WAGNER KIRKMAN BLAINE
KLOMPARENS & YOUMANS LLP
ATTORNEYS AT LAW

SEPTEMBER 2011 CPA NEWSLETTER
ALLOCATION OF DEBT AMONG PARTNERS IN TIERED PARTNERSHIPS

by Belan K. Wagner

This month's newsletter focuses on allocation of debt among partners in tiered partnerships.

Last month we reviewed the fundamentals of debt allocation under Section 752. This month we are going to look at a particular entity structure and discuss how the anti-abuse rules under Section 752 would apply. The structure is a limited partnership with a corporate or limited liability company as the general partner.

Whenever an entrepreneurial business is being formed, the client typically asks: "What type of entity should I use?" The types of entities that are available are S or C Corporations, General or Limited Partnerships and Limited Liability Companies. Each has their own problems. The corporate structures do not allow for easy admittance or exit of new owners. A general partnership doesn't provide for liability protection. A limited partnership has to have a general partner, and if the same person is both the limited and general then there is no limited liability protection. A limited liability company can't be used for some types of businesses and it has an onerous tax structure based on gross receipts rather than net income.

A good case example of the problems that can be presented in selecting an entity is a "house flipper business." Many clients are now getting into the business of buying houses, remodeling them, and then selling or leasing the house with an eye to resale down the road. The gross receipts in this type of business far outweigh the net profits and therefore a limited liability company often carries with it a heavy state tax burden. A C Corporation carries with it the cost of potential double taxation when money is distributed to the owners. An S Corporation can work in many cases but it is not the entity of choice since it is cumbersome to admit additional owners and distributions in kind are complicated because they are subject to an entity level tax. Limited Partnerships work well, but in order to achieve limited liability protection another entity has to be formed such as a Limited Liability Company or S Corporation to be the general partner. In this last

structure, the general partner, either an S Corporation or Limited Liability Company, owns 1% and the entrepreneurs own 99% as limited partners. The benefit of the Limited Partnership with a limited liability entity as the general partner is that new owners can be admitted easily, there is little entity level tax, and distributions in kind generate little entity level tax issues.

We have used the Limited Partnership with a limited liability general partner structure for clients for years. One practical problem is the additional administrative complexity of two returns, two sets of books, and the complexity of providing the governance documents and explaining the structure to third parties such as lenders, title companies etc. So, in order to use this type of entity structure, you need to have sufficient "economies of scale" to warrant its use. Once it is decided to use this type of entity structure, then the tax professional must analyze how Section 752 fits into the picture and that is the subject of this Newsletter.

Tiered Entity Rules (Reg. Sections 1.752-2(i) and 1.752-4(a):

These regulations essentially provide that where an upper-tier partnership ("UTP") holds an interest in a lower-tiered partnership ("LTP"), the UTP's share of the debt of the LTP is passed through to the UTP and the allocation of the debt so passed through is then allocated among the partners of the UTP under the normal Section 752 rules relating to recourse liabilities.

Example 1: For example, assume that a limited liability company is the sole general partner of a limited partnership which has recourse debt and that no limited partner has guaranteed the debt. All of the recourse debt would be allocated to the limited liability company as the UTP.

A second rule provides that the UTP is allocated liabilities of the LTP (which liabilities are not otherwise allocated to it under the normal rules) to the extent that a partner of the UTP bears the economic risk of loss for that liability.

Example 2: For example, assume the same facts as above in Example 1 except that the loan is non-recourse and secured by real property owned by the LTP and **guarantied by a 10% partner in the UTP**. Since the UTP and the 10% partner are not related parties, the loan is not allocated to the UTP under the normal rules of Section 752. However, under the special tiered partnership rules (Reg. Section 1.752-2(i)), if a partner

in the UTP bears the economic risk of loss for the liability, then that liability is treated as a recourse loan to the UTP and is allocated to the UTP. In this example, since the 10% partner is a partner of the UTP and not the LTP, the UTP is allocated the entire debt under the special tiered partnership rules.

Once the liabilities of the UTP are determined, then the normal allocation rules of Section 752 are used to determine the allocation of the UTP's liabilities among its own partners. In Example 2 above, the normal Section 752 rules would apply and all of the debt of the UTP would be allocated to the 10% partner who guarantied the debt. Under the normal rules, while the debt is nonrecourse to the LTP it is treated as recourse debt at the UTP level because the 10% partner is personally liable for that debt.

These regulations do not deal with the allocation of nonrecourse debt in tiered partnerships. However it appears that the proper way to treat nonrecourse debt is to use the normal rules of Section 752 to determine the amount of nonrecourse debt allocated to the UTP and then apply those same rules at the UTP level to determine the allocation among the UTP's partners. (Federal Taxation of Partnerships and Partners, McKee *et al* Section 8.03(5).)

Anti-Abuse Rules:

Generally speaking, the Section 752 Regulations presume that any person who has a legal obligation to pay a debt will, in fact, have the financial ability to pay that debt. (Reg. Section 1.752-2(b)(6).) This rule was adopted for administrative convenience because otherwise, in order to determine whether a debt should be allocated to a partner, the tax practitioner would have to perform a net worth test. This would necessitate appraisals and would open up the Pandora's Box of disputes over valuation.

In the context we are reviewing, this means that there is a corporate or limited liability general partner in a limited partnership, it is presumed that the general partner has sufficient net worth to satisfy any debts allocated to it, without regard to whether or not it is simply a shell entity.

Example 3: For example, assume that a lender requires a bankruptcy remote entity structure and a limited partnership is formed with X and Y being the only limited partners. X and Y also own XY Inc. which is an S Corporation and is a "shell" entity" and XY Inc is the general partner of the limited partnership. The

lender loans $1,000,000 to the limited partnership and there are no personal guaranties by either X or Y. Under the normal rules, all of the debt would be allocated to XY Inc. as it is the only partner that has liability for the recourse debt. The Tiered Partnership rules don't alter this result as neither X nor Y guarantied anything. So no part of the debt would normally be allocated to X or Y. This same result would apply even if XY Inc was a limited liability company rather than a corporation. Under the normal rule there is no need to determine whether XY Inc. can in fact pay the debt allocated as it is presumed that it will be able to do so.

There is an exception to the presumption that a partner can pay the debt allocated to it and this exception is commonly referred to as the "anti-abuse rule." Reg. Section 1.752-2(b)(6) states that the presumption that partners will pay their share of allocated debts does not apply if "the facts and circumstances indicate a plan to circumvent or avoid the obligation."

Reg. Section 1.752-2(j) elaborates on this rule:

> (j) *Anti-abuse rules.*—(1) *In general.*—an obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person for purpose of this section if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation to create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Circumstances with respect to which a payment obligation may be disregarded include, but are not limited to, the situations described in paragraphs (j)(2) and (j)(3) of this section.

Reg. Section 1.752-2(j)(4) gives the following example:

> *Plan to circumvent or avoid obligation.* A and B form a general partnership. A, a corporation, contributes $20,000 and B contributes $80,000 to the partnership. A is obligated to restore any deficit in its partnership capital account. The partnership agreement allocates losses 20% to A and 80% to B until B's capital account is reduced to zero, after which all losses are allocated to A. The partnership purchases depreciable property for $250,000 using its $100,000 cash and a

> $150,000 recourse loan from a bank. B guarantees payment of the $150,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership. A is a subsidiary, formed by a partner of a consolidated group, with capital limited to $20,000 to allow the consolidated group to enjoy the tax loses generated by the property while at the same time limiting it monetary exposure for such losses. These facts, when considered together with its guarantee, indicate a plan to circumvent or avoid A's obligation to contribute to the partnership. The rules of section 752 must be applied as if A's obligation to contribute did not exist. Accordingly, the $150,000 liability is a recourse liability that is allocated entirely to B.

The example given above includes an element of tax motivation in concluding that A's obligation to contribute money to satisfy the debt should be disregarded. In examining the anti-abuse rules, McKee mentions "tax motivation" as a factor:

> The scope of this anti-abuse rule seems to embrace situations in which (1) it appears that, *primarily* for tax avoidance purpose, one or more partners have undertaken a contribution or payment obligation that will not, or cannot practically, be enforced, *and* (2) if such obligation were not enforced, other partners would have payment or contribution obligations that would be enforced. In addition, the anti-abuse rule may apply in situations where the partners attempt to have debt that is substantively nonrecourse treated as recourse debt.

(McKee, Federal Taxation of Partnerships and Partners Section 8.02(5).

Whether or not a tax motivation is required to apply the anti-abuse rules can be quite important because often the creation of limited liability structures such as a limited partnership with a corporate or limited liability company general partner are not tax motivated, but rather are either required by the lender in order to have a bankruptcy remote entity or are designed to minimize exposure to third party claims. We submit that the presence or absence of a tax motivation is not essential to the application of the anti-abuse rules as both of the above-cited regulations define the test as whether the "principal purpose" is to eliminate that partner's economic risk of loss with respect to that obligation. Using a shell corporation or shell limited liability company as the general partner is specifically designed to make a loan a "non-recourse loan" with

respect to the individual limited partners even though, on the face of the loan, it appears to be recourse.

Example 4: Assume G and H, individuals, desire to form an entity to buy real property. The lender requires a bankruptcy remote entity and a limited partnership with a 1% corporate general partner is used. The corporation is owned equally by G and H. H also owes all the limited partnership interests. The loan is a recourse loan but there are no personal guaranties. How is the loan allocated? 100% to the general partner? 1% to the general partner and 99% to the limited partners?

Assuming our suggested analysis to be correct, then the debt would be treated as a "non-recourse loan" as no partner would bear the economic risk of loss with respect to that loan under the anti-abuse rules. The loan would then be allocated among the partners under the rules relating to non-recourse debts, i.e., 1% to the corporate general partner and 99% to G and H as limited partners.