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Proposed IRS Rules for Real Estate Partnerships

Anticipated Regulations Distinguish "Commercially Reasonable" Transactions from Those "Designed Solely to Obtain Tax Benefits"

Earlier this year, the Internal Revenue Service ("IRS") and the Treasury Department issued proposed regulations addressing partnership liabilities and relating to "disguised sales" of property. If enacted, the proposed regulations would significantly impact real estate partnerships and their partners (among other partnerships) that rely on allocations of liabilities, and those entering into tax-deferred partnership transactions.

Overview

On January 29, 2014, the Internal Revenue Service (IRS) and the Treasury Department issued proposed regulations clarifying or amending the rules for allocating partnership liabilities among partners and for partnership "disguised sales" (Internal Revenue Code Sections 752 and 707, respectively). In part, the proposed regulations would change the ways in which recourse liabilities can be allocated by eliminating "bottom-dollar guarantees" and imposing a "net value" requirement on partners to whom liabilities are allocated, and by addressing ambiguities in "disguised sale" regulations. Additional changes amend the way nonrecourse liabilities are allocated.

While some of the rules allow for a seven-year transition period, the proposed changes, if enacted, would figure immediately and significantly into most real estate transactions structured to avoid recognizing gain from contribution transactions and liability repayments. Highlights of the proposed regulations are reviewed below.

Current Rules Regarding Allocations of Partnership Recourse Liabilities

Existing Section 752 regulations generally divide liabilities into "recourse" and "nonrecourse" liabilities using an "economic risk of loss" test. The rules regarding allocation of partnership recourse liabilities generally enable a partner to deduct losses and receive tax-free cash distributions from the partnership.

In many cases, property contributed to a partnership that is encumbered by liabilities in excess of the contributor's tax basis in the property would cause the contributing partner to recognize taxable gain as a result of the partnership's assumption of the encumbering liabilities or subsequent liability repayments. To avoid the gain, a contributing partner may opt for a "bottom-dollar guarantee."

For the purposes of allocating recourse liabilities, Section 752 currently provides that a partner bears the economic risk of loss for a liability to the extent that the partner would be required to repay the liability in the "worst-case" event that the partnership's assets became worthless and the liability became due and payable. Under this hypothetical "worse case" test for risk of loss, the regulations would generally allocate an otherwise nonrecourse liability to a partner that guarantees the liability, even if the lender and the partnership reasonably anticipate that the partnership will be able to satisfy the liability with either partnership profits or capital. This scenario engendered the use of the “bottom-dollar guarantee,” in which, in foreclosure, the guaranteeing partner is liable only to the extent the lender does not collect at least the guaranteed amount.

Elimination of the “Bottom-Dollar” Guarantee

The IRS and the Treasury Department are concerned that some partners have entered into payment obligations that are not commercial, solely to achieve an allocation of a partnership liability. The proposed regulations eliminate the use of “bottom-dollar guarantees” in order to achieve such tax goals. Instead, debt would be treated as a recourse liability allocation only when it can be shown to pose real and meaningful economic risk to the partner.

Under the new rules, a guarantee would not be recognized for purposes of recourse liability allocation (excluding those imposed by state law) unless it meets a set of six requirements, and if the partner guaranteeing the liability satisfies a minimum net value requirement. The six-factor test, if satisfied, would establish that the terms of the payment obligation are commercially reasonable and are not designed solely to obtain tax benefits.

Significantly, the sixth requirement holds that the guaranteeing partner must be liable for no less than the full amount of the payment obligation. “Bottom-dollar guarantees” fail this test and thus would be ignored in determining whether debt is recourse to the guarantor.

The proposed regulations also establish that a guaranteeing partner’s payment obligation will only be recognized to the extent of the guarantor’s net value as of the allocation date, possibly limiting the ability of other partners’ ability to receive a full allocation of a guaranteed liability. This minimum net value requirement would not apply to individuals and decedents’ estates.

Clarifications to “Disguised Sale” Rules

A “disguised sale” may occur when a transfer of property from a partner to a partnership, followed by a related distribution of cash or other property, is deemed a sale or exchange of property to the partnership. Alternatively, a partnership may assume the liabilities of a contribution of property, in some circumstances resulting in a disguised sale.

Current regulations under Section 707 provide a number of exceptions to disguised sale treatment. The proposed regulations address certain technical ambiguities in the existing regulations, including expanding the definition of qualified liabilities, which would limit the ability of partners and partnerships to avoid disguised sale treatment and cause the contributing partner to recognize gain or loss as if the transaction was a sale to an unrelated party.

Additionally under Section 707, the current “preformation expenditures exception” provides that reimbursements from a partnership to a partner for certain costs and capital expenditures incurred with respect to contributed property would generally not be regarded as part of a disguised sale. This provision holds true only if the capital expenditures 1) are incurred within two years prior to the contribution of the property and 2) are limited to 20 percent of the fair market value of the contributed property at the time of the contribution. The limitation does not apply if the fair market value of the property does not exceed 120 percent of the partner’s adjusted tax basis of the property.

The proposed regulations clarify that the limitation on fair market value and the tax basis rule must be applied on a property-by-property basis, thus ending the practice of aggregating the value of contributed property for purposes of determining the amount of the limitation. Additionally, the preformation expenditures exception would not apply to expenditures that are funded through borrowings assumed by the partnership, to the extent the liability is allocated to another partner.

Effective Dates and Transition

The proposed regulations would be effective for liabilities incurred or assumed by a partnership, and for payment obligations entered into by a partner, on or after the date the proposed regulations become final.

Transitional rules also permit a partner to continue to apply current law regarding bottom-dollar guarantees for a seven-year period from the finalization of the proposed regulations to the extent that the partner's allocable share of partnership liabilities exceeds the partner's adjusted tax basis in its partnership interest on the date the proposed regulations are finalized.

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If you have any questions, please feel free to contact your Seiler professional at (650) 365-4646 or email info@seiler.com. We would be happy to discuss appropriate courses of action for your particular circumstance.

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