

AN ALERT FROM THE BDO NATIONAL TAX PRACTICE

# BDO KNOWS:

## PARTNERSHIP TAXATION



### SUBJECT

## NEW PROPOSED REGULATIONS ADDRESS LIABILITY ALLOCATIONS AND DEFICIT RESTORATION OBLIGATIONS

### SUMMARY

On October 4, 2016, Treasury issued proposed regulations (REG-122855-15) (“Proposed Regulations”) that withdraw and revise prior proposed regulations issued on January 30, 2014 (REG-119305-11). The new Proposed Regulations would strengthen anti-abuse rules in determining whether a partner bears the economic risk of loss (“EROL”) for partnership liabilities, and would create similar anti-abuse rules relating to a partner’s deficit restoration obligation. Changes to loan guarantees and deficit restoration obligations may be necessary to avoid unfavorable tax consequences in the event the regulations are finalized.

Final and temporary regulations relating to disguised sales and liability allocations were released at the same time as the Proposed Regulations. See TD 9787 and TD 9788. The effects of those regulations are addressed in separate Alerts.

### DETAILS

#### *Anti-Abuse Rules Relating to Liability Allocations*

Treas. Reg. section 1.752-1(a) treats a partnership liability as recourse to the extent a partner or related person bears the EROL. Treas. Reg. section 1.752-2(b) treats a partner as bearing the EROL for a liability to the extent that the partner or a related person would be obligated to make a payment if the liability became due and the partnership had no assets with which to satisfy the liability. For this purpose, an obligation to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation. Proposed Regulation Section 1.752-2(j)(3)(ii) would

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provide the following non-exclusive list of factors that may indicate the existence of such a plan:

- ▶ The lack of commercially reasonable contractual restrictions that protect the likelihood of payment,
- ▶ The lack of a requirement (either at the time the payment obligation is made or periodically) to provide commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party.
- ▶ The fact that the term of the payment obligation ends prior to the term of the partnership liability, or the partner or related person has a right to terminate its payment obligation, if the purpose of limiting the duration of the payment obligation is to terminate such payment obligation prior to the occurrence of an event or events that increase the risk of economic loss to the guarantor or benefited party.
- ▶ The existence of a plan or arrangement in which the primary obligor or any other obligor (or a person related to the obligor) with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonable foreseeable needs of such obligor.
- ▶ The fact that the payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection.
- ▶ In the case of a guarantee or similar arrangement, the fact that terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee.
- ▶ The fact that the creditor or other party benefiting from the obligation did not receive executed documents with respect to the payment obligation from the partner or related person before, or within a commercially reasonable period of time after, the creation of the obligation.

Additionally, the Proposed Regulations would deem a plan to circumvent or avoid an obligation to exist if the facts and circumstances indicate that there is not a reasonable expectation that the payment obligor will have the ability to make the required payments if the payment obligation becomes due and payable. In connection with this rule change, the Proposed Regulations would eliminate existing Treas. Reg. section 1.752-2(k), which limits the deemed EROL of a partner that owns its interest through a disregarded entity to the value of assets held by the disregarded entity.

### ***Recognition of Deficit Restoration Obligations***

In general, under Treas. Reg. section 1.704-1(b)(2)(ii), allocations specified by a partnership agreement that cause a partner to have a deficit capital account are respected only if the partner is unconditionally obligated to restore the amount of such deficit balance to the partnership within 90 days of the liquidation of his interest (a deficit restoration obligation, or "DRO"). The Proposed Regulations would provide that a partner is not considered to be subject to a DRO to the extent such partner's obligation is a bottom dollar payment obligation that is not recognized under Treas. Reg. section 1.752-2(b)(3) or is not legally enforceable, or if the facts and circumstances otherwise indicate a plan to circumvent or avoid such obligation. Proposed Regulation Section 1.704-1(c)(4)(B) provides a non-exclusive list of factors that may indicate the existence of a plan to circumvent or avoid a DRO obligation:

- ▶ The fact that the partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation.
- ▶ The fact that the partner is not required to provide (at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership.
- ▶ The fact that the obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account is negative.
- ▶ The failure to provide the terms of the DRO obligation to all the partners in the partnership in a timely manner.

Treasury asked for public comments as to whether and to what extent it is appropriate to continue to recognize DROs as payment obligations, and whether payment obligations created by partner notes should be treated as DROs.

### *Exculpatory Liabilities*

In the preamble to the Proposed Regulations, Treasury also requested comments regarding the proper treatment of exculpatory liabilities. An exculpatory liability is a liability that is recourse to an entity under state law and section 1001, but for which no partner bears the EROL. Comments are requested regarding the proper treatment of an exculpatory liability under regulations under section 704(b), and the effect of such a liability's classification under section 1001. Further, Treasury requested comments addressing the allocation of an exculpatory liability among multiple assets and possible methods for calculating minimum gain with respect to such liability.

### *Effective Date*

The provisions relating to DROs are proposed to apply on or after the date the regulations are published as final. The provisions relating to liability allocations are proposed to apply to liabilities incurred or assumed by a partnership, and to payment obligations imposed or undertaken with respect to a partnership liability on or after the date the regulations are published as final. Partnerships and their partners may rely on the Proposed Regulations immediately, except that Treas. Reg. section 1.752-2(k), which the regulations would eliminate, will continue to apply until the regulations are final.

## **BDO INSIGHTS**

If the Proposed Regulations are finalized, the allocation of liabilities by many partnerships may be altered to the extent that they run afoul of new anti-abuse provisions. Partners whose share of partnership liabilities are reduced may recognize gain on deemed distributions as a result. Taxpayers relying on allocations of recourse partnership liabilities to claim losses and support negative tax basis capital balances should consider whether changes to guarantees and similar arrangements are necessary to avoid gain recognition.

In addition, partners relying on deficit restoration obligations to support negative capital accounts may be allocated income to reduce or eliminate the negative balances if their restoration obligations are no longer respected. In particular, partners who have implemented limited or terminable DRO's should consider whether changes to their DRO obligations are necessary to avoid chargebacks of income in the event the regulations are finalized.

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