CHANGES TO PARTNERSHIP RECOURSE LIABILITIES IN FINAL REGULATIONS: UNDERSTANDING THE CLIFF EFFECT

by Lee Meyercord and Jessica Kirk*

On October 4, 2019, the IRS released final regulations under section 752.[1] Our Article titled "IRS Final Regulations Eliminate Bottom-Dollar Guarantees" in the Fall 2019 edition of the Texas Tax Lawyer summarized bottom-dollar guarantees, their use in tax-planning, and the temporary and final regulations under section 752 that ended the viability of bottom-dollar guarantees.[2]

The regulations under section 752 also address when partnership liabilities are considered recourse liabilities to partners, including a partner who is an entity disregarded as separate from its owner for federal income tax purposes. This Article summarizes the prior regulations and final regulations, including the so-called "cliff effect" created by the final regulations when there is no commercially reasonable expectation that a partner can pay the full amount of partnership liabilities.

Use of Debt Allocations in Tax Planning and Prior Regulations

A partner's basis determines the amount of distributions that a partner can receive tax-free and the amount of partnership losses that flow-through to the partner.[3] A partner's basis in her partnership interest includes her share of partnership liabilities.[4] For partnership basis allocation purposes, partnership liabilities are classified as recourse or nonrecourse.[5] A partnership liability is recourse and allocated to a specific partner if that partner bears the economic risk of loss for the liability.[6] By contrast, if no partner bears the economic risk of loss, a partnership liability is nonrecourse and allocated among the partners in accordance with the three-tier allocation rules in Treasury Regulations Section 1.752-3.[7]

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[1] T.D. 9877, 84 Fed. Reg. 54,014 (Oct. 9, 2019).

[2] Lee Meyercord & Jessica Kirk, *IRS Final Regulations Eliminate Bottom-Dollar Guarantees*, Texas Tax Lawyer, Fall 2019.

[3] *See* I.R.C. § 704(d)(1); Treas. Reg. § 1.731-1(a)(1)(i).

[4] I.R.C. §§ 722; 752(a).

[5] Treas. Reg. §§ 1.752-1(a)(1)-(2).

[6] Treas. Reg. §§ 1.752-1(a)(1); 1.752-2(a).

[7] Treas. Reg. §§ 1.752-1(a)(2); 1.752-3.

A partner bears the economic risk of loss to the extent that the partner would be obligated to pay the liability in a constructive liquidation.[8] The determination of whether a partner bears the economic risk of loss is based on the facts and circumstances and takes into account statutory and contractual obligations such as guarantees, indemnifications, and reimbursement agreements.[9] There is a presumption that partners and related persons with payment obligations actually perform those obligations, irrespective of their net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.[10] This is referred to as the satisfaction presumption.

Under the prior regulations, the satisfaction presumption was subject to an exception for a disregarded entity that did not have sufficient net value to pay the debt.[11] For example, A owns 100% of LLC, a disregarded entity for federal income tax purposes. A contributes $200,000 to LLC. A has no liability for LLC's debts or obligation to make a contribution to LLC.[12] LLC contributes $100,000 to a partnership in exchange for a partnership interest. The partnership incurs a $300,000 liability guaranteed by LLC. Under the prior regulations, the debt would be bifurcated and treated as recourse to A to the extent of LLC's net value of $100,000.[13] The balance would be a nonrecourse liability allocated among the partners under Treasury Regulations Section 1.752-3.

Proposed Regulations

In 2014, the IRS issued proposed regulations expanding the net value requirement to all partners and related persons other than individuals or estates.[14] The preamble to the 2014 proposed regulations requested comments concerning whether the net value rule should also apply to individuals and estates.[15] After considering the comments to the proposed regulations, the "IRS and Treasury Department agreed that expanding the application of the net value rules under 1.752-2(k) may lead to more litigation and unduly burden taxpayers."[16] In addition, the IRS and Treasury

[8] Treas. Reg. §§ 1.752-2(b)(1); 1.752-2(b)(5) ("A partner's or related person's obligation to make a payment with respect to a partnership liability is reduced to the extent that the partner or related person is entitled to reimbursement from another partner or a person who is a related person to another partner."); 1.752-2(j)(3) ("An obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation.").

[9] Treas. Reg. § 1.752-2(b)(3).

[10] Treas. Reg. § 1.752-2(b)(6).

[11] Treas. Reg. § 1.752-2(k) [prior to amendment by T.D. 9877, 84 Fed. Reg. 54,014 (Oct. 9, 2019)].

[12] *See also* Treas. Reg. § 1.752-2(k)(6), Ex. (2) [prior to amendment by T.D. 9877, 84 Fed. Reg. 54,014 (Oct. 9, 2019)].

[13] Treas. Reg. § 1.752-2(k) [prior to amendment by T.D. 9877, 84 Fed. Reg. 54,014 (Oct. 9, 2019)].

[14] REG-119305-11, 79 Fed. Reg. 4826 (Jan. 30, 2014).

[15] *Id.* at 4831.

[16] REG-12285-15, 81 Fed. Reg. 69,301, 69,305.

Department recognized that the net value requirement may not accurately take into account future earnings of a business entity, which would factor into lending decisions.[17]

On October 5, 2016, the IRS and Treasury issued proposed regulations that removed the net value requirement, and instead added a presumption to the section 752 anti-abuse rule.[18] Under this presumption, evidence of a plan to circumvent or avoid the obligation under the section 752 anti-abuse rule would have been deemed to exist if the facts and circumstances indicated that there was not a reasonable expectation that the debt would be repaid.[19] If such evidence was deemed to exist, the obligation could not be recognized for purposes of determining whether a partner had the economic risk of loss and the liability would be nonrecourse.[20]

Final Regulations

On October 4, 2019, the IRS released final regulations which were published in the Federal Register on October 9, 2019.[21] The final regulations take a different approach than the proposed regulations in an effort to more "accurately reflect economics."[22] Thus, the final regulations are focused on "whether a debtor will have the ability to make payments when due, not necessarily . . . whether the debtor has sufficient assets to satisfy an obligation currently."[23]

No Commercially Reasonable Expectation of Payment. The final regulations continue to apply the satisfaction presumption described above, but provide an exception 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 and payable."[24] Factors that a third party creditor would take into account when determining whether to grant a loan are facts and circumstances to be considered when determining whether there was a commercially reasonable expectation of payment.[25] In addition, the partner's ability to pay may be based on documents, such as balance sheets, income statements, cash flow statements, credit reports, and projected future financial results.[26] The IRS has described the test as an "earnings potential" test rather than a net worth test.[27]

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[17] *Id*.

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] T.D. 9877, 84 Fed. Reg. 54,014.

[22] *Id.* at 54,020.

[23] *Id.*

[24] Treas. Reg. § 1.752-2(k).

[25] *Id.*

[26] T.D. 9877, 84 Fed. Reg. 54,020.

[27] Eric Yauch & Lee A. Sheppard, *IRS Clarifies Aspects of Partnership Debt Regs*, Tax Notes, Feb. 3, 2020.

The final regulations give two examples illustrating this rule. The first example involves a disregarded entity (LLC) with no assets other than the partnership interest.[28] The regulations conclude that LLC's payment obligation is disregarded because LLC "has no assets with which to pay if the payment obligation becomes due and payable" and therefore "there is no commercially reasonable expectation that LLC will be able to satisfy its payment obligation."[29] The debt is nonrecourse and allocated among the partners according to the rules in Treasury Regulations Section 1.752-3.

In the second example, the facts are the same except that LLC holds real property with a net worth of $275,000 and the real property earns $20,000 of net rental income per year.[30] The regulations conclude that in this case "there is a commercially reasonable expectation that LLC will be able to satisfy its payment obligation" and therefore the debt is characterized as recourse and allocable entirely to the owner of the disregarded entity.[31]

The Cliff Effect. Neither of the examples in the final regulations explain whether the commercially reasonable expectation analysis would allow partnership debt to be bifurcated and treated as partially nonrecourse to a partner as was permitted for disregarded entities under the old regulations.[32] On January 28, 2020, the IRS informally confirmed practitioner's suspicions that the final regulations do not allow for bifurcation.[33] Instead, they take an all-or-nothing approach.[34] The all-or-nothing approach in the regulations is called a "cliff effect" because the full amount of partnership debt is treated as nonrecourse if there is no reasonable expectation that the guaranteeing partner can pay the full amount of partnership liabilities. For example, in the second example above, if there was a "commercially reasonable expectation" that LLC will be able to satisfy 50% of the debt but not all of the debt, the entire liability is treated as nonrecourse as opposed to 50% nonrecourse and 50% recourse to the owner of LLC.[35]

Effective Dates and Transitional Rule. The final regulations discussed in this Article apply to liabilities and payment obligations occurring on or after October 9, 2019, unless such liabilities

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[28] Treas. Reg. § 1.752-2(k)(2)(i), Ex. (1).

[29] *Id*.

[30] Treas. Reg. § 1.752-2(k)(2)(ii), Ex. (2).

[31] *Id*.

[32] Treas. Reg. §§ 1.752-2(k)(2) (i)-(ii), Ex. (1)-(2).

[33] Eric Yauch & Lee A. Sheppard, *IRS Clarifies Aspects of Partnership Debt Regs*, Tax Notes, Feb. 3, 2020**.** (explaining that Holly Porter, IRS Associate Chief Counsel (Passthrough and Special Industries) confirmed on January 28, 2020 at a New York State Bar Association conference that the application of the section 752 regulations "is a cliff test.").

[34] *Id.*

[35] At least one commentator has suggested that the cliff effect could be the subject of a *Chevron* challenge because there was no notice of the cliff effect in the prior regulations. Eric Yauch, *ABA Section of Taxation Meeting: IRS Hears Grievances on Cliff Effect of Debt Rules*, Tax Notes, Feb. 10, 2020.

or payment obligations were pursuant to a written binding contract effective before that date.[36] However, taxpayers may choose to apply the final regulations discussed in this Article to their liabilities at the beginning of the first taxable year of the partnership ending on or after October 5, 2016.[37]

Conclusion

While the commercially reasonable expectation rule may be more lenient than the prior net value rule, it is less certain in its application. Partners will need to make the commercial reasonable expectation determination on an annual basis.[38] A reduction in a partner's earning potential could cause a partnership liability to be treated as nonrecourse. The reduction of a partner's share of partnership liabilities in excess of basis triggers gain.[39] Thus, this onerous annual determination could create traps for the unwary if there is a change in a partner's earning potential.

[36] Treas. Reg. § 1.752-2(l)(1).

[37] *Id.*

[38] Eric Yauch, *ABA Section of Taxation Meeting: IRS Hears Grievances on Cliff Effect of Debt Rules*, Tax Notes, Feb. 10, 2020 (Caroline Hay, branch 1 attorney, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries) confirmed that the commercially reasonably expectation determination is done annually).

[39] I.R.C. §§ 752(b); 731(a)(1).