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The Death of the Bottom-Dollar Guarantee


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Real estate investors have used bottom-dollar guarantees, also termed "bottom dollar payment obligations" or BDPOs, for many years to increase a partner's basis in her partnership interest and defer gain recognition, often until the eventual (but inevitable) step-up in basis afforded to taxpayers at death under the Internal Revenue Code of 1986, as amended (the Code). However, the bottom-dollar guarantee technique was undermined by the Department of the Treasury on Oct. 5, 2016 when it issued temporary regulations (the "2016 temporary regulations") providing that, subject to certain transition rules, bottom-dollar guarantees would no longer be effective to increase the obligated partner's share of partnership liabilities because such obligations were regarded as lacking a significant non-tax commercial purpose. (*2016 Temporary Regulations §1.752-2T; Preamble to 2016 Temporary Regulations §1.752-2T*)

On April 5, 2019, the Treasury Priority Guidance Plan for 2019 announced that Treasury would prioritize the issuance of final regulations concerning partnership recourse liabilities, including bottom dollar payment obligations. (*2016 Temporary Regulations §1.752-2T; Preamble to 2016 Temporary Regulations §1.752-2T*). In the unlikely case that final regulations are not issued, the 2016 temporary regulations would lapse on Oct. 4, 2019 and bottom-dollar guarantees would once again enable partners to increase their share of partnership liabilities and defer gain.

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What is a Bottom Dollar Guarantee?

The bottom-dollar guarantee technique was based on two principles in tax regulations that implement partnership tax law. The first is the principle that the recourse liabilities of a partnership are allocated to the partners who would be liable if the partnership were unable to satisfy its liabilities. (*2016 Temporary Regulations §1.752-2T; 2016 Preamble to Temporary Regulations §1.752-2T*) Recourse liabilities are liabilities for which one or more partners in the partnership bear the "economic risk of loss." For recourse liabilities, a "constructive liquidation" test is used in order to determine who bears the "economic risk of loss." (*U.S. Treasury Regulations (as promulgated under the Code)("Treasury Regulations") §1.752-2(b)(1)*).

This test imagines that all of the partnership's liabilities become payable in full, all of the partnership's assets (except any property that secures the liabilities) are worth nothing, all partnership property is disposed of in taxable transactions for no consideration, all items of income, gain, loss, or deduction are allocated among the partners, and, finally, that the partnership liquidates.

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Under these circumstances, any partner who would be obliged to pay a creditor or contribute to the partnership is treated as bearing the "economic risk of loss" for a liability. Any instrument that allows a partner to bear "economic risk of loss" under this test while minimizing the actual risk of loss essentially permits the partner to increase the its share of partnership liabilities without bearing significant risk.

Under prior law, bottom-dollar guarantee was such an instrument. By way of example: a partnership owns real estate valued at $100 million and takes out a $90 million loan against the property. Partner X guarantees $1 million of the $90 million debt. The partnership only repays $500,000 before it defaults on the debt and the property becomes worthless. If Partner X's guarantee is structured as a bottom-dollar guarantee, she is liable for only $500,000 to the lender—the difference between what the lender has already received from the partnership and what Partner X has guaranteed with her bottom-dollar guarantee. She is not required to pay the full $1 million of her guarantee, even though the lender will have an $89 million loss. If the partnership repays $2 million on the loan before it defaults on the debt, Partner X has no liability to the lender.

The second principle of partnership tax law that explains the use of bottom-dollar guarantees in real estate partnerships relates to how basis is calculated. In partnerships, a partner's tax basis includes her share of the partnership's debt, and this rule allows a partner, among other things to receive distributions in excess of her investment in the partnership, creating what is sometimes called a "negative capital account," without paying tax, so long as the partner has sufficient basis attributable to a share of partnership debt. The bottom-dollar guarantee has historically been used to allow a partner to keep a share of partnership debt for this purpose without also having a significant risk that she might have to come out of pocket to repay that debt.

To get more technical, under Section 752(a) of the Code and the regulations thereunder, each partner is treated as contributing cash to the partnership in an amount equal to any partnership liabilities that she assumes. This increases the partner's "outside basis", a partner's basis in the partnership, by the amount of liabilities assumed by the partner (e.g. a partner's guaranteeing of partnership liabilities with a bottom-dollar guarantee). In other words, each partner is given credit in her "outside basis" for her share of partnership liabilities. (*Code §722*) Under Section 752(b) of the Code, a partner is treated as having received a distribution of cash from the partnership in an amount equal to the amount of any of her individual liabilities that are assumed by the partnership. This has the effect of decreasing the partner's outside basis. (*Code §733*)

In the real estate context, these rules can have profound economic impacts on a partner's recognition of taxable gain. Under the above rules, there is a deemed distribution to a partner when a partnership assumes liability or if there is otherwise a reduction in a partner's liability for partnership property. Any distribution that exceeds a partner's basis can result in taxable gain. The bottom-dollar guarantee allows a partner to establish and maintain a share of partnership liability to avoid any deemed distribution of cash in excess of basis which could result in taxable gain.

> The "vertical slice" guarantee arrangement is specifically described in the temporary regulations and a number of commentators believe it can be a reasonable alternative to the bottom-dollar guarantee that allows a partner to increase her basis in her partnership interest without being on the hook for the entirety of the partnership's liability.

2016 Temporary Regulations

After a number of prior proposed regulations under Section 752 of the Code, the IRS issued the 2016 Temporary Regulations on Oct. 5, 2016, providing that bottom dollar payment obligations were not considered contractual obligations under which partners have payment obligations for purposes of determining a partner's share of recourse liabilities. (*2016 Temporary Regulations §1.752-2T(b)(3)*) The preamble to the 2016 Temporary Regulations asserted that bottom-dollar guarantees lacked "a significant non-tax commercial purpose" (*Preamble to 2016 Temporary Regulations §1.752-2T*) and provided that guarantors of bottom-dollar guarantees have no "economic risk of loss" and that as a result, such guarantees are therefore not taken into account in determining a partner's share of recourse liabilities. (*2016 Temporary Regulations §1.752-2T(b)(3); Treasury Regulations §1.752-2*) As such, they could no longer be used to increase a partner's basis in the partnership, nor cover any eventual gain generated from a deemed distribution of cash under Section 752(b).

The 2016 temporary regulations generally defined a bottom dollar payment obligation as "any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation, if, and to the extent that, any amount of the partnership liability is not otherwise satisfied." (*2016 Temporary Regulations §1.752-2T(b)(3)(ii)(C)(1)(i)*) Lastly, the 2016 temporary regulations also imposed a disclosure requirement on partnerships that have bottom dollar payment obligations. (*2016 Temporary Regulations §1.752-2T(b)(3)(ii)(D)*)

The 2016 temporary regulations became effective when issued on October 5, 2016 and were accompanied by a two complex rules that provide a transition period for bottom-dollar guarantees that are already in place.

First: The 2016 temporary regulations provide that the rules apply for new liabilities, thus barring the use of new bottom-dollar guarantees. Liabilities incurred or assumed by a partnership and bottom-dollar guarantees imposed as a result of a written binding contract in effect prior to October 5, 2016 are grandfathered in and are presumably not subject to the 2016 Temporary Regulations. (*2016 Temporary Regulations §1.752-2T(l)(2)*)

Second: The 2016 temporary regulations provide that if a partner (the "transition partner") has a share of a recourse partnership liability under Treasury Regulations §1.752-2(a) as a result of bearing the "economic risk of loss" under the old rules in Treasury Regulations §1.752-2, the partnership (the "transition partnership") may choose not to apply the new rules under the temporary regulations to the extent the amount of the transition partner 's share of liabilities under the old rules exceeded the amount of the transition partner 's adjusted basis in its partnership interest prior to October 5, 2016 (the "Grandfathered Amount").

Note that because of the grandfathered amount limitation, this transition rule may not grandfather the entire amount of an existing bottom-dollar guarantee; instead the grandfathering is limited to the amount that was actually "protecting" a negative capital account on the effective date. The protection of this rule only applies for a seven-year period beginning on Oct. 5, 2016. (*2016 Temporary Regulations §1.752-2T(l)(3)*).

In addition, if the direct or indirect ownership of the transition partnership changes by 50 percent or more, the transition partnership may no longer take advantage of the this transition rule.

It is not entirely clear how the two rules above work together, namely whether existing liabilities and obligations are grandfathered in indefinitely, or whether they lapse following the seven year transition period. Most practitioners believe that that the first transition rule likely applies indefinitely with respect to guarantee and indebtedness in existence prior to Oct. 5, 2016, although there is no clear guidance. There is even more uncertainty as to how these transition rules should be interpreted in the context of a refinancing.

Some commentators have noted that bottom-dollar guarantees are not grandfathered in in the context of a refinancing (*David F Cullen & Sukbae David Gong, UPREITs: Vertical Slice Guarantee Agreements, Journal of Passthrough Entities, Aug. 25, 2017; Blake Rubin, Andrea Macintosh Whiteway, Maximilian Pakaluk, New Temporary and Proposed Partnership Liability Allocation Regulations are Deeply Flawed and Should Be Withdrawn, PLI, Feb. 1, 2017*), while others believe that transition partnership can disregard the temporary regulations for a transition partner 's Grandfathered Amount provided by the transition partner 's existing bottom-dollar guarantee until 2023, to the extent such Grandfathered Amount exceeds the amount of the transition partner 's adjusted basis in its partnership interest prior to October 5, 2016. (*Stephen Giordano, Tax Protection in UPREIT Deals Under New Partnership Regs, Tax Notes, Oct. 23, 2017*).

As mentioned above, Treasury announced that it is prioritizing the issuance of final regulations concerning partnership recourse liabilities, including bottom dollar payment obligations. If the 2016 temporary regulations are finalized before Oct. 4, 2019 in substantially unchanged form, the rules stated thereunder will become permanent and a partner utilizing a bottom-dollar guarantee arrangement may need to find an alternative arrangement after 2023, at least in the case of a refinancing.

Vertical Slice Guarantee

One potential replacement arrangement is the "vertical slice" guarantee. The "vertical slice" guarantee arrangement is specifically described in the temporary regulations and a number of commentators believe it can be a reasonable alternative to the bottom-dollar guarantee that allows a partner to increase her basis in her partnership interest without being on the hook for the entirety of the partnership's liability. The vertical slice guarantee is a guarantee of a percentage of the partnership's nonrecourse liability corresponding to the amount of increased basis needed to prevent a distribution in excess of basis under Section 752(b) of the Code.

The 2016 temporary regulations specify that "a payment obligation is not a bottom dollar payment obligation merely because a maximum amount is placed on the partner's or related person's payment obligation, a partner's or related person's payment obligation is stated a fixed percentage of every dollar of the partnership liability to which such obligation relates, or there is a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable." (*2016 Temporary Regulations §1.752-2T(b)(3)(ii)(C)(2) (emphasis not in the text)*)

By way of example: a partnership owns real estate valued at $100 million and takes out a $90 million loan against the property. Partner X guarantees $1\frac{1}{9}$ percent of the debt, representing $1 million of the $90 million debt. The partnership only repays $9 million before it defaults on the debt and the property becomes worthless. If Partner X's guarantee is structured as a vertical slice guarantee, she is liable for only $900,000 to the lender. If the partnership repays $81 million, her liability is only $100,000. Both are greater than the liability she would have had under a bottom-dollar guarantee ($0), but in both cases her liability is less than under a "full," or "top dollar," $1 million guarantee.

Depending on the leverage of the partnership, the vertical slice guarantee may entail a reasonable amount of risk so as to provide an alternative to the currently defunct bottom-dollar guarantee.