

TREASURY TREMORS:

The Ground is Shifting with Respect to the Allocation of Partnership Liabilities to Partners

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On January 29, 2014, the Treasury Department issued proposed regulations under Internal Revenue Code Section 752, which, if adopted as proposed, would significantly alter the manner in which partnership liabilities are allocated to partners and would particularly affect the real estate industry.

The allocation of partnership liabilities is important because a partner's share of liabilities provides tax basis in the partner's partnership interest. Tax basis is critical to a partner, as it determines the amount of losses that the partner can deduct from the partnership, and determines the amount of cash distributions that a partner can receive without recognizing taxable income.

Under the current regime, recourse partnership debt is allocated to the partner who bears the economic risk of loss for the debt. In order to increase a partner's basis in his partnership interest, a partner may wish to assume the economic risk of loss for a debt that is otherwise a partnership debt, *i.e.*, a debt in which the lender can look only to the partnership's assets for satisfaction of the debt. A common technique to accomplish this goal, while minimizing the risk that the partner would actually be required to pay on the debt, is for the partner to provide a "bottom-dollar" guarantee of partnership debt. For example, with respect to a partnership debt of \$1,000,000, a partner may provide a personal guarantee to the lender which requires the partner to pay on the guarantee only in the event the lender is not able to recover more than \$900,000. That is, although the partner is guaranteeing only the "bottom" \$100,000 of the entire \$1,000,000 debt, such a guarantee, under the current regulations, will increase his partnership basis by \$100,000.

The proposed regulations, however, state that an obligation of a partner to make a payment on a partnership debt will be recognized only if, in addition to other new requirements, the partner would be liable for the full amount of his obligation if, and to the extent that, any amount of the partnership debt is not satisfied out of the partnership's assets. The reference to "any" amount of the partnership debt would effectively eliminate the use of bottom-dollar guarantees in allocating partnership debt to partners. In the example above, to be respected under the proposed regulations, the partner's payment obligation must occur in the event that any amount of the \$1,000,000 debt is not satisfied, not just in the event that the bottom \$100,000 is not satisfied.

Another common technique to increase basis is for one partner ("Partner A") to agree to indemnify another partner ("Partner B") for a portion of the partnership debt that Partner B is guaranteeing. For example, assume that Partner B agrees to provide a personal guarantee of \$100,000 with respect to a \$1,000,000 partnership nonrecourse debt (assume this is not a "bottom-dollar" guarantee, *i.e.*, Partner B's obligation to pay \$100,000 occurs in the event that any portion of the \$1,000,000 is not paid), and Partner A agrees to indemnify Partner B up to \$10,000 of Partner B's guarantee. Under the current regulations, Partner B would have a debt share of \$90,000 and Partner A's share of the debt would be \$10,000.

The proposed regulations, however, state that where a partner that provides a guarantee has a right to be reimbursed or indemnified for any portion of the guarantee, no matter how small, the partner providing the guarantee cannot be treated as bearing the economic risk of loss for any portion of the guaranteed liability. Thus, in the example above, because of Partner A's relatively small indemnification in the amount of \$10,000 in favor of Partner B, none of Partner B's \$100,000 guarantee will be treated as increasing the basis of Partner B.

The proposed regulations also impose a net value requirement which provides that a guarantor's payment obligation will be recognized only to the extent of the guarantor's net value. This requirement, which applies only to entities, is a change to the current regulations which contain a presumption that a guarantor would actually be able to satisfy its payment obligation.

The proposed regulations are intended to apply to liabilities incurred or assumed by a partnership, and to payment obligations undertaken by a partner with respect to a partnership liability, on or after the effective date of the final regulations.

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