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Practitioners Fuming After Issuance of New Bottom-Dollar Guarantee Rules

by Amy S. Elliott

Summary by taxanalysts®

Treasury on January 29 released proposed disguised sale/partnership debt allocation regulations (REG-119305-11) that upend the current rules on the treatment of partnership recourse and nonrecourse liabilities in section 752, prompting harsh criticism from practitioners who described the regs as disastrous.

Full Text Published by taxanalysts®

Treasury on January 29 released proposed disguised sale/partnership debt allocation regulations (REG-119305-11) that upend the current rules on the treatment of partnership recourse and nonrecourse liabilities in section 752, prompting harsh criticism from practitioners who described the regs as disastrous.

The new rules prevent some bottom-dollar guarantees from being recognized for purposes of section 752 and require obligors to maintain a commercially reasonable net worth throughout the term of the payment obligation. The preamble to the proposed regs states that 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." (Prior coverage.)

"Taxpayers are going to not like these regs," said Richard M. Lipton of Baker & McKenzie. It is obvious that the drafters of the regulations "do not have the foggiest idea what actually goes on in the real world" insofar as what terms normal, commercially reasonable, arm's-length loan guarantees have, he said.

Blake D. Rubin of McDermott Will & Emery said that while the proposed section 707 disguised sale rules are generally not problematic, the proposed section 752 rules are "an unmitigated disaster." The proposed regulations "turn section 752 into a mechanism to prevent partners from deducting their properly allocated share of losses, and to trigger gain on transfers of encumbered property," Rubin said. "Taxpayers and their advisers should cry foul -- loudly."

But others were more measured in their reaction to the regulations. Noel Brock, a professor at West Virginia University, said, "Treasury is to be commended on providing much-needed guidance regarding the ordering of and doubling up of the various exceptions to the disguised sale rules. The application of these exceptions has been ambiguous for quite some time."

"I appreciate the government's transparency and eagerness for comments," said Todd McArthur of PricewaterhouseCoopers LLP. "It definitely seems like they are trying to understand all perspectives before finalizing."

Commercially Reasonable Terms

A summary of the new guidance was provided by Craig Gerson, attorney-adviser in the Treasury Office of Tax Legislative Counsel, on January 24 at the American Bar Association Section of Taxation meeting in Phoenix. The

most controversial aspect of the new rules involves requiring obligors to maintain a commercially reasonable net worth, provide commercially reasonable documentation regarding its financial condition, and receive arm's-length consideration for assuming the payment obligation. The rules also deny the tax benefits of bottom-dollar guarantees. (Prior coverage [□](#).)

"The proposed changes to section 752 could adversely affect the commercial real estate marketplace," said Ryan McCormick of the Real Estate Roundtable. "By upending the certainty that exists under the current regime, the proposed rules could undermine taxpayers' ability to finance job-creating construction, capital improvements, and property upgrades."

Bottom-Dollar Guarantees

Specifically, McCormick said that the changes aimed at bottom-dollar guarantees "appear particularly overbroad and seem to disregard guarantees that may otherwise have arisen in a commercial setting."

"There have been billions of dollars worth of transactions utilizing bottom-dollar guarantees to prevent recapture," Lipton said. "Obviously these new rules would prevent those types of transactions, which is not necessarily a good thing from an economic activity standpoint."

Lipton added that if people cannot dispose of leveraged real estate or other assets without significant adverse tax consequences, "the transactions will just stop until people get comfortable with other ways to get around these rules."

The government is trying to change the rules because it believes some people are able to "game" them, Lipton said. "Within a few years, we'll figure out all of the different ways to allocate liabilities and determine basis under these rules," he predicted.

Optionality

Under the new reg. section 1.752-2 rules, a partner won't get credit for debt that it guarantees unless: (1) the document creating the payment obligation meets six new requirements, and (2) the partner satisfies a minimum net value requirement.

Professor Howard E. Abrams of Harvard Law School said the guidance will enable people who could satisfy the new requirements to intentionally fail to meet them to take advantage of the nonrecourse debt rules. "It will let people who currently can't get deductions get deductions," he said. "I [will be able to] structure transactions where people who have no skin in the game can now claim deductions. I think that's inappropriate. These are supposed to be antiabuse rules, not pro-abuse rules."

Abrams posed an example involving carried interest in a real estate partnership where the investors include a pension fund. The investors may not want the depreciation that comes with an allocation of basis, "so all they have to do is not comply with one of these rules and all of a sudden the debt that should be recourse to the pension fund now becomes nonrecourse and gets shared by the carried interests."

Abrams said he thinks the real estate industry "will be throwing a party" for the reg drafters because of the optionality, which will allow taxpayers to manipulate allocating the basis or the depreciation. "There will be a lot of people who find [the regs] very annoying, but there will be many situations where they are a godsend," he said.

Rather than the market responding by shying away from deals that don't meet the requirement to be recourse, Abrams said he thinks the market will just end up paying more for tax advice. "This will increase the rates of the highest paid partnership experts."

Lipton agreed. "If they're trying to take tax out of the deals," the drafters failed, he said, adding that the regs "will just increase the emphasis on tax."

McArthur said that while he appreciates the government's efforts to provide clear rules in the form of six requirements, "there may be other ways to achieve that goal without forcing any unnatural act." He continued, "For example, I can imagine a reasonable arm's-length business deal where one partner is willing to guarantee partnership debt for nontax purposes without being remunerated." McArthur added that under the regs, that type of guarantee would not create a recourse obligation unless the partners were compensated.

Documentation Requirement

Abrams said that as he understands it, the regulations' requirement that the partner provide documentation regarding its financial condition means that the documentation must be provided to the lender.

"The only person who's going to require you to [provide net worth documentation] is a bank," Abrams said. The only way a partner will satisfy the regulation is by going to the bank and getting its name added to the loan document -- the note -- so that it has a credit requirement that can be satisfied only by providing documentation of net worth, he said.

The bank will charge a fee and may insist that the interest rate go up, Abrams said. "It used to be you could do this without calling your banker, and now you can't," he said.

Lipton said he represents very high-net-worth individuals and partnerships, many of which have never created a financial statement. "Are they going to have to create them just because of this set of regulations? That's not the way the world's supposed to work," he said.

Lots of Nonrecourse Debt

Abrams said practitioners will find the regulations annoying because they'll implicate the nonrecourse debt rules in many garden variety transactions. He said those rules are complex and that many practitioners haven't bothered to learn them.

Abrams said that although the new net worth rules are based in part on the existing reg. section 1.752-2(k) rules, all the new requirements in the bottom-dollar guarantee rules have also been extended to disregarded entities. "Although this is not in the disregarded entity section [of the regulations], all of the documentation requirements, the commercially reasonable restrictions, all of that now applies to disregarded entities" in order to ensure parity, he said. "I suspect people won't see that, because they did it in a way that's very peculiar," he added.

Another provision brought over from the reg. section 1.752-2(k) rules involves how net value is calculated. The rules have always provided that if a partner has a net value of \$100,000 and receives a partnership distribution of \$35,000, the partner's net value remains \$100,000, he said.

"That's always seemed insane to me," Abrams said. But now that the provision applies beyond disregarded entities, "lots of people are going to care" because net value doesn't actually mean what the partner is worth, he said.

Nonrecourse Liability Allocation

Abrams also had concerns about the rules for the allocation of nonrecourse liabilities under reg. section 1.752-3. The rules provide that partnerships can use a safe harbor -- the general profits interest method -- to allocate nonrecourse debt in accordance with the partners' profits interests. "Your liquidation percentage . . . has nothing to do with profits from the nonrecourse property," he said.

"I find it remarkably disingenuous for them not to admit that when they're giving you a safe harbor for calculating profits, they're just ignoring profits entirely," Abrams said of the reg drafters. "The legislative history says profits. . . . They're supposed to do what Congress tells them."

"They completely divorced their safe harbor from anything they're supposed to be thinking about," he added.

Under the new regulations, a partner calculates its interest in partnership profits by using its liquidation value percentage, which is defined as "the amount of cash the partner would receive with respect to the interest if, immediately after formation of the partnership. . . 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 reg. section 1.752-7 liabilities in a fully taxable transaction, and then liquidated."

Abrams said that requiring partners to determine the FMV of all of the partnership's assets -- and requiring a revaluation every time the debt shifts -- is expensive. "These regulations tell you, 'I don't care how expensive it is. You want the safe harbor? You value everything the partnership owns,'" he said. "For a lot of partnerships, the safe harbor is no safe harbor at all because it's too expensive to comply."

Disguised Sale Rules

The regulations contain several less controversial clarifications to the section 707 disguised sale rules, including the addition of an ordering rule in reg. section 1.707-5, a clarification involving the preformation capital expenditure exception, and a clarification to the anticipated reduction rule in reg. section 1.707-5.

Monte A. Jackel of Monte A. Jackel Federal Tax Advisory Services LLC told Tax Analysts that "a substantial portion of the recommendations and analysis contained in" an article he coauthored with Suzanne Walsh for *Tax Notes* in 2007 "has somehow found its way into the proposed regs." (See "Disguised Sales Revisited," *Tax Notes*, Jan. 15, 2007, p. 179 [□](#).)

Jennifer H. Alexander of Deloitte Tax LLP, a former attorney-adviser (partnerships) in the Treasury Office of Tax Legislative Counsel, referenced Jackel's article on multiple occasions when pointing out issues that would be addressed in the regulations. (Prior coverage [□](#), [□](#).)

Effective Date and Transition

The regulations are effective upon finalization and do not allow for reliance in the meantime. The proposed changes to the reg. section 1.752-2 rules also include a transition rule that permits partners to grandfather an amount equal to the partner's negative tax capital as it exists immediately before finalization and apply the old rules to that amount for seven years.

Brock said that the seven-year transitional relief will have to be extended for some subgroups of taxpayers, including some publicly traded real estate investment trust and umbrella partnership REIT taxpayers. "Failure to provide a longer transitional relief period for such taxpayers could cause undesired consequences in the capital markets," he said.

Tax Analysts Information

Code Sections: Section 707 -- Related Interest Transactions
Section 752 -- Partnership Liabilities

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