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Allocating Partnership Liabilities Under the New Section 752 Regulations

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THE NEW SECTION 752 REGULATIONS

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King & Spalding - Atlanta

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§ 8.01 Overview of the Liability Sharing Rules

[1] General

Sections 752(a) and 752(b) speak in terms of increases or decreases "in a partner's share of the liabilities of a partnership," yet nowhere in the statute is any attempt made to indicate the manner in which a partner's "share" of liabilities is to be determined. That task is left entirely to the Regulations. The original liability sharing rules, which were promulgated as Regulation § 1.752-1(e) in 1956 and are referred to in this Chapter as the Old Regulations, are a mere two paragraphs in length. While the Old Regulations were mercifully brief, they were mercilessly ambiguous and unhelpful in resolving even simple liability sharing questions in the context of modern complex partnerships. The Old Regulations were replaced in late 1988 by comprehensive new regulations. These rules, which were published in proposed and temporary form, are referred to in this Chapter as the New Regulations. The New Regulations are regrettably lengthy, complex and detailed, but they provide a framework that is both theoretically sound and sufficiently comprehensive to resolve clearly most of the issues that were left open by the Old Regulations.

* This outline is a draft of a Chapter to be included in the next edition of McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners (Warren, Gorham & Lamont).

Both the Old Regulations and the New Regulations share a common theoretical underpinning: partnership recourse liabilities are allocated among the partners in the manner in which they share partnership losses, while partnership nonrecourse liabilities are allocated in the manner that the partners share profits. In contrast, however, to the Old Regulations, which did not identify the nature of the controlling loss or profit sharing ratios, the New Regulations provide detailed rules for determining the loss or profit sharing ratios that govern liability allocation.

[2] Effective Date of New Regulations

With significant exceptions, the New Regulations apply, on a liability by liability basis, to liabilities incurred on or after January 30, 1989. Conversely, the Old Regulations continue to apply to liabilities incurred before January 30, 1989, and under a special grandfather rule, to liabilities incurred on or after January 30, 1989, pursuant to a "written binding contract" in effect before December 29, 1988 and at all times thereafter.¹

Although the effective date provisions do not expressly so state, it seems that any transaction between the partnership-obligor and a holder of a partnership liability that would be treated by the holder as a sale or exchange of the liability under § 1001 should constitute the incurring of a new liability by the obligor partnership. This concept probably means that most refinancings will be subject to the New Regulations. In addition, liabilities of a partnership that is terminated for tax purposes under § 708(b)(1)(B) should be treated as incurred by the
successor partnership upon its deemed formation, and hence should be governed by the New Regulations.

While the New Regulations generally apply prospectively on a liability-by-liability basis, there is one significant area of retroactivity relating to loans that are nonrecourse liabilities for purposes of Regulation § 1.1001-2 and are held or guaranteed by a partner. The New Regulations apply to any such liabilities beginning on the later of March 1, 1984, or the first day thereafter on which a partner either holds the liability or guarantees it. Thus, if a partner guaranteed or held an otherwise nonrecourse partnership liability prior to March 1, 1984 and at all times thereafter, the New Regulations are not retroactively applied. Instead, the Old Regulations and interpretive authority continue to apply. In any other case, the New Regulations apply retroactively to March 1, 1984, or the first day thereafter that a partner either held the liability or guaranteed it. Although the language of the effective date rules are opaque on the point, Treasury officials have indicated that, under their intent and interpretation of the rules, nonrecourse liabilities held or guaranteed, prior to December 29, 1988, by related persons (and not directly by partners) are not covered by the retroactive rules in the New Regulations.

Partnerships were permitted to come under the New Regulations as of their first taxable year ending after December 29, 1988, by making an election on a timely filed (with extensions) return for their first taxable year ending after December 30, 1988. If an
election was made, all liabilities were reallocated according to the New Regulations, and any net adjustments were treated as net § 752(a) or § 752(b) contributions or distributions.

In the absence of an election to apply the New Regulations to all partnership liabilities beginning with partnership's first taxable year ending after December 29, 1988, the Old Regulations and related interpretive authority continue to apply to most partnership liabilities incurred before January 30, 1989. Accordingly, for an indefinite period both the Old Regulations and the New Regulations will apply simultaneously to most partnerships in existence on January 30, 1989. The significance of the Old Regulations will, of course, wane over time and the manner in which the New Regulations resolve certain issues may influence the resolution of similar issues under the Old Regulations. Nevertheless, for many partnerships, the Old Regulations will be important for a long time.

8.02 The Old Regulations

The Old Regulations are reprinted in their entirety below:

Partner's share of partnership liabilities. A partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement. In the case of a limited partnership, a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution
which he is obligated to make under the limited partnership agreement. However, where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits. The provisions of this paragraph may be illustrated by the following example:

Example. G is a general partner and L is a limited partner in partnership GL. Each makes equal contributions of $20,000 cash to the partnership upon its formation. Under the terms of the partnership agreement, they are to share profits equally but L's liabilities are limited to the extent of his contribution. Subsequently, the partnership pays $10,000 for real property which is subject to a mortgage of $5,000. Neither the partnership nor any of the partners assume any liability on the mortgage. The basis of such property to the partnership is $15,000. The basis of G and L for their partnership interests is increased by $2,500 each, since each partner's share of the partnership liability (the $5,000 mortgage) has increased by that amount. However, if the partnership had assumed the mortgage so that G had become personally liable thereunder, G's basis for his interest
would have been increased by $5,000 and L's basis would remain unchanged.\textsuperscript{6}

In applying these rules, it is necessary to distinguish limited partnerships from other partnerships, and limited partners from other partners of limited partnerships. Neither "limited partnership" nor "limited partner" is defined in the Code or Regulations, but the internal logic of the quoted Regulation suggests that the key concept should be limited liability under applicable state law. Thus, "limited partnership" includes any partnership in which some of the partners enjoy limited liability, a definition that encompasses partnerships formed under state statutes corresponding to the Uniform Limited Partnership Act as well as partnerships formed under other limited liability statutes peculiar to certain states. Similarly, the term "limited partner" should include any partner enjoying limited liability under applicable state statutes.\textsuperscript{7} A putative limited partnership which fails to comply substantially with the requirement that a certificate of limited partnership be filed under the Uniform Limited Partnership Act may be treated as a general partnership for state-law purposes\textsuperscript{8} and should also be categorized as a general partnership under § 1.752-1(e) of the Old Regulations. A partner who is denominated a limited partner but who in fact participates in the management and control of the partnership, thereby subjecting himself to liability as a general partner,\textsuperscript{9} should be treated as a general partner for purposes of the Regulation.
[1] Restatement of the Old Sharing Rules

The manner in which the Old Regulations allocate liabilities among partners in a general partnership may be restated as follows: All recourse liabilities are allocated in accordance with the ratios in which the partners share partnership losses, while all nonrecourse liabilities are allocated in accordance with the ratios in which they share partnership profits.

The rules applicable to limited partnerships are more complicated, and may be restated as follows:

Rule 1. First, all partners, general and limited, share nonrecourse liabilities in accordance with their respective interests in partnership profits.

Rule 2. Next, each limited partner's share of recourse liabilities is equal to the lesser of (1) the amount, if any, by which the total contribution that he is obligated to make to the partnership exceeds his actual contribution, or (2) that portion of such liabilities which corresponds to his share of partnership losses.

Rule 3. Finally, all remaining partnership recourse liabilities are shared among the general partners in proportion to their respective interests in partnership losses (e.g., if general partner A has a 15 percent interest in losses and general partner B has a 5 percent interest in losses, three-quarters of unallocated recourse liabilities are allocated to A and one-quarter to B).
The assertion, in the third rule, that all unallocated recourse liabilities are allocable to the general partners is based on the last sentence of the Example in Old Regulation § 1.752-1(e), which allocates 100 percent of a recourse liability to a general partner who has an interest of only 50 percent in partnership profits (and, presumably, losses). The method of sharing recourse liabilities among several general partners is based on the first sentence of the Old Regulations. The third rule is defensible on the ground that it increases partners' bases in the aggregate by the full amount of partnership liabilities, thereby preserving the fundamental equality of basis between partners and partnership.

The sharing rules provided by the Old Regulations for recourse liabilities apparently were intended to reflect the manner in which the partners will share responsibility for payment of the liability if it is not satisfied by the partnership. In effect, each partner is permitted to increase the basis of his partnership interest by the portion of the liability which he is contingently liable for if the partnership fails. The sharing rules with respect to nonrecourse liabilities necessarily are based on different considerations, since there is no possibility that the partners may be called upon to satisfy such liabilities. By allocating nonrecourse liabilities to all partners in accordance with their profit-sharing ratios, the Old Regulations recognize that the liability will be satisfied only out of profits or assets of the partnership and that no partner, regardless of
his status as a general or limited partner, has any personal responsibility for the debt.\textsuperscript{13}

[2] Nonrecourse Liabilities Under the Old Regulations

Because the Old Regulations allocate recourse liabilities according to the partners' loss interests and nonrecourse liabilities according to their profits interests, it is important to distinguish recourse from nonrecourse liabilities. This distinction is crucial for limited partners who can only include recourse liabilities in their bases to the extent of their obligations to make additional contributions.

[a] Defining Nonrecourse Liabilities

A partnership obligation is a nonrecourse liability within the meaning of Old Regulation § 1.752-1(e) if it is both a "liability" for purposes of § 752 and "nonrecourse" as defined by the Regulations. Paragraphs 7.01 and 7.02 discuss various theories under which certain obligations may be excluded from the § 752 definition of "liability." Under the Old Regulations, a nonrecourse liability is a liability with respect to which "none of the partners have any personal liability." The key words in the Regulation are "none" and "any," both of which suggest a narrow construction of the provision.\textsuperscript{14}

The Regulation contains only one example of a nonrecourse liability: a mortgage liability on real estate acquired by a partnership, subject to the mortgage but without the assumption by the partnership or any partner of any liability on the mortgage. Other types of nonrecourse liabilities would include notes secured
by purchase-money deeds of trusts in states (such as California) that have enacted antideficiency legislation in connection with certain types of transactions, and notes under which the creditor's recourse is contractually limited to property securing the note. State law should be determinative in ascertaining whether a liability is nonrecourse.

The Tax Court's first encounter with the nonrecourse liability definition occurred in an unusual factual situation and produced a literal interpretation of the definition. In Curtis W. Kingbay, the taxpayers (husband and wife) were the only original limited partners in a partnership that incurred losses substantially in excess of their capital contributions. The sole general partner was a nominally capitalized corporation owned by the husband. The partnership borrowed substantial sums from the husband and also from unrelated institutional lenders to finance the construction of apartment buildings. The corporate general partner was personally liable for all of these debts.

The Commissioner determined that no portion of these debts should be added to the limited partners' bases, and, hence, disallowed all deductions in excess of their equity investments under § 704(d). The taxpayers argued, among other things, that the debts were in substance nonrecourse because the general partner was a dummy with no significant assets. The Tax Court rejected this argument, stating that because the corporate general partner served a business purpose -- limiting the personal liability of the taxpayers -- it was a viable entity and should
not be ignored, particularly at the behest of those who had formed it. 17

Some commentators have concluded that Kingbay indicates a tendency to exalt form over substance in literally applying the nonrecourse liability rules, but the case really seems to be little more than another application of the basic axiom that a taxpayer who has made his bed must lie in it. Whether the government will have as hard a time arguing substance over form in a different case remains to be seen. 18

[b] Conduit Purchases

In some cases, a lender providing financing for the purchase of a partnership asset may insist on personal liability. It has been suggested that nonrecourse treatment may be achieved even under these circumstances, if the general partner purchases the property, becoming personally liable for the financing, and then transfers it to the partnership subject to the liability, but without the assumption of the liability by the partnership. The result of these transactions is that no partner has any personal liability as a partner and, if there is more than one general partner, some general partners have no personal liability in any capacity.

The validity of the distinction between a general partner who is liable as a partner and a general partner who is liable in another capacity is questionable. The Old Regulation makes no distinction of this sort, and there seems to be no difference in substance. The probability that the courts would refuse to honor
this distinction is increased if it is obvious, as it ordinarily will be, that the general partner acted on behalf of the partnership in purchasing the property. 19

The presence of multiple general partners does little to improve the efficacy of this technique. Nonrecourse liabilities are those with respect to which "none of the partners have any personal liability." 20 If the partnership purchases the property directly, subject to (but without assuming) the indebtedness and one of the general partners agrees to be personally liable for the debt, it is clear that the debt is not a nonrecourse liability within the meaning of the Old Regulation. Separation of the transaction into two steps should not alter this result. 21

Outside the conduit context, a nonrecourse loan directly from a general partner has been treated as a nonrecourse debt under the Old Regulations. 22 The step-transaction doctrine is not relevant in this context. However, the general partner obviously bears the economic risk of loss, albeit in its capacity as a lender rather than as a partner. Under the New Regulations, nonrecourse loans from partners (or related persons) cannot increase the basis of the other partners in their partnership interests. 23

[c] Guaranties by Nonpartners

A similar technique for attempting to satisfy the nonrecourse liability definition involves the parent corporation of a corporate general partner acting as guarantor of the partnership's nonrecourse indebtedness. Alternatively, the guarantor may be an individual nonpartner-shareholder of the corporate general
partner. Arguably, since the guarantor is not a partner, the nonrecourse liability definition has been satisfied. No "partner" has any personal liability for the debt.

Despite technical compliance with the definition, most seasoned tax practitioners are likely to have some misgivings about this approach. Even if the corporate general partner is a substantial entity, formed for valid business reasons unrelated to the matter at hand, the Service may attempt to treat the liability as a recourse liability on the theory that a guaranty by a shareholder of the general partner means the shareholder's assets, including its shares of the corporate general partner, are available to satisfy the guaranty. Through these shares in the general partner, the argument follows, the guaranteed creditor will ultimately be able to look to the assets of the general partner to satisfy the debt, just as if the general partner had guaranteed the debt directly. The shareholder's guaranty can thus be viewed as a guaranty by both the shareholder and the general partner, and if so viewed, it is a violation of the nonrecourse liability rules.

While the Service may attempt to treat partnership nonrecourse liabilities as recourse liabilities to the extent that such liabilities are guaranteed by non-partners who are related to partners, any such argument is weakened by the effective date provisions of the New Regulations. Under the New Regulations an otherwise nonrecourse partnership liability is treated as a recourse liability to the extent that the liability is guaranteed
by a partner or a person related to a partner.\textsuperscript{26} The New Regulations apply to partnership nonrecourse liabilities that are directly guaranteed by partners beginning as early as March 1, 1984,\textsuperscript{27} but do not apply to partnership nonrecourse liabilities that were guaranteed by related persons before January 30, 1989.\textsuperscript{28} Since the New Regulations apply retroactively to nonrecourse liabilities that are directly guaranteed by partners, but not to partnership nonrecourse liabilities guaranteed by related persons, it seems reasonable to infer that the regulation writers believed that the related person rules in the New Regulations constituted a change in the law and not merely a clarification of the Old Regulations. This inference seems all the more reasonable because the term "related person" is defined very narrowly in the New Regulations to include only those related parties that can reasonably be viewed as economic alter egos.

\textbf{[d] Partial Recourse Debts}

Another technique to enhance the lender's position, without disturbing the nonrecourse character of most of a partnership's indebtedness, is to provide for personal liability with respect to only a portion of the debt (e.g., the general partners might agree to guarantee 20 percent of an otherwise nonrecourse loan). The difficulty with this approach lies in the definitional language of Old Regulation § 1.752-1(e), which limits nonrecourse liabilities to those with respect to which no partner has "any personal liability" (emphasis added). Arguably, liability for 20 percent of the debt taints the entire debt under this language.\textsuperscript{29}
Despite the language of Old Regulations, the portion of the debt that is not guaranteed must be satisfied solely from the profits of the partnership and should, in theory, be allocated according to the profit-sharing ratios of the partners. This portion of the debt cannot be economically borne by any of the partners, and thus it should not be allocated to the general partners in accordance with their loss-sharing ratios simply because one partner is personally liable on a different portion of the debt. This result is particularly perverse if the partial guarantor is a limited partner, in which case the potential personal liability of a limited partner could act as a springboard to shift the liability away from the limited partners.\textsuperscript{30}

While the Service seems to agree that it is appropriate to bifurcate a partially recourse debt for this purpose, the Tax Court has had some difficulty getting the message. In Arthur E. Long,\textsuperscript{31}, the Tax Court indicated in dicta that a partially recourse debt is treated as recourse in its entirety under the Old Regulations. The Service responded by announcing in a ruling that it will not follow Long on this point, but will apply the Old Regulations by fragmenting partially recourse liabilities into their recourse and nonrecourse components.\textsuperscript{32} Nevertheless, in George F. Smith, Jr.,\textsuperscript{33} which was decided after the Service issued its ruling, the Tax Court, without citing the ruling, again treated a partial recourse liability as fully recourse for § 752 purposes.
The New Regulations expressly recognize that a single liability may be partly recourse and partly nonrecourse and treat the two parts as separate liabilities for § 752 purposes.34

1 8.03 Sharing Recourse Liabilities Under the New Regulations

[1] Background: The Raphan Case and Section 79 of the 1984 Act

In Raphan v. United States,35 the Claims Court considered whether a limited partnership liability was recourse or nonrecourse for purposes of applying the Old Regulation § 1.752-1(e) sharing rules. The debt in question was secured by partnership assets and the terms of the debt imposed no liability on the partnership or its partners beyond the value of the collateral; however, the limited partnership's general partner personally guaranteed the debt. The Claims Court held that the guarantee did not cause the general partner to be personally liable for the debt within the meaning of the Regulation. Accordingly, the court held that the debt was a nonrecourse liability which could be included in the limited partners' bases.

Prodded by the Treasury, which feared a massive raid on the fisc following Raphan, Congress concluded that the Claims Court's holding was "inappropriate"36 and directed, in § 79(a) of the Tax Reform Act of 1984, that § 752 (and the Regulations thereunder) should be applied without regard to the result reached in Raphan.37 In addition, § 79(b) of the 1984 Act directs the Treasury to amend the § 752 Regulations to address the basis
effects of "guarantees, assumptions, indemnity agreements, and similar arrangements."

The Conference Report accompanying the 1984 Act contains additional guidance for the Treasury. The rejection of the "holding of the Raphan decision" is to be effective March 1, 1984, but other changes in the New Regulations are to be prospective.\(^38^\) The New Regulations are to be based "largely on the manner in which the partners, and persons related to the partners, share the economic risk of loss with respect to partnership debt (other than bona fide nonrecourse debt, as defined by [the New Regulations])."\(^39^\)

[2] The Economic risk of Loss Concept

Under the New Regulations, a partnership liability is a recourse liability only to the extent that one or more partners (or related persons) bear the "economic risk of loss" with respect to the liability.\(^40^\) A partner's share of partnership recourse liabilities "equals that portion of the recourse liabilities of the partnership for which such partner [or persons related to such partner] bears the economic risk of loss. . . ."\(^41^\) Thus, under the New Regulations the economic risk of loss concept is critical both in determining whether liabilities are recourse and in allocating recourse liabilities among the partners.

The concept of economic risk of loss is explicated in detail below, but it is important to understand at the outset that a liability which is treated as a nonrecourse liability for other tax and business purposes may constitute a recourse liability.
under the New Regulations. For example, a partner is treated as bearing the economic risk of loss for a liability (and therefore the liability is treated as recourse for § 752 purposes) to the extent that the partner (or a related person) holds or guarantees the liability,\textsuperscript{42} even if the liability would be treated as nonrecourse for purposes of Regulation § 1.1001-2 or for other purposes.

Despite the length and detail of the regulatory definition of the term "economic risk of loss,"\textsuperscript{43} the underlying concept is relatively simple and can be summarized as follows: At any time, a partner bears the economic risk of loss for a partnership liability to the extent that the partner (or a related person) would be legally obligated to make net payments, directly or indirectly, to satisfy the liability out of his or her non-partnership assets if, at such time, the partnership had no assets and all its liabilities were due. The New Regulations summarize the test for economic risk of loss as follows:

"Generally, a partner bears the economic risk of loss for a partnership liability to the extent that the partner (or person related to the partner) would be obligated to make a payment to the creditor or a contribution to the partnership with respect to a partnership liability (and would not be entitled to be reimbursed for such contribution or payment by another partner, a person related to another partner, or the partnership) if all of the partnership's liabilities were due and payable in full, all of the partnership's assets
(including money) were worthless, the partnership disposed of all of its assets in a fully taxable transaction for no consideration (other than relief from certain [generally nonrecourse] liabilities), and the partnership allocated its items of income, gain, loss, deduction, and credit for the year among the partners and liquidated the partners' interests in the partnership.44

Five aspects of the test for economic risk of loss merit emphasis: First, the test takes into account all statutory and contractual obligations relating to partnership liabilities and capital among the partners, between the partners and the partnership, between the partnership and its creditors, and between the partners and the partnership's creditors.45 Thus, guarantees, indemnifications and other obligations running to creditors, other partners or the partnership are relevant, even if they are not included in the partnership agreement. Second, any obligation of a partner to make a payment or a contribution is offset by any right of such partner to be reimbursed or indemnified by any other partner (or a person related to any other partner) for any such payment or contribution.46 Thus, for example, even though a limited partner's separate guarantee of a recourse partnership liability is taken into account in determining whether he or she bears the economic risk of loss for such liability, any economic risk of loss that would otherwise result from such guarantee is reduced to the extent that, upon performance of the guarantee, the guarantor/limited partner would
be subrogated to the creditor's claim against the partnership and the general partners. Third, for purposes of determining economic risk of loss, obligations and rights of persons that are related to a partner are treated as obligations and rights of the partner. Fourth, in measuring economic risk of loss, the New Regulations assume that any partner, related person or the partnership will actually discharge its contractual obligation to make payments unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. Finally, and perhaps most importantly, at any given time, a partner's economic risk of loss for partnership liabilities is determined by assuming, regardless of the partnership's actual financial situation, that its assets are worthless and that it is liquidated.

Even to those accustomed to the ironic twists of federal tax law, it may seem strange that the New Regulations require a prosperous, ongoing partnership to allocate its recourse liabilities among its partners on the assumption that the its assets become instantly worthless and that it liquidates. Indeed, most partnerships pay their liabilities out of profits and even those that fall on hard times generally satisfy their obligations by liquidating existing partnership assets, without the necessity of calling on their partners. Even in the direst case, a partnership can be expected to have some asset value remaining to mitigate the amount that its partners must contribute or pay to satisfy its liabilities. Why then, are the New Regulations based on an assumption that is almost never true?
The answer lies in the relationship between the basis rules in § 752, the allocation rules in § 704(b), and the limitation in § 704(d), which prevents a partner from deducting losses in excess of the basis of his or her partnership interest. The New Regulations explicitly recognize the need to coordinate the operation of the liability sharing rules in § 752 with the § 704(b) allocation rules: "The coordination of these two sections reflects the fact that one of the principal purposes for including partnership liabilities in the bases of the partners' interests in the partnership is to support the deductions that will be claimed by the partners for the items attributable to those liabilities." In the "normal" situation in which the bases of the partners for their partnership interests are equal to the partnership's aggregate basis for its assets, the most direct way to accomplish this coordination is to allocate partnership liabilities among the partners for basis purposes so as to reflect the way in which partnership losses would be allocated among the partners if the "maximum" loss were sustained with respect to existing partnership liabilities (in other words, if all partnership assets became worthless and the partners were required to satisfy all recourse liabilities out of non-partnership assets). Thus, in allocating liabilities under § 752, it is appropriate to anticipate how partnership losses (in excess of partnership capital) would be allocated if the partnership incurred the maximum loss it could incur. Accordingly, in determining economic risk of loss for partnership liabilities the
New Regulations assume the worst -- that all partnership assets become worthless -- and seek to "preallocate" partnership recourse liabilities in a manner that will track the manner in which partnership losses would be allocated if the worst happened. If something less catastrophic than the worst occurs, no harm is done by this approach.


A partner bears the economic risk of loss for a partnership liability only to the extent he would bear the loss out of his non-partnership assets if the partnership were wholly unable to pay the liability. Therefore, as a condition precedent to determining who bears the economic risk of loss for partnership liabilities under the New Regulations, it is necessary to hypothesize a situation in which, simultaneously, the partnership's assets become wholly worthless, the partners' capital accounts are adjusted to reflect a loss of the entire book value of the partnership's assets, all contractual and statutory obligations of the partners relating to the partnership and its liabilities are triggered and performed, and the partnership liquidates. The New Regulations understatedly refer to this hypothetical cataclysm as a "constructive liquidation."

The following events are deemed to occur in connection with a constructive liquidation:

(1) Assets Become Worthless. With limited exceptions, all partnership assets (including money, insurance claims and other rights against unrelated persons) become wholly worthless.51 The
only assets that are not treated as becoming worthless under this rule are (a) certain assets which, although nominally owned by the partnership for the sole purpose of securing payment of a partnership liability, are consistently treated by the New Regulations as if they were actually owned by the partner who contributed them, and (b) obligations of partners and related persons to make contributions to the partnership or payments to creditors or other persons with respect to partnership liabilities.

(2) **Liabilities Become Due.** All of the partnership's liabilities become fully due and payable "because of the partnership's failure to make the payments required with respect to such liabilities . . . ." Such liabilities include any "wrapped indebtedness" owed by a partner or related person to a third party that is treated as a separate liability of the partnership.

(3) **Assets Are Disposed Of.** With certain exceptions, the partnership disposes of all of its assets in a fully taxable transaction for no consideration. There are two exceptions to this general rule: First, assets that are contributed to and used by the partnership for the sole purpose of securing partnership liabilities are treated as disposed of for their fair market value in complete or partial satisfaction of the liabilities they secure. Second, after taking into account such dispositions, partnership assets that are security for nonrecourse liabilities (those with respect to which the creditor's repayment rights are...
limited to one or more partnership assets) are treated as disposed of in satisfaction of such liabilities.58

(4) All Items Are Allocated. The partnership's tax year closes on the date of the constructive liquidation and all items of partnership income, gain, loss, deduction and credit (actual items as well as those generated by the hypothetical liquidation) are allocated to the partners in accordance with the partnership agreement.59

(5) Liquidation. The partners' interests in the partnership are liquidated.60

The net effect of steps (1) through (4) is to create a hypothetical balance sheet. The asset side of this balance sheet will always be zero. The only liabilities remaining on the other side of the balance sheet will be those with respect to which partners or related persons bear the economic risk of loss. The partners' capital accounts will be fully adjusted to reflect the disposition of all of the partnership's assets and will, in the aggregate, have a net deficit balance exactly equal to the remaining liabilities. The next step is to utilize this balance sheet and the definitions of "net contribution obligations" and "net payment obligations" to determine the extent to which each partner would bear the economic risk of loss with respect to each partnership liability, as discussed below in § 8.03[4]. Before turning to this step, however, it may be helpful to consider a simple example of the mechanics of a constructive liquidation:
Example. A and B form the AB general partnership to invest in real estate. Each contributes $100,000 cash. In addition, B contributes marketable securities which have a fair market value and a basis of $100,000 at all relevant times. All profits and losses are to be allocated equally to the partners, except that any gain or loss with respect to the securities is to be allocated 100% to B. The partnership agreement provides that capital accounts will be maintained in accordance with the § 704(b) Regulations, liquidating distributions will be based on capital accounts, and any partner with a deficit capital account balance on liquidation must make it up. The partnership buys building X for $300,000, consisting of a $100,000 cash down payment and a $200,000 full recourse note to the seller, and building Y for $400,000, consisting of a $50,000 cash down payment and a $350,000 nonrecourse loan to the seller that is secured by a mortgage on building Y and a pledge of the marketable securities contributed by B. The remaining $50,000 of cash is retained for future needs. Following these transactions, the balance sheet of AB is as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash $50,000</td>
<td>Recourse Loan $200,000</td>
</tr>
<tr>
<td>Securities 100,000</td>
<td>Nonrecourse Loan 350,000</td>
</tr>
<tr>
<td>Building X 300,000</td>
<td>Total Liabilities 550,000</td>
</tr>
<tr>
<td>Building Y 400,000</td>
<td>Capital Accounts</td>
</tr>
<tr>
<td>Total $850,000</td>
<td>A $100,000</td>
</tr>
<tr>
<td></td>
<td>B 200,000</td>
</tr>
<tr>
<td></td>
<td>Total Capital 300,000</td>
</tr>
<tr>
<td></td>
<td>Liabilities and Capital $850,000</td>
</tr>
</tbody>
</table>
Upon a constructive liquidation of the partnership immediately after these transactions, the cash and both buildings are treated as worthless; the securities are treated as if they were owned by B under the special "solely for security" rule. Both loans are treated as due and payable. The partnership is treated as receiving consideration in the form of relief from liability upon the hypothetical disposition of its assets to the extent that the nonrecourse loan is a liability for which the creditor's repayment rights are limited to one or more partnership assets. Under the "solely for security" rule, the pledge of the securities is treated as an obligation of B to make a payment to the nonrecourse creditor, limited to the value of the securities. Thus, only $250,000 of the $350,000 nonrecourse loan is a liability with respect to which the creditor's rights are limited to partnership assets, and the partnership is deemed to receive consideration of $250,000 in relief from such liability in exchange for building Y, which has a basis of $400,000, thus generating a $150,000 loss. The cash and building X are treated as being worthless and disposed of in a taxable transaction, generating an additional $350,000 loss. Total losses of $500,000 are allocated equally between A and B, producing the following balance sheet:
As discussed below, this balance sheet demonstrates that A and B have contribution obligations of $150,000 and $50,000, respectively, with respect to the $200,000 recourse loan, and consequently $150,000 of such loan increases A’s basis and $50,000 increases B’s basis. The $100,000 of the "nonrecourse" loan that is secured by the securities is allocated entirely to B, and the remaining $250,000 is treated as a nonrecourse liability that is allocated in accordance with the rules discussed in ¶ 8.04 below.

[4] **Net Contribution and Net Payment Obligations**

All statutory and contractual obligations of the partners (and related persons) to the partnership, to other partners (or related persons), and to partnership creditors are taken into account in determining the extent to which the partners bear the economic risk of loss for partnership liabilities. The New Regulations divide these obligations into two categories: (1) net contribution obligations, and (2) net payment obligations.

[a] **Net Contribution Obligations**

[1] General

A partner has the economic risk of loss for a partnership liability to the extent the partner would be required to make a net contribution to the partnership with respect to such liability
if the partnership were constructively liquidated.\footnote{63} Generally, there are three steps in determining a partner's net contribution obligation: (1) determine the gross contributions that the partner would be required to make in the event of a constructive liquidation; (2) determine the net contributions that the partner would be required to make by reducing his gross contributions by any right that he has to be reimbursed for such contributions; and (3) determine what portion of any resulting net contributions would be applied, directly or indirectly, to pay a particular partnership liability and is therefore a net contribution obligation "with respect to" that partnership liability.

A partner's gross contribution obligation is equal to the sum of (1) the outstanding principal balance of any promissory note made by such partner and contributed by him to the partnership;\footnote{64} (2) any other obligation of such partner to make contributions to the partnership, whether arising by operation of law (for example, under the Uniform Partnership Act or Uniform Limited Partnership Act) or under the partnership agreement (for example, an obligation to make a fixed contribution or to restore a deficit capital account at the time of liquidation);\footnote{65} and (3) the amount of such partner's obligation to "reimburse" other partners for their contributions to the partnership.\footnote{66}

The net contribution a partner would be required to make to the partnership at the time of a constructive liquidation is the gross contributions such partner would be required to make "reduced by the aggregate amount of the reimbursements ... that
such partner or a person related to such partner would be entitled to receive with respect to such contributions." Reimbursements are discussed in ¶ 8.03[4][c] below.

[iii] Allocating Net Contribution Obligations to Specific Partnership Liabilities

Once a partner's net contribution obligation is determined by ascertaining the contributions he would be required to make at the time of a constructive liquidation and reducing those contributions by any reimbursements to which he would be entitled, the final step is to determine the extent to which the net contribution obligation is "with respect to" a partnership liability. A net contribution obligation whose proceeds would not be applied, directly or indirectly, to pay partnership liabilities does not result in economic risk of loss with respect to such liabilities and, hence, does not cause liabilities to be allocated to the obligated partner under § 752.

The New Regulations define an obligation to make a net contribution with respect to a partnership liability as --

"the amount determined by multiplying the net contribution that such partner would be obligated to make to the partnership at the time of [a constructive] liquidation ... by the fraction obtained by dividing--

(i) The outstanding partnership indebtedness

(within the meaning of paragraph (d)(3)(ii)(B)(4) of this section) with respect to that liability at the time of such liquidation; by
(ii) The sum of the net contributions that all partners would be obligated to make to the partnership at the time of such liquidation.68

This formula effectively allocates individual partnership liabilities among the partners according to their relative net contribution obligations.

Example. After a constructive liquidation, a two-person partnership has liabilities of $50 and $150 and each of its partners has a deficit capital account of $100 that he is obligated to restore. Each partner is allocated $75 of the $150 liability ($100 net contribution obligation, multiplied by the "outstanding partnership indebtedness . . . with respect to [such] liability" of $150, divided by the partners' aggregate net contribution obligations of $200).69

The partners' aggregate net contribution obligations are likely to exceed the partnership's recourse liabilities if, after a constructive liquidation, any partner has a positive capital account. In this situation, the regulatory formula prevents any partner from claiming economic risk of loss for a partnership liability to the extent his net contribution would be applied to repay a portion of another partner's positive capital account.

Example: Assume that, after a constructive liquidation of a three-person partnership, the partnership has a single recourse liability of $100, one partner has a positive capital account of $100, and the other two partners are liable to restore their negative capital accounts of $100.
each. The partners have no other payment obligations with respect to the liability. The proceeds of the deficit capital account contributions of the two partners with negative capital accounts would be applied to pay both the liability and the third partner's positive capital account. Under these circumstances, even though each of the deficit capital account partners has a $100 net contribution obligation, each has a net contribution obligation with respect to the partnership liability of only $50 ($100 net contribution obligation, multiplied by partnership indebtedness with respect to the liability of $100, divided by the $200 aggregate net contribution obligation of both deficit capital account partners). Accordingly, each has an economic risk of loss of $50 with respect to the liability.

The third partner, who has a positive capital account and no net contribution obligation, has no economic risk with respect to the liability, even though he may have a share of partnership losses which, under the Old Regulations, would result in a portion of the liability being included in the basis of his interest.

The formula quoted above includes the curiously redundant sounding phrase "outstanding partnership indebtedness . . . with respect to [a partnership] liability." While the notion that a partnership may not have an indebtedness with respect to a portion of a partnership liability may seem novel, one reason for this phrase is to assure that a net contribution obligation does not
result in a partner being treated as having an economic risk of loss for a nonrecourse partnership liability. Thus, the New Regulations provide that a partnership is not treated as having an "indebtedness" with respect to a partnership liability to the extent the liability "constitutes a liability for which the creditor's right to repayment is limited to one or more assets of the partnership. . . ." In addition, the partnership is not treated as having an indebtedness with respect to a liability to the extent a partner is treated as having a nonreimbursable obligation to pay such liability because he or she has contributed assets that are used solely to secure it. This exclusion is necessary because the economic risk of loss for such liability is already allocated to the property-contributing partner to the extent of the value of the contributed property and, therefore, should not be allocated a second time as a result of such partner's or another partner's net contribution obligation.

[b] Net Payment Obligations

In general, a partner may have the economic risk of loss for a partnership liability either because he is obligated to make a net contribution with respect to such liability or because he is obligated to make a net payment with respect to such liability. Net contribution obligations are discussed in ¶ 8.03[4][a]. This ¶ 8.03[4][b] discusses net payment obligations.

Generally, a partner has a net payment obligation with respect to a partnership liability to the extent that, upon a constructive liquidation of the partnership, the partner (or a
related person) would be obligated to either pay the liability or reimburse another partner (or a related person) for paying the liability and would not himself be entitled to reimbursement for his payment.\textsuperscript{73} The concept of reimbursement is discussed in ¶ 8.03[4][c] below. Since a payment obligation does not include a contribution obligation,\textsuperscript{74} payment obligations generally include only those obligations (such as guarantees, indemnification agreements and the like) running directly to creditors and obligations to reimburse others for obligations running directly to creditors. For example, if a general partner would be obligated under the partnership agreement or applicable state law to contribute funds to satisfy unpaid partnership creditors upon a constructive liquidation, a limited partner's contractual obligation to directly reimburse the general partner for a portion of such contribution would be a contribution obligation, rather than a payment obligation. On the other hand, a limited partner's separate guarantee of a partnership liability would constitute a payment obligation.

[i] Payment Obligation Resulting From Contribution of Property Solely to Secure Partnership Liability

The New Regulations provide a special rule under which a partner is treated as having a payment obligation with respect to a liability to the extent of the value of any property that the partner contributes to the partnership solely for the purpose of securing such liability.\textsuperscript{75} Specifically, if (1) a partner makes a contribution of property (including money, but not including a promissory note made by the partner that is not readily

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tradeable), and (2) the property is used solely to secure the payment of a partnership liability, then the partnership's obligation to use the property to discharge the liability is treated as a payment obligation of the contributing partner. The New Regulations include a presumption that contributed property is used solely to secure a liability if "substantially all of the items of income, gain, loss, and deduction attributable to such . . . property are allocated to the contributing partner and the portion of such items allocated to the contributing partner is greater than such partner's share of any other significant item of partnership income, gain, loss, or deduction."\textsuperscript{76}

This special "solely for security" rule is essentially an anti-gaming provision designed to prevent partners from converting recourse liabilities into nonrecourse liabilities. Under the normal operation of the New Regulations, a partnership liability is a nonrecourse liability if the creditor's sole recourse is against partnership property, so that no partner's separate assets can be reached to satisfy the claim. On the other hand, a partnership liability is a recourse liability to the extent the separate assets of a partner are pledged to secure payment, even though the pledgor/partner is not otherwise personally liable for the debt.\textsuperscript{77} In the absence of the special solely for security rule, the partners could convert what would otherwise be a recourse partnership liability into a nonrecourse liability, while effectively allowing the contributing partner to retain the economic benefits of owning the contributed property, if instead
of directly pledging non-partnership property to the creditor,
(1) the partner contributed the property to the partnership,
(2) the partnership used the property solely to secure the debt,
and (3) substantially all of the income and loss from the property
was specially allocated to the contributing partner.⁷⁸

[c] Reimbursement

If a partner (or related person) would be obligated to make a
 contribution or payment upon a constructive liquidation of the
 partnership, but would be entitled to be reimbursed for all or a
 portion of such contribution or payment, then, in determining such
 partner’s net contribution or net payment obligation, the
 contribution or payment obligation is reduced by the amount of the
 reimbursement right.⁷⁹ Moreover, a person who is obligated to
 reimburse a partner for making a contribution is himself treated
 as having a contribution obligation, and a person who is obligated
 to reimburse a partner for making a payment is treated as having a
 payment obligation.⁸⁰

A partner (or related person) is treated as having a right to
be reimbursed for a payment or contribution to the extent that—

"(1) Another partner, a person related to a another
 partner, or the partnership would be obligated to make a
 payment to such partner or related person in the event that
 such partner or related person makes a payment or
 contribution pursuant to such obligation; and

(2) The reimbursing payment that such other person would
 be obligated to make is recognized under this paragraph
(d)(3)(ii) as an obligation to make a payment to a creditor or other person with respect to a partnership liability or a contribution to the partnership (or in the case of an obligation of the partnership to reimburse a partner for a contribution to the partnership, such obligation would be recognized as an obligation to make a contribution to the partnership if the partnership were a partner)."**81**

[5] **Obligations Taken Into Account in Determining Net Contribution and Net Payment Obligations**

[a] **General**

In general, a partner, a related person, or a partnership has an obligation to make a payment or contribution for purposes of the net payment and net contribution rules to the extent that any other person has "a legally enforceable right to require such partner, related person, or partnership to make such payment or contribution." **82** Such legally enforceable obligations may be imposed by the partnership agreement, applicable state law, or by collateral agreements, such as guarantees or indemnities; however, an obligation is not taken into account if its existence or amount cannot be determined with reasonable certainty or it is subject to contingencies that "make it unlikely that the obligation would ever be discharged." **83** The determination of whether an obligation exists is made by taking into account all facts and circumstances. **84**

While there is some uncertainty as to what type of contingencies should be taken into account in determining whether an obligation is likely to be discharged, the treatment of certain
contingencies is relatively clear. Generally, the fact that an obligor is not likely to have sufficient assets to perform the obligation generally is not a contingency that prevents the obligation from being taken into account.\textsuperscript{85} Conversely, because the entire scheme of allocating recourse liabilities under the economic risk of loss approach is premised on the assumption that the partnership will not have any assets to pay its liabilities, the fact that such situation is extremely unlikely to occur should not be a relevant contingency. For similar reasons, a requirement that a creditor exhaust its remedies against the partnership before exercising rights under a guarantee should not prevent the guarantor's obligation from being taken into account for § 752 purposes.\textsuperscript{86}

Questions concerning the impact of contingencies may arise if the obligor's obligation is subject to contingencies related to the partnership's performance. For example, if a partner is obligated to make a payment with respect to a partnership liability or a contribution to the partnership only after construction of the partnership's property is complete or the partnership has achieved a certain level of economic performance, the contingency probably should prevent the payment or contribution obligation from being taken into account until the contingency is satisfied. This treatment appears to be warranted because, in the event of a constructive liquidation before the contingency is satisfied, the contingency will never be satisfied and the obligation will never come into being. Conversely, if a
partner's currently existing contribution or payment obligation may cease at some point in the future, it probably should be taken into account until the occurrence of the event that causes it to end, regardless of whether that event is likely or unlikely to occur. Any contingency that smacks of unreality is suspect, however. For example, if an obligation is only enforceable under the laws of a foreign country that has no jurisdiction over the person or property of the obligor, the probability that the obligee will not be able to enforce its right against the obligor may be significant enough to warrant disregarding the obligation. In addition to the notion that obligations are to be disregarded if they are too uncertain or contingent, the New Regulations contain an explicit anti-abuse rule, under which contribution and payment obligations are not recognized if the facts and circumstances indicate a plan to circumvent or avoid the obligation. 87

If a contribution or payment obligation is not recognized under these rules the partners' net payment and contribution obligations are determined by ignoring the obligation that is not recognized. 88

[b] Arrangements Tantamount to a Guarantee

In determining whether a partner has an obligation to make a payment or contribution, the New Regulations provide that a contractual obligation that is not a direct payment obligation may nevertheless be treated as a payment obligation if it is "tantamount to a guarantee." 89 Under this anti-abuse rule,
certain contractual undertakings that are not literal and direct payment or contribution obligations may nevertheless be treated, in effect, as payment or contribution obligations. To come within this rule, an undertaking must be entered into to obtain a loan and must eliminate substantially all the risk to the creditor that the partnership will not satisfy its obligations under the loan, assuming the partners satisfy their contractual undertaking. In addition, one of the principal purposes of the arrangement must be to permit partners (other than those who are directly or indirectly liable for the undertaking) to include a portion of the loan in the bases of their partnership interests.

Under the first prong of this rule, the undertaking must eliminate substantially all of the risk that a partnership liability will not be satisfied under the facts of a constructive liquidation. Example (17) of New Regulation §1.752-1T(k) concludes that a partner’s guarantee that the partnership will complete a building does not cause the guarantor-partner to bear the economic risk of loss with respect to an otherwise nonrecourse liability secured by the building. While the creditor clearly benefits from the completion guarantee, the guarantee does not eliminate the risk that the partnership will default on the liability or that the completed building will have insufficient value to satisfy the liability. On the other hand, a guarantee that collateral will have a specified value would effectively eliminate the creditor’s risk to the extent of the guaranteed value.90
Example (20) of New Regulation 1.752-1T(k) illustrates a situation in which an undertaking eliminates substantially all of a creditor's risk. In this example, a partnership acquires a computer that is subject to an existing two-year lease. The partnership obtains a loan to acquire the computer. In order to induce the creditor to make the loan, one partner agrees to master lease it from the partnership under a "hell or high water" lease which requires the master lessor to maintain the computer and to continue making lease payments even if the computer is damaged or destroyed. The rental payments under the master lease are sufficient to fully amortize all amounts due under the loan and the lease agreement is pledged to the lender. Otherwise, the loan is nonrecourse. The example concludes that the master lease eliminates the creditor's risk of nonpayment.

Under the facts of this example, the other partner invested in the partnership, in part, to obtain tax benefits. Although the other partner needed to include a portion of the liability for the loan in its basis in order to take full advantage of such losses, it apparently was unwilling to obligate itself to make a contribution or payment to satisfy the loan in the event the partnership failed, and the lender was unwilling to make a loan secured solely by the computer. Thus, the example concludes that one of the principal purposes of the master lease is to permit the other partner to include a portion of the liability in his basis. Accordingly, the master lease is treated as tantamount to a guarantee and the partner who master leased the computer is
treated as having the economic risk of loss for the entire liability.

The "arrangements tantamount to a guarantee" rule of the New Regulations is narrowly drawn so as to only apply to prevent gross manipulation of the concept of economic risk of loss. It is not intended to apply to common, commercial undertakings that do not fully secure a creditor or to arrangements that lack a significant tax avoidance motivation.

[c] Obligations Limited to the Value of Property

In order to be taken into account as a payment or contribution obligation for purposes of determining who bears the economic risk of loss for a partnership liability, it is not necessary that an obligation be a general liability obligation of a partner or related person. To the contrary, an obligation that is secured only by non-partnership property of the obligor (or is otherwise limited to the value of such property) is taken into account as a payment or contribution obligation. Thus, while a partnership liability that is secured only by partnership property is a nonrecourse liability as to which no partner bears any economic risk of loss, a partnership liability that is secured by a partner's non-partnership property may be a recourse liability as to which such partner bears some or all of the economic risk of loss.

The amount of a contribution or payment obligation that is limited to the value of a partner's (or related person's) non-partnership property is based on the fair market value of the
property. If the fair market value of the property is "readily ascertainable (e.g., marketable securities)," or if the property is "of a type that by its terms increases or decreases in value (e.g., a debt instrument on which principal payments are made during its term)," the value of such property is determined at the same time as the amount of the payment or contribution obligation that is secured by such property (or limited by its value) is determined. Thus, a partner's economic risk of loss for a partnership liability will fluctuate with the value of such property to the extent the contribution or payment obligation that creates such economic risk of loss is secured only by (or is limited to) the value of such property.

If the property (for example, real estate) is not readily marketable and its value is not self-adjusting, its value is determined as of "the latest of the time that the liability is incurred, the time that the liability is assumed, or the time of the most recent valuation of such property that is made in connection with such liability." Thus, if a partner pledges property to secure an existing partnership liability, the property apparently must be valued at the time of the pledge, even if no actual valuation is made at that time.

[d] Obligations to Pay Interest

The drafters of the New Regulations were concerned that partnerships might attempt to manipulate the economic risk of loss rules by incurring long term liabilities that are nonrecourse as to principal, but recourse as to interest. If the partnership's
obligation to pay principal is deferred to the end of the term of the liability, while the guaranteed interest payments are required to be paid currently, the present value of the nonrecourse obligation to pay deferred principal may be nominal in comparison to the present value of the guaranteed interest. However, without a special anti-abuse rule, the entire principal would be treated as nonrecourse. New Regulation § 1.752-1T(d)(3)(v) is designed to prevent this perceived potential for abuse. It provides:

"[I]f one or more partners (or persons related to such partners) would be obligated (whether pursuant to the partnership agreement, by operation of law, or otherwise) to pay more than 20 percent of the total interest that will accrue on any nonrecourse liability of the partnership during the term of such liability (or if the liability has an indefinite term, the expected term of such liability) if the partnership fails to pay such interest, then each such partner's economic risk of loss for such liability shall be increased by an amount equal to the sum of the present values of the remaining interest payments that such partner (or any person related to such partner) would be obligated to make if the partnership fails to make those payments (taking into account any payment that such partner or related person may be required to make pursuant to that obligation only to the extent that such partner or related person would not be entitled to be reimbursed (within the meaning of paragraph (d)(3)(ii)(C) of this section) for such payment.)"]
For this purpose, the present values of future interest payments are determined based on the applicable Federal rate. Example (21) of the New Regulations makes it clear that application of the assumed interest rule does not create an additional partnership liability equal to the present value of the guaranteed interest payments. Instead, a portion of the nonrecourse principal equal to present value of the interest payments is recharacterized as a recourse liability and allocated to the partners who are obligated to pay the interest. The balance of the nonrecourse principal is treated as a separate nonrecourse liability and is allocated among the partners under the nonrecourse sharing rules.

The purview of the recourse interest rule is subject to a limitation that is both significant and uncertain in scope. Specifically, the New Regulations provides as follows:

"An obligation of a partner to pay any portion of the interest that will accrue on a nonrecourse liability of the partnership shall not be treated as an obligation to pay such interest for purposes of this paragraph (d)(3)(v) unless it is reasonable to expect, based on all the facts and circumstances, that the partner would be required to pay substantially all of the interest subject to that obligation if the partnership failed to pay such interest. For example, if a partner guarantees the payment of the interest due on an otherwise nonrecourse liability but the lender can only enforce that guarantee by first foreclosing on the property..."
subject to such liability, it generally will not be reasonable to expect that the partner would be required to pay substantially all of the interest subject to that guarantee unless substantially all of the interest due on such liability is payable at the end of the term of the liability (e.g., a liability on which no payments of principal or interest are due until maturity)."^{99}

The preceding limitation should be read carefully. It does not say that the recourse interest rule generally applies only if the interest on a nonrecourse liability is payable at or near the end of the term of the liability. Instead, it prevents the recourse interest rule from applying if the partner or person who is personally liable to pay the interest is not really liable for paying future interest because the apparent obligation to pay future interest effectively can be avoided by (1) defaulting on a single interest payment, (2) forcing the lender to foreclose on the security in full satisfaction of the principal amount of the debt, and (3) thereby preventing future interest from accruing on a debt that has been satisfied. Thus, if the lender can enforce the interest guarantee without foreclosing on the property and thereby extinguishing the underlying debt, the recourse interest rule may apply even though interest, principal or both are required to be paid or amortized over the life of the loan.\textsuperscript{100}

The percentage of unpaid interest for which partners have personal liability may, in some situations, change over time as interest payments are made. It is unclear whether the 20 percent
rule is applied only at the time the partnership incurs the nonrecourse liability, or whether it applies on an ongoing basis. The language of New Regulation 101 is not instructive. Probably what was intended is that the rule applies at the first time the recourse interest payments exceed 20 percent of total anticipated interest, regardless of when the liability is incurred, and that thereafter the rule continues to apply until all guaranteed interest is paid; however, it is uncertain whether the New Regulation will be so interpreted.

[e] Presumption that Obligations Will Be Satisfied

The New Regulations require that the rules relating to the determination of the partners' economic risk of loss be applied by assuming that each partner, related person and the partnership that has a payment or contribution obligation "actually discharges such obligation at the time of the constructive liquidation." 102 Moreover, the New Regulation makes clear that this assumption generally applies "even if such partner's net worth is less than the amount of the obligation." 103

While the inclusion of this full performance assumption in the New Regulations may be surprising, its absence would create substantial practical problems. Imagine the nightmare of having to establish each partner's net worth each time it is necessary to determine the basis of any partner's interest in the partnership. Moreover, a general rule that ignores the net worth of the partners in determining economic risk of loss for § 752 purposes is consistent with the § 704(b) rules, under which the substantial
economic effect of a partnership loss allocation is generally
determined by assuming that the loss actually occurs and that it
is actually borne by the partners to whom it is allocated.

To forestall abuse of the generally applicable assumption
that persons obligated to make payments or contributions will
actually perform notwithstanding the inadequacy of their net
worth, the New Regulations include an anti-abuse rule that
suspends the assumption where "the facts and circumstances
indicate a plan to circumvent or avoid [an] obligation." The
Regulations contain one example, summarized below, that
illustrates such a plan.

Example. A parent corporation desires to acquire an
interest as the sole general partner of a limited
partnership. The parent corporation expects the partnership
to provide an attractive investment and to yield significant
tax losses that the parent can use. To limit its monetary
exposure, the parent forms a subsidiary (which will be
included in the parent's consolidated return) for the sole
purpose of acquiring the partnership interest and capitalizes
the subsidiary with only the funds needed to acquire the
general partner interest. As general partner, the subsidiary
has the legally enforceable obligation, to the extent of its
net worth, to make contributions to the partnership to permit
the partnership to satisfy its unpaid liabilities. The
partnership has one limited partner, which has no obligation
to make contributions to the partnership in excess of its
initial contribution and which is not liable for its deficit capital account. The limited partner, however, agrees to indemnify the partnership's creditor if, but only if, the creditor has first exhausted its remedies against the partnership. If the parent corporation had directly acquired the general partner interest, the parent would have had a net contribution obligation and, hence, the economic risk of loss, for the entire partnership liability. However, the facts that the subsidiary was formed to limit the parent's liability while providing tax losses to the parent through its consolidated return, "when considered together with [the limited partner's] indemnification agreement," indicate a plan to circumvent or avoid the subsidiary's contribution obligation. Accordingly, the subsidiary's ostensible net contribution obligation is ignored and the economic risk of loss for the partnership's liability falls on the limited partner, who is deemed to have a net payment obligation to the extent of its liability under its indemnification agreement.

As adumbrated by the foregoing example and other examples contained in the New Regulations, the scope of this anti-abuse rule seems to embrace situations in which (1) it appears that, for tax avoidance purposes, one or more partners have undertaken a contribution or payment obligation that will not, or cannot practically, be enforced, and (2) if such obligation were not
enforced, other partners would have payment or contribution obligations that would be enforced.

In addition, the anti-abuse rule may apply in situations in which the partners attempt to have debt that is substantively nonrecourse treated as recourse debt. For example, suppose that, as in the preceding example, a parent corporation forms a nominally capitalized single purpose subsidiary to become the sole general partner of a limited partnership and the partnership incurs a debt that is nominally a general liability obligation of the partnership for which the subsidiary/general partner is personally liable; however, assume that the limited partner has no indemnification obligation to the creditor. Thus, because the limited partner has no personal liability for the debt and the general partner (a nominally capitalized corporate subsidiary) has no separate assets that the creditor can reach, the debt is effectively secured only by the partnership’s assets. Under the anti-abuse rule, the net contribution obligation of the general partner should be ignored and the debt should be treated as a nonrecourse debt and allocated in accordance with the nonrecourse liability sharing rules.  

[f] Time That Net Contribution and Net Payment Obligations Must Be Satisfied; Effect on Recognition of Obligations

With certain exceptions, contribution or payment obligations will not be recognized in computing a partner’s net contribution or net payment obligation if the contribution is not required to be made within a specified time period after the partner’s interest in the partnership is liquidated or such payment is not
required to be made within a reasonable time after the liability
to which it relates becomes due. 108 In fact, however, as a result
of the application of the exceptions to this general rule, the
effect of the New Regulations is generally to recognize all
obligations, but value deferred obligations on a discounted basis
to take into account the period between the occurrence of the
triggering event and the time that the obligation is required to
be performed.

Specifically, an obligation to make a payment to a creditor
or other person with respect to a partnership liability is
recognized in full for purposes of computing a partner's net
payment obligation "only to the extent that such obligation is
required to be satisfied within a reasonable period of time after
such partnership liability becomes due and payable." 109 If
satisfaction within a reasonable time is not required under the
terms of the instrument or law giving rise to the payment
obligation, then the obligation is taken into account only to the
extent of its discounted value, as discussed below. No clear
guidance is provided as to what is a reasonable time period. In
general, however, commercially reasonable prerequisites to
performance of a payment obligation should not trigger the
discount rules. For example, a condition that performance under a
guarantee or indemnity agreement is not required until the
creditor exhausts its remedies against the partnership's assets
should not be viewed as imposing an unreasonable delay in the
performance of the guarantor's obligation.
The issue of what is an unreasonable delay in the time prescribed for performing a payment obligation is somewhat clouded by the fact that the constructive liquidation rules assume that at the time of a constructive liquidation all partnership liabilities "become due and payable in full because of the partnership's failure to make the payments required," whether or not the liabilities would be accelerated by an actual liquidation of the partnership.\textsuperscript{110} For example, assume that the partnership has a liability that will become due in ten years or on an earlier default, but that the debt instrument does not provide for acceleration of maturity in the event of an earlier liquidation of the partnership. Assume further that a partner has guaranteed the liability. It seems the assumption that the liability becomes due and payable on the day of the constructive liquidation should also apply to accelerate the time at which the guarantee is deemed to be enforceable, but the New Regulations are not explicit on this point.

A contribution obligation is recognized in full:

"only to the extent that such obligation must be satisfied by the later of--

(A) The end of the partnership taxable year in which the partner's interest in the partnership is liquidated; or

(B) 90 days after the date of such liquidation."\textsuperscript{111}

A partner's interest is treated as liquidated on the earlier of the date on which the partnership is liquidated or the date on which the interest is liquidated under Regulation § 1.761-1(d).\textsuperscript{112}
A partnership is treated as liquidated on the earlier of the date on which it terminates under § 708(b)(1)(A), or the date on which it ceases to be a going concern even though its existence is continued for purposes of winding up its affairs, paying its debts and distributing its remaining assets.

In applying these concepts in the context of a constructive liquidation, the time at which a partner would be required to perform a contribution obligation is determined by ascertaining the time that he would have to perform under the partnership agreement or applicable law if the partnership actually liquidated on the date of the constructive liquidation. For example, assume that a partner is obligated to make an additional contribution five years after the date on which his interest in partnership liabilities is being determined (and, therefore, five years after the date on which a constructive liquidation is deemed to occur) and that the obligation would not be accelerated if the partnership is liquidated sooner. Under these circumstances, the contribution obligation would not be required to be made within the prescribed time period and it would be discounted to its present value.

It is not entirely certain how the New Regulations apply if a partner's contribution obligation would be immediately payable upon a liquidation of the partnership but would not be required to be made if his interest were liquidated on that day under Regulation § 1.761-1(d). This type of contribution obligation literally does not satisfy the timing requirement of the New
Regulations even though the contribution would, in fact, be required to be made on the date of the constructive liquidation if the partnership actually liquidated on that date.\textsuperscript{115}

A contribution or payment obligation is not treated as satisfied by delivery of a promissory note if the maker of the note is the person required to make the payment or contribution or a related person, unless the note is readily tradable on an established securities market.\textsuperscript{116} A contribution obligation imposed by law is deemed to satisfy the timing requirements of the New Regulations, apparently without regard to the time that the law would require performance.\textsuperscript{117}

If a payment or contribution obligation fails to meet the prescribed timing requirements, it is recognized to the extent of its discounted present value as of the date of the constructive liquidation.\textsuperscript{118} Under the New Regulations, a deferred obligation is treated as having a value equal to its principal amount if it bears interest at a rate that equals or exceeds the applicable Federal rate (under § 1274(d)) from the date the liability to which it relates becomes due and payable until the payment obligation is due.\textsuperscript{119} If the obligation does not bear adequate interest, its value is the imputed principal amount that it would have under § 1274(b) at the time of valuation.\textsuperscript{120}

Accordingly, although a partner's note (or the note of a related person) is generally not treated as "satisfying" a payment or contribution obligation, the principal amount of such a note (if it bears adequate interest) or its imputed principal amount
Examples of Net Payment and Net Contribution Obligations

Upon emerging from the foregoing mouse's eye view of the maze of rules that determines whether a partner has a net contribution obligation or a net payment obligation with respect to a partnership liability, it may help to recall that (1) to the extent a partner has such a net contribution or net payment obligation with respect to a partnership liability, he also has a share of the "economic risk of loss" for the liability; and (2) to the extent of his share of such economic risk of loss, the liability is included in the basis of his partnership interest under § 752. The New Regulations provide a number of helpful examples that illustrate both the fundamental and esoteric aspects of the determination of a partner's net contribution and net payment obligations. The following examples are based substantially on those contained in the Regulations.

Example 1. Net contribution obligation of equal partners in a "simple" pro rata general partnership. Partners A and B each contribute $20,000 to form a general partnership. The partnership purchases property for $100,000, using its $40,000 of cash equity and incurring a recourse purchase money liability of $60,000. The partners agree to share all profits and losses equally. The partnership is so "simple" that it does not maintain capital accounts or provide for the restoration of capital account deficits under the substantial
economic effect safe harbor of Regulation § 1.704-1(b)(2). Instead, under state law, the partners are obligated to contribute equally to make up any losses in excess of their initial capital contributions.

Upon a constructive liquidation, the partnership would incur a $100,000 loss as the result of a taxable disposition of its property for no consideration, and its $60,000 liability would become due and payable. Since A and B are each responsible under state law for one-half of the partnership's losses, each would be required to contribute $30,000 to satisfy the liability, and the New Regulations assume that each will, in fact, perform his contribution obligation. Moreover, because neither A nor B has a right to reimbursement from the other (or a person related to the other), each has a net contribution obligation of $30,000 with respect to the partnership's liability. Accordingly, A and B each bear $30,000 of the economic risk of loss for the partnership's $60,000 liability.

Example 2. Overlapping contribution and payment obligations in a simple limited partnership. The facts are the same as in Example 1, except that B is a limited partner who guarantees the entire $60,000 partnership liability, but has no obligation to make any additional contribution to the partnership under the partnership agreement or state law. In the event of default, the creditor could proceed directly against the partnership or
against B as guarantor. If B is required to perform under the guarantee, he will be subrogated to the creditor’s claim against the partnership in its capacity as primary obligor for the liability.

Under these circumstances, B has no obligation to make a contribution to the partnership, but B’s guarantee constitutes an "obligation to make a payment to a creditor or other person with respect to a partnership liability." However, if B performed this payment obligation, he would be subrogated to the creditor’s claim against the partnership. Accordingly, B would be able to enforce the liability against the partnership. Since the partnership has no assets, A, as the sole general partner, would be required to contribute $60,000 to the partnership to permit it to pay B as subrogee under the liability. Thus, B would be entitled to full reimbursement for his payment under the guarantee, and B would have no net payment obligation with respect to the liability. Consequently, B would have no economic risk of loss for the liability. A, on the other hand, would have no right to reimbursement for his $60,000 contribution obligation. Accordingly, A has a net contribution obligation and the resultant economic risk of loss for the entire $60,000 partnership liability.

Example 3. Economic risk of loss not shared in proportion to partners’ interests in partnership losses. The facts are the same as in Example 1, except that (1) the
partnership agreement provides that net taxable loss will be allocated 90 percent to A and 10 percent to B, and (2) the partnership agreement provides, in accordance with the § 704(b) Regulations, that capital accounts will be properly determined and maintained for the partners, distributions in liquidation of the partnership will be made to satisfy the partners' positive capital account balances, and any partner having a deficit capital account balance will be required to restore such balance on liquidation.

As in Example 1, upon a constructive liquidation, the partnership would incur a $100,000 loss. This loss would be allocated 90 percent to A and 10 percent to B. The effect on the partners' capital accounts would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account on formation</td>
<td>$20,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Less: loss</td>
<td>(90,000)</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Capital account after constructive liquidation</td>
<td>($70,000)</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

Under these facts, A would be required to make a net contribution equal to the $70,000 deficit balance in his capital account. B, on the other hand, would have no contribution obligation, but would have the right to receive a distribution of $10,000 in satisfaction of his positive capital account.
Under the New Regulations, $60,000 of A’s $70,000 net contribution obligation would be a net contribution "with respect to" the partnership liability; the $10,000 remainder would be made to satisfy B’s positive capital account. Accordingly, A has the economic risk of loss for the entire $60,000 partnership liability. Significantly, even though B is allocated 10 percent of partnership losses, he has no economic risk of loss for the partnership’s liability under the facts of this Example. Because B’s share of the putative $100,000 partnership loss is borne entirely out of his initial capital contribution, he will not bear any loss attributable to the $60,000 liability.

Example 4. Net payment obligations resulting from guarantees and indemnities in a simple limited partnership. C and D form a limited partnership with C as the general partner and D as the limited partner. Each contributes $10,000. The partnership purchases real property for $100,000, making a $20,000 down payment and giving the seller a promissory note for $80,000 secured by a mortgage on the property. Except for the its rights against the property under the mortgage, the seller has no recourse against the partnership; however, C, the general partner, guarantees the payment of the promissory note. If the partnership defaults on the note and C performs on the guarantee, he will be subrogated to the seller’s claim against the real property under the mortgage, but he will have no rights as subrogee.
against other partnership property or the partners. D, the limited partner, does not guarantee the partnership's note, but enters into a separate agreement to indemnify C for one-half of any amount that C is required to pay under the guarantee.

All partnership losses are allocated to C, the general partner. The partnership agreement complies with the alternative test for economic effect in the § 704(b) Regulations.

In the event of a constructive liquidation of the partnership, the real property is deemed to become worthless and the $80,000 partnership liability under the promissory note is deemed to become due and payable. Moreover, the partnership is treated as disposing of the real property to the creditor in a taxable transaction for no consideration other than "relief from any liability for which the creditor's right to repayment is limited to one or more assets of the partnership. . . ." In determining whether a creditor's right to repayment is limited to partnership assets, any rights the creditor has to receive net payments from the partners are disregarded. Accordingly, because the seller has no right to be satisfied by contribution from the partners (but only to be satisfied through C's payment obligation under the guarantee), the seller's right to repayment is limited to partnership assets, and the partnership is treated as realizing the full amount of the
liability upon the constructive disposition of the real property to the seller. In this transaction, the partnership realizes a $20,000 loss.

The entire $20,000 loss is allocated to C, creating a $10,000 deficit balance in his capital account. While C is obligated to contribute $10,000 to the partnership to eliminate this deficit balance, the proceeds of the contribution must be applied by the partnership to satisfy the $10,000 positive balance in D’s capital account and not to pay the partnership liability. Thus, C’s $10,000 net contribution obligation is not "with respect to" the liability. Consequently, C has no economic risk of loss as a result of this net contribution obligation.

However, C is obligated under the guarantee to pay the seller the full difference between the $80,000 liability and the assumed zero value of the real property. This obligation is a payment obligation with respect to the liability. As a result, however, of D’s agreement to indemnify C for one-half of D’s loss under the guarantee, C is entitled to be reimbursed by D for $40,000 of the $80,000 payment under the guarantee. Thus, C has a $40,000 net payment obligation ($80,000 payment obligation, less right to reimbursement of $40,000). C’s total economic risk of loss with respect to the $80,000 liability is therefore $40,000.

D has no direct contribution or payment obligation. However, D is required to reimburse C for $40,000 of the
$80,000 that C is required to pay under the guarantee. Under the New Regulations, a partner has a payment obligation with respect to a partnership liability to the extent that he or she is obligated to make a payment to another partner with respect to any payment to a partnership creditor by the other partner. Thus, D's obligation to indemnify C is a net payment obligation (D has no right to be reimbursed for such indemnification payment), and D has a $40,000 economic risk of loss for the partnership's $80,000 liability.

It is noteworthy that the economic risk of loss in this example is borne equally by C and D, even though the partnership agreement purports to allocate partnership losses solely to C. Thus, if the allocation scheme is respected for § 704(b) purposes, the result, contrary to the purpose of the New Regulations, is that partnership recourse liabilities are allocated in a manner that differs from the allocation of correlative losses under § 704(b). This discontinuity suggests that the loss allocation scheme is defective under the § 704(b) rules. A consistent answer under both the § 704(b) and the § 752 rules can be achieved if the guarantee and indemnity agreements are treated as part of the partnership agreement for purposes of § 704(b) and partnership losses in excess of the partners' aggregate capital accounts are required to be allocated equally between the partners. 138
There is some potential in this type of situation for taxpayers to whipsaw themselves. Assume that after several years the partnership has realized actual losses of $60,000, all of which are attributable to depreciation and all of which have been allocated to C under the agreement. No principal has been paid to the seller. At this point, the partnership's balance sheet is as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real property</td>
<td>$40,000</td>
</tr>
<tr>
<td>Note to Seller</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

Capital:

<table>
<thead>
<tr>
<th>Capital</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>(50,000)</td>
</tr>
<tr>
<td>D</td>
<td>10,000</td>
</tr>
</tbody>
</table>

Total Assets $40,000
Total Liabilities and Capital $40,000

Upon a constructive liquidation, the partnership would be treated as realizing a gain of $40,000 upon a constructive disposition of the real property to the seller in satisfaction of his note. Assuming the partnership contains a normal chargeback provision under which the first profits are allocated to offset any prior losses, this gain would be allocated entirely to C, producing a $10,000 deficit balance in his capital account. As before, the $10,000 that C is obligated to contribute to restore this deficit balance will be paid to D to satisfy his positive capital account balance and hence C's contribution obligation is not "with respect to the seller's note." Examination of the guarantee and indemnification arrangements outside the partnership leads to the conclusion, as before, that C and D each have a net payment obligation of $40,000 with respect to the seller's
note. Inclusion of C's $40,000 share of this liability in his basis along with his $10,000 capital contribution reveals that $10,000 of the $60,000 losses allocated to him should have been suspended under § 704(d). These suspended losses should be triggered when C contributes $10,000 to permit the partnership to satisfy D's positive capital account.

Example 5. Economic risk of loss where liability is secured, in part, by pledge of contributed property used solely to secure such liability. E and F form a general partnership. E contributes $60,000 in cash and F contributes $15,000. The partnership purchases a building for a $30,000 down payment and a $70,000 recourse loan from an unrelated lender. The "extra" $45,000 that E contributes is deposited in an escrow account that is pledged to the lender to secure the purchase money debt for the building. Under the partnership agreement, partnership income and loss will generally be shared equally by the partners, except that income from the escrow account will be allocated 95 percent to E and 5 percent to F. Capital accounts are maintained in accordance with the § 704(b) Regulations and each partner is liable to restore his deficit capital account on liquidation of his interest.

Under the New Regulations, if contributed property is used solely to secure a partnership liability, the partnership's obligation to use the property to discharge the liability is treated as an obligation of the contributing
partner to make a payment to the creditor.\textsuperscript{140} Moreover, on a constructive liquidation, any such property is not deemed to become worthless.\textsuperscript{141} Instead, the property is treated as transferred in complete or partial satisfaction of the liability.

Accordingly, on a constructive liquidation of the partnership, the building would be deemed to become worthless, while the $45,000 escrow account would not be treated as worthless, but would be treated as transferred in partial satisfaction of the $70,000 partnership liability. On a deemed disposition of the building for no consideration, the resulting $100,000 partnership loss would be allocated equally to the partners and have the following effect on their capital accounts:

<table>
<thead>
<tr>
<th></th>
<th>E</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital accounts on formation</td>
<td>$60,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Less: loss</td>
<td>(50,000)</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Capital accounts after constructive liquidation</td>
<td>$10,000</td>
<td>($35,000)</td>
</tr>
</tbody>
</table>

The transfer of the $45,000 escrow account to the creditor is treated as a payment to the creditor by E; however, E’s right to receive a $10,000 distribution from the partnership is a right to be reimbursed for such payment. Accordingly, E has a net payment obligation of $35,000.

F, on the other hand, is obligated to make a contribution to the partnership of $35,000 to satisfy his
deficit capital account liability. This contribution
obligation is allocated to the partnership liability only to
the extent it does not exceed "the outstanding partnership
indebtedness with respect to that liability." The
outstanding indebtedness with respect to the partnership
liability is $35,000 (original liability of $70,000,
decreased by $45,000 deemed payment by transfer of the escrow
account, increased by E's right to a $10,000 reimbursement
for a portion of such deemed payment). Thus, F has a net
contribution obligation with respect to the liability of
$35,000. Accordingly, E and F each have a $35,000 economic
risk of loss for the partnership's $70,000 liability.

Example 6. Economic risk of loss with respect to a
partnership liability that is secured only by a pledge of a
partner's note and by partnership assets. G and H form a
general partnership, with G contributing $125,000 cash and H
contributing $25,000 cash and his promissory note in the
principal amount of $100,000. H's note is payable in five
years and bears interest in excess of the applicable Federal
rate. Under its terms, the note is not accelerated on a
liquidation of the partnership during its five year term.
The partnership buys a building for $1,000,000, paying
$150,000 in cash and giving the seller a partnership
promissory note for $850,000, secured solely by the building
and a pledge of H's promissory note. Partnership income and
loss are allocated and capital accounts are maintained in
accordance with the § 704(b) Regulations and the partners are generally liable to restore their deficit capital accounts on liquidation of their interests, except that, during the term of his promissory note, H is not required to restore the first $100,000 of his deficit capital account.

Common sense indicates, under these facts, that H should bear the economic risk of loss for the $100,000 portion of the liability to the seller that is secured by his promissory note and that the $750,000 balance, which is secured only by partnership property, should be a nonrecourse liability. In this case common sense is right, but the path to this answer under the New Regulations is tortured.

On a constructive liquidation, the partnership’s liability of $850,000 is deemed to become due and payable and the building with a basis of $1,000,000 is deemed to become worthless; however, H’s promissory note is not a partnership asset for purposes of the constructive liquidation rules. Accordingly, it is not deemed to become worthless.

In addition, on a constructive liquidation, the partnership is treated as disposing of the presumptively worthless building. In this constructive disposition, the partnership is treated as realizing only that portion of the $850,000 liability as to which the creditor’s right to repayment is limited to partnership assets. For this purpose, a liability is one for which the creditor’s right to repayment is limited to partnership assets only to the extent
that the balance of the liability exceeds the amount that the partners would have to contribute to satisfy the liability on a constructive liquidation. H’s obligation to make a contribution pursuant to his promissory note is recognized only to the extent of the discounted present value of the note, because the note is not accelerated on a liquidation of the partnership. Because the note bears interest at or above the applicable Federal rate, it is deemed to have a value equal to its face amount of $100,000. Accordingly, $750,000 of the total liability of $850,000 is treated as payable only out of partnership assets, and the partnership is treated as realizing $750,000 on the constructive sale of the building. Since the building has a basis of $1,000,000, the partnership recognizes a $250,000 loss on the sale. The effect of this loss on the partners’ capital accounts is as follows:

<table>
<thead>
<tr>
<th></th>
<th>G</th>
<th>H</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital accounts on formation</td>
<td>$125,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Less: loss</td>
<td>(125,000)</td>
<td>(125,000)</td>
</tr>
<tr>
<td>Capital accounts after constructive liquidation</td>
<td>$0</td>
<td>($100,000)</td>
</tr>
</tbody>
</table>

H’s obligation to restore his $100,000 deficit capital account is governed by his promissory note. Even though the note is not accelerated by the liquidation, it is nevertheless deemed to have a value of $100,000 because it bears adequate interest. Accordingly, H is treated as having
a contribution obligation of $100,000 for which he is not entitled to reimbursement. The partnership's "indebtedness with respect to the liability" for the loan is $100,000 (total liability of $850,000, decreased by $750,000 portion as to which the creditor's right to repayment is limited to partnership assets). Thus, H has a net contribution obligation of $100,000 for the partnership's $100,000 indebtedness with respect to the $850,000 liability. Accordingly, H has a $100,000 economic risk of loss for the partnership's liability. G has no payment or contribution obligation under the facts of a constructive liquidation. Accordingly, he has no economic risk of loss. The $750,000 portion of the partnership's liability as to which no partner has the economic risk of loss is a nonrecourse liability.

[7] Nonrecourse Partnership Liabilities Held by a Partner or Related Person

[a] General

If a partner (or a related person) holds a partnership liability that would otherwise be treated as a nonrecourse liability under the New Regulations, a special rule transmutes the liability into a recourse liability and allocates the entire risk of loss to the partner who holds it or with respect to whom the holder is a related person. This rule has no application to a liability owed to a partner if the liability is otherwise a recourse partnership liability (i.e., a liability as to which the partners have the economic risk of loss under the general net
payment and net contribution rules discussed in ¶ 8.03[4] and 8.03[5] above). Furthermore, this rule only applies if the partner-held nonrecourse liability is, in fact, a liability for tax purposes and is not disguised equity.¹⁵¹

The scope of this special rule is considerably broadened by the fact that it applies to nonrecourse partnership liabilities held by "related persons" to partners.¹⁵²

[b] De Minimis Rule

The New Regulations include a very significant "de minimis" rule, under which a partner will not be treated as bearing the economic risk of loss for an otherwise nonrecourse partnership liability held by such partner (or a related person) if

"(A) The partner's interest (including the interest of any person related to such partner) in each item of partnership income, gain, loss, deduction, or credit is 10 percent or less; and

(B) Such loan constitutes qualified nonrecourse financing within the meaning of section 465(b)(6)."¹⁵³

Under this exception, an otherwise nonrecourse loan from an institutional lender to a partnership may be treated as a nonrecourse loan (that is, the lender or a related person-partner will not be treated as having the economic risk of loss for such loan) even if the lender (or a related person) is a partner, so long as the aggregate interest of the lender (and all related persons) in each partnership item is 10 percent or less.
The *de minimis* rule is very helpful in structuring participating loans in connection with real estate transactions. 154 A pervasive concern in structuring such loans is the risk that the putative lender will be treated as a partner rather than a creditor for tax purposes. 155 If the "lender" is treated as a partner, the tax benefits anticipated by the "borrower" are likely to be substantially diminished; the lender may also have adverse tax consequences. The concern that the lender may be treated as a partner is usually exacerbated by the lender’s desire to have management rights and powers in excess of those normally held by a conventional lender in order to protect his participation rights.

The *de minimis* rule provides a tool to minimize the risk that the lender will be treated as a partner in this type of situation, provided the lender is a qualified lender for purposes of § 465(b)(6). 156 Instead of simply structuring the deal as a participating loan, the lender’s position is bifurcated as follows:

(a) The lender (or a related person) forms a partnership with the would-be borrower. This partnership becomes the borrower and owner of the property that is to be encumbered by the loan. The partnership agreement gives the lender (or a related person), in his capacity as a partner, the management rights and powers desired by the lender. A portion (not in excess of a 10% interest) of the lender’s participation rights are built into the partnership agreement. 157
(b) The lender makes a participating, commercially reasonable, nonrecourse loan to the partnership, secured by the partnership's property. The loan documents do not give the lender any control or management rights other than those normally included in conventional nonparticipating loans. The lender's participation rights under the loan are reduced as necessary to reflect the economic rights held by the lender (or a related person) through the partnership.

By separating the management rights and powers from the loan, the suggested structure should significantly reduce the likelihood that the lender will be treated as a partner with respect to the loan portion of the transaction.

[c] Wrapped Indebtedness

An otherwise nonrecourse partnership liability that is held by a partner (or related person) may include or reflect an underlying obligation ("wrapped indebtedness") owed by the partner (or related person) to another creditor. In this situation, if the wrapped indebtedness encumbers partnership property the partnership is treated as having two liabilities: a debt directly to the holder of the wrapped indebtedness, and a debt to the partner (or related person) who holds the "wrapping" indebtedness in an amount equal to the difference between the amount of the wrapping indebtedness and the amount of the wrapped indebtedness. 159

Example 1. A partner owns property that is encumbered by a nonrecourse liability to an unrelated third party of
$200,000. The partner sells the property to the partnership for $300,000 receiving a down payment of $60,000. The partnership pays the $240,000 balance of the purchase price by taking the property subject to the existing $200,000 first mortgage (the partnership will directly service the $200,000 mortgage) and giving the selling partner a nonrecourse note of the partnership for the remaining $40,000, secured by a second mortgage on the property. Under these circumstances, the partnership has two obligations, one to the holder of the $200,000 note secured by the first mortgage and one to the selling partner for $40,000, secured by the second mortgage. No partner has any economic risk of loss for the $200,000 liability. The $40,000 liability is a partner nonrecourse debt owed to the selling partner. The selling partner bears the economic risk of loss for this liability. In this Example, there is no wrapped indebtedness.

**Example 2.** The facts are the same as in Example 1, except that the partnership does not agree to directly service the first mortgage. Instead, the partnership gives the selling partner a nonrecourse note for $240,000 that is secured by a second "all-inclusive" mortgage. The selling partner is required to service the first mortgage note of $200,000 from the payments received from the partnership. Under these circumstances, the $240,000 partnership note "wraps" the $200,000 first mortgage note. Thus, the $200,000 first mortgage note is a wrapped indebtedness.
Because the partnership is treated as having a direct obligation to the holder of the wrapped indebtedness, the results are the same as in Example 1. No partner (including the selling partner) has any economic risk of loss for the $200,000 wrapped indebtedness, even though the wrapped indebtedness is "reflected in" the $240,000 partnership liability to the selling partner. The $40,000 portion of the $240,000 liability to the selling partner that is in excess of the wrapped indebtedness is a partner-held nonrecourse liability of the partnership, as to which the selling partner bears the economic risk of loss. 160

[8] Tiered Partnerships

Two special rules bear on the application of the economic risk of loss rules to situations involving partnerships in which other partnerships are partners ("tiered partnership" situations). First, if a partnership (an "upper-tier partnership") holds an interest in another partnership (a "subsidiary partnership"), the upper-tier partnership's liabilities are treated as including its share of the subsidiary partnership's liabilities. 161 Thus, the partners of the upper-tier partnership include in the bases of their interests in the upper-tier partnership their allocable portions of the subsidiary partnership's liabilities.

Second, an upper-tier partnership's share of the economic risk of loss for a subsidiary partnership's liabilities is determined under a two-step approach. The normal rules are first applied to determine what the upper-tier partnership's economic
risk of loss for subsidiary partnership liabilities would be if the special tier partnership rules were inapplicable. Then, the upper-tier partnership is also treated as bearing the economic risk of loss for any of the subsidiary partnership's liabilities that are not allocated to it in the first step to the extent the upper-tier partnership's partners would bear the economic risk of loss for such liabilities if such liabilities were direct liabilities of the upper-tier partnership.

Example. An upper-tier partnership is the sole general partner of a subsidiary limited partnership. No limited partner of the subsidiary partnership is obligated to make any additional contribution to the subsidiary partnership or to make any payment with respect to the subsidiary partnership's liabilities. The subsidiary partnership has two liabilities, a full recourse liability of $100 and a liability of $200 for which the subsidiary has pledged property, but has not assumed general liability. A ten percent partner of the upper-tier partnership has guaranteed both of the subsidiary partnership's liabilities.

Applying the economic risk of loss rules, the upper-tier partnership has a net contribution obligation for, and directly bears the economic risk of loss with respect to, the $100 full recourse liability. Under the normal rules, however, the upper-tier partnership would not bear the economic risk of loss for the subsidiary's $200 liability that is secured only by a pledge of the subsidiary's assets.
and a guarantee by a ten-percent partner of the upper-tier partnership, because the upper-tier partnership and that partner are not "related persons." However, if the $200 liability were a liability of the upper-tier partnership, the partner who guaranteed it would have a net payment obligation with respect to such liability and, therefore, would bear the economic risk of loss for it. Accordingly, under the special tier partnership rules the upper-tier partnership has the economic risk of loss for both of the subsidiary partnership's liabilities.165

The New Regulations provide that a liability can be taken into account only once for § 752 purposes.166 In the context of tier partnerships this limitation prevents a person who is a partner in both an upper-tier partnership and a subsidiary partnership from including the same liability of the subsidiary in the bases of his interests in both the upper-tier partnership and the subsidiary partnership. In this type of situation, the liabilities apparently should be apportioned to the partner's respective bases in the upper-tier and subsidiary partnerships in proportion to the economic risk of loss that he bears as a partner of each partnership. Thus, a partner's economic risk of loss in the subsidiary partnership should be computed, first, as if he were not a partner in the upper-tier partnership. Subsidiary partnership liabilities should be allocated to his basis in the subsidiary partnership to the extent of the resulting economic risk of loss. Then, his economic risk of loss should be computed
for the upper-tier partnership using the tier partnership rules. Any resulting indirect increase in his risk of loss for subsidiary partnership liabilities over his economic risk of loss as a direct partner of the subsidiary partnership should be allocated to his basis in the upper-tier partnership.

[10] Overlapping Economic Risk of Loss

The New Regulations anticipate the possibility that the aggregate amount of economic risk of loss that all of the partners are determined to bear for a partnership liability may exceed the aggregate amount of the liability. Under these circumstances, the economic risk of loss borne by each partner with respect to such liability ... shall equal the amount determined by multiplying the amount of such liability ... by the fraction obtained by dividing the amount of economic risk of loss that such partner is determined to bear with respect to that liability ... under the first sentence of this paragraph (d)(3)(i) by the sum of such amounts for all partners. 167

While apportionment of the economic risk of loss for a partnership liability makes sense where the partners would otherwise be treated as bearing an aggregate economic risk of loss that exceeds the liability, such a situation is likely to occur only as a result of sloppy legal work or an inadvertent effort to subvert the economic risk of loss rules. This is because, under the normal application of the rules, a partner has the economic risk of loss for a partnership liability only if he is the last person in the
chain of partners (and related persons) who would be required to make a contribution to pay the liability, pay the liability directly, or reimburse another partner (or related person) for such a contribution or payment. In order for the partners’ aggregate economic risks of loss, determined under these rules, to exceed the amount of the liability, it is necessary for the economic arrangement of the partners to contain an economic discontinuity under which, depending on external events, the last person in the chain may not always be the same person.

Example. The only liability of a two-person limited partnership is a $100 loan from a bank. Under the terms of the loan and the partnership agreement, the bank can proceed to collect the loan directly from the partnership. If the partnership’s assets are insufficient to satisfy the loan, the general partner is obligated to contribute funds to pay the difference. The limited partner has no obligation whatsoever to make any further contributions to the partnership. Moreover, the general partner has no direct or indirect right of reimbursement from the limited partner. Thus, the general partner apparently has the economic risk of loss for the entire $100 loan.

The limited partner, however, has guaranteed the loan. Under the guarantee agreement, the bank can proceed directly against the limited partner as guarantor without exhausting its remedies against the partnership and, in an unusual twist, the limited partner would not be subrogated to the
bank's claim against the partnership if the limited partner is required to pay the bank under the guarantee. Moreover, payment by the limited partner under the guarantee is not treated as a capital contribution and, hence, such payment does not increase the limited partner's capital account. Thus, applying the normal rules, the limited partner would be treated as having a net payment obligation of $100 and the economic risk of loss for the entire partnership liability.

Under these facts, the bank has a choice of remedies -- it can proceed against the partnership, in which case the general partner is solely responsible for the loan, or it can proceed against the limited partner, in which case the limited partner holds the proverbial bag. Thus, depending on the whim of the bank, responsibility for the loan, in the event of a constructive liquidation, can fall entirely on either of the partners, and under the New Regulations the economic risk of loss for the liability is, therefore, apportioned between them.\textsuperscript{168}

What is unusual about the preceding example is not that the general partner is generally liable to make contributions to pay partnership obligations or that the limited partner guaranteed a specific obligation. Those things happen frequently, but when they do, the partners generally structure the agreements so that a creditor's selection of a collection option will not affect their rights and obligations, as among themselves, for the liability.

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As suggested above, permitting the lender to choose who will bear the final loss for a partnership liability inserts a potential for economic randomness in a transaction that generally reflects either poor coordination of the documents or an effort to play games with the § 752 rules. If the taxpayers cannot prove that the such randomness was not part of a plan to circumvent of avoid the § 752 rules, the IRS may disregard the ostensible economic risk of loss borne by the partner who benefits tax-wise from the arrangement.\textsuperscript{169} If, however, the randomness is not tax motivated, the Regulations provide for the economic risk of loss for a liability to be shared in proportion to partners's economic risk of loss, as determined under the normal application of the rules.

§ 8.04 Sharing Nonrecourse Liabilities

[1] General

The New Regulations define "nonrecourse liability" by exclusion. A nonrecourse liability is simply any "liability of the partnership to the extent, but only to the extent, that no partner bears the economic risk of loss."\textsuperscript{170} By adopting this definitional approach, the New Regulations assume that all partnership liabilities will be allocated among the partners under either the recourse sharing rules discussed in § 8.03 above or the nonrecourse sharing rules discussed in this § 8.04.

In general, a partner's share of partnership nonrecourse liabilities is the sum of --
(1) the partner's share of partnership minimum gain,

(2) the amount of gain that the partner would recognize under § 704(c), or in the same manner as under § 704(c) in connection with a revaluation of partnership property pursuant to the § 704(b) Regulations,\textsuperscript{171} if the partnership disposed of property in a taxable transaction in full satisfaction of such liabilities and for no further consideration; and

(3) the partner's proportionate share of the "excess nonrecourse liabilities" of the partnership.\textsuperscript{172}

This scheme for allocating nonrecourse liabilities effectively coordinates the liability allocation rules of § 752 with the income and loss allocation rules of § 704(b) in an entirely sensible manner. To the extent a partner receives an allocation of nonrecourse deductions or a distribution of nonrecourse liability proceeds that increases the partner's share of partnership minimum gain,\textsuperscript{173} the increase in minimum gain "attracts" an equal amount of available nonrecourse liabilities into the basis of the partner's interest so that, to the maximum extent possible, the partner has sufficient basis in his partnership interest to claim a current deduction for such nonrecourse deductions under § 704(d) or receive such distribution without recognizing gain under § 731.

[2] Coordinating Shares of Nonrecourse Deductions With Shares of Minimum Gain

A partner's share of partnership minimum gain generally is determined in accordance with the § 704(b) Regulations.\textsuperscript{174}
However if it is necessary to compute a partner's interest in partnership nonrecourse liabilities during a partnership taxable year, his interest in minimum gain is computed "as if the partnership taxable year had ended immediately prior to such determination." Furthermore, for purposes of applying the § 752 rules, any increase in a partner's share of minimum gain is treated as occurring immediately before the event that causes the increase. This timing rule assures that the basis increase attributable to an allocation or distribution that increases minimum gain is available to the partner in determining the tax consequences of such allocation or distribution.

[3] Excess Nonrecourse Liabilities

The "excess nonrecourse liabilities" of a partnership is an amount equal to the excess of the aggregate partnership nonrecourse liabilities over the sum of the nonrecourse liabilities that are allocated to the partners (a) in an amount equal to their shares of minimum gain, and (b) in an amount equal to their § 704(c) (and § 704(c) equivalent) balances. Thus, excess nonrecourse liabilities represent the residual balance of partnership nonrecourse liabilities. They are allocated among the partners in proportion to their interests in partnership profits.

The determination of the partners' interests in partnership profits is generally determined by reference to "all facts and circumstances relating to the economic arrangement of the partners." Under a special dispensation, however, the partners
may specify their respective interests in partnership profits in 
the partnership agreement and the interests so specified will be 
respected if they are "reasonably consistent with allocations 
(which have substantial economic effect under § 1.704-1(b)) of 
some significant item of income or gain among such partners." 180

Example (22) of New Regulation § 1.752-1T(k) makes clear that the 
partnership is not required to have the specified items of income 
or gain in the taxable year with respect to which excess 
nonrecourse deductions are being allocated if there is a 
"reasonable likelihood that over the partnership's life it will 
recognize [significant] amounts of [such] income and gain." In 
Example (22), the partners' initial sharing ratio is 10:90, with a 
"flip-flop" to 50:50 after an earn-out period. The agreement 
adopts the residual 50:50 ratio for sharing excess nonrecourse 
deductions. Under the facts of the Example, there is a reasonable 
likelihood that the partnership will be successful enough that the 
flip-flop will occur and significant items of income and gain will 
eventually be allocated equally between the partners. 
Accordingly, the adoption of the 50:50 ratio for sharing excess 
nonrecourse deductions is respected from the outset.

No guidance is provided as to what level of probability 
constitutes a "reasonable likelihood." In the facts of the 
example, the 50:50 ratio becomes operative as soon as the 
partnership has a single dollar of net profit (that is, as soon as 
it has recouped all prior net losses, if any). No indication is 
given as to the likelihood that the partnership will ever generate
net profits or whether the 50:50 ratio would have been respected if the partnership had been a high-risk venture with a high probability of failure. The "reasonable likelihood" standard appears only in Example (22) and not in the operative language of the Regulation. Therefore, while partners can safely adopt a profit ratio that satisfies the reasonable likelihood standard, other specified ratios may be respected as long as they correspond to the sharing ratios applicable to a significant item of income or gain, provided such ratio is likely to come into play if the partnership is successful.

The largesse of the New Regulations in permitting partners broad latitude to specify their interests in excess nonrecourse liabilities is more apparent than real. In most situations, the partners will be indifferent as to how excess nonrecourse liabilities are shared, because they will need the basis provided by such liabilities only to "cover" allocations of nonrecourse deductions or distributions attributable to nonrecourse debt. There are, to be sure, exceptions. For example, if a partner with a zero basis in his partnership interest receives a distribution of money that does not increase minimum gain, he may need a share of the partnership's excess nonrecourse liabilities to avoid recognizing gain on the distribution under § 731.

The following example illustrates the determination of the partners' shares of partnership nonrecourse liabilities in a situation involving nonrecourse deductions.181
Example. GP and LP form a limited partnership. GP, the general partner, contributes $20,000, and LP, the limited partner, contributes $180,000. The partnership purchases a building for $1,000,000, paying $200,000 in cash and giving a promissory note in the principal amount of $800,000. The note is secured solely by a mortgage on the building. Neither the partnership nor any partner has any personal liability on the note in any capacity. The partnership agreement generally provides for partnership income and loss to be allocated and capital accounts to be maintained in accordance with the economic effect rules of the § 704(b) Regulations, and the partners are obligated to restore any deficit balances in their capital accounts on liquidation of their interests. In addition, the partnership agreement contains a minimum gain chargeback provision in accordance with the § 704(b) Regulations.

The partnership agreement further provides that, except as required by the minimum gain chargeback provision, (1) all partnership items will be allocated 10 percent to GP and 90 percent to LP until the partnership recognizes items of income and gain equal to all items of loss and deduction, and (2) thereafter all items will be allocated equally between the partners. Finally, the agreement provides that, for purposes of sharing excess nonrecourse liabilities, the partners will be deemed to have equal interests in partnership profits. This specified sharing ratio is
consistent with the manner in which the partners will share items of income and gain after the initial "10:90" phase. Moreover, there is a reasonable likelihood that the partnership will recognize significant items of income and gain that will be allocated equally between the partners. Accordingly, the 50:50 profits interests specified by the agreement for sharing excess nonrecourse deductions are respected.\textsuperscript{182}

In each of the partnership's first two taxable years, it has rental income of $95,000, operating expenses of $10,000, interest expense of $80,000 and depreciation of $90,000, resulting in a taxable loss of $85,000. Under the agreement, each year's $85,000 loss is allocated 10 percent to GP and 90 percent to LP. In the aggregate, therefore, GP is allocated losses of $17,000 and LP is allocated losses of $153,000 in the first two years.

Since the basis of the building is $820,000 at the end of year 2 (original cost of $1,000,000, less aggregate depreciation of $180,000), while the nonrecourse liability remains $800,000, the partnership would not recognize gain if it disposed of the building at the end of year 2 for no consideration other than relief of the nonrecourse liability. Accordingly, through the end of year 2, the partnership has no nonrecourse deductions and no minimum gain.\textsuperscript{183} In the absence of minimum gain, the entire nonrecourse liability is an "excess nonrecourse liability."\textsuperscript{184} Excess nonrecourse
liabilities are shared in proportion to each "partner's percentage interest in partnership profits." The partners have validly determined that their interests in partnership profits, for § 752 purposes, will be deemed to be equal. Therefore, at the end of years 1 and 2, each partner's interest in nonrecourse liabilities is $400,000.

The partnership's operating results are the same for year 3 as for years 1 and 2 ($95,000 rent, $10,000 expenses, $80,000 interest expense, $90,000 depreciation deduction, yielding a taxable loss of $85,000). The plot thickens, however, because the $90,000 depreciation deduction in year 3 causes the partnership to have a $70,000 minimum gain at the end of year 3 ($820,000 basis at the end of year 2, minus $90,000 year 3 depreciation, produces a basis of $730,000 at the end of year 3, which is $70,000 less than the nonrecourse encumbrance). $70,000 of the year 3 depreciation deduction constitutes nonrecourse deduction.

Pursuant to the partnership agreement all partnership items, including the $70,000 of nonrecourse deductions, are allocated 10 percent to GP and 90 percent to LP. The allocation of all items other than the nonrecourse deductions has substantial economic effect under the § 704(b) Regulations. The allocation of the nonrecourse deductions is "deemed to be made in accordance with the partners' interest in the partnership." The impact of these allocations on
the partners' capital accounts through the end of year 3 is as follows:

<table>
<thead>
<tr>
<th></th>
<th>GP</th>
<th>LP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account on formation</td>
<td>$20,000</td>
<td>$180,000</td>
</tr>
<tr>
<td>Less: loss in years 1 and 2</td>
<td>(17,000)</td>
<td>(153,000)</td>
</tr>
<tr>
<td>Less: loss in year 3 (without regard to nonrecourse deductions)</td>
<td>(1,500)</td>
<td>(13,500)</td>
</tr>
<tr>
<td>Less: nonrecourse deductions in year 3</td>
<td>(7,000)</td>
<td>(63,000)</td>
</tr>
<tr>
<td>Capital account at end of year 3</td>
<td>($5,500)</td>
<td>($49,500)</td>
</tr>
</tbody>
</table>

At the end of year 3, GP’s share of minimum gain is $7,000 and LP’s share is $63,000.189

Pursuant to the New Regulations, partnership nonrecourse liabilities are allocated first to the partners to the extent of their respective shares of minimum gain. Accordingly, at the end of year 3, GP and LP are allocated $7,000 and $63,000, respectively, of the partnership’s nonrecourse liabilities to match their shares of minimum gain. The remaining $730,000 of nonrecourse liabilities constitute excess nonrecourse liabilities that are allocated equally between the partners in accordance with the specified profit sharing ratios. Therefore, at the end of year 3, GP’s share of nonrecourse liabilities is $372,000 ($7,000 share to match minimum gain and $365,000 share of excess), and LP’s share is
$428,000 ($63,000 share to match minimum gain and $365,000 share of excess).

[4] Effect of Section 704(c)-Type Built-In Gain

Just as a partner's share of minimum gain "attracts" an equal share of partnership nonrecourse liabilities under the New Regulations, the New Regulations also provide that a portion of a partner's share of built-in gain under section 704(c)\(^{190}\) and the "$704(c) equivalent" rules of the § 704(b) Regulations\(^{191}\) attracts partnership nonrecourse deductions. Specifically, a partner's share of nonrecourse liabilities includes an amount of such liabilities that equals --

"The amount of any taxable gain that would be allocated to the partner under section 704(c), or in the same manner as under section 704(c) in connection with a revaluation of property pursuant to § 1.704-1(b)(2)(iv)(f) or (L) . . . , if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of such liabilities and for no other consideration. . . ."\(^{192}\)

The rule allocating nonrecourse deductions to a partner to the extent of his share of such built-in gain is necessary because minimum gain is computed by reference to the book value of partnership property as determined for § 704(b) capital account maintenance purposes.\(^{193}\) Under this rule, a partnership will have no minimum gain with respect to property subject to a nonrecourse liability even though the liability exceeds the adjusted tax basis
of the property, so long as it does not exceed the book value of the property.\textsuperscript{194} The New Regulations assure, to the maximum extent possible, that a partner will have a sufficient share of nonrecourse liabilities under § 752 to cover his share of the difference between the book value and the tax basis of the encumbered property (i.e., his share of the "quasi-minimum gain").

Example. In exchange for a one percent interest in partnership capital, profits and losses, a partner contributes to a partnership property with a basis of $60 and a value of $100, subject to a $99 nonrecourse liability. The property is properly entered on the partnership’s books for capital accounting purposes at a value of $100, and the partner’s capital account is credited with the $1 net value of his contribution. Because the $100 book value of the property exceeds the $99 nonrecourse liability secured by the property, the partnership has no minimum gain with respect to the property.\textsuperscript{195} Thus, no portion of the nonrecourse liability is allocated to any partner to match his or her share of minimum gain.

If, immediately after the contribution, the partnership sold the property for no consideration other than satisfaction of the $99 nonrecourse liability, the partnership would recognize a $1 book loss and a $39 built-in tax gain ($99 amount realized, less adjusted basis of $60). This entire $39 tax gain would be allocated to the contributing partner under § 704(c). Therefore, the
contributing partner is allocated a $39 share of the $99 nonrecourse liability to match his share of the built-in § 704(c) gain. The $60 balance of the nonrecourse liability is an "excess nonrecourse liability" that is allocated among the partners according to their interests in partnership profits. Thus, as a one percent partner, the contributing partner's initial share of the nonrecourse liability is $39.60.

Assuming that the partnership's only liability is the $99 nonrecourse liability, the effect of the contribution on the contributing partner is that he contributes property with a basis of $60 and receives a net § 752(b) distribution of $59.40, leaving him with no gain recognized as a result of the contribution and a basis in his partnership interest of sixty cents. But for the fact that the New Regulations attract nonrecourse liabilities to cover the contributing partner's built-in gain under § 704(c), this partner would have recognized a gain of $38.01 on the contribution ($98.01 net § 752(b) distribution, less $60 basis of contributed property).

The mechanical application of these rules can be quite complex, because § 704(c) applies only to the excess of the book value to the partnership over its tax basis and partnership minimum gain is computed by reference to the book value (not the basis) of contributed property. If the contributed property is
depreciable, book depreciation deductions will exceed tax
depreciation deductions if the book value of the property exceeds
its tax basis. Over time, these book-tax depreciation differences
will decrease the difference between the book value and tax basis
of the contributed property, the amount of built-in gain subject
to § 704(c) will also decrease, and the amount of nonrecourse
liabilities allocated to cover the declining built-in gain will
also decrease. Moreover, any reductions in a partner’s share of
nonrecourse liabilities that results from a decrease in his
built-in § 704(c) gain must be reallocated, first, to the partners
to the extent of any increase in minimum gain for the year197, and
then to the partners according to their interests in profits.198
This calculation is further complicated by the fact that
partnership minimum gain is computed by reference to the excess of
nonrecourse liabilities over the book value of partnership
property.199

Example. A partner contributes property with a value of
$100 and a basis of zero to a partnership. The property is
encumbered by a nonrecourse liability of $90. The
partnership has no other liabilities and the partner makes no
other contribution to the partnership. The contributing
partner has a ninety percent interest in partnership profits;
however, the agreement validly allocates only fifty percent
of the partnership’s nonrecourse deductions to the
contributing partner. During the partnership’s first year,
it has no income or loss other than a book depreciation
deduction of $20 with respect to the contributed property.

At the time of contribution, the entire $90 nonrecourse
liability is allocated to the contributing partner and the
beginning basis of his partnership interest is zero. At the
end of year one, the § 704(c) gain with respect to the
property is reduced from $100 to $80, because of the $20 year
one book depreciation deduction. Therefore, at the end of
year one only $80 of the $90 nonrecourse liability is
allocated to the contributing partner under New Regulation
§ 1.752-1T(e)(1)(ii). The remaining $10 of the nonrecourse
liability must be allocated under either New Regulation
§ 1.752-1T(e)(1)(i) or § 1.752-1T(e)(1)(iii).

During year one, partnership minimum gain increases from
zero to $10 (excess of $90 nonrecourse liability, over the
$80 book value of the property at the end of the year).
Thus, the $10 portion of the nonrecourse liability that is no
longer allocated to the contributing partner under New
Regulation § 1.752-1T(e)(1)(ii) must be reallocated to the
partners, under Temp. Reg. § 1.752-1T(e)(1)(i), in the manner
that they share the $10 increase in minimum gain. Since only
50 percent of the partnership's nonrecourse deductions are
allocated to the contributing partner, his share of the $10
increase in minimum gain is $5. Thus, the contributing
partner's share of the nonrecourse liability under New
Regulation § 1.752-1T(e)(1)(ii) has decreased by $10, while
his share of the $10 portion of the liability that is allocated under New Regulation § 1.752-1T(e)(1)(i) increases by only $5. The $5 difference results in a net § 752(b) distribution of $5 to the contributing partner, which is taxable to him under § 731(a)(1) since his basis is zero.

[5] Tiered Partnerships

The Regulations provide that if one partnership (an "upper-tier partnership") is a partner in another partnership (a "subsidiary partnership"), the upper-tier partnership's share of the subsidiary partnership's liabilities (other than any such liability that is owed to the upper-tier partnership) shall be treated as a liability of the upper-tier partnership for purposes of determining the bases of the partners of the upper-tier partnership. Unlike the Regulations governing the allocation of recourse liabilities,\textsuperscript{201} however, the Regulations governing the allocation of nonrecourse liabilities contain no special rules for determining the upper-tier partnership's share of the subsidiary partnership's nonrecourse liabilities.

Under these circumstances, it appears that the procedure for dealing with nonrecourse liabilities in tier partnership situations is as follows: First, determine the extent to which any partner of the subsidiary partnership bears the economic risk of loss for the subsidiary's liabilities. In making this determination, apply the the special tier partnership rules to determine the upper-tier partnership's economic risk of loss for such liabilities.\textsuperscript{202} Second, as to any of the subsidiary
partnership's liabilities for which no partner (including the upper-tier partnership) bears the economic risk of loss (and which are, therefore, nonrecourse liabilities of the subsidiary partnership), apply the normal rules for allocating nonrecourse liabilities as if the upper-tier partnership were not itself a partnership. The upper-tier partnership's share of the subsidiary's nonrecourse liabilities, as so determined, are treated as nonrecourse liabilities of the upper-tier partnership for purposes of applying § 752 to its partners. To determine the interest of of the partners of the upper-tier partnership in the subsidiary partnership's minimum gain, reference should be made to the special tier partnership rules contained in the § 704(b) Regulations.203

1 8.05 Related Persons

Under the New Regulations, a partner shares recourse partnership liabilities to the extent the partner, or a related person to the partner, bears the "economic risk of loss" for such liabilities.204 In addition, the § 752 definitions of economic risk of loss (with all its references to related persons) and nonrecourse liability are imported to the § 704(b) Regulations.205 Thus, the concept of "related persons" has a significant impact on the application of both § 752 and § 704(b).

For these purposes, a person is related to a partner "if and only if such person and the partner bear a relationship to each other that is specified in section 267(b) (without modification by
section 267(e)(1)) or section 707(b)(1). . . ."206 The potential breadth of this definition is considerably narrowed, however, by New Regulation § 1.752-1T(h)(2), which provides that -- sections 267(b) and 707(b)(1) shall be applied by --

(i) Substituting "80 percent or more" for "more than 50 percent" each place it appears in such sections;

(ii) Excluding brothers and sisters from the members of a person's family; and


The New Regulations provide generally that if a person is related to more than one partner, he will be treated as related to the partner to whom he has the "greatest percentage of related ownership."207 In those cases in which a person has an equal percentage of related ownership to more than one partner, such person's payment obligation, contribution obligation or interest in a partner nonrecourse liability, as the case may be, shall be allocated equally to all such equally related partners, unless the facts and circumstances indicate that such benefit or burden should be allocated among the equally related partners in a different manner.

The percentage of related ownership is the greater of the percentage ownership of the related person by the partner, or the percentage ownership of the partner by the related person.208 All natural persons who are related by virtue of being members of the same family are treated as having a percentage relationship of zero. This does not mean that they are not related persons;

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rather it means that they are equally related (a partner is equally related to his parents, spouse and children for this purpose).

The New Regulations provide that members of the same partnership will generally not be treated as related persons to each other for purposes of applying § 752 to the liabilities of that partnership.209
Temp. Reg. § 1.752-4T(a).

Temp. Reg. § 1.752-4T(b). This Regulation also contains an exception for binding written contracts in effect prior to March 1, 1984 and at all times thereafter.

Temp. Reg. § 1.752-4T(b) does not appear to support this interpretation, but is likely to be clarified by the Treasury, hopefully soon.

Temp. Reg. § 1.752-4T(c). For calendar year partnerships, this means that the election had to be made on their returns for calendar year 1988; those partnerships that filed their 1988 returns without making the election have permanently missed the opportunity to have all of their liability sharing issues resolved under the New Regulations and, for ill or good, must continue to live under a combination of the old and new liability sharing regimes as long as they have pre-January 30, 1989 liabilities.


Reg. § 1.752-1(e) (1956). The proposed regulation published for public comment prior to the adoption of this final regulation contained no sharing rules. See Prop. Reg. § 1.752-1 (1955).

Cf. Rev. Proc. 89-12, § 1.02, 1989-7 I.R.B. 22 (application of classification ruling requirements to entities not formed
under the Uniform Partnership Act or a version of the Uniform Limited Partnership Act).


See Uniform Limited Partnership Act § 7; Revised Uniform Limited Partnership Act § 303 (1976 and 1985); R. Whitmire, W. Nelson, W. McKee & M. Kuller, Federal Taxation of Partnerships and Partners: Structuring and Drafting Agreements ¶ 8.01 (1989). Cf. Financial Dynamics, Ltd. v. United States, 80-2 USTC ¶ 9585 (M.D. Fla. 1980); Ina L. Block, 41 TCM 546, 551 (1980) (taxpayer limited partner failed to prove that his activity would have subjected him to liability as general partner under applicable state law; "intriguing issue" of whether general partner liability under state law results in general partner status under Old Regulation § 1.752-1(e) not reached).

See Rev. Rul. 69-223, 1969-1 CB 184, 185 (entire amount of recourse liability increases general partner's basis.)
general partner's interest in profits and losses only 10 percent).

See ¶ 6.01.

Although theoretically sound, the reliance on loss-sharing ratios to apportion recourse liabilities may be criticized because it ignores the vast majority of cases in which the partnership does not fail, and the liability is satisfied out of partnership profits. Furthermore, most loans, whether recourse or nonrecourse, are based primarily on the value of the property used to secure the loan, and in the event of default, the lender typically looks first to the property rather than any persons who may be personally liable. Nevertheless, allocating recourse liabilities in accordance with ultimate loss-sharing ratios is consistent with the manner in which partnership losses are allocated under § 704(b). The New Regulations, like the Old Regulations, look to risk of loss to allocate recourse liabilities.

In Cecil R. Richardson, 76 TC 512, 529-530 (1981), aff'd on other issues, 693 F.2d 1189 (5th Cir. 1982), the Tax Court dealt with the basis consequences of an agreement among general partners as to which of them would be responsible for certain partnership liabilities. In Richardson, a number of new partners were admitted to an existing partnership. In connection with their admission, the old partners agreed to be solely responsible for certain partnership debts. For purposes of computing the § 752(b) deemed distribution and
the concomitant § 731 gain to the old partners upon admission of the new partners, the court allocated the specified liabilities entirely to the old partners.

Although difficult to rationalize in terms of the sharing rules of § 1.752-1(e) of the Old Regulations, the result reached in Richardson appears sensible in the context of the business arrangement and the risk sharing between the old and new partners. Further, the same result would be reached if the old partners were treated as individually assuming the specified partnership liabilities, thereby entitling them to § 752(a) basis increases by reason of the constructive cash contributions associated with their assumption of the liabilities. Unfortunately, the Richardson opinion does not refer to either § 752(a) or the Old Regulations, and it is unclear whether the court (a) viewed the transaction as if the old partners had individually assumed the liabilities, or (b) intended to sanction an allocation of partnership liabilities among partners based on their business agreement rather than the § 1.752-1(e) Regulations. See James V. Proesel, 77 TC 992 (1981) (recourse liability allocated according to loss-sharing ratios; guarantee of, and actual payment by, certain partners does not preclude inclusion by all partners of pro rata share of recourse liability).
See Richard C. Brown, 40 TCM 725, 730 (1980) (quoting this text with approval), aff'd unpublished opinion (9th Cir. 1982).

See Raphan v. United States, 759 F.2d 879 (Fed. Cir. 1985), (cert. denied) ("nonrecourse" partnership loan personally guaranteed by general partner classified as recourse loan for purposes of Old Regulation § 1.752-1(e), notwithstanding guarantor's rights as creditor of partnership if called upon to honor guarantee), rev'g on this issue 83-2 USTC ¶ 9613 (Cl. Ct. 1983); Marcus W. Melvin, 86 TC 63 (1987); Sidney J. Gefen, 87 TC 1471 (1986); Edwin D. Abramson, 86 TC 360 (1986) (limited partner who guarantees part of otherwise nonrecourse partnership debt may increase basis by amount guaranteed); George F. Smith, Jr., 84 TC 889 (1985) (assumption agreement), aff'd unpublished opinion (D.C. Cir. 1986); Rev. Rul. 83-151, 1983-2 CB 105 ("nonrecourse" loan guaranteed by general partner; limited partner may not include in basis).

Prior to being reversed by the Federal Circuit, the Claims Court's decision in Raphan inspired the enactment of § 79 of the Tax Reform Act of 1984, authorizing the promulgation of New Regulations to overrule the Claims Court's decision in Raphan.

46 TC 147 (1966).

Inexplicably, the Commissioner did not attack the partnership as an association, notwithstanding the presence of a "dummy" general partner. See Reg. § 301.7701-2(d)(2); ¶ 3.06.
See also John A. Laney, 39 TCM 654 (1979), aff'd, 674 F.2d 342 (5th Cir. 1982); Richard C. Brown, 40 TCM 725 (1980), aff'd unpublished opinion (9th Cir. 1982).

The New Regulations are generally consistent with the holding of Kingbay. Thus, Temp. Reg. § 1.752-1T(d)(3)(ii)(D)(2) provides generally that, for purposes of determining whether a partner bears the economic risk of loss with respect to a partnership liability, it is assumed that all persons discharge their legal obligations, whether or not they would in fact have the net worth to do so if the partnership's assets were worthless; however, Temp. Reg. § 1.752-1T(d)(3)(ii)(D)(3) provides an "anti-gaming" rule under which this performance assumption does not apply if the facts and circumstances indicate a plan to avoid the obligation. See infra ¶ 8.03[5][e].

This distinction was rejected in John A. Laney, 39 TCM 654, 662 (1979) (issue 1), aff'd, 674 F.2d 342 (5th Cir. 1982). Cf. Richard C. Brown, 40 TCM 725 (1980), aff'd unpublished opinion (9th Cir. 1982). Under the New Regulations, a liability is a recourse liability to the extent any partner bears the economic risk of loss with respect to such liability, even if such risk is borne in a non-partner capacity. See Temp. Reg. §§ 1.752-1T(d)(2), 1.752-1T(d)(3); infra ¶ 8.03[2].

Reg. § 1.752-1(e) (emphasis added).
See, e.g., Minnesota Tea Co. v. Helvering, 302 US 609, 613 (1938): "A given result at the end of a straight path is not made a different result because reached by following a devious path." However, if the conduit purchase is made through a nonpartner nominee corporation (see ¶ 3.10) and no partner is personally liable for debts encumbering the property, the Service has ruled that the debts are nonrecourse for purposes of § 752. Rev. Rul. 75-31, 1975-1 CB 10.


24 Cf. Carriage Square, Inc., 69 TC 119, 141 (1977) (dissenting opinion) (sole shareholder of corporate general partner guarantees partnership borrowings; for purposes of § 704(e)(1), borrowed funds should be considered part of general partner's capital investment in partnership).

25 One possible technique to avoid this argument is to structure the shareholder's guaranty to exclude shares of the general partner from the assets to which the creditor may look for satisfaction of the guaranty. If the lender is willing to negotiate on this basis, such an exclusion is clearly
advisable as a matter of careful tax planning. If a partnership debt is guaranteed by an unrelated third party, which is paid a fee by the partnership for performing this service, the guaranty should not disturb the nonrecourse character of the debt: No "partner" is personally liable, nor are the assets of any partner at risk as a result of such a guaranty. See Rev. Rul. 75-31, 1975-1 CB 10.

See Temp. Reg. § 1.752-1T(d)(3)(ii)(A)(1)(i). Related persons are defined by Temp. Reg. § 1.752-1T(h) to include generally spouses, lineal ancestors and descendants, and eighty percent controlled entities; see infra § 8.05.

Temp. Reg. § 1.752-4T(b).

Id.


Rev. Rul. 84-118, 1984-2 CB 120.

84 TC 889, 903-904 (1985), aff'd unpublished opinion (DC Cir. 1986).

Temp. Reg. § 1.752-1T(j)(2).


-8-
The reversal of the Claims Court decision in *Raphan* occurred after the 1984 Act was enacted.


Id.

Temp. Reg. § 1.752-1T(d)(2). Although this part of the New Regulation does not expressly refer to related persons, it refers to Temp. Reg. § 1.752-1T(d)(3), which includes a panoply of related person rules.

Temp. Reg. § 1.752-1T(d)(1). Again, although this portion of the New Regulation does not expressly refer to related persons, it includes a reference to Temp. Reg. § 1.752-1T(d)(3).


Temp. Reg. § 1.752-1T(a)(1)(ii).

Temp. Reg. 1.752-1T(d)(3)(ii)(D); cf. Reg. § 1.704-1(b)(2)(ii)(h) (broadly defining the term "partnership agreement" for purposes of the allocation rules of § 704(b)). Under the Old Regulations it was not clear whether indemnities and the like would be taken into account.
in determining a limited partner’s obligation to make an additional contribution. See supra ¶ 8.02[2][c].


47 Related person is defined in Reg. § 1.752-1T(h). See infra ¶ 8.05.


52 See Temp. Reg. § 1.752-1T(d)(3)(ii)(A)(2)(ⅱ). Such assets, to the extent of their fair market value, are treated as disposed of in complete or partial satisfaction of the liabilities they secure. See infra ¶ 8.03[5][c].

53 Since the purpose of the entire exercise is to determine the amounts that the partners (and related persons) would be obligated to pay or contribute with respect to partnership liabilities, these obligations are given full effect in the analysis, and the New Regulations explicitly assume that in most instances each partner and related person will fully
perform these obligations. See Temp. Reg. § 1.752-1T(d)(3)(ii)(D)(2); infra ¶ 8.03[5][e].


55 See Temp. Reg. § 1.752-1T(d)(3)(i); infra ¶ 8.03[7][c].


57 See Temp. Reg. § 1.752-1T(d)(3)(ii)(A)(2)(ii); infra ¶ 8.03[5][c].


60 Id.


64 Temp. Reg. § 1.752-1T(d)(3)(ii)(B)(2)(i). Consistent with the § 704 capital account maintenance rules (see Reg. § 1.704-1(b)(2)(iv)(d)(2)), a promissory note made by a partner and contributed to a partnership is treated as a contribution, rather than a contribution obligation, if the note is readily tradeable on an established securities market at the time of its contribution. A promissory note that is made by a related person and contributed after December 29, 1988, is treated for § 752 purposes as made by the partner.


Temp. Reg. § 1.752-1T(d)(3)(ii)(B)(A)(i)(A). Temp. Reg. § 1.752-1T(d)(3)(ii)(B)(4)(ii) defines the portion of a partnership liabilities for which a creditor's right to repayment is limited to one or more assets of the partnership by excluding the portion of such liability that is not so limited. Thus, a creditor's right to repayment of a liability is limited to the extent that the total outstanding balance of such liability "exceeds the aggregate amount that the partners would be obligated to contribute to the partnership to discharge that liability if ... the partnership constructively liquidated." Id.

In determining the amounts the partners would have to contribute to satisfy a liability in a constructive liquidation, two modifications to the normal assumptions relating to constructive liquidations are made. First, in applying the constructive liquidation rules, it is assumed, contrary to Temp. Reg. § 1.752-1T(d)(3)(iii)(A), that any assets that have been contributed for the limited purpose of securing partnership liabilities (see Temp. Reg. § 1.752-1T(d)(3)(ii)(A)(2)(ii)) become worthless. The reason for this modification is mechanical: Temp. Reg. § 1.752-1T(d)(3)(ii)(B)(4)(i)(B) provides directly that a partnership does not have an indebtedness with respect to a
liability that is secured by assets described in Temp. Reg. § 1.752-1T(d)(3)(ii)(A)(2)(ii). Therefore, to avoid a double exclusion it is necessary not to treat such liabilities as liabilities to which the creditor's right to repayment is limited to one or more partnership assets under Temp. Reg. §§ 1.752-1T(d)(3)(ii)(B)(4)(i)(A) and 1.752-1T(d)(3)(ii)(B)(4)(ii).

Second, in determining whether a liability is one as to which the creditor's right is limited to partnership assets, Temp. Reg. § 1.752-1T(d)(3)(ii)(B)(4)(i)(B) assumes, contrary to the general rule in Temp. Reg. § 1.752-1T(d)(3)(ii)(D)(2), that in the constructive liquidation the partners do not satisfy their payment obligations (as opposed to contribution obligations) under Temp. Reg. § 1.752-1T(d)(3)(ii)(A)(2).

72 Temp. Reg. § 1.752-1T(d)(3)(ii)(A). In addition, a partner has the economic risk of loss if he is the holder of an otherwise nonrecourse partnership liability. Temp. Reg. § 1.752-1T(d)(3)(i)(B).
See infra § 8.03[5][c].

See Temp. Reg. § 1.752-1T(k) Example (12)(ii). Temp. Reg. § 1.752-1T(d)(3)(ii)(A)(2)(ii) also contains a tracing rule under which the solely for security rule applies if the partnership uses the proceeds of contributed property to acquire other property that, in turn, is used solely to secure a partnership liability.


Temp. Reg. § 1.752-1T(d)(3)(ii)(C). A right to be reimbursed by a person other than a partner, related person to a partner, or the partnership is not treated as a right to reimbursement. However, the preamble to the New Regulations, indicates that the Service is still considering whether to extend the concept of reimbursement to include rights to be reimbursed by unrelated third parties.


Temp. Reg. § 1.752-1T(d)(3)(ii)(D)(1)(ii). Example (16) of New Regulation § 1.752-1T(k) illustrates the facts and circumstances test. It involves a liability of a general partnership that is secured by a mortgage on a building. The liability is generally nonrecourse, but the partnership is liable to the creditor "to the extent of any decrease in the
value of the . . . building resulting from the partnership's failure to properly maintain the property." If the building were to diminish in value because of the partnership's failure to maintain it, the general partners would be liable to make contributions to satisfy the partnership's obligation if the partnership's assets were inadequate. Therefore, the question addressed by the example is whether the legally enforceable obligation to indemnify the creditor for decreases in value attributable to lack of maintenance constitutes an obligation to make a contribution to the partnership in the event of constructive liquidation. In the example, no facts establish "with reasonable certainty the existence of any liability on the part of the partnership (and its partners) for damages resulting from the partnership's failure to properly maintain the building. . . ." Accordingly, the example concludes that the indemnification obligation does not establish a contribution obligation on the part of any partner and, hence, that no partner has any economic risk of loss with respect to the liability. Thus, the liability is not a recourse liability. Of course, the result would be different if the facts clearly indicated that the value of the building had diminished as a result of inadequate maintenance. The facts and circumstances test of Temp. Reg. § 1.752-1T(d)(3)(ii)(D)(1)(ii) should be read in conjunction with Temp. Reg. § 1.752-1T(d)(3)(iv) under which "arrangements
tantamount to a guarantee" are treated as actual guarantees. See infra § 8.03[5][b].


In applying these rules, it is significant that, under the New Regulations, a single liability may be treated as a recourse liability in part and a nonrecourse liability in part. Temp. Reg. § 1.752-1T(j)(2). Thus, if a partner guarantees that collateral for an otherwise nonrecourse liability will have a minimum value that is less than the full amount of the liability, the portion of the liability equal to the guaranteed value may be treated as a recourse liability and the remainder as a nonrecourse liability. Moreover, an undertaking that eliminates the creditor's risk for a period of time that is less than the entire term of the liability should be treated as tantamount to a guarantee during the time that the undertaking is effective. The relevant question is whether, at the particular time the liability is being tested, the undertaking would eliminate the creditor's risk under the facts of a constructive liquidation occurring at that time.
"Property" for this purpose does not include a promissory note if the maker of the note is the person who is obligated to make the contribution or payment, unless the note is readily tradable on an established securities market. Moreover, a partner's interest in the partnership is deemed to have a value of zero for this purpose. Therefore, a partner (or related person) does not have a contribution or payment obligation to the extent his obligation to make a payment with respect to a partnership liability or a contribution to the partnership is secured only by a pledge of his interest in the partnership.

The anti-abuse rule in the New Regulations is limited to liabilities that are nonrecourse as to principal, even though the perceived abuse could also apply to liabilities that are recourse as to principal. This result was clearly intended. See Temp. Reg. § 1.752-1T(d)(3)(v)(A) (last sentence).
Example (10) of New Regulation § 1.752-1T(k) involves precisely these facts. In Example (10), the limited partner's indemnification agreement does not give rise to a net payment obligation of the limited partner because, under the general operating rules of the New Regulations, it is assumed that the general partner will perform its contribution obligation and, therefore, the indemnification obligation of the limited partner will never be required to be performed.

Cf. Reg. § 1.704-1(b)(2)(ii)(c) (penultimate sentence) (deficit capital account restoration obligation may be ignored for purposes of applying the economic effect test if "the facts and circumstances otherwise indicate a plan to avoid or circumvent such obligation"). In view of the stated objective of the New Regulations to "coordinate" with the § 704(b) Regulations (see Temp. Reg. § 1.752-1T(a)(1)(iv)), this provision of the § 704(b) Regulations and the comparable anti-abuse rule in the New Regulations should be applied consistently to avoid whipsawing partners by allocating losses and liabilities in different ways. Unfortunately, because the rules are worded somewhat differently, it remains to be seen whether the courts will adopt this approach.


Temp. Reg. § 1.752-1T(d)(3)(ii)(E)(3)(i). Temp. Reg. § 1.752-1T(d)(3)(ii)(E)(3)(i) attempts to prevent unreasonable delays in liquidation from being an effective means to avoid the general timing rules of Temp. Reg. § 1.752-1T(d)(3)(ii)(E). However, the effectiveness of this provision is constricted by the statute of limitations, since it will not be known that an unacceptable delay has occurred in liquidating a partner's interest until the liquidation actually occurs.

See ¶ 12.02.

Temp. Reg. § 1.752-1T(d)(3)(ii)(E)(3)(iii). Because such an obligation fails the requirement of Temp. Reg. § 1.752-1T(d)(3)(ii)(E)(1)(ii), it apparently is taken into account only to the extent of its discounted value under Reg. § 1.752-1T(d)(3)(ii)(E)(2). Under this Regulation, however, the discount factor seems to be zero, since it requires that discounted value be determined by reference to the "value that such obligation would have if the partnership constructively liquidated at the time of such determination."

Id.


This example is based on Temp. Reg. § 1.752-1T(k) Example (3).


This example is based on Temp. Reg. § 1.752-1T(k) Example (4).


The analysis, but not the result, of this example would change if, under terms of B's guarantee, the creditor were required to exhaust his remedies against the partnership before proceeding against B under the guarantee. Since, under Temp. Reg. § 1.752-1T(d)(3)(ii)(D)(2), it is assumed that all partners actually perform their obligations, in a constructive liquidation under the modified facts the creditor would proceed against the partnership first; the partnership would pay the liability in full with the proceeds of A's contribution; and B would never be required to make a payment under the guarantee. Under these circumstances, B's guarantee does not create a payment obligation. In contrast, in the facts of Example 2 the guarantee causes B to have a payment obligation, but his right to reimbursement prevents
him from having a net payment obligation. In either case, the entire economic risk of loss for the liability falls of A.

This example is based generally on Temp. Reg. § 1.752-1T(k) Example (6).


Temp. Reg. § 1.752-1T(k) Example (8) illustrates another situation in which the economic risk of loss for partnership liabilities is not borne by the partners in proportion to their overall interests in partnership losses, because their relative interests in existing partnership capital differ from their loss interests.

This example is a modification of Temp. Reg. § 1.752-1T(k) Example (14).


See Reg. § 1.704-1(b)(2)(ii)(h). If the guarantee and indemnity are given effect under § 704(b), allocation of the first $20,000 of losses entirety to C has economic effect, but losses in excess of $20,000 must be allocated 50% to each partner to reflect the guarantee and indemnity agreements.
This example is based on Temp. Reg. § 1.752-1T(k) Example (12).


This example is based on Temp. Reg. § 1.752-1T(k) Example (13).


Example (18) of Temp. Reg. § 1.752-1T(k) provides an example of the determination of the economic risk of loss with respect to a nonrecourse debt that is held by a person related to one partner and guaranteed, in part, by another partner.

See generally ¶ 7.02[2].

See infra ¶ 8.05.

See Temp. Reg. § 1.752-1T(d)(3)(vii); see ¶ 10.11[1].

Literally, the de minimis rule is limited to amounts borrowed "with respect to the activity of holding real property"
(§ 465(b)(6)(B)(i)), since this is the only type of loan that can constitute "qualified nonrecourse financing" within the meaning of § 465(b)(6). It is not clear whether this limitation was intended by the drafters of the New Regulations. See ¶ 3.03[3] [1st Edition].

See §§ 465(b)(6)(D), 46(c)(8)(D)(iv). The lender must be "actively and regularly engaged in the business of lending money."

This structure can also be used to reduce debt/equity concerns (see ¶ 7.02 [1st Ed.]) by funneling a portion of the funds supplied by the lender into the partnership as a capital contribution.

A "related person" within the meaning of § 46(c)(8)(D)(v) cannot be a qualified lender for purposes of § 465(b)(6) unless the loan is "commercially reasonable and on substantially the same terms as loans involving unrelated persons." § 465(b)(6)(D)(ii). The relevant "related person" rules are in § 465(b)(3)(C), which generally is based on §§ 267(b) and 707(b)(1), modified to reduce "50%" to "10%." Since the lender (or a related person) will not have more than a 10% interest in the borrower-partnership, it will not be a related person to the partnership within the meaning of § 707(b)(1). The possible application of § 267(b) is less certain because of § 267(e), which provides that for certain purposes a person who owns (directly or indirectly) any capital or profits interest in a partnership is a related
person to the partnership. In the absence of clear authority as to whether the reference to § 267(b) in § 465(b)(3)(C) encompasses the partner-partnership rule in § 267(e), it seems prudent to attempt to comply with the "commercially reasonable" standard in § 465(b)(6)(D)(ii), thereby negating any related person concerns.


160 See Temp. Reg. § 1.752-1T(k) Example (19). The result in both examples in the text would change if the $200,000 first mortgage were a recourse obligation of the selling partner that was not assumed by the partnership. In such a case, whether the partnership took the property "subject to" the first mortgage (as in Example 1), or the first mortgage liability were a wrapped indebtedness included in a $240,000 nonrecourse note (as in Example 2), the selling partner would have a net payment obligation and the economic risk of loss for the first mortgage liability.

In Example 2, if the wrapping indebtedness (the second mortgage owed to the selling partner) were a recourse obligation, the wrapped indebtedness would be ignored and the entire wrapping indebtedness would be treated as single recourse partnership liability.

161 Temp. Reg. § 1.752-1T(j)(1). This rule does not apply to liabilities of the subsidiary partnership that are owed to the upper-tier partnership. Cf. Rev. Rul. 77-309, 1977-2 CB 216 (under Old Regulations, limited partner’s basis for
interest in upper-tier partnership includes his share of upper-tier partnership's share of nonrecourse liabilities of subsidiary partnership).

162 Temp. Reg. § 1.752-1T(d)(3)(vi)(A). In making this determination any liability of the subsidiary partnership that is owed to the upper-tier partnership is ignored, because an upper-tier partnership cannot have a share of liabilities as to which it is the creditor. Temp. Reg. § 1.752-1T(j)(1).


164 The fact that a partner of the upper-tier partnership has guaranteed this liability does not prevent the upper-tier partnership from having a net contribution obligation for the entire $100 recourse liability. See Temp. Reg. § 1.752-1T(k) Example (4).


166 Temp. Reg. § 1.752-1T(j)(5).

167 Temp. Reg. § 1.752-1T(d)(i)(last sentence).

168 Cf. Temp. Reg. § 1.752-1T(k) Example (9).


170 Temp. Reg. § 1.752-1T(e)(2).


172 Temp. Reg. § 1.752-1T(e)(1).

173 See Reg. § 1.704-1T(b)(4)(iv)(f).


175 Temp. Reg. § 1.752-1T(e)(3)(i).
The example is based substantially on Temp. Reg. § 1.752-1T(k) Example (22).


Temp. Reg. § 1.752-1T(e)(1).


See generally § 10.10.


Temp. Reg. § 1.752-1T(e)(1)(ii). For purposes of computing built-in gain for this purpose, this New Regulation further provides that--

"the amount of taxable gain that would be recognized by the partnership if it disposed of an item of partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of such liabilities shall be computed by taking into account
only the portion of the adjusted tax basis of such property that is allocated to nonrecourse liabilities of the partnership under the principles of § 1.704-1T(b)(4)(iv)(c)(1) and (2)."


194 There are several circumstances under which the book value of partnership property may differ from its adjusted tax basis to the partnership. If a partnership acquires property by contribution from a partner, the property is entered on the partnership's books at its then fair market value, rather than its adjusted tax basis. See Reg. § 1.704-1(b)(2)(iv)(d). Similarly, the book value of property may differ from its adjusted tax basis as a result of certain permitted revaluations of the property for book purposes only. See Reg. §§ 1.704-1(b)(2)(iv)(f), 1.704-1(b)(2)(iv)(e).


196 Section § 752(b) distribution of $99, less § 752(a) contribution of $39.60. See Reg. § 1.722-1; ¶ 4.03. Under Temp. Reg. § 1.752-1T(j)(3), § 752(a) contributions and $ 752(b) distributions that occur as a result of a single transaction are combined into a single net § 752(a) or $ 752(b) contribution or distribution.

197 Temp. Reg. § 1.752-1T(e)(1)(i).

198 Temp. Reg. § 1.752-1T(e)(1)(iii).

Temp. Reg. § 1.752-1T(e)(1)(ii).

Temp. Reg. § 1.752-1T(d)(3)(vi); see ¶ 8.03[8].

Id.


Temp. Reg. § 1.752-1T(a)(1)(ii), 1.752-1T(d)(3).


Temp. Reg. § 1.752-1T(h)(1).

Temp. Reg. § 1.752-1T(h)(3).


Temp. Reg. § 1.752-1T(h)(4).