Recourse and Nonrecourse Liability in Partnership Agreements
Leveraging Section 752 to Minimize Tax Impact of Partnership Liability and Debt Allocations

THURSDAY, MAY 10, 2018
1pm Eastern  |  12pm Central  |  11am Mountain  |  10am Pacific

Today’s faculty features:
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DISTINGUISHING PARTNERSHIP LIABILITIES AND THEIR IMPACT

BETTY J. BOYD, M.A., ESQ., LL.M.
PARTNERSHIP LIABILITY

Two legal labs, Unity and Bartlett, drive to the bank to take out a partnership loan...what can they teach us about their loan’s character & impact?
LEARNING OBJECTIVES

Learn...

* How to identify the **debt’s character** as either recourse or nonrecourse.

* How recourse and nonrecourse debt is **allocated** to a partner’s outside basis under **I.R.C. § 752**. This ties into...
  - How losses are allocated under **I.R.C. § 704(b)**.
  - Whether a partner runs up against the **loss limitations** under **I.R.C. § 704(d)**.

* How recourse and nonrecourse debt affects a partner’s at-risk amount under **I.R.C. § 465**.
  - This affects whether a partner will be entitled to **claim an allocated loss**.
• How debt is allocated to partners is also important in determining whether a partner needs to recognize gain on his/her distributions under I.R.C. §731(a)(1).

We will not be discussing this topic in this presentation – but be aware.
CHARACTER OF DEBT

THINK RECURSE OR NONRECURSE – OF COURSE!


CHARACTER OF DEBT
GENERAL STATE LAW DEFINITION

• **Recourse Debt**: The lender *can* seek a **deficiency judgment** against the borrower when the collateral is insufficient to satisfy the debt.

• **Nonrecourse Debt**: The lender *cannot* seek a **deficiency judgment** against the borrower when collateral is insufficient to satisfy the debt.
CHARACTER OF DEBT
I.R.C. 752 DEFINITION

- **Think Recourse or Nonrecourse** –

  - **Recourse** Liability - Partner (or related person) bears the economic risk of loss if the liability is not paid.
    - **related person** - 80% rule
  - **Nonrecourse** Liability – No partner (or related persons) bears the economic risk of loss if the liability is not paid. **Treas. Reg. § 1.752-1(a).**
CHARACTER OF DEBT
WHAT TO LOOK FOR?

STATE LAW
&
CONTRACT LAW
CHARACTER OF DEBT
WHAT TO LOOK FOR?

• **State law**
  • Statues & case law
  • State law entity type
  • State law partner type
CHARACTER OF DEBT
WHAT TO LOOK FOR?

- **Contract law**
  - Loan documents
  - Partnership agreement
  - Side agreement(s)
WHY IS IT IMPORTANT?

RECOURSE AND NONRECOURSE CHARACTER
CHARACTER OF DEBT
WHY IS IT IMPORTANT?

It affects how the liability is allocated to a partner’s outside basis under I.R.C. § 752. Recourse liabilities are allocated differently than nonrecourse debts.

This impacts a partner’s loss limitations of I.R.C. § 704(d) and distributions under I.R.C. § 731.
CHARACTER OF DEBT
WHY IS IT IMPORTANT?

• It affects whether the partner will be considered at-risk for purposes of I.R.C. § 465
• A partner is at-risk for a liability to which s/he is personally liable or has pledged property (other than that used in the activity).
ALLOCATION OF DEBT & LOSS

PARTNER BASIS FROM DEBT FINANCING
ALLOCATION OF DEBT
HOW THE DEBT APPEARS ON K-1

A partnership liability is **recourse** to the extent that any partner (or related person) bears the economic risk of loss. Treas. Reg. § 1.752-1(a)(1).

A partnership liability is **nonrecourse** to the extent that no partner (or related partner) bears the economic risk of loss. Treas. Reg. § 1.752-1(a)(2).

- For purposes of I.R.C. § 752, we are looking to see if the liability is recourse or nonrecourse to the partner receiving a K-1 (and **NOT** the partnership borrowing the money).
- Consider all the facts and circumstances
ALLOCATION OF RECOUSe DEBT
CONSTRUCTIVE LIQUIDATION

• (1) all of the partnership's liabilities become payable in full;
• (2) with the exception of property contributed to secure a partnership liability, all of the partnership's assets, including cash, have a value of zero;
• (3) the partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership);
• (4) all items of income, gain, loss, or deduction are allocated among the partners; and
• (5) the partnership liquidates.
ALLOCATION OF RECOUSE DEBT
CONSTRUCTIVE LIQUIDATION

• Based on a hypothetical constructive liquidation (worst-case scenario).
• Key Question: Who is ultimately responsible for the debt, with no right of reimbursement/recourse from another partner or partnership?)
Bartlett and Unity want to buy a hot dog stand for $10,000.

They form an LLC (“Hot Dogs on the Pier”) in San Francisco. They are 50/50 members of Hot Dogs.
The LLC borrows the $10,000 to buy the hot dog stand. To induce the loan, Unity signs a guarantee, but Bartlett does not.
ALLOCATION OF RECURSE DEBT
BRIEF EXAMPLE

• The debt is a recourse debt for I.R.C. § 752 purposes because Unity bears the economic risk of loss.

• Unity will be allocated the entire $10,000 of debt because she bears 100% economic risk of loss if the partnership cannot pay.
CHARACTER OF DEBT
INTERPLAY BETWEEN 704 AND 752

• I.R.C. §§ 752 and 704(b) also work together to determine HOW losses are allocated.
  • Recourse debt and losses are allocated based on who will pay the debt if the partnership cannot (SEE test under I.R.C. §704(b)).
INTERPLAY BETWEEN 704 AND 752
RE COURSE DEBT

LOSS ALLOCATION Follows BASIS ALLOCATION
A PARTNER GETS BASIS FOR NONRECOUReSE LIABILITY!

Basis and not liable! I feel good!
ALLOCATION OF NONRECOUERSE DEBT
THREE TIERS

Treas. Reg. § 1.752-3(a)

- **Partner’s Share of nonrecourse debt:**

- **Tier #1**: Future Tufts Gain or Partner’s Share of Minimum Gain (PMG) under I.R.C. § 704(b) +

- **Tier #2**: I.R.C. § 704(c) Minimum Gain from a Partner’s Contributed Property +

- **Tier #3**: Partner’s Interests in Profits (PIP)
ALLOCATION OF NONRE COURSE DEBT
BRIEF EXAMPLE

• Unity contributes a laptop to Hot Dogs.
• She borrowed $1,200 to purchase the laptop (nonrecourse).
• There is still $1,100 owed on the laptop when it is contributed to Hot Dogs.
• There is a remaining basis of $1,000 when the laptop is contributed.
The partnership agreement allocates income and deductions (including nonrecourse deductions) 50/50 between Bartlett and Unity.

Hot Dogs takes a $200 depreciation deduction on the computer.

In addition, there is still $100 of built in minimum gain due to Unity at the end of the first year.
ALLOCATION OF NONREOCUERSE DEBT FOLLOWS PARTNERSHIP AGREEMENT

• FIRST YEAR: The allocation of the $1,100 nonrecourse debt associated with the laptop is as follows:

  - Tier 2: $100 **built in minimum gain** due to Unity.
  - Tier 3: $500 to Bartlett and Unity (each) – this is the remaining debt not in tier 1 and tier 2. This $1000 represents future nonrecourse deductions which will be allocated to Bartlett and Unity in the future.

Remaining Basis $1,000

Remaining Debt $1,100

Total annual depreciation $200 (after 1st year)
SECOND YEAR: The allocation of the $1,100 nonrecourse debt associated with the laptop is as follows:

- **Tier 1**: $100 to Bartlett and Unity (each) – this is the nonrecourse deductions allocated to them.
- **Tier 2**: $100 built in minimum gain due to Unity.
- **Tier 3**: $400 to Bartlett and Unity (each) – this is the remaining debt not in tier 1 and tier 2. This $800 represents future nonrecourse deductions which will be allocated to Bartlett and Unity in the future.
CHARACTER OF DEBT
INTERPLAY BETWEEN 704 AND 752

• I.R.C. §§ 752 and 704(b) also work together to determine how losses are allocated.
  • Nonrecourse debt and losses are allocated based on the partnership agreement.
ALLOCATION OF NONRECOourse DEBT
INTERPLAY WITH SEC. § 704

• Partnership nonrecourse debt can have no substantial economic effect to the partners outside the partnership.

• However, I.R.C. § 752 assumes the partnership will pay the liability (and, therefore, the partners will eventually pay through the partnership).

• Therefore, the partners are allocated nonrecourse debt (to be included in their basis).
INTERPLAY BETWEEN 704 AND 752
NONRECOURSE DEBT

**BASIS ALLOCATION** Follows **LOSS ALLOCATION**
AT RISK LIMITATIONS

NO LOSS ALLOWED WHERE PARTNER NOT AT RISK
PARTNER CANNOT CLAIM A LOSS UNLESS S/HE IS AT RISK

Please, please, may I use the loss?
CANNOT CLAIM ALLOCATED LOSS IF NOT AT RISK

- All partnership liabilities are included in the partners’ outside basis per IRC § 752(a)

BUT

- Only recourse and qualified nonrecourse liabilities can be included in the partners’ at-risk amounts per IRC § 465(b)(2),(6)

OUTSIDE BASIS VS. AT-RISK IN ACTIVITY

<table>
<thead>
<tr>
<th>Recourse:</th>
<th>Basis, At-Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonrecourse:</td>
<td>Basis, At-Risk</td>
</tr>
<tr>
<td>Qualified Nonrecourse</td>
<td>Basis, At-Risk</td>
</tr>
</tbody>
</table>


**NONRECOURSE DEBT AT RISK? QUALIFIED NONRECOURSE DEBT**

Allocated like any nonrecourse debt but treated at risk.

- Borrowed for use in an activity of holding real property, and that is

- Loaned (or guaranteed) by a federal, state, or local government or is borrowed from a "qualified" person (engaged actively and regularly in the business of lending money).

Ooh La! Qualified nonrecourse debt!
Partners are generally at risk for the following:

• Their contributions to the partnership

• Their share of recourse debt (for which they bear a risk of loss).

• Their share of qualified nonrecourse debt.
**General partners** are personally liable for a partnership’s **recourse loans** under state law.

A partner can be at-risk for a partnership debt if they have:

- Personally liability (e.g., **guarantor**);

**OR**

- **Pledged property** not used in the activity;

**AND**

- The partner is not protected against loss (e.g. indemnification)
AT RISK
WHAT’S AT RISK

• Limited partners are not personally liable for a partnership’s recourse loans under state law.
• But a limited partner can still be at-risk for a partnership debt if they have:
  • Personally liability (e.g., guarantor);
  OR
  • Pledged property not used in the activity;
  AND
  • The partner is not protected against loss (e.g. indemnification)

CAUTION: State law may require general partners to reimburse limited partners for amounts paid under a guarantee.
**AT RISK**

**WHAT’S AT RISK**

- **LLC members** are not personally liable for a partnership’s **recourse loans** under state law.
- But an LLC member can still be at-risk for a partnership debt if they have:
  - Personally liability (e.g., **guarantor**);
  - **Pledged property** not used in the activity;
- **AND**
  - The partner is not protected against loss (e.g. indemnification)
(b)(3) **CERTAIN BORROWED AMOUNTS EXCLUDED**

**A) In general** Except to the extent provided in regulations, for purposes of paragraph (1)(B), amounts borrowed shall not be considered to be at risk with respect to an activity if such amounts are borrowed from any person who has an interest in such activity or from a related person to a person (other than the taxpayer) having such an interest.

**B) Exceptions** (i) Interest as creditor

Subparagraph (A) shall not apply to an interest as a creditor in the activity.
• Unity lends money to Hot Dog for operating capital;
• Bartlett signs an agreement to indemnify Unity for 50% of the loan;
• Unity and Bartlett are allocated 50% each of the basis for this partnership liability under section 752;
• The debt is recourse; and
• Unity and Bartlett will be allocated 50% each of any loss derived from the debt;
• However, can Unity and Bartlett both claim the loss?
• The answer is no. Only Unity is at-risk.
BRIEF EXAMPLE

Bartlett (Indemnitor)

Unity (Lender)

Hot Dogs LLC
RE COURSE FOR BASIS AND LOSS ALLOCATION

BUT NOT AT RISK

• Related party loans (Due To/From Affiliates)
  • IRC section 752, Basis - Deems loans from 80% related parties as coming from you (under -4 reg.). But they did not come from you.
  • IRC section 465, Not at Risk – If there is no personal liability and no pledged property outside the activity.
• Assume the same facts as the last example except the lender is *Unity’s wholly-owned corporation* and Bartlett does not sign an indemnification agreement.
BRIEF EXAMPLE

Bartlett  (No Indemnity)

Unity  (Related to Lender)

| Hot Dogs LLC  | (Loan) | Wholly Owned Corp |

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CONCLUSION

MAKE NO BONES ABOUT THE CHARACTER OF YOU LOANS
BARTLETT’S NYLABONE IS COLLATERAL FOR A LOAN...
UNITY’S & BARTLETT’S CLOSING WORDS...

• With a recourse loan, the lender can take everything you own.
• With a nonrecourse loan, the lender is limited to your Nylabone.
• Know the difference...
• So you don’t say, “If I had only known!”
Recourse and Nonrecourse Liabilities in Partnership Agreements

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May 10, 2018
The Shifting Landscape for Partnership Liabilities

- Significant Regulations activity in October 2016:

  - Disguised Sales
    - Caution is in order for transactions involving either leveraged distributions and/or contribution of encumbered assets

  - Bottom Dollar Guarantees
Determination of Recourse Liabilities under Section 752

Temporary Regulations
Recourse Liabilities

General Rules - Liabilities

- **Recourse Liability** - A partnership liability is a recourse liability to the extent that a partner or related person bears the economic risk of loss (“EROL”) for that liability.

- **Nonrecourse Liability** - A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the EROL for that liability.
Recourse Liabilities

General Rules

• Each partner’s share of a recourse partnership liability equals the portion of the liability, if any, for which the partner or related person bears the EROL.

• A partner generally bears the EROL for a partnership liability if the partner or related person has a payment obligation if, upon a constructive liquidation of the partnership, the partnership’s assets are worthless and the liability became due and payable (“constructive liquidation test”).

• Partners and related persons are presumed to be able to satisfy their payment obligations irrespective of their net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.
Recourse Liabilities
Payment Obligations

In determining whether a payment obligation exists, all statutory and contractual obligations relating to the partnership liability are taken into account including:

• Contractual obligations outside the partnership agreement - such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors, to other partners, or to the partnership;

• Obligations to the partnership that are imposed by the partnership agreement - including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership; and

• Payment obligations imposed by state or local law - including the governing state or local law partnership statute (whether in the form of direct remittances to another partner or a contribution to the partnership).
Recourse Liabilities
Bottom Dollar Payment Obligations

The New Temporary Regulations

A bottom dollar payment obligation is NOT recognized for purposes of determining economic risk of loss with respect to a liability

*Bottom Dollar Payment Obligation = No EROL*
Recourse Liabilities

Bottom Dollar Payment Obligations

• A bottom dollar payment obligation is defined as:

  • With respect to a guarantee or similar arrangement - any payment obligation for which the partner is liable for less than the full amount of such partner's payment obligation if any amount of the partnership liability is not satisfied.

  • With respect to an indemnity or similar arrangement - any payment obligation for which the partner is liable for less than the full amount of such partner's payment obligation, if any amount of the indemnitee's payment obligation (that is recognized) is satisfied.

  • Principal purpose of avoidance - an arrangement that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements, and with a principal purpose of avoiding such liabilities being treated as a bottom dollar payment obligation.
Recourse Liabilities
Bottom Dollar Payment Obligations

Example:
A real estate partnership owns property worth $100 million and is encumbered by debt of $70 million.
A 1% partner needs $7 million of debt to support their deficit capital account, and therefore guarantees the bottom 10% of the debt.
This means that the partner would not have to pay on his guarantee unless (and only to the extent) that the value of the property were to drop below $7 million.
Highly unlikely that such an event would occur given the $100 million value of the property at the time of the guarantee.

Result - No real EROL = Bottom Dollar Guarantee
Recourse Liabilities

Exceptions

A payment obligation is not a bottom dollar payment obligation merely because:

1. A maximum amount is placed on the partner's or related person's payment obligation,
2. A partner's or related person's payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates (vertical slice guarantee), or
3. There is 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.
Recourse Liabilities

Exceptions

Vertical Slice Example

If a 1% partner guarantees the bottom 10% of a $70 million debt, it would be considered a bottom-dollar guarantee and not respected.

However, if that same partner guaranteed a vertical 10% of the debt, the partner would be allocated $7 million of recourse liabilities for purposes of Sec. 752, even though it could be unlikely that the partner would ever have to pay $7 million on the guarantee given that the property could be sold to satisfy a large portion of the outstanding debt if necessary.
Recourse Liabilities
Exceptions (cont.)

• 90 Percent Exception:
  • If a partner has a payment obligation that would be recognized (initial payment obligation) but for the effect of an indemnity, reimbursement agreement, or similar arrangement,
  • Then such bottom dollar payment obligation is recognized if, taking into account the indemnity, reimbursement agreement, or similar arrangement, the partner or related person is liable for at least 90 percent of the partner’s or related person’s initial payment obligation
Recourse Liabilities
Exceptions (cont.)

90 Percent Exception Example:

Partner A guarantees 100% of a partnership liability and Partner B indemnifies Partner A for the first 1% of Partner A’s obligation. Under the general rule, A’s obligation is a bottom dollar payment obligation since A is not obligated for the full guarantee. However, since A is obligated for at least 90% of the obligation, A’s payment obligation is recognized for purposes of Section 752.
Recourse Liabilities

Special Rule

• An indemnity, reimbursement agreement, or similar arrangement will be recognized only if, before taking into account the indemnity, reimbursement agreement, or similar arrangement, the indemnitee’s or other benefited party’s payment obligation is recognized or would be recognized if such person were a partner or related person.
Recourse Liabilities

Example 1

- A, B, & C are equal members of ABC, LLC.

- A guarantees up to $300 if ANY of the $1000 Bank loan is not paid.

- B guarantees up to $200, but ONLY if Bank otherwise recovers LESS than $200.

- Both A and B waive their rights of subrogation against each other.

- How is the liability allocated under the temporary regs?
Recourse Liabilities

Example 1

Because A is obligated to pay up to $300 if ANY of the $1000 Bank note is not recovered, A’s guarantee is NOT a bottom dollar payment obligation.

Therefore, A’s payment obligation is recognized and $300 will be allocated to A related to the payment obligation.
Recourse Liabilities

Example 1

Because B is obligated to pay up to $200 ONLY if Bank recovers LESS than $200 of the $1000 liability, B’s guarantee IS a bottom dollar payment obligation.

Therefore, B’s payment obligation is NOT recognized and $0 will be allocated to B related to the payment obligation.
Recourse Liabilities

Example 1

Total Liability Allocation:

A’s Guarantee  $300
B’s Guarantee  $  0

The remaining $700 is allocated to A, B, & C under the nonrecourse liability allocation rules.
Recourse Liabilities

Example 2

Same facts as in Example 1 except that:

- C agrees to indemnify A up to $100 that A pays with respect to its $300 guarantee
- C agrees to indemnify B fully with respect to its $200 guarantee
Recourse Liabilities

Example 2

Since A’s obligation:
• Would be recognized but for the effect of C’s indemnity and
• C is obligated to pay A up the full amount of C’s indemnity, then
• C’s indemnity is NOT a bottom dollar payment obligation and is recognized.
Recourse Liabilities
Example 2

Because C’s indemnity is recognized:
• A is treated as liable for only $200 of its $300 guarantee
• Therefore, A is not liable for the entire amount of its guarantee.
• Conclusion: A’s guarantee IS a bottom dollar payment obligation and it NOT recognized.

ABC, LLC

$1000 loan from Bank

A

B

C

$0 Liability Allocation
Recourse Liabilities
Example 2

Because B’s payment obligation was NOT recognized independent of C’s indemnity, then C’s indemnity of B is NOT recognized.

$0 is allocated to both B and C related to their payment obligations.
Recourse Liabilities

Example 2

Total Liability Allocation:

A’s Guarantee $0
B’s Guarantee $0
C’s Indemnity $100

The remaining $900 is allocated to A, B, & C under the
nonrecourse liability allocation rules.
Recourse Liabilities

Anti-abuse Rule

• Irrespective of the form of a contractual obligation, the Commissioner may treat a partner as bearing the EROL with respect to a partnership liability to the extent that with respect to a contractual obligation:
  • Another partner (or a person related to another partner) enters into a payment obligation and
  • A principal purpose of the arrangement is to cause the payment obligation to be disregarded under the general rules
• This rule is to avoid manipulation intended to achieve a tax result that is not consistent with the economics of the arrangements such as the partners agreeing among themselves to create a bottom dollar payment obligation so that a liability will treated as nonrecourse.
Recourse Liabilities
Required Disclosure

• Bottom dollar payment obligations must be disclosed on a Form 8275, Disclosure Statement, attached to the partnership return for the taxable year in which the bottom dollar payment obligation is undertaken or modified.
Recourse Liabilities

Required Disclosure (cont.)

- The disclosure must include the following information:
  - A caption identifying the statement as a disclosure of a bottom dollar payment obligation under section 752;
  - An identification of the payment obligation with respect to which disclosure is made;
  - The amount of the payment obligation;
  - The parties to the payment obligation;
  - A statement of whether the payment obligation is treated as recognized for purposes of section 1.752-2T(b)(3); and
  - If, applicable, the facts and circumstances that clearly establish that a partner or related person is liable for up to 90 percent of the partner’s or related person’s initial payment obligation and, but for an indemnity, reimbursement agreement, or similar arrangement, the partner’s or related person’s initial payment obligation would have been recognized.
Recourse Liabilities

Effective Date

• Applies to liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken with respect to a partnership liability on or after October 5, 2016

• Exception for liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to October 5, 2016

• A partnership may elect to apply the rules in the temporary regulations to all of its liabilities as of the beginning of the first taxable year of the partnership ending on or after October 5, 2016
Recourse Liabilities

Transition Relief

• If a partner’s allocable share of recourse partnership liabilities immediately prior to October 5, 2016 exceeds the amount of the partner’s adjusted basis in its partnership interest at such time (the “Grandfathered Amount”), a partnership can continue to apply the old rules to a transition partner to the extent of the partner’s adjusted Grandfathered Amount for a **seven year period**.

• A transition partner will cease to be a transition partner if:
  • It is a partnership, S corporation, or a business entity disregarded as an entity separate from its owner, and
  • the direct or indirect ownership of that transition partner changes by 50 percent or more.
Recourse Liabilities

Transition Relief (cont.)

• A partner’s Grandfathered Amount is reduced for:
  • Certain reductions in the amount of liabilities allocated to that partner under the transition rules and
  • Upon the sale of any partnership property, for any tax gain (including Section 704(c) gain) allocated to the partner less that partner’s share of amount realized
Disguised Sales and Partnership Liabilities

Section 707
Disguised Sales and Partnership Liabilities

Any advanced dealings in Sub K require firm grasp on fundamental principles that underlie (or purportedly underlie) Subchapter K.

Primary underlying taxation principle is aggregate theory.

Understanding aggregate theory principles goes a long way in dealing with complex Sub K rules.
Disguised Sales and Partnership Liabilities

Ideally, Code and Regs are drafted to support the aggregate theory.

• When the rules stray, results can be difficult or odd to analyze or explain.

• “Purest” form of aggregate theory entity is sole proprietorship
  • Study of sole prop can be very insightful to understanding the role of Sec. 752.
Disguised Sales and Partnership Liabilities

Consider Bob’s Food Truck, LLC.
• 100% owned by Bob
• Bob invests $20,000, borrows $55,000 and acquires equipment.
• Initial balance sheet - Assets:
  • Cash $10,000
  • Inventory 5,000
  • Equipment 60,000

• As a sole proprietor, Bob has full tax basis in the assets. Sec. 752 does not come into play.
Disguised Sales and Partnership Liabilities

Same facts except:

• Bob and Kevin each contribute $10,000 to the LLC
• LLC borrows $55,000 from bank
• Initial LLC balance sheet - Assets:
  • Cash $10,000
  • Inventory 5,000
  • Equipment 60,000

• Just like sole proprietor, LLC has full tax basis in its assets.
Disguised Sales and Partnership Liabilities

• Absent Sec. 752, Bob and Kevin would each have $10,000 tax basis for their LLC investment
  • Inside and outside tax basis of assets/ownership interests would not match
  • This mismatch would be inconsistent with aggregate
• Sec. 752 completes aggregate theory
  • Combination of equity investment plus liabilities equals tax basis of assets.
• This is an important foundational principle that resides under Sec. 752.
Disguised Sales and Partnership Liabilities

A common scenario professionals frequently deal with:

• Protecting deficit equity from accelerated gain recognition
Disguised Sales and Partnership Liabilities

- Assume after first year of operation, Bob’s Food Truck, LLC balance sheet has the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$15,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>5,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>60,000</td>
</tr>
<tr>
<td>A/D</td>
<td>(35,000)</td>
</tr>
<tr>
<td>Total</td>
<td>45,000</td>
</tr>
<tr>
<td>Bank debt</td>
<td>$55,000</td>
</tr>
<tr>
<td>Equity</td>
<td>20,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>(30,000)</td>
</tr>
<tr>
<td>Total</td>
<td>$45,000</td>
</tr>
</tbody>
</table>
Disguised Sales and Partnership Liabilities

• Assume after first year of operation, Bob’s Food Truck, LLC balance sheet has the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$15,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>5,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>60,000</td>
</tr>
<tr>
<td>A/D</td>
<td>(35,000)</td>
</tr>
<tr>
<td>Total</td>
<td>45,000</td>
</tr>
<tr>
<td>Bank debt</td>
<td>$55,000</td>
</tr>
<tr>
<td>Equity</td>
<td>20,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>(30,000)</td>
</tr>
<tr>
<td>Total</td>
<td>$45,000</td>
</tr>
</tbody>
</table>

The first year loss was funded with the full equity and then $10,000 of the debt.
Disguised Sales and Partnership Liabilities

Several operators agree to join forces and create purchasing and scheduling synergies, among many other benefits:
Disguised Sales and Partnership Liabilities

Several operators agree to join forces and create purchasing and scheduling synergies, among many other benefits:

Each LLC will contribute their existing assets and liabilities to the new LLC.
Your clients, Bob and Kevin, want to know what to be aware of to make sure this is ultimately a nontaxable combination for them.
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- Assets - TB $45,000
- Liabilities $55,000
Disguised Sales and Partnership Liabilities

Your clients, Bob and Kevin, want to know what to be aware of to make sure this is ultimately a nontaxable combination for them.

- Ordinarily, the answer is relatively simple:
  - Make sure allocation of liabilities from LLC is sufficient to at least cover/support the contributed deficit
Disguised Sales and Partnership Liabilities

• Ordinarily, the answer is relatively simple:

  • Make sure allocation of liabilities from LLC is sufficient to at least cover/support the contributed deficit

• Tax basis of LLC interest:
  • Asset contribution $45,000
  • Liability assumption (55,000)
  • Initial taxable distribution in excess (10,000)
Disguised Sales and Partnership Liabilities

The critical piece of the puzzle here is the Sec. 752(b) treatment of the liability transfer/assumption as a:

“distribution of money to the partner by the partnership”

When dealing with the disguised sale rules, the critical piece of the puzzle is the question of whether:

“the partnership is treated as transferring consideration to the partner.” Reg. Sec. 1.707-5(a)(1)
Disguised Sales and Partnership Liabilities

- In this simple example, Bob and Kevin are looking to have an allocation of at least $10,000 of LLC debt to preserve the currently nontaxable treatment.

- Tax basis of LLC interest:
  - Asset contribution: $45,000
  - Liability assumption: $(55,000)
  - Initial taxable distribution in excess: $(10,000)
Disguised Sales and Partnership Liabilities

Sec. 707 Disguised Sale Rules

• Intended to prevent nontaxable liquidation of asset ownership and/or nontaxable conversion of asset to cash

• Prevent abuse of Sec. 721 and Sec. 731 nontaxable transactions

• Most obvious DS involves contribution of property and related distribution of cash

• More difficult DS to deal with involve contribution of leveraged assets
  • This is also a very common scenario
Disguised Sales and Partnership Liabilities

There are two basic questions to be addressed:

• Is there a disguised sale?

• If so, what are the proceeds from the sale?

For this presentation, we are only dealing with disguised sales of property under Sec. 707.
Decision points within the 707 regulations

1. Sale of property exists under Reg. Sec. 1.707-3(a)(1) if:
   - There is a transfer of property by a partner to a partnership and a related transfer of money or other consideration back to the partner. Reg. Sec. 1.707-3(b)(1).
     - Reg. Sec. 1.707-3(c) contains two year presumption.

2. Were liabilities assumed? Reg. Sec. 1.707-3(b)
Decision points within the 707 regulations

3. Were the liabilities “qualified liabilities?” Reg. Sec. 1.707-5(a)(6)  
   ▶ Qualified liabilities are most advantageous.

4. What portion of qualified liabilities are “consideration”? Reg. Sec. 1.707-5(a)(5)

5. What remaining liabilities are not qualified liabilities?

Qualified liabilities

1.707-5(a)(6)(i) - Five categories of qualified liability

1. Older than two years and encumbered transferred property throughout
2. Within two years, not in anticipation of transfer, and encumbered property throughout
3. Allocable to capital expenditures of transferred property
4. Incurred in ordinary course of trade or business only if all assets of t/b are transferred
5. Not incurred in anticipation of transfer but incurred in connection with trade or business and all assets transferred
Qualified liabilities

1.707-5(a)(6)(ii)

If an otherwise qualified liability is also a recourse liability, it is only a qualified liability to the extent the liability is not in excess of value of transferred property.
Qualified liabilities

Reg. Sec. 1.707-5(a)(7)(i)

Unchanged is the presumption attached to liabilities incurred within two years of the transfer.

Reg. Sec. 1.707-5(a)(7)(ii)

Note that the 2016 revisions include a new disclosure requirement for transfers of qualified liabilities incurred within two years of transfer.
Let’s return to Bob and Kevin:

- Bob’s Food Truck, LLC will transfer:
  - All trade or business assets to Super Truck, LLC
  - Super Truck, LLC will assume all liabilities
    - Therefore, there will be a transfer of property and related transfer of “other consideration” under 1.707-3(b)(1)
    - As a result, there is a sale under 1.707-3(a)(1)

- Key question: To what extent will liabilities assumed be treated as “consideration” under 1.707-5?
Disguised Sales and Partnership Liabilities

The liabilities of Bob’s Food Truck:

- Incurred within two years of the transfer
- Were not incurred in anticipation of the transfer
- Encumbered the assets transferred throughout the entire period

Therefore, the liabilities should be treated as qualified (but will have a presumption of not being qualified).

- Look to 1.707-5(a)(5) to determine treatment
(i) If the transfer is not otherwise treated as part of a sale, the transfer of qualified liabilities will not be treated as part of a sale.

What this means is that if there is not another component that creates a sale, then the qualified liabilities are fine.

- If there was a related transfer of cash to Bob’s LLC, the transaction would have a component that creates a sale and qualified liabilities need to be further analyzed.
Disguised Sales and Partnership Liabilities

A “clean” transfer of assets subject to qualified liabilities, and nothing else in the mix - keeping two year rules in mind - there is little concern.
Disguised Sales and Partnership Liabilities
Liabilities other than qualified

Reg. Sec. 1.707-5(a)(1) - Basic rule:

- Liabilities other than qualified result in consideration to extent such liability exceeds the transferring partner’s share of that liability immediately after.

- It is in this last phrase where all of the difficulty resides
Disguised Sales and Partnership Liabilities
Liabilities other than qualified

• Reg. Sec. 1.707-5T(a)(2) was part of the 2016 regulation issue

• This section outlines the rules that apply to determining the partner’s share

  • It is this section in which all of the controversy now lies
Disguised Sales and Partnership Liabilities

Consider the example of Bud and Doris.

- Have extensive potato farm landholdings
  - FMV of land: $39 million
  - TB of land: $10 million
  - Current long-term debt on land: $11.5 million

- Bud and Doris are seeking an exit strategy
  - In particular are seeking a strategy for succession to the actual farming operations
  - The assets must remain productive
Disguised Sales and Partnership Liabilities

Key factors here include:

- Significant built-in taxable gain
- Significant unencumbered value
- Need to provide for a long-term, orderly succession
Disguised Sales and Partnership Liabilities

Bud and Doris’ LLC could:
• Obtain new debt and make a leveraged distribution
• Any taxable gain remains deferred

Problem:
• Does not address succession of business operations
Disguised Sales and Partnership Liabilities

Proposal:

• Bud and Doris contribute $14 million of net value to MegaSpud LLC as part of a large rollup for a proportionate 20% interest.

• Projections from Megaspud reflect total post transaction debt of $70 million to be guaranteed proportionately by all LLC members

• Bud and Doris 20% share of $70 million debt would be $14 million
Disguised Sales and Partnership Liabilities

Recap:

- Current net value of holdings:
  - Land value of $39 million,
  - less debt of $11.5 million,
  - equals $27.5 million net value

- Could reduce to $14 million net with additional $13.5 million of debt

- Current untaxed gain of $29 million
  - Seek to defer as long as possible
Disguised Sales and Partnership Liabilities

Proposal:

• MegaSpud proposed obtaining all of the B&D land subject to $25 million of debt for net value contribution of $14 million

Initial analysis of how to accomplish:

• B&D LLC borrows $13.5 million for leveraged distribution
  • LLC would have $39 million of land and $25 million debt
• Bud and Doris contribute 100% of B&D LLC to MegaSpud, LLC for the 20% interest
Disguised Sales and Partnership Liabilities

Walk through at the asset level:

- Contribute land $10.0 m
- Debt assumed by Megaspud $(25.0)m
- Debt allocated back to B&D $14.0 m **
- Net (gain) - Distrib in excess $(1.0) m

** Under the scenario presented, the total debt of Megaspud immediately post transaction is projected to be $70 million. 20% allocation would be $14.0 million.
Disguised Sales and Partnership Liabilities

Absent disguised sale rules current tax impact is only dependent on whether Sec. 752 deemed distribution creates a distribution in excess of tax basis.

- Contribute land $10.0 m
- Debt assumed by Megaspud ($25.0)m
- Debt allocated back to B&D $14.0 m **
- Net (gain) - Distrib in excess ($1.0) m

** Under the scenario presented, the total debt of Megaspud immediately post transaction is projected to be $70 million. 20% allocation would be $14.0 million.
Disguised Sales and Partnership Liabilities

Megaspud and B&D agree in principle to the transaction as outlined.

• Bud and Doris execute a new $13.5 million borrowing and receive a distribution from the LLC

• Transfer to Megaspud will consist of:
  • $11.5 million of qualified liabilities
  • $13.5 million of other liabilities
Disguised Sales and Partnership Liabilities

Need to first address the liability other than qualified:

Pre October 2016 rules:

- Reg. Sec. 1.707-5(a)(2)(i) stated that a partner’s share of a recourse liability equals the partner’s share of such liability under the rules of Sec. 752.
  - Quite simple actually
Disguised Sales and Partnership Liabilities

Pre October 2016 rules

• In our example, B&D have agreed to guarantee 20% of $70 million, or $14 million

• Strategic angle is for Bud and Doris to personally guarantee new $13.5 million note and retain that sole personal guarantee on that debt after transfer.

• Under the prior rules, their share of that particular non-qualified debt before and after is equal to $13.5 million

• As a result, no disguised sale proceeds
Disguised Sales and Partnership Liabilities
Pre October 2016 rules

• Bud and Doris hold an interest in Megaspud in which:
  • They have recognized a $1 million gain on a distribution in excess of basis
  • Retain an additional $28 million of Sec. 704(c) gain
  • Will recognize cash-less income of $13.5 million as new liability is paid down by Megaspud

• Overall very good tax and business succession planning
Disguised Sales and Partnership Liabilities

Need to first address the liability other than qualified: October 2016 rules:

• Reg. Sec. 1.707-5T(a)(2)(i) states very simply that for 1.707-5 a partner’s share of a liability - whether recourse or nonrecourse - is determined by applying same percentage used for excess nonrecourse liabilities under 1.752-3(a)(3)

• Such amount shall not exceed their share that is otherwise determined applying Sec. 752.
Disguised Sales and Partnership Liabilities
October 2016 Rules

• The new rules published in 2016 mean that for Bud and Doris and their succession plan with Megaspud:
  • The leveraged distribution of $13.5 million will be treated as proceeds from a sale in the amount of at least 80% of the $13.5 million
  • They will be allocated 20% as their share under 1.707-5T(a)(2)(i) pursuant to the rules under 1.752-3.
  • Because the other liabilities have “otherwise created a sale,” the qualified liabilities also need to be carefully examined
Disguised Sales and Partnership Liabilities

Discussion regarding PLR 201714028
Partnership Liabilities

Open forum