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# Partnership Debt Allocations in the New “Risk of Loss” World

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HOLLAND & HART 

# Agenda

1. Overview: Outside Basis, § § 752 and 707 and Deficit Restoration Obligations
2. The Bottom Dollar Guarantee Issue and Prior Guidance
3. 2019 Final Regulations and Planning Opportunities
4. Remaining Issues

# Why Does Outside Basis Matter?

A partner's outside basis affects:

- Ability to claim losses (§704(d))
- Taxability of distributions of money (§731 and §733)
- Basis of property received in distributions (§732)
- Gain or loss on disposition of partnership interest (§731 or §741)

# Outside Basis Calculation

## Increased By - § 705(a)(1):

- Contributions (Cash or basis of property)
- Taxable income items
- Nontaxable income items (i.e., permanently tax exempt income)
- Excess of deductions for depletion over adjusted basis of property subject to depletion
- Increase in a partner's share of liabilities

## Decreased By - § 705(a)(2):

- Distributions (cash or property)
- Taxable loss items
- Nondeductible items not chargeable to a capital account
- Depletion deduction for oil and gas wells (to the extent the deduction does not exceed the partner's share of adjusted basis of property)
- Decrease in a partner's share of liabilities

## Section 752 Liabilities and Basis

- § 752(a) provides that an increase in a partner's share of a partnership liability is treated as contribution of money by the partner to the partnership
- § 752(b) provides that a decrease in a partner's share of a partnership liability is treated as a distribution of money to that partner

# Section 752 Recourse Liabilities

## Recourse Liabilities

- Liabilities for which a partner or related party bears the economic risk of loss (EROL)
- A partner generally bears the EROL for a partnership liability if the partner or related person has an obligation to make a payment if upon a constructive liquidation of the partnership, the partnership's assets are worthless and the liability becomes due and payable

# Section 752 Nonrecourse Liabilities

## Nonrecourse Liabilities

- Liabilities for which no partner is considered to bear the EROL
- Allocated to partners under three tier system (Treas. Reg. § 1.752-3(a))
  - ❖ §704(b) minimum gain
  - ❖ §704(c) taxable gain
  - ❖ Excess nonrecourse liabilities – partner's share of partnership profits

# Section 752 Nonrecourse Liabilities

## Excess Nonrecourse Liabilities – Partner’s Share of Profits

- Significant Item Method - interests specified must be reasonably consistent with allocations of a significant item of income or gain that have substantial economic effect
- Alternative Method – can be allocated in accordance with the manner in which it is reasonably expected that the deductions attributable to a nonrecourse liability will be allocated



# Section 752 Nonrecourse Liabilities

## Excess Nonrecourse Liabilities – Partner's Share of Profits

- Additional Method – can be allocated to a partner that has contributed built-in gain property when the property is subject to the nonrecourse liability, up to the full amount of built-in gain that is allocable to the partner under § 704(c), to the extent the built-in gain exceeds the § 704(c) minimum gain with respect to the property

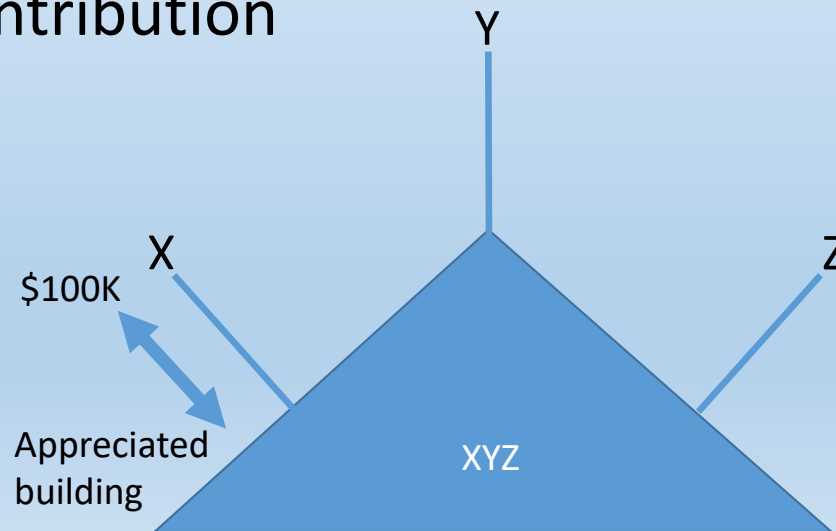
## Section 707 – Disguised Sales

- Direct or indirect transfer by partner to partnership of money or property and related direct or indirect transfer by partnership to partner of money or property may be reclassified as a sale or exchange of property between the partner and the partnership – § 707(a)(2)(B)
- Regulations provide ten factors to be considered for purposes of determining whether a transfer to a partnership and a subsequent transfer to a partner is a sale – Treas. Reg. § 1.707-3(b)(2)
- Rules are intended to prevent taxpayers from characterizing sales of property as tax-free contributions and distributions

# Disguised Sale Example

- X contributes appreciated building with FMV of \$200K
- Receives \$100K cash plus a partnership interest in XYZ
- Treated as sale with respect to 50% of the building and 50% as a tax-free contribution

<u>Building</u>
FMV \$200K
Basis \$50K



## Disguised Sale – Presumptions

- Transfers made within two years of each other presumed part of a sale (Treas. Reg. § 1.707-3(c))
- Transfers made after two years of contribution presumed not be part of sale (Treas. Reg. § 1.707-3(d))

# Disguised Sale – Exceptions

## Payment and Distribution Exceptions (Treas. Reg. § 1.707-4(a) and(b))

- Guaranteed payments: reasonable payment that is determined without regard to partnership income
- Preferred returns: reasonable preferential distribution of partnership cash flow that is matched by an allocation of available income or gain
- Operating cash flow distributions: distribution cannot exceed partnership's net cash flow multiplied by the lesser of the distributee-partner's interest in partnership profits for either the year or the life of the partnership

# Disguised Sale – Exceptions

## Preformation Expenditure Reimbursement (Treas. Reg. § 1.707-4(d))

- Reimbursement of capital expenditures incurred with respect to the contributed property within 2 years of the contribution
  
- 20% limit and 120% exception
  - ❖ 20% limit: Reimbursement cannot exceed 20% of the fair market value of the relevant property (as of the time of its transfer)
  - ❖ 120% exception: 20% limit does not apply if the basis of the property does not exceed 120% of the fair market value of the property
  - ❖ 20% limit (and 120% exception) generally applied on a property-by-property basis

# Disguised Sale – Exceptions

## Debt Financed Distributions (Treas. Reg. § 1.707-5(b))

- Generally, allows for partnership borrowing and a distribution that does not exceed the partner's allocable share of that liability
  
- Ordering Rule
  - ❖ Transfers to a partner are first tested under the debt financed distribution exception
  - ❖ Any amount not excluded under this exception is then tested under other exceptions to disguised sale treatment

# Disguised Sale – Liability Shifts

## Liability Shift or Reduction (Treas. Reg. § 1.707-5(a))

- If property transferred is subject to a liability and liability is shifted to other partners or reduced, treated as a disguised sale unless liability is **qualified**



# Disguised Sale – Qualified Liabilities

## Qualified Liabilities (Treas. Reg. § 1.707-5(a)(6))

- Incurred more than two years prior to the transfer and has encumbered property during such two-year period;
- Incurred within two years, was not incurred in anticipation of transfer and has continuously encumbered property;
- Traced to capital expenditures with respect to the property;
- Incurred in ordinary course of trade or business and all material assets of trade or business are contributed; or
- Incurred in connection with the conduct of a trade or business (but not in anticipation of the transfer), but only if all of the material assets to such trade or business are transferred to the partnership

# Deficit Restoration Obligations (DROs)

- An obligation in the partnership agreement for a partner to restore a deficit balance in its capital account, make payments on a promissory note or contribute capital to the partnership
- DROs can increase basis for purposes of allocations losses and distributions; good alternative to guarantee or indemnity, e.g., diversification of assets and only two parties

# Bottom Dollar Guarantees

- A payment guarantee by a partner to repay a portion of the partnership debt only if the creditor is unable to collect the full amount of the debt from the partnership, i.e., a guarantee of the last dollars of a liability
- Generally, converts nonrecourse liability to recourse liability, increasing basis in partnership interest

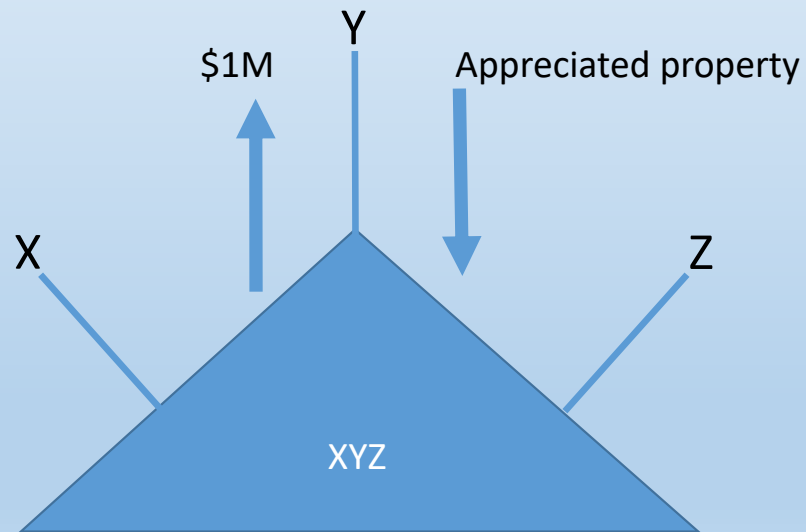
## Bottom Dollar Guarantee – Example

- Partner Y contributes a building worth \$20M, XYZ borrows \$10M against building and distributes \$1M to Partner Y
- Partner Y makes a bottom-dollar guarantee of \$1M of the loan with the lender providing that Partner Y will not be obligated to pay the lender unless the lender collects less than \$1M
- Under the § 752 liability allocation rules, Partner Y's bottom-dollar guarantee would result in a \$1M recourse liability allocation to Partner Y with the remaining \$9M treated as a nonrecourse liability

# Bottom Dollar Guarantee – Example

- Y is allocated \$1M recourse liability

FMV	\$20M
Liability	\$10M
Distribution to Y	\$1M



## 2014 Proposed Regulations

- Treasury and IRS were concerned that *“some partners or related persons have entered into payment obligations that are not commercial solely to achieve an allocation of a partnership liability to such partner”*
- Generally, taxpayer friendly changes proposed to § 707 Regulations that were finalized in 2016

# 2014 Proposed Regulations

## Changes proposed to § 752 Regulations:

- Added certain required factors to recognize payment obligations (including DROs) and prohibited bottom-dollar guarantees
- Revised the anti-abuse rule to address the use of intermediaries, tiered partnerships or similar arrangements to avoid new rules
- Added a net value requirement for all partners and related parties other than individuals or decedent's estates

# 2014 Proposed Regulations

## Changes proposed to § 752 Regulations (cont'd):

- Replaced satisfaction presumption with multi-factor test for commercial reasonableness
- Reduced partner's payment obligation amount by any amount of reimbursement expected
- Removed significant item and alternative method from allocation of nonrecourse liabilities and added liquidation value percentage



# 2016 Final and Temporary Regulations

## Changes made to § 707 Regulations:

- Temporary regulations required a partner to apply the same percentage used to determine the partner's share of excess nonrecourse liabilities under Treas. Reg. § 1.752-3(a)(3) for disguised sale purposes
- A partner's share of a partnership liability for disguised sale purposes does not include any amount of the liability for which another partner bears the EROL for the partnership liability

# 2016 Final and Temporary Regulations

Changes made to § 752 Regulations :

- Temporary regulations retained the restriction on certain guarantees and indemnities, but added a new definition of “bottom dollar payment obligation” that did not include vertical slice guarantees
- Restored asset net value test for disregarded entities

# 2016 Final and Temporary Regulations

Changes made to § 752 Regulations (cont'd):

- Bottom dollar payment obligations recognized if guarantor liable for at least 90% of such guarantor's payment obligation (taking into account the right of indemnification) (the "90% Rule") (subject to anti-abuse)

# 2016 Final and Temporary Regulations

Changes made to § 752 Regulations (cont'd):

- Added an anti-abuse rule that if a partner bears the EROL for a liability, cannot be treated as nonrecourse
- Added a disclosure requirement for all bottom-dollar guarantees
- Provided transition relief for any partner whose allocable share of liabilities exceeds its adjusted basis for 7-year period

# 2016 Proposed Regulations

- §752 Proposed Regulations dropped the general net-value requirement and repropose a modified, multifactor test for whether payment obligations would be respected under a general anti-abuse rule; retained multi-factor test for satisfaction presumption but moved to anti-abuse rule
- §704 Proposed Regulations adopted a separate nonexclusive list of factors in testing for the validity of a DRO and provided that a DRO that is disregarded under the § 704 Regulations will also be disregarded for purposes of the § 752 Regulations

# 2018 Proposed Regulations

- Proposed to withdraw the § 707 Temporary Regulations and reinstate the rules previously in effect under Treas. Reg. § 1.707-5(a)(2)

## 2019 Final Regulations – Treas. Reg. § 1.707-5(a)(2) Disguised Sales– Liability Allocations

- Final regulations adopt the 2018 Proposed Regulations and reinstate the previous rules which allocate liabilities for purposes of the disguised sale rules under § 752 generally

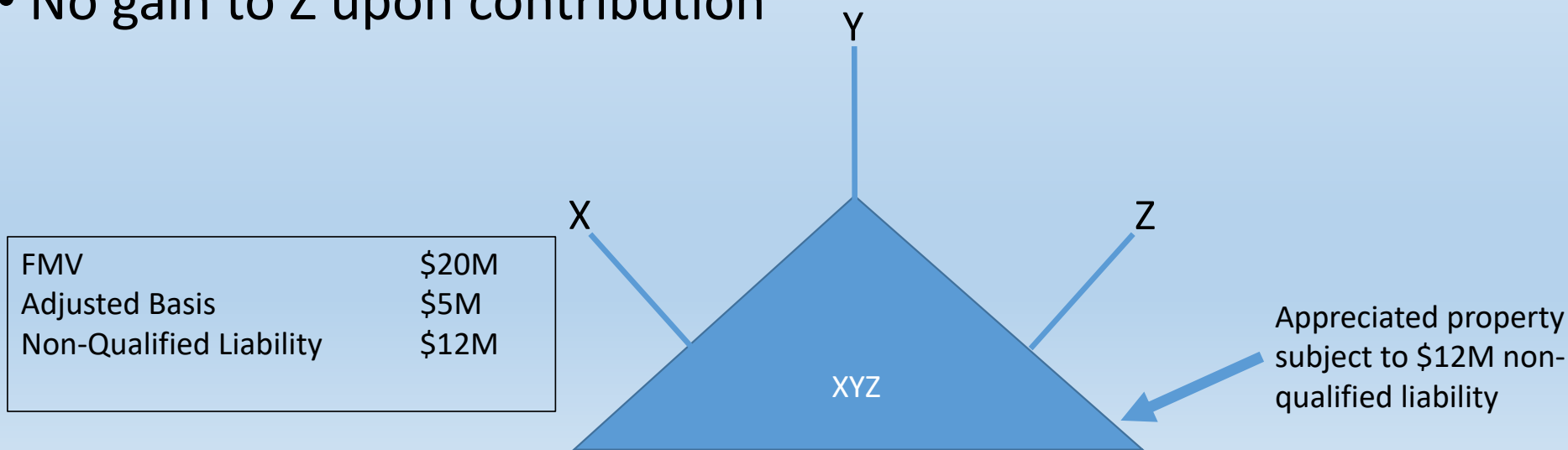
## 2019 Final Regulations – Treas. Reg. § 1.707-5(a)(2) Disguised Sales – Liability Allocations

- *“The Treasury Department and IRS continue to study the merits of the approach in the 707 Temporary Regulations and other approaches, including these final regulations, to determine which results in the most appropriate treatment of liabilities in the context of disguised sales.”*



## 2019 Final Regulations – Treas. Reg. § 1.707-5(a)(2) Disguised Sales– Liability Allocations Example

- Z contributes building subject to \$12M non-qualified liability
- Assume liability would be nonrecourse and allocated 1/3<sup>rd</sup> to each partner under Treas. Reg. § 1.752-3(a)(3)
- Z guarantees \$8M of liability in valid guarantee under § 752
- No gain to Z upon contribution



## 2019 Final Regulations – Treas. Reg. § 1.707-9 Effective Dates and Transition Rule

- Generally, apply with respect to transfers that occur on or after October 4, 2019
- Partnerships and its partners may apply to transfers on or after January 3, 2017
- For transfers before January 3, 2017, rules in 2016 Temporary Regulations apply
- In sum, can use old rules for all times since 2016 Temporary Regulations

## 2019 Final Regulations – Treas. Reg. § 1.752-2(b)(3) Bottom Dollar Payment Obligations

(1) For a guarantee or similar arrangement, any payment obligation other than one in which the partner or related person is, or would be, liable up to the full amount of the partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied

## 2019 Final Regulations – Treas. Reg. § 1.752-2(b)(3) Bottom Dollar Payment Obligation Example

- A, B and C are equal partners in a partnership. ABC borrows \$1,000 from bank. A guarantees payment of up to \$300 if any amount of the \$1000 liability is not recovered. B guarantees payment of up to \$200 of ABC liability, but only if bank otherwise recovers less than \$200.
- Because A is obligated to pay \$300 if any amount of \$1000 is not recovered, A's guarantee is recognized. A's EROL is \$300.
- Because B is obligated to pay \$200 only if Bank otherwise recovers less than \$200, B's guarantee is not recognized as it is a bottom dollar obligation

## 2019 Final Regulations – Treas. Reg. § 1.752-2(b)(3) Bottom Dollar Payment Obligations

(2) As to an indemnity or similar arrangement, any payment obligation other than one in which the partner or related person is, or would be, liable up to the full amount of the partner's or related person's payment obligation, if, and to the extent that, any amount of the indemnitee's or benefited party's payment obligation that is recognized under the regulations is satisfied

## 2019 Final Regulations – Treas. Reg. § 1.752-2(b)(3) Bottom Dollar Payment Obligation Example

- Same facts as previous. C agrees to indemnify A up to \$100 that A pays with respect to its guarantee and to indemnify B up to the full amount of its guarantee
- Because A's obligation would be recognized but for C's indemnity, C's indemnity is recognized and C's EROL is \$100

## 2019 Final Regulations – Treas. Reg. § 1.752-2(b)(3) Bottom Dollar Payment Obligation Example

- Further, because A is now liable for \$200 only to the extent that \$100 of the liability is not satisfied, A is not liable if, and to the extent, any amount of liability is not satisfied. A's obligation is no longer recognized and its EROL is \$0.
- Because B's obligation is not recognized, C's indemnity with respect to B is also not recognized
- \$100 is allocated to C as a recourse liability and \$900 as a nonrecourse liability

## 2019 Final Regulations – Treas. Reg. § 1.752-2(b)(3) Bottom Dollar Payment Obligations

(3) As to an obligation to make a capital contribution or to restore a deficit capital account on liquidation of the partnership, any payment obligation other than one in which the partner is or would be required to make the full amount of the partner's capital contribution or to restore the full amount of the partner's deficit capital account.



## 2019 Final Regulations – Treas. Reg. § 1.752-2(b)(3) Bottom Dollar Payment Obligations

(4) An arrangement that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements, and with a principal purpose of avoiding having at least one of the liabilities or payment obligations as to those liabilities being treated as a bottom-dollar payment obligations

## 2019 Final Regulations – Treas. Reg. § 1.752-2(b)(3) Bottom Dollar Payment Obligation Example

- ABC borrows a total of \$1,000 from bank and breaks the loan into five \$200 tranches. A guarantees payment of tranche #1 and B guarantees payment of tranche #2.
- A and B are both only obligated to pay if tranche #1 and tranche #2 are not recovered, respectively
- Based on the facts and circumstances, the liabilities were incurred pursuant to a single transaction or arrangement with a principal purpose of avoiding having at least one of the liabilities treated as a bottom dollar payment obligation
- A and B's EROL is \$0

## 2019 Final Regulations – Treas. Reg. § 1.752-2(b)(3) Bottom Dollar Payment Obligation Exceptions

A payment obligation is not treated as a bottom dollar payment obligation merely because:

- (1) a maximum amount is placed on the payment obligation;
- (2) the payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates [vertical slice guarantee]; or
- (3) there is a right of proportionate contribution between partners or related persons who are co-obligors and each of them is jointly and severally liable

# 2019 Section 752 Final Regulations

## Vertical Slice Guarantee

### Vertical Slice Guarantees

- Potential replacement arrangement as allows a partner to increase basis, but only be liable for part of liability
- Specifically blessed by final regulations
- Partner's payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which the obligation relates

# 2019 Section 752 Final Regulations

## Vertical Slice Guarantee Example

### Vertical Slice Guarantee Example

- Partnership owns real estate valued at \$50M and takes out \$30M loan against the property
- Partner Y guarantees 10% of the \$30M debt, creating a § 752 recourse liability to Partner Y of \$3M
- Partnership only pays \$5M before property becomes worthless and defaults on the debt
- Partner Y would be required to pay \$2.5M ( $\$30M - \$5M = \$25M$ , 10% of \$25M is \$2.5M)

## 2019 Final Regulations – Treas. Reg. § 1.752-2(b)(3) 90% Rule Exception

- If partner or related person is liable for at least 90% of its payment obligation, not treated as bottom dollar payment obligation
- Thus, if the obligor's ultimate liability under the guarantee (or similar arrangement) is reduced by no more than 10% of the total liability as the result of an indemnity, reimbursement agreement, or similar arrangement made by another partner, then the partner's obligation for the remaining amount is still recognized and creates EROL

# 2019 Final Regulations – Treas. Reg. § 1.752-2(b)(3) Bottom Dollar Payment Obligations

## Disclosure Requirements

- Must disclose on a Form 8275 for taxable year in which the bottom dollar payment obligation is undertaken or modified
- Disclosure must include a statement as to whether the obligation is a guarantee, a reimbursement, an indemnity or DRO

## 2019 Final Regulations – Treas. Reg. § 1.752-2(k) Historical Satisfaction Presumption

- § 752 Regulations historically presumed that a partner (or a related person) would fulfill its obligations
- Generally, there was no net worth requirement (except for disregarded entities, which have a net value requirement) unless the facts and circumstances indicated a plan to circumvent or avoid the obligation



## 2019 Final Regulations – Treas. Reg. § 1.752-2(k) Satisfaction Presumption

- Satisfaction presumption does not apply if the facts and circumstances show that *“there is not a commercially reasonable expectation that the payment obligor will have the ability to make the required payments under the terms of the obligation if the obligation becomes due a payable.”*
- Final regulations focus on whether the debtor will have the ability to make payments when due and not whether debtor has sufficient assets to satisfy an obligation currently
- Applies to all partners; obligor includes a disregarded entity and grantor trust

## 2019 Final Regulations – Treas. Reg. § 1.752-2(k) Satisfaction Presumption Example

- A forms a wholly-owned LLC with \$1000 capital contribution and no liability for LLC's debts and LLC has no enforceable right to contribution
- LLC contributes \$1000 to partnership in exchange for a GP interest; other partners receive LP interests
- Partnership borrows \$5000 and buys a property worth \$10K
- LLC guarantees entire liability
- Because LLC has no assets other than partnership interest, LLC's guarantee is not recognized and liability is allocated as nonrecourse

## 2019 Final Regulations – Treas. Reg. § 1.752-2(k) Satisfaction Presumption Example

- The facts are the same except LLC also holds real property worth \$5000 and expects to earn \$2000 of net rental income from such property
- Because there is a commercially reasonable expectation that LLC will be able to satisfy its payment obligation, its guarantee is recognized and \$5000 liability is characterized as recourse and allocated to the LLC

## 2019 Final Regulations – Treas. Reg. § 1.752-2(k) Satisfaction Presumption

- Final regulations and examples do not provide whether a liability that fails to meet satisfaction presumption can be bifurcated into nonrecourse and recourse
- IRS informally confirmed in January 2020 that final regulations do not allow for bifurcation – “all or nothing” approach
- Cliff effect of treating the entire liability as nonrecourse if there is no reasonable expectation that guaranteeing partner can satisfy full amount of liabilities

## 2019 Final Regulations – Treas. Reg. § 1.752-2(j) Anti-Abuse Rule

- A payment obligation is not recognized if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's EROL with respect to that obligation or create the appearance of the partner or related person bearing the EROL when the substance of the arrangement is otherwise
- Related person is a person who bears a relationship to a partner under § § 267(b) or 707(b), substituting 80% for 50%

## 2019 Final Regulations – Treas. Reg. § 1.752-2(j)(3) Anti-Abuse Factors

Final regulations contain a non-exclusive list of factors that indicate a plan to circumvent or avoid payment obligation:

- (1) the partner or related person is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment
- (2) the partner or related person is not required to provide commercially reasonable documentation regarding its financial condition to the benefited party

## 2019 Final Regulations – Treas. Reg. § 1.752-2(j)(3) Anti-Abuse Factors

Non-exclusive factors (cont'd):

- (3) The term of the payment obligation ends prior to the term of the partnership liability, or the obligor has a right to terminate its payment obligation when events occur increasing the risk of economic loss to the guarantor or benefited party
- (4) The primary obligor (or related person) holds money or other liquid assets in an amount that exceeds the reasonably foreseeable needs of such obligor

## 2019 Final Regulations – Treas. Reg. § 1.752-2(j)(3) Anti-Abuse Factors

Non-exclusive factors (cont'd):

- (5) The payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection



## 2019 Final Regulations – Treas. Reg. § 1.752-2(j)(3) Anti-Abuse Factors

Non-exclusive factors (cont'd):

- (6) The payment obligation does not result in any substantial change to the terms of the liability
- (7) The creditor or other benefited party does not receive executed documents with respect to the payment obligation before, or within a commercially reasonable period of time after, the creation of the obligation

## 2019 Final Regulations – Treas. Reg. § 1.752-2(j)(3) Anti-Abuse Rule Example

- In Year 1, ABC form a partnership that obtains a loan from a bank treated as nonrecourse because no partner bears EROL
- In Year 3, A guarantees the entire amount of the liability. The bank did not request the guarantee, and the terms of the loan do not change as a result of the guarantee. A does not provide any executed documents as to A's guarantee to the bank. The bank also does not require any restrictions on asset transfers by A and no such restrictions exist.
- A's Year 3 guarantee is not recognized under the anti-abuse rule. Thus, ABC's liability continues to be treated as nonrecourse.

## 2019 Final Regulations – Treas. Reg. § 1.752-2(j)(2) Arrangements Tantamount to a Guarantee

Irrespective of the contractual obligation, a partner is considered to bear the EROL for a partnership liability if an obligation is undertaken by a partner or related person that significantly reduces the risk to the lender and either:

(1) Principal purpose of the obligation is to permit other partners to include a portion of the loan in their basis; or

(2) Another partner or related person enters into an obligation whose principal purpose is to cause the obligation to be disregarded.

# 2019 Section 752 Final Regulations

## Nonrecourse Allocations

### Nonrecourse Allocation

- If nonrecourse liability characterization is preferred, and bank requires a guarantee, partners may be able to intentionally create a bottom dollar payment obligation, resulting in an increase to the total nonrecourse liabilities to be allocated
- Must consider the anti-abuse rule previously described and disclosure requirements

## 2019 Final Regulations – Treas. Reg. § 1.752-2(l) Bottom Dollar Effective Date and Transition Rule

- Generally, for bottom dollar payment obligations, effective for partnership liabilities incurred or assumed and obligations imposed or undertaken with respect to partnership liabilities on or after October 5, 2016
- If liability in effect prior to October 5, 2016, partnership allowed to apply a 7-year transition rule (through October 4, 2023) to grandfathered amount, which is the amount the allocation of partnership liabilities with respect to bottom dollar payment obligations exceeds a partner's outside basis

## 2019 Final Regulations – Treas. Reg. § 1.752-2(l) Bottom Dollar Transition Rule Example

- As of October 5, 2016, a partner has a negative \$50 tax capital account and a bottom dollar payment obligation that, if respected, would cause the partner to be allocated \$100 of partnership liabilities
- The partner's outside basis would be \$50 and the grandfathered amount would be \$50

# 2019 Final Regulations – Treas. Reg. § 1.752-2(l) Bottom Dollar Transition Rule

Grandfathered Amount is reduced for:

- Certain reductions in the amount of liabilities allocated to a partner
- Sale of any partnership property for tax gain (including built-in gain under § 704(c)) allocable to the partner less the partner's share of the amount realized
- Significant modifications or refinances of liabilities

Partners should consider restructuring their bottom-dollar guarantees prior to the end of the transition period

## 2019 Final Regulations – Treas. Reg. § 1.752-2(l) Other Effective Dates

- Changes to Satisfaction Presumption and the Anti-Abuse Rule are effective for partnership liabilities incurred or assumed by a partnership and to payment obligations imposed or undertaken with respect to a partnership liability on or after October 9, 2019
- Effective date does not apply to liabilities or obligations in effect before that date



## 2019 Final Regulations – Treas. Reg. § 1.704-1(b)(2)(ii)(C)(4) Deficit Restoration Obligations

Final regulations include rules under § 704 providing that capital contribution obligations and DROs will not be respected if:

- The obligation is a bottom dollar payment obligation under Treas. Reg. § 1.752-2(b)(3) [full amount?];
- Not legally enforceable; or
- Facts and circumstances indicate a plan to circumvent or avoid such obligation

## 2019 Final Regulations – Treas. Reg. § 1.704-1(b)(2)(ii)(C)(4) Deficit Restoration Obligations

Factors indicating a plan to circumvent or avoid an obligation:

- (1) The partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation
  
- (2) The partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership

## 2019 Final Regulations – Treas. Reg. § 1.704-1(b)(2)(ii)(C)(4) Deficit Restoration Obligations

Factors (cont'd):

(3) The obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account is negative other than when a transferee partner assumes the obligation

(4) The terms of the obligation are not provided to all the partners in the partnership in a timely manner

## 2019 Final Regulations – Treas. Reg. § 1.704-1(b)(2)(ii)(C)(4) Deficit Restoration Obligations Effective Date

- Changes to § 704 Regulations state they are effective for partnership tax years ending on or after October 9, 2019, but likely apply to existing DROs
- Partners and partnerships should review existing DROs to ensure a true repayment obligation exists
- Can DROs any longer be capped?

## 2019 Final Regulations Remaining Issues

- Ongoing study of liability rule for disguised sales
- Guidance under § 465 in determining a partner's at-risk amount for deficit restoration obligations and guarantees
- Recourse versus nonrecourse debt under § 1001
- Exculpatory liabilities – treatment under §§ 704 and 1001 and allocation among multiple assets