CORPORATE TAX - USA

New regulations change allocation of partnership liabilities

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Introduction

On October 4 2016 the Treasury Department and the Internal Revenue Service issued revised regulations governing how recourse partnership liabilities are allocated among partners. These temporary regulations, which are binding on taxpayers immediately, relate to so-called 'bottom-dollar payment obligations' (BDPOs). Generally, if a partner guarantees a recourse partnership liability, the liability will be allocated to that partner and will increase the partner's basis in his or her partnership interest – thereby increasing the amount of money or property that the partner may receive in distributions from the partnership, or the amount of partnership losses that he or she can be allocated, without incurring income tax.

Under the new regulations, certain guarantees, indemnities and similar arrangements (referred to collectively as 'guarantees') classified as BDPOs will be disregarded for the purpose of characterising partnership liabilities as recourse obligations. Instead, such liabilities will be treated as non-recourse obligations and allocated among the partners accordingly. Although the 'bottom-dollar' moniker implies that only guarantees of the last dollars of a recourse partnership obligation will be disregarded, the temporary regulations apply much more broadly. The new rules generally do not apply to obligations in place before October 5 2016, unless they are modified. Partners and partnerships planning to enter into or modify guarantees should ascertain whether and how the new rules affect their intended structures.

Changes in the rules

A partnership's liabilities are allocated among its partners for purposes of determining each partner's tax basis in his or her partnership interest and, accordingly, the amount of money or other property that each partner can receive as a distribution from the partnership or the amount of partnership losses that can be allocated to each partner without incurring income tax. The new rules were intended to curb perceived abuses – in particular, the use of guarantees lacking significant non-tax commercial purposes to characterise obligations as recourse liabilities and thereby artificially increase the guaranteeing partner's basis in the partnership.

Generally, a recourse partnership liability would be allocated to the partner who, if the partnership were liquidated and the obligation became due and payable, would be obligated to make a payment or a contribution to the partnership with respect to that liability. Formerly, all statutory and contractual obligations relating to a partnership liability were taken into account, including guarantees relating to less than all of the partnership liability, such as a tranche-based or 'horizontal slice' guaranty. For example, if Partner A guaranteed the first $500 of a $1,000 recourse partnership liability and Partner B guaranteed the second $500, the liability would be evenly split between Partners A and B.

AUTHORS

Jonathan S Brenner

Elizabeth J Stevens

Under the new rules, because Partner B's guaranty does not extend to any portion of the first dollar of the liability, it will be disregarded and the second $500 of the $1,000 liability will be allocated among the partners as if it were a non-recourse liability. The new rules presumptively disregard BDPOs, subject to limited exceptions. They also require disclosure on the partnership's information return of any BDPO, as well as the partnership's position as to whether and why that BDPO should be respected under the rules.

Bottom-dollar payment obligations

BDPOs are not limited to guarantees of the last dollar of an obligation. A BDPO is any payment obligation on which the obligor-partner would not be liable up to the full amount of his or her obligation if, and to the extent that, any amount of the partnership's liability were unsatisfied. Separate prongs of the BDPO definition address indemnities and arrangements involving tiered partnerships, intermediaries, senior and subordinate liabilities and other structures that convert what would otherwise be a single liability into multiple liabilities.

In the simple example above, Partner B's guaranty is a BDPO because, if the partnership were to satisfy its recourse obligation in part, Partner B would not necessarily be required to make good on any portion of his or her guaranty. For example, if the partnership failed to satisfy half (or less than half) of its $1,000 liability, Partner A (not Partner B) would be liable for the balance. Alternatively, suppose that Partner B guarantees the full $1,000 of the partnership liability and, instead of guaranteeing a portion of that liability directly, Partner A agrees to indemnify Partner B for the first $500 that Partner B pays out on his or her guaranty. Partner B's guaranty is again a BDPO, because Partner B is liable only to the extent that any amount beyond $500 of the partnership liability is not satisfied; Partner A is liable for the first $500, albeit indirectly.

These examples illustrate how the BDPO definition generally captures payment obligations with respect to horizontal slices of a partnership liability. A guaranty of any slice that does not include a portion of the first dollar of the partnership's obligation is a BDPO. However, a guaranty will not qualify as a BDPO merely because it does not extend to the full amount of the partnership liability and vertical slice guarantees (which cover a fixed percentage of every dollar of the partnership liability) are generally not BDPOs. Moreover, where partners are co-obligors on a guaranty or indemnity for which they are jointly and severally liable, their proportionate rights of contribution do not cause the guaranty to become a BDPO.

Effective date

By their terms, the temporary regulations apply only to recourse liabilities incurred by a partnership, and guarantees undertaken with respect to recourse partnership liabilities, on or after October 5 2016. Liabilities incurred and guarantees undertaken pursuant to a binding contract executed before that date are excepted. The regulations do not explicitly address modifications of partnership liabilities, but the preamble states that such modifications and refinancings of pre-existing obligations that are subject to guarantees trigger application of the new rules. A partnership can elect to apply the new rules to all pre-existing obligations.

The application of the BDPO rules to modifications and refinancings is tempered by a transition rule. A partnership may choose to disapply the BDPO rules with respect to any partner (referred to as a 'transition partner') whose share of partnership recourse obligations determined under prior law exceeded such partner's basis in his or her partnership interest on October 5 2016 to the extent of such excess. A partnership may apply this grandfathering treatment to a transition partner for up to seven years from the effective date of the temporary regulations.

Effect on taxpayers

Because the BDPO definition under the new rules is broad, they reach obligations that represent standard practice in some industries. Consequently, partners and partnerships that anticipate relying on guarantees to characterise partnership obligations as recourse liabilities or modifying any partnership liability subject to an existing guaranty should determine:

- whether any proposed modification would result in application of the BDPO rules to a pre-existing guaranty;
- whether any guaranty would be a BDPO;
- whether any BDPO would qualify for an exception to the presumptive disregard of BDPOs; and
- the partnership's reporting obligations with respect to any such BDPO.

Given the immediate effect of the new regulations, such determinations should be made before any new recourse partnership liabilities are incurred or new partner guarantees are undertaken, and before any existing recourse partnership liability subject to a guarantee is modified.

For further information on this topic please contact Jonathan S Brenner at Caplin & Drysdale, Chartered's New York office by telephone (+1 212 379 6000) or email (jbrenner@capdale.com). Alternatively, contact Elizabeth J Stevens at Caplin & Drysdale, Chartered's Washington DC office by telephone (+1 202 862 5000) or email (estevens@capdale.com). The Caplin & Drysdale, Chartered website can be accessed at www.caplindrysdale.com.
