Recourse and Non-Recourse Debt for Partnerships
Minimizing the Tax Impact of Partner Liability and Debt Allocations Under Sections 752 and 704

THURSDAY, DECEMBER 5, 2013, 1:00-2:50 pm Eastern

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Recourse and Non-Recourse Debt for Partnerships Webinar

Dec. 5, 2013

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Today’s Program

Overview of recourse/nonrecourse liabilities
[Robert B Keyser, II]  Slide 7 - Slide 15

General Allocation Rules
[Robert B Keyser, II]  Slide 16 - Slide 52

Nonrecourse Deductions and Minimum Gain Chargebacks
[Jeffrey N. Bilsky]  Slide 53 - Slide 76

Qualified Nonrecourse Financing and Use of Guarantees
[Robert B Keyser, II]  Slide 77 - Slide 92

Partner Nonrecourse Deductions
[Jeffrey N. Bilsky]  Slide 93 - Slide 108
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Introduction

• A partners adjusted basis is affected the partner's share of partnership debt.

• Partnership debt includes any partnership obligation that:
  – creates an asset,
  – results in an expense to the partnership or
  – results in a nondeductible, noncapitalizable item at the partnership level.
Introduction (continued)

• This definition includes certain contingent liabilities

• Definition also includes most debt that is deemed a liability for financial accounting purposes
  • Excludes accounts payable of cash basis entities
• An increase in a partner’s share of partnership debt is treated as a cash contribution by the partner to the partnership.
  – A partner’s share of partnership debt increases as the total amount of partnership debt increases.
  – A decrease of a partner’s share of partnership debt is treated as a cash distribution to the partner.
IRC §752 (continued)

- A partner’s share of partnership debt decreases as a result of:
  - Decreases in the total amount of partnership debt, and
  - Assumptions of the partner’s debt by the partnership
EXAMPLE 1

Mary and Kevin form MK and contribute the following: Mary, cash of $50,000; Kevin, land with FMV of $80,000, subject to $30,000 liability. MK borrows $100,000 to finance construction of a building. At the end of year 1, MK owes trade accounts payable to vendors in the amount of $8,000. No other activity occurred.
EXAMPLE 1  (continued)

Their bases would be determined as follows:

<table>
<thead>
<tr>
<th>Mary’s Basis</th>
<th>Kevin’s Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash</strong></td>
<td><strong>Basis in Land</strong></td>
</tr>
<tr>
<td><strong>$50k</strong></td>
<td><strong>$80k</strong></td>
</tr>
<tr>
<td><strong>Plus: Share of debt</strong></td>
<td><strong>Less: Debt assumed by</strong></td>
</tr>
<tr>
<td><em>(assumed by MK)</em></td>
<td><em>(assumed by MK)</em></td>
</tr>
<tr>
<td><strong>$15k</strong></td>
<td><em>(MK)</em> <em>(assumed by MK)</em> <em>(assumed by MK)</em></td>
</tr>
<tr>
<td><strong>Initial Basis</strong></td>
<td><strong>$65k</strong></td>
</tr>
<tr>
<td><strong>Initial Basis</strong></td>
<td><strong>$65k</strong></td>
</tr>
<tr>
<td><strong>Plus: Share of loan</strong></td>
<td><strong>Plus: Share of loan</strong></td>
</tr>
<tr>
<td><strong>$50k</strong></td>
<td><strong>$50k</strong></td>
</tr>
<tr>
<td><strong>Plus: Share of trade payables</strong></td>
<td><strong>Plus: Share of trade payables</strong></td>
</tr>
<tr>
<td><strong>$4k</strong></td>
<td><strong>$4k</strong></td>
</tr>
<tr>
<td><strong>Basis at year end</strong></td>
<td><strong>Basis at year end</strong></td>
</tr>
<tr>
<td><strong>$119</strong></td>
<td><strong>$119</strong></td>
</tr>
</tbody>
</table>
EXAMPLE 2

Continuing with the same facts as Example A, in the second year MK generates $120,000 of taxable income and repays the construction loan and trade payables. Taxable income is allocated equally. The repayment of the loans and the trade payables is treated as a cash distribution and reduces basis as follows:
**EXAMPLE 2** (continued)

**Taxable income is allocated equally. The repayment of the loans and the trade payables is treated as a cash distribution and reduces basis as follows:**

<table>
<thead>
<tr>
<th></th>
<th>Mary’s Basis</th>
<th>Kevin’s Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis at beginning of year 2</td>
<td>$119k</td>
<td>$119k</td>
</tr>
<tr>
<td>Plus: Share of income</td>
<td>$60k</td>
<td>$60k</td>
</tr>
<tr>
<td>Less: Share of loan</td>
<td>($50k)</td>
<td>($50k)</td>
</tr>
<tr>
<td>Less: Share of trade payables</td>
<td>($4k)</td>
<td>($4k)</td>
</tr>
<tr>
<td>Basis at year end</td>
<td>$125k</td>
<td>$125k</td>
</tr>
</tbody>
</table>
Recourse vs. Nonrecourse

Partnership debt is classified as either recourse or nonrecourse.

- **Recourse Debt** – debt of the partnership that at least one partner is personally liable for.
  - The personal liability can exist through operation of state law or through personal guarantees made to the creditor.
  - Personal liability of a party related to a partner (via attribution rules) is treated as personal liability of the partner.
Recourse vs. Nonrecourse (continued)

• **Nonrecourse Debt** – debt for which no partner (or related party) is personally liable.
  
  – Lenders of nonrecourse debt generally require collateral be pledged against the loan. In the event of a default, only the collateral can be claimed by the lender.
  
  – Because LLC members typically are not personally liable for LLC debt, most LLC debt will be considered nonrecourse.
Recourse Debt Rules

Recourse debt created after 1/29/1989 is shared in accordance with a constructive liquidation scenario. Under this, the following is deemed occur at year-end.

1. Partnership assets become worthless
2. Worthless assets are sold (for $0) and losses on the sales are determined
3. The losses are allocated based on loss sharing
4. Any partner with a (deemed) negative capital account balance is treated as contributing cash to the partnership to restore capital account

5. Deemed contributed cash is used to pay the liabilities of the partnership

6. Partnership is deemed to liquidate and any remaining cash distributed to partners with positive account balances
Recourse Debt Rules (continued)

Thus, a partner’s share of partnership recourse liabilities equals the amount of the partner’s cash contribution that would be used (in step 5) in payment of the partner’s recourse liabilities.
EXAMPLE 3

James and Isaac each contribute $40,000 of cash to a newly formed JI partnership. Both James and Isaac have 50% interests in capital, profits and losses. After the first year, the balance sheet of JI is as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Basis</th>
<th>FMV</th>
<th>Liab/Cap</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$25k</td>
<td>$25k</td>
<td>Recourse payable</td>
<td>$60k</td>
<td>$60k</td>
</tr>
<tr>
<td>Receivables</td>
<td>$12k</td>
<td>$12k</td>
<td>James, capital</td>
<td>$26k</td>
<td>$26k</td>
</tr>
<tr>
<td>Land/Bldg.</td>
<td>$75k</td>
<td>$75k</td>
<td>Isaac, capital</td>
<td>$26k</td>
<td>$26k</td>
</tr>
<tr>
<td>Total</td>
<td>$112k</td>
<td>$112k</td>
<td></td>
<td>$112k</td>
<td>$112k</td>
</tr>
</tbody>
</table>
EXAMPLE 3 (continued)

The recourse payable ($60,000) is shared in accordance with the constructive liquidation scenario. All of the assets (including cash) are deemed to be worthless and are sold for $0. This creates a loss of $112,000, which is allocated equally between the partners. The $56,000 loss creates negative capital accounts of $30,000 for both James and Isaac. In a real liquidation, the partners would be required to contribute $30,000 each and the cash would be used to pay the liability, and JI would cease to exist. Because each partner would be required to contribute $30,000 in the liquidation scenario they share the recourse payable equally and each have adjusted basis for their partnership interests of $76,000 ($26,000 + $30,000).
EXAMPLE 4

A, B, and C form ABC general partnership with each contributing of $100,000. The partnership agreement provides that losses are allocated 20% to A, and 40% to B and C. ABC purchases an asset for $500,000, using the capital contributed and borrowing the rest on a recourse note. In a hypothetical liquidation scenario, the loss of $500,000 would be allocated $100,000 to A and $200,000 to B and C. Continuing the liquidation, A’s capital account would be reduced to $-0-, and B and C’s accounts would drop to negative $100,000, which as general partners, they would have to restore.
In this case only B and C bear the risk of loss of the recourse note and all their bases would be determined as follows:

<table>
<thead>
<tr>
<th>A’s Basis</th>
<th>B and C’s Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash</strong></td>
<td><strong>Cash</strong></td>
</tr>
<tr>
<td>$100k</td>
<td>$100k</td>
</tr>
<tr>
<td><strong>Initial Basis</strong></td>
<td><strong>Initial Basis</strong></td>
</tr>
<tr>
<td>$100k</td>
<td>$100k</td>
</tr>
<tr>
<td><strong>Plus: Share of recourse loan</strong></td>
<td><strong>Plus: Share of recourse loan</strong></td>
</tr>
<tr>
<td>$0k</td>
<td>$100k</td>
</tr>
<tr>
<td><strong>Basis at year end</strong></td>
<td><strong>Basis at year end</strong></td>
</tr>
<tr>
<td>$100k</td>
<td>$200k</td>
</tr>
</tbody>
</table>
EXAMPLE 5

D, E, and F form DEF general partnership with D contributing $300,000, E contributing $200,000, and E contributing $100,000. The partnership agreement provides that losses are allocated 20% to D, and 40% to E and F. ABC purchases land for $1,000,000, using the capital contributed and borrowing the rest on a recourse note. In a hypothetical liquidation scenario, the loss of $1,000,000 would be allocated $200,000 to A and $400,000 to E and F. E’s capital account would be reduced to $100,000, E’s capital account would drop to negative $200,000, and F’s to negative $250,000, which as general partners, they would have to restore.
EXAMPLE 5 (continued)

In this case only E and F bear the risk of loss. But E bears 40% and F bears 60%. Their bases would be determined as follows:

<table>
<thead>
<tr>
<th></th>
<th>D’s Basis</th>
<th>E’s Basis</th>
<th>F’s Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$300k</td>
<td>$200k</td>
<td>$100k</td>
</tr>
<tr>
<td>Initial Basis</td>
<td>$300k</td>
<td>$200k</td>
<td>$100k</td>
</tr>
<tr>
<td>Plus: Share of recourse</td>
<td>loan (0%) $0k</td>
<td>loan (40%) $160k</td>
<td>loan (60%) $240k</td>
</tr>
<tr>
<td>Basis at year end</td>
<td>$300k</td>
<td>$360k</td>
<td>$340k</td>
</tr>
</tbody>
</table>
EXAMPLE 6

Now assume James and Isaac have different interests in partnership losses—James 70%; Isaac 30%. Under the constructive liquidation scenario, the deemed $112,000 loss is allocated $78,400 to James and $33,600 to Isaac. James’ capital account is negative $52,400 ($26,000 - $78,400) and Isaac’s capital account is negative $7,600 ($26,000 - $33,600). Each partner is deemed to contribute cash equal to these negative capital accounts, and the cash is used to pay the recourse payable. Thus, James and Isaac share $52,400 and $7,600, respectively, in the recourse debt.
Because James would be required to contribute $52,400 in the liquidation scenario he has adjusted basis for his partnership interests of $78,400 ($26,000 + $52,400).

Since Isaac would be required to contribute $7,600 in the liquidation scenario he has adjusted basis for his partnership interests of $33,600 ($26,000 + $7,600).
Nonrecourse Debt Rules

As mentioned, most debt of LLCs will be nonrecourse. Nonrecourse debt is allocated in three (3) stages.

First, an amount of debt equal to the amount of minimum gain is allocated to partnership who share in minimum gain (first tier).

—In general, minimum gain approximates the amount of nonrecourse (mortgage) liability on a property in excess of the “book” basis of the property.
Nonrecourse Debt Rules (continued)

—If a lender forecloses on partnership property, the result is treated as a deemed sale of the property for the mortgage balance. Gain is recognized for at least the amount of the liability in excess of the property’s “book” basis—hence, minimum gain.

• Allocation of minimum gain is typically addressed in the partnership agreement.
Nonrecourse Debt Rules (continued)

Second, the amount of nonrecourse debt equal to the remaining *precontribution gain* under § 704 is allocated to the partner who contributed the property and debt to the partnership (second tier).

—For this purpose, the remaining precontribution gain is the excess of the current nonrecourse debt balance on the contributed property over the current tax basis of the contributed property.
Nonrecourse Debt Rules (continued)

—Note that this calculation is only required when the “book” and “tax” bases of the contributed property is different.

Third, any remaining nonrecourse debt is allocated to the partners in accordance with one of several different allocations methods.

—The partnership agreement specifies which allocation method is used—most commonly profit sharing ratio is used.
EXAMPLE 7

Dave contributes a nondepreciable asset to the BCD partnership for a one-third interest in its profits, losses and capital. The asset has an adjusted tax basis to Dave of $48,000 and a FMV and “book” basis on the date of contribution of $100,000. The asset is subject to a nonrecourse note in the amount of $70,000.
EXAMPLE 7 (continued)

Because the “book” basis exceeds the nonrecourse debt, there is no minimum gain.

Under § 704© principles, the Regulations (§ 1.704-3) provide that the first $22,000 of non recourse debt ($70,000 - $48,000) is allocated to Dave. Assume the partnership agreement allocates the remaining $48,000 of nonrecourse debt to the partners in accordance with profit and Dave’s share is $16,000. Thus Dave shares in $38,000 of the nonrecourse debt.
EXAMPLE 7 (continued)

Dave’s basis in his partnership interest is determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis of contributed property</td>
<td>$48k</td>
</tr>
<tr>
<td>Less: Liability assumed by partnership</td>
<td>($70k)</td>
</tr>
<tr>
<td>Plus: Allocation of 704© debt</td>
<td>$22k</td>
</tr>
<tr>
<td>Basis before remaining allocation</td>
<td>$-0-</td>
</tr>
<tr>
<td>Plus: Allocation of remaining non-recourse debt</td>
<td>$16k</td>
</tr>
<tr>
<td>Basis in partnership interest</td>
<td>$16k</td>
</tr>
</tbody>
</table>
EXAMPLE 7 (continued)

The § 704© allocation of nonrecourse debt prevents Dave from receiving a deemed distribution ($70,000) in excess of the property he contributed ($48,000). Without these rules regarding allocation of nonrecourse debt, in some cases a contributing partner would be required to recognize gain on a contribution of property encumbered by nonrecourse debt.
EXAMPLE 8

Alice and Brad form AB, LLC and agree to share all partnership items 50/50. Alice contributes depreciable property subject to a nonrecourse liability of $3,000 with an adjusted tax basis of $2,000 and a FMV of $5,000. Brad contributes $2,000 in cash.

[At the time of Alice’s contribution of the property to the LLC, there is immediately a $3,000 of built-in gain (the difference between the FMV and the adjusted basis)]
EXAMPLE 8 (continued)

There are no first-tier (minimum gain) allocations because the book value of the property at the time of contribution ($5,000) exceeds the amount of the liability ($3,000).
EXAMPLE 8 (continued)

If AB, LLC sells the contributed property in full satisfaction of the liability and for no other consideration, AB, LLC would recognize a taxable gain of $1,000 on the sale ($3,000 loan - $2,000 adjusted basis). All of this taxable gain would be allocated to Alice.

This hypothetical sale would also result in a book loss of $2,000 to AB, LLC ($3,000 loan (sale price) - $5,000 book value of property). Under the terms of the operating agreement, this book loss is allocated equally to the partners.
EXAMPLE 8 (continued)

Because Brad would receive a $1,000 book loss but no corresponding tax loss, the hypothetical sale would result in a $1,000 disparity between Brad’s book and tax allocations
If AB, LLC uses the traditional method of allocation, Alice would be allocated the total of $1,000 of taxable gain from the hypothetical sale of the contributed property. Therefore, Alice would be allocated $1,000 of nonrecourse liabilities immediately after the contribution.
EXAMPLE 8 (continued)

If AB, LLC uses the remedial method of allocation, AB, LLC would be required to make a remedial allocation of $1,000 of tax loss to Brad in connection with the hypothetical sale to eliminate the $1,000 disparity between Brad’s book and tax allocations. AB, LLC would also be required to make an offsetting remedial allocation of tax gain to Alice of $1,000. Thus, Alice would be allocated $2,000 of tax gain ($1,000 actual gain and $1,000 allocation of remedial gain) from the hypothetical sale.
EXAMPLE 8 (continued)

Therefore, if AB, LLC uses the remedial allocation method, Alice would be allocated $2,000 of nonrecourse liabilities immediately after contribution.
If AB, LLC uses the traditional method with curative allocations, AB, LLC would be allowed to make reasonable curative allocations to reduce or eliminate the difference between the book and tax allocations to Brad that resulted from the hypothetical sale. AB, LLC’s ability to make curative allocation would depend on the existence of other partnership items and could not be determined solely from the hypothetical sale of the contributed property.
EXAMPLE 8 (continued)

Because any potential curative allocations could not be determined solely from the hypothetical sale of the contributed property, curative allocations are not taken into account in allocating nonrecourse liabilities. Therefore, if AB, LLC used the traditional method with curative allocations, Alice would be allocated $1,000 of the nonrecourse liability on contribution.
EXAMPLE 8 (continued)

Following the allocations above (first-tier and second-tier), AB, LLC has excess nonrecourse liability that must be allocated between Alice and Burt (the third-tier). Several alternative exist for allocating excess nonrecourse liability (the third-tier). First, AB, LLC may elect to allocate excess nonrecourse liabilities in accordance with profit sharing, is determined by taking into account all facts and circumstances and economic arrangement of the partners.
EXAMPLE 8 (continued)

Second, AB, LLC’s operating agreement may specify the partner’s interest in partnership profits for purpose of allocating excess nonrecourse liabilities. If the agreement states that each partner will be allocated a 50% share of all partnership items, such allocations would be without economic effect, however, and therefore cannot be used for allocating excess nonrecourse liabilities.
Finally, AB, LLC may choose to allocate the excess nonrecourse liabilities in accordance with the manner in which it is reasonable expected that the deductions attributable to the excess nonrecourse liabilities will be allocated. Because Alice and Brad have agreed to allocate all partnership items 50% to each partner, they will each be entitled to a $2,500 book depreciation over the life of the contributed asset.
The contributed asset, however, has an adjusted tax basis of only $2,000 and, regardless of the method used by AB, LLC the entire $2,000 of the tax depreciation over the life of the property must be allocated to Brad. Thus, AB, LLC must allocate all of excess nonrecourse liabilities to Brad if it chooses to allocate the excess nonrecourse liabilities in accordance with the manner that the deductions attributable to the excess nonrecourse liabilities will be allocated.
NONRECOURSE DEDUCTIONS
& MINIMUM GAIN CHARGEBACK
Nonrecourse Deductions

Example:

Partnership Agreement:
• All income allocated 90/10
• Liquidating distributions based on positive capital accounts
• No DRO, but meets the alternative test

Capital Accounts
A = $0
B = $0
Nonrecourse Deductions

AB breaks even for the year before depreciation of $20.

Do these allocations have economic effect?

Who bears the risk of loss?

**Capital Accounts**
- A = $0 - $18 = ($18)
- B = $0 - $2 = ($2)

$20 Depreciation

Assets
N/R Loan

A

B

$(18) Deprec

$(2) Deprec

$180

($200)
Nonrecourse Deductions

- Nonrecourse deductions are deductions and losses generated by funds borrowed on a nonrecourse basis.
- Nonrecourse deductions CANNOT have substantial economic effect because only the lender bears the risk of loss.
- Normal allocation rules do not apply.
- Must be allocated in accordance with PIP.
Allocation of Nonrecourse Deductions

• Because they cannot have economic effect, allocations of nonrecourse deductions must be in accordance with PIP

• Safe Harbor Rule: N/R allocations will be respected if:
  – Allocations under the agreement otherwise have substantial economic effect, and
  – N/R deductions are allocated “in a manner reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to property securing the nonrecourse liability”, and
  – The agreement contains a Minimum Gain Chargeback provision

• Minimum Gain Chargeback:
  – When minimum gain decreases, income allocated in proportion to each partner’s share of minimum gain at end of prior year
The Amount of Nonrecourse Deductions

- A partnership’s nonrecourse deductions for a tax year is an amount of deductions equal to:
  - The increase in the partnership’s Minimum Gain for the year, less
  - Distributions of N/R borrowing attributable to an increase in minimum gain

- A partner’s share of minimum gain is treated as a DRO (i.e., he is allowed to have a negative capital account to that extent)
Minimum Gain

• Minimum Gain is the amount by which nonrecourse debt exceeds the 704(b) basis of the property securing the debt

• Events that may increase minimum gain:
  – Depreciation of the property
  – Distribution of N/R borrowing

• Property by property determination
Minimum Gain – Multiple Nonrecourse Liabilities

• Allocate 704(b) basis to each debt
• Allocate basis to highest priority debt first to the extent of its outstanding balance
• Then to subordinate debts in order of priority
• Proportionate to basis if equal priority
• Minimum gain for each debt is excess of balance over allocated basis
Minimum Gain – Multiple Nonrecourse Liabilities

PRS LLC holds real estate with a section 704(b) basis of $1,000x subject to three liabilities:

1. A first mortgage of $800x from an unrelated bank
2. A second mortgage of $400x from one of the PRS members
3. Accounts payable of $50x to a member for management services

How much minimum gain is associated with each liability?
## Minimum Gain – Multiple Nonrecourse Liabilities

<table>
<thead>
<tr>
<th>First mortgage:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability Amount</td>
<td>$800x</td>
</tr>
<tr>
<td>704(b) Basis</td>
<td>(800x)</td>
</tr>
<tr>
<td>Minimum Gain</td>
<td>0x</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Second mortgage:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability Amount</td>
<td>$400x</td>
</tr>
<tr>
<td>704(b) Basis</td>
<td>(200x)</td>
</tr>
<tr>
<td>Minimum Gain</td>
<td>200x</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Accounts Payable:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability Amount</td>
<td>50x</td>
</tr>
<tr>
<td>704(b) Basis</td>
<td>(0x)</td>
</tr>
<tr>
<td>Minimum Gain</td>
<td>50x</td>
</tr>
</tbody>
</table>
Sharing Minimum Gain

A partner’s share of Minimum Gain equals:

• His cumulative allocations of non-recourse deductions, plus

• Distributions made to him of proceeds of a nonrecourse liability allocable to an increase in partnership minimum gain, less

• His share of reductions in minimum gain
Character of Nonrecourse Deductions

Ordering Rules:

- Nonrecourse deductions consist of:
  - Depreciation or cost recovery deductions
  - A pro rata portion of other partnership losses, deductions, and expenditures for the year
  - Any excess nonrecourse deductions are carried over.
Nonrecourse Deductions

Exercise 1, part 1:

A and B each contribute $40 to new partnership AB. AB uses $50 and incurs a $200 nonrecourse mortgage to buy a rental real estate property for $250.

During 2008, AB has the following items of taxable income:

- Gross Rents $90
- Operating Expenses (75)
- Interest Expense (paid) (20)
- Depreciation Expense (40)

AB does not make any principal payments on the mortgage.

Does AB have any nonrecourse deductions in 2008?
## Nonrecourse Deductions

Exercise 1, part 1:

End of 2008:

<table>
<thead>
<tr>
<th></th>
<th>Beginning</th>
<th>Ending</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of Mortgage</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Basis of Rental Property</td>
<td>($___)</td>
<td>($___)</td>
</tr>
<tr>
<td>Excess of Mortgage over Basis</td>
<td>_______</td>
<td>______</td>
</tr>
</tbody>
</table>

Increase in minimum gain = 
Nonrecourse Deductions =
Character of nonrecourse deductions is
### Nonrecourse Deductions

Exercise 1, part 1:

End of 2008:

<table>
<thead>
<tr>
<th></th>
<th>Beginning</th>
<th>Ending</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of Mortgage</td>
<td>$ 200</td>
<td>$ 200</td>
</tr>
<tr>
<td>Basis of Rental Property</td>
<td>($ 250)</td>
<td>($ 210)</td>
</tr>
</tbody>
</table>

Excess of Mortgage over Basis

- Excess of Mortgage over Basis: 0
- Increase in minimum gain = 0
- Nonrecourse Deductions = 0
- Character of nonrecourse deductions is N/A
Nonrecourse Deductions

Exercise 1, part 2:

During 2009, AB has the following items of taxable income:

- Gross Rents $95
- Operating Expenses (75)
- Interest Expense (paid) (20)
- Depreciation Expense (40)

AB does not make any principal payments on the mortgage.

Does AB have any nonrecourse deductions in 2009?
Nonrecourse Deductions

Exercise 1, part 2:

End of 2009:

<table>
<thead>
<tr>
<th></th>
<th>Beginning</th>
<th>Ending</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of Mortgage</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Basis of Rental Property</td>
<td>($___)</td>
<td>($___)</td>
</tr>
</tbody>
</table>

Excess of Mortgage over Basis

Increase in minimum gain =

Nonrecourse Deductions =

Character of nonrecourse deductions is
Nonrecourse Deductions

Exercise 1, part 2:

End of 2009:

<table>
<thead>
<tr>
<th></th>
<th>Beginning</th>
<th>Ending</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of Mortgage</td>
<td>$ 200</td>
<td>$ 200</td>
</tr>
<tr>
<td>Basis of Rental Property</td>
<td>($ 210)</td>
<td>($ 170)</td>
</tr>
</tbody>
</table>

Excess of Mortgage over Basis 0 30

Increase in minimum gain = 30
Nonrecourse Deductions = 30

Character of nonrecourse deductions is depreciation expense.
Nonrecourse Deductions

Exercise 1, part 3:

During 2010, AB takes out a second mortgage on the property for $100. The proceeds are traced under Treas. Reg. section 1.163-8T to distributions, of which A and B each received $50. AB has the following items of taxable income:

- Gross Rents $105
- Operating Expenses (75)
- Interest Expense (paid) (30)
- Depreciation Expense (40)

AB does not make any principal payments on either mortgage.

Does AB have any nonrecourse deductions in 2010?
## Nonrecourse Deductions

**Exercise 1, part 3:**

**End of 2010:**

<table>
<thead>
<tr>
<th></th>
<th><strong>Beginning</strong></th>
<th><strong>Ending</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of 1\textsuperscript{st} Mortgage</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Amount of 2\textsuperscript{nd} Mortgage</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Basis of Rental Property</td>
<td>($_____)</td>
<td>($____)</td>
</tr>
</tbody>
</table>

**Excess of Mortgage over Basis**

\[
\text{Excess of Mortgage over Basis} = \_
\]

\[
\text{Increase in minimum gain} = \_
\]

\[
\text{Amount attributable to distribution of N/R borrowing} = \_
\]

**Nonrecourse Deductions**

\[
\text{Nonrecourse Deductions} = \_
\]

**Character of nonrecourse deductions is**

\[
\text{Character of nonrecourse deductions is} = \_
\]
Nonrecourse Deductions

Exercise 1, part 3:

End of 2010:

<table>
<thead>
<tr>
<th></th>
<th>Beginning</th>
<th>Ending</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of 1\textsuperscript{st} Mortgage</td>
<td>$200</td>
<td>$200</td>
</tr>
<tr>
<td>Amount of 2\textsuperscript{nd} Mortgage</td>
<td>$0</td>
<td>$100</td>
</tr>
<tr>
<td>Basis of Rental Property</td>
<td>($170)</td>
<td>($130)</td>
</tr>
</tbody>
</table>

Excess of Mortgage over Basis | 30        | 170    |

Increase in minimum gain = 140

Amount attributable to distribution of N/R borrowing = 100

Nonrecourse Deductions = 40

Character of nonrecourse deductions is depreciation expense
Minimum Gain Chargeback

Assume the AB partnership agreement provides that profits and losses are allocated 60% to A and 40% to B. At the end of 2010, A and B share minimum gain as follows:

<table>
<thead>
<tr>
<th></th>
<th>Partner A</th>
<th>Partner B</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008 Nonrecourse Deductions</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2009 Nonrecourse Deductions</td>
<td>(18)</td>
<td>(12)</td>
</tr>
<tr>
<td>2010 Nonrecourse Deductions</td>
<td>(24)</td>
<td>(16)</td>
</tr>
<tr>
<td>2010 Distribution</td>
<td>(50)</td>
<td>(50)</td>
</tr>
<tr>
<td>Minimum Gain</td>
<td>(92)</td>
<td>(78)</td>
</tr>
</tbody>
</table>
In 2011, the building is sold for $400, generating gain of $270, and the loan is repaid. There are no other items of income during the year. How is the gain allocated?

<table>
<thead>
<tr>
<th></th>
<th>Partner A</th>
<th>Partner B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Gain Chargeback</td>
<td>92</td>
<td>78</td>
</tr>
<tr>
<td>Remaining Income</td>
<td>60</td>
<td>40</td>
</tr>
<tr>
<td>Total Gain</td>
<td>152</td>
<td>118</td>
</tr>
</tbody>
</table>
QUALIFIED NONRECOUPSE FINANCING AND USE OF GUARANTEES
Qualified Nonrecourse Financing

I. When some or all of the partners are personally liable for partnership recourse debt, that debt is included in their adjusted basis.

II. Usually, these partners also include the debt in their amount at risk.
Qualified Nonrecourse Financing

I. No partner, however, carries any financial risk of nonrecourse debt. Therefore, as a general rule, partners cannot include nonrecourse debt in their amount at risk even though the debt is included in the adjusted basis of the partnership interest.

II. In many cases, however, there is an exception to the general rule.
Qualified Nonrecourse Financing

I. Real estate nonrecourse financing provided by a bank, retirement plan or similar party, or by a Federal, state or local government generally is deemed to be at risk. 465(b)(6).

A. Such debt is referred to as qualified nonrecourse financing.
Qualified Nonrecourse Financing

I. When determining a partner’s loss deduction, the overall limitation rule is invoked first—that is, the deduction is limited to the partner’s outside basis at the end of the partnership year.

II. Then, the at-risk provisions are applied to see if the remaining loss is still deductible. Suspended losses are carried forward until the partner has sufficient amount at risk. 465(a)(2).
Kyle invests $5,000 in the Kyle Jensen Partnership as a 5% general partner. Shortly thereafter, the partnership acquires an (non real estate) asset for $250,000 ($50,000 from the partnership and $200,000 secured by a local bank with a recourse mortgage). Assume Kyle’s share of the recourse debt is $10,000 and his basis is $15,000 ($5,000 + $10,000). Since the debt is recourse, Kyle’s at risk amount is also $15,000. Kyle’s share of partnership losses in the first year of operation is $12,000. He is entitled to deduct the full loss under the overall and at risk limitations.
EXAMPLE 10

Assume the same facts, but instead the bank loan is nonrecourse. Kyle’s basis is still $15,000 but he can only deduct $5,000 of the loss under the at risk limitations. His amount at risk does not include the nonrecourse loan.

I. Note that if the partnership had acquired real estate then Kyle would have been considered at risk with regard to the loan
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Subrogation

I. A limited partner that guarantees a partnership liability bears the economic risk of loss for her share of the liability. The partner’s right to subrogation, however, must be taken into account to determine if she bears the economic risk of loss. Reg. 1.752-2(b)(1), (3)
EXAMPLE 11

Gary, the general partner, and Harold, the limited partner form GH, LP, with each contributing $40,000. The GH partnership agreement provides for equal sharing of profits and losses. GH purchases depreciable property with $80,000 in cash and a $120,000 recourse note. Harold guarantees the note. As a LP, Harold has no obligation to make any additional contributions to GH.
EXAMPLE 11 (continued)

Harold’s guarantee, of course, requires him to repay the note if the partnership defaults. As a guarantor, however, Harold is subrogated to the seller’s right against the partnership under the note. Thus if HG constructively liquidates, Harold is entitled to reimbursement from the partnership for any payment made on the note under the guarantee (because if his right of subrogation)
EXAMPLE 11 (continued)

We see that Harold does not in fact bear the economic risk of loss for the note. Gary bears the economic risk since his is the sole general partner, and as such, required to make a contribution to the partnership to pay the subrogee, Harold.
Indemnification

I. A LP that indemnifies a GP who guarantees a partnership liability bears the economic risk of loss to the extent he is obligated to reimburse the GP.

II. The LP is deemed to have an obligation to make a payment to the creditor or other person, assuming the partnership cannot pay the debt under a constructive liquidation. Reg. 1.752-2(f), Exs. 3, 4.
EXAMPLE 12

Martha, a GP, and Nan, an LP, each contribute $100,000 to form MN, LP. They agree to share profits and losses equally. MN purchases rental property for $200,000 cash and a $700,000 nonrecourse note. Martha provides additional security by personally guaranteeing the note. Accordingly, Martha is liable for the difference between the value of the property and the outstanding balance of the loan.
EXAMPLE 12 (continued)

In connection with the loan, Nan agrees to indemnify Martha for 50% of any payment Martha is required to make under the guarantee.

Upon a constructive liquidation, Martha is required to pay the outstanding balance on the nonrecourse note, but Nan is required to reimbursement of 50% of any payments made.
EXAMPLE 12 (continued)

*Martha and Nan equally bear the economic risk of loss of the nonrecourse liability. The liability is treated as a recourse liability that the partners share equally.*
PARTNER NONRECOUPED DEDUCTIONS

Jeffrey N. Bilsky, BDO USA
Partner Nonrecourse Deductions

Example:

Partnership Agreement:
• All income allocated 90/10
• Liquidating distributions based on positive capital accounts
• No DRO, but meets the alternative test
• AB Borrowed $200 from B on a Nonrecourse basis

Capital Accounts
A = $0
B = $0
AB breaks even for the year before depreciation of $20.

Do these allocations have economic effect?

Who bears the risk of loss?

Capital Accounts
A = $0 - $18 = ($18)
B = $0 - $2 = ($2)
Partner Nonrecourse Deductions

• Partner nonrecourse deductions
  – Deductions and losses generated by funds borrowed on a N/R basis
  – A partner or related person bears the economic risk of loss because, for example, the partner or related person is the lender or guarantor.

• Allocated to the partner that bears the economic risk of loss

• Otherwise, rules similar to other N/R deductions apply
  – Partner Nonrecourse debt minimum gain
  – Partner Nonrecourse debt minimum gain chargeback

• If there is Nonrecourse and Partner Nonrecourse debt in a partnership, priority becomes critical
Partner Nonrecourse Deductions

B bears the economic risk of loss so the losses must be allocated entirely to B.

Capital Accounts
A = $0 - $18 = ($18)
B = $0 - $2 = ($2)
LEVERAGED PARTNERSHIP STRUCTURES, CANAL, TRIBUNE, AND THE PENDING SECTION 752 REGULATIONS

Jeffrey N. Bilsky, BDO USA
Leveraged Partnerships
Typical Structure

Seller

Assets to Be Sold

Buyer

Other Assets

P-ship
Leveraged Partnerships
Typical Structure

Seller Liable on Note:
• Provides basis
• Avoids disguised sale

Diagram showing the typical structure:
- Seller pays cash to P-ship.
- Buyer receives cash from P-ship.
- Bank provides cash to Seller and receives a note from Buyer.
- P-ship holds cash from Buyer and note from Seller.
Leveraged Partnerships
Canal Corporation (2010)

• Facts

• A subsidiary of Canal (Wisco) contributed assets valued at $775m to a partnership with Georgia Pacific (GP)
• The LLC borrowed and distributed $755.2 million to Wisco
• Wisco loaned the $755.2 million to Canal.
• GP guaranteed the debt, but Wisco indemnified GP
• Wisco owned only the loan and a corporate jet
Leveraged Partnerships
Canal Corporation (2010)

• The Decision
  • Wisco had no actual liability so the transaction was a disguised sale
  • Neither the lender nor GP requested the indemnification
  • Wisco was not required to hold sufficient assets to satisfy its obligation
  • The indemnity was limited to principal
  • Wisco told credit rating agencies that it had no risk on the indemnity
Leveraged Partnerships
Canal Corporation (2010)

Canal

$755m loan

Wisco

Indemnity

GP

Other Assets

Pship

Assets
FMV=$775m

Bank

$755M

Guaranty

Note

$755m
The taxpayer appears to be the Tribune Company

- S corporation owned by an ESOP
- Wanted to sell its Newsday business
- Large potential BIG tax
Leveraged Partnerships
CCA 201324013 - Facts

- In 2008 formed Partnership with a subsidiary of Cablevision
  - Tribune contributed Newsday
  - Cablevision Sub contributed $35m cash and $650m in Cablevision notes
  - Partnership was not allowed to sell Newsday for 10 years

- Partnership borrowed and distributed $612m to Tribune
  - Secured by all of Partnership’s assets
  - Guaranteed by Cablevision and Cablevision Sub
  - Cablevision’s guarantee obligation indemnified by Tribune
  - Tribune retained a 3% interest in the partnership worth $5m
Leveraged Partnerships  
CCA 201324013 - Conclusions

• Tribune’s obligation under the indemnity agreement should be disregarded
  — Neither Cablevision nor the Bank required or negotiated for the indemnity
    — No net worth requirement was imposed
    — Other standard commercial terms were lacking, such as a fee and an obligation to provide annual financial statements
    — Tribune would get the collateral if called upon to pay the indemnity
  — Cablevision Sub’s ability to pay was based on Cablevision’s payment of the notes. If Cablevision could not pay the notes, it probably could not pay the guarantee either
Leveraged Partnerships
CCA 201324013

• On audit, IRS’ found a disguised sale, assessed $190m tax, $17m interest and $38m penalties

• A similar transaction involving Tribune’s disposition of the Chicago Cubs is now being audited ($225m additional tax plus interest & penalties at stake)
Pending Guidance under Section 752: Possible Planning Implications

• Pending proposed regulations relating to Section 752 liability allocations.

• Key issues addressed expected to include:
  • Limits on use of bottom-dollar loan guarantees
  • Net worth maintenance requirement

• Potential impact on planning and transaction structuring?