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Debt and taxes: IRS proposes dramatic changes

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Debt financing enhances investment returns and provides cash for constructing and acquiring major capital assets. For these reasons, debt financing plays a significant role in financing real estate investment and development.

Debt financing also has tax benefits. The basis of property acquired with cash has the same tax basis in the property owner's hands even though some or all of the cash was obtained with debt financing. The tax law presumes that the property owner will repay the debt associated with the financing. So, for example, when Thomas Jefferson buys Monticello with $400,000 cash and $600,000 debt financing from Ben Franklin, Tom gets $1 million tax basis in Monticello even though he used $600,000 of debt financing from Ben to buy Monticello.

Tom's tax basis credit matters to him. His basis in the property is the amount of capital he can recover from the property tax-free. Tax basis also serves to measure investment for determining losses. If some of Monticello is depreciable, Tom's tax basis is used to determine the amount of his depreciation deductions.

When a partnership incurs a debt, a similar dynamic unfolds. Say Tom and James Madison form a general partnership, TJ. Tom contributes $240,000 for a 60% share of TJ and James contributes $160,000 for a 40% share. TJ borrows $600,000 from Ben to acquire Monticello for $1 million. Here, TJ has a $1 million basis in Monticello, even though it only has $400,000 of its money in the deal. Further, Tom and James get basis credit in their partnership interests for the debt incurred because they are ultimately personally liable as general partners (60% Tom; 40% James).

If TJ is an LLC that is a tax partnership, the situation is a little different. Neither Thomas nor James has an individual obligation to repay the debt (unless one or both guarantee the debt - more on that later). Thomas and James will still share basis credit attributable to the debt, likely according to how they share a significant income tax item.

If James guaranties the debt, and Tom does not, James will get all of the basis credit related to the debt. Under present law, James gets full basis credit even if James lacks the net worth to perform on the guaranty.

James' basis credit in his LLC interest matters to him. It measures the amount of capital that can be recovered from TJ tax free (through distributions), and the amount of TJ's losses that can be allocated to James.

The drive for basis credit has produced some very creative arrangements. Some of these arrangements effectively eliminate real economic risk to the person nominally guarantying debt.

The Internal Revenue Service has successfully challenged several of these arrangements in court. Now the service seeks to prevent abuses by regulation. To that end, the service issued proposed regulations that impose strict conditions for respecting guaranties and other similar arrangements.

Under the proposed rules, James Madison's guaranty of JL, LLC debt to Ben Franklin would not be recognized unless:

1. James is

a. Required to maintain a "commercially reasonable" net worth for the term of the guaranty, or

b. Is prohibited by contract from transferring its assets for inadequate consideration;

2. James periodically provides commercially reasonable financial statements, presumably to JL, LLC;

3. James' guaranty must not terminate before JL's debt to Ben terminates;

4. James does not require JL, LLC or any other obligor to hold liquid assets that exceed JL's reasonable business;

5. James receives arm's length consideration for the guaranty (like a guaranty fee);

6. James would be personally liable if the LLC's liability is not otherwise satisfied. So, James pays if JL, LLC defaults, and Ben fails to fully recover from JL the amount of its debt to him. This rule effectively eliminates bottom dollar guaranties.

Because James is an individual, the proposed regulations presume that he will have economic risk of loss as to his guarantied debt, regardless of his net worth. However, if James' wholly-owned corporation guarantied the debt, James (as the person related to the guarantor) would be credited with economic risk of loss only to the extent the entity had actual net worth to cover it.

These proposed regulations mark a dramatic shift from the manner in which debt of tax partnerships is currently allocated. And while these rules may not be finalized as drafted, something like them is coming.

It is time to determine whether and how new rules like the proposed regulations will affect your deals. Review each deal where one or more partners (members in LLCs) or related persons are contractually agreeing to personally perform on debts obligations of the (tax) partnership. In such cases, draft new agreements or amendments requiring any partner (or related party) with a payment obligation like a guaranty or indemnity to comply with the reasonable requests of the partnership for information required to implement Treasury Regulation Â§1.752-3 (the applicable regulation).

The proposed regulations have transition rules that apply for arrangements entered into before the rules are finalized. The transition rules provide some relief for up to seven years. Consider now how you would apply the transitional relief to the extent possible.

In any case, big changes in debt allocations lie ahead. We need to begin thinking now about how to adapt to the changes and also how we transition existing arrangements into the new world the new regulations will create when finalized.

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