Originally published in the:
New York Law Journal *October 21, 2020*

More Liabilities Please: The Allocation of a Partnership's Liabilities

By: Ezra Dyckman and Charles S. Nelson

The allocation of a partnership's liabilities is often important, because a partner's share of a partnership's liabilities is included in the tax basis of his partnership interest, and a partner's tax basis in his partnership interest can determine the extent to which he can receive tax-free distributions or allocations of losses from a partnership. In addition, if a partner's share of a partnership's liabilities is reduced, the partner may recognize taxable income as a deemed distribution in excess of basis.

In October, 2019, the Treasury Department finalized a set of regulations that will have an important impact on how liabilities are allocated when a partner guarantees partnership debt.

In determining the allocation of a partnership's liabilities, longstanding Treasury Regulations differentiate between a "nonrecourse liability," which is generally allocated among the partners in accordance with their interests in the profits of the partnership, and a "recourse liability," which is allocated to each partner to the extent he bears the "economic risk of loss" with respect to the liability.

A partner is generally treated as bearing the economic risk of loss with respect to a liability to the extent that the partner (or a related person) would be required to make a payment in a hypothetical scenario where (1) all of the partnership's liabilities become due and payable and (2) all of the partnership's assets become worthless.

Prior to 2016, a partner could take advantage of these rules by issuing a so-called "bottom-dollar guarantee" of partnership debt, whereby the partner would guarantee only the least risky dollars of the liability. Under the economic risk of loss rules, the partner would generally be allocated an amount of debt equal to the bottom-dollar guarantee, notwithstanding that it was often highly unlikely that the partner would ever have to make a payment under the guarantee.

In 2016, the Treasury Department issued temporary regulations under which bottom-dollar guarantees would be disregarded in determining whether a partner bears the economic risk of loss with respect to a partnership liability.

However, in an another attempt to restrict what it viewed as potentially abusive transactions, in 2014, Treasury issued proposed regulations that would have imposed strict requirements on which types of payment obligations would be treated as giving a partner the economic risk of loss with respect to a partnership liability.

In particular, the proposed regulations provided a list of requirements that had to have been satisfied for any payment obligation, and if any one of those requirements was not met, that payment obligation would be disregarded in determining whether a partner bears the economic risk of loss with respect to the liability.

As a result of these proposed regulations, many partner guarantees, even though economically meaningful, would have been ignored if the partner's primary motivation for making the guarantee was tax related.

In response to comments, in 2016, Treasury withdrew the 2014 proposed regulations and issued new proposed regulations. In October, 2019, these regulations were finalized. Under the final 2019 regulations, a payment obligation, even if not a bottom-dollar guarantee, is disregarded in determining whether a partner bears the economic risk of loss with respect to a liability if the facts and circumstances evidence a plan to circumvent or avoid the obligation.

In making this determination, the final regulations include a list seven non-exclusive factors that may be relevant, but, unlike the 2014 proposed regulations, the rules provide that the presence or absence of any one factor is not dispositive. In addition, these factors are now part of an "anti-abuse" rule rather than a general requirement. Thus, the factors are relevant only in determining whether there exists a plan to circumvent or avoid the obligation itself.

The relevant factors listed in the regulation are (1) whether the partner is subject commercially reasonable contractual restrictions to protect the likelihood of payment; (2) whether the partner is required to provide commercially reasonable documentation regarding the partner's financial condition; (3) whether the term of the payment obligations ends prior to the term of the liability (if the purpose of the restricted term was to end the obligation prior to the occurrence of an event that would increase the risk of economic loss to the guarantor); (4) whether the partnership or other obligor holds money in an amount that exceeds its reasonable foreseeable needs; (5) whether the payment obligation does not permit the creditor to promptly pursue payment following a default; (6) whether the terms of the partnership liability would be substantially the same had the partner not agreed to provide the guarantee; and (7) whether the creditor did not receive executed documents with respect to the obligation before, or within a commercially reasonable period of time after, the liability was incurred.

These final regulations are relatively favorable to taxpayers compared to the 2014 proposed regulations that were withdrawn, because a real guarantee that has economic substance should generally be respected in allocating debt under the final regulations, even if income tax motivations were the primary—or even sole—reason for entering into the guarantee.

In contrast, it appears that guarantees may be disregarded under these rules only if they were structured in a manner to minimize the risk that the guarantor would actually be required to make a payment. Nevertheless, the rules provide significant uncertainty compared to prior law, since the facts and circumstances of each partner guarantee must now be analyzed to determine whether it meets the balancing test enacted in these regulations.

Ezra Dyckman *is a partner at Roberts & Holland.* Charles S. Nelson *is an associate at the firm.*