

AN ALERT FROM THE BDO NATIONAL TAX PRACTICE

BDO KNOWS:

PARTNERSHIP TAXATION



SUBJECT

LIABILITIES RECOGNIZED AS RECOURSE PARTNERSHIP LIABILITIES UNDER SECTION 752

SUMMARY

On October 5, 2016, the IRS published final and temporary regulations (TD 9787 and TD 9788) under 752 of the Internal Revenue Code ("Code"). The temporary regulations provide rules relating to when certain obligations are recognized for purposes of determining whether a liability is a recourse liability under section 752. In particular, the rules address whether a bottom dollar payment obligation is recognized for purposes of determining if a partner or related party bears the economic risk of loss ("EROL") for a liability under section 1.752-2.

DETAILS

Overview

Section 1.752-1(a)(1) provides that a partnership liability is a recourse liability to the extent that a partner or related person bears the EROL for that liability under section 1.752-2. Section 1.752-2(a) provides that a 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. Section 1.752-1(a)(2) provides that a partnership liability is a nonrecourse liability to the extent that no partner or related person bears the EROL for that liability under section 1.752-2.

A partner generally bears the EROL for a partnership liability if the partner or related person has a payment obligation under section 1.752-2(b). A partner generally has a payment obligation to the extent that the partner or related person would have to make a payment if, upon a constructive liquidation of the partnership, the partnership's assets were worthless and the liability became due and payable (constructive liquidation test). Section 1.752-2(b)(6) presumes partners and related persons will satisfy their payment obligations

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irrespective of their net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.

Payment Obligations under the Temporary Regulations

The new section 1.752-2T provides that the determination of the extent a partner has a payment obligation under section 1.752-2(b)(1) is based on the facts and circumstances.¹ To the extent that a payment obligation is not recognized, section 1.752-2(b) is applied as if the obligation did not exist.² All statutory and contractual obligations relating to the partnership liability are taken into account for purposes of applying these rules, 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 as described in section 1.704-1(b)(2)(ii)(b)(3) (taking into account section 1.704-1(b)(2)(ii)(c)); and
- ▶ Payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state or local law, including the governing state or local law partnership statute.

Under the temporary regulations, a bottom dollar payment obligation is not recognized for purposes of determining whether a partner or related person has EROL with respect to a liability.³ However, if a partner or related person has a payment obligation that would be recognized (initial payment obligation) but for the effect of an indemnity, reimbursement agreement, or similar arrangement, 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.⁴

Definition of Bottom Dollar Payment Obligations⁵

A bottom dollar payment obligation is defined to include any payment obligation that is the same as or similar to any of the arrangements listed below:

- ▶ With respect to a guarantee or similar arrangement, any payment obligation other than one in which 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 partnership liability is not otherwise satisfied.⁶

¹ Section 1.752-2T(b)(3)(i).

² *Id.*

³ Section 1.752-2T(b)(3)(ii)(A).

⁴ Section 1.752-2T(b)(3)(ii)(B).

⁵ The temporary regulations provide an example illustrating the difference between guarantees of first and last dollars, i.e., top and bottom guarantees. Specifically, Example 10 provides the following illustration:

A, B, and C are equal members of a limited liability company, ABC, that is treated as a partnership for federal tax purposes. ABC borrows \$1,000 from Bank. A guarantees payment of up to \$300 of the ABC liability is owed if any amount of the full \$1,000 liability is not recovered by Bank. B guarantees payment of 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 is not a bottom dollar payment obligation. Therefore, A's payment obligation is recognized and the amount of A's EROL under section 1.752-2(b)(1) is \$300.

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 is a bottom dollar payment obligation and, therefore, is not recognized. Accordingly, B bears no EROL under section 1.752-2(b)(1) for ABC's liability.

In sum, \$300 of ABC's liability is allocated to A under section 1.752-2(a), and the remaining \$700 liability is allocated to A, B, and C under section 1.752-3.

⁶ Section 1.752-2T(b)(3)(ii)(C)(1)(i).

- ▶ With respect to an indemnity or similar arrangement, any payment obligation other than one in which 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 benefited party's payment obligation that is recognized is satisfied.⁷
- ▶ An arrangement with respect to a partnership liability 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 a series of related transactions or arrangements, and with a principal purpose of avoiding having at least one of such liabilities or payment obligations with respect to such liabilities being treated as a bottom dollar payment obligation.⁸

Notwithstanding the foregoing, 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);⁹ 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.¹⁰

Bottom Dollar Payment Obligations - Required Disclosure

A partnership must disclose a bottom dollar payment obligation with respect to a partnership liability on a completed Form 8275, Disclosure Statement.¹¹ The Form 8275 must be attached to the partnership return for the taxable year in which the bottom dollar payment obligation is undertaken or modified. The disclosure must include the following information:

1. A caption identifying the statement as a disclosure of a bottom dollar payment obligation under section 752;
2. An identification of the payment obligation with respect to which disclosure is made;
3. The amount of the payment obligation;
4. The parties to the payment obligation;
5. A statement of whether the payment obligation is treated as recognized for purposes of section 1.752-2T(b)(3); and
6. 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.

A special rule for indemnities and reimbursement agreements is provided where 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.¹²

⁷ Section 1.752-2T(b)(3)(ii)(C)(1)(ii).

⁸ Section 1.752-2T(b)(3)(ii)(C)(1)(iii).

⁹ A, B, and C are equal members of limited liability company, ABC, that is treated as a partnership for federal tax purposes. ABC 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 is owed. A's guarantee satisfies the requirements described in section 1.752-2T.

If \$250 of the \$1,000 partnership liability is not recovered by Bank, A is only obligated to pay \$62.50 (\$250 x 0.25) pursuant to the terms of the guarantee. Because A is obligated to pay a fixed percentage of every dollar of the partnership obligation to which such obligation exists, the arrangement will not be treated as a bottom dollar payment obligation to the extent of \$62.50. The remaining portion of the liability, however, will be treated as a nonrecourse liability subject to section 1.752-3.

¹⁰ Section 1.752-2T(b)(3)(ii)(C)(2).

¹¹ Section 1.752-2T(b)(3)(ii)(D).

¹² Section 1.752-2T(b)(3)(iii).

Anti-abuse Rule

In order to avoid manipulation intended to achieve a federal income tax result that is not consistent with the economics of the arrangements, the new temporary regulations add an additional anti-abuse rule to prevent the partners from agreeing among themselves to create a bottom dollar payment obligation so that the liability will be treated as nonrecourse.¹³ Under this 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, or portion thereof, 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.

Effective Dates

The new temporary regulations apply 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, (other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date).¹⁴ 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, 2016.¹⁵

Transition relief is provided for any partner whose 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"). Under the transition relief rules, 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.¹⁶

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 if the direct or indirect ownership of that transition partner changes by 50 percent or more.¹⁷ The termination of a transition partnership under section 708(b)(1)(B) does not affect the Grandfathered Amount of a transition partner that remains a partner in the new partnership, if the new partnership is treated as a continuation of the transition partnership. In addition, 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.

¹³ Section 1.752-2T(j)(2).

¹⁴ Section 1.752-2T(l)(2).

¹⁵ Section 1.752-2T(l)(3).

¹⁶ *Id.*

¹⁷ *Id.*

BDO INSIGHTS

- ▶ With limited exception, the temporary regulations effectively eliminate the ability to use new bottom dollar payment obligations to create EROL for purposes of Section 752. These rules may have a significant impact on partners, including the immediate recognition of taxable income. For example:
 - Without EROL, a partner will be allocated fewer partnership liabilities. Therefore, the partner's basis will be reduced, which may limit the ability of the partner to deduct allocable losses.
 - Partners with negative tax capital accounts due to prior loss allocations or prior cash distributions may be required to recognize taxable income to the extent they no longer have EROL with respect to a partnership liability.
- ▶ Any payment obligation, including an obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership may be a bottom dollar payment obligation if it meets the requirements described in the regulations.
- ▶ An anti-abuse rule prevents partners from agreeing to create a bottom dollar guarantee in order to treat a liability as a nonrecourse liability in situations where a partner actually bears the EROL for a partnership liability.

Partners who have existing bottom dollar obligations will be able to use the former rules for a seven-year period to the extent that their allocable share of recourse partnership liabilities immediately prior to October 5, 2016, exceeds the amount of the partner's adjusted basis at such time. However, partners will need to monitor the Grandfathered Amount as it will be reduced for decreases in partner's share of liabilities and on the sale of partnership property.

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