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Proposed Treasury Regulations Modify Debt Allocation and Disguised Sales Rules (Eliminating the Use of "Bottom-Dollar" Guarantees)

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

On January 30, 2014, the Treasury Department published proposed regulations (the "Proposed Regulations") relating to disguised sales, allocation of liabilities, and other partnership tax issues. Among the proposed rules is a new rule that will significantly change how real estate assets are acquired by real estate funds and real estate investment trusts ("REITs").

I. Bottom Dollar Guarantees

Background -- Contributions of Real Estate to Funds and REITs

Real estate funds, including funds used by REITs to acquire and hold their real estate assets (such funds "UPREIT" partnerships), are generally structured as partnerships for income tax purposes. This tax structure is tax efficient in several ways, including in that it allows the fund to accumulate real estate assets not only through a traditional purchase, but also through a tax free contribution in exchange for equity in the partnership.

Although contributions of real estate to UPREIT and other partnerships are generally tax-free, complications arise when, as is usually the case, the contributed real estate is subject to a mortgage or other debt. Specifically, 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 partnership is treated as having assumed the debt in connection with the contribution, with the amount of such gain generally equal to amount by which the assumed liability exceeds the contributor's adjusted income tax basis in the contributed property.

The Current Rules -- Avoiding Gain through "Bottom-Dollar" Guarantees

Nevertheless, the contribution of real estate to a partnership that is subject to debt in excess of the contributor's basis in the real estate does not automatically trigger gain for the contributor. This is because the amount of debt that is considered to have been assumed by the partnership is offset dollar for dollar by the amount of liabilities of the partnership that are allocable to the contributor, who after the contribution is a now a partner in the contributee partnership. Under the current Regulations, liabilities of a partnership are 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. This debt allocation rule carries within it the power to control the allocation of partnership liabilities to a new partner contributing real estate to the partnership, and to help that partner avoid having gain on the contribution.

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Under the current rules, one of the most commonly used mechanisms to control the allocation of partnership liabilities to a contributing partner, and thus help her to avoid gain on a contribution of real estate that is subject to debt in excess of basis, has been to allow the contributor to guaranty some liabilities of the partnership. Typically, these guarantees are structured as "bottom-dollar" guarantees - *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. While such a guarantee has a very low risk, under the current Regulations it is effective to allocate that portion of the liability to the contributing partner. Further, under the current Regulations, there is generally no requirement to determine whether the contributing partner has a net worth that would allow the partner to actually satisfy its obligation under the guaranty, though the current Regulations do provide that disregarded entities that guarantee payments are subject to a "net value" test.

The Proposed Rules -- Elimination of the "Bottom-Dollar" Guarantee

Under the Proposed Regulations, a guarantee or other obligation will only be recognized for purposes of allocating partnership liabilities if the obligation meets the following requirements:

A. the partner is either (a) required to maintain a commercially reasonable net worth throughout the term of the liability, or (b) subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration;

B. the partner is required periodically to provide commercially reasonable documentation regarding its financial condition;

C. the term of the partner's obligation does not end prior to the term of the partnership liability;

D. the partner's obligation does not require the primary obligor (or any other obligor) to hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor;

E. the partner must receive arm's length consideration for assuming the payment obligation;

F. in the case of a guarantee or similar arrangement, the partner would be liable for the <u>full amount</u> of its payment obligation if, and to the extent that, <u>any</u> amount of the partnership liability is not otherwise satisfied; and

G. in the case of an indemnity, reimbursement agreement, or similar arrangement, the partner would be liable for the <u>full amount</u> of its payment obligation if, and to the extent that, <u>any</u> amount of the indemnitee's payment obligation is satisfied.

In addition, the Proposed Regulations would also extend the "net value" requirement to all types of partners, other than individuals and estates.

The Proposed Regulations provide examples that explicitly illustrate that a "bottom-dollar" guarantee will not be respected for liability allocation purposes because it fails to meet all of the above-described requirements and bears "no economic risk of loss." The examples further illustrate that even a partial guarantee (*e.g.*, 25% of each dollar of a liability) will not be respected.

The Proposed Regulations would also expand the anti-abuse rule to prevent arrangements intended to avoid the new rules. For example, an attempt to circumvent the new rules through the use of a financial intermediary to artificially convert a single mortgage loan into senior and junior tranches would not be respected.

Request for Comments

The preamble to the Proposed Regulations requests comments regarding certain issues relating to the proposed debt allocation rules. In particular, it asks for comments with respect to (i) whether, and under what circumstances, a partial guarantee should be respected and (ii) whether the anti-abuse rule should be broadened to include other types of structures or arrangements that could be used to circumvent the new restriction on bottom-dollar guarantees.

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II. Other Rules in the Proposed Regulations

The Proposed Regulations also contain a new proposed rule modifying the existing safe harbor for allocating excess nonrecourse liabilities to partners. The new rule would require that such liabilities be allocated in accordance with the partners' "liquidation value percentages" (as opposed to the current rule allowing allocations that are reasonably consistent with the allocation of some other significant partnership item). Also, among other modifications to the disguised sales rules, the rules relating to the "preformation expenditures" exception to the disguised sales rule have been modified to apply on a property-by-property basis.

III. Proposed Rules -- Effective Date and Transition Rules

If finalized in their current form, the Proposed Regulations provide that the new rules relating to the disguised sales rules would apply to transfers occurring on or after the date that the Proposed Regulations are finalized. The new rules relating to the allocation of liabilities (including the elimination of "bottom-dollar" guarantees) will apply to liabilities incurred and assumed by a partnership and to payment obligations imposed or undertaken with respect to a partnership liability on or after the date the Proposed Regulations are published in final form. However, the Proposed 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 current rules can continue to apply the current rules for a period of seven years after the Proposed Regulations become final. (Certain proposed rules would create a limit and adjustments to that limit with respect to the amount of such liabilities that can be grandfathered under the current rule.)

IV. Observations

These proposed rules eliminating "bottom-dollar" guarantees for liability allocation purposes had been anticipated by tax practitioners for some time now. Representatives of the Treasury Department and Internal Revenue Service had been discussing their study of this issue for over a year. Should the Proposed Regulations become final in their current form, contributors seeking to avoid gain that would be triggered by a contribution of their real estate to an UPREIT or other partnership should expect that their guarantee arrangements will need to be, in form and substance, more similar to arms-length obligations undertaken for a sophisticated creditor to be respected for income tax purposes.

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 this issue could impact you or your company. Also, as mentioned above, the Treasury Department is seeking comments regarding several aspects of the 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.

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

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