New Tax Regulations Significantly Impact Many Common Partnership Transactions

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The Treasury recently issued several new final, temporary and proposed regulations under Code Sections 704, 707 and 752 (the "New Regulations") significantly affecting the taxation of many partnership transactions. For purposes of this discussion, a partnership and its partners includes a limited liability company taxed as a partnership and its members. This Alert highlights several common situations impacted by the New Regulations.

Computation of Partnership Tax Basis and Its Relevance

Several aspects of the New Regulations affect the determination of a partner's tax basis in his partnership interest. Before getting into the details of the New Regulations, let's first review the significance of basis and its general computations. Among other things, a partner's tax basis is critical to the partner's ability to deduct his allocated share of partnership losses, and the ability of the partner to receive nontaxable actual and deemed distributions of cash from the partnership. Basis is generally created by the partner's capital contributions, plus his share of profits, and minus his share of losses and distributions. An increase in a partner's share of partnership debt is treated as a deemed cash contribution by such partner (i.e., a basis increase). Conversely, a decrease in a partner's share of debt is treated as a deemed distribution of cash to such partnership (i.e., a basis decrease).

The determination of a partner's share of partnership debt depends upon whether the debt is recourse, meaning one or more partners (or related persons) has an "economic risk of loss" ("EROL") for all or a portion of the debt, or nonrecourse, meaning no partner (or related person) has any EROL regarding the debt. Recourse debt is generally allocated among the partners in proportion to their respective shares of partnership losses. Conversely, nonrecourse debt is allocated among the partners in proportion to their respective shares of partnership profits. Debt may be specifically allocated to a partner to the extent such partner alone bears the risk of loss if the partnership is unable to pay the debt.

Revised Treatment of Partner Guarantees

Historically, a partner could increase his allocation of partnership debt by guaranteeing payment of a portion of such debt, either voluntarily or because of a lender requirement, thereby incurring an EROL. A partner guarantee can take several forms, including a full guarantee and a limited guarantee of a designated portion of the debt. A limited guarantee in turn can be cast a variety of ways, including a "top," "bottom" or "vertical slice" guarantee.

Top. A top guarantee assures the lender that the guarantor will pay the first dollars of debt that the partnership is unable to pay (e.g., on a $5 million loan with a $250,000 top guarantee, if the partnership is unable to make the first $250,000 of installment payments, the guarantor partner is liable to pay that amount).

Bottom. A bottom guarantee does not result in a guarantor partner's liability to pay unless when the loan arrangement terminates the lender fails to receive a stated minimum repayment (e.g., on a $5 million loan with a $1 million bottom guarantee, the guarantor's obligation to pay does not arise unless the lender fails to receive at least a $1 million repayment).

Vertical Slice. A vertical slice guarantee obligates the guarantor partner to pay a stated percentage of each dollar of debt that is not repaid.

A bottom guarantee creates less economic risk to the guarantor partner because the likelihood of liability from the guarantee is considerably lower than with either a top or vertical slice guarantee. In the past, a partner giving a limited bottom guarantee of say $1 million on a $5 million loan was treated as being fully liable on, and therefore was fully allocated, $1 million of the partnership debt. The New Regulations drastically alter this treatment by stating that a bottom dollar payment obligation ("BDPO") is ignored in determining a partner's debt allocation for basis computation. A BDPO is generally defined as any guarantee other than one where the guarantor partner (or a person related to such partner) would be liable for the full amount of the partner's payment obligation if any amount of guaranteed debt were not otherwise satisfied. A significant exception applies to a guarantee where the guarantor partner (or related person) is liable for at least 90 percent of the initial debt obligation. Partnerships are now required to disclose any BDPO on Form 8275 and, if applicable, the details concerning a situation for which the above 90 percent exception applies. Vertical slice guarantees, top dollar guarantees that are capped at a specified amount, and joint/several guarantees with a right of proportionate contribution, are generally still respected.

Examples of Reduced Basis Consequences

The above described BDPO limitation could adversely impact many real estate transactions. For example, if a partner contributes to the partnership low basis appreciated property that is encumbered by debt, upon contribution for tax purposes much of the debt may be re-allocated to the other partners. Such a reduction in the share of debt allocated to the contributing partner may trigger a deemed cash distribution to the to the contributor resulting in his recognition of taxable gain if the deemed distribution exceeds his partnership basis. This situation can no longer be remedied by a typical BDPO guarantee given by the contributor.

A partner's lower basis caused by the BDPO limitation may also restrict the partner's ability to deduct his allocation of partnership tax losses, including losses generated by depreciation and interest expenses.

In summary, bottom guarantees have been mostly eliminated.

Anti-Abuse Rules

The New Regulations include new "anti-abuse" rules that can disregard any type of guarantee if the facts and circumstances evidence a plan to avoid the payment obligation. The following seven non-exclusive factors are considered:

- A lack of commercially reasonable restrictions to ensure the likelihood of payment.
- No requirement to provide commercially reasonable documentation regarding the guarantor's financial condition.
- The fact that the term of the guarantee ends prior to the term of the partnership debt, or the guarantor has a right to terminate the guarantee.
- A situation where the partnership holds an amount of liquid assets that exceeds its reasonable foreseeable needs.
- The creditor is unable to promptly pursue collection following a partnership payment default.
- The fact that the terms of the partnership debt would be substantially the same without the guarantee.
- The creditor receiving the benefit of the guarantee did not receive executed documents from the guarantor before, or within a commercially reasonable time after, the creation of the guarantee.

In summary, all guarantee arrangements will be scrutinized.

Impact on "Disguised Sale" Rules

Another area adversely affected by the New Regulations is the characterization of a series of partnership transactions as a "disguised sale."

First, a bit of background. Partnership tax rules generally permit a partner to contribute property to a partnership tax-free. Also, partnership tax rules generally permit a partner to receive a tax-free distribution of cash, provided the amount of cash distributed does not exceed his partnership tax basis. This lead parties to do transactions such as the following: Partner A would contribute appreciated property to the partnership, and Partners B and C would contribute cash. The partnership would then leverage the property with debt, and distribute cash to Partner A while reducing his partnership percentage. Provided that the distributed cash did not exceed his tax basis (considering his allocable share of the partnership debt), Partner A would have in effect "sold" part or all the contributed property, but not have recognized a taxable gain.

For many years, the partnership tax rules have treated a transaction similar to the one described above as a "disguised sale" that results in a taxable gain to Partner A. The New Regulations continue the presumption of the prior regulations that when a partner contributes property and receives a disproportionate distribution within two years, the transactions are collapsed and taxed as a disguised sale. However, prior to the New Regulations there were certain exceptions to disguised sale treatment, including post-contribution distributions related to: (i) assumption of "qualified liabilities," (ii) certain debt financed distributions, and (iii) reimbursements of certain preformation capital expenditures.

***Qualified Liability Exception*.** Provided that a series of transactions is not otherwise treated as a disguised sale, if the partnership assumes a "qualified liability" or takes the property subject to such a liability, it is not treated as part of a sale. "Qualified liabilities" are defined in the regulations under Section 707, and include (i) debt incurred by the contributor partner more than two years prior to the contribution and that has encumbered the property throughout that two year period, (ii) debt incurred for capital expenditures on the contributed property, and (iii) debt incurred in the ordinary course of a contributed business. If the transactions are otherwise treated as a sale, then a qualified liability causes additional sale consideration subject to certain limitations. Provisions in the New Regulations deal with an anticipated reduction in a partner's share of liabilities, include an expanded definition of qualified liabilities, provide a "step-in-the shoes" rule similar to the preformation expenditures exception described below, address tiered partnerships and make other technical refinements. The New Regulations add as a new type of qualified liability a debt not incurred in anticipation of the contribution of the property, but that was incurred in connection with a trade or business in which the property was used, but only if essentially all of the assets related to that trade or business are contributed. Such liabilities need not encumber the contributed property.

***Debt Financed Exception*.** If, in connection with the contribution of appreciated property by a partner, the partnership assumes a liability (other than a "qualified liability" as discussed above) of the contributor, the portion of such liability that is re-allocated to the other partners is generally treated as disguised sale proceeds causing the contributor to recognize taxable gain inherent in the contributed property. The prior regulations contained an exception to the disguised sale rules by allowing a partner to defer gain on relief of nonqualified liabilities and to receive nontaxable actual cash distributions funded from partnership borrowings, to the extent of the contributor's allocable share of the relevant partnership liability. Such share of liability could be increased by a guarantee from the contributor. The IRS viewed some of these guarantee arrangements to have been undertaken for tax reasons, and not legitimate business purposes. In response, the New Regulations eliminate this type of guarantee planning by specifying that, for purposes of the disguised sale rules, all partnership debt must be treated as nonrecourse debt and be allocated among the partners in accordance with their interests in partnership profits.

***Preformation Expenditures Exception*.** Another exception from the disguised sale rule applies to certain capital expenditures (such as partnership organization and syndication costs) and costs capitalized as part of the basis of the contributed property (together, so-called "preformation expenditures"). This exception is available only to the extent that the reimbursed expenditures do not exceed 20 percent of the fair market value ("FMV") of the contributed property (the "20 percent limitation"). However, the 20 percent limitation is inapplicable if the FMV of the contributed property does not exceed 120 percent of the partner's tax basis in the property (the "120 percent test"). The New Regulations clarify that, generally, the preformation expenditures exception applies on a property-by-property basis. However, in specified circumstances aggregation of properties is permitted. A new provision allows a partner who previously acquired the contributed property in a tax-deferred exchange to "step in the shoes" of the prior owner who incurred qualifying capital expenditures with regard to the property. Also, special rules deal with a tiered partnership situation.

The New Regulations add a rule coordinating the above exceptions for preformation capital expenditures and qualified liabilities. Previously, some contributing partners claimed they could receive a nontaxable reimbursement of preformation expenditures even though the same expenditures were paid from proceeds of a "qualified liability", thereby receiving a double benefit. The New Regulations eliminate such double dipping.

The New Regulations require disclosure to the IRS on Form 8275 whenever consideration is distributed to a partner within two years of such partner's contribution of property to the partnership, unless the consideration is either: (i) a guaranteed payment for capital, (ii) a reasonable preferred return, (iii) an operating cash flow distribution. Disclosure is required even when the partners believe that one of the other exceptions to disguised sale treatment is applicable.

IRS Scrutiny of a Deficit Restoration Obligation

A partner historically was treated as having liability for partnership debt to the extent of the partner's obligation to restore a deficit in his capital account upon termination of the partnership (a "deficit restoration obligation," or "DRO"). The New Regulations specify four nonexclusive factors to be considered to determine whether a DRO should be disregarded because of a plan to avoid its payment. The factors to be weighed in the analysis are:

- is the partner subject to commercially reasonable provisions for collection of the obligation;
- must the partner provide the partnership commercially reasonable documentation of his financial condition;
- could the DRO end before the liquidation of the partner's interest or when his capital account is negative; and
- are the terms of the DRO timely provided to all other partners.

DROs will also be subject to the significant BDPO limitations described above.

Effective Dates

The effective dates of the New Regulations are a somewhat confusing mixed bag. The final regulations under Sections 707 and 752 became effective October 5, 2016. The temporary regulations under Section 752 apply starting October 5, 2016, while the temporary regulations under Section 707 (that include the revised "disguised sale" rules) apply starting January 3, 2017. Various proposed regulations would become effective prospectively from the date they are published as final regulations. Fortunately, the new provisions ignoring bottom dollar guarantees have a "grandfathering" exception that can respect such existing guarantees for up to seven years. Partnerships have the ability to apply certain of the New Regulations earlier than their mandatory effective dates.

Conclusion

This Alert does not cover all nuances of the lengthy and complex New Regulations, but instead highlights their impact on some more common partnership transactions. As described above, in the future, for tax purposes, some traditionally used guarantee arrangements and other potential partner payment obligations will be disregarded, despite their economic consequences. Partners and partnerships should review their existing partnership agreements, related financing documents and other agreements to evaluate the impact of the New Regulations. Some transition relief may be applicable for a limited time. Prospective transactions, including joint ventures taxed as partnerships, should be carefully structured to navigate the hazards of these regulations.

If you have any questions, please contact Jeff Goldman (jgoldman@dykema.com), Steve Grob (sgrob@dykema.com), Robert Nelson (rnelson@dykema.com) or your Dykema relationship attorney.

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