IRS Targets Use of Bottom-Dollar Guarantees to Defer Tax

by Jason D. Navarino

One of the advantages of holding assets such as real estate through entities treated as partnerships for federal income tax purposes is the ability to borrow against those assets and withdraw the money without triggering tax. For example, suppose Alice and Bob are co-owners of a rental property. To limit their personal liability, they are advised to contribute the property to a newly formed limited liability company (LLC), which by default will be taxed as a partnership. Due to prior depreciation, Alice and Bob have a very low adjusted basis in the property, and when they contribute the property in exchange for LLC membership interests, they get the same low basis in their membership interests. A few months later, Alice and Bob find themselves short of cash. They can cause the LLC to refinance the property and distribute the loan proceeds to them, but they worry that a distribution in excess of basis typically results in taxable gain. Thankfully, Section 752(a) of the Internal Revenue Code allows them to increase their basis on account of the LLC's new liability, thereby offsetting the distribution and resulting in no taxable gain. If Alice and Bob held the property through an S corporation, which does not benefit from Section 752 or any similar statute, they would not be so fortunate.

The current regulations under Section 752 provide that a partner's basis in his or her partnership interest (outside basis) is increased on account of a partnership liability, such as a mortgage on a property owned by the partnership, if and to the extent that he or she (or a related person) "bears the economic risk of loss" with respect to that liability. If the partnership is the obligor under the debt but a particular partner guarantees the debt, that partner would typically get the basis credit on account of that debt.

One technique that real estate owners frequently use to exit their real estate investments while deferring tax is to contribute their property to an investment partnership, such as an UPREIT or a DownREIT[1] (a partnership with a real estate investment trust (REIT), or an affiliate of a REIT, as the general partner), that holds multiple properties. The contribution often frees the owner from having to manage the property, allows the owner to achieve greater diversification, and permits the owner to convert its equity in the partnership to cash or marketable securities (such as publicly traded REIT shares) on demand—although that conversion typically ends the tax deferral. If the partnership assumes any mortgage on the property, however, unless the owner bears the economic risk of loss with respect to an equivalent amount of partnership liabilities (either the assumed mortgage, if it is not paid off, or another debt of the partnership), the owner will be treated as having received a distribution equal to the amount of the mortgage. If the owner had a low basis in the property before the contribution, this could result in a deemed distribution in excess of basis, which is taxable.

A frequent solution in these situations is for the partnership to offer the owner an opportunity to give a bottom-dollar guarantee of an equivalent amount of partnership debt. The bottom-dollar guarantee can be a low-risk proposition for the owner. Only if the partnership cannot otherwise satisfy the full amount of the debt with its own assets will the guarantor be called upon to pay up, and then only to the extent the partnership has not already satisfied the debt. Still, the current 752 regulations would seem to support treating the guarantor as bearing the economic risk of loss for the guaranteed amount of debt, thereby increasing the guarantor's outside basis and allowing him or her to pull out more cash without triggering tax.

In Jan. 2014, the U.S. Department of the Treasury issued proposed regulations under Section 752 that, if finalized in their current form, would seem to prevent the use of bottom-dollar guarantees to increase a partner's outside basis. Under the proposed regulations, a partner's guarantee or other obligation to satisfy a partnership liability will not be respected for outside basis purposes unless a number of requirements are met, including that the partner be required to maintain "a commercially reasonable net worth" during the term of the obligation or accept "commercially reasonable contractual restrictions on transfers of assets for inadequate consideration," that the term of the obligation not end before the term of the underlying partnership liability, that the partner receive "arm's length consideration" for assuming the obligation (*i.e.*, a guarantee fee), and that the partner be liable for up to the full amount of its obligation if any amount of the underlying partnership liability—not just the bottom dollar—is not satisfied.

The proposed regulations provide that guarantees and other obligations that are now sufficient to increase outside basis but will not be sufficient once the regulations are finalized will be grandfathered for seven years after the regulations are finalized. The proposed regulations have received considerable attention and raised a fair amount of concern, so it remains to be seen if, when and in what form they will be finalized.

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Endnote

1. Both UPREITs and DownREITs are partnerships with a REIT (or an affiliate of a REIT) as the general partner. In an UPREIT, the REIT typically holds all of its assets through the UPREIT. With a DownREIT, the REIT only holds certain assets through the DownREIT, and holds the rest directly (or through an UPREIT or other DownREITs).