

## NEWS ALERT

### TAX GROUP



## IRS Final Regulations Eliminate “Bottom Dollar” Guarantees

By Marc T. Finer | December 2, 2019

On October 9, 2019, the Internal Revenue Service (“IRS”) issued [final regulations](#) on the allocation of partnership recourse liabilities that essentially eliminate the use of “bottom dollar” guarantees to increase a partner’s share of partnership liabilities when the partner actually has no economic risk of loss.

A “bottom dollar guarantee” is a payment guarantee by a partner to repay a portion of the partnership debt only if the creditor is unable to collect the full amount of the debt from the partnership. Historically, “bottom dollar” guarantees have been used to increase a partner’s tax basis in their partnership interest and allow the partner to receive tax-free cash distributions and tax losses and deductions in excess of his actual investment in the partnership. For example, assume a partnership refinances real estate worth \$20 million with a \$19 million loan. Partner A guarantees \$1 million of the loan to increase his basis in his partnership interest to \$1 million. This allows him to receive \$1 million of the refinancing proceeds from the partnership tax-free. If Partner A structures the guarantee as a bottom dollar guarantee, Partner A is not required to make good on any portion of his guarantee unless the partnership defaults on the loan at a time when the property has declined in value to less than \$1 million. Thus, a bottom dollar guarantee permits a partner to receive basis for partnership debt without having any meaningful risk of repaying any portion of the debt (i.e., economic risk of loss) since in most cases, the property securing the loan has some residual value and therefore, the loan secured by the property does not become completely worthless.

The final regulations define a “bottom dollar payment obligation” to include a payment obligation with respect to a guarantee other than one in which the partner (or related person) would be liable up to the full amount of the partner’s payment obligation to the extent that the partnership does not pay the liability. The definition also includes a capital contribution obligation and deficit restoration obligation except when the partner would be required to make the full payment.

The final regulations state that an obligation of a partner (or related person) to make a payment, other than a deficit restoration obligation, is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation. To assist taxpayers with this analysis, the final regulations provide a list of non-exclusive factors that may indicate a plan to circumvent or avoid a payment obligation:

- (1) The partner is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment.
- (2) The partner is not required to provide commercially reasonable documentation regarding the partner’s financial condition to the benefited party, including, for example, balance sheets and financial statements.
- (3) The term of the payment obligation ends prior to the term of the partnership liability, or the partner has a right to terminate its payment obligation, if the purpose of limiting the duration of the payment obligation is to terminate the payment obligation prior to the occurrence of an event or events that increase the risk of economic loss to the guarantor or benefited party (for example, termination prior to the due date of a balloon payment or a right to terminate that can be exercised because the value of loan collateral decreases).

(4) There exists a plan or arrangement in which the primary obligor or any other obligor with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonably foreseeable needs of such obligor.

(5) The payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection.

(6) In the case of a guarantee or similar arrangement, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee.

(7) The creditor or other party benefiting from the obligation did not receive executed documents with respect to the payment obligation from the partner before, or within a commercially reasonable period of time after, the creation of the obligation.

In the case of a deficit restoration obligation, the final regulations provide the following list of non-exclusive factors that may indicate a plan to circumvent or avoid the obligation:

(1) The partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation.

(2) The partner is not required to provide commercially reasonable documentation regarding the partner's financial condition to the partnership.

(3) The obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account is negative other than when a transferee partner assumes the obligation.

(4) The terms of the obligation are not provided to all of the partners in the partnership.

The final regulations require a partnership to disclose a bottom dollar payment obligation with respect to a partnership liability on a completed Form 8275 (Disclosure Statement) attached to the return of the partnership for the taxable year in which the bottom dollar payment obligation is undertaken or modified.

The final regulations make it clear that partner guarantees will only be respected if they establish a genuine commercial payment obligation. Therefore, a review of the terms of partner guarantees is suggested. In addition, partnership agreements should be reviewed to confirm that the language concerning capital contribution and deficit restoration obligations is consistent with the final regulations. However, due to the factual nature of these inquiries, the final regulations only provide a degree of assurance and may cause some taxpayer uncertainty.

*This Client Alert is intended to provide general information about the final regulations on bottom dollar payment obligations and is not intended to be a comprehensive summary of these final regulations. If you have any questions regarding the final regulations, how they might impact your business, and/or any potential tax planning opportunities that are available under the final regulations, please contact Marc T. Finer, Tax Partner, at 860-240-6096 or [mfiner@murthalaw.com](mailto:mfiner@murthalaw.com).*

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