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Working with the Section 752 Partnership Liability Allocation Rules (Slides)

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**Working with the
Section 752
Partnership Liability Allocations Rules**

**60th Annual
William and Mary Tax Conference**

Presenters

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Why Important

- **Partner's basis in interest (“outside basis”) includes a share of partnership liabilities**
- **Partner may receive cash distributions tax free to extent of outside basis**
- **Partner may deduct losses to extent of outside basis**

Why Important

- **Decreases in partner's share of partnership liabilities treated as deemed distribution of cash**
- **To the extent liability share reduction/ deemed distribution of cash exceeds outside basis, taxable gain**

Why Important

- Partner's outside basis generally equals tax basis capital account plus share of liabilities
- If share of liabilities reduced below tax basis negative capital account, taxable gain triggered

Why Important

- **Common causes of reduction in share of liabilities:**
 - **Reduction in partnership liabilities**
 - **Contribution of encumbered property**
 - **Change in debt terms**
 - **Admission of new partner**
 - **Sec. 704(c) “burn off”**

Sec. 752 Mechanics

- **Increase in partner's share of partnership liabilities, or increase in partner's individual liabilities by assumption of partnership liability, treated as deemed cash contribution**
- **Deemed cash contribution increases outside basis**

Sec. 752 Mechanics

- **Decrease in partner's share of partnership liabilities, or decrease in partner's individual liabilities by partnership assumption of individual liability, treated as deemed cash distribution**
- **Deemed cash distribution decreases outside basis; triggers gain to extent it exceeds outside basis**

Sec. 752 Mechanics

- **Increases and decreases in single transaction netted**
- **Net increase treated as cash contribution**
- **Net decrease treated as cash distribution**

Sec. 752 Mechanics

Example: Property Contribution

- A contributes property with basis of \$60, subject to debt of \$100, for 50% interest in partnership
- Assume A's share of partnership liabilities post-contribution is \$50

Sec. 752 Mechanics

Example: Property Contribution

- **A is deemed to receive a \$50 cash distribution (decrease in personal liabilities of \$100, increase in share of partnership liabilities of \$50)**
- **A's basis in partnership interest is \$10 (\$60 basis in property minus \$50 deemed cash distribution)**

Recourse Liabilities

- **Liability is recourse to extent partner or related person bears “economic risk of loss”**
- **Constructive liquidation (“neutron bomb”) test to determine whether partner/related person bears economic risk of loss**

Recourse Liabilities

- **Generally presumed that person will perform obligation regardless of actual financial ability**
- **Partner bears economic risk of loss where partner or related person is nonrecourse lender**
- **10% exception**

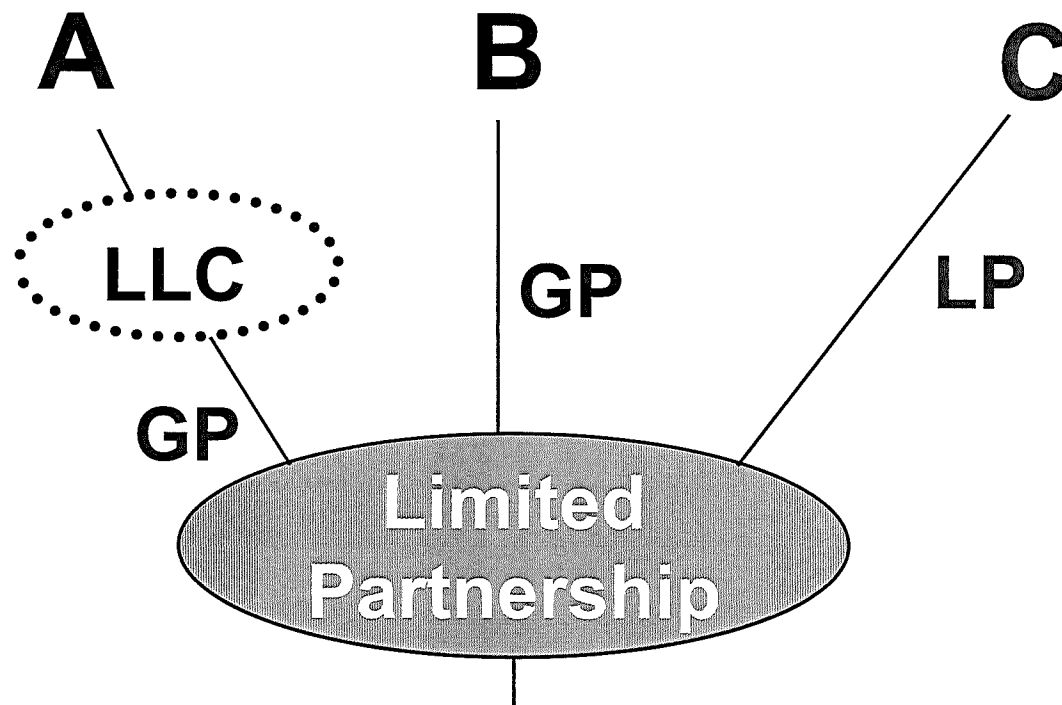
Nonrecourse Liabilities

- **No partner or related person bears economic risk of loss**
- **Three tier allocation**
 - **Share of partnership minimum gain**
 - **Sec. 704(c) minimum gain**
 - **Profits**

Nonrecourse Liabilities

- **Interaction with choice of Sec. 704(c) method**
- **Rev. Rul. 95-41**
- **Sec. 704(c) “burn-off” causes debt shift as property is depreciated**

Disregarded Entities



Recourse Liabilities
Nonrecourse Liabilities

Disregarded Entities

Final Regulations

- **Effective for obligations incurred or assumed by partnership after October 10, 2006**
- **Payment obligations of A DE taken into account only to extent of “net value” of DE**

Disregarded Entities

- **“DE” includes single owner LLC, QRS and QSUB**
- **“Net value” = fair market value reduced by value of obligations other than obligation to pay partnership liability, regardless of priority**

Disregarded Entities

- **“Net value” does not include value of interest in partnership whose liabilities are being allocated (but does include value of other partnership interests)**
- **“Net value” generally determined “as of the date partnership determines shares of liabilities” -- year end**

Disregarded Entities

- **Not redetermined unless non-de minimis contribution to or distribution from DE, or change in obligations, or sale of asset**
- **Partner owning partnership interest through DE must report ownership and “net value appropriately allocable to partnership’s liabilities on a timely basis”**

Disregarded Entities

- **Net value approach not currently extended to other entities, but proposed regulations would extend this approach to any tax disregarded entity if finalized**
- **Lots of planning – use of DEs, vs. S corporations, vs. multi-member LLCs**

Proposed Regulations: Recourse Liabilities

- **Three critical changes**
 - **Seven “recognition requirements” that must be satisfied for payment obligation to be recognized**
 - **Net value requirement currently applicable only to DEs extended to all regarded entities**
 - **Amount of any payment obligation of a partner or related person reduced to the extent of any right of reimbursement from any “person” (rather than partner or related person)**

Recourse Liabilities: Recognition Requirements

- **Payment obligation, other than one imposed by state law, must satisfy the following requirements:**
 - 1. Obligor must be required to maintain commercially reasonable net worth, or be subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration**
 - 2. Obligor must be required to periodically provide commercially reasonable documentation regarding obligor's financial condition**

Recourse Liabilities: Recognition Requirements

3. Term of payment obligation must not end prior to term of the partnership liability

4. Payment obligation must not require obligor with respect to partnership liability to hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor

5. Obligor must receive arm's length consideration for assuming the payment obligation

Recourse Liabilities: Recognition Requirements

6. In the case of a guarantee or similar arrangement, obligor must be liable up to the full amount of such obligor's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied (no bottom guarantees)

7. In the case of an indemnity or similar arrangement, obligor must be liable up to the full amount of such obligor's obligation if, and to the extent that, any amount of the indemnitee's payment obligation is satisfied (no bottom indemnities)

Recourse Liabilities: Recognition Requirements

- **Consequence of failing to satisfy new requirements is treatment of partnership liability as nonrecourse**
- **Will taxpayers be forced to require lenders to impose net worth documentation and maintenance requirements, or partnerships to pay a guarantee fee, to satisfy these requirements?**
- **Are the Regs valid? Do they overrule the *Raphan* case, as directed by Congress?**

Recourse Liabilities: Termination of Payment Obligation

- **The term of the obligation must not end prior to the term of the partnership liability**
- **Cannot terminate:**
 - **Pursuant to common commercial release terms**
 - **After conversion of OP Units to Common stock**
 - **On death**
 - **On agreed date, upon notice, subject to the property satisfying certain coverage ratios**

Recourse Liabilities: Bottom Guarantees

- **Cannot have joint but not several guarantees**
- **Cannot guarantee middle or bottom or vertical slice of debt**
- **If another party indemnifies for any amount of guaranteed debt, then no share of debt to guarantor**

Recourse Liabilities: Deficit Restoration Obligations

- **DROs not specifically addressed**
- **Unlikely that DRO can ever be taken into account as a payment obligation**
- **DRO presumably must satisfy all recognition requirements**

Recourse Liabilities: Deficit Restoration Obligations

- **DRO does not by its terms satisfy third nonrecognition requirement – obligation may terminate prior to term of the partnership liability**
 - **Section 704(b) regulations require that DRO be satisfied by later of the end of the taxable year in which the partner's interest in the partnership is liquidated or within 90 days of such liquidation**
- **Also may be afoul of prohibition of sixth nonrecognition requirement (no bottom guarantees)**

Recourse Liabilities: Anti-Abuse Rule

- **An obligation will not be taken into account if the facts and circumstances indicate that the partnership liability is part of a plan or arrangement involving the use of tiered partnerships, intermediaries, or similar arrangements to convert a single liability into more than one liability with a principal purpose of circumventing the sixth recognition requirement**
- **Guarantee of senior debt, with unguaranteed subordinated debt?**

Recourse Liabilities: Effective Date

- **Proposed Regulations will apply to liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken on or after the date final regulations are published, other than liabilities incurred or assumed and payment obligations imposed or undertaken pursuant to a written binding contract**
- **Proposed Regulations will apply to any recourse liability incurred after the effective date, even if that liability refinances a pre-effective date liability that was subject to a guarantee**

Recourse Liabilities: Transition Rule

- **Seven-year transition period**
- **During this period, if a partner (“Transition Partner”) has a share of recourse liabilities under current rules, partnership may choose not to apply new rules to an amount of partnership liabilities equal to the excess of the Transition Partner’s share of recourse liabilities over the Transition Partner’s adjusted basis in the partnership interest**
- **Amount of liabilities to which transition rule applies is reduced to the extent built-in gain attributable to Transition Partner’s negative tax basis capital account is recognized**

Recourse Liabilities: Transition Rule

- If Transition Partner is a partnership, S corporation or disregarded entity, 50 percent or more change in ownership of Transition Partner will terminate the transition period
- **PLANNING POINT** - Because the seven-year transition rule applies only if elected by the partnership, partners entering into guarantees and similar obligations now should negotiate to require the partnership elect the seven-year transition rule if the Proposed Regulations become effective and the partner so requests

Recourse Liabilities: Effective Date Issues

- **Pre-effective date guarantees**
 - **“Base case” should be grandfathered until guarantee is modified or debt is refinanced subject to sec. 1001 significant modification**
- **Term of years guarantee with automatic renewal in default of notice; no refi**
- **Above, plus post-effective date refi that is required by Debt Maintenance Agreement**
- **Above, but guarantee after refi is at election of partner**

Recourse Liabilities: Effective Date Issues

- **Pre-effective date guarantee if significant modification or refi of debt**
 - **7 year transition relief only to extent of negative capital account on effective date subject to reduction, but not increase**
- **Post-effective date DRO**
 - **Not clear whether DRO can ever be taken into account as a payment obligation as does not by its terms satisfy third nonrecognition requirement – obligation may terminate prior to term of the partnership liability**

Proposed Regulations: Nonrecourse Liabilities

- **Third Tier Significant Item Method and Alternative Method would be eliminated**
- **Instead, the Proposed Regulations would allow a partnership to allocate excess nonrecourse liabilities based on partners' "liquidation value percentages"**
- **Partner's liquidation value percentage is ratio of liquidation value of partner's interest in the partnership divided by aggregate liquidation value of all of partner's interests in the partnership**

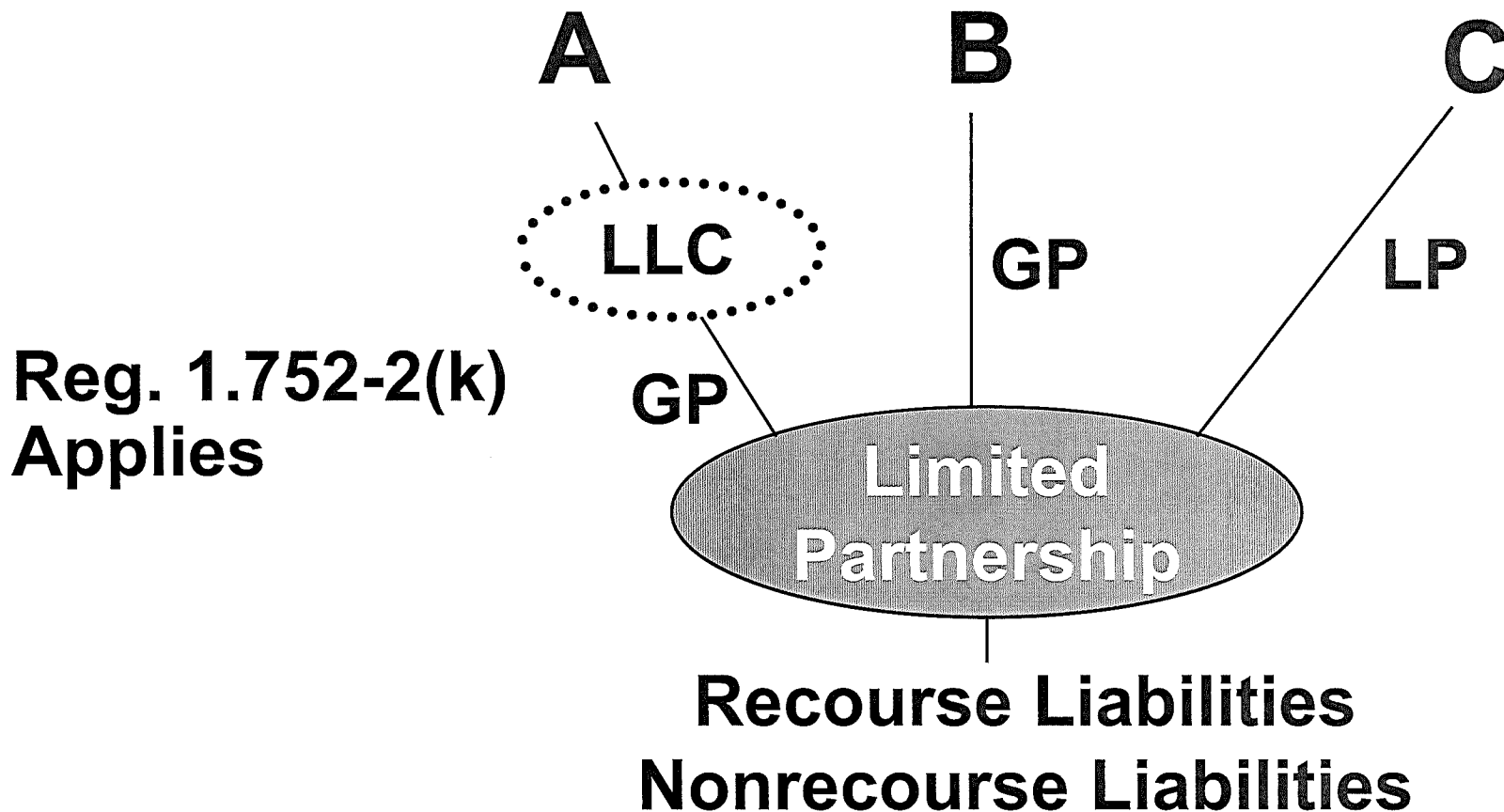
Proposed Regulations: Nonrecourse Liabilities

- **Liquidation value is amount partner would receive if, immediately after formation of partnership or occurrence of Sec. 704(b) revaluation event, partnership sold all assets for cash, satisfied all liabilities, paid unrelated party to assume all Treas. Reg. § 1.752-7 liabilities, and then liquidated**
- **Equal to interest in capital**
- **Liquidation value percentage must be determined upon formation and re-determined whenever Sec. 704(b) revaluation event occurs, regardless of whether partnership actually revalues its assets**

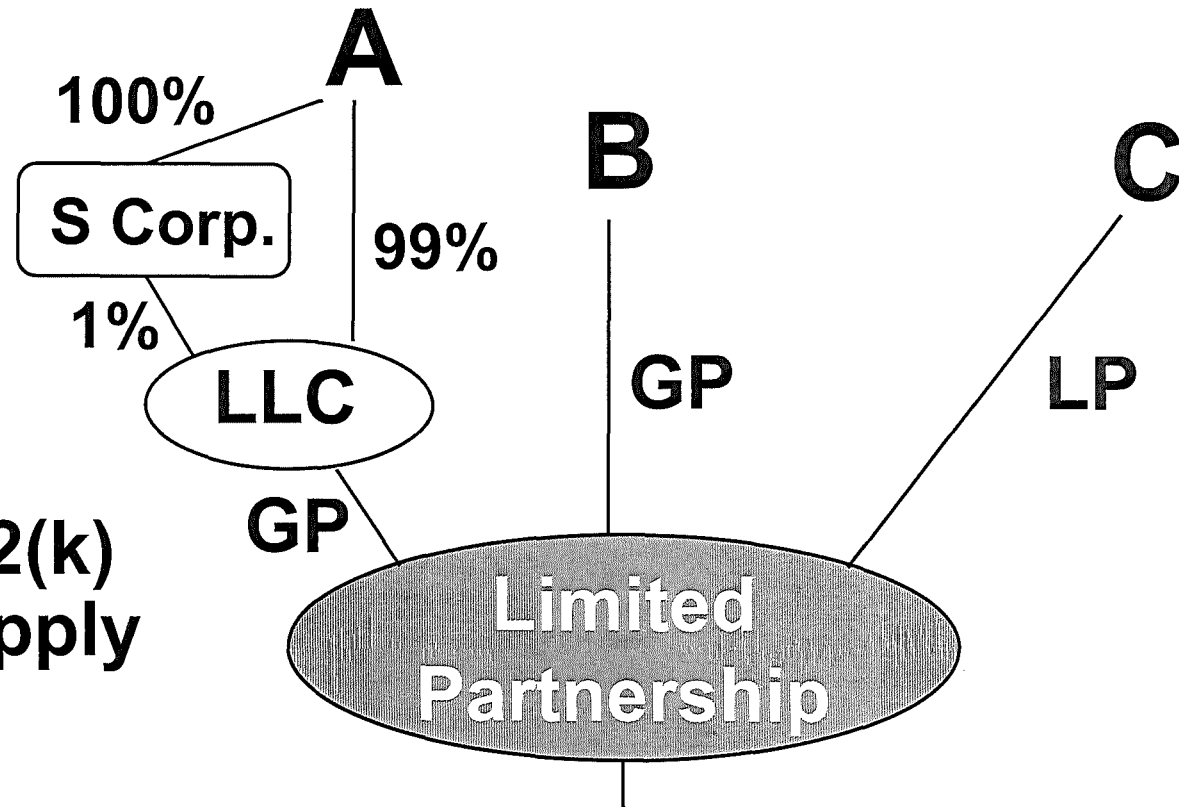
Proposed Regulations: Nonrecourse Liabilities

- **Proposed effective date is for liabilities incurred or assumed by a partnership on or after the date the Proposed Regulations are published as final regulations**

Ex. 1: Disregarded Entities



Ex. 2: Disregarded Entities



**Reg. 1.752-2(k)
Does Not Apply**

**Recourse Liabilities
Nonrecourse Liabilities**

Ex. 3: Nonrecourse Debt; Regular Guarantee

- **X is 1% limited partner in LP**
- **X enters into enforceable guarantee of \$10 of \$100 liability that is otherwise nonrecourse**
- **No right of subrogation or contribution**

Ex. 3: Nonrecourse Debt; Regular Guarantee

- **Guarantee should cause \$10 of debt to be allocated to X**
- **Does it matter if X enters into the guarantee for the sole purpose of boosting outside basis?**
- **Sec. 465 at-risk issue**

Ex. 4: Nonrecourse Debt; Bottom Guarantee

- **X is 1% limited partner in LP**
- **X enters into enforceable “bottom” guarantee of \$10 of \$100 liability that is otherwise nonrecourse**
- **No right of subrogation or contribution**

Ex. 4: Nonrecourse Debt; Bottom Guarantee

“X shall not be obligated to make any payment hereunder until all attempts to collect from Borrower, with due diligence and using reasonable means, have failed to produce gross proceeds to Lender (not taking into account any costs incurred by Lender in collecting such proceeds) of at least \$10. Such attempts shall include the exhaustion of all rights and remedies at law and in equity that Lender may have against Borrower and the Collateral securing the Loan.”

Ex. 4: Nonrecourse Debt; Bottom Guarantee

- **Bottom guarantee of collection should cause \$10 of debt to be allocated to X**
- **Does it matter if X enters into the guarantee for the sole purpose of boosting outside basis?**
- **What if GP has deficit restoration obligation?**

Ex. 5: Recourse Debt; Regular Guarantee

- **X is 1% limited partner in LP**
- **X enters into enforceable guarantee of \$10 of \$100 liability that is recourse**
- **No right of subrogation or contribution**

Ex. 5: Recourse Debt; Regular Guarantee

- X's guarantee does not cause \$10 of the recourse debt to be allocated to him
- On constructive liquidation, GP presumed to pay the debt; guarantee presumed never to be called
- See Reg. § 1.752-2(f), Example 3.

Ex. 6: Recourse Debt; Indemnity

- **X is 1% limited partner in LP**
- **X enters into enforceable indemnification agreement with GP pursuant to which X indemnifies GP for up to \$10 if GP is required to pay on the debt**
- **Recourse debt; no right of subrogation or contribution**

Ex. 6: Recourse Debt; Indemnity

- X's indemnity does cause \$10 of the recourse debt to be allocated to him
- On constructive liquidation, GP presumed to pay the debt; X presumed to pay on the indemnity

Termination of Guarantee or Indemnity

- **When can the guaranty or indemnity terminate?**
 - **Only when liability paid in full?**
 - **At will?**
 - **At will, but subject to appraisal requirement?**
 - **Term of years with renewal?**
 - **In UPREIT, upon conversion of OP units?**

Ex. 7: Recourse Debt; Conventional DRO

- **X is 1% limited partner in LP**
- **X enters into DRO -- upon liquidation, X is obligated to make capital contribution equal to lesser of \$10 or amount of deficit capital account balance**

Ex. 7: Recourse Debt; Conventional DRO

- **Partnership agreement complies with Reg. Sec. 704(b) safe harbor**
- **Partnership agreement amended to provide that all losses allocated to X until X's book capital account equals (\$10)**

Ex. 7: Recourse Debt; Conventional DRO

Partnership “book” balance sheet at time DRO
entered into:

Prop.	80	100 Rec. Liab.
		(.20) X
		(19.80) Others

Ex. 7: Recourse Debt; Conventional DRO

- **After constructive liquidation, X would have (\$10) capital account and obligation to contribute \$10 to pay the debt**
- **So DRO should cause \$10 of recourse debt to be allocated to X**
- **Sec. 465(e) issue - Hubert case**

Ex. 8: Recourse Debt; Bottom DRO

- **X is 1% limited partner in LP**
- **X enters into DRO -- upon liquidation, X is obligated to make capital contribution equal to lesser of \$10 or amount of deficit capital account balance**

Ex. 8: Recourse Debt; Bottom DRO

Partnership “book” balance sheet at time DRO
entered into:

Prop.	80	100 Rec. Liab.
		(.20) X
		(19.80) Others

Ex. 8: Recourse Debt; Bottom DRO

- **Partnership agreement complies with Reg. Sec. 704(b) safe harbor**
- **Partnership agreement amended to provide that first \$70.20 of loss on disposition of property allocated to other partner(s); last \$9.80 of loss allocated to X**

Ex. 8: Recourse Debt; Bottom DRO

- **After constructive liquidation, X would have (\$10) capital account and obligation to contribute \$10 to pay the debt**
- **So bottom DRO should cause \$10 of recourse debt to be allocated to X**

Ex. 8: Recourse Debt; Bottom DRO

- **Bottom DRO provides significantly lower economic risk for X than bottom guarantee of specific debt**
- **Bottom guarantee of specific debt exposes X to economic risk if specific property declines in value below the bottom guarantee amount**

Ex. 8: Recourse Debt; Bottom DRO

- If no secured nonrecourse debt, bottom DRO exposes X to economic risk only if entire portfolio of properties declines in value below the bottom DRO amount

Ex. 8: Recourse Debt; Bottom DRO

- **If secured nonrecourse debt and book value at least equal to nonrecourse debt, bottom DRO exposes X only if portfolio value in excess of nonrecourse debt declines below bottom DRO amount**

Ex. 8: Recourse Debt; Bottom DRO

- **Bottom guarantee of specific debt may be called if default on specific debt**
- **Bottom DRO may be called only if partnership actually liquidated**

Ex. 9: Nonrecourse Debt; Conventional DRO

- **X is 1% limited partner in LP**
- **X enters into DRO -- upon liquidation, X obligated to make capital contribution equal to lesser of \$10 or amount of deficit capital account balance**

Ex. 9: Nonrecourse Debt; Conventional DRO

- **Partnership agreement complies with Reg. Sec. 704(b) safe harbor**
- **Partnership agreement amended to provide that all losses allocated to X until X's book capital account equals (\$10)**

Ex. 9: Nonrecourse Debt; Conventional DRO

Partnership “book” balance sheet at time DRO
entered into:

Prop.	80	100 Nonrec. Liab.
		(.20) X
		(19.80) Others

Ex. 9: Nonrecourse Debt; Conventional DRO

- **After constructive liquidation, X would have \$0 capital account and no obligation to make any capital contribution**
- **So DRO will not cause any nonrecourse debt to be allocated to X**
- **Different answer if book value of property securing nonrecourse debt exceeds debt**

LLCs

- **No member of an LLC is liable for debts of the entity merely by virtue of being a member**
- **Absent a guarantee or other special circumstances, a liability that is state law recourse to an LLC should be treated as nonrecourse for purposes of Sec. 752**
- **Like an “exculpatory” liability**

LLCs: Guarantees

- **Guarantee (bottom or otherwise) of state law recourse liability should cause debt to be allocated to guarantor**
- **Guarantee (bottom or otherwise) of state law nonrecourse liability should cause debt to be allocated to guarantor**

LLCs: DROs

- **DRO in LLC should not cause state law nonrecourse debt to be allocated to member with DRO**
- **Whether a DRO in an LLC will cause state law recourse debt to be allocated to member with DRO may depend on whether member has positive or negative capital account**

Ex. 10: LLC; DRO; Recourse Debt; Negative CAs

- **X is 1% member in LLC**
- **X enters into DRO -- upon liquidation, X obligated to make capital contribution equal to lesser of \$10 or amount of deficit capital account balance**

Ex. 10: LLC; DRO; Recourse Debt; Negative CAs

- **LLC agreement complies with Reg. Sec. 704(b) safe harbor**
- **LLC agreement amended to provide that all losses allocated to X until X's book capital account equals (\$10)**

Ex. 10: LLC; DRO; Recourse Debt; Negative CAs

LLC “book” balance sheet at time DRO entered into:

Prop.	80	100 Rec. Liab.
		(.20) X
		(19.80) Others

Ex. 10: LLC; DRO; Recourse Debt; Negative CAs

- **DRO will not cause any portion of debt to be allocated to X**
- **Upon constructive liquidation:**

“If the creditor's right to repayment of a partnership liability is limited solely to one or more assets of the partnership, gain or loss is recognized in an amount equal to the difference between the amount of the liability that is extinguished by the deemed disposition and the tax basis (or book value to the extent section 704(c) or section 1.704-1(b)(4)(i) applies) in those assets.”

Ex. 10: LLC; DRO; Recourse Debt; Negative CAs

- **After constructive liquidation, X would have \$0 capital account and no obligation to make any capital contribution**
- **So DRO will not cause any state law recourse debt to be allocated to X if book capital accounts are negative**

Ex. 11: LLC; DRO; Recourse Debt; Positive CAs

Same facts, except LLC balance sheet at time DRO entered into as follows:

Prop.	120	100 Rec. Liab.
		.20 X
		19.80 Others

Ex. 11: LLC; DRO; Recourse Debt; Positive CAs

- **After constructive liquidation, X would have (\$10) capital account and obligation to contribute \$10 to pay the debt**
- **So DRO should cause \$10 of state law recourse debt to be allocated to X if book capital accounts are positive**

Ex. 12: LLC; CCO Tied to Value; Recourse Debt

Same LLC balance sheet as Ex. 10:

Prop.	80	100 Rec. Liab.
		(.20) X
		(19.80) Others

Ex. 12: LLC; CCO Tied to Value; Recourse Debt

- **X agrees that, upon liquidation, to the extent the value of assets available to satisfy debt is less than \$10, X will make a capital contribution of up to \$10 irrespective of whether X has a deficit capital account balance**

Ex. 12: LLC; CCO Tied to Value; Recourse Debt

- **After constructive liquidation, X would have \$0 capital account**
- **Nevertheless, X would have obligation to make \$10 capital contribution**

Ex. 12: LLC; CCO Tied to Value; Recourse Debt

- **Reg. § 1.752-2(b)(3)(ii) states that, in determining whether a partner bears the economic risk of loss, obligations imposed by the partnership agreement are taken into account,**

“including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation”

Ex. 12: LLC; CCO Tied to Value; Recourse Debt

- **So capital contribution obligation tied to value should cause \$10 of state law recourse debt to be allocated to X**

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