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Client Alert

There is life after death...of the Bottom-Dollar Guarantee

By Steven R. Meier, John P. Napoli, Michael Rosenthal, and Steven A. Richman

Seyfarth Synopsis: *On October 5, 2016, the Treasury Department published several pieces of guidance relating to disguised sales, allocation of liabilities, and other partnership tax issues, including "bottom-dollar" guarantees commonly used by partnerships (especially in the real estate industry) to allocate liabilities among their partners. The new guidance, offered in the form of final regulations (the "Final Regulations"), temporary regulations (the "Temporary Regulations") and newly-promulgated proposed regulations (the "New Proposed Regulations"), relates to the same issues which the Treasury Department previously addressed, in controversial, and generally poorly received, proposed regulations, promulgated in January 2014 (the "2014 Proposed Regulations"),[1] which among other things proposed the abolition of the "bottom-dollar" guarantee.*

While the rule in the 2014 Proposed Regulations disregarding such bottom dollar guarantees was generally retained, the Temporary Regulations and New Proposed Regulations do provide some welcome relief from some of the more onerous provisions of the 2014 Proposed Regulations. ***In sum, so long as a partner is willing and able to bear genuine (but manageable) economic risk to achieve the benefits of liability allocations, partners should continue to be able to successfully use liability allocations to avoid undesired tax recognition events.***

"Bottom-Dollar" Guarantees

Background

Contributions of real estate to a partnership, such as a fund used by a REIT to acquire and hold real estate (an "UPREIT" partnership), are generally tax-free. However, complications can arise when the contributed real estate is subject to a mortgage or other debt. The Internal Revenue Code of 1986, as amended (the "Code") and the underlying Treasury Regulations (the "Regulations") provide that a contributor of real estate will recognize gain (and thus generally owe tax) when contributed real estate is subject to debt if the amount of the assumed debt exceeds the sum of the contributor's adjusted income tax basis in the contributed property plus (critically) the amount of partnership liabilities allocated to the contributing partner.

The power to allocate liabilities has commonly meant the difference between a taxable and nontaxable contribution of encumbered property to a partnership. Under the prior Regulations, liabilities were allocated to any partner who would have a personal obligation to pay them off in a hypothetical situation in which all the assets of the partnership became worthless and all liabilities of the partnership became due and payable. When the general allocation rules result in a liability allocation shortfall, contributing partners were able to personally guarantee liabilities of the partnership, thereby making such liabilities "recourse liabilities" that were entirely allocated to such guaranteeing contributing partner.

1 See http://www.seyfarth.com/publications/OMM021214-CORP for Seyfarth Shaw's One Minute Memo addressing the 2014 Proposed Regulations.

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Nevertheless, contributing partners, while seeking to benefit from the liability allocations that arise from such guarantees, usually also sought to avoid meaningful risk of having to pay a lender of the partnership should the partnership default on its obligations. Prior to the 2014 Proposed Regulations, this collection risk was often managed through a "bottom-dollar" guarantee - *i.e.*, a guarantee of the last dollars of a liability of the partnership that can only be collected after all remedies against the primary obligor have been exhausted.[2] Because such "bottom-dollar" guarantees are extremely low risk, particularly where overall leverage ratios are moderate, they have always been controversial with the Internal Revenue Service ("IRS"). The IRS's suspicion of "bottom-dollar" guarantees was reinforced by the fact that, prior to the 2014 Proposed Regulations, there was no requirement that the guarantying partner have a net worth sufficient to fulfill any payment obligation under any guarantee (whether a bottom-dollar guarantee or otherwise). Thus, a contributing partner could be allocated partnership liabilities merely due to the theoretical payment obligation resulting from executing a guarantee, despite having no actual ability to ever satisfy such payment obligation. High-profile cases of extreme liability allocation, such as in *Canal Corp. v. Commissioner*[3] (involving Canal Corporation's attempted tax-free disposition of Wisconsin Tissue Mills to Georgia Pacific) and Chief Counsel Advice 2013 24013[4] (involving the Tribune Company's attempted tax-free disposition of Newsday to Cablevision) convinced the IRS that it needed more than the *ad hoc* application of the anti-abuse rule of Treasury Regulation Section 1.752-2(j) to put an end to what it perceived as the improper exploitation of the former liability allocation rules.

The 2014 Proposed Regulations

The 2014 Proposed Regulations, had they been finalized, would have stopped these practices by creating a list of factors, each of which would have been required to have been met in order to for a guarantee or other payment obligation to be recognized for purposes of allocating partnership liabilities. If any of the factors were missing, the partnership liability would have been allocated under the general rule of allocating nonrecourse partnership liabilities. These factors were designed to ensure that the guarantor would actually make a payment to satisfy the partnership liability. Included in this list were such factors as a net worth requirement of the guarantor and a requirement to periodically provide commercially reasonable documentation to the partnership concerning the guaranteeing partner's financial condition.

The final factor on the list was that the partner would be liable for the full amount of its payment obligation, if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. (A similar factor was in place in the case of a partner's indemnity obligation to the partnership for unsecured debt of a partnership.) Thus, under the 2014 Proposed Regulations, if the partnership could fail to pay any portion of the partnership liability without creating a payment obligation for the guarantor, the guarantee would not be recognized for purposes of allocating the liability.

While many members of the tax bar were not unsympathetic to the IRS's views on bottom-dollar guarantees, the 2014 Proposed Regulations, drafted as they were with the mindset that all liability allocation scenarios were miniature versions of the extreme facts of *Canal Corporation*, were overreaching and, unsurprisingly, heavily and nearly uniformly criticized. For example, many of the factors that the IRS sought to require as evidence of a "real-world" liability allocation were not present even in many ordinary non-tax-driven guarantees. In addition, the "commercially reasonable" documentation requirement was particularly difficult, given the ambiguity as to what would meet the standard. Further, the all-or-nothing approach to test the effectiveness of a liability guarantee would have the effect of, on the one hand, exacerbating the difficulties of attempting to comply with the factors and, on the other hand, being easily manipulated by a partnership that may have an incentive to avoid allocating liabilities to a partner making an otherwise legitimate commercially-driven guarantee of a partnership liability. Finally, the requirement of a guarantee being a full top-dollar guarantee was considered to be particularly onerous and would result in many commercially-reasonable guarantees not being recognized for purposes of allocating partnership liabilities.

The Temporary Regulations and the New Proposed Regulations

In response to these criticisms, the 2014 Proposed Regulations have been withdrawn. In their place, the Treasury has issued two separate sets of promulgated regulations - the Temporary Regulations to implement specific provisions relating to bottom-dollar guarantees, and the New Proposed Regulations that would deal with other issues relating to when payment obligations by a partner would be respected for purposes of allocating partnership liabilities.

2 For example, if a partnership liability is for $100 and the bottom-dollar guarantee is for $10 of that liability, the lender can only collect any amount from the guarantor if, after having exhausted all remedies against the partnership, it has collected less than $10. If the lender has only collected $5 from the partnership, the bottom-dollar guarantor would be liable for an additional $5. If the lender has collected a full $10 from the partnership, the bottom-dollar guarantor has no payment obligation to the lender.
3 135 T.C. 9 (2010).
4 June 14, 2013

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The Temporary Regulations - Bottom-Dollar Payment Obligations

Definition. The Temporary Regulations retain the general rule that a "bottom dollar payment obligation" will not be recognized for purposes of allocating the partnership liability to which the payment obligation relates (with one relatively narrow exception for a certain type of bottom dollar payment obligation). However, as described below, the definition of "bottom dollar payment obligation" specifically excludes certain other types of payment obligations, thereby providing several additional exceptions to the general non-recognition rule.

A "bottom dollar payment obligation" is defined as a payment obligation that is the same or similar to one of three types of obligations:

> With respect to a guarantee of partnership liability, a bottom dollar payment obligation is any guarantee other than one in which the guarantor is or would be liable up to the full amount of such guarantor's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. (This definition is similar to the "bottom dollar" factor in the 2014 Proposed Regulations as it related to guarantees.)
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> With respect to an indemnity, a bottom dollar payment obligation is any obligation other than one in which the indemnitor is or would be liable up to the full amount of such indemnitor's payment obligation if, and to the extent that, any amount of the indemnitee's payment obligation is satisfied, assuming that such indemnitee's payment obligation is itself recognized under these rules. (This definition is similar to the "bottom dollar" factor in the 2014 Proposed Regulations as it related to indemnities.)
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> Finally, a bottom dollar payment obligation also includes 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 the arrangement has a principal purpose of avoiding having at least one of such liabilities or payment obligations being treated as a bottom dollar payment obligation.

Although these basic definitions of a bottom-dollar guarantee have been retained from the 2014 Proposed Regulations, the Temporary Regulations provide meaningful exceptions. Under the Temporary Regulations, a payment obligation will not be a bottom dollar payment obligation merely because (i) a maximum amount is placed on the partner's payment obligation, (ii) a payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates, or (iii) there is a right of proportionate contribution running between partners who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable. Therefore, under the Temporary Regulations, a guarantee that is for a "vertical slice" of a partnership liability, or for only the top portion of a partnership liability, is not treated as a bottom dollar payment obligation.

Finally, if a payment obligation is treated as a bottom dollar payment obligation due to a right of the guarantor to be indemnified for a portion of such guarantor's guarantee payments, such bottom dollar payment obligation will still be recognized for purposes of allocating the partnership liability to the guarantor so long as the guarantor is liable for at least 90 percent of such guarantor's payment obligation (taking into account the right of indemnification) (the "90% Rule").

Reporting Obligations. Under the Temporary Regulations, a partnership must disclose to the Internal Revenue Service on Form 8275 attached to its annual tax return for the taxable year in which a bottom dollar payment obligation is undertaken or modified, certain information about such bottom dollar payment obligation. In the case of bottom dollar payment obligations that are recognized due to the 90% Rule, the disclosure statement must also include information establishing that such bottom dollar payment obligation is eligible to be recognized under the 90% Rule. However, because "vertical slice" and "top dollar" guarantees are excluded from the definition of bottom dollar payment obligations, no disclosure is required with respect to such guarantees.

Effective Date. The rules in the Temporary Regulations apply to all 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, and payment obligations imposed or undertaken, pursuant to a binding contract in effect prior to such date). However, as was the case in the 2014 Proposed Regulations, the Temporary Regulations provide for a transitional rule whereby a partner who had liabilities allocated to her in excess of her adjusted basis in her partnership interest under the prior rules can continue to apply the prior rules for a period of seven years with respect to an amount equal to such excess (with certain limits and adjustments with respect to the amount of such liabilities that can be grandfathered under the prior rules).

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Also, because these rules are issued in temporary regulations, rather than final regulations, the rules expire on October 4, 2019. However, because the text of the Temporary Regulations is also incorporated into the text of the New Proposed Regulations, to the extent the New Proposed Regulations are finalized, these rules will become part of the final regulations, which will be effective indefinitely.

The New Proposed Regulations - Additional Rules Concerning Allocation of Recourse Liabilities

As discussed above, the 2014 Proposed Regulations created a list of six factors, each of which needed to be met in order for a payment obligation to be recognized for purposes of allocating partnership liabilities. The New Proposed Regulations retain the list of factors, with certain modifications and additions. However, rather than being factors that must be met, the New Proposed Regulations provide them as a non-exclusive list of factors that are relevant in determining whether the facts and circumstances surrounding the payment obligations indicates the existence of a plan to circumvent or avoid the payment obligation, thereby resulting in such payment obligation being disregarded for purposes of allocating partnership liabilities.

List of Factors. Under the New Proposed Regulations, the following non-exclusive list of factors are relevant in determining whether there is a plan to circumvent or avoid the payment obligation (each based on the facts and circumstances existing at the time the payment obligation is made or modified):

A. The guarantor is not subject to commercially reasonable restrictions to protect the likelihood of payment (e.g., restrictions on transfers of assets of inadequate consideration).

B. The guarantor is not required to provide commercially reasonable documentation concerning its financial condition (either at the time the payment obligation is made or periodically).

C. The term of the payment obligation ends prior to the term of the partnership liability, or the guarantor has a right to terminate the payment obligation, if the purpose of such provisions is to terminate the payment obligation prior to the occurrence of an event that increases the risk of economic loss to the guarantor. (A guarantee that terminates upon the completion of a building construction project, which typically *decreases* the risk of loss to the guarantor, would not fall within this factor.)

D. There exists a plan or arrangement in which the partnership or any other obligor with respect to the partnership liability holds money or other liquid assets in an amount that exceeds the reasonable foreseeable needs of such obligor.

E. The guarantee does not permit the creditor to promptly pursue payment following a payment default on the partnership liability (or other arrangements indicating a plan to delay collection).

F. The terms of the partnership liability would be substantially the same had the guaranteeing partner not provided the guarantee.

G. The creditor or other party benefiting from the obligation did not receive executed documents with respect to the guarantee before, or within a commercially reasonable period of time after, the creation of the guarantee.

In addition, the New Proposed Regulations provide that evidence of a plan to circumvent or avoid an obligation is "deemed to exist" if the facts and circumstances indicate that there is not a reasonable expectation that the guarantor will have the ability to make the required payments if the payment obligation becomes due and payable. Unlike in the case of the non-exclusive list of factors, the New Proposed Regulations do not indicate whether this facts and circumstances test is tested only at the time of entering into or modifying the guarantee, or at any time when the partnership needs to allocate partnership liabilities to its partners.

Deficit Restoration Obligations. The New Proposed Regulations also provide similar rules regarding when a deficit restoration obligation (a "DRO") is recognized, including a rule that a DRO will not be recognized if it is a bottom dollar payment obligation, it is not legally enforceable, or the facts and circumstances indicate a plan to circumvent or avoid such obligation.

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The New Proposed Regulations provide a list of factors specifically relevant to DROs that are to be taken into consideration in determining whether such a plan to avoid payment exists.

Effective Date. If finalized, the rules in the New Proposed Regulations regarding guarantees and other payment obligations will apply to liabilities incurred or assumed by a partnership, and to payment obligations imposed or undertaken, on or after the date the regulations are published as final regulations. With respect to the rules relating to DROs, the rules will be effective for all DROs in existence as of such date. In both cases, however, taxpayer may rely on these rules for the period between October 5, 2016 and the date the regulations are published in final form.

Other New Rules in the Published Guidance: Disguised Sales and Exceptions

As noted, the Temporary Regulations and the Final Regulations also address, and will materially impact, the partnership disguised sales rules set forth in Code Section 707 (the "Disguised Sale Rules"). By way of background, Code Section 721 generally provides that the contribution of property to a partnership in exchange for an interest in the partnership is not a taxable transaction. However, the Disguised Sale Rules establish an exception to Code Section 721's general rule. Notably, if a partner contributes property to a partnership and the partnership distributes cash or other consideration to the contributing partner, or assumes a liability of the partner, the transaction may be re-characterized as a taxable sale of property from the partner to the partnership. Transfers between partners and partnerships made within two (2) years of each other are presumed to be subject to the Disguised Sale Rules (though taxpayers can overcome such presumption by clearly establishing that such transfers did not constitute a sale).

Notwithstanding the general Disguised Sale Rules, the Treasury Regulations have provided relief for taxpayers in the form of several exceptions. As briefly discussed below, the Temporary Regulations and the Final Regulations address several of the most common exceptions.

Debt-Financed Distributions. One of the more prolific exceptions to the Disguised Sale Rules provides that distributions to taxpayers that are traceable to partnership borrowing are not taxable disguised sale proceeds to the extent such distributions do not exceed the partner's allocable share of the subject liability (the "Debt-Financed Distribution Exception"). Where the Treasury Regulations previously allocated (i) recourse liabilities to partners pursuant to the rules in Code Section 752 (and the Treasury Regulations thereunder) and (ii) non-recourse liabilities to partners pursuant to the percentage used to allocate excess nonrecourse liabilities in Treasury Regulation Section 1.752-3(a)(3) (i.e., pursuant to such partner's share of partnership profits), the Temporary Regulations treat all partnership liabilities (both recourse and non-recourse) as non-recourse for purposes of the Debt Financed Distribution Exception.

As with bottom dollar guarantees, the IRS appears concerned with guarantees lacking significant business purpose. Consequently, a common strategy employed in leveraged partnership recapitalizations, whereby partners who, under the old rules, may have attempted to increase their allocable share of a partnership liability (and thereby mitigate the effect of the Disguised Sale Rules) by guaranteeing a portion of a partnership debt, is no longer effective. Non pro-rata distributions traceable to partnership borrowing will now likely trigger gain to the transferor partner to the extent the liability is incurred in connection with a disguised sale of property to a partnership.

These rules are effective for transactions in which all transfers occur on or after January 3, 2017.

Pre-Formation Capital Expenditures. A second exception to the Disguised Sale Rules is reimbursement for a partner's preformation capital expenditures. Under the Treasury Regulations, a transfer of cash or other property from a partnership to a partner does not constitute a taxable disguised sale of property to the partnership if (A) the payment to the partner is reimbursement for certain organization, syndication, or capital expenditure costs and (B) the reimbursements do not exceed 20% of the fair market value of such contributed property (the "20% Rule"). Prior to the 2014 Proposed Regulations, nothing prevented taxpayers from aggregating the value of all properties contributed to the partnership for purposes of the 20% Rule.[5] Concerned that taxpayers were aggregating multiple properties to qualify for the 20% Rule, where the individual properties would not qualify if analyzed independent of each other, the 2014 Proposed Regulations called for the 20% Rule and the 120% Rule to be applied on a property-by-property basis, rather than on an aggregated basis.

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5 The 20% Rule does not apply if the contributed property's fair market value does not exceed 120% of the contributing partner's basis in the property (the "120% Rule").

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The Final Regulations generally adopt the rules set forth in the 2014 Proposed Regulations and require the 20% Rule to be computed on a property-by-property basis. The preamble to the Final Regulations does acknowledge the burden of calculating the 20% Rule and 120% Rule on a property-by-property basis, and does provide for aggregation in limited circumstances.

The 2014 Proposed Regulations also provided a coordinating rule for reimbursement for capital expenditures allocable to "qualified liabilities" (a "QL"). Per the Treasury Regulations, a partnership's assumption of a QL (i.e., a liability provided for in Treasury Regulation Section 1.707-5(a)(6)) does not constitute a disguised sale of property to the partnership (the "QL Rule"). The 2014 Proposed Regulations clarified that a partner who contributed a particular type of QL[6] that was attributable to a capital expenditure could not double-dip on the tax benefits and receive a nontaxable cash distribution as a reimbursement for a pre-formation capital expenditure while also taking advantage of the QL Rule. The Final Regulations expand the rule to include any QL used to fund a capital expenditure where the economic burden for such liability shifts to other partners. For purposes of the Final Regulations, QLs will be deemed to fund capital expenditures to the extent such proceeds are actually used to fund (or are traceable to) such capital expenditures.

The Final Regulations are effective immediately.

Observations

The new rules relating to bottom dollar payment obligations will put an immediate stop to any future bottom dollar guarantees. Instead, in their place, we expect that contributing partners will opt for guaranteeing "vertical slices" of partnership debt on low-leveraged properties, in order to reduce the risk of the partnership defaulting. While the Temporary Regulations do not apply to bottom dollar guarantees currently in place, we expect that such existing bottom dollar guarantees will also begin to shift toward these "vertical slice" guarantees. In sum, in our view, the additional potential risks that partners will be required to accept under the Temporary Regulations to make a guarantee effective are manageable, and partnerships and their partners will continue to use partner guarantees to avoid tax recognition events.

With respect to the new rules in the New Proposed Regulations, while such rules are not yet effective, we expect to see partnerships and contributing partners start to take the factors into consideration and to start structuring such guarantees with as many of the factors as practicable.

Additionally, the Temporary Regulations have severely curtailed the tax benefits of leveraged partnership transactions.

Seyfarth Shaw's tax attorneys are very active in counseling real estate funds and UPREIT partnerships regarding these and other tax issues. You are urged to contact our attorneys if you believe these issues could impact you or your company. Also, the Treasury Department is seeking comments regarding the New Proposed Regulations. If you would like to discuss any such comments you may want to make, or if you would like Seyfarth Shaw's tax attorneys to make any comments on your behalf, please contact our attorneys to discuss these matters.

Steven R. Meier is a partner in the firm's Chicago office. John P. Napoli is a partner and Michael Rosenthal is an associate in Seyfarth's New York office, and Steven A. Richman is senior counsel in the firm's Atlanta office. If you would like further information, please contact your Seyfarth attorney, Steven R. Meier at smeier@seyfarth.com, John P. Napoli at jnapoli@seyfarth.com, Steven A. Richman at srichman@seyfarth.com, or Michael Rosenthal at mrosenthal@seyfarth.com.

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6 Specifically, "qualified liabilities" identified in Treasury Regulation Section 1.707-6(a)(6)(i)(C), i.e., liabilities allocable under the interest allocation rules in Treasury Regulation Section 1.163-8T.

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