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Client Alert: Recent Changes to Federal Partnership Tax Rules Eliminate Usefulness of Bottom-Dollar Guarantees and Reduce Effectiveness of Debt-Financed Distributions to Avoid Disguised Sale Treatment

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How partnership liabilities (including liabilities of a limited liability company treated as a partnership for tax purposes) are allocated among its partners is important. A partner's tax basis in its partnership interest is increased by the amount of partnership liabilities allocated to the partner. This increased tax basis could allow the partner to claim more deductions from the partnership, or receive more distributions without immediate taxation. Federal Treasury regulations governing how partnership liabilities are to be allocated have been recently modified. The following discussion addresses certain aspects of these changes.

Bottom-Dollar Guarantees

One approach that partners historically have used to obtain an allocation of partnership liabilities is to provide a "bottom dollar" guarantee of those liabilities. Such a guarantee would be triggered only if the partnership ultimately paid an amount on the liability equal to less than the guaranteed amount (for example, a partner's guarantee of $100,000 of a $1,000,000 partnership liability, where such guarantee would be triggered only to the extent that the partnership ultimately paid less than $100,000 on the liability). New final Treasury regulations disregard "bottom dollar payment obligations" for purposes of allocating partnership liabilities. A "bottom dollar payment obligation" is generally a guarantee (or indemnity) of a partnership obligation, other than one in which the guarantor would be liable for up to the full amount of their guarantee if *any amount* of the partnership liability is not satisfied. Under these rules, it is still acceptable for a partner's guarantee obligation to be capped at a maximum amount, and for a partner to guarantee a fixed percentage of each dollar of the partnership's obligation (a "vertical slice" guarantee). Similarly, partners who jointly and severally guarantee a partnership obligation can enter into a contribution agreement among themselves, requiring that each guaranteeing partner is responsible for only its proportionate share of any such guarantee obligation.

Disguised Sale: Debt-Financed Distributions

Where a partner contributes assets to a partnership, and receives a non-pro rata distribution close in time to the contribution (generally, within two years), this contribution/distribution is subject to potential treatment as a taxable sale of all or a portion of the property by the partner to the partnership (a disguised sale). Under a complex, taxpayer-favorable rule, disguised sale treatment may be avoided in whole or in part where a partnership borrows money and distributes all or a portion of the proceeds to the contributing partner. Generally, complete avoidance of disguised sale treatment under this approach requires allocation of the entire partnership loan to the contributing partner, which historically has been possible to accomplish. New final Treasury regulations, however, effectively eliminate this possibility by requiring that, for purposes of the disguised sale rules, all partnership debt be allocated among the partners in accordance with their interests in the partnership.

In addition to the items discussed above, the new Treasury regulations modify rules addressing the ability of a partner to receive tax-free distributions of preformation capital expenditures, as well as the impact of liabilities assumed by a partnership, in each case in connection with a partner's contribution of property to the partnership.

The recent Treasury regulation modifications will impact the tax consequences of a number of transaction structures that have been widely used by taxpayers in the past. Going forward, taxpayers engaging in such transactions will need to consult with their tax advisors as to the impact of the new rules on their desired tax results, as well as potential structuring alternatives available to mitigate any adverse consequences.