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

WEDNESDAY, DECEMBER 3, 2014, 1:00-2:50 pm Eastern

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Recourse and Non-Recourse Debt for Partnerships

Dec. 3, 2014

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Topics

• I. Introduction
• II. Nonrecourse Deductions & Minimum Gain Chargeback
• III. Legal Developments Leading Up to the Section 752 Proposed Regulations
• IV. Section 752 Proposed Regulations
Part I

Introduction
Effect of Liabilities on Basis

• In partnerships, partners include the amount of liabilities in the outside basis of their partnership interests.
  – contrast with C corporations

• Section 752(a): any increase in a partner’s share of the liabilities of a partnership, or any increase in a partner’s liabilities by reason of the assumption by that partner of partnership liabilities, is considered a contribution of money by the partner to the partnership. *See also* Treas. Reg. section 1.752-1(b).

• Section 752(b): any decrease in a partner’s share of the liabilities of a partnership, or any decrease in a partner’s liabilities by reason of the assumption by the partnership of the partner’s liabilities, is considered a distribution of money by the partnership to the partner. *See also* Treas. Reg. section 1.752-1(c).
Effect of Liabilities on Basis

- Section 722: Partners with deemed cash contributions will increase their basis by the amount of the deemed contribution.
- Section 705/733: Partners with deemed cash distributions will decrease their basis by the amount of the deemed distribution.
Relevance of Basis

• Section 704(d): A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred.
  – The excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

• This is intended to prevent a partner from claiming losses allocated to him to the extent that they would drive his basis negative.
Relevance of Basis

• Section 731: A partner can generally receive assets in a distribution and avoid gain recognition.

• Key exception: If the distribution (either actual or deemed) includes an amount of money or marketable securities which have a fair market value in excess of the distributee/partner’s basis in his partnership interest, the distribution to the partner will be taxable to the extent that it exceeds a partner’s basis in the partnership interest.
Contribution of Encumbered Property

• When a partner contributes encumbered property to a partnership, the partnership becomes the obligor on the debt.
• As a result, the contributing partner is relieved of his personal liability on the debt, and as a partner becomes responsible for a share of all of the partnership’s liabilities, including the liability encumbering the contributed property.
• This could result in both a decrease and an increase in the contribution partner’s share of liabilities.
• These adjustments are deemed to occur simultaneously and only the net change is taken into account. Treas. Reg. section 1.752-1(f).
• Therefore, section 731 can cause a contributing partner to recognize gain to the extent that that the amount of debt associated with the contributed property exceeds the partner’s basis in the partnership.
Change from Recourse to Nonrecourse

• A change in the recourse nature of a loan to nonrecourse may alter the sharing of the partners’ recourse and nonrecourse liabilities.
  – Accordingly, their bases must be adjusted to reflect the new sharing ratios. If a decrease in a partner's share of liabilities exceeds the partner's basis, he must recognize gain on the excess.

• Consider possible implications in the conversion of a limited partnership into an LLC.
  – Limited partnerships have general partners; LLCs do not.
Admission of a New Partner

• The admission of new partners may result in a partner receiving an allocable share of partnership liabilities.
• This may trigger deemed cash distributions to the other partners to the extent of reductions in their allocable share of partnership liabilities and may result in gain recognition under section 731.
Section 956

• Section 956 focuses on a controlled foreign corporation repatriating earnings by investing in certain specified types of U.S. property.
  – Generally, the investment is of a lasting nature which would reasonably be expected to produce income for an indefinite period of time.
• Section 956 does not contain an explicit rule that looks through a partnership interest to the assets held by a partnership.
• The IRS has ruled for purposes of Section 956 that a controlled foreign corporation owns a share of the U.S. property held by a partnership in which the controlled foreign corporation is a partner.
• Rev. Rul. 90-112 treats a 25 percent partner as owning 25 percent of the adjusted basis of the partnership's U.S. property.
• The general effect is that the amount of the adjusted basis is treated as a deemed distribution.
• In contrast to other situations, the taxpayer may want to limit the share of debt in this context.
Relationship between Capital Account and Tax Basis

• Section 704(b) capital accounts and tax basis are calculated similarly.
  – One important difference is that capital accounts do not take into account a partner’s share of partnership liabilities.

• If section 704(b) capital accounts are negative, often the reason is that there is debt at the partnership level.
  – Consider, for example, partnership assets that are fully depreciated to zero basis. Subsequently, the partnership borrows and the partners receive a share of the liabilities of the debt, and distributes the funds from the partnership.
  – Compare with the concept of an excess loss account in the corporate context.

• Generally, partners attempt to defer any gain as long as possible.
Current Regulations

• Recourse and nonrecourse liabilities are allocated under separate rules.

• A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability under Treas. Reg. section 1.752-2. See Treas. Reg. section 1.752-1(a)(1).

• A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability. See Treas. Reg. section 1.752-1(a)(2).
Economic Risk of Loss

• A partner has an economic risk of loss if that partner or a related person would be obligated (whether by agreement or law) to make a net payment to the creditor or a contribution to the partnership with respect to the liability if the partnership were constructively liquidated.

• A partner who is the creditor for a liability that would otherwise be a nonrecourse liability of the partnership has an economic risk of loss in that liability.
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Part II

Nonrecourse Deductions & Minimum Gain Chargeback
What is “minimum gain”? 

Minimum Gain is the amount by which the nonrecourse debt encumbering a piece of partnership property exceeds the 704(b) basis of such property.
Why is it called “minimum gain”? 

In *Commissioner v. Tufts* (1983), the Supreme Court ruled that when a borrower surrenders property to a lender in exchange for debt relief, the amount realized on the foreclosure includes the full amount of the nonrecourse debt. The amount realized is *not* limited to the fair market value of the property.

Where the book basis of the property is less than the outstanding amount of the nonrecourse debt, there is potential taxable gain on the disposition of the property regardless of its fair market value. This potential gain is referred to as the *minimum gain*.
Nonrecourse liabilities > book basis = \textit{minimum gain}

- Principal Amount of Nonrecourse Liability = $10mm
- Minimum Gain = $4mm
- Book Basis = $6mm

Minimum Gain in Context
When a Property is Encumbered by 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 $900x subject to three liabilities:

1. A first mortgage of $800x from an unrelated bank
2. A second mortgage of $200x 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

First mortgage:
Liability Amount $800x
704(b) Basis (800x)
Minimum Gain 0x

Second mortgage:
Liability Amount $200x
704(b) Basis (100x)
Minimum Gain 100x

Accounts Payable:
Liability Amount 50x
704(b) Basis (0x)
Minimum Gain 50x
How is minimum gain created?

Minimum gain is created in the following ways:
• Deductions (generally depreciation)
• Distribution of proceeds of nonrecourse debt (could create a capital account deficit)
• Conversion of a recourse debt to a nonrecourse debt
How Do Partners Share Minimum Gain?

A partner’s share of minimum gain equals:

His cumulative allocations of nonrecourse 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
What are 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 economic risk of loss.

Normal allocation rules do not apply.

Must be allocated in accordance with the partners' interest in the partnership.
How are nonrecourse deductions allocated?

Allocations of non-recourse deductions will be deemed to be made in accordance with the partners’ interests in the partnership if the following requirements are met:

• Book capital accounts are maintained in accordance with the economic effect safe harbor rules, liquidating distributions are made in accordance with positive capital account balances, and the partnership agreement either contains an unlimited deficit restoration obligation or a qualified income offset.

• The manner in which the partnership allocates nonrecourse deductions among the partners must be made in a manner similar to the allocation of items which do have substantial economic effect.

• The partnership agreement must have a minimum gain chargeback provision.

• All other material allocations and capital account adjustments under the partnership agreement are recognized under the regulations.
How are nonrecourse deductions allocated?

For example, if the partnership agreement splits all of a partnership’s items of income, gain, and loss 50/50, it would be inconsistent to allocate one partner 90% of the partnership’s nonrecourse deductions.

If the partnership agreement has a more complex economic sharing arrangement, nonrecourse deductions may be allocated within a certain range and still meet the consistency requirement. E.g., if a partnership has an initial sharing arrangement between a limited and a general partner of 90:10 which changes at the partnership’s break even point to a 50:50 split, then allocating nonrecourse deductions on any ratio between 90:10 and 50:50 will meet the consistency requirement. An allocation of 99:1, however, would not be considered to be consistent with other items which do have substantial economic effect.
How are nonrecourse deductions measured?

- Generally measured by net increase in partnership minimum gain during the year
- But reduced by distributions of proceeds of nonrecourse debt allocable to an increase in partnership minimum gain
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></th>
<th>Ending</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of Mortgage</td>
<td>$200</td>
<td></td>
<td>$200</td>
<td></td>
</tr>
<tr>
<td>Basis of Rental Property</td>
<td>($250)</td>
<td></td>
<td>($210)</td>
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</table>

Excess of Mortgage over Basis

<table>
<thead>
<tr>
<th></th>
<th>Beginning</th>
<th></th>
<th>Ending</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>0</td>
<td></td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>

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>$ 200</td>
<td>$ 200</td>
</tr>
<tr>
<td>Basis of Rental Property</td>
<td>($ 210)</td>
<td>($ 170)</td>
</tr>
<tr>
<td>Excess of Mortgage over Basis</td>
<td>0</td>
<td>30</td>
</tr>
</tbody>
</table>

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 distributed $50 each to A and B. 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>$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
Nonrecourse Deductions

Exercise 1, part 4:

Assume that AB also owned a second property with zero basis subject to a $50 nonrecourse mortgage. In 2011, AB sells the second property for $50. AB has the following items of taxable income:

- Sale of 2nd Property $ 50
- 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 2011?
## Nonrecourse Deductions

Exercise 1, part 4:

End of 2011:

<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>$100</td>
<td>$100</td>
</tr>
<tr>
<td>Basis of Rental Property</td>
<td>($130)</td>
<td>($90)</td>
</tr>
</tbody>
</table>

Excess of Mortgage over Basis  

\[
\begin{align*}
170 & \quad 210
\end{align*}
\]

Increase in minimum gain before accounting for 2\textsuperscript{nd} property = 40

\textit{Decrease in minimum gain due to pay off of 2\textsuperscript{nd} mortgage} = 50

Net Change in Minimum Gain = (10)

Nonrecourse Deductions = 0

\textit{There is a net DECREASE in minimum gain, so we need to apply the...}
Minimum Gain Chargeback

When there is a decrease in minimum gain, income must be allocated to the partner who received the corresponding nonrecourse deductions.
Minimum Gain Chargeback

A net decrease in partnership minimum gain occurs when:

• Debt is repaid
• There is a taxable disposition of the property encumbered by the debt, or
• A nonrecourse liability is converted to a recourse liability
**Minimum Gain Chargeback**

Assume the AB partnership agreement provides that profits and losses are allocated 50% to A and 50% to B, but nonrecourse deductions are allocated 90% to A and 10% 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>(90)</td>
<td>(10)</td>
</tr>
<tr>
<td>2010 Nonrecourse Deductions</td>
<td>(90)</td>
<td>(10)</td>
</tr>
<tr>
<td>2010 Distribution</td>
<td>(50)</td>
<td>(50)</td>
</tr>
<tr>
<td>Minimum Gain</td>
<td>(230)</td>
<td>(70)</td>
</tr>
</tbody>
</table>
Minimum Gain Chargeback

In 2011, the building is sold generating gain of $400, 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>230</td>
<td>70</td>
</tr>
<tr>
<td>Remaining Income</td>
<td>45</td>
<td>45</td>
</tr>
<tr>
<td>Total Gain</td>
<td>275</td>
<td>115</td>
</tr>
</tbody>
</table>
### Summary of minimum gain

<table>
<thead>
<tr>
<th></th>
<th>Book Basis</th>
<th>Principal Amount of Nonrecourse Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Beginning Minimum Gain</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Increase in Minimum Gain</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Decrease in Minimum Gain</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Part III

Legal Developments Leading Up to the Section 752 Proposed Regulations
Canal Corp. v. Comm’r

- WISCO’s indemnification obligation:
  - Not requested or required by Georgia Pacific
  - Limited to principal
  - Georgia Pacific had to proceed against JV before seeking indemnity
  - WISCO would receive enhanced interest in JV if WISCO had to pay on indemnity
  - WISCO not required to maintain a certain net worth
  - Georgia Pacific aware that WISCO’s assets were limited
- Although WISCO was not required to maintain a certain net worth, tax advisor advised that WISCO should, and assumed that it would, maintain net worth equal to 20 percent of the guaranteed amount
- Indemnification obligation was not treated as a liability for accounting purposes because likelihood of payment was remote
Indemnity was disregarded in determining share of debt, resulting in disguised sale treatment

The court applied Reg. § 1.752-2(j) primarily for the following reasons:
• No obligation for WISCO to maintain any net worth
• Indemnity terms made the likelihood of it being invoked remote
• “[C]ompelling” statements by executives that the only risks of transaction were tax risks, not risks from indemnity
• Intercompany note created appearance, but not reality, of economic risk
In concluding the indemnity should be disregarded under Reg. § 1.752-2(j), the IRS considered the following factors:
• No requirement to maintain net worth
• No requirement to share financial statements
• No arm’s length fee
• No evidence the parties engaged in genuine negotiations
• No practical or commercial risk the obligation would be enforced
• The indemnitor did not record the indemnity as a liability or contingent liability on its financial statements
Part IV

Section 752 Proposed Regulations
Section 752 Proposed Regulations

• Recourse debt
  – Payment obligations
  – Net value requirement
  – Examples

• Nonrecourse debt
  – Current and proposed regulations
  – Examples
Current Regulations

• Recourse and nonrecourse liabilities are allocated under separate rules.

• A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability under Treas. Reg. section 1.752-2. See Treas. Reg. section 1.752-1(a)(1).

• A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability. See Treas. Reg. section 1.752-1(a)(2).
Current Regulations

• A partner’s share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the economic risk of loss. See Treas. Reg. section 1.752-2(a).

• In general, a partner bears the economic risk of loss for a partnership liability to the extent that, upon a constructive liquidation of the partnership, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable. See Treas. Reg. section 1.752-2(b)(1).

• The determination of the extent to which a partner or related person has an obligation to make a payment is based on the facts and circumstances at the time of the determination. See Treas. Reg. section 1.752-2(b)(3).
Current Regulations

• All statutory and contractual obligations relating to the partnership liability are taken into account, including obligations imposed by the partnership agreement, contracts outside the partnership agreement, and state law. See Treas. Reg. section 1.752-2(b)(3)(iii).

• A partner also generally bears the economic risk of loss for a partnership liability to the extent that the partner or a related person makes (or acquires an interest in) a nonrecourse loan to the partnership and the economic risk of loss for the liability is not borne by another partner or if the partner or a related person pledges property as security for the liability. See Treas. Reg. sections 1.752-2(c)(1) and 1.752-2(h).
Current Regulations

• Generally, in a constructive liquidation, the following events are treated as occurring at the same time.
  – All partnership liabilities become payable in full.
  – All of the partnership's assets have a value of zero, except for property contributed to secure a liability.
  – All property is disposed of by the partnership in a fully taxable transaction for no consideration except relief from liabilities for which the creditor's right to reimbursement is limited solely to one or more assets of the partnership.
  – All items of income, gain, loss, or deduction are allocated to the partners.
  – The partnership liquidates.
Proposed Regulations

• “The IRS and the Treasury Department are concerned that some partners or related persons have entered into payment obligations that are not commercial solely to achieve an allocation of a partnership liability to such partner.” Preamble to Proposed Treasury Regulations (Reg—119305-11)

• Taxpayers generally may not rely on proposed regulations for planning purposes, except if there are no applicable final or temporary regulations in force and there is an express statement in the proposed regulations that taxpayers may rely on them currently.

• Special transition rule may “grandfather” certain liabilities of partnerships for 7 years after the effective date.
Proposed Regulations

• **Payment Obligation Requirements**: Payment obligations with respect to a partnership liability will not be recognized under section 752, unless the following factors are satisfied.

• 1. The partner or related person is—
  – required to maintain a “commercially reasonable” net worth throughout the term of the payment obligation; or
  – subject to “commercially reasonable” contractual restrictions on transfers of assets for inadequate consideration.

• Does a breach of a loan agreement cause the payment obligation to be disregarded under the Proposed Regulations?
Proposed Regulations

• 2. The partner or related person is required periodically to provide “commercially reasonable” documentation regarding the partner’s or related person’s financial condition.

• 3. The term of the payment obligation does not end before the term of the partnership liability.
  – For example, if loan extends for 10 years, guarantee must be for 10 years.
  – Consider whether it is common for lenders to require credit support for only a limited period of time, such as until a lease terminates, until certain income and/or asset coverage ratios are satisfied, or some other milestone is achieved.
Proposed Regulations

• 4. The payment obligation does not require that the primary obligor or any other obligor with respect to the partnership liability directly or indirectly hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor.

• 5. The partner or related person received arm’s length consideration for assuming the payment obligation.
   – How common is it from a commercial practice standpoint for guarantor to receive a fee for a guarantee?
   – How is the value of a guarantee determined? Do all guarantees even have value (cash or otherwise)?
   – Consider implications on whether the guarantee fee is taxable.
Proposed Regulations

6. In the case of a guarantee or similar arrangement, the partner or related person is or would be liable up to the full amount of the partner’s or related person’s payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. (Bottom Dollar Guarantee)
   - This prong is intended to address “bottom dollar guarantees”.
   - For this purpose, the terms of a guarantee or similar arrangement will be treated as modified by any right of indemnity, reimbursement, or similar arrangement regardless of whether that arrangement would meet these payment obligation requirements.
     • The modification rule does not apply to 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.
   - Consider whether breaking up a single loan into multiple tranches/tiers could satisfy this prong.
   - What if all the tranches/tiers were loans from a single lender?
Proposed Regulations

• In the case of an indemnity, reimbursement agreement, or similar arrangement, 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 other benefitted party’s payment obligation is satisfied.
Payment Obligations

• General observations:
  – As an economic matter, consider whether lenders and credit support providers generally expect the partnership itself to satisfy its obligations.
  – How often do commercial arrangements among third parties satisfy every single payment obligation requirement?
  – If commercial practices change over time, how relevant will these payment obligation requirements be after a period of time?
Payment Obligations

• General observations (cont’d):
  – Would the payment obligation requirements make it fairly easy for a partner to provide meaningful credit support for partnership liabilities while permitting the liabilities to be treated as nonrecourse under section 752?
    • If the lender is actually another partner B, could partner A purposely provide credit support but fail the payment obligation requirements, so that partner B could be allocated basis?
  – What if the assets of the partnership are so valuable relative to the loan that the guarantee is never expected to be called upon?
  – Should “vertical slice” guarantees (25% of every dollar) qualify?
  – Should “top slice” guarantees be disregarded if the guarantor has any right of indemnification from any person with respect to the guarantee (other than joint and several liability)?
  – What is the impact on deficit restoration obligations?
Section 752 Proposed Regulations

• Recourse debt
  – Payment obligations
  – Net value requirement
  – Examples

• Nonrecourse debt
  – Current and proposed regulations
  – Examples
Current Regulations

• Subject to the exceptions described herein, there is generally no requirement that a partner or related person have any particular net worth to support that partner’s or related person’s payment obligation for purposes of determining whether a partner bears economic risk of loss or has a payment obligation.

  – Partners and related persons are presumed to satisfy their obligations without regard to their actual ability to do so. See Treas. Reg. section 1.752-2(b)(6).
Current Regulations

• This general presumption of ability to pay is subject to two significant exceptions.
  – First, the regulations contain an anti-abuse rule that was applied by the Tax Court in Canal Corp.
    • An obligation of a partner or related person may be disregarded if facts and circumstances indicate that a principal purpose of the arrangement is to eliminate the partner’s economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise.
  – Second, Treas. Reg. section 1.752-2(k) provides that, in determining the extent to which a partner bears the economic risk of loss for a partnership liability, an obligation of a disregarded entity is taken into account only to the extent of the net value of the disregarded entity.
Proposed Regulations

• The proposed regulations generally expand the net value requirements currently applicable only to disregarded entities to all other persons (subject to exceptions):
  – The net value rules provide that the amount of partnership liabilities for which a partner may be treated as bearing the economic risk of loss cannot exceed the partner’s net worth.
  – If a partner’s net worth changes, the limit in the net value rules is similarly adjusted (but only at specified times).
  – In addition, the net value rules should not be confused with the first of the six payment obligation requirements (i.e., the obligation to maintain a commercially reasonably net worth or to be subject to limitations on one’s ability to transfer assets without adequate consideration).
Proposed Regulations

• Key exceptions to net value requirement:
  – Does not apply to payment obligations of individuals and decedents’ estates, and
    • Whereas all payment obligations must satisfy the first payment obligation requirement, individuals and decedents’ estates do not need to satisfy the net value rules.
  – Does not apply to trade payables
Section 752 Proposed Regulations

• Recourse debt
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Proposed Regulations—Ex. 3
(Guarantee by limited partner)

- E and F form a limited partnership.
- E, the general partner, contributes 2,000 and F, the limited partner, contributes 8,000 in cash to the partnership.
- E and F are both corporations.
- The partnership agreement allocates losses 20% to E and 80% to F until F’s capital account is reduced to zero, after which all losses are allocated to E.
- The partnership purchases depreciable property for 25,000 using its 10,000 cash and a 15,000 recourse loan from a bank.
- E’s net value at all times exceeds the 15,000 loan amount, but F guarantees payment of the 15,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership (including causing E to make any contributions required of a general partner under state law).
- In a constructive liquidation, the 15,000 liability becomes due and payable.
- All of the partnership’s assets, including the depreciable property, are deemed to be worthless. The depreciable property is deemed sold for a value of zero.
Proposed Net Value Regulations—Ex. 3 (Guarantee by limited partner)
Proposed Net Value Regulations—Ex. 3 (Guarantee by limited partner)

Step 1: 2,000 Contribution

Step 1: 8,000 Contribution

Step 2: F guarantees Bank loan to extent that loan remains unpaid after bank has exhausted its remedies against the partnership and E (as GP)

Bank

Step 2: 15,000 Loan

LP

Property

Step 3: Seller sells Property to LP for 25,000

Seller

E

GP interest

LP interest

F

Step 3: Seller sells Property to LP for 25,000

Property

Bank

Step 2: F guarantees Bank loan to extent that loan remains unpaid after bank has exhausted its remedies against the partnership and E (as GP)
Proposed Net Value Regulations—Ex. 3 (Guarantee by limited partner)

• E, as a GP, would be obligated by operation of law to make a net contribution to the LP of 15,000.

• Capital accounts are adjusted to reflect the loss on the hypothetical disposition, and E would have a capital account of negative 15,000 after the constructive liquidation.

• Because E has net value to the extent of its obligation, it is assumed that F would not have to satisfy F’s guarantee.

• The 15,000 loan is treated as a recourse liability because one or more partners bear economic risk of loss.

• E’s share of the liability is 15,000 and F’s share is 0.
Proposed Net Value Regulations—Ex. 10 (Guarantee of first and last dollars)

- A guarantees 300 if any amount of the full 1,000 is not recovered by Bank.
- B guarantees 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.
- 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 qualifies.
  - Therefore, A’s payment obligation is recognized for purposes of the section 752 rules.
  - The amount of A’s economic risk of loss is 300.
- However, 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 does not qualify.
  - Therefore, B’s payment obligation is not recognized for purposes of the section 752 rules.
  - Therefore, B bears no economic risk of loss for LLC’s liability.
- As a result, 300 of the liability is allocated to A and the remaining 700 liability is allocated to A, B, and C under the nonrecourse liability rules.
Proposed Net Value Regulations—Ex. 10 (Guarantee of first and last dollars)

A’s Guarantee of 300

B’s Guarantee of 200 (but only if Bank otherwise recovers less than 200)—”Bottom Dollar” Guarantee

1,000 Loan
Why is B’s guarantee a nonqualifying bottom dollar guarantee under the proposed regulations?

Question: As an economic matter, does B really have no economic risk of loss here? Should the remaining debt be all treated as nonrecourse?

If the Bank recovered 800 from other sources, B would not be liable under its guarantee.

If the Bank recovered 100 from other sources, B would be liable under its guarantee.
Proposed Net Value Regulations—Ex. 11 (Indemnification of Guarantees)

• Similar facts to Example 10.
• C agrees to indemnify A up to 50 that A pays with respect to its guarantee, and C agrees to indemnify B for the full 200 with respect to its guarantee.
• Because A’s obligation would be recognized but for the effect of C’s indemnity and C is obligated to pay A up to the full amount of C’s indemnity if A pays any amount on its guarantee of LLC’s liability, C’s indemnity of A’s guarantee qualifies.
  – Therefore, C’s economic risk of loss is 50.
• C’s indemnity of A’s guarantee is treated as modifying A’s guarantee such that A is treated as liable for 250 only to the extent any amount beyond 50 of the partnership liability is not satisfied.
  – Thus, A is not liable if, and to the extent, any amount of the partnership liability is not otherwise satisfied, and, as a result, A’s guarantee is not recognized.
  – Therefore, A bears no economic risk of loss for the debt.
• Because B’s obligation is not recognized, C’s indemnity of B’s guarantee is not recognized.
  – Therefore, C bears no economic risk of loss for the debt.
• As a result, 50 of the liability is allocated to C under and the remaining $950 liability is allocated to A, B, and C under nonrecourse liability rules.
Proposed Net Value Regulations—Ex. 11 (Indemnification of Guarantees)

- **A’s Guarantee of 300**
- **B’s Guarantee of 200 (but only if Bank otherwise recovers less than 200)—“Bottom Dollar” Guarantee**
- **C’s Indemnity of A for 50**
- **C’s Indemnity of B for 200**

Diagram:
- **A**
- **B**
- **C**
- **LLC**
- **Bank**
- **1,000 Loan**
Proposed Net Value Regulations—Ex. 12
(Partial guarantee of partnership liability)

• A, B, and C are equal members of LLC.
• LLC borrows 1,000 from Bank.
• A guarantees payment of 25 percent of each dollar of the 1,000 liability that is not recovered by Bank.
• If 250 of the 1,000 partnership liability is not recovered by Bank, A is only obligated to pay $62.50 ($250 × .25) pursuant to the terms of the guarantee.
• Because A is not obligated to pay up to the full amount of its payment obligation (250) to the extent that 250 is not recovered by Bank, A’s guarantee does not qualify, and A’s payment obligation is not recognized.
• As a result, the LLC liability is allocated to A, B, and C under the nonrecourse liability rules.
Proposed Net Value Regulations—Ex. 12
(Partial guarantee of partnership liability)

A’s Guarantee of 25% of each dollar that is not recovered

Bank

1,000 Loan

LLC
Section 752 Proposed Regulations

• Recourse debt
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• Nonrecourse debt
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  – Examples
Current Regulations

• Currently, nonrecourse debt is shared in the following order:
  – According to each partner’s share of minimum gain
    • This is the excess of minimum gain of nonrecourse liability over book basis for section 704(b) purposes of the property that secures debt.
    • The idea is that, if there is an allocation of nonrecourse deductions generated by the debt, there should be an allocation of the debt such that the partners’ have sufficient basis under section 704(d) to take the deductions. This is generally viewed as taxpayer friendly.
  – According to each partner’s share of section 704(c) minimum gain
    • This is the excess of the debt over basis of property being contributed to a partnership.
  – According to partnership’s profits
    • (i) each partner’s profit sharing ratio,
    • (ii) each partner’s sharing of nonrecourse deductions (the alternative method),
    • (iii) each partner’s sharing of a significant item of partnership income or gain (the significant item method), or
    • (iv) each partner’s excess section 704(c) gain
Proposed Regulations

• With respect to the partnership profits prong, the proposed regulations:
  – remove the significant item method and the alternative method for allocation of excess nonrecourse liabilities,
  – retain the excess section 704(c) gain method, and
  – provide for a liquidation value safe harbor.
Proposed Regulations

• “The IRS and the Treasury Department believe that the allocation of excess nonrecourse liabilities in accordance with the significant item method and the alternative method may not properly reflect a partner’s share of partnership profits that are generally used to repay such liabilities because the allocation of the significant item may not necessarily reflect the overall economic arrangement of the partners.”

• “The IRS and the Treasury Department, however, are aware of the difficulty in determining a partner’s interest in partnership profits in other than very simple partnerships and, therefore, recognize the need to have a bright-line measure of a partner’s interest in partnership profits.”
  – Preamble to Proposed Regulations (Reg—119305-11).
Proposed Regulations

• As a proxy to a partner’s interest in partnership profits, the proposed regulations provide that a partner’s liquidation value percentage determined upon formation of the partnership and redetermined upon the most recent occurrence of a book-up event under Treas. Reg. section 1.704-1(b)(2)(iv)(f)(5) is used.

• A partner’s liquidation value percentage is the ratio (expressed as a percentage) of the liquidation value of the partner’s interest in the partnership to the liquidation value of all of the partners’ interest in the partnership.
Proposed Regulations

• The liquidation value of a partner’s interest in a partnership is the amount of cash the partner would receive with respect to the interest if, immediately after formation of the partnership or the occurrence of a book-up event, the partnership:
  – sold all of its assets for cash equal to the fair market value of such property,
  – satisfied all of its liabilities, paid an unrelated third party to assume all of its Treas. Reg. section 1.752-7 liabilities in a fully taxable transaction, and
  – liquidated
Section 752 Proposed Regulations

• Recourse debt
  – Payment obligations
  – Net value requirement
  – Examples

• Nonrecourse debt
  – Current and proposed regulations
  – Examples
Proposed Nonrecourse Regulations—Ex. 2 (Excess nonrecourse liabilities allocated according to partners’ liquidation value percentages)

• **Scenario A:**
  • The partners agree to allocate excess nonrecourse liabilities in accordance with the partners’ liquidation value percentages and to liquidate according to positive capital accounts.
  • The liquidation value percentage for each of partners X and Y is 50% ((each partner’s liquidation value immediately after the formation of 100) divided by (LLCs aggregate liquidation value immediately after the formation of 200)).
    – Therefore, X and Y each has a 25 share of the 50 liability and each is treated as contributing 25 to LLC under section 752(a).
Proposed Nonrecourse Regulations—Ex. 2 (Excess nonrecourse liabilities allocated according to partners’ liquidation value percentages)

Step 1: Contribution
- X: $100 contribution
- Y: LLC interest

Step 2: Nonrecourse Loan
- Bank: $50 nonrecourse loan to LLC

Step 3: LLC purchases from Seller
- Land A: $50
- Land B: $200

Seller: Land A for $50 and Land B for $200.
Proposed Nonrecourse Regulations—Ex. 2 (Excess nonrecourse liabilities allocated according to partners’ liquidation value percentages)

• **Scenario B:**
• On September 1, 2015, LLC distributes Land C to X.
• Immediately prior to the distribution, LLC owns the following assets:
  – (1) Land A with a fair market value of 40 and an adjusted tax basis of 50;
  – (2) Land B with a fair market value of 800 and an adjusted tax basis of 200; and
  – (3) Land C with a fair market value of 400 and an adjusted tax basis of 390.
• The outstanding principal on the partnership liability is 40.
• Therefore, immediately prior to the distribution, X and Y each own an interest in LLC with a net fair market value of 600 (40+800+400-40 divided by 2).
• The partners continue to agree to allocate excess nonrecourse liabilities in accordance with the partners’ liquidation value percentages.
• Assume LLC has no items of income, gain, loss, deduction, or credit in its taxable year ending December 31, 2015.
Proposed Nonrecourse Regulations—Ex. 2 (Excess nonrecourse liabilities allocated according to partners’ liquidation value percentages)

September 1, 2015,

Step 1: 100 Contribution

Step 2: Principal = 40 Nonrecourse Loan

Step 3: LLC purchases from Seller Land A for 50 and Land B for 200.

Step 4: LLC distributes Land C to Y

<table>
<thead>
<tr>
<th>Land A</th>
<th>FMV: 40, AB: 50</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land B</td>
<td>FMV: 800, AB: 200</td>
</tr>
<tr>
<td>Land C</td>
<td>FMV: 400, AB: 390</td>
</tr>
</tbody>
</table>

X

Y

LLC

Bank

Seller
Proposed Nonrecourse Regulations—Ex. 2 (Excess nonrecourse liabilities allocated according to partners’ liquidation value percentages)

- **Scenario B (cont’d):**
  - The distribution of Land C to X is an event described in Treas. Reg. section 1.704–1(b)(2)(iv)(f)(5) and, thus, X’s liquidation value percentage must be redetermined as of September 1, 2015.
  - Immediately after the distribution, X’s liquidation value percentage is 25%.
    - \(200 (600 (X’s \text{ liquidation value before distribution of Land C}) \text{ minus } 400 \text{ (value of Land C)}), \text{ divided by}
    - \(800 \text{ (800 plus 40 minus 40 (LLC’s aggregate liquidation value immediately after the distribution of 800))} \).
  - Accordingly, X’s share of the 40 liability is reduced from 20 to 10 on September 1, 2015, while Y’s share of the liability is increased from 20 to 30.
    - Thus, X is treated as receiving a distribution of 10 from LLC under section 752(b), and Y is treated as contributing 10 to LLC under section 752(a).
Proposed Nonrecourse Regulations—Ex. 2 (Excess nonrecourse liabilities allocated according to partners’ liquidation value percentages)

• **Scenario B (cont’d):**

• Prior to the distribution, X had a basis in his LLC interest of 320.
  – Because the distribution of 10 to X does not exceed X’s 320 adjusted basis in its interest in LLC, X recognizes no gain.
  – Afterwards, X’s basis in Land C is 310.
    • Section 732(a)(2) provides that X’s basis in Land C shall not exceed the adjusted basis of X’s interest in the LLC reduced by any money distributed in the same transaction.
Conclusion

• Consider the potential impact of the proposed regulations on the ability of a partner to:
  – make tax-deferred contributions of leveraged property to a partnership,
  – receive tax-deferred distributions of cash from a partnership, and
  – continue to take losses (where a partner otherwise would have sufficient basis under the current regulations).

• Consider whether the proposed regulations will result in the more likely application of the nonrecourse debt rules.