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ALLOCATION OF NONRECOURSE LIABILITIES: IRS TAKES TWO STEPS FORWARD, ONE BACK

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In *Rev. Rul.* 95-41, the Service examines the impact of the Section 704(c) built-in gain rules on the allocation of partnership liabilities and generally provides guidance that is favorable to taxpayers, as far as it goes. Nevertheless, the IRS fails to resolve specific issues with respect to second- and third-tier allocations of debt, particularly where multiple properties are subject to one nonrecourse liability, leaving practitioners no choice but to apply whatever method seems reasonable.

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A partner who contributes encumbered property to a partnership and who has taken depreciation deductions attributable to the debt (i.e., has taken such deductions in excess of his contributed capital) must be allocated a sufficient amount of partnership liabilities in order to avoid the recognition of gain on the contribution. This may be difficult where, for example, the partnership pays down a portion of the debt on the contributed property. This difficulty exists, in part, because of the interplay between Sections 704(c) and 752. In *Rev. Rul.* 95-41, 1995-23 IRB 5, the Service published guidance on the interrelationship of these sections in the allocation of basis attributable to nonrecourse debt. As discussed in detail below, although some questions have been answered (generally in favor of taxpayers), many difficulties remain in ensuring that contributing partners receive allocations of partnership liabilities sufficient to enable them to avoid the recognition of gain.

The issues that arise because of Sections 704(c) and 752 include the following:

1. Does the use of the remedial allocation method described in the Section 704(c) Regulations affect the second-tier allocation of partnership liabilities under Reg. 1.752-3(a)(2)?

2. Should the third-tier allocation scheme of Reg. 1.752-3(a)(3) include Section 704(c) built-in gain to the extent such gain is not otherwise taken into account under a second-tier allocation?

3. How does the second-tier allocation scheme work when a partnership has multiple properties subject to one nonrecourse debt?

Statutory and Regulatory Framework

The starting point is the provisions of the Code and Regulations governing contributions of property to partnerships and allocations of partnership liabilities.

Contributions of property. Section 704(c)(1)(A) provides that "income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution." In general, this section requires that a partner who contributes property with built-in gain be allocated that built-in gain when the partnership disposes of the property. It also requires, to the extent possible, that depreciation deductions be allocated to the noncontributing partner in an amount equal to the deductions the partner would have been allocated had the contributed property had a tax basis equal to its value.

Any reasonable method of making tax allocations may be used to eliminate the disparity (the book-tax differential) between the basis and FMV of property con-

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tributed by a partner to the partnership (or of property that is revalued under Reg. 1.704-1(b)(2)(iv)).[1] Three methods are deemed to be reasonable:

1. The traditional method.
2. The traditional method with curative allocations.
3. The remedial allocation method.

Allocations of liabilities. Section 752(b) provides that "[a]ny decrease in a partner's share of the liabilities of a partnership or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership." Thus, Section 752(b) deems any decrease in a partner's share of liabilities to be a distribution of money to that partner. Under Section 731(a)(1), to the extent such a deemed distribution exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution, gain is recognized. To compute any such gain when a partner's share of partnership liabilities is reduced, it is necessary to compare the partner's share of partnership liabilities before and after the reduction.

Reg. 1.752-3 provides a three-tier scheme for determining a partner's share of the nonrecourse liabilities of a partnership.[2] Under these rules, a partner's share of the nonrecourse liabilities of a partnership equals the sum of the following:

Tier I. The partner's share of partnership minimum gain determined in accordance with the rules of Section 704(b) and the Regulations thereunder.[3]

Tier II. The taxable gain that would be allocated to the partner under Section 704(c) (or in the same manner as Section 704(c) in connection with a revaluation of partnership property)[4] if the partnership (in a taxable transaction) disposed of all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration.[5]

Tier III. The partner's share of the excess nonrecourse liabilities (those not allocated under the above provisions) of the partnership, as determined in accordance with the partner's share of partnership profits. The "partner's interest in partnership profits" is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify the partners' interest in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the Section 704(b) Regulations) of some other significant item of partnership income or gain. Alternatively, 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. Excess nonrecourse liabilities are not required to be allocated under the same method each year.

The Ruling. The IRS responded to the requests of taxpayers, practitioners, and commentators who were grappling with, and attempting to fashion reasonable positions regarding, the issues outlined above. Although, as discussed below, there are several issues that remain unanswered and the Service's analysis and conclusions are subject to criticism in certain respects, *Rev. Rul.* 95-41 provides much needed guidance concerning the allocation of nonrecourse liabilities.

The Ruling begins by framing the issue in a straightforward fashion: How does Section 704(c) affect the allocation of nonrecourse liabilities under Reg. 1.752-3(a)? It posits that taxpayers A and B form partnership PRS as equal partners, agreeing that each will be allocated 50% of all partnership items.[6] The depreciable property contributed by A has an FMV of $10,000, an adjusted tax basis of $4,000, and is encumbered by a nonrecourse liability of $6,000. Thus, A's net equity value in the property is $4,000, and A's initial book capital account in PRS is $4,000.[7] In addition, since the nonrecourse liability exceeds the tax basis of the property at its contribution to the partnership, A could be required to recognize taxable income by application of Sections 752(b) and 731(a)(1) if A does not receive a sufficient allocation of PRS's liabilities to "cover" A's negative tax capital account of $2,000 on the formation of PRS (i.e., $4,000 adjusted tax basis of contributed property minus nonrecourse liability of $6,000 equals negative tax capital account of $2,000).[8]

Allocations Under Rev. Rul. 95-41

The Ruling properly concludes that A and B do not receive a Tier I allocation of nonrecourse liabilities on the formation of PRS because no partnership minimum gain exists as to the contributed property at the PRS-level. The book value (i.e., the FMV of the property at contribution) of $10,000 exceeds the $6,000 nonrecourse liability encumbering the property.[9]

Tier II allocation. With respect to the allocation of the nonrecourse liabilities of PRS under Tier II, the Ruling properly concludes that if PRS sold the contributed property for the amount of the nonrecourse liability ($6,000), PRS would recognize taxable gain of $2,000 ($6,000 minus $4,000 adjusted tax basis of the contributed property), and that A would be allocated this $2,000 of taxable gain if PRS elected to use the traditional method with respect to the contributed property. *Rev. Rul.* 95-41 concludes that under Tier II, $2,000 of the $6,000 nonrecourse liability is allocable to A because the $2,000 is Section 704(c) "minimum gain."

Prior to the issuance of this Ruling, it was unclear whether the adoption of the remedial allocation method would change this result. The Ruling provides that if PRS had adopted the remedial allocation method, A would be allocated $4,000 of the liability under Tier II. This is the sum of (1) $2,000 (the excess of the $6,000 of debt over the $4,000 of tax basis) plus (2) $2,000 (the gain that would be allocated to A under the remedial allocation method if the property were sold for $6,000).

The IRS also concludes that if PRS adopted the traditional method with curative allocations,[10] only $2,000 of

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the debt would be allocated to A under Tier II, based on the following rationale: "If *PRS* used the traditional method with curative allocations described in § 1.704-3(c), *PRS* would be permitted to make reasonable curative allocations to reduce or eliminate the difference between the book and tax allocations to B that resulted from the hypothetical sale. However, *PRS*'s ability to make curative allocations would depend on the existence of other partnership items and could not be determined solely from the hypothetical sale of the contributed property. *Because any potential curative allocations could not be determined solely from the hypothetical sale of the contributed property, curative allocations are not taken into account in allocating nonrecourse liabilities under § 1.752-3(a)(2).*" (Emphasis added.)

Tier III allocation. With respect to allocations of nonrecourse liabilities under Tier III, *Rev. Rul.* 95-41 sets forth three approaches for allocating PRS's "excess nonrecourse liabilities" (as noted above, excess liabilities are those that are not allocated to the partners under Tiers I and II). The Ruling restates Tier III's general rule that excess nonrecourse liabilities may be allocated according to how the partners share partnership profits and that the partners' interests in partnership profits generally are determined by taking into account all the facts and circumstances relating to the economic arrangement of the partners. In this regard, the Ruling states:

"The partners' agreement to share the profits of the partnership equally is one fact to be considered in making this determination. Another fact to be considered is a partner's share of § 704(c) built-in gain to the extent that the gain was not taken into account in making an allocation of liabilities under § 1.752-3(a)(2) [Tier II]. This built-in gain is one factor because, under principles of § 704(c), this excess built-in gain, if recognized, will be allocated to A. *A*'s share of § 704(c) built-in gain that is not taken into account in making allocations under § 1.752-3(a)(2) is, therefore, one factor, but not the only factor, to be considered in determining *A*'s interest in partnership profits.

"The amount of § 704(c) built-in gain that is not considered in making allocations under § 1.752-3(a)(2) must be given an appropriate weight in light of all other items of partnership profit. For example, if it is reasonable to expect that *PRS* will have items of partnership profit over the life of the partnership that will be allocated to *B*, *PRS* may not allocate all of the excess nonrecourse liabilities to *A*. Rather, the remaining nonrecourse liabilities must be allocated between *A* and *B* in proportion to their interests in total partnership profits."

As a second alternative, the Ruling states that the partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities so long as the allocation is reasonably consistent with allocations of some other significant item of partnership income or gain that has "substantial economic effect" under the Section 704(b) Regulations. The Service concludes that an allocation of excess nonrecourse liabilities 50% to each of A and B would be appropriate if the 50-50 allocation of income and gain between A and B has substantial economic effect. Nevertheless, because Section 704(c) allocations do not have substantial economic effect under the Section 704(b) Regulations, they cannot be used as a basis to allocate excess nonrecourse liabilities under this alternative.

As a final choice, *Rev. Rul.* 95-41 provides that the partnership can choose to allocate the excess nonrecourse liabilities in accordance with the manner in which deductions attributable to such excess nonrecourse liabilities will be allocated. Under the Ruling's facts, A and B each will be allocated 50% of each of the partnership's items of gain and loss and, as a result, will be allocated $5,000 of book depreciation with respect to the contributed property over its remaining useful life. Since the tax basis of the contributed property only equals $4,000, however, all of the $4,000 of tax depreciation must be allocated to B under Section 704(c). As a result, all of the $4,000 of excess nonrecourse liabilities are allocated to B.

Impact of Different 704(c) Methods on Tier II Allocations

Under the remedial allocation method, a partnership allocates artificially created items of taxable income, gain, loss, or deduction to ensure that a noncontributing partner receives equal amounts of tax and book items.[11] Actual tax items are not needed in order to make the remedial allocation in a particular year.

Under *Rev. Rul.* 95-41, the full amount of the Section 704(c) built-in gain that is attributable to a partner, rather than merely the excess of the liabilities over the adjusted tax basis of the contributed property (i.e., the Section 704(c) minimum gain), is taken into account for purposes of allocating liabilities where the remedial allocation method has been elected. On its face, this result appears to be sound because the remedial allocation method results in the contributing partner being allocated the full amount of the built-in gain (and not just the Section 704(c) minimum gain) when the property is sold, as illustrated below:

Example: A and B form equal partnership AB. A contributes property X with an FMV of $150 and a tax basis of zero, subject to a nonrecourse liability of $60. B contributes (1) property Y with an FMV and a tax basis of $100 subject to a $90 liability and (2) $80 of cash. AB uses $60 of the $80 cash contributed by B and pays off the debt secured by property X. A's initial tax basis in its interest in AB will equal its tax basis in property X (zero) minus the liabilities secured by property X that are taken subject to by AB ($60) plus its share of the $90 liability secured by property Y. If A's share of the $90 liability is less than $60, A's initial tax basis in its AB interest will be zero and A will be required to recognize taxable gain equal to the excess of $60 over A's share of the $90 liability.

At the time that property X is contributed to AB, the built-in gain attributable to X is $150, all of which is attributable to A for purposes of Section 704(c)(1)(A) and the Regulations thereunder. Thus, if X were sold immediately by AB for $150, AB would recognize $150 of taxable gain, all of which would be allocated to A.

Under *Rev. Rul.* 95-41, following the repayment of the $60 liability, the Section 704(c) minimum gain attributable to property X would be zero (because the debt would then be zero). Thus, no portion of the $90 liability would be allocable to A under Tier II if the traditional method or the traditional method with curative allocations were elected with respect to X. On the other hand, if AB were to adopt the remedial allocation method with respect to X, $75 of the $90 liability would be allocated to A under Tier II. This $75 Tier II allocation equals the gain that would be allocated to A under the remedial allocation method if X were sold for zero. In such event, AB would realize a $150 book loss, 50% of which would be allocated to B. Under the remedial allocation method, AB must "create" and allocate a $75 tax loss to B and a corresponding $75 tax gain to A. It is this allocation of $75 of tax gain that supports a Tier II allocation of $75 to A. The balance of the $90 liability (all $90 if the traditional method or the traditional method with curative allocations is elected or $15 if the remedial allocation method is elected) would be an excess nonrecourse liability and thus would be allocated under Tier III.

The results obtained under *Rev. Rul.* 95-41 in this context are entirely understandable and supportable if AB elects the traditional method (no Tier II allocation) or the remedial allocation method ($75 Tier II allocation). The denial of a Tier II allocation to A in this situation if the traditional method with curative allocations is used does not appear to be as well grounded. The Service's position appears to be that the allocation of items of income and gain under the curative allocations method is too uncertain in timing and amount to accurately predict the appropriate debt allocation to the contributing partner under Tier II. The Ruling then states that a curative allocation based solely on sale gain is inappropriate for purposes of supporting an allocation under Tier II. This position seems unduly harsh if it results in contributing partners recognizing gain on contribution transactions. If unrelated partners elect to resolve problems caused by the ceiling rule through the use of curative allocations, the partners have taken steps designed to ensure that the contributing partner will recognize the built-in gain not later than the time the contributed property is sold by the partnership. In these circumstances, the purpose underlying Tier II would seem to be fulfilled (i.e., that contributing partners be allocated liabilities sufficient to avoid the recognition of gain by them on the contribution of encumbered properties to partnerships).

"Profits" and Remaining 704(c) Built-In Gain

In order to ascertain a partner's share in partnership profits for purposes of Tier III, it is necessary to determine what the term "profits" means. Unfortunately, explicit guidance on this issue is not found in the Code, Regulations, case law, or rulings. As explained more fully below, *Rev. Rul.* 95-41's failure to provide a meaningful gloss on "profits" adds complexity to the allocation of excess nonrecourse liabilities.

In determining whether Section 704(c) built-in gain should affect the allocation of excess nonrecourse liabilities, the Service could have chosen between two different definitions of "profits." One possible interpretation of the term is that it refers to "book profit" required to be allocated under the Section 704(b) Regulations. Under this approach, a partner's share in partnership profits would take into account only allocations of economic profit governed by Section 704(b) and not profit (built-in gain) required to be allocated under Section 704(c).

Another possible interpretation of "profits" is that it means all profits, including any built-in gain required to be allocated under Section 704(c) to the extent such gain is not already taken into account in determining a partner's share of liabilities under Tier II. Under this interpretation, a partner's share of partnership profits would be the portion of the Section 704(c) gain not taken into account under Tier II plus a percentage of the partnership's remaining "book profit" to which that partner is entitled. Nevertheless, because the Tier II rules explicitly mention Section 704(c) gain while the Tier III rules do not, the Service could have taken the position that any allocations of partnership liabilities made on the basis of Section 704(c) built-in gain should be made solely under Tier II and, therefore, may not be taken into account under Tier III.

As discussed above, under the Tier III rules each partner's "share" of partnership profits may be specified in the partnership agreement provided the shares specified are reasonably consistent with allocations (that have substantial economic effect under the Section 704(b) Regulations) of some other significant item of partnership income or gain. Section 704(b) governs the allocation of book profits, and these are the only allocations that can have substantial economic effect.[12] Because allocations under Section 704(c) do not affect the partners' book capital accounts, they cannot have substantial economic effect. Because Reg. 1.752-3(a)(3) specifically permits profits to be determined based on the allocation of book profits that have substantial economic effect, but does not mention built-in gain allocations under Section 704(c), Section 704(c) allocations arguably should be ignored in determining profits for purposes of Tier III. The Regulations, however, permit—but do not require—partnerships to specify the partners' interests in profits, subject to the "reasonable consistency" requirement. Thus, it appears that this provision may create only a safe harbor, and is not intended to represent the exclusive manner of determining the partners' interests in profits.

Reg. 1.752-3(a)(3) states that a "partner's interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners." Arguably, a partner's contribution of property with Section 704(c) built-in gain is a fact that should be taken into account under this test. Indeed, if the property is sold for its book value, the only profit to be allocated is the built-in gain under Section 704(c).

Additional support for defining "profits" to include Section 704(c) built-in gain perhaps exists in the prior Regulations under Section 752. Under those rules, the allocation of nonrecourse liabilities among partners was made solely with reference to each partner's interest in partnership "profits." Many practitioners took the position under this Regulation that nonrecourse liabilities should be allocated in the same manner that all sources of partnership income were allocated. The final Section 752 Regulations allocate liabilities under Tier III based on the partners' share of "profits" only after allocations of liability have been made under the first two tiers. Nevertheless, "profits" has been used in both the old and the new Regulations. If the term were broad enough to include Section 704(c) built-in gain under the old Regulations, arguably it is broad enough to subsume Section 704(c) built-in gain under the new Regulations.

There are arguments, however, that only book profits should be used for making Tier III allocations. The disguised sale rules of Section 707(a)(2)(B) and the Regulations thereunder recharacterize certain contributions of property to a partnership and related distributions of cash or property as sales. Under Reg. 1.707-5, a related contribution/distribution may be treated as a disguised sale where a partner receives a nonrecourse loan and shortly thereafter contributes the encumbered property to a partnership. Under Reg. 1.707-5(a)(1), any reduction in the partner's "share" of the liability immediately after the contribution is treated as part of the sales proceeds. Under Reg. 1.707-5(a)(2), the partner's "share" of the liability is determined solely under Tier III. If "profits" under Tier III were to include Section 704(c) built-in gain, illogical situations could result under Reg. 1.707-5 because an inverse relationship would be created between the contributing partner's Section 704(c) built-in gain and the disguised sale proceeds. Thus, the Section 707(c) rules could be said to imply that book profits, rather than profits determined with reference to Section 704(c) built-in gain, are the profits intended to be used in determining allocations under Tier III.[13]

Rev. Rul. 95-41's approach to Tier III adds complexity to, rather than simplifying, the allocation of excess nonrecourse liabilities. The discussion regarding the allocation of excess nonrecourse liabilities in accordance with Section 704(b) profits or in accordance with how the partners agree to share nonrecourse deductions merely restates the safe harbor methods set forth in Reg. 1.752-3(a)(2). Thus, it does little more than provide numerical illustrations of how these safe harbor methods work. The balance of the Ruling's discussion of Tier III centers on what can appropriately be taken into account as "profits" among the partners under the general facts-and-circumstances rule of Tier III.

The Service's failure to provide any meaningful interpretation of "profits" for purposes of Tier III continues the confusion that has existed since the original Section 752 Regulations were promulgated.[14] It is still unclear what this term means if the partners' residual profit percentages differ from their capital contribution percentages or one partner's capital is subordinated to the capital of another partner. Similarly, it is unclear how to apply this term when there are multiple tiers of profit splits, depending on certain designated target economic returns. The Ruling compounds the uncertainty respecting the interrelationship between Section 704(c) and the allocation of Tier III liabilities by providing, for purposes of Tier III, that Section 704(c) built-in gain that remains unabsorbed by an allocation of nonrecourse liabilities to a partner under Tier II is a "factor" but not the "only factor" that may be taken into account in allocating excess nonrecourse liabilities under Tier III. The problem with these statements is that there is no explanation of how the Section 704(c) factor is supposed to be taken into account, the weight to be given to this factor relative to the other profit "factors" (which are not stated), and whether the choice of Section 704(c) method will affect the amount of liabilities allocated to a partner under Tier III.

While the Ruling states that "appropriate weight" must be given to the remaining Section 704(c) gain allocable to the contributing partner in light of all other items of partnership profit and whether it is "reasonable to expect" that the partnership will have items of profit that will be allocable to the noncontributing partner, it is silent as to what weight might be appropriate or how to establish reasonableness. Contrary to *Rev. Rul.* 95-41's implication that future expectancy is relevant in determining profits, the Service has stated in the service partner context that a partner will not have income on receipt of a partnership profits interest if, on immediate liquidation of the partnership on the date of receipt of such interest, the service partner would not be entitled to any proceeds.[15] Thus, in the service partner context, no value is attributed to the expectancy of future profits.

It would seem appropriate for the IRS to apply the position it took with respect to the service partners in this context as well, and give priority to the remaining Section 704(c) gain over other, more speculative partnership profits in allocating excess nonrecourse liabilities under Tier III. If this analysis were applied to the facts of the Ruling, A, the contributing partner, would have received a Tier III allocation of $3,000.[16]

The foregoing position promotes the policy of facilitating partnership restructurings in connection with workouts. In addition, taxpayers apparently would not have an opportunity to "game the system" since the FMV of property (and therefore the Section 704(c) built-in gain) will be negotiated among partners who are likely to have adverse tax and economic interests with respect to this issue. Thus, an overstatement of the FMV of property merely to create a larger nonrecourse debt allocation would not occur without significant economic consequences to the overall business deal, and therefore, does not seem to pose a meaningful risk in this context. Finally, regardless of whether the ceiling rule is applicable in a given situation, the full Section 704(c) built-in gain is actually recognized by the contributing partner, and the full relief from liability will occur when the property is disposed of. Accordingly, the full unallocated Section 704 (gain) should be taken into account on a priority basis, despite the Ruling's language implying the contrary.

Tier II Allocations and Multiple Properties

As described above, under Tier II a partner contributing an encumbered property to a partnership is allocated partnership nonrecourse liabilities equal to any taxable gain that would be allocated to the partner under Section 704(c) if the partnership (in a taxable transaction) disposed of all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration.

Several issues arise when multiple partnership properties are encumbered by a single nonrecourse debt (e.g., the properties are cross collateralized) or where different components of a property's basis, when aggregated, equal or exceed the debt encumbering the property. The solutions to these issues are very difficult because of the lack of authority interpreting the language of Tier II. Unfortunately, *Rev. Rul.* 95-41 does not address this issue.

The allocation of partnership liabilities under Tier II will depend on how the liability is allocated among the contributed properties for purposes of computing Section 704(c) minimum gain. The issues surrounding debt allocations involving multiple properties can best be illustrated by the following.

EXAMPLE: A, B, and C contribute properties A, B, and C, respectively, to partnership ABC. The FMV and adjusted tax basis of, and the nonrecourse liabilities to which each property is subject, are set forth below.

	Property			
	A	B	C	Total
FMV	$400	$300	$500	$1,200
Basis	200	200	-0-	400
Liabilities	200	100	300	600

At the outset, the partners' shares of the $600 of liabilities are as follows:

	Partner			
	A	B	C	Total
Minimum gain	$ -0-	$ -0-	$ -0-	$ -0-
704(c) minimum gain	-0-	-0-	300	300
"Excess"	100	100	100	300
Total	$ 100	$ 100	$ 400	$ 600

Thereafter, ABC refinances the existing indebtedness with new nonrecourse debt of only $400 that is cross collateralized by properties A, B, and C. There appear to be three approaches to allocating the $400 of partnership liabilities among A, B, and C.

Alternative I—Treat all partnership property as a single property with a single basis of $400 and subject to a single debt of $400, resulting in the following allocations:

	Partner		
	A	B	C
Minimum gain	$ -0-	$ -0-	$ -0-
704(c) minimum gain	-0-	-0-	-0-
"Excess"	133	133	133
Total	$ 133	$ 133	$ 133[17]

Alternative II—The $400 nonrecourse liability is allocated among the partners based on, and in proportion to, the FMV of the contributed properties, resulting in the following allocations:

	Partner			
	A	B	C	Total
Minimum gain	$ -0-	$ -0-	$ -0-	$ -0-
704(c) minimum gain	-0-	-0-[18]	166[19]	166
"Excess"	78	78	78	234
Total	$ 78	$ 78	$ 244	$ 400

Alternative III—The $400 nonrecourse liability is allocated among the partners in proportion to their respective amounts of Section 704(c) built-in gain, resulting in the following allocations:

	Partner			
	A	B	C	Total
Minimum gain	$ -0-	$ -0-	$ -0-	$ -0-
704(c) minimum gain	-0-[20]	-0-[21]	250[22]	250
"Excess"	50	50	50	150
Total	$ 50	$ 50	$ 300	$ 400

Because of the lack of clear authority in establishing a method for allocating nonrecourse liabilities under Tier II among the partners, there would seem to be a good reporting position for each of the methods outlined above so long as the method chosen is applied reasonably and consistently. Unfortunately, the simplified facts and analysis in *Rev. Rul.* 95-41 ignored this issue entirely, and the Service apparently has no plans to issue guidance at this time.[23]

Conclusion

Some questions have been answered (for the most part, favorably from a taxpayer's standpoint) while many still remain in the area of nonrecourse debt allocations. Generally, the interaction of Section 704(c) with Section 752 can provide partial—and often complete—deferral to taxpayers in connection with deemed distributions arising from shifts in nonrecourse debt in partnership consolidations, including UPREIT formation or acquisition transactions, and in partnership recapitalization/workout transactions.

To obtain and "lock in" this deferral benefit, however, practitioners who represent taxpayers facing these issues must face and resolve favorably a number of issues, including the Section 704(c) method to be used,[24] the allocation scheme among properties if they are cross-collateralized, how excess nonrecourse liabilities may be allocated under Tier III, the existence and extent of restrictions on dispositions of partnership properties, and whether a partner will be given latitude to use other techniques, such as guarantees of nonrecourse debt, if and when the deferral benefits available under Reg. 1.752-3 are reduced or eliminated in future years.

A key point to remember, however, is that these techniques provide taxpayers with the ability to defer or spread potential tax liability associated with shifts of nonrecourse debt, not to permanently avoid them. A taxpayer may experience a "dribble out" of Section 731(a)(1) gain over time by virtue of the application of Section 752(b) if the taxpayer's percentage of the partnership's nonrecourse deductions is less than his original percentage of the nonrecourse debt. In these circumstances, as the taxpayer and other partners receive allocations of nonrecourse deductions, debt that was disproportionately allocated to the contributing partner under Tier II or Tier III will be shifted to the other partners under Tier I. At some point, these shifts in liabilities will result in deemed distributions to the taxpayer

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that give rise to gain recognition under Section 731(a)(1).

Alternatively, a taxpayer may experience more immediate and substantial deemed distributions under Sections 752(b) and 731(a)(1) if nonrecourse debt allocated to the taxpayer is paid down, property with Section 704(c) minimum gain or built-in gain being relied upon by the taxpayer to support Tier II or Tier III debt allocations is sold, or property with Section 704(c) built-in gain is cross-collateralized with other property and debt is allocated among the properties in a manner that shifts the debt previously allocable to the taxpayer to other partners. Because all of these events can have significant tax, business, or liquidity consequences to taxpayers, practitioners must analyze the short- and long-term consequences of the debt allocation method being chosen, and clients must be made aware of the immediate and potential future consequences to them. ■

[redacted]emain in [redacted]ributing [redacted]llocations of [redacted]t to enable [redacted].

[redacted]he full [redacted]gain is taken [redacted]cating [redacted]e remedial [redacted]

[redacted] that a [redacted] based [redacted] is [redacted]urposes of [redacted]r Tier II.

1 For a complete analysis of the Section 704(c) allocation methods, see Frankel, Loffman, and Present, "Final Allocation Regulations Still Permit Planning to Avoid Impact of the Ceiling Rule" and "Final Regulations Add Simplicity but Retain Planning Opportunities," 80 JTAX 272 and 330 (May and June 1994).

2 A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for such liability. Reg. 1.752-1(a)(2). Reg. 1.752-2 provides the rules for determining a partner's share of recourse liabilities.

3 Reg. 1.752-3(a)(1). Partnership minimum gain, as defined under Reg. 1.704-2(d)(1), is determined by "first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than the full satisfaction of the liability." Under Reg. 1.704-2(d)(3), if partnership property subject to one or more nonrecourse liabilities is, under Reg. 1.704-1(b)(2)(iv)(d), (f) or (r), reflected on the partnership books at a value that differs from its adjusted tax basis, the determination of minimum gain is made with reference to "book value."

4 See Regs. 1.704-1(b)(2)(iv)(f) and (g).

5 Reg. 1.752-3(a)(2). The second allocation tier requires debt to be allocated based on the amount of Section 704(c) gain that would result if all partnership property subject to nonrecourse liabilities were disposed of in full satisfaction of those liabilities but for no other consideration.

6 This statement in Rev. Rul. 95-41, 1995-23 IRB 5, is directed at how the partners will share book items for tax purposes under Section 704(b). Section 704(c) (and the Section 704(c) method elected by PRS) will dictate how tax items will be shared so as to take into account the difference between the FMV and the tax basis of the property contributed to PRS by A.

7 Reg. 1.704-1(b)(2)(iv).

8 If PRS had been an existing partnership in which A was a partner, the negative capital account would have been required to be "supported" by partnership minimum gain under Reg. 1.704-2(b)(2) or A would have suffered a chargeback of income. Similarly, the issues dealt with in the Ruling likewise would become relevant if PRS were an existing partnership and B contributed cash of $4,000 to PRS for a 50% interest because this contribution would qualify as a "revaluation event" under Reg. 1.704-1(b)(2)(iv)(f) that gives rise to "reverse Section 704(c) allocations" using the principles of Section 704(c). See Reg. 1.704-3(a)(6).

9 Reg. 1.752-3(a)(1) (partner's share of nonrecourse liabilities of partnership includes partner's share of partnership minimum gain); Reg. 1.704-2(d)(3) (partnership minimum gain is determined with reference to contributed property's book value rather than its adjusted tax basis).

10 See Reg. 1.704-3(c).

11 Reg. 1.704-3(d).

12 Reg. 1.704-1(b)(2)(iv)(d)(3).

13 See McKee, Nelson, and Whitmire, *Federal Taxation of Partnership and Partners*, first ed. (Warren, Gorham & Lamont, 1977), ¶8.04[4].

14 Reg. 1.752-1(e) (1956) (allocate nonrecourse debt according to how partners' share partnership "profits"). This Regulation was superseded by the current Section 752 Regulation cited and discussed herein.

15 Rev. Proc. 93-27, 1993-2 CB 27. See generally Egerton, "Rev. Proc. 93-27 Provides Limited Relief on Receipt of Profits Interests for Services," 79 JTAX 132 (September 1993).

16 The remaining $2,000 of Section 704(c) gain plus 50% of the final $2,000 of debt. As discussed in the text below, however, if nonrecourse deductions are allocated 50-50 between A and B, A's basis will be eroded as Tier III liabilities are moved to Tier I on a 50-50 basis as partnership Section 704(b) minimum gain is generated.

17 C's share of partnership liabilities is decreased from $400 to $133, resulting in a deemed distribution of $267 under Section 752(b), and because C's adjusted tax basis in his partnership interest is zero, C recognizes gain of $267 under Section 731(a)(1).

18 $300 FMV divided by $1,200 total FMV equals 1/4, which when multiplied by the $400 debt results in $100 of allocable liability. There is no Section 704(c) minimum gain, however, because the $100 does not exceed the $200 basis of B's contributed property.

19 $500 FMV divided by $1,200 total FMV equals 5/12, which when multiplied by the $400 debt results in $166 of allocable liability. Section 704(c) minimum gain is $166 (C's share of liability less zero basis). C's share of partnership liabilities is decreased from $400 to $244, resulting in a deemed distribution of $156 under Section 752(b). Again, because C's adjusted tax basis in his partnership interest is zero, C recognizes gain of $156 under Section 731(a)(1). Compared with Alternative I (see note 17, *supra*), C's taxable gain is reduced by $111 (from $267 to $156) as a result of C's receipt of a Tier II allocation under this alternative.

20 A's built-in gain of $200 divided by total built-in gain of $800 equals 1/4, which when multiplied by the $400 debt results in $100 of allocable liability. There is no section 704(c) minimum gain.

21 B's built-in gain of $100 divided by total built-in gain of $800 equals 1/8, which when multiplied by the $400 debt results in $50 of allocable liability. There is no Section 704(c) minimum gain.

22 C's built-in gain of $500 divided by total built-in gain of $800 equals 5/8, which when multiplied by the $400 debt results in $250 of allocable liability. Section 704(c) minimum gain is $250 (C's share of liability less zero basis).

23 See Ltr. Rul. 9507023, however, where the Service ruled that a liability allocation among partners in a partnership with cross-collateralized properties, based on the relative FMVs of the properties, was acceptable.

24 On this issue, while the remedial allocation method may produce the largest allocation of nonrecourse debt to the taxpayer under Tier II, it does not allow the contributing partner to benefit from the application of the ceiling rule. As a result, the remedial allocation method may produce a significantly larger or faster gain recognition under Section 704(c) than the other possible methods. In addition, the preferred Section 704(c) method of one partner may be the least favorable to the other, so this issue often is the subject of considerable analysis and negotiation.

The Ruling's failure to provide a meaningful gloss on 'profits' adds complexity to the allocation of excess nonrecourse liabilities.

Remaining 704(c) gain should take priority over speculative partnership profits in allocating excess nonrecourse liabilities under Tier III.