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THE WINDOW FOR USING "PHANTOM GUARANTEES" TO GENERATE TAX BENEFITS MAY SOON BE CLOSING

For many years, it has been fairly common for partners of partnerships[1] to guarantee partnership debt in an effort to increase the adjusted tax basis of their partnership interests. Enhancing tax basis has many valuable tax benefits to the guaranteeing partner ranging from avoiding gain recognition on distributions of money from the partnership to increasing the amount of currently recognizable partnership losses, among other tax benefits. Of course, the key to successfully using a partner guarantee of partnership debt to enhance tax basis is minimization (or even elimination) of the corresponding financial risk to the partner.

Although a partner's guarantee of partnership debt generally has significant value, most partners are unwilling to personally assume the debt of a partnership. Recognizing the inherent wisdom of avoiding personal liability for third party obligations, strategies have been designed whereby a partner can personally assume partnership debt, and thereby take advantage of the corresponding tax benefits, while minimally increasing the partner's exposure to financial risk. One such strategy uses a so-called "bottom-dollar guarantee."

A bottom-dollar guarantee occurs when a partner agrees to pay a debt of the partnership only if the lender collects less than the guaranteed amount from the partnership or the value of the collateral declines below a specified amount. For example, if a partnership has a $5 million non-recourse loan with a bank, and a partner guarantees the first $1 million of partnership debt, the partner will only be required to satisfy the guarantee if the lender cannot collect at least $1 million of the $5 million debt from the partnership. Once the partnership pays $1 million of the debt to the bank, the guaranteeing partner is relieved of any further liability for the partnership's obligation. Under current tax rules, the guaranteeing partner may increase the adjusted basis of the partner's partnership interest by $1 million even though the likelihood that the partner will ever have to make good on the guarantee is remote (and nonexistent after the partnership pays the first $1 million of partnership debt). For purposes hereof, a partner's guarantee of partnership debt that is likely never to become due is referred to as a "Phantom Guarantee".

The window of opportunity for increasing the adjusted tax basis of a partnership interest using a Phantom Guarantee may soon close and many partners with currently negative tax basis capital accounts may be forced to recognize substantial gains for tax purposes. On January 29, 2014, the U.S. Treasury Department and the Internal Revenue Service (together, the "Government") issued proposed regulations under Section 752 of the Internal Revenue Code of 1986, as amended ("IRC"), which make it much more difficult for partners to artificially increase tax basis using Phantom Guarantees (the "Proposed Regulations"). The Proposed Regulations apply prospectively from the date they are published as final in the Federal Register, which has not yet occurred. As a result, the planning window

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[1] For purposes hereof, references to the term "partner" include a member of an LLC and references to the term "partnership" include an LLC.

remains open for partners who have not considered the tax advantages associated with a Phantom Guarantee. However, given that it has been almost two years since the regulations were first proposed, there is likely only limited time remaining for partners to use Phantom Guarantees for tax planning purposes.

I. The Problem the Government Has With the Existing Regulations.[2]

The Proposed Regulations signal the Government's belief that the current approach to partner guarantees is inappropriate given that, in most cases, (1) a partnership will satisfy its liabilities with partnership profits, (2) the partnership's assets will not become worthless, and (3) the payment obligations of partners or related persons will never be called upon. The Government is primarily 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 (thereby artificially increasing the partner's tax basis). There is no doubt that the Government correctly understands that most Phantom Guarantees cannot be justified on a purely non-tax economic basis.

Because of its concerns, the Proposed Regulations provide that obligations to make a payment with respect to a non-recourse partnership liability (excluding those imposed by state law) will not be recognized unless the obligation satisfies a six-factor test designed to ensure that the partner's payment obligation is *bona fide* with respect to the liability. These six factors generally include a requirement that the partner maintain a commercially reasonable net worth throughout the term of the payment obligation, or, alternatively, agree to be subject to restrictions that would limit transfers of assets for "inadequate consideration." In addition, a partner must periodically provide commercially reasonable documentation regarding the partner's, or a related person's, financial condition, and the partner must receive an arm's-length payment for assuming the payment obligation. Among the other factors, in the case of a Phantom Guarantee or other types of guarantees, the partner must be liable for the full amount of the partnership liability if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. Therefore, Phantom Guarantees (*i.e.*, bottom-dollar guarantees) will no longer be respected for purposes of determining whether debt is recourse to a guaranteeing partner.

II. Using a Phantom Guarantee to Facilitate the Generational Transfer of Family Assets.

A. <u>A Typical Wealth Planning Scenario</u>.

Consider the following fairly typical family wealth planning scenario. John Smith ("Dad") is the grantor of the John Smith Living Trust (the "Trust," which is disregarded for income tax purposes), which has real estate holdings valued at $12 million. Dad would like to minimize future estate taxes by making current lifetime transfers (*i.e.*, gifts) of real estate to his children. Dad also wants to minimize any current income taxes associated with the transfer of these assets to his children.

To facilitate his wealth planning strategy, the Trust will contribute certain land and improvements (the "Land") to Smith, LLC (the "LLC") in exchange for 99% of the LLC's membership interests. The other 1% of the LLC's membership interests will be held by one of Dad's children so that the LLC is classified as a partnership for tax purposes. The adjusted tax basis of the Land is $500,000, and it is currently encumbered by a secured note issued to a bank in the amount of $3,000,000 (the "Note").

For federal income tax purposes, at the time the Land is contributed to the LLC, the Trust is initially credited with an adjusted basis in its LLC membership interest equal to the adjusted basis of the Land. Therefore, the Trust has an initial basis in its membership interest of $500,000.

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[2] Rather than force the casual reader to wade through the text of the relevant sections of the IRC and the U.S. Treasury Regulations ("Treas. Reg."), all such references are included in Appendix A at the conclusion of this article.

Because the LLC is assuming the Note, and because the Trust is being relieved of the obligation associated with the Note (for example purposes only, the bank is assumed to have released the Trust from its existing guarantee), the Trust is deemed to receive a distribution of money from the LLC for the amount of the Note assumed by the LLC ($3,000,000). The Trust is also deemed to make a cash contribution to the LLC equal to its share of the LLC's liabilities following the exchange ($2,970,000). Therefore, the Trust is deemed to receive a **$30,000** net cash distribution from the LLC at the time the LLC takes the Land subject to the Note. The deemed distribution is intended to reflect the net amount of the original obligation the Trust has been relieved of, *i.e.*, its $3,000,000 obligation before the exchange less, solely for income tax purposes, the $2,970,000 non-recourse liability deemed allocated to the Trust after the contribution.

For income tax purposes, distributions of money by a partnership to a partner are taxable to the extent that the distribution exceeds the partner's adjusted basis in the partnership interest. In this example, the deemed distribution of money from the LLC is not taxable to the Trust because the Trust's initial adjusted basis in its membership interest is $500,000, which is more than sufficient to absorb the deemed cash distribution from the LLC. Therefore, following the contribution of the Land to the LLC and the LLC's assumption of the Note, the Trust has an adjusted tax basis in its membership interest in the LLC of **$470,000**.

B. The Tax Trap.

As mentioned, the purpose of organizing the LLC is to facilitate a partial transfer of Dad's real estate to his children that will reduce future *estate* tax while also avoiding current *income* tax. To facilitate Dad's desired transfer, Dad (through Dad's Trust) will initially make a gift to his wife, Jane Smith ("Mom"), of a portion of his membership interest in the LLC that is valued for gift tax purposes at no more than $5,430,000, which is the 2015 lifetime exclusion limit (Mom has not previously made any gifts other than annual exclusion gifts). For purposes of this example, assume that Dad's gift to Mom equals 50% of the Trust's membership interest in the LLC.

For income tax purposes, the Trust is ignored and the Trust's interest in the LLC is deemed to be held directly by Dad. As a result, Dad's gift to Mom is exempt from federal income tax pursuant to IRC Section 1041(a). Likewise, IRC Section 2523(a) exempts transfers between spouses from gift tax, so there is no adverse gift tax consequence associated with Dad's gift.

Mom will immediately transfer her 49.50% membership interest in the LLC to her children thereby fully utilizing her lifetime exclusion amount. Because the transfer of the LLC membership interest first from Dad to Mom and then from Mom to her children is valued for gift tax purposes using discounts for lack of marketability and minority interest, real estate valued at far in excess of $5,430,000 has been transferred out of Dad's estate where it will continue to appreciate in value without any adverse tax consequences to Dad's estate.

Following the transfer of 50% of its membership interest in the LLC to Mom, the Trust will be deemed for federal income tax purposes to receive a distribution of money from the LLC equal to the decrease in its share of the LLC's obligations, which is **$1,485,000**. At that time, the Trust's adjusted basis in its LLC membership interest is **$235,000** (50% of $470,000, as determined above). Therefore, for federal income tax purposes, the Trust incurs a gain of **$1,250,000**, and the Trust's remaining adjusted basis in its membership interest is zero.

C. Using a Phantom Guarantee to Avoid the Trust's Gain and Preserve Basis.

The gain of $1,250,000 incurred by the Trust upon transferring 50% of its membership interest in the LLC to Mom can be avoided if Dad guarantees payment of the Note (in full or using a bottom-dollar guarantee of $1,250,000). Of course, since the fair market value of the Land is $12 million, the Land would have to decrease in value significantly for Dad's guarantee to be acted upon. In other words, given the value of the Land securing the Note, absent an event of historic consequence, it is highly unlikely that Dad's guarantee will ever be called upon. The recourse obligation Dad is deemed to have assumed for income tax purposes is illusory. Yet, the current Treasury Regulations generally allocate an otherwise nonrecourse liability of the partnership to the partner that guarantees the liability even if the lender and the partnership reasonably anticipate that the partnership will be able to satisfy the liability with either partnership profits or capital.

For example, assume that Dad guarantees the first $1,250,000 of the partnership's Note. As described above, the Trust's adjusted basis in its LLC membership interest was $235,000 at the time of Dad's gift to Mom. Therefore, Dad's bottom-dollar guarantee of the LLC's Note will increase the Trust's adjusted basis in its LLC membership interest to **$1,485,000**. Following the transfer of 50% of its membership interest in the LLC to Mom, the Trust is deemed for federal income tax purposes to receive a distribution of money from the LLC equal to the decrease in its share of the LLC's obligations, which is $1,485,000. Since the Trust's adjusted basis in its LLC membership interest is now also $1,485,000, there is no taxable gain associated with Dad's gift to Mom. All Dad has to do to add additional basis to cover the Trust's remaining 49.50% membership interest in the LLC is to personally guarantee an additional portion of the LLC's Note.

Dad's use of a Phantom Guarantee to shift valuable assets out of his estate while also avoiding a current income tax perfectly fits the Government's concern that some partners or related persons have entered into payment obligations that are not commercial solely to achieve an allocation of a non-recourse partnership liability to such partner. In Dad's example, either the LLC will satisfy the Note with the LLC's profits or the Land will remain sufficiently valuable that its eventual sale will fully satisfy the LLC's obligation under the Note.

D. The Tax Opportunity.

The multi-factor analysis set out in the Proposed Regulations will not adversely impact Dad's expected tax consequences if his bottom-dollar guarantee is in place before the new rules are published in final form in the Federal Register. The Proposed Regulations only apply to liabilities incurred or assumed by a partnership and to payment obligations imposed or undertaken with respect to a partnership liability after the Proposed Regulations become final (the "Final Date"). Therefore, Phantom Guarantees like Dad's bottom-dollar guarantee that are entered into prior to the Final Date will not be disturbed by the new rules. Considering how long it has been since the Proposed Regulations were first issued, it is not clear how much longer the current regulations will remain in force.

In contrast to Dad's transaction, many wealth planning strategies do not hinge on the value of the assets securing an obligation of the partnership to be so far in excess of the obligation as to entirely eliminate financial risk to the guarantor. For these more typical scenarios, a bottom-dollar, vertical slice or similar carved-out partner guarantee may be necessary to permit the guaranteeing partner to take advantage of a tax opportunity while also minimizing corresponding financial risk.

Whether the desire for added tax basis relates to estate planning, increased lifetime distributions of money from a partnership, or the current use of allocated partnership loss, the current IRC Section 752 rules are exceptionally taxpayer friendly. In contrast, the Proposed Regulations under Treas. Reg. § 1.752-2 significantly restrict the ability of partners to obtain tax basis using personal guarantees, as well as increase both the burden and the administrative cost associated with a personal guaranty.

In view of the Proposed Regulations under Treas. Reg. § 1.752-2, partners looking to obtain tax benefits associated with personal guarantees of non-recourse partnership debt should contact their tax advisors before the window for using the current debt allocation rules closes for good.

APPENDIX A

I. <u>The Tax Technical Rules</u>.

IRC Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership is treated as a contribution of money by the partner to the partnership. IRC Section 752(b), provides that any decrease in a partner's individual liabilities by reason of the assumption by the partnership of those liabilities is treated as a deemed distribution of money to the partner by the partnership.

Treas. Reg. § 1.752-1(f) provides that if, as a result of a single transaction, a partner incurs both an increase in the partner's share of the partnership liabilities and a decrease in the partner's individual liabilities, only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership.

Treas. Reg. § 1.752-1(e) provides that, if property is contributed by a partner to the partnership and the property is subject to a liability of the transferor, the transferee is treated as having assumed the liability, to the extent that the amount of the liability does not exceed the fair market value of the contribution.

Treas. Reg. § 1.752-1(a)(1) provides that a partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss.

Treas. Reg. § 1.752-2(a) and (b) provide that a partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the economic risk of loss. A partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner.

Treas. Reg. § 1.752-2(b)(3)(i) provides that contractual obligations outside of the partnership agreement include guarantees and indemnifications running directly to creditors, or to other partners, or to the partnership.