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Bottom Dollar Partnership Guarantees Are Falling Off A Cliff

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Because of an expiring transition rule, a partner that currently relies on a "bottom dollar guarantee" to support an allocation of liabilities may be required to recognize gain under section 731(a) unless that partner takes action before October 4, 2023.[1] After a brief overview and discussion of the applicable Treasury regulations, we describe the action that should be taken.

I. Overview

In October 2019, the IRS and Treasury issued final regulations (the "2019 Regulations") that provide that "bottom dollar payment obligations" (commonly referred to as "bottom dollar guarantees") do not cause a partnership's liabilities to be treated as recourse with respect to the partner providing the guarantee. The result of this rule is that a bottom dollar guarantee does not cause the guaranteed liability to be allocated to the partner providing the guarantee.[2] The absence of such an allocation may cause the partner providing the guarantee to recognize gain in an amount up to the amount of the liabilities. The 2019 Regulations are effective for partnership liabilities incurred and guarantees entered into on or after October 5, 2016.

The 2019 Regulations include a seven-year transition rule for a partner that had a "negative tax capital account" immediately before October 5, 2016 and was relying on an allocation of recourse liabilities to avoid gain recognition. In general, a partner would have a "negative tax capital account" to the extent that the partner has previously been allocated losses or deductions or received distributions from the partnership in excess of the partner's capital investment in the partnership (*i.e.*, capital contributions to the partnership and previous allocations of income or gain by the partnership to the partner). The transition rule also applies to liabilities incurred and payment obligations entered into before October 5, 2016 that were subsequently refinanced or modified.

When the transition rule expires on October 4, 2023, bottom dollar guarantees will no longer be effective to cause partnership liabilities to be treated as recourse with respect to the partner providing the guarantee. As a result, absent other action, the partner may recognize gain under section 731(a) to the extent of the partner's remaining "negative tax capital account."

II. Discussion

A. Background on the Allocation of Partnership Liabilities

An entity that is classified as a partnership for U.S. federal income tax purposes allocates its liabilities among its partners in accordance with section 752 and the regulations interpreting section 752. Any liability that is allocated to a partner increases that partner's basis in its partnership interest. A partner with a share of liabilities may, therefore, be able to receive greater distributions of money from the partnership without recognizing gain under section 731(a) or claim deductions for a greater amount of partnership deductions than would be possible without the share of liabilities.

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When a partner's share of a liability decreases—whether because the liability is repaid or because it is allocated to a different partner—the partner whose share decreases is treated as receiving a distribution of money in an amount equal to the reduction. If the amount of the reduction exceeds the partner's basis in its interest, the partner recognizes taxable gain under section 731(a).

Whether a partnership liability is allocated to a particular partner depends, in the first instance, on whether the liability is "recourse" or "nonrecourse." A liability that is "recourse" to a particular partner is allocated to that partner. A liability that is not recourse to any particular partner is considered "nonrecourse" and generally is allocated among all partners (though, in many cases, there is substantial flexibility with respect to the allocation of nonrecourse liabilities under Treas. Reg. § 1.752-3).

For this purpose, a liability is a recourse liability when a partner or related person bears the "economic risk of loss" with respect to that liability. To determine whether any partner or related person bears the economic risk of loss with respect to a liability, the Treasury regulations require the partnership to determine whether any partner would have a "payment obligation" if all of the assets of the partnership (including cash) became worthless and the liabilities became due (this is sometimes referred to as the "atom bomb test").[3]

B. Use of Guarantees to Cause Allocations of Liabilities

A partner that wishes to be allocated a share of partnership liabilities in excess of its share of nonrecourse liabilities sometimes will guarantee repayment of some or all of the partnership's liabilities. For example, if a partner with a $0 basis in its interest is entitled to a distribution of money from the partnership, and the partner does not want to recognize taxable gain on the distribution, the partner might guarantee a partnership liability before the distribution. If the amount of the guarantee is at least equal to the amount of money to be distributed, the distribution does not cause the partner to recognize gain under section 731(a) because the liability "supports" the distribution by providing additional basis.

This well-understood and perfectly acceptable planning technique, of course, is not without economic risk; a partner that guarantees a liability may be called upon to satisfy that guarantee. With lower-leverage partnerships, this can be relatively low risk. In a higher-leverage partnership—for example, certain real estate joint ventures—however, the risk can be more significant.

Before the issuance of temporary Treasury regulations in October 2016, a partner that sought to be allocated a share of liabilities while reducing the associated economic exposure sometimes entered into a so-called "bottom dollar guarantee." Unlike other guarantees (in which the guarantor is liable for the amount guaranteed beginning with the first dollar of the unsatisfied outstanding principal balance), a bottom dollar guarantee requires the guarantor to make a payment only to the extent that the lender ultimately collects less than the amount guaranteed. That is, a bottom dollar guarantee exposes the guarantor to the *last* dollars of loss rather than the first. A bottom dollar guarantee thus caused a liability to be a recourse liability that exposed the guarantor to lower risk while still constituting sufficient risk exposure to support an allocation of liabilities (in an amount equal to the guarantee). This allowed the partner providing the guarantee to avoid gain recognition to the extent of the associated liabilities.

C. IRS and Treasury Response to Bottom Dollar Guarantees

The IRS and Treasury perceived bottom dollar guarantees as lacking commercial substance and, in January 2014, proposed an initial set of regulations seeking to curb their use. Under the final 2019 Regulations, "bottom dollar payment obligations" are not recognized (*i.e.*, a bottom dollar guarantee does not result in the guarantor partner being treated as having the economic risk of loss with respect to the liability). Under the

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regulations, a bottom dollar payment obligation generally includes any payment obligation under a guarantee or similar arrangement with respect to which the partner (or a related person) is not liable for up to the full amount of the payment obligation in the event of non-payment by the partnership. In other words, the lender must be able to recover from the guarantor beginning with the lender's first dollar of loss. In determining whether a guarantee meets the definition of a bottom dollar payment obligation, and, relatedly, whether the partner (or a related person) bears the economic risk of loss, every aspect of the guarantee must be considered, including whether, by reason of contract, state law, or common law, the partner has a reimbursement or contribution right (for example, by claiming reimbursement or contribution from the joint venture on a priority basis relative to the other partners, from the other partners, or from third parties).

The determination of whether a particular guarantee meets the definition of "bottom dollar payment obligation" is, therefore, a mixed issue of law and transaction-specific facts.

D. Special Rule for "Vertical Slice" Guarantees

One important clarification of the bottom dollar guarantee rules is the rule for so-called "vertical slice" guarantees. The 2019 Regulations provide that a guarantee is not a bottom dollar guarantee if the guaranteed obligation equates to a fixed percentage of every dollar of the guaranteed partnership liability. That is, a partner does not need to guarantee the entire liability but rather can guarantee a "vertical slice" of the entire liability. For example, suppose a partner agrees to guarantee ten percent of a $100 million partnership liability, which would be $10 million. In a typical guarantee, the partner would be liable for the first $10 million of the lender's losses—that is, if the lender recovers less than $100 million, the guarantor is liable for up to $10 million. If, however, the partner enters into a "vertical slice guarantee" for ten percent of the lender's loss up to the same $10 million amount, the partner would be liable for ten percent of each dollar of the lender's loss, thus reducing its effective economic exposure in the event of a loss. That is, if the lender recovered only $60 million from the partnership, the guarantor would be liable for $4 million (ten percent of the $40 million loss). Unlike a bottom dollar guarantee (which, in the example, would not have resulted in a payment obligation because the lender recovered in excess of the $10 million guaranteed amount), a "vertical slice guarantee" exposes a guarantor partner to liability from the first dollar of loss.

Accordingly, a partner seeking to provide a guarantee of only a portion of a partnership liability may be able to use a "vertical slice guarantee" to accomplish this goal while reducing economic exposure in the event of a loss.

E. Anti-Abuse Rule

The 2019 Regulations contain an anti-abuse rule pursuant to which a payment obligation is disregarded if the facts and circumstances indicate a plan to circumvent or avoid the obligation. Factors cited by the regulations as evidence of such a plan include the partner (or a related person) not being subject to commercially reasonable contractual restrictions that protect the likelihood of payment and that the terms of the partnership liability would be substantially the same had the partner (or related person) not agreed to provide the guarantee. These rules should be considered if entering into a guarantee or other payment obligation.

III. How May The Expiration Of The Transition Rule Impact You?

If you:

- are a partner in an entity classified as a partnership for U.S. federal income tax purposes;
- guaranteed one or more partnership liabilities before October 5, 2016; and
- your share of partnership liabilities exceeded your basis in your partnership interest

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at that time;

then you should consult your tax lawyers to determine whether the guarantee is a bottom dollar payment obligation. If it is, the transition rule described above will expire on October 4, 2023, and you should consider whether to take any action before that date. Actions that can be taken include entering into a replacement guarantee that complies with the 2019 Regulations before October 4, 2023. If you do not, you may recognize gain equal to all or a portion of your current "negative tax capital account," either in 2023 or later.

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[1] Unless indicated otherwise, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury regulations promulgated under the Code.

[2] The 2019 Regulations finalized temporary regulations promulgated in T.D. 9788 on October 5, 2016.

[3] There is a special rule for liabilities with respect to which the lender may look only to specific partnership assets. In that case, the liability is treated as satisfied by transferring the property to the lender.

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