Client Alert

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IRS Issues Proposed Regulations That Would Curtail Common Tax-Planning Strategies Used by Real Estate Partnerships and Their Partners

The Internal Revenue Service ("IRS") recently issued proposed regulations (the "Proposed Regulations") addressing the rules for allocating partnership liabilities among partners and the partnership "disguised sale" rules. If finalized in their current form, the Proposed Regulations would curtail certain common tax-planning strategies used by real estate partnerships and their partners. Specifically, the Proposed Regulations would eliminate the tax advantages associated with so-called "bottom-dollar guarantees," which are widely used by partners in real estate partnerships (including operating partnerships of UPREITs) to avoid recognizing gain in connection with contribution transactions and subsequent liability repayments. Additionally, several of the proposed changes to the disguised sale rules would make it more difficult for partners contributing real estate to a partnership to extract cash on a tax-deferred basis. Discussed below are some of the more significant changes in the Proposed Regulations.

Allocations of Partnership Recourse Liabilities

Allocation of Recourse Liabilities Generally

Generally, a reduction in the partnership liabilities allocated to a partner is treated as a deemed cash distribution, which is taxable to the extent it exceeds the partner's adjusted tax basis in his partnership interest. In many cases, a partner that contributes property to a partnership that is encumbered by liabilities in excess of the contributor's tax basis in the property may recognize taxable gain as a result of the partnership's assumption of the encumbering liabilities or subsequent liability repayments. To avoid this result, the partner may seek to have other partnership liabilities allocated to him. That allocation can be accomplished under current law by using a "bottom-dollar guarantee" to cause otherwise nonrecourse liabilities of the partnership to be "recourse" liabilities with respect to the contributing partner.

Under current law, for purposes of allocating "recourse" liabilities, a partner is considered to bear the economic risk of loss for a partnership liability to the extent that the partner would be obligated to make a payment if the partnership's assets were worthless and the liability became due and payable. Under this "nuclear scenario" approach to determining risk of loss, liabilities that are otherwise nonrecourse to the partnership are generally allocated to the partner who guarantees the liability (the "Guaranteeing Partner"). This is true even if the lender and the partnership reasonably anticipate that the partnership will be able to satisfy the liability. The "nuclear scenario" approach gave rise to the use of bottom-dollar guarantees. In a bottom-dollar guarantee, a partner's guarantee obligation arises only if the lender receives, in foreclosure, an amount less than the guaranteed amount (i.e., if a partner provides a $10 bottom-dollar guarantee of a $100 liability, the Guaranteeing Partner would be liable only to the extent the lender received less than $10 in foreclosure).

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Elimination of the Bottom-Dollar Guarantee

The Proposed Regulations eliminate bottom-dollar guarantees as a tax-planning tool. In general, the changes are an attempt by the IRS and Treasury to treat debt as "recourse" for liability allocation purposes only when the partner has real and meaningful economic risk with respect to the debt.

The Proposed Regulations provide that guarantees will not be recognized for purposes of recourse liability allocations unless (1) a six-factor test is satisfied and (2) the Guaranteeing Partner satisfies a minimum net value requirement. One of the requirements of the six-factor test is that the Guaranteeing Partner is liable for the full amount of his payment obligation if, and to the extent that, any amount of the guaranteed liability is not otherwise satisfied. Typical bottom-dollar guarantees would fail this requirement, because a bottom-dollar guarantee typically applies only to a portion of the guaranteed liability. Although the minimum net value requirement would not apply to individuals and decedent's estates, that requirement may limit the ability of other partners to receive a full allocation of any guaranteed liability.

Modifications to the Partnership Disguised Sale Rules

Disguised Sales Generally

A partner who contributes property to a partnership and receives a related distribution of cash or other property may be treated as if he sold his property to the partnership, which is referred to as a "disguised sale." A similar result also can occur in some circumstances when a partnership assumes liabilities in connection with a contribution of property. The recharacterization of a contribution and related distribution or liability assumption as a disguised sale causes the contributing partner to recognize gain or loss as if the transaction was a sale to an unrelated party.

Exception for Preformation Capital Expenditures

Under the current disguised sale rules, distributions that reimburse a partner for certain capital expenditures incurred by the partner in anticipation of the formation of the partnership are not treated as part of a disguised sale (the "Preformation Expenditures Exception"). The Preformation Expenditures Exception generally applies only to the extent that the reimbursed expenditures do not exceed 20 percent of the fair market value (the "FMV Limitation") of the property at the time of the contribution. The FMV Limitation does not apply, however, if the FMV of the property at the time of contribution does not exceed 120 percent of the partner's adjusted basis in the property at the time of contribution (the "FMV Limitation Exception").

The Proposed Regulations would clarify that multiple properties may not be aggregated for the purposes of applying the FMV Limitation and the FMV Limitation Exception, which is contrary to the position taken by many contributors. Instead, the Preformation Expenditures Exception must be applied on a property-by-property basis. In addition, the Proposed Regulations prevent "double dipping" transactions where the partnership both reimburses the contributor's preformation capital expenditures and assumes the liability used to finance them. As a result, the Preformation Expenditures Exception may be of significantly less value to partners contributing properties to a partnership.

Effective Dates

The Proposed Regulations are prospective in nature (i.e., they would be effective for transactions occurring after they are finalized). Additionally, the Proposed Regulations provide transition relief with respect to the elimination of bottom-dollar guarantees. Under the transition rule, partners utilizing bottom-dollar guarantees to maintain deferral may continue to apply current law for a seven-year period following the finalization of the Proposed Regulations if the partner's allocable share of partnership liabilities under

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current law exceeds the partner's adjusted tax basis in its partnership interest on the date the Proposed Regulations are finalized.

View a copy of the Proposed Regulations.

Hunton & Williams LLP Tax Practice

Hunton & Williams LLP attorneys are available to provide more information about the Proposed Regulations. If you would like to receive more information, please contact the attorneys listed below.

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