" liability that is used to shelter a cash distribution to a partner from immediate taxation.

Recourse Liabilities

A partnership liability is considered a recourse liability to the extent a partner or a related person bears the economic risk of loss for that liability. In determining who bears the risk of loss, the existing regulations apply a hypothetical liquidation approach and look to whether a partner or related person would be obligated to pay the liability if the partnership's assets (including cash) became worthless and the liability became due. Both contractual and statutory obligations are taken into account. Prior to 2006,

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the regulations assumed that each and every partner or related person would satisfy its payment obligations, regardless of its net worth, subject to certain anti-abuse rules.

In 2006, the regulations were amended to limit this satisfaction presumption with respect to payment obligations of disregarded entities. The intent of the 2006 amendments was to prevent the characterization of a partnership liability as recourse where a disregarded entity, such as a single-member LLC, was used to limit its owner's actual risk of loss with respect to the liability. Under these rules, an obligation of a disregarded entity is taken into account only to the extent of the entity's net value, excluding for these purposes the fair market value of the disregarded entity's interest in the partnership for which the determination is being made and any property pledged to secure any liabilities of the partnership.

The proposed requirements for recognition of a partner's (or related person's) payment obligation include:

- **Reasonable net worth**: The obligor must maintain a commercially reasonable net worth throughout the term of the payment obligation or be subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration.
- **Documentation**: The obligor must periodically provide commercially reasonable documentation of its financial condition.
- **Term of payment obligation**: The payment obligation must not have a term that ends prior to the term of the partnership liability.
- **Liquidity requirement for other obligors**: The payment obligation must not require that the primary obligor or any other obligor of the partnership liability hold money or other liquid assets in excess of its reasonable needs.
- **Arm's length consideration**: The obligor must receive arm's length consideration for assuming the payment obligation.
- **Full dollar obligation**: The obligor must be liable for no less than the full amount of the payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.

The last requirement is intended to do away with "bottom-dollar," "vertical slice" and similar guarantees and arrangements that the IRS views as being motivated by tax planning considerations rather than legitimate commercial concerns.

For purposes of applying the six-prong test described above, all contractual obligations and arrangements outside the partnership agreement generally are taken into account. While the proposed regulations markedly raise the bar for characterizing a liability as recourse, they also introduce a certain optionality. Taxpayers seeking to apply the nonrecourse debt allocation rules might intentionally plan to fail one or more of the recognition requirements, even in cases where one partner is providing meaningful credit support.

Nonrecourse Liabilities

Nonrecourse liabilities are partnership liabilities for which no partner is considered to bear the economic risk of loss. A creditor of a nonrecourse liability generally may look only to the assets of the partnership for payment. Absent any partner guarantee or indemnity arrangements, liabilities of an LLC typically are

considered nonrecourse liabilities because members of an LLC generally are not liable for the debts and obligations of the LLC under state law.

Under current regulations, a partner's share of a nonrecourse liability is determined under a three-tier approach that generally attempts to align the allocation of nonrecourse liabilities with the manner in which the partners share the taxable income of the partnership. Under the third tier, any excess nonrecourse liabilities not allocated under the first two tiers are generally allocated in accordance with the partner's shares of the partnership's profits, determined based on all relevant facts and circumstances. The current regulations provide flexibility in determining a partner's share of profits so long as the allocation is consistent with the allocation of some other significant item of income or gain of the partnership or the manner in which the deductions attributable to the liability are reasonably expected to be allocated.

The proposed regulations would replace these methods of determining the partners' shares of partnership profits with an approach that resembles a targeted allocation, effectively imposing a periodic valuation requirement. Under the proposed regulations, partnerships would be permitted to use the partners' "liquidation value percentages" as a measure of their interests in the partnership's profits for purposes of allocating excess nonrecourse liabilities. A partner's liquidation value percentage generally would be determined based on the relative amount the partner would receive if the partnership sold all of its assets for fair market value, satisfied its liabilities and then liquidated. For this purpose, the fair market value of any property subject to nonrecourse debt cannot be less than the amount of the debt. No other rules are provided for determining the value of a partnership's assets.

The proposed regulations contemplate that a partner's liquidation value percentage would be determined at the time of partnership formation and then redetermined upon certain "book-up" events, regardless of whether the partners' capital accounts are adjusted due to that event. This snapshot approach seems to limit the flexibility of partnerships to allocate excess nonrecourse liabilities differently from year to year to reflect changes in the partners' interest in partnership profits, absent a redetermination event. Given the complexity of some economic arrangements, it would seem reasonable to permit partnerships to redetermine the partners' liquidation value percentages at the end of each taxable year.

Transition Rules

The proposed regulations generally would apply prospectively to liabilities incurred by a partnership, and payment obligations imposed on or undertaken by a partner, on and after the date the regulations become final, unless incurred pursuant to a written binding contract in effect prior to that date. Transitional relief would be provided to any partner (transition partner) whose share of recourse liabilities under the existing regulations exceeds its tax basis in its partnership interest at the time the final regulations go into effect. Under the transition rules, a partnership may continue to apply the current regulations to treat a liability as recourse to a transition partner to the extent of the grandfathered amount for up to seven years. The grandfathered amount would be subject to reduction in connection with any taxable sale of property by the partnership and any other event that results in a reduction of the transition partner's share of the partnership's liabilities.

A 50 percent or greater change in the ownership of any transition partner that is a partnership, S corporation or disregarded entity will cause the transition partner to cease to be eligible for the transition rules, potentially resulting in an income recognition event at that time. A "technical termination" of a partnership will not cause the partnership and any continuing transition partner to cease being eligible for the transition rules.

Disguised Sale Rules

The partnership disguised sale rules under IRC Section 707 apply to transactions that may, in substance, be sales between a partner and a partnership. These rules generally provide that, in certain circumstances, a contribution of property by a partner to a partnership, followed by a distribution of cash or other consideration by the partnership to the contributing partner, will be treated, in or whole or in part, as a taxable sale of the property by the partner to the partnership. A partnership's assumption of a liability in connection with a contribution of property generally is treated as a distribution of money to the contributing partner to the extent the liability is allocated to other partners under the rules discussed above. The proposed regulations would amend the existing disguised sale regulations to clarify the application of certain exceptions and rules for determining when a contribution and distribution should be treated as a sale, and to take into account the proposed changes to the partnership debt allocation rules described above. The proposed regulations would apply to transfers occurring on or after the date the regulations are finalized.

Debt-Financed Distributions

The existing regulations provide detailed rules for determining when sale treatment is appropriate in connection with a distribution of the proceeds of a partnership borrowing. Generally, a distribution is treated as sale proceeds (assuming another exception does not apply) only to the extent the distribution exceeds the partner's allocable share of the liability incurred to fund the distribution. The proposed regulations establish an ordering rule that requires the exception for debt-financed distributions be applied before any other exception.

Preformation Capital Expenditures

The existing regulations include an exception for distributions in reimbursement of capital expenditures incurred by a partner during the two year period prior to the partner's contribution of property to the partnership. Under this exception, a distribution is not treated as sale proceeds to the extent the distribution does not exceed 20 percent of the fair market value of the contributed property. This limitation does not apply if the fair market value of the contributed property does not exceed 120 percent of the contributing partner's adjusted basis in the property at the time of the contribution.

The proposed regulations clarify that (i) the fair market value limitation applies on a property-by-property basis and (ii) the exception does not apply to reimbursement of capital expenditures funded by a liability that is assumed by the partnership to the extent the reimbursement exceeds the contributing partner's share of the liability.

Unsecured Trade or Business Liabilities

Under the existing regulations, a partnership's assumption of a "qualified liability" will only be treated as sale proceeds if the transaction is otherwise subject to sale treatment. The proposed regulations add an additional category of qualified liability that includes liabilities incurred in connection with the conduct of a trade or business, provided the liability was not incurred in anticipation of the contribution and all of the assets material to that trade or business are contributed to the partnership. There is no requirement that the liability encumber the contributed assets, thereby permitting general unsecured debt to qualify as a qualified liability. The general presumption that liabilities incurred within the two year period prior to a contribution are incurred in anticipation of the contribution would apply to this new category of liabilities unless the facts and circumstances clearly establish otherwise and certain disclosure requirements are met.

Anticipated Reduction

In determining the extent to which an assumption of liabilities or a debt-financed distribution by a partnership should be treated as a sale, the current regulations take into account any subsequent reduction in a partner's share of partnership liabilities if the reduction is anticipated and is part of a plan to avoid sale treatment. The proposed regulations clarify that the anticipated reduction is only taken into account if it is not subject to the entrepreneurial risks of partnership operations, and add a presumption that a reduction in a partner's share of the liability due to a decrease in the partner's net value within two years of the partnership's assumption or incurrence of the liability was anticipated absent contrary facts and circumstances.

Tiered Partnerships

The proposed regulations clarify the application of the disguised sale rules to tiered partnership structures. Under the proposed rules, a partner that contributes its interest in a partnership (the lower-tier partnership) to another partnership (the upper-tier partnership) must take into account its share of the lower-tier partnership's liabilities when applying the disguised sale rules. For this purpose, the upper-tier partnership's share of the lower-tier partnership's liability is treated as a qualified liability to the extent the liability would have been a qualified liability if the liability was assumed in a transfer of the lower-tier partnership's assets to the upper-tier partnership instead.

Partnership Mergers

The proposed regulations provide that increases and decreases in a partner's share of partnership liabilities in connection with a partnership merger or consolidation are netted by a partner in the terminating partnership and the resulting partnership for purposes of applying the disguised sale rules to any distributions by the terminating partnership to the partner.

Conclusion

While still only in proposed form, the changes to the treatment of partnership liabilities and disguised sale transactions contemplated under the proposed regulations are likely to be material to many partnerships and their partners. Even in advance of the promulgation of final regulations, taxpayers should consult their tax advisors and consider carefully the potential impact of these changes on transactions and arrangements currently being planned or undertaken.

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