2023 Year-End Guide – Partnerships

The IRS in the past year has been actively challenging partnerships' tax positions in court – from the valuation of granted profits interests to limited partner self-employment exemption claims and the structuring of leveraged partnership transactions. At the same time, the agency is dedicating to new funding and resources to examining partnerships.

These developments, along with some reporting and regulatory changes, mean there are a number of tax areas partnerships should be looking into as they plan for year end and the coming year:

- Review Valuation of Granted Profits Interests, Partners' Capital Accounts
- Consider Active Limited Partners' Potential Liability for Self-Employment Tax
- Prepare for Expanded IRS Audit Focus on Partnerships
- Review Structure of Leveraged Partnership Transactions, Application of Anti-Abuse Rules
- Prepare for New Reporting on 2023 Form 1065 Schedule K-1
- Evaluate Before Year End Expiration of Partnership Bottom-Dollar Guarantee Transition Rules

Review Valuation of Granted Profits Interests, Partners' Capital Accounts

In a recent Tax Court case, the IRS attempted — unsuccessfully — to supplant the fair market value agreed to by unrelated parties in a partnership transaction with its expert's higher estimate, asserting that the taxpayer received a taxable capital interest in exchange for services provided to a partnership, not a nontaxable profits interest. If structured and substantiated properly, profits interests can be valuable tools for compensating providers of services to partnerships at no immediate tax cost. Although the court upheld the taxpayers' valuation, the IRS challenge highlights the importance for partnerships to:

- Properly determine, support and document value when granting and establishing rights to profits interests, and
- Strongly consider revaluing partners' capital accounts according to Treasury regulations to reflect fair market value when profits interests are granted.

The case, *ES NPA Holding LLC v. Commissioner*, T.C. Memo 2023-55 (May 3, 2023), involved a partnership (ES NPA) that provided services to another partnership in exchange for a partnership interest. The taxpayers contended that interest was a profits interest, which was not immediately taxable. The IRS argued that, under its higher estimation of the value of the underlying business, ES NPA took a capital interest in the partnership that ostensibly should be immediately taxable.

Relying on the fair market value negotiated among the parties to the transaction, the Tax Court agreed with the taxpayer that there was not a taxable capital shift between partners. Unsurprisingly, the Tax Court also concluded — premised on the IRS's guidance in Revenue Procedure 93-27 — that receipt of a profits interest will not result in the immediate recognition of taxable income. What is somewhat surprising is that the IRS challenged whether the interest was, in fact, a profits interest.

Facts in ES NPA Holding

Under the basic facts, a partnership (NPA, LLC) had three classes of units, including Class A, Class B and Class C units. Upon liquidation of NPA, LLC, the Class A and Class B units were to receive 100% of the original capital assigned to these units before any amounts would be distributable to the Class C units – which were the units that ES NPA received in exchange for its services.

After an unrelated third party purchased 70% of the company for $21 million, the parties to the transaction agreed that the original capital assigned to the Class A and Class B units was $21 million and $9 million, respectively. Thus, the total agreed to value of NPA, LLC was $30 million. Under this valuation, the Class C units held by ES NPA would have $0 value in the event of a hypothetical liquidation of NPA, LLC, at the time of the transaction – suggesting ES NPA received only a profits interest in NPA, LLC.

IRS Challenge

Despite the parties' agreement as to the $30 million equity valuation, the IRS argued that the value of NPA, LLC was $52.5 million. Using this value, the IRS determined that the liquidation value of the Class C units held by ES NPA was in excess of $12 million (rather than $0). Assuming this valuation is accurate, the Class C units would be considered capital interests and would not be eligible for the safe harbor under Revenue Procedure 93-27, which generally exempts from immediate taxation profit interests – but not capital interests – received in exchange for the provision of services to a partnership.

Based on its arguments, the IRS appears to believe that such a capital shift would be immediately taxable to the recipient. Although not specifically addressed in the Tax Court's decision, receipt of a capital interest in exchange for the performance of services is generally a taxable event under established case law. However, there is some question around whether a capital interest received for purposes other than the performance of services would be immediately taxable.

Tax Court's Holding

Ultimately, the Tax Court concluded that the best estimate of fair market value in this case was the purchase price agreed to by unrelated parties. While acknowledging that formal valuation reports may be helpful in establishing fair market value, the Tax Court noted that such appraisals are not required. Rather, as in this case, deference was provided to the transaction price agreed to by unrelated taxpayers. Importantly, the Tax Court noted that the testimony of the selling taxpayer was credible and unbiased. The Tax Court further noted, "we find nothing in the record to dispute a finding that the transaction was arm's length and bona fide."

What If the Court Accepted the IRS's Narrow Reading of Its Own Revenue Procedure?

Although this case is a "win" for the taxpayer, the IRS presumably didn't go to court without reason. The IRS believed the recipient of the Class C units should immediately recognize taxable income. However, the IRS's primary argument sought to prevent application of Revenue Procedure 93-27 via a narrow reading of the guidance. The IRS's primary argument was not whether the Class C units represented a capital interest. What if the Tax Court agreed that Revenue Procedure 93-27 didn't apply to these facts?

Revenue Procedure 93-27 is a safe harbor provision that states the IRS will not treat receipt of a profits interest as immediately taxable. If the Tax Court agreed that the safe harbor didn't apply, as argued by the IRS, the IRS would still need to address judicial precedent holding that receipt of a profits interest is not taxable because the value of the interest received is speculative. Thus, the IRS would then have had to successfully argue that the Class C units had value beyond speculation. Given the result in the IRS's secondary, capital shift argument, it seems unlikely that it would have prevailed.

Key Considerations and Takeaway

Acknowledging the taxpayer's success in this case, it is important to note that the IRS sought to challenge the taxpayer in court. This is presumably not a decision taken lightly by the IRS. Is this a warning sign to taxpayers when structuring transactions where the buyer anticipates future upside that may or may not be speculative?

There are a few important factors that, if the facts had been different, potentially could have altered the outcome of the case:

- The Tax Court found the selling taxpayer's testimony to be credible and unbiased, with nothing in the record indicating something other than an arm's-length transaction.
- The facts did not indicate that the taxpayer needed the cash to support further business operations, was simply looking to monetize his investment as quickly as possible or otherwise facing circumstances prompting the seller to sell at a discount.
- The lack of taxpayer relatedness was important in supporting the use of the agreed fair market value.
- The discussion within the Tax Court's opinion doesn't address whether the property owner ever sought other bids for his business or if that would have changed the court's analysis and conclusion regarding the credibility and unbiased nature of the witness.

Ultimately, while a positive outcome for the taxpayer in this case, the IRS's decision to take this case to trial should serve as a cautionary tale. Taxpayers are well advised to closely scrutinize the factors in their own transactions to ensure the fair market value positions are fully documented and supported.

When issuing a profits interest, it's critical to document the valuation of the partnership and to strongly consider a book up of capital accounts to reflect the valuation. Analyzing and documenting whether the bargaining positions of the parties are truly adversarial would presumably help substantiate the parties' agreement of value.

Consider Active Limited Partners' Potential Liability for Self-Employment Tax

A judicial resolution may be near for the unanswered question of whether limited partners in state law limited partnerships may claim exemption from self-employment (SECA) taxes — despite being more than passive investors. Depending on the outcome in the pending Soroban Capital Partners litigation, limited partners in state law limited partnerships who actively participate in the partnership's business may lose the opportunity to claim this exemption. If this happens, these limited partners would likely become subject to SECA tax on their partnership income.

SECA taxes can be substantial for active partners in profitable partnerships. The SECA tax rate consists of two parts: 12.4% for social security (old-age, survivors, and disability insurance) and 2.9% for Medicare (hospital insurance). While the 12.4% social security tax is currently limited to the first $160,200 of self-employment earnings, partners who are subject to SECA tax must pay the 2.9% Medicare part of the tax on their entire net earnings from the partnership. There is also an additional 0.9% Medicare tax on all earnings from the partnership over a certain base amount (currently $125,000; $200,000; or $250,000 depending on the partner's tax filing status).

Why are some limited partners in jeopardy of losing their SECA tax exemption?

Under Internal Revenue Code Section 1402(a)(13), the distributive share of partnership income allocable to a "limited partner" is generally not subject to SECA tax, other than for guaranteed payments for services rendered. However, the statute does not define "limited partner," and proposed regulations issued in 1997 that attempted to clarify the rules around the limited partner exclusion have never been finalized.

More recently, courts have held — in favor of the IRS — that members in limited liability companies (LLCs) and partners in limited liability partnerships (LLPs) that are active in the entity's trade or business are ineligible for the SECA tax exemption. Despite these IRS successes, some continue to claim that state law controls in defining "limited partner" in the case of a state law limited partnership and, therefore, limited partners in state law limited partnerships — even active limited partners — may be eligible for the SECA tax exemption. This issue has yet to be specifically addressed by the courts, but Soroban Capital Partners may be the first case to squarely resolve it.

What is the issue in the Soroban Capital Partners litigation?

The Soroban Capital Partners litigation filed with the Tax Court involves a New York hedge fund management company formed as a Delaware limited partnership. The taxpayers challenge the IRS's characterization of partnership net income as net earnings from self-employment subject to SECA tax. According to the facts presented, each of the three individual limited partners spent between 2,300 and 2,500 hours working for Soroban, its general partner and various affiliates – suggesting that the limited partners were "active participants" in the partnership's business.

In its March 2 objection to the taxpayers' motion for summary judgment, the government contends that the term "limited partner" is a federal tax concept that is determined based on the actions of the partners – not the type of state law entity. Citing previous cases, the government asserts that the determination of limited partner status is a "facts and circumstances inquiry" that requires a "functional analysis." The taxpayers in Soroban, on the other hand, argue that such a functional analysis does not apply in the case of a state law limited partnership and that, in the case of these partnerships, limited partner status is determined by state law.

Under the functional analysis adopted by the Tax Court in previous cases, to determine who is a limited partner, the court looks at the relationship of the owner to the entity's business and the factual nature of services the owner provides to the entity's operations. For the SECA tax exemption to apply, the government states (citing case law), "an owner must not participate actively in the entity's business operations and must have protection from the entity's obligations."

What should limited partners do pending the outcome of the Soroban case?

Limited partners who actively participate in the partnership's business should review their facts and circumstances and potential exposure to SECA tax. Although there is currently no clear authority precluding active limited partners of a state law limited partnership from claiming exemption from SECA tax, such a position should be taken with caution and a clear understanding of the risks—including being subject to IRS challenge if audited. The IRS continues to focus on scrutinizing such claims through its SECA Tax compliance campaign. Moreover, the opportunity to claim the exemption could be significantly narrowed depending on the outcome of Soroban Capital Partners.

Prepare for Expanded IRS Audit Focus on Partnerships

The IRS on September 8, 2023, announced that it will leverage funding from the Inflation Reduction Act to take new compliance actions, including actions focused on partnerships and other high income/high-wealth taxpayers. It intends to use artificial intelligence (AI) and improved technology to identify potential compliance risk areas.

Subsequently, on September 20, the IRS further announced plans to establish a new work unit to focus on large or complex pass-through entities. The new pass-through area workgroup will be housed in the IRS Large Business and International (LB&I) division and will include the people joining the IRS under a new IRS hiring initiative. The creation of this new unit is another part of the IRS's new compliance effort.

With respect to partnerships, the IRS announcement on new enforcement efforts indicates that the IRS will focus on two key areas:

- Expanding its Large Partnership Compliance program by using AI to identify compliance risks, and
- Increasing use of compliance letters focused on partnerships with balance sheet discrepancies.

Large Partnership Compliance and AI

The IRS began focusing on examinations of the largest and most complex partnership returns through its Large Partnership Compliance pilot program launched in 2021. It now plans to expand the program to additional large partnerships, using AI to select returns for examination. The AI, which has been developed jointly by experts in data science and tax enforcement, uses machine learning technology to identify potential compliance risks in partnership tax and other areas.

The IRS stated that it plans, by the end of this month, to have opened examinations of 75 of the largest partnership in the U.S. in a cross section of industries – including hedge funds, real estate investment partnerships, publicly traded partnerships, and large law firms.

Compliance Letters and Balance Sheet Discrepancies

The IRS has identified ongoing discrepancies in balance sheets of partnerships with over $10 million in assets. The IRS announcement explains that there have been an increasing number of partnership returns in recent years showing discrepancies in balances between the end of one year and the beginning of the next year – many in the millions of dollars, without any required attached statement explaining the discrepancy.

The IRS states that it did not previously have the resources to follow up and engage with large partnerships on these discrepancies. Using its new resources, the IRS plans to approach the issue by mailing out compliance letters to around 500 partnerships starting in early October. Depending on the partnerships' responses, the IRS might take additional action, including potential examination.

Planning Considerations

With the passage of the Bipartisan Budget Act of 2015 (BBA), promulgating new centralized partnership audit rules, there has been an increased focus on partnership compliance. In conjunction, recent reporting updates for Schedule K-1, Schedule K-2, and Schedule K-3 require partnerships to now disclose additional information. This new announcement from the IRS reflects the agency's continued focus on partnership compliance using a variety of tools, including AI, and further highlights the necessity for consistent and accurate partnership reporting.

With the IRS signaling its areas of focus, taxpayers can proactively enhance their "exam readiness." Prior to initiation of an exam, taxpayers may wish to consider taking steps such as confirming application of the BBA partnership audit rules across entities within a complex structure, identifying open tax years for entities subject to these rules, assessing completeness of existing tax return workpapers and relevant documentation, and establishing a framework of the exam response process.

Once an audit notice or compliance letter arrives, prepared taxpayers will be ready to implement their exam process. Key to a taxpayer's exam process will be considering designation of the partnership representative, availability of documentation that the IRS will likely request, familiarity with operating agreements and other transaction documents, and accessibility of qualified advisors to assist in the exam process.

Review Structure of Leveraged Partnership Transactions, Application of Anti-Abuse Rules

On May 12, the Department of Justice (DOJ) filed its opening brief in its appeal to the Seventh Circuit of the Tax Court's decision in *Tribune Media Co. v. Commissioner* (T.C. Memo 2021-122). The government views the Tax Court's ruling as paving the way for inappropriate income tax planning, potentially enabling taxpayers to follow the roadmap created by the taxpayer in *Tribune Media* to implement leveraged partnership transactions without triggering taxable gain while avoiding incurring meaningful economic risk.

The appeal is primarily focused on perceived errors by the Tax Court in applying a liability allocation anti-abuse rule under Treas. Reg. §1.752-2(j) and the general partnership anti-abuse rule under Treas. Reg. §1.701-2. If successful on appeal, the case would likely be remanded to the Tax Court for a determination regarding applicability of the liability allocation and general anti-abuse rules. It is unclear whether the Tax Court would reach a different conclusion upon remand.

The initial brief submitted by DOJ contains a discussion of factors determined to be relevant in concluding the taxpayer's guarantee was without substance. Consideration should be given to these factors – summarized in the conclusion below – when structuring or evaluating transactions.

Summary of Relevant Facts

In 2009, Tribune Media Company completed a transaction in which it contributed the Chicago Cubs baseball team to a partnership in exchange for an interest in the partnership plus a $714 million cash distribution. Under the disguised sale of property rules in section 707(a)(2)(B), the $714 million would be viewed as a consideration received in connection with a partial sale of the Chicago Cubs baseball team.

However, through use of liability guarantees, a significant portion of the debt used to fund the cash distribution was allocated to Tribune Media. Under an exception to the disguised sale rules, distributions funded by debt allocated to the distributee are not treated as disguised sale consideration.

Based on rules described in Treas. Reg. §1.752-2, to the extent a partner bears economic risk of loss (EROL) with respect to a liability, the liability will be allocated to the partner. For purposes of determining whether a taxpayer has EROL with respect to a particular liability, the regulations provide for an analysis relying on hypothetical facts. Under Treas. Reg. §1.752-2(b), a partner bears EROL with respect to a liability to the extent that, if the partnership constructively liquidated, the partner or a related person would be obligated to make a payment with respect to the liability. For purposes of this analysis, regulations require the constructive liquidation to be determined under all the following hypothetical facts:

- All the partnership's liabilities become payable in full.
- With the exception of property contributed to secure a partnership liability (see Treas. Reg. §1.752-2(h)(2)), all the partnership's assets, including cash, have a value of zero.
- The partnership disposes of all its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditors' right to repayment is limited solely to one or more assets of the partnership).
- All items of income, gain, loss or deduction are allocated among the partners.
- The partnership liquidates.

To benefit from the debt financed distribution exception to the disguised sale rules, Tribune Media agreed to guarantee a portion of the debt used to fund the distribution. The objective of this guarantee was to create EROL resulting in an allocation of the liability to Tribune Media. Based on the terms of the executed agreements and the general rules described in Treas. Reg. §1.752-2, Tribune Media properly bore EROL. As shown on applicable income tax returns, partnership liabilities were allocated to Tribune Media and reflected its EROL.

Liability Allocation Anti-Abuse Rule

Upon examination, the IRS concluded that the parties' attempt to create EROL violated the anti-abuse rule under Treas. Reg. §1.752-2(j), which generally provides that an obligation of a partner to make a payment may be disregarded if facts and circumstances indicate that a principal purpose of the arrangement is to eliminate the partner's EROL with respect to that obligation.

As discussed in both the Tax Court's opinion and DOJ's opening appeals brief, the parties structured an arrangement that met the literal requirements to create EROL under Treas. Reg. §1.752-2. However, under the government's view of the facts, Tribune Media did not bear meaningful risk of loss. The government noted that that "[t]he Tax Court and Tribune itself concluded that Tribune had no more than a 'remote' risk under the Senior Guarantee" with "myriad protections in place that all but assured Tribune would never be called upon to repay any portion of the Senior Debt."

It appears that, in evaluating applicability of the section 752 anti-abuse rule, the Tax Court focused on the fiction that is deemed to occur for purposes of determining EROL under Treas. Reg. §1.752-2.

Consequently, the Tax Court assumed the debt became due and all relevant assets became worthless. Under this interpretation, Tribune Media would be called upon to satisfy the outstanding liability. Consequently, the Tax Court concluded that the actual and remote risk to Tribune Media wasn't relevant to the anti-abuse rule under Treas. Reg. §1.752-2(j). With this ruling the Tax Court would significantly limit the potential effectiveness of the anti-abuse rule.

The government views the reference in Treas. Reg. §1.752-2(j) to "facts and circumstances" to mean a required analysis of the actual economic arrangement of the parties. This contrasts with the view apparently taken by the Tax Court. In the Tax Court's analysis, the anti-abuse analysis was conducted under the lens of the hypothetical factual assumptions required under the general rule of Treas. Reg. §1.752-2(b). The different views, of course, could have dramatic results in terms of whether and when the anti-abuse rule may apply.

General Partnership Anti-Abuse Rule

In addition to the liability allocation anti-abuse rule under Treas. Reg. §1.752-2(j), the government has also taken issue with the Tax Court's application of the general partnership anti-abuse rule under Treas. Reg. §1.701-2. In its decision, the Tax Court noted that the Treas. Reg. §1.701-2 anti-abuse rules apply only "to the function of the partnership as a whole." The government, on the other hand, points out that Treas. Reg. §1.701-2(a)(2) requires that "[t]he form of each partnership transaction must be respected under substance over form principles."

Ultimately, DOJ believes the Tax Court has misapplied the general anti-abuse rule. Acknowledging that the totality of the transaction may have had a business purpose, analyzing specific aspects under the general anti-abuse rule is appropriate. Similar to the discussion around the liability allocation anti-abuse rule, a recharacterization of the loan guarantee could have a significant impact on the tax consequences to the parties involved.

Conclusion

Based on the status of the Tribune Media case and the government's appeal, there are a few important factors for consideration and reasonably drawn conclusions.

The government disagrees with the manner in which the Tax Court applied both the liability allocation anti-abuse rule and the general anti-abuse rule. It is reasonable to conclude that, if faced with a similar fact pattern, the IRS will challenge application of the debt-financed distribution exception to the disguised sale rules. In its brief, DOJ described the following factors as critical in its determination that the loan guarantee was without economic substance:

- The Cubs' baseball club had strong revenue flow and structural protections built into the transaction ensuring the ability of the Cubs to meet its financial obligations. In particular, the Cubs had stable and growing cash flow streams from long-term media rights agreements along with strong ticket sale revenue. Debt service arrangements were structured to pull from these cash flow streams.

- As part of obtaining approval from Major League Baseball to complete the transaction, several parties to the transaction executed an operating support agreement intended to provide a "financial safety net" to the Cubs in times of economic uncertainty.

- To prevent potential creditor seizure of the Cubs baseball team, the Commissioner of Major League Baseball had the authority to take significant actions, including requiring funding additional equity contributions, the sale of the team and the provision of a super-senior loan to fund operating expenses.
- There is unique value to the collateral associated with a major league baseball team. Based on S&P valuations, upon a distressed asset sale, a 40% reduction in the value of the collateral would still yield significant value.
- Tribune Media documented its belief that the possibility of its guarantees would be called upon was remote. On its financial statements, Tribune Media disclosed the guarantees in the notes but did not record a liability, create a reserve, or report any value associated with the guarantees.

The Tax Court evaluated application of both the liability allocation anti-abuse rule and the general anti-abuse rule. The Tax Court concluded that the liability allocation anti-abuse rule was inapplicable. This conclusion was premised on application of the hypothetical transactions described in Treas. Reg. §1.752-2(b), i.e., the loan becomes due and payable, and the obligor has no assets with which to satisfy the obligation. Under this assumption, the Tax Court concluded that the remoteness of the guarantor's obligation is not relevant. If this approach is accurate, application of the liability allocation anti-abuse rule would certainly seem to be significantly limited. If appropriate to analyze this anti-abuse rule under actual facts, it's unclear whether the Tax Court would have reached a different end result.

Until resolved on appeal, taxpayers should be able to rely on the Tax Court's ruling in *Tribune Media* to structure transactions involving debt-financed distributions. However, taxpayers should likewise be prepared for IRS challenge if audited.

Prepare for New Reporting on 2023 Form 1065 Schedule K-1

The IRS included new and modified reporting requirements in its draft 2023 Form 1065 Schedule K-1, released on June 14, 2023, including:

- A modified reporting requirement concerning decreases in a partner's percentage share of the partnership's profit, loss and capital, and
- A new reporting requirement relating to partnership debt subject to guarantees or other payment obligations of a partner.

Decreases in a Partner's Share of Partnership Profit, Loss and Capital

The modification to the Schedule K-1 reporting reflected on the draft 2023 Schedule K-1 concerns certain decreases in a partner's percentage share of the partnership's profit, loss and capital from the beginning of the partnership's tax year to the end of the tax year.

Reporting a partner's percentage share of the partnership's profit, loss and capital at the beginning and the end of the tax year is not a new requirement. Prior versions of the Schedule K-1 require the partnership to check a box indicating if a decrease in a partner's percentage share of profit, loss and capital from the beginning of the tax year to the end of the tax year is due to a sale or exchange of partnership interests. The draft 2023 Schedule K-1 refines this reporting by distinguishing, in Part II, Item

J, between decreases due to sales of partnership interests and decreases due to exchanges. Partnerships must check one box if a decrease in a partner's percentage share of profit, loss and capital from the beginning to the end of the partnership tax year is due to a sale of partnership interests and a separate box if the decrease is due to an exchange of partnership interests.

While it is unclear why the IRS distinguishes a sale from an exchange in this context, in the absence of clarifying instructions to the 2023 Form 1065, an exchange of partnership interests should be interpreted broadly to encompass any non-sale transfers of partnership interests, whether taxable or not, including by gift, a redemption or otherwise.

Partnership Debt Subject to Guarantees or Other Payment Obligations of a Partner

The new reporting requirement reflected on the draft 2023 Schedule K-1 underscores the importance of properly classifying partnership liabilities as recourse or nonrecourse under the Section 752 rules. The draft 2023 Schedule K-1, in Part II, Item K3, requires the partnership to check a box if a partner's share of any partnership indebtedness (also reported on the Schedule K-1) is subject to guarantees or other payment obligations by the partner.

The existence of a guarantee or other partner payment obligation is relevant in determining whether a partnership liability is considered recourse or nonrecourse under the rules of Section 752. Regulations state that a partnership liability is a recourse liability to the extent that any partner or related person bears an economic risk of loss with respect to the obligation. A partner that has an obligation to make a net payment to a creditor or other person with respect to a partnership liability upon a constructive liquidation of the partnership, including pursuant to a deficit restoration obligation (DRO) in the partnership agreement, is considered to bear the economic risk of loss of that partnership liability. A partner's payment obligation with respect to partnership debt may arise pursuant to any contractual guarantees, indemnifications, reimbursement agreements or other obligations running directly to creditors, to other partners or to the partnership.

The existence of a debt guarantee or other payment obligation by the partner with respect to a partnership liability may indicate that the partner bears some or all of the economic risk of loss for such liability, which is a key factor in classifying a partnership liability as recourse or nonrecourse under the rules of Section 752.

Evaluate Before Year End Expiration of Partnership Bottom-Dollar Guarantee Transition Rules

The transition period for "bottom-dollar" guarantees ended on October 4, 2023, and in some cases partners that were relying on bottom-dollar guarantees for partnership tax basis would have needed to have new arrangements in place by that time if they intended to preserve tax basis associated with a bottom-dollar guarantee. However, partners in some partnerships may have until the end of the partnership tax year to set up new arrangements.

Bottom-Dollar Guarantees and Transition Period

A bottom-dollar guarantee is a guarantee by a partner of an amount of partnership debt, where the partner pays only if the creditor collects less than the full amount of the debt from the partnership. Further, in a bottom-dollar guarantee, even if the creditor does not collect the full amount of the debt, the bottom-dollar guarantor pays nothing provided the creditor collects at least the amount of the bottom-dollar payment obligation. For example, a lender loans ABC partnership $100 secured by land and partner A guarantees the bottom $10 of the loan. If the lender can only recover $11 of the $100 loan, then Partner A has no obligation on the guarantee. However, if the lender can only recover $6 of the $100 loan, then Partner A would be liable for $4 under the guarantee ($10 bottom guarantee less $6 recovered).

Regulations under Section 752 issued in 2019 curtailed the use of bottom-dollar payment obligations to establish economic risk of loss for a guarantor to be allocated recourse liabilities on partnership debt incurred after October 5, 2016, unless special transition rules applied. The transition rules in the 2019 regulations allowed taxpayers to continue using bottom-dollar guarantees for debt existing on October 5, 2016, to the extent the basis associated with the allocation of liabilities in connection with the bottom-dollar guarantee under the old rules protected a negative capital account prior to that date.

The transition rules were effective for only a seven-year period that ends on October 4, 2023.

Tax Implications of Transition Period Ending

Upon expiration of the seven-year transition period on October 4, 2023, any debt supported by a bottom-dollar guarantee during the transition period will no longer be adequate to support the allocation of the debt to the guarantor and the liability must be reallocated among the partners based on the rules of Section 752. If debt allocations change due to the expiration of the transition period, a partner with a negative tax capital amount no longer supported by debt may recognize gain under Section 731.

Despite the final demise of bottom-dollar guarantees, other options may be available for partners to achieve desired tax results, such as using “vertical slice guarantees,” under which a partner guarantees a percentage of each dollar of debt, and intelligently managing non-recourse liability allocations.

Planning Considerations

Partnerships should review liability allocations to ensure that tax deferrals continue as planned. The transition period under the 2019 regulations ended October 4, 2023, but there may still be time to make arrangements to preserve tax basis before the end of the partnership tax year.

Partners are required to determine the adjusted basis of their interest in a partnership only when necessary for the determination of their tax liability or that of any other person. Otherwise, the determination of the adjusted basis of a partnership interest is ordinarily made as of the end of a partnership tax year. Therefore, if a partner is not otherwise required to determine the adjusted basis of his or her partnership interest in order to determine the partner’s own tax liability or that of any other person for the period between October 4, 2023, and the end of the partnership’s tax year, the partner may have until the end of the partnership’s tax year to set in place alternative arrangements.

Partnerships must disclose bottom-dollar guarantees on Form 8275 for tax years ending on or after October 5, 2016, in which the guarantee is undertaken or modified.