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Acquisitions, Dispositions & Structuring Techniques Corner

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Did IRS Err in New TAM on Allocation of Excess Nonrecourse Liabilities?

In September 2004, the IRS released TAM 200436011,[1] which addresses the allocation of excess nonrecourse liabilities under Reg. §1.752-3(a)(3). The TAM will likely be quite controversial because it reaches a conclusion that is contrary to the plain language of the applicable regulation.

The issue in TAM 200436011 is whether a gross income allocation to a partner (X) is an allocation of a significant item of partnership income or gain which has substantial economic effect for purposes of Reg. §1.752-3(a)(3). If it is, then the allocation could be used to allocate 100 percent of the excess nonrecourse liabilities to X. The allocation of liabilities to X could then be used to avoid gain recognition as a result of a distribution to X.

Notwithstanding the plain language of the applicable regulation, the IRS concluded that the allocation to X of 100 percent of the third-tier allocations of excess nonrecourse liabilities is inappropriate. Reg. §1.752-3(a)(3) contemplates that partners will allocate the excess nonrecourse liabilities in a manner that is consistent with the way they share a significant item of partnership income or gain that has substantial economic effect. According to the IRS, the regulation looks to how the partners share a class of partnership income or gain rather than a gross income allocation within a class of income. There does not appear to be any basis for the IRS's conclusion.

Facts

In TAM 200436011, X was in the process of acquiring another company. In order to obtain cash for the acquisition, X decided to restructure and leverage its Z assets. To accomplish the desired result, X organized Y, a limited liability company classified as a partnership for federal tax purposes, with third parties and conveyed to Y its Z assets with a fair market value of $A. Y subsequently borrowed $D against the assets that were contributed by X and against the assets contributed by the other members of Y. Simultaneously, Y made a distribution to X of $B in cash and issued to X senior preferred, junior preferred and junior common interests.

In particular, X was issued 100 percent of the senior preferred issues in Y, which is entitled to an F-percent preferred return payable from gross income. Pursuant to the operating agreement for Y, X was allocated 100 percent of the gross income of Y every quarter up to the amount of the preference on the senior preferred interest. The operating agreement for Y specifically allocated $B of the excess nonrecourse liabilities to X (with the balance being allocated to another member of Y) and provided that, for purposes of determining X's share of nonrecourse liabilities, reference should be made to the allocation of gross income with respect to the senior preferred interest

Applicable Law

The central provision in this TAM is Reg. §1.752-3(a)(3), which addresses the allocation of excess nonrecourse liabilities. Excess nonrecourse liabilities are the amount by which nonrecourse liabilities exceed the nonrecourse liabilities that must be allocated to partners with respect to partnership minimum gain and the built-in minimum gain under Reg. §1.752-3(a)(1) and (2), respectively. As a practical matter, in most cases the excess nonrecourse liabilities of a partnership are equal to the partnership's basis in its assets, because any liabilities in excess of this amount will usually be allocated under the first two tiers of allocations.

The regulation sanctions four methods for the allocation of excess nonrecourse liabilities, of which two are generally the most important. First, the regulation

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provides that a partner's share of the excess nonrecourse liabilities is determined in accordance with the partner's share of partnership profits. In order to determine the partner's share of partnership profits, all facts and circumstances relating to the economic arrangement of the partners are taken into account. Alternatively, the partnership agreement may specify the partner's interest in the partnership profits for purposes of allocating the excess nonrecourse liabilities, provided that the interests so specified are reasonably consistent with allocations of some other significant item of partnership income or gain that has substantial economic effect under Code Sec. 704(b). In addition, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on Code Sec. 704(c) property or property for which reverse Code Sec. 704(c) allocations are applicable.

The regulations contain an example concerning the allocation of excess nonrecourse liabilities. In Reg. §1.752-3(c), Example 2, it is assumed that A and B are equal partners. However, the partnership agreement provides that all depreciation deductions will be allocated to partner A. The partners agree to allocate excess nonrecourse liabilities in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. Assuming that the allocation of depreciation to A is valid, all of the excess nonrecourse liabilities would be allocated to A.

These regulations concerning the allocation of excess nonrecourse liabilities are applicable for purposes of determining whether a distribution made to a partner in connection with a transfer of money to the contributing partner gives rise to a disguised sale under Code Sec. 707(a)(2)(B). Under Reg. §1.707-5(b)(1), if a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under Temporary Reg. §1.163-8T to a transfer of money or other consideration with 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner's allocable share of the partnership liability. To determine the partner's share of liability, reference is made to the partner's share of excess nonrecourse liabilities under Reg. §1.752-3(a)(3).

The Ruling

In TAM 200436011, the taxpayer argued that liabilities incurred by the partnership in the amount of $B could be allocated to X because that allocation was consistent with the allocation to X of 100 percent of the gross income of the partnership with respect to the senior preferred interest. According to the taxpayer, this allocation of gross income is an allocation of a significant item of partnership income that has substantial economic effect, so that the allocation effectively can be used to "drag" an allocation of debt under Reg. §1.752-3(a)(3).

The IRS never responded directly to this argument. Instead, the IRS contended that the phrase "a significant item of partnership income or gain" in the regulation refers to a significant *class* of partnership income or gain (even though the word *class* is not in the regulation). According to the IRS, the point of the third-tier allocation in Reg. §1.752-3(a)(3) is to match the excess nonrecourse deductions up with the manner in which the partners share a significant economic item of partnership income or gain. To simply consider a single gross income allocation in isolation does not encompass this sharing concept. While acknowledging that X was getting 100 percent of a specific gross income allocation, the IRS contended that the allocation does not truly reflect overall the economic relationship between the parties with respect to that item of partnership income. Thus, it cannot be what was intended by the third-tier allocation permitted in the regulation.

The IRS stated its belief that the regulation's reference to a "significant item of partnership income or gain" does not refer to a traunch of bottom-line gross or net income; rather, according to the IRS, it refers to partnership income of a certain character or type, such as gain from the sale of property or tax-exempt income.

The IRS justified this conclusion by referring to the phrase "items of income" as used in the Code Sec. 704(b) regulations. The IRS noted that Reg. §1.704-1(b)(1)(vii) provides that Code Sec. 704(b) and Reg. §1.704-1(b) apply to "allocations of income, gain, loss, deduction and credit, allocations of specific items of income, gain, loss, deduction and credit, and allocations of partnership net or 'bottom line' taxable income and loss. An allocation to a partner of a share of partnership net or 'bottom line' taxable income or loss shall be treated as an allocation to such partner of the same share of each item of income, gain, loss and deduction that is taken into account in computing such net or 'bottom line' taxable income or loss."

The IRS stated that the Code Sec. 704(b) regulation distinguishes between allocations of "items of income" and allocations of partnership net or "bottom line" income, and that an allocation of a share of partnership net income is treated as an allocation of the same share of each item of income. Under this regulation, an allocation of a 50-percent share or traunch of partnership gross or net income is not treated as the allocation of 100 percent of a single item of income; it is treated as an allocation of a 50-percent share of each item of income. Given the interdependence between the regulations under Code Secs. 752 and 704(b), the IRS contended that it is appropriate to interpret "items of income" for purposes of the Code Sec. 752 regulations consistently with its interpretation for purposes of the Code Sec. 704(b) regulations.

Thus, the IRS contended that the "more appropriate" view of what constitutes a "significant item of partnership income or gain that has substantial economic effect," as that phrase is used in Reg. §1.752-3(a)(3), is to examine the manner in which the partners share items of economic significance and determine if the allocation is consistent with the manner in which the partners share the items. For example, suppose a 50/50 partnership agrees to allocate the first $100 of gross income, an item or income or gain, to Partner 1 and the remaining gross income to Partner 2. Assume further that the partnership agreement provides that for purposes of Reg. §1.752-3(a)(3), the allocations of excess nonrecourse liabilities will be made in accordance with the manner in which the partners share the first $100 of gross income. Under the taxpayer's theory, Partner 1 would be entitled to 100 percent of the third-tier allocation. However, assuming that the total amount of gross income of the partnership is $500, Partner 1 is being allocated only 20 percent of the total gross income of the partnership. Given this, the IRS contended that it was not "appropriate" for Partner 1 to be allocated 100 percent of the third-tier allocations because it does not truly reflect the underlying economic relations of the partners. Therefore, it is consistent with the "purpose" of the third-tier allocation regulations for Partner 1 to be allocated 20 percent of the excess nonrecourse liabilities, if gross income is the item the taxpayer chooses to follow.

Analysis

The IRS's conclusion in TAM 200436001 is very troubling. It appears that the IRS decided to ignore the plain language of the regulations under Code Sec. 752 because the IRS did not believe that the result claimed by the taxpayer was "contemplated" or "intended" by those regulations. However, the regulations are absolutely clear, and the only abuse in this situation is the strained interpretation proffered by the IRS. The IRS also ignored language in the regulations under Code Sec. 704(b) that were consistent with the Code Sec. 752 regulations. *See* Reg. §1.704-2(e)(2).

The taxpayer in TAM 200436001 took advantage of the provision in the regulations that allows a partnership agreement to allocate excess nonrecourse liabilities. The regulations require the IRS to respect the allocation that is made by the taxpayer if such allocation is reasonably consistent with the allocations of some other significant item of partnership income. The taxpayer used the allocation of the first layer of gross income to partner X to support the allocation of excess nonrecourse liabilities.

The regulations require the IRS to respect the allocation that is made by the taxpayer if such allocation is reasonably consistent with the allocations of some other significant item of partnership income.

The IRS could counter the taxpayer only by stating that it was not "contemplated" that an allocation of a layer of gross income would support an allocation of excess nonrecourse liabilities. But it does not matter what was "contemplated" by the drafters of the regulations—what matters is what the regulations say. And in this case, the regulations expressly require only that the debt allocation be "reasonably consistent" with an allocation of some other significant item of partnership income, which in this case was the first layer of gross income. The language of the regulations directly refutes the IRS's position.

Moreover, the IRS's example in TAM 200436001 is self-defeating. In the example, Partner 1 was allocated the first $100 of gross income but only 1/5 of the total gross income of the partnership; the IRS contended that Partner 1 could be allocated only 20 percent of the excess nonrecourse liabilities of the partnership. This argument effectively disregards the alternative methods provided in Reg. §1.752-3(a)(3) and requires, instead, that excess nonrecourse liabilities be allocated on the basis of a partner's share of partnership profits. But this approach is expressly provided in the regulations as the first—but not the exclusive—means to allocate excess nonrecourse liabilities.

Put simply, it appears in TAM 200436011 that the IRS did not like the result reached under the regulations. So the IRS ignored the plain language of the regulations under Code Sec. 752—and relied upon other regulations that were not applicable—to reach a contrary conclusion. This is the type of analysis which, if it were engaged in by a taxpayer, could result in penalties for intentional disregard of rules and regulations. Hopefully, the IRS will realize that it undermines the credibility of the tax system if the administrator ignores the rules in order to reach a more favorable result for the FISC. If the IRS does not like the way that taxpayers can allocate excess nonrecourse liabilities under Reg. §1.752-3(a)(3), the IRS could amend the regulations. But the IRS cannot simply ignore them, as it appears to be doing in TAM 200436011.

ENDNOTES

1 TAM 200436011 (Apr. 30, 2004).