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IRS Says "Yes" to Leveraged Partnerships and "No" to Bottom Dollar Guarantees... At Least for Now

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By: ***Elizabeth L. McGinley***

On June 18, 2018, the IRS issued proposed Treasury regulations (the 2018 Regulations) that, if finalized, would withdraw certain proposed and temporary Treasury regulations issued in 2016 related to the allocation of partnership liabilities (the 2016 Regulations). In their place, the 2018 Regulations would reinstate previous Treasury regulations regarding the allocation of partnership liabilities (the Prior Regulations), which were often utilized to defer taxable gain to partners in connection with leveraged partnership distributions, and therefore were viewed as taxpayer friendly. However, the 2018 Regulations, if finalized, would not withdraw provisions of the 2016 Temporary Regulations eliminating the benefits of so-called bottom dollar guarantees.

Under general federal income tax principles, a partner in a partnership (the Contributing Partner) generally can contribute appreciated property to a partnership without recognizing taxable gain and, separately, can receive a distribution from a partnership without recognizing taxable gain to the extent of the tax basis in its partnership interest. A major departure from this general treatment is found in the disguised sale rules, which can cause a contribution of appreciated property from, and distribution to, a partner to be integrated into a single taxable sale by the partner to the partnership.

The Prior Regulations, however, offered a Contributing Partner the opportunity to avoid recognizing taxable gain resulting from a disguised sale by utilizing an exception for debt-financed distributions. Pursuant to this exception, the disguised sale rules would not apply to a distribution received by the Contributing Partner that was funded with the proceeds of partnership debt, often referred to as a leveraged partnership distribution, but only to the extent the Contributing Partner was allocated a portion of such partnership debt under the principles of Code Section 752. Code Section 752 generally allocates recourse debt to a partner to the extent such partner (or a related person) bears the economic risk of loss with respect to the debt. The Prior Regulations therefore allowed a Contributing Partner to claim an allocation of the partnership's debt if, and to the extent that, the Contributing Partner agreed to guarantee the debt. This permitted the Contributing Partner to receive a distribution of debt-financed proceeds to the extent of the dollar amount of the guarantee without application of the disguised sale rules, therefore allowing the Contributing Partner to receive the distribution without recognizing taxable gain.

The 2016 Regulations, issued on October 5, 2016, restricted such opportunity for tax deferral under the debt-financed distribution exception by requiring that, in the disguised sale context, partnership debt must be allocated among the partners generally in accordance with their share of partnership profits and without regard to any partner's guarantee of the debt. This change was intended to prevent Contributing Partners from entering into guarantees or other similar arrangements solely for the purpose of avoiding the application of the disguised sale rules, rather than for business or commercial purposes. In addition, the 2016 Regulations provided new rules that disregarded so-called bottom dollar guarantee structures in connection with the partnership debt allocation rules. For purposes of these rules, a bottom dollar guarantee generally was defined as any guarantee whereby the guarantor guarantees a portion of the partnership debt if the borrower defaults, but only to the extent the lender was able to recover less than the guaranteed amount from the borrower.

On April 21, 2017, President Trump issued an executive order directing the Treasury Department to review all significant tax regulations issued on or after January 1, 2016 with an eye towards reducing complexity and undue financial burden on taxpayers, and eliminating regulations that exceed the statutory authority of the IRS. Pursuant to this review process, the IRS issued the 2018 Regulations, which reinstate the rules for debt allocation for disguised sale purposes in the Prior Regulations. As a result, Contributing Partners once again may assume the economic risk of loss by guaranteeing partnership debt and therefore avoid recognizing gain in connection with a debt-financed distribution. However, the 2018 Regulations preserve the rules in the 2016 Regulations related to bottom-dollar guarantees and, as a result, such arrangements continue to be disregarded in the leveraged partnership context.

Commentators and practitioners were pleasantly surprised that the 2018 Regulations appear to restore the Contributing Partners' opportunity to avoid recognizing gain in leveraged partnership transactions. Moreover, the 2018 Regulations are proposed to apply after they are published as final regulations but may be applied to transactions occurring on or after January 3, 2017. Partners, however, should proceed with caution. The 2018 Regulations are in proposed form and the IRS has indicated that it is continuing to study the allocation of liabilities in the disguised sale context. Some commentators have acknowledged that the IRS may, in fact, provide further guidance limiting the potential use of the economic risk of loss standard for purposes of debt-financed distributions, particularly in the case of guarantees or other arrangements lacking commercial or economic substance. On the other hand, some commentators view the withdrawal of the 2016 Regulations as a tacit admission by the Treasury Department, which sought to overturn well-established partnership law with temporary regulations, that the 2016 Regulations exceeded the Treasury Department's regulatory authority, and that any further change to the debt-financed distribution rules would require legislative action from Congress. Congress, however, did not choose to address debt-financed distributions in the Tax Cuts and Jobs Act, which might be a sign that the 2018 Regulations are likely to be finalized in their current form, and that the preferential rules for debt-financed distributions are here to stay.

Commentators and practitioners generally were not surprised that the rules from the 2016 Regulations concerning bottom dollar guarantees survived in the 2018 Regulations. The IRS generally appears to disfavor such arrangements as lacking economic substance, and therefore it is expected the regulations disregarding bottom dollar guarantees will not be removed.