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**PARTNERSHIP WORKOUTS:  
PROBLEMS AND SOLUTIONS UNDER  
FINAL SECTION 704(b) and 752 REGULATIONS\***

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## Partnership Workouts: Problems And Solutions Under Final Section 704(b) And 752 Regulations

To many tax advisors, Sections 704(b) and 752<sup>1</sup> are the heart and soul of Subchapter K of the Internal Revenue Code. These statutory provisions embody the essence of the "aggregate" theory of partnerships and partners. They are also the provisions that served to fuel the tax shelter industry by permitting real estate investments to be "leveraged" for tax purposes.

Although the statutory language of Sections 704(b) and 752 has not changed since the passage of the Tax Reform Act of 1976, the regulations promulgated under these sections have been proposed, repropoed and otherwise revised at least 10 times during the past decade.<sup>2</sup> These changes have introduced a variety of new terms and

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<sup>1</sup> All references herein to sections are to sections of the Internal Revenue Code of 1986, as amended.

<sup>2</sup> Regulatory guidance for applying the 1976 amendment to Section 704(b) was not available until 1983, when the Treasury Department issued proposed regulations. See Prop. Treas. Reg. § 1.704-1(b) (1983), 48 Fed. Reg. 9871 (1983). These regulations were eventually finalized on December 24, 1985, and further amended on September 8, 1986. See Treas. Reg. § 1.704-1(b) (1986), 50 Fed. Reg. 53420 (1985), 51 Fed. Reg. 32061 (1986). A portion of these regulations, contained in Treas. Reg. § 1.704-1(b)(4)(iv) (1986), addressed allocations of deductions attributable to nonrecourse liabilities ("Former 704(b) Regulations"). On December 30, 1988, and November 21, 1989, the Treasury Department issued temporary regulations substantially revising the nonrecourse allocation rules in the Former 704(b) Regulations ("Temporary 704(b) Regulations"). See Treas. Reg. §§ 1.704-1T(b)(0) to -1T(b)(5) (1989), 53 Fed. Reg. 53161 (1988), 54 Fed. Reg. 48096 (1989). On December 27, 1991, the Temporary 704(b) Regulations, at long last, were finalized with minor modifications ("Final 704(b) Regulations"). See Treas. Reg. § 1.704-2, 56 Fed. Reg. 66978 (1991).

Prior to 1988, rules for allocating nonrecourse liabilities among partners were contained in Treas. Reg. § 1.752-1(e) (1960) ("Former 752 Regulations"). On December 29, 1988, the Treasury Department issued temporary regulations replacing the Former 752 Regulations. These temporary regulations were amended on November 21, 1989, and July 31, 1991 (as amended, "Temporary 752 Regulations"). See Treas. Reg. §§ 1.752-0T to -4T (1991), 53 Fed. Reg. 53143 (1988), 54 Fed. Reg. 48094 (1989), 56 Fed. Reg. 36702 (1991). Final regulations were eventually issued on December 23, 1991 ("Final 752 Regulations"). See Treas. Reg. §§ 1.752-1 to -4, 56 Fed. Reg. 66348 (1991).

concepts and have transformed what has always been a complex area of the tax law into one where many tax advisors have simply given up and do not even attempt to understand, much less comply with, the intricate and highly technical rules that are at the core of these regulations. For those of us who have not given up, we have found ourselves continuously amending and reamending partnership agreements (as well as our standard forms) to address the changes that have been thrust upon us during this time period. In some instances, the ink has barely dried when new regulations were issued and further conforming changes were needed.

Fortunately, with the promulgation last December of the Final 752 Regulations and the Final 704(b) Regulations, it appears that a long regulatory journey is almost<sup>3</sup> concluded. As that journey ends, however, another arduous trek begins: mastering the intricacies of the final regulations and understanding their intended and unintended impact on partnerships and their partners.

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These different sets of regulations have spawned extensive commentary. *See, e.g.,* Presant & Loffman, "The Final Partnership Nonrecourse Debt Allocation Regulations," 65 *Taxes* 67 (Feb. 1987); Brumbaugh & Hauschild, "Treatment of Partnership Allocations Attributable to Nonrecourse Indebtedness," 3 *J. Partnership Tax.* 99 (Summer 1986); Brumbaugh & Coleman, "Nonrecourse Debt Regulations Resolve Most Special Allocation Issues," 4 *J. Partnership Tax.* 21 (Spring 1987); Frankel & Coffin, "New Section 752 Regulations Clarify Treatment of Partnership Liabilities," 6 *J. Partnership Tax.* 179 (Fall 1989); Frankel & Coffin, "Treatment of Allocations Attributable to Loans Under New 704(b) Regulations," 6 *J. Partnership Tax.* 294 (Winter 1990); Lord, "Amendments to Recent Liability Regulations Clarify Ambiguities and Provide Consistency," 7 *J. Partnership Tax.* 115 (Summer 1990); Pickron, "New 752 Prop. Regs. Simplify Rules for Allocating Partnership Liabilities," 75 *J. Tax.* 358 (Dec. 1991). For a general discussion of the Final 752 Regulations, *see* Pickron, "Final Rules on Allocation of Partnership Liabilities Still Leave Unanswered Questions," 76 *J. Tax.* 272 (May 1992); Presant, Loffman & Abramowitz, "The Final Regulations Under Section 752," 19 *J. Real Est. Tax.* 267 (Summer 1992); Cuff, "Allocating Partnership Liabilities" 70 *Taxes* 303 (May 1992). For a general discussion of the Final 704(b) Regulations, *see* Hamill, "Final Regulations Concerning Liabilities Join Substantial Economic Effect Rules," 9 *J. Partnership Tax.* 99 (Summer 1992). It is beyond the scope of this Article to discuss all of the various changes that were made to the Section 704(b) and 752 regulations between 1983 and 1991.

<sup>3</sup> Due to several technical problems, it appears that further minor modifications likely will be made to the Section 704(b) regulations.

The authors believe that the impact, reach and continuing uncertainties of these regulations can be best explained and illustrated through a series of scenarios involving a troubled partnership which is seeking to deal with its financial problems by undergoing a debt or equity restructuring. This Article initially sets forth factual assumptions common to typical post-1991 workouts and debt restructurings. Following a brief summary of the various effective date and transition rules in the Section 704(b) and 752 regulations, this Article then discusses five different scenarios to illustrate the manner in which the new regulations operate and affect workout transactions.

### Factual Assumptions

Steven and Brian are natural persons. On June 16, 1983, Steven and Brian formed a general partnership ("Partnership") for the purpose of constructing an office building ("Building"). The Partnership's taxable year is the calendar year.

Steven and Brian share equally all of the Partnership's profits, losses and distributions. Each partner has the right under the partnership agreement to initiate a capital call to fund any operating deficit incurred by the Partnership. If, however, either partner fails to fund his share of any such capital call, his interest in the Partnership is diluted pursuant to a formula prescribed in the partnership agreement.

During 1983, an unrelated lender ("Lender") made a fully nonrecourse loan ("Nonrecourse Loan") to the Partnership the proceeds of which were used to finance the development of the Building, which was placed in service on January 1, 1984.

As of January 1, 1993, the outstanding principal balance of the Partnership's nonrecourse debt is \$5 million, the Partnership's adjusted tax basis in the Building is \$2 million, each partner's adjusted tax basis in his partnership interest is \$1 million, and each partner's capital account has a deficit balance of \$1.5 million. Due to local market conditions, the Partnership's cash flow has declined and the Partnership requires additional capital to fund its operating expenses and debt service obligations.

### Effective Dates, Transition Relief<sup>4</sup>

There are a number of ways the Partnership and its partners could attempt to manage their financial difficulties. The initial tax issue in virtually every partnership workout or debt restructuring, however, is which set or sets of Section 704(b) and 752 regulations would apply to the partnership and its restructured liabilities. As the discussion of different scenarios below illustrates, dramatically different tax consequences may result from the application of different versions of these regulations.

Unfortunately, the effective date and transitional relief rules of the Section 704(b) and 752 regulations are perhaps their most complex provisions. This part of the Article summarizes the rules most relevant to post-1991 workouts and debt restructurings.

**Section 752 Regulations.** As a general matter, a partnership liability will be subject to a different set of Section 752 regulations depending on when the liability was incurred or assumed by the partnership. For example, the Former 752 Regulations generally apply to liabilities incurred or assumed prior to January 30, 1989. The Temporary 752 Regulations generally apply to liabilities incurred or assumed on or after January 30, 1989, but prior to December 28, 1991.<sup>5</sup> The Final 752 Regulations generally apply to liabilities incurred or assumed on or after December 28, 1991.<sup>6</sup> Unfortunately, significant exceptions and caveats to these general rules complicate the analysis of any partnership workout or debt restructuring.

Partnerships may elect to apply the Final 752 Regulations to *all* pre-existing liabilities that otherwise would be grandfathered. This election is effective as of the beginning of the first taxable year ending

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<sup>4</sup> These rules are summarized on Appendices A through D to this Article.

<sup>5</sup> Treas. Reg. § 1.752-4T(a) (1991).

<sup>6</sup> Treas. Reg. § 1.752-5(a). For this purpose, an existing liability is not treated as newly incurred or assumed by virtue of a constructive termination of the partnership under Section 708(b)(1)(B). See Treas. Reg. § 1.752-5(c).

on or after December 28, 1991 (*i.e.*, 1991 for calendar-year partnerships), but must have been made on a written statement attached to the partnership's tax return for such taxable year.<sup>7</sup> It is unclear whether partnerships can make this election validly on amended returns. The Final 752 Regulations fail to specify whether the election must be attached to an original tax return, and the Internal Revenue Service ("IRS") has not indicated whether it will permit partnerships to use amended returns to make this election.

Under the Temporary 752 Regulations, partnerships similarly could have elected to apply the Temporary 752 Regulations to all pre-existing liabilities that otherwise would not have been subject to those regulations as of the beginning of the first taxable year ending after December 29, 1988 (as of January 1, 1988, for calendar-year partnerships).<sup>8</sup> In this context, the original version of the Temporary 752 Regulations also failed to specify whether elections could be made on amended 1988 returns, but the IRS nevertheless accepted elections on such returns.<sup>9</sup> Eventually, the Temporary 752 Regulations were specifically revised to permit the use of amended returns.<sup>10</sup>

If a partnership is unable or otherwise fails to elect to apply the Final or Temporary 752 Regulations, individual pre-existing liabilities nevertheless may become subject to one or the other versions of the new rules. The regulatory preamble to the Final 752 Regulations indicates that a pre-existing liability will be treated as exchanged for a newly incurred or assumed liability when it is "materially modified."<sup>11</sup>

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<sup>7</sup> See Treas. Reg. § 1.752-5(b).

<sup>8</sup> Treas. Reg. § 1.752-4T(d)(1) (1991).

<sup>9</sup> See, *e.g.*, PLR 9024078 (Mar. 21, 1990); PLR 9024031 (Mar. 15, 1990); PLR 9034034 (May 25, 1990).

<sup>10</sup> See Treas. Reg. § 1.752-4T(d)(3) (1991).

<sup>11</sup> 56 Fed. Reg. 66350 (1991).

As a result, otherwise grandfathered liabilities may be subject to a different set of Section 752 regulations depending on the date of any "material modification." By way of illustration, if a pre-existing liability was materially modified on or after January 30, 1989, but prior to December 28, 1991, the debt would have become subject to the Temporary 752 Regulations on the date of the modification. If the same liability is again materially modified on or after December 28, 1991, it would then become subject to the Final 752 Regulations on the date of the second modification.

Unfortunately, it is not clear what constitutes a "material modification" for Section 752 purposes.<sup>12</sup> The regulatory preamble to the Final 752 Regulations states simply that a guaranty of a liability by a partner or a related person will not be treated as a modification of the debt for this purpose.

Another important exception to the general rules involves liabilities incurred on or after March 1, 1984, and prior to January 30, 1989.<sup>13</sup> As a general matter, the Former 752 Regulations apply to these liabilities. Nevertheless, the Temporary 752 Regulations would apply retroactively to any such loan made to the partnership directly by a partner. If the loan was not made directly by a partner, but was guaranteed by him, the Temporary 752 Regulations would begin to apply to the loan as of the date of the partner's guaranty.

This exception does not extend to loans made or guaranteed during this period by persons related to a partner (rather than directly by the partner himself). The Former 752 Regulations continue to apply

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<sup>12</sup> IRS representatives have informally indicated that they will not provide any guidance regarding the meaning of material modification in this context until they have fully assessed all of the ramifications of the United States' Supreme Court's decision in *Cottage Savings Ass'n v. Comm'r*, 111 S. Ct. 1503 (1991). Caution therefore should be exercised by prudent tax advisors whenever a partnership debt is being restructured, because lender or borrower concessions of any kind may constitute material modifications of the debt under general income tax principles. *See, e.g.*, IRC § 1001. IRS representatives have even suggested that the partial prepayment of a debt might constitute a material modification for Section 752 purposes.

<sup>13</sup> Treas. Reg. § 1.752-4T(b) (1991).



to these pre-January 30, 1989 related partner loans unless and until an overall election is made or the loan is materially modified on or after January 30, 1989.<sup>14</sup>

**Section 704(b) Regulations.** The Final 704(b) Regulations generally apply only to taxable years beginning on or after December 28, 1991 (*i.e.*, 1992 for calendar-year partnerships).<sup>15</sup> Special transitional relief is available, however, to pre-existing partnerships.

For partnerships formed on or after December 30, 1988 and prior to December 28, 1991, the Temporary 704(b) Regulations generally continue to apply, provided the partnership complied with the Temporary 704(b) Regulations prior to December 28, 1991.<sup>16</sup> For partnerships formed prior to December 30, 1988, the Former 704(b) Regulations generally continue to apply, provided the partnership complied with the Former 704(b) Regulations prior to December 30, 1988.<sup>17</sup>

If not otherwise subject to the Final 704(b) Regulations, a partnership may elect to apply these regulations to its first taxable year ending on or after December 28, 1991 (*i.e.*, 1991 for calendar-year

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<sup>14</sup> 56 Fed. Reg. 66350 (1991) (regulatory preamble to the Final 752 Regulations). The regulatory preamble also makes clear that the Former 752 Regulations apply to all liabilities incurred or assumed prior to March 1, 1984, unless and until an election is made to apply a subsequent version of the Section 752 regulations or the loan is materially modified. This grandfather status applies, regardless of whether a partner directly made the loan prior to March 1, 1984, or a third party made the loan prior to March 1, 1984, and the partner directly guarantees the loan on or after March 1, 1984.

<sup>15</sup> Treas. Reg. § 1.704-2(l)(1)(i).

<sup>16</sup> Treas. Reg. § 1.704-2(l)(1)(ii).

<sup>17</sup> Treas. Reg. § 1.704-2(l)(1)(iii). Although this regulation does not explicitly state that the partnership must have continued to comply with the Former 704(b) Regulations between December 29, 1988 and December 28, 1991, continuing compliance presumably was intended.

partnerships).<sup>18</sup> This election must be made on a written statement attached to the partnership's tax return for such year. As with similar elections to apply the Final 752 Regulations to a partnership's pre-existing liabilities, it is not clear whether amended returns may validly be used to make this election.<sup>19</sup>

If a pre-existing partnership does not elect to apply the Final 704(b) Regulations, it nevertheless will become subject to the new regulations if its partnership agreement is materially modified on or after December 28, 1991.<sup>20</sup> Upon such a modification, the Final 704(b) Regulations begin to apply for the taxable year of the modification and all years thereafter.<sup>21</sup>

Additional transitional relief is accorded to partnerships, regardless of the date of their formation, for deductions attributable to certain liabilities grandfathered under the Section 752 regulations. Three exceptionally complex provisions of the Final 704(b) Regulations must be taken into account when allocating these deductions under the Final, Temporary *and* Former 704(b) Regulations. Unfortunately, the relief provided by these special rules for Section 704(b) purposes is not

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<sup>18</sup> Treas. Reg. § 1.704-2(l)(4). Partnership formed prior to December 30, 1988, could also have elected to apply the Temporary 704(b) Regulations. See Treas. Reg. § 1.704-1T(b)(4)(iv)(m)(4) (1989). This election must have been made on the partnership's tax return for its first taxable year ending after December 29, 1988 (*i.e.*, 1988 for calendar-year partnerships).

<sup>19</sup> See text accompanying notes 8-10 *supra*.

<sup>20</sup> See Treas. Reg. §§ 1.704-2(l)(1)(ii), -2(l)(1)(iii). In the case of a partnership formed prior to December 30, 1988, a material modification of its partnership agreement between December 30, 1988, and December 27, 1991, would have caused the Temporary 704(b) Regulations to apply.

<sup>21</sup> If a partnership agreement is materially modified on a day other than the first day of the partnership taxable year, the change in the governing Section 704(b) regulations apparently occurs as of the first day of the year during which the material modification occurs. See, *e.g.*, Treas. Reg. § 1.704-2(l)(1)(iii)(A).

entirely consistent with the Section 752 treatment of the corresponding liabilities.<sup>22</sup>

One provision, contained in Treas. Reg. § 1.704-2(l)(3), applies to nonrecourse liabilities incurred or assumed by partnerships prior to March 1, 1984, if the liability is directly made or guaranteed by a partner ("(l)(3) liabilities"). These liabilities are governed by the Former 752 Regulations, and direct partner guaranties (regardless of their effective dates) generally do not cause the Final or Temporary 752 Regulations to apply to pre-March 1, 1984 loans.<sup>23</sup>

For Section 704(b) purposes, however, (l)(3) liabilities must be bifurcated and treated partly as a nonrecourse liability and partly as a partner nonrecourse debt.<sup>24</sup> Although not entirely clear, the nonrecourse portion of an (l)(3) liability appears to be initially equal to the amount of Section 704(b) minimum gain that was attributable to the liability as of the end of the first partnership taxable year ending on or after December 31, 1986 (*i.e.*, 1986 for calendar-year partnerships). In other words, the nonrecourse portion of an (l)(3) liability appears to be equal to the pre-1987 nonrecourse deductions allocated in respect of the liability. All post-1986 deductions, in effect, would constitute partner nonrecourse deductions and would be allocable 100% to the lender or guarantor partner.<sup>25</sup>

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<sup>22</sup> In the regulatory preamble to the Final 704(b) Regulations, the Treasury Department concedes that these rules are complex and indicates that these rules are not intended to correspond exactly with the effective date rules of the Section 752 regulations. *See* 56 Fed. Reg. 66982 (1991).

<sup>23</sup> *See* note 14 *supra*.

<sup>24</sup> Treas. Reg. § 1.704-2(l)(3). Special "nonrecourse" treatment accorded by this provision applies for purposes of the Final, Temporary *and* Former 704(b) Regulations. *See generally* Treas. Reg. §§ 1.704-2(b)(3) (general Section 704(b) definition of "nonrecourse liability"), -2(b)(4) (general Section 704(b) definition "partner nonrecourse debt").

<sup>25</sup> Treas. Reg. § 1.704-2(l)(3)(i); *see* Lord, *supra* note 2, at 133-34 (discussion of Treas. Reg. § 1.704-1T(b)(4)(iv)(m)(3) (1989), the predecessor to Treas. Reg. § 1.704-2(l)(3)). This provision is exceptionally complex and in many respects incomprehensible. It is generally understood, however, that its purpose is to avoid

It should be noted that (l)(3) liabilities do not include loans made or guaranteed by a related person (rather than directly by a partner). By its own terms, this provision applies only to "grandfathered partner nonrecourse debt," which is defined as any pre-January 30, 1989 liability that was not subject to the Temporary 752 Regulations, but would have been subject to the Temporary 752 Regulations as a result of section 1.752-4T(b) of the Temporary 752 Regulations if the liability had been incurred or assumed on or after March 1, 1984. The literal language of section 1.752-4T(b) referred only to partnership liabilities directly made or guaranteed by partners on or after March 1, 1984, and did not operate to cause the Temporary 752 Regulations to apply to related person loans or debt guaranteed by related persons. Accordingly, special nonrecourse treatment of deductions attributable to (l)(3) liabilities should never be available to related person loans or debt guaranteed by related persons.

A second special rule, contained in the first two sentences of Treas. Reg. § 1.704-2(l)(2), applies solely to nonrecourse liabilities made or guaranteed by related persons prior to January 30, 1989 ("(l)(2) liabilities").<sup>26</sup> Its apparent purpose is to coordinate more closely the Section 704(b) and 752 treatment of these liabilities. The Former 752 Regulations generally apply to (l)(2) liabilities unless and until an election is made to apply new regulations or a material modification of the debt occurs on or after January 30, 1989. By reason of this special rule, deductions attributable to an (l)(2) liability may also be treated as third-party nonrecourse deductions (rather than as partner nonrecourse

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recapture, pursuant to a minimum gain chargeback, of pre-1987 nonrecourse deductions claimed by non-guarantor partners. In effect, non-guarantor partners are permitted to retain their pre-1987 shares of minimum gain, apparently so long as the debt is not reduced and the basis of the property securing such debt is not increased. In addition to being overly complicated, this provision still produces extremely harsh results, because it does not protect the non-guarantor partner from recapturing all post-1986 nonrecourse deductions. In some cases, post-1986 deductions may have been validly allocated to the non-guarantor partner before a guaranty was ever contemplated. The authors consider this treatment to be unfair and are hopeful that the Treasury Department will modify this rule so that it does not retroactively require a partner to recapture properly claimed deductions from prior years.

<sup>26</sup> Treas. Reg. § 1.704-2(l)(2) (first two sentences).

deductions) to the extent that the only economic risk of loss borne by any partner is attributable to a pre-January 30, 1989 interest of the related person.<sup>27</sup>

A third rule, contained in the third sentence of Treas. Reg. § 1.704-2(l)(2), must also be taken into account for Section 704(b) purposes. According to its literal language, it appears that *all* post-1988 deductions attributable to non-(l)(3) liabilities incurred or assumed prior to January 30, 1989, may also be treated as third-party nonrecourse deductions, provided a post-1988 consistency requirement is met by all partners.<sup>28</sup> By way of explanation, the relevant regulatory language provides:

However, for partnership taxable years beginning on or after December 29, 1988, a pre-January 30, 1989, liability, *other than a liability subject to paragraph (l)(3) of this section or former § 1.704-1T(b)(4)(iv)(m)(3) (whichever is applicable), that is treated as grandfathered under former §§ 1.752-1T through -3T (whichever is applicable)* will be treated as a nonrecourse liability for purposes of this section, provided all partners in the partnership consistently treat the liability as nonrecourse for partnership taxable years beginning on or after December 29, 1988.<sup>29</sup>

Unfortunately, this language does not create a picture of clarity.

This provision might be interpreted as expressing nothing more than a post-1988 consistency rule for pre-January 30, 1989 loans that

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<sup>27</sup> The special nonrecourse treatment accorded by this provision applies for purposes of the Final *and* Temporary 704(b) Regulations. It should also be noted that this treatment is conditioned upon these loans being grandfathered for purposes of the Final and Temporary 752 Regulations. Thus, if any such loan has been materially modified on or after January 30, 1989, special grandfather status will be lost for purposes of both Section 704(b) and Section 752.

<sup>28</sup> Treas. Reg. § 1.704-2(l)(2) (last sentence).

<sup>29</sup> *Id.* (emphasis supplied).

otherwise constitute related person (l)(2) liabilities by reason of the first two sentences of Treas. Reg. § 1.704-2(l)(2). This interpretation seems reasonable in light of the overall statutory and regulatory scheme, because related person nonrecourse loans made between March 1, 1984, and January 29, 1989, may be treated as third-party nonrecourse loans for Section 752 purposes, but direct partner nonrecourse loans made between March 1, 1984 and January 29, 1989, must be treated as partner nonrecourse debt for Section 752 purposes.

On the other hand, this provision might also be interpreted as creating a significantly broader third category of grandfathered nonrecourse deductions. Based on a literal interpretation of the regulatory language, it could be argued that special Section 704(b) treatment should be available to post-1988 deductions attributable to (i) direct partner loans made on or after March 1, 1984, and prior to January 30, 1989, (ii) related person loans made prior to March 1, 1984, (iii) related person loans made on or after March 1, 1984, and prior to January 30, 1989, (iv) third-party, partner-guaranteed loans made on or after March 1, 1984, and prior to January 30, 1989 (regardless of whether the guaranty is provided before or after January 30, 1989), (v) third-party, related person-guaranteed loans made prior to March 1, 1984 (regardless of whether the guaranty is provided before or after January 30, 1989), and (vi) third-party, related person-guaranteed loans made on or after March 1, 1984, and prior to January 30, 1989 (regardless of whether the guaranty is provided before or after January 30, 1989).

Indeed, the regulatory language emphasized above operates narrowly to exclude only (l)(3) liabilities and similar pre-March 1, 1984 partner nonrecourse loans described in the Temporary 704(b) Regulations. The emphasized language does not purport to exclude any of the pre-January 30, 1989 liabilities described in the preceding paragraph. Accordingly, if this provision establishes an independent rule and its consistency requirement is satisfied after 1988, calendar-year partnerships subject to the Final 704(b) Regulations arguably would be entitled to treat all deductions attributable to these loans as third-party nonrecourse deductions.

On balance, the latter interpretation of this provision appears somewhat unreasonable. For example, as illustrated in the Appendices, nonrecourse treatment for a broader category of loans would be somewhat anomalous in light of the apparent regulatory framework. With respect to (l)(3) liabilities, bifurcated Section 704(b) treatment (*i.e.*, partial characterization as partner nonrecourse debt) is provided for *pre-March 1, 1984* direct partner loans or direct partner-guaranteed loans. What valid policy could simultaneously support the treatment of a *post-March 1, 1984* direct partner loan as third-party nonrecourse debt when the Temporary 752 Regulations unquestionably allocate all of the debt to the lender or guarantor partner?

Perhaps, this provision might be more reasonably interpreted as applying only to related-person loans incurred or assumed by the partnership prior to January 30, 1989. To be sure, the Former 752 Regulations apply to these loans even if a related-person guaranty is provided on or after January 30, 1989, and special Section 704(b) relief would not appear to be unreasonable under these circumstances. If this interpretation were correct, a post-January 30, 1989 guaranty by a related person should not cause an otherwise nonrecourse loan to cease to be treated as such for Section 704(b) purposes.

In the authors' opinions, however, the third sentence of Treas. Reg. § 1.704-2(l)(2) is properly interpreted only as expressing a consistency rule for pre-January 30, 1989, related person loans that are otherwise entitled to transition relief by reason of the first two sentences of Treas. Reg. § 1.704-2(l)(2). Unfortunately, the regulatory language appears to stand alone as an independent rule, and the Treasury Department has not acted to clarify the underlying rationale for the provision. Until then, prudent tax advisors should approach *post-January 30, 1989* guaranties by related persons and this particular issue with extreme caution.

### Scenario One

**SCENARIO ONE — BASIC SQUEEZEDOWN.** *Steven delivers a capital call to Brian requesting each partner to contribute \$750,000 in capital to the Partnership to fund \$1.5 million of deductible operating expenses. Brian fails to fund his share, and Steven contributes 100 percent of the required capital on January 1, 1993. As a result, Brian's interest in Partnership profits is reduced immediately from 50 percent to 5 percent under the dilution formula.*

The dilution of Brian's interest in the Partnership will have dramatically different tax consequences depending on whether the Final 752 Regulations or the Former 752 Regulations are applicable to the Nonrecourse Loan as of January 1, 1993.

#### Former 752 Regulations

A partner's share of a nonrecourse liability was determined under the Former 752 Regulations in the same manner as the partners shared the partnership's profits. There was virtually no authority, however, as to what constituted a partner's interest in partnership profits for this purpose. Nevertheless, a shift in the partners' overall shares of partnership profits was widely believed to cause a similar shift in their percentage shares of all nonrecourse liabilities outstanding at the time of the shift.

If the Former 752 Regulations apply to the Nonrecourse Loan as of January 1, 1993, the dilution of Brian's interest in Partnership profits from 50 percent to 5 percent would likely cause a reduction in Brian's share of such liability from \$2.5 million to \$250,000. The resulting deemed cash distribution would reduce Brian's adjusted tax basis in his partnership interest from \$1 million to zero, and Brian would recognize \$1.25 million of taxable income under Section 731(a)(1).

#### Final 752 Regulations

Although the determination of a partner's share of a nonrecourse liability is more complex under the Final 752 Regulations, the new regulations offer significantly different



tax consequences that may be attractive to the individual partners. The decrease in a partner's interest in partnership profits can still result in a shift of nonrecourse liabilities away from the diluted partner, but the amount of any deemed cash distribution should never exceed the diluted partner's adjusted tax basis in his partnership interest immediately before the shift.

Under the Final 752 Regulations, each partner's share of a nonrecourse liability is equal to the sum of three amounts: (i) his share of the partnership's minimum gain attributable to the liability as determined under Section 704(b), plus (ii) his share of the minimum gain then attributable to the liability as computed under the principles of Section 704(c), plus (iii) his share of any residual portion of the liability ("excess nonrecourse liability"). In effect, these rules stratify nonrecourse liabilities into three different tiers and allocate each tier among the partners on a different basis.<sup>31</sup>

A partner's share of any Section 704(b) minimum gain is generally equal to the amount of nonrecourse deductions previously allocated to the partner in respect of the nonrecourse liability, plus any cash distributions previously made to him that are attributable to the liability, minus his aggregate share of any net decreases in the partnership's minimum gain attributable to the liability. A partner's share of Section 704(c) minimum gain is generally equal to the amount of taxable gain (if any) that would be allocated to him under Section 704(c) (or in accordance with Section 704(c) principles in the event of a revaluation of the partnership's assets under Treas. Reg. § 1.704-1(b)(2)(iv)(f) if the partnership were to dispose of property securing the nonrecourse liability in full satisfaction of the nonrecourse liability. The partners' shares of any excess nonrecourse liability generally are based upon their respective percentage interests in the partnership's profits or the manner in which it is reasonably expected that the deductions attributable to the liability will be allocated.<sup>32</sup>

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<sup>31</sup> Treas. Reg. § 1.752-3(a).

<sup>32</sup> Under Treas. Reg. § 1.752-3(a)(3), the partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities so long as the specified profits interests are reasonably consistent with other

Under the Section 704(b) regulations, partners have the option, upon the contribution of a greater than *de minimis* amount of cash or other property as consideration for an interest in the partnership, to revalue the partnership's assets for book purposes and correspondingly adjust their capital account balances.<sup>33</sup> These adjustments, if made, cause the book values of the partnership's assets and the partners' capital account balances to reflect more closely the fair market value of the partnership's assets and the partners' indirect economic interests in those assets. The book basis of each partnership asset is therefore adjusted to equal its fair market value (with an asset subject to a nonrecourse liability being valued at not less than the amount of the liability). The partners' capital accounts are then adjusted to reflect the manner in which the unrealized income or loss inherent in each revalued asset would have been allocated among the partners if the asset had been sold for its fair market value immediately before the capital contribution.

As a consequence of these revaluation rules, an increase in the book basis of a partnership asset to the outstanding amount of the nonrecourse liability secured by the asset causes the partnership's Section 704(b) minimum gain, and the partners' respective shares thereof, to be reduced to zero. At the same time, however, the partners' shares of Section 704(c) unrealized gain is increased by the amount of reduction in Section 704(b) minimum gain.

If the Final 752 Regulations apply to the Nonrecourse Loan as of January 1, 1993, and the partners elect *not* to revalue the Building and their capital accounts in connection with Steven's capital contribution, the amount of the Partnership's first tier nonrecourse liability would be equal to the Partnership's \$3 million amount of Section 704(b) minimum gain, and each of Steven's and Brian's shares would be \$1.5 million. Absent a revaluation, no unrealized gain would

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allocations of significant items of partnership income or gain that have substantial economic effect. The Final 752 Regulations do not require partnerships to use the same method of allocating excess nonrecourse liabilities from one year to the next, so long as each allocation satisfies the "reasonably consistent" criteria.

<sup>33</sup> Treas. Reg. §§ 1.704-1(b)(2)(iv)(f), -1(b)(2)(iv)(g).

be allocable to either partner under Section 704(c). In effect, the Partnership would retain its \$3 million "historic" amount of Section 704(b) minimum gain, and the partners' "historic" shares would not change.<sup>34</sup>

On the other hand, if the partners elect to revalue as a result of Steven's capital contribution, the book basis of the Building would be increased from \$2 million to \$5 million. As a consequence, the Partnership's Section 704(b) minimum gain would decline from \$3 million to zero,<sup>35</sup> but the deficit balance in each of Steven's and Brian's capital accounts (thereafter adjusted solely for book items of profit and loss) would be increased from \$1.5 million to zero to reflect that \$1.5 million of unrealized gain inherent in the Building would have been allocated to each partner if the Building had been sold for \$5 million immediately before Steven's capital contribution. Brian's share of the Partnership's Section 704(c) unrealized gain therefore would be increased from zero to \$1.5 million. In effect, the revaluation would create amounts of Section 704(c) minimum gain with respect to both Steven and Brian, which would replace their prior shares of Section 704(b) minimum gain.

The amount of the Partnership's third tier nonrecourse liability would be equal to \$2 million in either case, and \$100,000 of this excess nonrecourse liability presumably would be allocable to Brian. As a result of this multi-tier analysis, the dilution of Brian's interest in Partnership profits from 50% to 5% would reduce his share of the Nonrecourse Loan from \$2.5 million to only \$1.6 million. While the \$900,000 deemed cash distribution would reduce Brian's adjusted tax basis in his partnership interest from \$1 million to \$100,000, the

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<sup>34</sup> It is important to note that this result is not dependent upon the actual fair market value of the Building. Thus, even if the fair market value of the Building has experienced a significant decrease, Brian's share of the Partnership's Section 704(b) minimum gain would remain constant, thus permitting Brian to "stay afloat" notwithstanding the dilution of his interest in the Partnership's profits.

<sup>35</sup> Although the Partnership would experience a \$3 million decrease in its Section 704(b) minimum gain, mandatory income allocations would not be triggered by reason of the minimum gain chargeback requirement of the Section 704(b) regulations. See notes 43-44 *infra* and accompanying text.

dilution would not trigger any immediately recognizable taxable income to Brian under Section 731(a)(1).<sup>36</sup>

**Scenario One Summary.** Based upon the foregoing analysis, it seems clear that Brian's tax position would be best served if (1) the Nonrecourse Loan is governed by the Final 752 Regulations as of January 1, 1993, and (2) the Partnership does not elect to revalue its assets. Because the Partnership incurred the Nonrecourse Loan prior to January 30, 1989, however, neither the Final nor Temporary 752 Regulations will generally apply.

Unless the Partnership elected to apply the new rules by attaching a written statement to its original 1991 tax return, or is permitted to make the election by filing an amended 1991 return, the partners should consider causing the Partnership's nonrecourse debt to be materially modified in connection with Brian's dilution or causing the

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<sup>36</sup> The immediate benefits of the Final 752 Regulations do not come without an ultimate price to Brian. If the partners elect to revalue assets and capital accounts in this manner, future items of depreciation, cost recovery or other amortization in respect of the Building would be computed for "book" purposes. As these "book" items are allocated and deducted, the Partnership would experience related increases in its Section 704(b) minimum gain and decreases in its Section 704(c) unrealized gain. If the Partnership's nonrecourse deductions are thereafter shared by Steven and Brian in accordance with their new 95-5% sharing ratios, while the old Section 704(c) unrealized gain was shared equally, future allocations of "book" deductions would have the effect of increasing Steven's share of liabilities and decreasing Brian's share. Brian thus would experience deemed cash distributions under Sections 752(b) and 733(1) as the Partnership's nonrecourse debt is systematically shifted away from him in this manner. Under these circumstances, Brian may eventually receive deemed cash distributions in excess of his adjusted tax basis, and thus may be required to recognize taxable income under Section 731(a)(1). If the partners elect *not* to revalue, amounts of Section 704(c) minimum gain would not be created, and subsequent allocations of deductions would not have the effect of shifting tax basis automatically from Brian to Steven. Thus, a decision *not* to revalue may produce meaningful tax advantages to Brian. On the other hand, the Final 704(b) Regulations warn that the failure to revalue assets and capital accounts following Steven's capital contribution may result in a taxable event (presumably taxable shifts of capital) to some or all of the partners. See Treas. Reg. §§ 1.704-1(b)(2)(iv)(f), -1(b)(1)(iii) and -1(b)(1)(iv). Where the fair market value of the partnership's assets does not exceed its liabilities, however, it appears that the failure to revalue should not create any immediately adverse tax consequences to the partners.

Partnership to transfer the Building subject to the Nonrecourse Loan to a new partnership owned 10 percent by the Partnership and 90 percent by Steven. Although such a dropdown transaction would not cause the Partnership to become subject to the Final 752 Regulations, the new partnership would be subject to the new rules. As described in Scenario Three below, Brian could then continue to include a sufficient amount of the nonrecourse debt in the adjusted tax basis of his Partnership interest to avoid immediate recognition of taxable income under Section 731(a)(1).

### Scenario Two

**SCENARIO TWO—SQUEEZEDOWN WITH NONRECOURSE DEBT REDUCTION.** *Instead of being used to fund operating expenses, the \$1.5 million of cash contributed by Steven on January 1, 1993, is immediately used by the Partnership to reduce the outstanding principal balance of its nonrecourse debt from \$5 million to \$3.5 million.*

Tax ramifications are substantially more difficult to determine when capital is disproportionately contributed to repay nonrecourse liabilities of the partnership or fund capital additions, rather than to pay deductible operating expenses. This difficulty stems, in large part, from the uncertainty about the operation of minimum gain chargebacks under the Section 704(b) regulations and the timing of deemed cash distributions attributable to repayments of nonrecourse liabilities.

Mechanically, this transaction consists of two steps. Steven first contributes \$1.5 million of new capital, and Brian's interest in Partnership profits is diluted from 50 percent to 5 percent. Second, the Partnership then uses Steven's new capital and repays \$1.5 million of its nonrecourse debt.

The implications of Steven's contribution and the dilution of Brian's interest are the same as discussed above in the context of Scenario One, where Steven contributed capital to fund the Partnership's

operating expenses. Assuming the Final 752 Regulations apply,<sup>37</sup> Brian would experience a \$900,000 deemed cash distribution that would reduce his adjusted tax basis in his partnership interest from \$1 million to \$100,000, but he would not be required immediately to recognize any taxable income under Section 731(a)(1). Unfortunately, the tax implications of the Partnership's partial prepayment of the Nonrecourse Loan are not as certain, and may turn, in part, on the Partnership's decision to revalue or not revalue its assets.

**Final 704(b) Regulations: Minimum Gain Chargeback.** Under the Final 704(b) Regulations, unless a specific exception applies, allocations of income pursuant to a minimum gain chargeback are required in all circumstances when a partnership experiences a net decrease in minimum gain for a taxable year.<sup>38</sup> The amount required to be allocated to each partner is equal to his share of the net decrease.<sup>39</sup> For this purpose, a partner's share of any decrease in partnership minimum gain is equal to the total net decrease multiplied by his percentage share of the partnership's minimum gain as of the end

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<sup>37</sup> IRS representatives have suggested that the partial prepayment of a partnership's otherwise grandfathered liability might be viewed as a "material modification" of the debt for Section 752 purposes, thus triggering the application of the new Section 752 regulations. See note 12 *supra*.

<sup>38</sup> Treas. Reg. § 1.704-2(f)(1).

<sup>39</sup> Some practitioners have suggested that the minimum gain chargeback requirement does not require items of gross income to be allocated to the partners experiencing decreases in their shares of minimum gain; rather, under this theory, only net income of the partnership would be allocable to such partners. See, e.g., Lipton, "Planning for Noncorporate Debt Workouts Outside of Bankruptcy," 70 *Taxes* 275, 298, n. 161 (May 1992); but see Hamill, *supra* note 2, at 117. Although the authors understand how this conclusion might be rationalized because the Final 704(b) Regulations do not explicitly require gross income allocations, the authors are of the view that the purposes and theories underlying the minimum gain chargeback requirement compel the conclusion that gross income allocations are in fact required. In addition, on June 26, 1992, the Treasury Department revised Treas. Reg. § 1.704-2(f)(7), Example 2, to make it clear that minimum gain chargebacks require gross income rather than net income allocations. See 57 Fed. Reg. 28611 (1992).

of the immediately preceding year.<sup>40</sup> Minimum gain allocations are made effective as of the end of the taxable year.

Partial prepayment of the Nonrecourse Loan on January 1, 1993, may cause a decrease in the Partnership's minimum gain for 1993. To explain, Brian's tax position probably would be best served, but for the debt's prepayment, by the Partnership's election not to revalue its assets.<sup>41</sup> In this event, the outstanding debt would be reduced from \$5 million to \$3.5 million while the Partnership's adjusted tax basis in the Building remains constant at \$2 million. Accordingly, the Partnership would experience a \$1.5 million net decrease in its minimum gain for 1993 from \$3 million to \$1.5 million. Each of Steven's and Brian's share of this net decrease (50% as of December 31, 1992) would be \$750,000. As a consequence, the Partnership's minimum gain chargeback would require the Partnership to allocate \$750,000 of income and gain to Brian.<sup>42</sup>

On the other hand, if the Partnership elects to revalue its assets in connection with Steven's capital contribution, the Partnership's book basis in the Building would be increased from \$2 million to \$5 million. Although the Partnership's minimum gain would decline from \$3 million to zero, the Section 704(b) regulations would operate to limit the amount of income required to be allocated pursuant to a minimum gain allocation.

By way of explanation, if an upward revaluation occurs pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(f) and the partnership's minimum gain is reduced *solely* as a result of the revaluation, the amount of the reduction is added back to any other increases or decreases in minimum gain for the same taxable year in order to determine whether there has

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<sup>40</sup> Treas. Reg. § 1.704-2(g)(2).

<sup>41</sup> See note 36 *supra* and accompanying text.

<sup>42</sup> The Final 704(b) Regulations would confer a specific exception upon Steven; the Partnership therefore would not be required to make any minimum gain allocation to him. See text accompanying note 45 *infra*.

occurred a net increase or decrease for the year.<sup>43</sup> As a result, no net increase or decrease in minimum gain normally occurs *solely* as a result of upward revaluations of partnership assets, and thus no minimum gain chargeback is normally triggered solely by such revaluations. Partners' shares of minimum gain may thus be reduced, provided such reduction occurs solely by reason of an upward revaluation, without triggering a minimum gain allocation.

If the \$3 million reduction in the Partnership's minimum gain is respected as occurring *solely* as a result of Steven's capital contribution and the Partnership's revaluation, the Partnership's book basis in the Building would be adjusted upward to \$5 million, and the Partnership's minimum gain would be reduced to zero without triggering a minimum gain allocation. Following this adjustment, the Nonrecourse Loan could be repaid without triggering additional reductions in minimum gain.<sup>44</sup>

To the extent, however, that the \$3 million reduction in minimum gain is not respected as occurring *solely* as a result of the Partnership's revaluation, the Partnership would experience a net decrease in minimum gain, and minimum gain allocations would be required for 1993. It could be argued that, of the total \$3 million reduction in minimum gain, \$1.5 million should be treated as occurring, at least *partially*, as a result of the Partnership's repayment of the Nonrecourse Loan. If this were the correct interpretation of the *solely* requirement, the Partnership would experience a \$1.5 million net decrease in its minimum gain for 1993, each partner's share of the net decrease (50% as of December 31, 1992) would be \$750,000, and \$750,000 of Partnership income would be mandatorily allocated to Brian in 1993.

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<sup>43</sup> See Treas. Reg. §§ 1.704-2(d)(4), -2(g)(2).

<sup>44</sup> Post-revaluation minimum gain arises as a result of allocations of nonrecourse deductions as calculated for book purposes. Treas. Reg. § 1.704-2(d)(3). If, immediately following the revaluation, partnership assets are reflected on the partnership's books at an amount equal to or greater than the nonrecourse debt, post-revaluation debt payments will trigger decreases in minimum gain only to the extent that nonrecourse deductions have been allocated after the revaluation.



Whether Brian could avoid this interpretation of the *solely* requirement by delaying the debt payment and thereby separating it from Steven's capital contribution is doubtful. It appears this issue may turn on the facts and circumstances of each case. Where the specific purpose of a partner's capital contribution is the funding of debt service payments, it seems especially difficult to argue that any minimum gain reduction occurs solely as a result of the capital contribution.

**Minimum Gain Chargeback Exception.** The Final 704(b) Regulations appropriately provide that no minimum gain chargeback is required to a partner like Steven who contributes capital that is applied to reduce the outstanding amount of the partnership's nonrecourse liability. Minimum gain chargebacks would have been required to all partners under the Temporary 704(b) Regulations, without regard to whether any individual partner made capital contributions that, in effect, triggered a reduction in his share of the partnership's minimum gain. Under the Final 704(b) Regulations, however, a partner is not required to be allocated income under a minimum gain chargeback:

- 1) to the extent his share of the net decrease in minimum gain is caused by a guarantee, refinancing or other change in the debt instrument causing the liability to become a recourse liability and the partner bears the economic risk therefor;
- 2) to the extent he contributes capital to the partnership, such cash is used to repay the nonrecourse liability or increase the adjusted basis of partnership assets, and his share of the net decrease in minimum gain results from the debt repayment or the basis increase; or
- 3) the chargeback would cause a distortion in the economic arrangement among the partners and it is not expected that the partnership will have sufficient amounts of future income to correct the distortion and the IRS at the

request of the partnership, waives the minimum gain chargeback requirement.<sup>45</sup>

As a result of these exceptions, no minimum gain allocation would be required to Steven in 1993, even if the Partnership experiences a \$1.5 million net decrease in its minimum gain and Steven's share of the net decrease is \$750,000.

**Partners' Shares of Net Decrease In Partnership's Minimum Gain.** While an exception to the minimum gain chargeback requirement is appropriate for partners who make economic investments in or in respect of properties secured by nonrecourse liabilities, distortions in the partners' economic arrangement are possible under the new Final 704(b) Regulations. The risk of these distortions is created because a partner's economic investment in a nonrecourse property is not necessarily accompanied by an equal reduction in his share of the partnership's minimum gain for the nonrecourse property. If there are insufficient amounts of partnership income to restore nonrecourse deductions previously claimed by the non-contributing partners with respect to the property, the non-contributing partners' capital accounts and their interests in other partnership assets will, in effect, be economically subordinated to the contributing partner's capital account interest in those other assets.

To illustrate, the following chart assumes the Partnership does not elect to revalue its assets on Steven's capital contribution, and summarizes relevant capital account activity for Steven and Brian prior to the partial debt repayment on January 1, 1993:

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<sup>45</sup> Treas. Reg. §§ 1.704-2(f)(2) to -2(f)(4). Treas. Reg. § 1.704-2(f)(4) states that the IRS will not waive a minimum gain chargeback requirement unless the facts demonstrate that the partners have made capital contributions or received net income allocations that have restored prior allocations of nonrecourse deductions or distributions of nonrecourse loan proceeds and the imposition of the chargeback would distort the partners' economic arrangement. The intended coverage of this provision is illustrated by Treas. Reg. § 1.704-2(f)(7), Example 1.

	Steven		Brian		Building	
	Capital Account	Minimum Gain	Capital Account	Minimum Gain	Basis	Debt
January 1, 1984	\$0	\$0	\$0	\$0	\$5.0	\$5.0
1984-1992 Loss Allocations	<u>-1.50</u>	<u>1.50</u>	<u>-1.50</u>	<u>1.50</u>	<u>-3.0</u>	<u>-</u>
	-1.50	1.50	-1.50	1.50	2.0	5.0
Capital Contribution	<u>1.50</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
	0	1.50	-1.50	1.50	2.0	5.0
Debt Repayment	<u>-</u>	<u>-.75</u>	<u>-</u>	<u>-.75</u>	<u>-</u>	<u>-1.5</u>
January 1, 1993	<u>\$0</u>	<u>\$ .75</u>	<u>-\$1.50</u>	<u>\$ .75</u>	<u>\$2.0</u>	<u>\$3.5</u>

The \$1.5 million deficit balance in Steven's capital account on December 31, 1992, would be eliminated as a result of his capital contribution. Brian's capital account balance, however, would be unaffected. The Partnership's Section 704(b) minimum gain would be reduced from \$3 million to \$1.5 million immediately after the Nonrecourse Loan is partially repaid. If this decrease is the only change in the Partnership's minimum gain for 1993, each partner's share of this net decrease, determined by reference to their respective 50% shares of minimum gain as of December 31, 1992, would be \$750,000. Each partner's share of minimum gain therefore would be reduced by only \$750,000, even though Steven's entire capital contribution (\$1.5 million) is applied by the Partnership to reduce its nonrecourse debt. In effect, \$750,000 of Steven's capital contribution is being accounted for as if it were invested in Partnership assets with respect to which Brian was previously allocated nonrecourse deductions.

Unless and until the subsequent operations of the Building are sufficiently successful to add \$750,000 of additional capital to the Partnership, Brian's capital account interest in other unrelated Partnership assets will be economically junior to Steven's capital account interest. To illustrate, assume the Partnership recognizes less than \$750,000 of income and gain (*i.e.* the mandatory allocation to Brian under the minimum gain chargeback) prior to the Building's

sale and the Partnership's liquidation. Upon a sale of the Building for its \$3.5 million debt, Steven would be allocated gain from the sale, because his share of the partnership minimum gain would be reduced to zero by the sale. This allocation would result in the following capital account adjustments:

	Steven		Brian		Building	
	Capital Account	Minimum Gain	Capital Account	Minimum Gain	Basis	Debt
January 1, 1993	\$0	\$.75	-\$1.50	\$.75	\$2.0	\$3.5
Sale For Debt	<u>.75</u>	<u>-.75</u>	<u>.75</u>	<u>-.75</u>	<u>-2.0</u>	<u>-3.5</u>
Ending	<u>\$.75</u>	<u>\$0</u>	<u>-\$ .75</u>	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>

In effect, Steven's capital account would reflect a \$750,000 economic interest in other Partnership assets, and Brian would suffer a \$750,000 diminution of his capital account interest in other Partnership assets.

If the Final 704(b) Regulations had provided that Steven's share of the Partnership's net decrease in minimum gain was \$1.5 million instead of \$750,000, this economic distortion would have been avoided. In that event, no minimum gain allocation would have been made to Brian in 1993, and on the liquidating sale of the Building, 100% of the remaining minimum gain would have been allocated to Brian. Such an allocation would have completely restored Brian's capital account balance to zero, and avoided an unintended economic benefit to Steven.

The authors believe that these types of economic distortions can be avoided only if the Final 704(b) Regulations are amended to redefine the manner in which the partners are to be allocated the net decrease in the partnership's minimum gain in this context. Specifically, net decreases in minimum gain caused by any event described in a minimum gain chargeback exception should be attributed to the specific partner entitled to the benefit of the exception. In the absence of such an amendment, the tax advisor must be mindful of the potential need to request an offsetting allocation waiver from the IRS.

**Timing Of Deemed Cash Distributions.** Partial repayment of the Nonrecourse Loan on January 1, 1993, also would cause an additional \$1.5 million deemed cash distribution to the partners. Under the Final 752 Regulations, Brian's share of this deemed distribution would be \$750,000, \$650,000 greater than the adjusted tax basis of his Partnership interest immediately after the dilution of his interest in the Partnership's profits from 50% to 5%. An unresolved issue involves the tax consequences of this distribution to Brian under Section 731(a)(1). Section 731(a)(1) looks to the distributee partner's adjusted tax basis "*immediately before the distribution,*" and might be interpreted as requiring Brian's mid-year recognition of taxable income, even though the decrease in his share of the Nonrecourse Loan (as a result of the partial repayment) would also have been matched by a year-end minimum gain allocation under the Final 704(b) Regulations.

The resolution of this issue depends on whether the deemed cash distribution should be treated as occurring, for purposes of Section 731(a)(1), at the time of the debt repayment or at the end of the year immediately after giving effect to minimum gain allocations under the Final 704(b) Regulations. This issue has never been directly addressed by the IRS or the courts.

Indeed, prior to dramatic changes made to the minimum gain chargeback rules in the Final 704(b) Regulations, this issue never required the attention of the IRS or the courts. To explain, if a Section 754 election were in effect for 1993, the Partnership generally would be entitled to increase its assets' adjusted tax bases under Section 734(b) as a result of any gain recognized by Brian under Section 731(a)(1). Brian, in turn, generally would be entitled to increase the balance of his capital account as a result of the special basis.<sup>46</sup> Under the Temporary 704(b) Regulations, this capital account adjustment would have operated to ensure that Brian's capital account balance would not have been impermissibly negative, and therefore the minimum gain chargeback of

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<sup>46</sup> See Treas. Reg. § 1.704-1(b)(2)(iv)(m)(4).

the Temporary 704(b) Regulations would not have applied.<sup>47</sup> The Final 704(b) Regulations are the first edition of Section 704(b) regulations that require minimum gain chargebacks without regard to whether a partner's capital account is impermissibly negative.

For other purposes, the IRS has ruled that the tax consequences of deemed cash distributions must be considered at the time they occur.<sup>48</sup> On the other hand, it seems possible to conclude that deemed cash distribution caused by shifts in nonrecourse liabilities should be treated as occurring at the end of the year. Treas. Reg. § 1.731-1(a)(1)(ii) provides that partnership advances and draws against a partner's distributive share of partnership income are not required to be treated, for purposes of Section 731(a)(1), as distributed until the last day of the taxable year. Treas. Reg. § 1.752-4(d) provides that a partner's share of a partnership's nonrecourse liabilities must be determined whenever such determination is necessary to determine the partner's tax liability, and Treas. Reg. § 1.705-1(a)(1) also provides that a partner's adjusted tax basis in his partnership interest is determined whenever necessary to determine his tax liability, and that this determination is ordinarily made at the end of the partnership's taxable

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<sup>47</sup> Under the Temporary 704(b) Regulations, the amount of income to be allocated under a minimum gain chargeback was equal to the *greater* of (i) if the decrease in minimum gain was attributable to a *disposition of property*, the decrease in the partner's share of minimum gain that was allocable thereto, or (ii) the excess of the deficit balance in his capital account (determined as of the end of the year) over the sum of (A) his remaining share of Section 704(b) minimum gain, plus (B) any amount he was obligated to restore to his negative capital account under Treas. Reg. § 1.704-1(b)(2)(ii)(c). See Treas. Reg. § 1.704-1T(b)(4)(iv)(e) (1991). A partial debt repayment did not involve a *disposition* of property. Therefore, under the Temporary 704(b) Regulations, an allocation of minimum gain was triggered as a result of a partial debt repayment only to the extent that the repayment caused a partner's capital account balance to be impermissibly negative. If reductions in a partner's share of minimum gain (triggered by debt repayments) were matched with reductions in the deficit balance of his capital account (triggered by capital account adjustments for gain recognized under Section 731(a)(1)), no minimum gain allocation was required.

<sup>48</sup> See Rev. Rul. 81-242, 1981-2 C.B. 147 (partners recognized gain under Section 731(a)(1) as a result of the partnership's repayment of debt with condemnation proceeds even though the partnership subsequently purchased replacement property under Section 1033 which was subject to debt).

year. Moreover, commentators have suggested that the effect of deemed cash distributions should not be tested until the end of the year.<sup>49</sup> The authors understand that IRS and Treasury Department representatives have reacted sympathetically to practitioners' suggestions that partners could, in effect, be taxed twice in this manner, and have suggested that corrective action or guidance may be issued addressing this issue.<sup>50</sup>

**Scenario Two Summary.** Because the Partnership was formed prior to December 30, 1988, the Former 704(b) Regulations generally will apply to the Partnership in 1993. Provided the Partnership's properties (and the partners' capital accounts) are revalued, the reduction in the Partnership's Section 704(b) minimum gain would not trigger minimum gain allocations to either partner under the Former 704(b) Regulations, because neither partner's capital account balance would be impermissibly negative. Nevertheless, partial repayment of the Nonrecourse Loan would cause a \$1.5 million deemed cash distribution to the partners under Section 752. Brian's share would reduce his adjusted tax basis in his Partnership interest to zero, and trigger \$650,000 of immediate taxable income under Section 731(a)(1).

An interesting question arises as to whether the Partnership's partnership agreement would be "materially modified" for Section 704(b) purposes as a result of Steven's contribution of capital and the dilution of Brian's interest in the Partnership. If so, the Final 704(b) Regulations would begin to apply to the Partnership as of January 1, 1993. It could be argued that Brian's dilution would occur automatically pursuant to pre-existing terms and provisions of an existing partnership agreement, and the existing agreement itself would

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<sup>49</sup> See Willis, Pennell, and Postlewaite, *Federal Taxation of Partnerships and Partners* (1989), §§ 67.06, 132.03; Lipton, *supra* note 39, at 285, n. 77; but see McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners* (2d ed. 1990), at ¶ 19.03[2].

<sup>50</sup> Even if the Section 731(a)(1) determination is properly made at the end of the year following minimum gain allocations for the year, Brian still faces the risk of double taxation if the Partnership does not have a sufficient amount of income items to allocate pursuant to the minimum gain chargeback for 1993, thereby causing the minimum gain chargeback to operate in future years until its mission is fully satisfied.

not be modified. On the other hand, Steven's capital contribution undoubtedly would alter the partners' respective rights to the Partnership's capital and profits. Whether altering the partner's rights and liabilities in their partnership, pursuant to admittedly pre-conceived and established mechanics, could avoid being treated as a material modification of the partnership agreement is doubtful.

If the Final 704(b) Regulations apply in 1993 as a result of Brian's dilution and Steven's investment, it seems likely that a minimum gain chargeback would require a \$750,000 minimum gain allocation to Brian in 1993. Unless the deemed cash distribution attributable to the partial repayment of the Nonrecourse Loan may be treated, for purposes of Section 731(a)(1), as occurring at the end of 1993 immediately after this minimum gain allocation, Brian also would be required to recognize \$650,000 of additional taxable income in 1993.

**SCENARIO THREE - GUARANTY OF NONRECOURSE LOAN.** *In lieu of contributing cash to the Partnership, Steven persuades the Lender to accept, effective as of January 1, 1993, Steven's personal guaranty of 50% of the Nonrecourse Loan. Brian's interest in Partnership profits is simultaneously diluted from 50% to 5%.*

Like the preceding Scenarios, the combination of Brian's dilution and Steven's additional economic commitment will have different tax consequences depending on which versions of the Section 704(b) and 752 regulations apply to the Partnership and the Nonrecourse Loan as of January 1, 1993.

**Former 752 Regulations.** The Former 752 Regulations did not address whether partner-guaranteed liabilities should be treated as "nonrecourse" liabilities or how such liabilities should be allocated among the partners. In *Raphan v. United States*, the Federal Circuit Court of Appeals held, however, that limited partners were not permitted to include in the adjusted tax bases of their partnership interests any portion of an otherwise nonrecourse liability which had



been guaranteed by a partner.<sup>51</sup> In addition, in Revenue Ruling 84-118,<sup>52</sup> the IRS ruled that an otherwise nonrecourse, partner-guaranteed liability was a "recourse" liability allocable solely to the guarantor partner, but only to the extent of the guaranteed portion of the liability.

If the Former 752 Regulations apply to the Nonrecourse Loan as of January 1, 1993, and the rationale of *Raphan* and Revenue Ruling 84-118 is followed, Steven's guaranty would cause 50% of the loan to be converted to a "recourse" liability for Section 752 purposes, all of which would be allocable to Steven. The continuing "nonrecourse" portion of the loan would be allocable to both partners.

Presumably, the allocation of the \$2.5 million non-guaranteed portion of the Nonrecourse Loan would be made in accordance with the partners' revised sharing ratios. Under these circumstances, Brian's share of the Nonrecourse Loan would decrease from \$2.5 million before the restructuring to \$125,000 (5% of \$2.5 million), a \$2.375 million reduction.

The terms of Steven's guaranty might limit his liability to the Lender to the amount by which the Building's fair market value declines below \$2.5 million and the Partnership's other assets are insufficient to satisfy the Nonrecourse Loan. Under these circumstances, it seems clear that the Lender alone would bear the economic risk that the Building's fair market value might decline from \$5 million to \$2.5 million. Thus, it could be argued that Steven has guaranteed only the "bottom" 50% of the Nonrecourse Loan, and the "top" 50% of the loan continues to be a nonrecourse liability. Because Brian's share of the

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<sup>51</sup> 759 F.2d 879 (Fed. Cir. 1985), *rev'g*, 83-2 U.S.T.C. § 9613 (Cl.Ct. 1983). See also Rev. Rul. 83-151, 1983-2 C.B. 105. Although *Raphan* and Rev. Rul. 83-151 stand for the rule that a partner-guaranteed loan should not be treated as a "nonrecourse" liability for Section 752 purposes, it is possible that other courts might reach a different conclusion under the Former 752 Regulations, particularly if the guaranty arises many years after a true "nonrecourse" loan originally was made. For example, a different conclusion by the lower court in *Raphan* initially prompted Congress in 1984 to direct the Treasury Department to revise the Former 752 Regulations.

<sup>52</sup> 1983-2 C.B. 105.

deductions attributable to the nonrecourse portion of the loan (*i.e.*, the first \$2.5 million of deductions attributable to the Building) was 50%, and presumably Brian's share of Partnership income used to repay the nonrecourse portion of the loan would be 50%, it seems reasonable to take the position that Brian's share of the post-guaranty nonrecourse portion of the loan should be 50% under the Former 752 Regulations, or \$1.25 million. Consistent with this rationale, Brian's share of the Nonrecourse Loan would be reduced, but only by \$1.25 million.

This analysis of Brian's "share of the partnership's profits" under the Former 752 Regulations appears reasonable, provided items of the Partnership's gross income are required to be allocated to Steven and Brian in accordance with their old 50-50 sharing ratios as and when the Partnership repays the "top" 50% nonrecourse portion of the Nonrecourse Loan. If gross income is actually required to be allocated in this manner, it could be reasoned that Brian's share of the actual "profits" of the Partnership used to repay the nonrecourse portion of the loan was 50%, and therefore, Brian should be entitled to a 50% share of the nonrecourse portion.<sup>53</sup>

This analysis of Brian's "share of the partnership's profits" under the Former 752 Regulations, while reasonable, in effect adopts an ordering concept for liabilities of different priorities (*i.e.* "top" versus "bottom") and an informal version of a minimum gain chargeback to adjust the partners' capital accounts for Steven's economic risk of loss associated with specific declines in the Building's value. In theory, it should be noted that this ordering concept and minimum gain chargeback are similar to the concepts used in the "constructive liquidation" analysis of the Final 752 Regulations. In both cases, the goal is the measurement of the partners' economic risks of loss.

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<sup>53</sup> Unfortunately, this argument would require a good degree of foresight on the part of the Partnership's original tax advisors. If the Partnership's partnership agreement is amended as of January 1, 1993, to provide for gross income allocations of this nature, it presumably will be treated as "materially modified" as of this date. Regardless of whether Brian's "automatic" dilution is a material modification of the Partnership's partnership agreement for Section 704(b) purposes, this "gross income" amendment should trigger the applicability of the Final 704(b) Regulations to the Partnership as of January 1, 1993.

The Former 752 Regulations embodied neither concepts of economic risk of loss, ordering concepts for liabilities of different priorities, nor minimum gain chargebacks. Accordingly, it seems reasonable for Brian to argue that he should be entitled to share 50% of the nonrecourse portion of the Nonrecourse Loan -- regardless of "top" or "bottom" priority characterizations -- provided items of the Partnership's gross income are required to be allocated to the partners in accordance with their old 50-50 sharing ratios as and when the Partnership repays the nonrecourse portion of the loan.

Unless any deemed cash distribution to Brian (regardless of whether the amount of the deemed distribution is \$2.375 million or \$1.25 million) may be treated, for Section 731(a)(1) purposes, as occurring at the end of 1993 immediately after any allocations of income pursuant to a minimum gain chargeback, Brian would be required immediately to recognize as taxable income any portion of such distribution in excess of \$1 million.

**Final 752 Regulations.** Under the Final 752 Regulations, a single partnership liability may be bifurcated and treated as part "nonrecourse" and part "recourse."<sup>54</sup> Different methods of allocating the liability among the partners apply to the separate portions of the liability. Partners' shares of a nonrecourse liability are determined pursuant to the multi-tier rules discussed above. A liability is recourse to the extent that any partner or related person bears the economic risk of loss for the liability,<sup>55</sup> and a partner's share of a recourse liability is that portion of the liability for which he bears the economic risk of loss.<sup>56</sup>

If the Final 752 Regulations apply to the Nonrecourse Loan as of January 1, 1993, the \$2.5 million portion that is guaranteed by

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<sup>54</sup> Treas. Reg. § 1.752-1(i).

<sup>55</sup> Treas. Reg. § 1.752-1(a)(1).

<sup>56</sup> Treas. Reg. § 1.752-2(a).

Steven would be treated as "recourse" and allocated 100% to Steven.<sup>57</sup> The \$2.5 million non-guaranteed portion would continue to be treated as "nonrecourse."

If the Partnership elects not to revalue its assets in connection with Steven's guaranty and Brian's dilution, the \$2.5 million decrease in the Partnership's "nonrecourse" liability would trigger a reduction in Section 704(b) minimum gain from \$3 million to \$500,000. Each partner's share of this decrease (determined by reference to their 50% shares of minimum gain on December 31, 1992) would be \$1.25 million, and their shares of the remaining Section 704(b) minimum gain would be \$250,000.

Under these circumstances, the amount of the Partnership's first tier nonrecourse liability would be equal to \$500,000, \$250,000 of which would be shared by each partner. The remaining \$2 million of excess nonrecourse liability presumably would be allocated \$1.9 million to Steven and \$100,000 to Brian. Thus, as a result of Steven's guaranty and the dilution of Brian's partnership interest, Brian's share of the Nonrecourse Loan would be reduced from \$2.5 million to \$350,000, and a \$2.15 million deemed cash distribution to Brian would occur.

If Section 731(a)(1) is interpreted as requiring mid-year recognition of income, Brian would be taxed twice in 1993, because the deemed distribution exceeded the adjusted tax basis in his partnership interest "*immediately before the distribution*" by \$1.15 million. On the other hand, if the deemed distribution may be interpreted as occurring, for Section 731(a)(1) purposes, at the end of 1993 after giving effect to mandatory minimum gain allocations for the year, Brian's pre-distribution basis in his Partnership interest would be increased to \$2.25 million as a result of a \$1.25 million minimum gain chargeback. The \$2.15 million distribution would reduce his adjusted tax basis to

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<sup>57</sup> If 50% of the Nonrecourse Loan instead were guaranteed by a person related to Steven, Steven also would be allocated 100% of the guaranteed portion of the debt. These conclusions assume that Brian would not be obligated to restore any deficit balance in his capital account and that Steven would not be entitled to any reimbursement from Brian if he were called upon to honor his guaranty. See Treas. Reg. §§ 1.752-2(b)(3)(i), -2(b)(5).

\$100,000, but would not trigger the recognition of any additional taxable income under Section 731(a)(1).

**Final 704(b) Regulations.** If the Final 704(b) Regulations apply to the Partnership in 1993, but neither the Final nor the Temporary 752 Regulations apply to the Nonrecourse Loan as of January 1, 1993, detailed attention must be accorded to special treatment accorded by the Final 704(b) Regulations to grandfathered liabilities.

As discussed above, the Final 704(b) Regulations contain a special rule for deductions attributable to partner-guaranteed nonrecourse liabilities incurred by a partnership prior to March 1, 1984. These so-called (l)(3) liabilities are bifurcated and treated partly as nonrecourse liability and partly as partner nonrecourse debt. Steven's guaranty of 50% of the Nonrecourse Loan on January 1, 1993, would cause the Nonrecourse Loan to become an (l)(3) liability, and therefore bifurcated for Section 704(b) purposes.

The non-guaranteed amount, plus that portion of the guaranteed amount equal to the pre-1987 depreciation deductions claimed in respect of the Building would be treated, for Section 704(b) purposes, as a third-party nonrecourse liability. The remaining portion of the guaranteed amount (equal to the post-1986 deductions attributable to the loan) would be recharacterized as partner nonrecourse debt. As a result, it appears that the Partnership would suffer a substantial decrease in its minimum gain (from \$3 million prior to the restructuring to the portion of the loan that continues to be treated as a nonrecourse liability).

Brian, having suffered a reduction in his share of minimum gain, would have to be allocated items of Partnership income pursuant to a minimum gain chargeback. On the other hand, the Partnership would not be required to make any minimum gain allocation to Steven, even though his share of the Partnership's minimum gain also declined.<sup>58</sup>

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<sup>58</sup> Treas. Reg. § 1.704-2(f)(2) (a partner is not subject to the minimum gain chargeback requirement to the extent his share of the net decrease in minimum gain is caused by a guaranty and the partner bears the economic risk loss for the newly guaranteed debt). See Treas. Reg. § 1.704-2(f)(7) Example 2. The amount of Steven's

**Scenario Three Summary.** Based on the various Section 704(b) and 752 transition rules, it seems clear that Steven's guaranty would not, in and of itself, cause the Final 752 Regulations to apply to the Nonrecourse Loan. Rather, the Former 752 Regulations would continue to apply to the Nonrecourse Loan, unless the Partnership has validly elected to apply the Final 752 Regulations or the loan is "materially modified" in some manner other than by providing Steven's guaranty.

Brian would recognize a significant amount of taxable income under Section 731(a)(1) unless the Nonrecourse Loan could be treated under the Former 752 Regulations as a nonrecourse liability (at least to the extent of the partners' negative capital accounts). Otherwise, Brian will be deemed to receive a substantial distribution of cash under Sections 752(b) and 733(l).

Even if Brian can avoid these potential basis traps, Brian must still consider the effect of Section 704(b). Steven's guaranty would cause a part of the guaranteed portion of the Nonrecourse Loan (equal to the post-1986 deductions attributable to the guaranteed portion) to be recharacterized as partner nonrecourse debt for Section 704(b) purposes. Thus, post-1992 deductions attributable to the guaranteed portion would thereafter be allocable 100% to Steven, and Partnership income equal to Brian's share of the post-1986 deductions attributable to the guaranteed portion would have to be allocated to him in 1993 pursuant to a minimum gain chargeback. Brian, however, would not be required to recapture, pursuant to the minimum gain chargeback, any of the pre-1987 deductions claimed by him, until the Nonrecourse Loan is repaid.

If a person related to Steven were to guaranty the Nonrecourse Loan instead of Steven and the Partnership has consistently treated the Nonrecourse Loan as a nonrecourse liability, Brian might argue, based on a literal interpretation of the last sentence of Section 1.704-2(l)(2) of the Final 704(b) Regulations and the fact that the Nonrecourse Loan was incurred prior to January 30, 1989, that the guaranty should be

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share of the decrease in minimum gain will depend on whether the Former or Final 752 Regulations apply to the Nonrecourse Loan following his guaranty.

disregarded for Section 704(b) purposes.<sup>59</sup> If this argument is successful, the guaranty would have no minimum gain implications to Brian. Whether this argument would succeed is not certain, however.

**SCENARIO FOUR - ADMISSION OF NEW PARTNER.** *As of January 1, 1993, the fair market value of the Building declines to \$4 million, and neither Steven nor Brian is willing to fund any portion of the Partnership's operating deficit. The Partnership therefore solicits additional funding from third-parties. After extensive negotiations, Parker is admitted to the Partnership in consideration of his agreement to fund all future operating deficits. Under the revised partnership agreement, Parker is entitled to receive a preferential return on, and of, his capital contributions, together with 95% of the profits attributable to the Building. The interests of Steven and Brian in the residual profits of the Partnership are simultaneously reduced to 2.5% each.*

Parker's participation can be structured in one of at least two ways:

- 1) Parker can be admitted to the Partnership and become a partner directly therein, or
- 2) Parker and the Partnership can form a new partnership ("Sub-Partnership") with Parker contributing cash and the Partnership contributing the Building to the new Sub-Partnership.

As illustrated below, these alternatives can have drastically different results for the parties.

If Parker is admitted directly as a partner of the Partnership, the partnership agreement would be amended and the existing partners'

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<sup>59</sup> See notes 28-29 *supra* and accompanying text.

percentage interests in partnership profit and loss would be reduced. The same considerations would apply in this case as were taken into account in Scenario One where Steven agreed to fund the Partnership's deficit.

On the other hand, Parker may wish to avoid undisclosed or unknown liabilities of the old Partnership. In that case, Parker would probably insist that the alternative structure involving the new Sub-Partnership be utilized. If this technique is employed, the same type of analysis would be required, with special consideration to the impact of Section 752(c). The Sub-Partnership's initial book basis in the Building would be equal to the Building's \$4 million fair market value, and the Partnership's initial capital account in the Sub-Partnership would be zero.<sup>60</sup> The Partnership's adjusted tax basis in the Sub-Partnership would carry over from its \$2 million basis in the Building, adjusted by any deemed cash contributions or distributions under Section 752.

The Nonrecourse Loan, in the hands of the Sub-Partnership, would be allocated under the multi-tier nonrecourse rules of the Final 752 Regulations.<sup>61</sup> Section 752(c) provides, however, that a liability to which a property is subject shall be deemed to be the liability of the property's owner only to the extent of the property's fair market value. Section 752(c) could be interpreted as requiring the Sub-Partnership to

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<sup>60</sup> See Treas. Reg. §§ 1.704-1(b)(2)(iv)(b)(2), -1(b)(2)(iv)(d)(1) (Section 7701(g) does not apply in determining fair market value of contributed property). See generally McKee, Nelson & Whitmire, *supra* note 49, at ¶ 7.04[3]; Burke, "Partnership Formation Under the Temporary Section 752 Regulations: A Reply and Further Discussion," 69 *Taxes* 116, 125 (Feb. 1991); Lokken, "Contributions of Overencumbered Property: A Reply and Further Discussion," 5 *J. Partnership Tax.* 242, 243 (Fall 1988); but see Carman & Brown, "Another Look at Accounting for Contributions of Overencumbered Property: Turning Basis Inside Out," 7 *J. Partnership Tax.* 192, 193-94 (Summer 1990) (contributing partner's initial capital account should be equal to fair market value of contributed property less the total amount of nonrecourse debt secured thereby).

<sup>61</sup> For purposes of determining whether the Final 752 Regulations apply to a partnership liability, the partnership is treated as assuming or incurring a secured nonrecourse liability when the property securing the liability is contributed to the partnership. This is the result, even if the contributing partner is itself a partnership that originally assumed or incurred the liability prior to December 28, 1991.



be treated as acquiring the Building subject only to that portion of the Partnership's nonrecourse debt that did not exceed the Building's \$4 million fair market value. Although not entirely clear, it appears that the \$1 million of excess nonrecourse debt should be deemed to remain outside the Sub-Partnership at the Partnership level. If this interpretation of Section 752(c) is correct, the \$1 million of excess debt would remain a liability of the Partnership which arguably continues to *burden* its partnership interest in the Sub-Partnership.<sup>62</sup> Thus, the Sub-Partnership's total amount of nonrecourse liabilities apparently would be \$4 million.

Although the Final 704(b) Regulations would apply to the new Sub-Partnership, no Section 704(b) minimum gain would initially exist

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<sup>62</sup> See Burke, *supra* note 60, at 125; Stafford, "Section 752(c): The Other Issue in *Tufts v. Commissioner*, 42 *Tax Lawyer* 93 (Fall 1988). It has been suggested that while Section 752(c) may limit the amount of liabilities deemed taken subject to by the Sub-Partnership, the old Partnership nevertheless should be deemed relieved of the entire liability for purposes of determining its basis in its interest in the subpartnership. See Burke, *supra* note 60, at 125; Andrews, "On Beyond *Tufts*," 61 *Taxes* 949, 958-59 (Dec. 1983). The latter theory seems incongruous, however, because it would effectively result in the excess portion of the debt vanishing both inside and outside the partnership (*i.e.*, such amount would not be considered a liability of either the old partnership or the subpartnership). Such a conclusion would thus ignore the fact that the liability does exist and that it burdens the property. The better view, therefore, is that by virtue of Section 752(c), the excess portion of the debt should be deemed to be a continuing liability of the old partnership that is "secured" by its interest in the subpartnership. Another interesting application of this concept is found in the recently promulgated proposed regulations under Section 707(a)(2)(B) (PS-163-84, Apr. 25, 1991). Under Prop. Reg. § 1.707-5(a), if property is contributed to a partnership subject to nonrecourse debt and the amount of the debt exceeds the then fair market value of the property, the debt will be treated as a *qualified liability* only to the extent it does not exceed the fair market value of the property. As is the case with contributions and distributions of property to which Section 752(c) applies, Prop. Reg. § 1.707-5(a) fails to state how the excess amount of the debt is to be treated. Some practitioners are fearful that this regulation might result in a contribution of an overencumbered property being treated as a taxable sale under Section 707(a)(2)(B) notwithstanding the fact that the contributing partner has not received cash or been relieved of any debt as a result of the contribution. It is hoped that this fear is unfounded and that the Treasury Department will clarify that contributions of overencumbered assets do not result in adverse tax consequences to the contributing partner under Section 707(a)(2)(B) or otherwise under Subchapter K.

at the Sub-Partnership level, because the Sub-Partnership's book basis in the Building would be equal to the total amount of the Sub-Partnership's nonrecourse debt (\$4 million). Instead, the Partnership's transfer of the Building to the Sub-Partnership would be subject to Section 704(c). Mandatory elimination of the \$2 million book-tax difference attributable to the Building and the Partnership would be required with special allocations of Sub-Partnership income and deductions. Thus, while the Sub-Partnership's first tier of nonrecourse liability would be zero, its second tier initially would be \$2 million, all of which would be allocable to the Partnership under the Final 752 Regulations. The remaining \$2 million of excess nonrecourse liabilities presumably would be allocable \$1.9 million to Parker and \$100,000 to the Partnership.

The Partnership's share of nonrecourse debt would be reduced from \$5 million to \$3.1 million (\$1 million at the Partnership level and \$2.1 million at the Sub-Partnership level). The resulting \$1.9 million deemed cash distribution would reduce its adjusted tax basis in its partnership interest in the Sub-Partnership from \$2 million to \$100,000. Thus, the Partnership should not have to recognize any immediate gain under Section 731(a)(1).<sup>63</sup> Moreover, the Partnership's "historic" \$3 million of minimum gain initially would be preserved at the Partnership level, despite the contribution of the Building to the Sub-Partnership, because the Partnership's share of the Sub-Partnership's nonrecourse debt (\$2.1 million) plus the excess portion of the debt deemed owed by the Partnership outside the Sub-Partnership (\$1 million) would exceed its adjusted tax basis in its partnership interest in the Sub-Partnership (\$100,000) by \$3 million.<sup>64</sup>

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<sup>63</sup> As the Partnership's share of the Sub-Partnership's debt is shifted over time to Parker, however, the Partnership (and thus Steven and Brian) will be required to recognize income as the amount of deemed cash distributions exceed its adjusted tax basis in its partnership interest.

<sup>64</sup> If the excess \$1 million nonrecourse debt is not taken into account under Section 752(c) in the manner described in the text, it appears that the Partnership's minimum gain would be deemed to decrease, which could trigger a minimum gain chargeback to Steven and Brian at the Partnership level. If, however, Steven's and Brian's sharing percentages apply to all items of Partnership income and gain and are not affected by the restructuring, it does not appear that minimum gain allocations would have any

A yet unanswered question is the extent to which the proposed regulations under Section 707(a)(2)(B) may change these results. It appears that these regulations should be totally inapplicable to the Sub-Partnership so long as the debt secured by the contributed Building was incurred more than two years prior to the contribution or was incurred to purchase the Building.<sup>65</sup> The result seems less clear, however, if the Sub-Partnership simultaneously pays down part of the nonrecourse debt with cash contributed by Parker. Hopefully, the Treasury Department will clarify these matters when the proposed regulations under Section 707(a)(2)(B) are finalized.

**SCENARIO FIVE - ADMISSION OF LENDER TO THE PARTNERSHIP.** *Negotiations with third parties are unsuccessful, and the Lender becomes uncomfortable with the prospect of Steven and Brian continuing to exercise control over the Building and the Partnership. The Lender demands to be admitted (either directly or through an affiliate) as a partner in the Partnership.*

If the Lender (or an affiliate) were admitted to the Partnership, additional tax considerations would apply.<sup>66</sup>

**Section 752 Regulations.** As always, the initial tax issue for consideration is which set of Section 752 regulations would apply to the Nonrecourse Loan following an admission of the Lender (or affiliate of the Lender) to the Partnership. If the Final 752 Regulations were to apply to the Nonrecourse Loan and neither Steven nor Brian guarantees the loan, the liability would be allocated 100% to the Lender, and each pre-existing partner's share of the loan would be reduced from \$2.5

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impact different from "routine" allocations of operating income.

<sup>65</sup> Prop. Treas. Reg. §§ 1.707-5(a)(6)(i)(A), -5(a)(6)(i)(B).

<sup>66</sup> The discussion which follows assumes that the admission of the Lender to the Partnership may be effected on a tax free basis either under the common law equity for debt exception to noncancellation of indebtedness income or pursuant to Section 721. For a further discussion of these issues, see Frankel, "Tax Planning for Troubled Real Estate and Partnership Transactions - Part 1," 19 *J. Real Est. Tax.* 285, 309-310 (Summer 1992).

million to zero. The resulting deemed cash distributions to Steven and Brian would cause each of them to recognize \$1.5 million of taxable income under Section 731(a)(1).<sup>67</sup>

Neither the Section 752 regulations nor the regulatory preambles provide any specific guidance for analyzing the Section 752 consequences of a lender's admission to a partnership. Following a lender's admission to a partnership, however, it could be argued that the liability is analogous to a direct partner loan or liability directly guaranteed by a partner. According to the preamble to the Final 752 Regulations, direct partner guaranties of a pre-March 1, 1984 loan like the Nonrecourse Loan will not cause the Final 752 Regulations to apply to the loan, even if the guaranty is provided on or after December 28, 1991.

Based on the preamble to the Final 752 Regulations, it appears reasonable for Steven and Brian to take the position that the Lender's admission (or the admission of the Lender's affiliate) to the Partnership on January 1, 1993, should not cause the Final 752 Regulations to apply to the Nonrecourse Loan. Unfortunately, how the Nonrecourse Loan would be treated under the Former 752 Regulations is unclear.

The foregoing analysis assumes that the Nonrecourse Loan remains intact and is not canceled or otherwise materially modified in

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<sup>67</sup> Treas. Reg. § 1.752-2(c). However, if the Lender receives less than a 10% interest in all items of Partnership income and loss and the Lender is either a governmental unit or a qualified lender, *i.e.*, is actively and regularly engaged in the business of lending money and was not the seller of the encumbered property, the Nonrecourse Loan will be treated as a nonrecourse liability notwithstanding the Lender's admission to the Partnership. Treas. Reg. § 1.752-2(d)(1). It should be noted that the 10% *de minimis* rule apparently can not be satisfied if the Lender were to become a general partner and Steven and Brian were converted to limited partners in the absence of an agreement by Steven and Brian to restore any deficit balances in their capital accounts upon the liquidation of the Partnership. The only way Steven or Brian could continue to include a portion of the Nonrecourse Loan in basis would be for such partner to guarantee a portion of such loan. Thus, by guarantying either the *top* or *bottom* portion of the Nonrecourse Loan, Steven and/or Brian could continue to include a sufficient amount of the loan in basis to avoid gain recognition under Section 731(a)(1).

connection with the admission of the Lender (or its affiliate) to the Partnership. If the Nonrecourse Loan is contributed to the Partnership and thereby canceled, Steven's and Brian's respective shares of the Partnership's liabilities would be reduced to zero. If the loan remains outstanding but is materially modified, the Final 752 Regulations would begin to apply.

In either case, Steven and Brian could be deemed to receive large cash distributions, resulting in immediate taxable income under Section 731(a)(1). Careful consideration must be given to whether Section 731(a)(1) should be applied at the time the Lender is admitted to the Partnership, or at the end of the taxable year.

**Applicability of Final 704(b) Regulations.** The Final 704(b) Regulations will begin to apply to the Partnership when its partnership agreement is amended to admit the Lender (or the Lender's affiliate) as a partner. If the Partnership experiences a net decrease in its Section 704(b) minimum gain for 1993 as a result of the restructuring, minimum gain allocations will be required to be made to Steven and Brian to reflect their shares of the net decrease. Whether the Partnership experiences a net decrease in Section 704(b) minimum gain turns upon whether the Nonrecourse Loan is grandfathered under Section 1.704-2(l)(2) or 1.704-2(l)(3) of the Final 704(b) Regulations.

If the Lender is itself admitted to the Partnership, it appears that the Nonrecourse Loan will become an (l)(3) liability subject to special bifurcated treatment. As described in Scenario Three above, the Nonrecourse Loan will be transformed into partner nonrecourse debt except to the extent Steven and Brian were allocated pre-1987 deductions in respect of the Building. The Partnership would experience a decrease in its Section 704(b) minimum gain equal to the post-1986 deductions allocated prior to 1993. Minimum gain allocations would be required to Steven and Brian to recapture their shares of these deductions.

If an affiliate of the Lender is admitted to the Partnership, it appears that the Nonrecourse Loan might be treated, based on the literal language of Section 1.704-2(l)(2) of the Final 704(b) Regulations, as an (l)(2) liability. If so, the Nonrecourse Loan could continue to be treated

as a third-party nonrecourse liability, and Steven and Brian would not be required to recapture any of the nonrecourse deductions previously allocated to them.

If the Nonrecourse Loan is contributed to the Partnership by the Lender in exchange for a partnership interest, the liability would disappear, and the Partnership's Section 704(b) minimum gain would be reduced to zero, regardless of which version of the Section 704(b) regulations is applicable. In this event, Steven and Brian would have to be allocated \$3 million of items of Partnership income pursuant to the minimum gain chargeback. Once again, the potential for double taxation would exist if the decrease in basis occasioned by the cancellation of the debt is tested mid-year for purposes of Section 731(a)(1).

### Conclusion

The Final 704(b) and 752 Regulations have a profound impact on the tax consequences that are likely to be felt by a partnership and its partners when the partnership or its liabilities are restructured as part of a partnership workout transaction. The transition rules must be carefully reviewed to determine which sets of regulations apply in a particular context. Pending additional guidance from the IRS, tax advisors must tread cautiously and painstakingly analyze the effect of Sections 704(b) and 752 on each step of a partnership workout.

Appendix A

Section 704(b)/752 Transition Summary

Partner Nonrecourse Loans			
Date Incurred Or Assumed By Partnership	Applicable 752 Regulations	752 Treatment	704(b) Treatment
Before March 1, 1984	Former	Recourse debt is allocable in same manner as partners share partnership losses; Nonrecourse debt is allocable in same manner as partners share partnership profits	Pre-1987 deductions treated as true "nonrecourse deductions"; post-1986 deductions treated as "partner nonrecourse deductions" allocable 100% to lender/partner <sup>1</sup>
March 1, 1984, to January 29, 1989	Temporary <sup>2</sup>	Debt allocable 100% to lender/partner	All deductions treated as "partner nonrecourse deductions" allocable 100% to lender/partner <sup>1</sup>
January 30, 1989, to December 27, 1991	Temporary <sup>4</sup>		
December 28, 1991 -	Final <sup>5</sup>		

<sup>1</sup> See Treas. Reg. § 1.704-2(l)(3). Although the Temporary 752 Regulations generally would not apply to partner loans made before March 1, 1984, Treas. Reg. § 1.752-4T(e) (1989) permitted partnerships to apply the Temporary 752 Regulations to that portion of any liability treated as a partner nonrecourse debt under the Section 704(b) regulations. To the extent that post-1986 deductions attributable to a pre-March 1, 1984 partner nonrecourse loan are required to be treated as "partner nonrecourse deductions" for Section 704(b) purposes, and therefore allocable 100% to the lender/partner, the advantage of partially applying the Temporary 752 Regulations to the loan pursuant to this so-called "basis shift election" would be to ensure that a sufficient portion of the loan would be allocated to the lender/partner to permit him to deduct the post-1986 deductions.

<sup>2</sup> Treas. Reg. § 1.752-4T(h) (1991).

<sup>3</sup> If the partner loan was incurred or assumed on or after March 1, 1984, and prior to January 29, 1989, it might be argued that the literal language of the regulations permit post 1988 deductions attributable to the loan to be treated as third-party nonrecourse deductions. See Treas. Reg. 1.704-2(l)(2) (last sentence). See generally text accompanying note 29 of the Article.

<sup>4</sup> Treas. Reg. § 1.752-4T(a) (1989).

<sup>5</sup> Treas. Reg. § 1.752-5(a).

## Appendix B

## Section 704(b)/752 Transition Summary

Related Person Nonrecourse Loans			
Date Incurred (Or Assumed By Partnership)	Applicable 752 Regulations	752 Treatment	704(b) Treatment
Before March 1, 1984	Former	Recourse debt is allocable in same manner as partners share partnership losses; Nonrecourse debt is allocable in same manner as partners share partnership profits	All deductions treated as true "nonrecourse deductions" <sup>1</sup>
March 1, 1984, to January 29, 1989			
January 30, 1989, to December 27, 1991	Temporary <sup>2</sup>	Debt allocable 100% to related partner	All deductions treated as "partner nonrecourse deductions" allocable 100% to related partner
December 28, 1991 -	Final <sup>3</sup>		

<sup>1</sup> See Treas. Reg. § 1.704-2(l)(2) (first two sentences).

<sup>2</sup> Treas. Reg. § 1.752-4T(a) (1991).

<sup>3</sup> Treas. Reg. § 1.752-5(a).



Appendix C

Section 704(b)/752 Transition Summary

Partner-Guaranteed, Third-Party Loans				
Date Incurred Or Assumed By Partnership	Date of Guaranty	Applicable 752 Regulations	752 Treatment	704(b) Treatment
Before March 1, 1984	Before March 1, 1984	Former	Recourse debt is allocable in same manner as partners share partnership losses; Nonrecourse debt is allocable in same manner as partners share partnership profits	Pre-1987 deductions treated as true "nonrecourse deductions"; post-1986 deductions treated as "partner nonrecourse deductions" allocable 100% to guarantor/partner <sup>1</sup>
	March 1, 1984, to January 29, 1989			
	January 30, 1989, to December 27, 1991			
	December 28, 1991 -			
March 1, 1984, to January 29, 1989	March 1, 1984, to January 29, 1989	Temporary <sup>2</sup>	Debt allocable 100% to guarantor/partner	All deductions treated as "partner nonrecourse deductions" allocable 100% to guarantor/partner <sup>3</sup>
	January 30, 1989, to December 27, 1991			
	December 28, 1991 -			
January 30, 1989, to December 27, 1991	January 30, 1989, to December 27, 1991	Temporary <sup>4</sup>	Debt allocable 100% to guarantor/partner	All deductions treated as "partner nonrecourse deductions" allocable 100% to guarantor/partner <sup>3</sup>
	December 28, 1991 -			
December 28, 1991 -	December 28, 1991 -	Final <sup>5</sup>	Debt allocable 100% to guarantor/partner	All deductions treated as "partner nonrecourse deductions" allocable 100% to guarantor/partner <sup>3</sup>

<sup>1</sup> See Treas. Reg. § 1.704-2(l)(3).

<sup>2</sup> Treas. Reg. § 1.752-4T(b) (1991).

<sup>3</sup> If the partner-guaranteed loan was incurred or assumed on or after March 1, 1984, and prior to January 30, 1989, it might be argued that the literal language of the regulations permit post-1988 deductions attributable to the loan to be treated as third-party nonrecourse deductions, regardless of post-January 30, 1989 guaranties by partners. See Treas. Reg. 1.704-2(l)(2) (last sentence). See generally text accompanying note 29 of the Article

<sup>4</sup> Treas. Reg. § 1.752-4T(a) (1991).

<sup>5</sup> Treas. Reg. § 1.752-5(a).

## Appendix D

## Section 704(b)/752 Transition Summary

Related Person-Guaranteed, Third-Party Loans				
Date Incurred Or Assumed By Partnership	Date of Guaranty	Applicable 752 Regulations	752 Treatment	704(b) Treatment
Before March 1, 1984	Before March 1, 1984	Former	Recourse debt is allocable in same manner as partners share partnership losses; Nonrecourse debt is allocable in same manner as partners share partnership profits	All deductions treated as true "nonrecourse deductions" <sup>1</sup>
	March 1, 1984, to January 29, 1989			All deductions treated as "partner nonrecourse deductions" allocable 100% to related partner <sup>2</sup>
	January 30, 1989, to December 27, 1991			All deductions treated as true "nonrecourse deductions" <sup>3</sup>
	December 28, 1991 -			All deductions treated as "partner nonrecourse deductions" allocable 100% to related partner <sup>4</sup>
March 1, 1984, to January 29, 1989	March 1, 1984, to January 29, 1989	Former	Recourse debt is allocable in same manner as partners share partnership losses; Nonrecourse debt is allocable in same manner as partners share partnership profits	All deductions treated as true "nonrecourse deductions" <sup>1</sup>
	January 30, 1989, to December 27, 1991			All deductions treated as "partner nonrecourse deductions" allocable 100% to related partner <sup>2</sup>
	December 28, 1991 -			All deductions treated as "partner nonrecourse deductions" allocable 100% to related partner <sup>4</sup>
January 30, 1989, to December 28, 1991	January 30, 1989, to December 27, 1991	Temporary <sup>5</sup>	Debt allocable 100% to related partner	All deductions treated as "partner nonrecourse deductions" allocable 100% to related partner
	December 28, 1991 -			All deductions treated as "partner nonrecourse deductions" allocable 100% to related partner
December 28, 1991 -	December 28, 1991 -	Final <sup>6</sup>	Debt allocable 100% to related partner	All deductions treated as "partner nonrecourse deductions" allocable 100% to related partner

<sup>1</sup> See Treas. Reg. § 1.704-2(l)(2) (first two sentences).

<sup>2</sup> If the related party-guaranteed loan was incurred or assumed prior to January 30, 1989, it might be argued that the literal language of the regulations permit post-1988 deductions attributable to the loan to be treated as third party nonrecourse deductions, regardless of post-January 30, 1989 guaranties by related persons. See Treas. Reg. 1.704-2(l)(2) (last sentence). See generally text accompanying note 29 of the Article.

<sup>3</sup> See Treas. Reg. § 1.704-2(l)(2) (first two sentences).

<sup>4</sup> If the related party-guaranteed loan was incurred or assumed before January 30, 1989, it might be argued that the literal language of the regulations permit post-1988 deductions attributable to the loan to be treated as third party nonrecourse deductions, regardless of post-January 30, 1989 guaranties by related persons. See Treas. Reg. 1.704-2(l)(2) (last sentence). See generally text accompanying note 29 of the Article.

<sup>5</sup> Treas. Reg. § 1.752-4T(a) (1991).

<sup>6</sup> Treas. Reg. § 1.752-5(a).