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

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WORKING WITH THE
SECTION 752
PARTNERSHIP LIABILITY ALLOCATION RULES

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(continued)

**PLANNING FOR PARTNERSHIP LIABILITY ALLOCATIONS, INCLUDING THE NEW PROPOSED REGULATIONS**

By

Blake D. Rubin, Andrea M. Whiteway and Jon G. Finkelstein
McDermott Will & Emery LLP, Washington, D.C.
September 2014

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PLANNING FOR PARTNERSHIP LIABILITY ALLOCATIONS, INCLUDING THE NEW PROPOSED REGULATIONS

By
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January 2014

I. INTRODUCTION

A. The allocation of partnership liabilities can be critical to effectuating the tax planning goals of a partner.

B. A partner’s basis in a partnership interest generally includes the partner’s allocable share of partnership liabilities. A partner’s basis in the partnership interest is of great importance for two principal reasons.

C. First, a partner recognizes gain upon a distribution of cash from a partnership only to the extent the distribution exceeds the partner’s basis in the partnership interest. Section 731(a)(1). On the other side of the coin, a partner may receive distributions of cash up to the amount of the partner’s basis in the partnership interest without recognizing taxable gain.

D. Second, a partner may deduct losses of the partnership only to the extent of the partner’s basis in the partnership interest. Section 704(d).

E. Accordingly, a partner’s allocation of partnership liabilities is important in determining the extent to which the partner can receive tax-free distributions of cash and deduct losses of the partnership.

F. In addition, a decrease in a partner’s share of liabilities causes the partner to recognize taxable gain to the extent such decrease exceeds the partner’s basis in the partnership. Section 752(b); Section 731(a). Such a deemed cash distribution could occur, for example, if a partnership reduces a liability, or if another partner guarantees a partnership liability. Thus, it is important for a partner to know how partnership liabilities are allocated for Federal income tax purposes and how to achieve an allocation that is beneficial to that partner.

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3 Unless otherwise noted or clear from context, section references are to the Internal Revenue Code of 1986, as amended.
G. Part II of this outline summarizes the rules for allocating partnership liabilities for Federal income tax purposes under the existing section 752 regulations and contains a series of examples that illustrate techniques for managing the allocation of partnership liabilities under these rules. In addition, this section explains how these rules and techniques apply to limited liability companies ("LLC") that are treated as partnerships for Federal income tax purposes.\textsuperscript{4}

H. Part III of this outline summarizes and analyzes the proposed partnership liability regulations under section 752 that were issued on January 29, 2014. As noted below, the proposed regulations would significantly change the way partnership liabilities are allocated to partners and would, in many cases, trigger gain to partners that have negative tax basis capital accounts or limit the ability of partners to take losses into account.

II. PLANNING UNDER THE EXISTING PARTNERSHIP LIABILITY ALLOCATION RULES

A. ALLOCATION OF PARTNERSHIP LIABILITIES: GENERAL RULES

1. Increase in Share of Liabilities

   a. Under section 752(a), any increase in a partner’s share of liabilities of a partnership, or any increase in a partner’s individual liabilities by reason of the assumption by such partner of partnership liabilities, is treated as a contribution of money by such partner to the partnership.

   b. Under section 722, this deemed contribution of money by the partner to the partnership increases the partner’s basis in the partnership interest.

2. Decrease in Share of Liabilities

   a. Under section 752(b), any decrease in a partner’s share of the liabilities of a partnership, or any decrease in a partner’s individual liabilities by reason of the assumption by the partnership of such individual liabilities, is treated as a distribution of money to the partner by the partnership. Under sections 733(1) and 705(a)(2), this deemed distribution of money by the partnership to the partner reduces the partner’s basis in the partnership interest, but not below zero.

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\textsuperscript{4} An LLC is taxable as a partnership for Federal income tax purposes unless it elects to be taxed as a corporation under the "check-the-box" regulations. Treas. Reg. § 301.7701-3(b)(1).
b. Under section 731(a), upon a distribution of money to a partner by a partnership (including a deemed distribution of money pursuant to Section 752(b)), gain is recognized by the distributee partner to the extent that the money distributed exceeds the adjusted basis of the partner’s interest immediately before the distribution.

3. Increases and Decreases in Single Transaction
   a. Treas. Reg. § 1.752-1(f) provides that if, as a result of a single transaction, a partner incurs both an increase in the partner’s share of partnership liabilities (or the partner’s individual liabilities) and a decrease in the partner’s share of partnership liabilities (or the partner’s individual liabilities), only the net decrease is treated as a distribution of money and only the net increase is treated as a contribution of money.

4. Definition of “Liability” for Purposes of Section 752
   a. Section 752 does not define the term “liability.” Until 2005, the regulations under section 752 likewise did not define the term.
   b. In Rev. Rul. 88-77, 1988-2 CB 128, the Internal Revenue Service (the “Service”) held that, for purposes of section 752, the terms “liabilities of a partnership” and “partnership liabilities” include an obligation only if and to the extent that incurring the liability creates or increases the basis to the partnership of any of the partnership’s assets (including cash attributable to borrowings), gives rise to an immediate deduction to the partnership, or, under section 705(a)(2)(B), currently decreases a partner’s basis in the partner’s partnership interest.
   c. Based on this analysis, the Service concluded that accrued but unpaid expenses and accounts payable are not liabilities within the meaning of section 752 for purposes of computing the adjusted basis of a partner’s interest in a partnership using the cash method of accounting.
   d. In Rev. Rul. 95-26, 1995-1 CB 131, the Service held that a short sale of securities creates a partnership liability for purposes of section 752 because the short sale creates an obligation to deliver the securities while the cash proceeds from the sale increase the basis of the partnership’s assets. See also Salina Partnership v. Commissioner, 80 T.C.M. (CCH) 686 (2000).
   e. 2005 Regulations. In 2005, as part of the amendments to the section 752 regulations addressing non-tax basis liabilities discussed in Part IV hereof, Treas. Reg. 1.752-1 was amended to provide a definition of “liability” for purposes of section 752.
Treas. Reg. 1.752-1(a)(4) now provides that an obligation is a liability if and to the extent that incurring the obligation --

i. creates or increases the basis of any of the obligor’s assets (including cash);

ii. gives rise to an immediate deduction to the obligor; or

iii. gives rise to an expense that is not deductible in computing the obligor’s taxable income and is not properly chargeable to capital.

f. An “obligation” is any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Code. Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, and futures contracts. Thus, an “obligation” the incurrence of which creates or increases basis, give rise to an immediate deduction or gives rise to a non-deductible, non-capitalizable expense is treated as a liability.

5. Recourse Liabilities and Nonrecourse Liabilities

a. Partnership liabilities are classified as either recourse or nonrecourse, and this classification determines the allocation rules that apply.

b. If one or more partners bears the “economic risk of loss” (see below) with respect to part, but not all, of a partnership liability represented by a single contractual obligation, that liability is treated as two or more separate liabilities for purposes of section 752. Treas. Reg. § 1.752-1(h).

6. Partner’s Share of Partnership Recourse Liabilities

a. In General. A partnership liability is a recourse liability to the extent that any partner or related person bears the “economic risk of loss” for that liability. Treas. Reg. § 1.752-1(a)(1). In general, recourse liabilities are allocated to the partner who would be responsible for paying them if the partnership were unable to. In order to determine who bears the economic risk of loss for a recourse liability, the regulations employ a “constructive liquidation” test.
b. **Constructive Liquidation Test.** Treas. Reg. § 1.752-2(b)(1) provides that upon a constructive liquidation, all of the following events are deemed to occur simultaneously:

i. All of the partnership’s liabilities become payable in full;

ii. With the exception of property contributed to secure a partnership liability, all of the partnership’s assets, including cash, have a value of zero;

iii. The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor’s right to repayment is limited solely to one or more assets of the partnership);

iv. All items of income, gain, loss, or deduction are allocated among the partners; and

v. The partnership liquidates.

c. A partner bears the economic risk of loss for a liability to the extent that if the partnership constructively liquidated, the partner (or a related person) would be obligated to either pay a creditor or make a contribution to the partnership because the liability would be due and the partner (or related person) would not be entitled to reimbursement. Treas. Reg. § 1.752-2(b).

d. In circumstances where a partner is entitled to reimbursement, the economic risk of loss is shifted to the obligor under such reimbursement arrangement. Treas. Reg. § 1.752-2(b)(3) provides that all statutory and contractual obligations relating to the partnership liability are taken into account for purposes of determining which partner bears the risk of loss, including

i. contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other partners, or to the partnership;

ii. obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership; and

iii. payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law, including the governing state partnership statute.
e. **Deemed Satisfaction of Obligation.** For purposes of determining the extent to which a partner or related person has a payment obligation and bears the economic risk of loss for a recourse liability, it is assumed that all partners and related persons actually perform on their obligations, irrespective of their net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. Treas. Reg. § 1.752-2(b)(6); Treas. Reg. § 1.752-2(j)(3).

i. **Exception.** A partner’s or related person’s obligation to make a payment may be disregarded or treated as an obligation of another person if the facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner’s economic risk of loss with respect to the obligation or create the appearance that the partner or related person bears the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Treas. Reg. § 1.752-2(j)(1).

f. **Partner or Related Person as Nonrecourse Lender.** A partner is considered to bear the economic risk of loss for a partnership liability to the extent that the partner or a related person makes (or acquires an interest in) a nonrecourse loan to the partnership and the economic risk of loss for the liability is not borne by another partner. Treas. Reg. § 1.752-2(c).

g. **De Minimis Exceptions.** If a partner has a 10-percent or less interest (directly or indirectly) in each item of partnership income, gain, loss, deduction, or credit then the partner is not considered to bear the economic risk of loss with respect to:

i. a nonrecourse loan from the partner to the partnership that constitutes qualified nonrecourse financing within the meaning of section 465(b)(6) (determined without regard to the type of activity financed); or

ii. a guarantee of a loan that would otherwise be a nonrecourse loan of the partnership and that would constitute qualified nonrecourse financing within the meaning of section 465(b)(6) (determined without regard to the type of activity financed) if the guarantor had made the loan to the partnership. Treas. Reg. § 1.752-2(d).

h. **Nonrecourse Liability with Interest Guaranteed by Partner.** If one or more partners or related persons guarantee the payment of more than 25 percent of the total interest that will accrue on a partnership nonrecourse liability over its remaining term, and it is
reasonable to expect that the guarantor will be required to pay substantially all of the guaranteed future interest if the partnership fails to do so, then the liability is treated as two separate partnership liabilities, a guaranteed liability and a nonrecourse liability. Treas. Reg. § 1.752-2(e)(1).

i. Reasonable Expectation of Payment by Guarantor. It is reasonable to expect that the guarantor will be required to pay substantially all of the guaranteed future interest if, upon a default in payment by the partnership, the lender can enforce the guaranty without foreclosing on the collateral property. Treas. Reg. § 1.752-2(e)(1).

ii. Portion of Stated Principal Amount Treated as Guaranteed Liability. The partner or related person that has guaranteed the payment of interest is treated as bearing the economic risk of loss for the partnership liability to the extent of the present value of the guaranteed future interest payments. The remainder of the stated principal amount of the partnership liability constitutes a nonrecourse liability. Treas. Reg. § 1.752-2(e)(1).

   a) Discount Rate. The present value of the guaranteed future interest payments is computed using a discount rate equal to either the interest rate stated in the loan document, or if interest is imputed under section 483 or section 1274, the applicable federal rate, compounded semianually. Treas. Reg. § 1.752-2(e)(2).

iii. Exceptions. The general rule of Treas. Reg. § 1.752-2(e)(1) does not apply to a partnership nonrecourse liability:

   a) if the guarantee of interest by the partner or related person is for a period not in excess of the lesser of five years or one-third of the term of the liability. Treas. Reg. § 1.752-2(e)(3); or

   b) if a partner that has a 10-percent or less interest (directly or indirectly) in each item of partnership income, gain, loss, deduction, or credit guarantees the interest on a loan to the partnership that constitutes qualified nonrecourse financing within the meaning of section 465(b)(6) (determined without regard to the type of activity financed). An allocation of interest to the extent paid by the
guarantor is not treated as a partnership item of deduction or loss subject to the 10 percent or less rule. Treas. Reg. § 1.752-2(e)(4).

c) **Definition of Related Person.** Treas. Reg. § 1.752-4(b) generally provides that a person is related to a partner if the person and partner bear a relationship to each other that is specified in sections 267(b) or 707(b)(1), subject to the following modifications:

[i] Substitute “80 percent or more” for “more than 50 percent” each place it appears in those sections;

[ii] A person’s family is determined by excluding brothers and sisters; and

[iii] Disregard sections 267(e)(1) and 267(f)(1)(A).

7. **Partner’s Share of Partnership Nonrecourse Liabilities**

a. **Definition.** A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability. Treas. Reg. § 1.752-1(a)(2).

b. **Three-Tier Allocation.** A partner’s share of partnership nonrecourse liabilities equals the sum of the following:

i. A partner’s share of partnership minimum gain determined pursuant to section 704(b) (the “First Tier”). Treas. Reg. § 1.752-3(a)(1).

a) **Partnership Minimum Gain.** Partnership minimum gain is generally the excess of the nonrecourse liability over the section 704(b) “book value” of property securing the liability.

b) **Partner’s Share of Partnership Minimum Gain.** Treas. Reg. § 1.704-2(g)(1) provides that a partner’s share of partnership minimum gain at the end of any taxable year is generally equal to the sum of partnership nonrecourse deductions allocated to the partner up to that time and the distributions made to the partner up to that time of proceeds of a nonrecourse liability allocable to an increase in partnership minimum gain; minus
the sum of the partner's aggregate share of the net decreases in partnership minimum gain plus the partner's aggregate share of decreases resulting from revaluations of partnership property subject to one or more partnership nonrecourse liabilities.

c) 

**Partnership Nonrecourse Deductions.**

Treas. Reg. § 1.704-2(c) provides that the amount of nonrecourse deductions for a partnership for a taxable year generally equals the net increase in partnership minimum gain during the year, reduced (but not below zero) by the aggregate distributions made during the year of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain.

ii. 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) if partnership property is revalued) if the partnership disposed of all partnership property subject to nonrecourse liabilities for no consideration other than full satisfaction of the liabilities. Treas. Reg. § 1.752-3(a)(2) (the "Second Tier").

a) The amount computed under the Second Tier is sometimes referred to as "section 704(c) minimum gain."

b) Where the contributed property is depreciable, the amount of section 704(c) minimum gain (and therefore the Second Tier allocation of debt) is reduced over time as book and tax depreciation deductions are claimed. When the property is fully depreciated, section 704(c) minimum gain and the Second Tier allocation will be reduced to zero. See Treas. Reg. § 1.704-3(a)(3)(ii).

c) For purposes of determining the amount of partnership liabilities that are allocable to a partner under the Second Tier, where there are multiple properties subject to a single nonrecourse liability, the partnership may allocate the liability among the multiple properties using any reasonable method. Treas. Reg. § 1.752-3(b)(1). The portion of the nonrecourse liability allocated to each item of partnership property is then treated as a separate loan.
d) In general, a partnership may not change the method of allocating a single nonrecourse liability among multiple properties while any portion of the liability is outstanding. Treas. Reg. § 1.752-3(b)(1).

e) However, when any property previously securing the liability ceases to be subject to the liability, the portion of the liability allocated to that property must be reallocated among the properties still subject to the liability. Treas. Reg. § 1.752-3(b)(1).

f) The method for allocation of the liability is not reasonable if it allocates to any item of property an amount of the liability that, when combined with any other liabilities allocated to the property, is in excess of the fair market value of the property at the time the liability is incurred. Treas. Reg. § 1.752-3(b)(1).

iii. The partner's share of the excess nonrecourse liabilities determined in accordance with the partner's share of partnership profits. Treas. Reg. § 1.752-3(a)(3) (the "Third Tier").

a) The partner's interest in partnership profits is determined by taking into account all facts and circumstances related to the economic arrangement of the partners.

b) The partnership agreement may specify the partner's interest in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interest so specified is reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some significant item of partnership income or gain.

c) Alternatively, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated.

d) Additionally, the partnership may first allocate excess nonrecourse liabilities to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property or property for
which reverse section 704(c) allocations are applicable by virtue of a book-up (as described in Treas. Reg. § 1.704-3(a)(6)(i)) where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the amount of gain taken into account under the Second Tier with respect to such property.

c. **Interplay With Section 704(c) Method**

i. Rev. Rul. 95-41, 1995-1 C.B. 132, explains how section 704(c) affects allocations of nonrecourse liabilities under Treas. Reg. § 1.752-3(a).

ii. Allocations under the First Tier are not affected by section 704(c).

iii. Allocations under the Second Tier take into account remedial allocations of gain that would be made to the contributing partner under Treas. Reg. § 1.704-3(d), but do not take into account curative allocations under Treas. Reg. § 1.704-3(c).

iv. Allocations under the Third Tier are affected by section 704(c) as follows:

   a) If the partnership determines the partners’ interests in partnership profits based on all the facts and circumstances relating to the economic arrangement of the partners, section 704(c) built-in gain that was taken into account under the Second Tier is one factor, but not the only factor, to be considered under the Third Tier.

   b) If the partnership chooses to allocate excess nonrecourse liabilities in a manner reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain, section 704(c) does not affect the allocation of nonrecourse liabilities under the Third Tier because section 704(c) allocations do not have substantial economic effect.

   c) If the partnership chooses to allocate the Third Tier in accordance with the manner in which it is reasonably expected that deductions attributable to the nonrecourse debt will be allocated, the
partnership must take into account the section 704(c) allocations in determining the manner in which the deductions attributable to the nonrecourse liabilities will be allocated.

d. **Rev. Rul. 95-41 Importance Eclipsed.** The importance of the holding of Rev. Rul. 95-41 regarding the impact of section 704(c) in determining the Third Tier allocation has been eclipsed by the rule in Treas. Reg. § 1.752-3(a)(3) allowing the Third Tier to be allocated first to a partner up to the amount of built-in gain allocable to such partner not taken into account in the Second Tier, which was added by an amendment to Treas. Reg. § 1.752-3(a)(3) issued October 30, 2000.

8. **Disregarded Entities**

a. **In General.**

i. On August 12, 2004, the Service issued proposed regulations addressing the consequences of owning a partnership interest through a disregarded entity (such as a single owner LLC) on the allocation of partnership liabilities under section 752.

ii. On October 11, 2006, the Service issued final regulations that largely follow the proposed regulations. The final regulations seek to clarify the effect of the state law liability shield provided by the disregarded entity in determining the extent to which a partner who owns a partnership interest through a disregarded entity may be treated as bearing the economic risk of loss for a partnership liability. The final regulations are effective for liabilities incurred or assumed by a partnership on or after October 11, 2006 other than liabilities incurred or assumed by a partnership pursuant to a written binding contract in effect prior to October 11, 2006.

iii. The final regulations are unquestionably based on a sound analysis of the extent to which a partner who owns a partnership interest through a disregarded entity bears the economic risk of loss for a partnership liability. This theoretical purity, however, comes at the cost of significant taxpayer compliance burdens in an area where, based on informal conversations with government representatives involved in developing the regulations, there was no evidence of taxpayer abuse. Moreover, in a closely related area, the existing section 752 regulations deliberately
sacrifice theory in favor of administrability, and the final regulations create inconsistencies with those existing provisions.

b. **The Final Regulations**

i. **In General.** The final regulations provide that in determining the extent to which a partner bears the economic risk of loss for a partnership liability, payment obligations of a disregarded entity are taken into account for purposes of section 752 only to the extent of the “net value” of the disregarded entity as of the date on which the partnership determines the partner’s share of partnership liabilities pursuant to Treas. Reg. §§ 1.752-4(d) and 1.705-1(a). The new rules apply to business entities such as single owner LLCs that are disregarded as separate from their owner under Treas. Reg. §§ 301.7701-1 through 301.7701-3, as well as to “qualified REIT subsidiaries” under section 856(i) and “qualified subchapter S subsidiaries” under section 1361(b)(3).

ii. **Net Value Determination**

a) Under Treas. Reg. § 1.752-2(k)(2), the “net value” of a disregarded entity is equal to the fair market value of all assets owned by the disregarded entity that may be subject to the claims of creditors, less obligations of the disregarded entity that do not constitute payment obligations of the disregarded entity that are taken into account under Treas. Reg. § 1.752-2(b) in determining the extent to which a partner bears the economic risk of loss for a partnership liability. For this purpose, a disregarded entity’s assets include the entity’s enforceable rights to contributions from its owner, but exclude the disregarded entity’s interest in the partnership (if any). Likewise, the value of any property of the disregarded entity that is pledged to secure a partnership liability and therefore taken into account under the pledge rule of Treas. Reg. § 1.752-2(h) is excluded. The final regulations clarify that the value of the disregarded entity’s interest in a partnership other than the partnership for which the net value determination is being made is included in the net value of the disregarded entity.
b) In determining the net value of the disregarded entity, the final regulations require that any subsequent reduction in net value be taken into account if at the time the net value is determined it is anticipated that the reduction will occur and the reduction is part of a plan that has as one of its principal purposes creating the appearance that a partner bears the economic risk of loss for a partnership liability. Treas. Reg. § 1.752-2(k)(4). In addition, if one or more disregarded entities have payment obligations with respect to one or more partnership liabilities, or liabilities of more than one partnership, the partnership must allocate the net value of each disregarded entity among partnership liabilities in a reasonable and consistent manner, taking into account priorities among partnership liabilities. Treas. Reg. § 1.752-2(k)(3).

iii. Redetermination of Net Value

a) Under the final regulations, once the net value of the disregarded entity is determined, this net value is not redetermined unless (i) there is more than a de minimis contribution to the disregarded entity of property other than property pledged to secure a partnership liability, unless the contribution is followed immediately by a contribution of equal net value by the disregarded entity to the partnership for which the net value of the disregarded entity otherwise would be determined, taking into account any obligations assumed or taken subject to in connection with such contributions; (ii) there is more than a de minimis distribution from the disregarded entity of property other than property pledged to secure a partnership liability, unless the distribution immediately follows a distribution of equal net value to the disregarded entity by the partnership for which the net value of the disregarded entity otherwise would be determined, taking into account any obligations assumed or taken subject to in connection with such distributions; (iii) a change in the legally enforceable obligation of the owner of the disregarded entity to make contributions to the disregarded entity; (iv) the incurrence, refinancing, or assumption of an obligation of the disregarded entity that does not constitute a Treas. Reg. § 1.752-
2(b) payment obligation of the disregarded entity; (v) the sale or exchange of a non-de minimis asset of the disregarded entity (in a transaction that is not in the ordinary course of business). Treas. Reg. § 1.752-2(k)(2).

b) The final regulations provide that a disposition of a non-de minimis asset requires an adjustment to the net value of the disregarded entity only to the extent such asset changed in value, without valuing other assets held by the disregarded entity.

c) The final regulations provide that the net value of the disregarded entity must be determined as of the earlier of (A) the first date occurring on or after the date on which the requirement to determine the net value of the disregarded entity arises on which the partnership otherwise determines a partner’s share of partnership liabilities under Treas. Reg. § 1.705-1(a) and Treas. Reg. § 1.752-4(d), or (B) the end of the partnership’s taxable year in which the requirement to determine the net value of the disregarded entity arises.

iv. Reporting Requirement. The final regulations impose a reporting obligation on partners who own partnership interests through disregarded entities in order to enable the partnership to properly allocate liabilities. Treas. Reg. § 1.752-2(k)(5) requires that a partner that may be treated as bearing the economic risk of loss for a partnership liability based upon an obligation of a disregarded entity must provide information as to the entity’s tax classification and net value to the partnership on a timely basis.

v. Pledged Property; Conforming Changes

a) The final regulations clarify the rule of Treas. Reg. § 1.752-2(h) (which generally provides that a partner bears the economic risk of loss to the extent of the value of the partner’s separate property pledged as security for a partnership liability) by providing that the extent to which a partner bears the economic risk of loss for a partnership liability as a result of a direct or indirect pledge is limited to the net fair market value of the property. The final regulations further provide that if additional property is made subject to a pledge, the addition is
treated as a new pledge and the net fair market value of all of the pledged property must be determined at that time. In addition, if pledged property is subject to one or more other obligations, those obligations must be taken into account in determining the net fair market value of pledge property at the time of the pledge or contribution. The preamble to the final regulations states that the Service and Treasury may continue to study whether further modifications to the pledge rule are necessary.

b) The final regulations also include conforming changes to Treas. Reg. §1.704-2(f)(2), (g)(3) and (i)(4). Those rules provide certain exceptions from the minimum gain chargeback requirements of the section 704(b) regulations that apply when the character of partnership debt under section 752 changes as a result of a guarantee, lapse of a guarantee, conversion, refinancing or other change in the debt instrument. Under the final regulations, those rules would apply upon any change in the character of partnership debt under section 752, whether as a result of the circumstances specified in the current regulations or as a result of changes under the rules of the final regulations.

vi. Extension of Rules to Other Entities. The preamble to the proposed regulations stated that “[t]he IRS and Treasury Department are considering and request comments regarding whether the rules of the proposed regulations should be extended to payment obligations of other entities, such as entities that are capitalized with nominal equity.” The final regulations do not extend the net value approach to thinly capitalized entities. However, the preamble to the final regulations states that the Service and Treasury may continue to study this issue.

c. Comments and Observations on the Regulations

i. Should the “Deemed Satisfaction” Rule Apply to Disregarded Entities?

a) As discussed above, the “deemed satisfaction” rule of Treas. Reg. § 1.752-2(b)(6) provides that for purposes of determining the extent to which a partner or related person has a payment obligation
and bears the economic risk of loss for a recourse liability, all partners and related persons are assumed to actually perform their obligations, irrespective of their net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. Treas. Reg. § 1.752-2(j) provides anti-abuse rules that prevent manipulation or abuse of the "deemed satisfaction" rule. Treas. Reg. § 1.752-2(j)(1) states that an obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person for purposes of the section 752 regulations if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner’s economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Likewise, Treas. Reg. § 1.752-2(j)(3) provides that an obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation.

b) Instead of the net value approach taken by the final regulations, the final regulations could simply have clarified that the "deemed satisfaction" rule and anti-abuse backstop apply to obligations of disregarded entities. Under such an approach, the fact that a disregarded entity that provides state law liability protection is the obligor on a payment obligation would not be taken into account in determining whether the disregarded entity’s owner bears the economic risk of loss for a partnership liability, unless the facts and circumstances evidence a plan to circumvent or avoid the obligation. That is, the same rules that apply with respect to regarded entities would be applied to disregarded entities.

c) As illustrated by the following examples, the failure to apply the "deemed satisfaction" rule and anti-abuse backstop results in economically similar arrangements being treated differently.

d) Example 1.
Taxpayer is the sole owner of an LLC that owns two assets: an interest as the sole general partner in a limited partnership, and land worth $20,000. The partnership has a liability that constitutes a general obligation of the partnership of $100,000.

Under Treas. Reg. § 1.752-2(k) and Treas. Reg. § 1.752-1(i), the $100,000 liability is bifurcated and treated as a recourse liability of $20,000 with respect to which the taxpayer bears the economic risk of loss and a nonrecourse liability of $80,000. Thus, the taxpayer includes $20,000 of the liability in the basis of its interest in the partnership as a recourse liability with respect to which the taxpayer bears the economic risk of loss.

e) Example 2.

The facts are the same as in Example 1, except that the taxpayer owns a 99% interest in the LLC and the taxpayer’s affiliate owns a 1% interest. The final regulations are inapplicable because the LLC is a regarded entity taxable as a partnership.

If the “deemed satisfaction” rule of Treas. Reg. § 1.752-2(b)(6) applies, the entire $100,000 liability is treated as a recourse obligation of the LLC and is includible in the basis of the taxpayer and its affiliate. On the other hand, if the anti-abuse backstop

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5 Treas. Reg. § 1.752-1(i) states that if one or more partners bears the economic risk of loss as to part, but not all, of a partnership liability represented by a single contractual obligation, that liability is treated as two or more separate liabilities for purposes of section 752. The portion of the liability as to which one or more partners bear the economic risk of loss is a recourse liability and the remainder of the liability, if any, is a nonrecourse liability.

6 The LLC would bear the economic risk of loss with respect to the $100,000 liability and thus would be allocated the entire liability. See Treas. Reg. § 1 752-2(i). The $100,000 liability would then be treated as a liability of the LLC and allocated to the taxpayer and its affiliate in accordance with the rules for allocating nonrecourse liabilities (because neither the taxpayer nor its affiliate would bear the economic risk of loss for the liability). See Treas. Reg. § 1.752-4(a).
rule of Treas. Reg. § 1.752-2(j) applies because the facts and circumstances evidence a plan to circumvent or avoid the obligation, then the obligation of the LLC is not recognized, the liability is treated as nonrecourse and no portion of the $100,000 liability is allocated to the LLC as a recourse liability.  

f) In terms of their actual exposure to economic loss on account of the $100,000 liability, the taxpayers in Examples 1 and 2 are identically situated. Nevertheless, the regulations provide for three different allocations of the liability depending on the details of the ownership structure and the application of the anti-abuse backstop rule.

g) The preamble to the proposed regulations acknowledged that applying the “deemed satisfaction” rule would lead to the conclusion that payment obligations of a disregarded entity should be allocated to its owner for tax purposes because the owner and the disregarded entity are treated as a single entity for Federal income tax purposes. Nevertheless, the final regulations adopt the net value approach discussed above. The preamble to the proposed regulations states that “because only the assets of a disregarded entity may be available to satisfy payment obligations undertaken by the disregarded entity, a partner should be treated as bearing the economic risk of loss for a partnership liability as a result of those payment obligations only to the extent of the net value of the disregarded entity’s assets.” While that logic is unassailable, interests of administrability would argue in favor of extending the “deemed satisfaction” rule to disregarded entities, particularly in light of the fact that government representatives involved in developing the regulations have indicated

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7 In both Example 1 and Example 2, to the extent the $100,000 liability is treated as a nonrecourse liability of the partnership, some portion may still be allocated to the taxpayer and its affiliate under the rules relating to the allocation of nonrecourse liabilities. See generally Treas. Reg. § 1.752-3.
informally that they are not aware of any evidence of taxpayer abuse in this area. Nevertheless, Treasury and the Service made the call the other way.

ii. **Time for Determining Liability Shares**

a) Treas. Reg. § 1.752-2(k)(2)(iv) requires that the net value of a disregarded entity be determined "on the earlier of (A) the first date occurring on or after the date on which the requirement to determine the net value of a disregarded entity arises under paragraph (k)(2)(ii)(A) or (B) of this section on which the partnership otherwise determines a partner's share of partnership liabilities under §§ 1.705-1(a) and 1.752-4(d); or (B) the end of the partnership's taxable year in which the requirement to determine the net value of a disregarded entity arises under paragraph (k)(2)(ii)(A) or (B)." Treas. Reg. § 1.752-4(d) states that "[a] partner's share of partnership liabilities must be determined whenever the determination is necessary in order to determine the tax liability of the partner or any other person."

Treas. Reg. § 1.705-1(a) states that:

> A partner is required to determine the adjusted basis of his interest in a partnership only when necessary for the determination of his tax liability or that of any other person. The determination of the adjusted basis of a partnership interest is ordinarily made as of the end of a partnership taxable year.

b) Under section 731(a)(1), a partner must recognize gain to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution. Moreover, a decrease in a partner's share of liabilities is treated as a deemed distribution of money under section 752(b) that potentially triggers gain under section 731(a)(1). As a result, it appears that a partnership must determine liability shares whenever there is a decrease in any partner's share (which may be attributable to an increase in another partner's
share), because the decrease must be compared against the partner’s basis immediately before to
determine if gain is triggered.

c) Nevertheless, examples in the final regulations appear to assume that the partnership only
determines liability shares at the end of the tax year. In Treas. Reg. § 1.752-2(k)(6), Example 2, A forms
a wholly owned LLC in 2007 with a capital
contribution of $100,000, which LLC contributes to
a limited partnership. LLC is the only partner with
a capital account deficit restoration obligation. In
2008, LLC borrows $300,000 on a recourse basis.
As of December 31, 2008, when the partnership
first determines liability shares, no portion of the
liability is treated as recourse with respect to LLC
because LLC has no net value. Thereafter, on
January 1, 2009, A contributes $250,000 to LLC,
and on January 5, 2009, LLC borrows $100,000,
and purchases land for $350,000, which declines in
value to $275,000 by December 31, 2009.

d) In analyzing the results for 2009, Treas. Reg. §
1.752-2(k)(6), Example 2 concludes that because
the partnership determines debt shares as of year­
end, $175,000 of the partnership’s liabilities are
treated as recourse with respect to LLC, which is
equal to the net value of LLC on December 31,
2009. In fact, however, it appears that the
partnership would be required by Treas. Reg. §
1.752-4(d) to determine debt shares as of the
January 1, 2009 date of A’s capital contribution to
LLC, because as of that date a portion of the
partnership’s liabilities would become recourse with
respect to LLC, thereby producing a deemed
distribution to the other partners under section
752(b) that is potentially taxable to them under
section 731(a)(1)(a). Moreover, applying the net
value test on January 1, 2009 creates different
results, because the equity value of the property
owned by LLC on January 1, 2009 is $250,000
(rather than $175,000 at year end). Furthermore, no
event occurs between January 5 and December 31,
2009 that would allow a redetermination of LLC’s
net value. Thus, on the facts of Treas. Reg. § 1.752­
2(k)(6), Example 2, whether $175,000 or $250,000
of partnership liabilities are treated as recourse with
respect to LLC depends on the time the partnership is required to determine liabilities.

iii. **Reporting and Compliance Issues.**

a) As discussed above, Treas. Reg. § 1.752-2(k)(5) requires that a partner that may be treated as bearing the economic risk of loss for a partnership liability based upon an obligation of a disregarded entity must provide information as to the entity's tax classification and net value to the partnership on a timely basis.

b) The regulations do not address a variety of related reporting and compliance issues raised by the net value approach. What level of diligence is required of the disregarded entity in determining its net value? Are appraisals of assets required? Is expert evaluation of contingent obligations that may reduce net value required? Is annual reporting to the partnership sufficient, or is more frequent reporting required if an event occurs that requires redetermination of value? Is a statement that the net value of the disregarded entity exceeds its payment obligations sufficient, or must the disregarded entity report a dollar amount for its net value (thereby revealing potentially confidential financial information)? May the partnership simply accept the information as reported by the disregarded entity, or does the partnership have an obligation to investigate or confirm the information? How should the partnership allocate its liabilities if the disregarded entity fails to supply the required information?

c) These and other questions relating to compliance with the new rules await further explication.

iv. **“Obligations” of Disregarded Entity Taken into Account**

a) As discussed above, pursuant to Treas. Reg. § 1.752-2(k)(2), the “net value” of a disregarded entity is equal to the fair market value of all assets owned by the disregarded entity that may be subject to the claims of creditors, “less obligations of the disregarded entity that do not constitute Treas. Reg. § 1.752-2(b)(1) payment obligations of the
The second use of the word “obligations” in the quoted language clearly refers to obligations described in Treas. Reg. § 1.752-2(b)(1). The first use of the word “obligations” apparently is intended to refer to some broader category. Informal discussions with government officials involved in developing the regulations confirm that the first use of the word “obligations” is intended to be very broad and would encompass, for example, an obligation to make payments under a lease. Assuming that first use of the word “obligations” includes an obligation to make payments under a lease, it is not clear how such an obligation should be taken into account. For example, is the stream of required lease payments to be discounted to present value at a particular interest rate? Or is the obligation to make payments under a lease taken into account only to the extent that the lease is at an above market rent such that the taxpayer would pay to be relieved of the obligation? The final regulations could have referred to the definition of obligations contained in Treas. Reg. § 1.752-1(a)(1)(ii), as follows:

(ii) Obligation. For purposes of this paragraph and § 1.752-7, an obligation is any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code. Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, and futures contracts.

b) Presumably, the “amount” of any such obligation should be the amount of cash that a willing assignor would pay to a willing assignee to assume the obligation in an arm’s-length transaction. See Treas. Reg. § 1.752-7(b)(3)(ii).

v. Conforming Changes to Section 704(b) Regulations
a) The section 704(b) regulations contain an anti-abuse rule that is similar to the anti-abuse rule in the section 752 regulations that "backstops" the "deemed satisfaction" rule. Specifically, Treas. Reg. § 1.704-1(b)(2)(ii)(c) provides:

A partner in no event will be considered obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section) to the extent such partner's obligation is not legally enforceable, or the facts and circumstances otherwise indicate a plan to avoid or circumvent such obligation.

b) Consistent with the treatment of disregarded entities under the final regulations, Treas. Reg. § 1.704-1(b)(2)(ii)(c) should be amended to provide that a deficit restoration obligation of a disregarded entity will only be taken into account for purposes of the regulations under section 704(b) to the extent of the net value of the disregarded entity.

vi. Allocation of Net Value.

a) Treas. Reg. § 1.752-2(k)(3) provides that if one or more disregarded entities have payment obligations with respect to one or more partnership liabilities, or liabilities of more than one partnership, the partnership must allocate the net value of each disregarded entity among partnership liabilities in a reasonable and consistent manner, taking into account priorities among partnership liabilities.

b) Treas. Reg. § 1.752-2(k)(6), Example 4, concludes that an allocation of net value first to the partnership’s senior debt and only thereafter to its junior debt is a reasonable method of allocating net value. In fact, the partnership’s property will be used to satisfy its senior debt first, so it is more likely that the disregarded entity’s net value will be used to satisfy the partnership’s junior debt.

c) Thus, arguably, it would make more sense to allocate the net value of the disregarded entity to

d) Informal discussions with government personnel involved in developing the regulations indicate that they view the allocation of net value to senior debt first as consistent with the constructive liquidation test of the section 752 regulations, but that in certain circumstances, it might be reasonable to allocate to the junior debt first.

B. TECHNIQUES FOR MANAGING LIABILITY REALLOCATIONS

1. Introduction. This Part II.B. illustrates various techniques for managing the allocation of liabilities through a series of examples in the context of a limited partnership as well as the various special considerations that arise in the context of limited liability companies.

2. Managing Liability Allocations in Limited Partnerships

a. Example 3: Nonrecourse Debt; Conventional Guarantee. Assume that X is a limited partner in a limited partnership and is allocated one percent of partnership profits and losses. The partnership's only debt is a nonrecourse debt of $100 from a third party.

   Assume that X must maintain a share of the debt at least equal to $10 in order to avoid receiving a deemed distribution under section 752(b) that will exceed X's basis in its partnership interest and trigger gain under section 731(a). X enters into a guarantee of $10 of the debt that is legally enforceable under state law. Under the guarantee, X has no right of subrogation against any other party.

   i. Tax Consequences. The guarantee should cause $10 of the debt to be allocated to X. X bears the economic risk of loss with respect to $10 of the liability. The liability is treated as two separate liabilities for purposes of section 752: a $10 recourse liability and a $90 nonrecourse liability. Treas. Reg. § 1.752-1(i). Upon a constructive liquidation, all assets of the partnership would have a value of zero, and any assets securing the nonrecourse liability would be conveyed to the lender in satisfaction of the nonrecourse debt. X would be obligated to pay $10 to the lender and would not have any right to recover the payment from any other party. Accordingly, X bears the economic risk of loss for $10 and is allocated $10 of the debt. See Treas. Reg. § 1.752-2(f), Example 5.
ii. Maintaining an Amount At-Risk Under Section 465 With a Guarantee

a) Section 465(a) generally provides that, in the case of an individual and certain closely held corporations, any loss from an activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk at the close of the taxable year.

b) Section 465(e)(1) provides that if a taxpayer’s at-risk amount is reduced below zero then losses previously allowed for a taxable year to which the rules apply are recaptured to the extent of the negative amount.

c) Section 465(b) provides that a taxpayer is considered at risk to the extent of any money contributed to an activity by the taxpayer, and with respect to any money borrowed by the taxpayer to be used in the activity, to the extent that the taxpayer is personally liable for repayment, subject to certain exceptions.

d) As discussed in more detail below, case law supports the conclusion that a properly structured guarantee increases a partner’s amount at risk.


i. The facts are the same as the facts in Example 3, except that X enters into a $10 “bottom” guarantee of the debt. A “bottom guarantee” is a guarantee of the last dollars of the debt, which is the least risky portion of the debt. The “bottom” guarantee provides:

“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 the 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.”
Thus, in general, X will only have economic exposure under the bottom guaranty to the extent the value of the collateral declines below $10.

ii. **Tax Consequences.** Although as a practical matter, a decline in the value of the collateral to below $10 may be unlikely, X would be considered to bear the economic risk of loss with respect to $10 of the debt because the constructive liquidation analysis of Treas. Reg. § 1.752-2(b)(1) assumes that the value of all partnership assets is zero. Accordingly, the “bottom” guarantee would cause $10 of the debt to be allocated to X.

iii. The fact that the “bottom” guarantee may be entered into with a tax motivation should not detract from this conclusion.

   a) Treas. Reg. § 1.752-2(b) contains no inquiry into tax motivation or purpose, but only as to economic risk of loss. In addition, Treas. Reg. § 1.704-2(m), Example 1(vii) specifically addresses the consequences of a “bottom” guarantee on the computation of “minimum gain” under the section 704(b) regulations, but does not in any way suggest that the “bottom” guarantee is illusory or should be disregarded.

   b) Likewise, Treas. Reg.1.737-4(b), Example 2 involves a fact pattern in which a partner guarantees a partnership nonrecourse debt with a principal purpose of increasing the partner’s basis under section 752(a) and avoiding gain under section 737. (Section 737 generally requires gain recognition in the case of certain distributions of property to a partner to the extent the fair market value of the property exceeds the partner’s basis in the partnership interest). Notwithstanding this malicious principal purpose, the example concludes that the basis increase under section 752(a) must be given effect and that the section 737 gain is therefore avoided.

iv. Therefore, a “bottom” guarantee allows a partner to maintain a required level of partnership debt allocation with significantly less risk than a conventional guarantee.
v. An issue arises as to who bears the ultimate “economic risk of loss” when a limited partner of a partnership guarantees an otherwise nonrecourse debt of the partnership and the general partner has a capital account deficit restoration obligation (“DRO”). Accordingly, when structuring a guarantee arrangement, the documents should provide that in the event that the general partner has a DRO, the specific debt subject to the limited partner’s guarantee is, in effect, excluded from the general partner’s DRO. In addition, for the guarantee to be effective, the limited partner must waive its right of subrogation against the partnership.

c. Example 5: Recourse Debt; Conventional Guarantee. The facts are the same as in Example 3, except that the debt is recourse.

i. Tax Consequences. X’s guarantee will not cause $10 of debt to be allocated to X. Upon a constructive liquidation, all assets of the partnership have a value of zero. Because the debt is recourse, the lender can proceed against the general partner’s separate assets to collect the debt. Alternatively, the general partner may be viewed as having an obligation to make a contribution to the partnership to enable it to pay the debt. Treas. Reg. § 1.752-2(f), Example 3. Moreover, subject to an anti-abuse rule to prevent manipulation, all partners and related persons who have obligations to make payments are presumed to perform those obligations, irrespective of their actual net worth. Treas. Reg. § 1.752-2(b)(6). Accordingly, the general partner is deemed to satisfy the debt and the lender is deemed not to call upon X’s guarantee. Therefore, X is deemed not to be required to make a payment on the guarantee and X does not bear the risk of loss for any part of the debt. See Treas. Reg. § 1.752-2(f), Example 3.

d. Example 6: Recourse Debt; Indemnification Obligation. The facts are the same as the facts in Example 5, except that instead of entering into a guarantee of the recourse debt, X enters into an indemnification agreement with the general partner of X’s limited partnership under which X would indemnify the general partner for up to $10 if the general partner is required to make a payment on the debt.

i. Tax Consequences. As a result of the indemnification agreement, X bears the ultimate risk of loss with respect to $10 of the debt because X would be required to make a $10 payment to the general partner under the constructive liquidation analysis where all of the partnership’s assets
have a value of zero. Accordingly, \( X \) is allocated $10 of the debt.

e. Termination of a Guarantee or Indemnification Agreement. In some cases, a partner that enters into a guarantee or indemnification agreement in order to receive a debt allocation will want the guarantee or indemnification to terminate upon the partner’s exit from the partnership.

i. Various approaches have been taken by practitioners to terminate a guarantee or indemnification agreement.

a) Some guarantees or indemnity agreements are structured so that they can be terminated at will, provided that an independent appraisal of the property subject to the debt establishes that the property has a value equal to the outstanding debt on the property or a multiple thereof. The appraisal requirement should prevent the Service from arguing that a guarantee or indemnity agreement is illusory because a guarantor could not terminate the agreement if the guarantor would otherwise be called upon to perform on the agreement. In addition, the “constructive liquidation” analysis looks at a specific point in time for purposes of allocating liabilities. There is no inquiry regarding the future termination of a guarantee.

b) Limited partners in umbrella partnership real estate investment trusts (“UPREIT”) may structure guarantees or indemnities that expire upon the conversion of operating partnership (“OP”) units (“OP Units”) to stock of the real estate investment trust (“REIT”).

8 An UPREIT is a REIT where substantially all of the assets of the REIT are owned through an OP composed of the REIT as general partner and others as limited partners. Limited partners in the OP typically have the option to exchange OP Units for common stock of the REIT on a one-for-one basis. For further discussion of debt management issues in the context of REIT’s, see Blake D. Rubin, Andrea R. Macintosh and Jonathan I. Forrest, Doing A Deal With A REIT: The Property Owner’s Perspective, New York University 57th Institute on Federal Taxation § 15.01 (1999).
c) An automatic termination seems literally to be effective under the constructive liquidation analysis because it looks only at a specific point in time for purposes of allocating liabilities.

d) However, allowing a guarantee or indemnification agreement to automatically expire upon conversion of OP Units to REIT stock may raise questions about the validity of the entire arrangement. For example, where a limited partner in an operating partnership can convert its OP Units into stock at any time, it follows that any time that it appears that the limited partner would be called upon to perform on the guarantee or indemnity, the limited partner could convert its OP Units to REIT stock in order to avoid incurring liability. The Service may attempt to attack the guarantee or indemnity and deny the allocation of debt to the limited partner under these circumstances.

e) A safer approach is to establish a term for the guarantee or indemnity. Under this structure, the guarantee or indemnity can be renewed at the option of the limited partner, but the limited partner could not terminate the guarantee or indemnity at will.

f) The most conservative approach would be to provide that the guarantee or indemnity continues in full force and effect until repayment of the underlying indebtedness.

f. Example 7: Recourse Debt; Conventional DRO. The facts are the same as the facts in Example 3, except that, instead of entering into a guarantee, X enters into a DRO for $10. Under the DRO, upon liquidation of X’s interest in the partnership, X will be obligated to make a capital contribution to the partnership equal to the lesser of $10 or the amount of X’s deficit capital account. Assume further that the partnership agreement meets the requirements of the safe harbor of Treas. Reg. § 1.704-1(b)(2), and that, in lieu of the one percent allocation of losses to X described in Example 3, the partnership agreement requires that X be allocated all losses until
X's capital account equals ($10). Finally, assume that the "book" balance sheet of the partnership reflects the following.\(^9\)

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\(^i\). **Tax Consequences.** X's DRO should cause $10 of the debt to be allocated to X. Upon a constructive liquidation of the partnership, the Property would have a zero value and the partnership would be deemed to dispose of it for no consideration, resulting in an $80 loss. Of this amount, $9.80 would be allocated to X and the balance would be allocated to the other partners. X would have a deficit capital account of $10, and would be required to contribute this amount to the partnership. As a result, X would bear the economic risk of loss for $10 of the debt. See Treas. Reg. § 1.752-2(f), Example 2.

\(^g\). **Example 8: Recourse Debt; "Bottom" DRO.** Through careful drafting of the loss allocation, X's DRO could be turned into a "bottom" DRO. That is, the first $70.20 of loss on disposition of the Property could be allocated to partners other than X, and only the final $9.80 of loss could be allocated to X. As a result, only if the Property declined in value below $9.80 would X actually receive a loss allocation that increases X's deficit capital account and thus X's obligation to make a capital contribution.

\(^i\). **Tax Consequences.** Like a conventional DRO, a "bottom" DRO should cause $10 of the debt to be allocated to X because the value of the property would be deemed to be zero under the constructive liquidation analysis and X would be required to satisfy its obligations under the DRO. Thus, X would bear the risk of loss with respect to $10 of the debt.

\(^9\) "Book" capital accounts are capital accounts maintained in accordance with the capital account maintenance rules set forth in Treas. Reg. § 1.704-1(b)(2). "Tax basis" capital accounts are maintained in the same manner as "book" capital accounts, except that contributed (or revalued) property is reflected at its adjusted tax basis and thereafter adjusted to reflect depreciation allowable for tax purposes.
ii. A “bottom” DRO would effectively decrease X’s practical economic risk under the DRO. Indeed, at least in a multi-asset partnership, a “bottom” DRO likely would impose less practical economic risk on X than a “bottom” guarantee of a specific nonrecourse debt. A “bottom” guarantee of a specific debt would expose X if there is a decline in value of the collateral below the guaranteed amount.

iii. In contrast, a “bottom” DRO would generally expose X only if the combined value of all assets of the partnership falls to below the DRO amount. The analysis is somewhat more complex if the partnership has secured nonrecourse debt. In that case, assuming the assets securing the nonrecourse debt have “book” value at least equal to the nonrecourse debt, X would only be exposed if the value of all partnership assets in excess of its nonrecourse debt declines to below the DRO amount.

iv. In addition, a “bottom” guarantee of a specific debt could be called upon if there is a default under the specific debt that is guaranteed. This could occur even if a multi-asset partnership is financially healthy (if, for example, the specific property securing the nonrecourse debt is non-performing). In contrast, a “bottom” DRO could be called upon only if the multi-asset partnership is actually liquidated, which may not occur even if the partnership goes into bankruptcy.

h. Deficit Restoration Obligations, At-Risk Amounts and Hubert

i. Background

a) In Hubert Enterprises v. Commissioner, 125 T.C. No. 6 (September 21, 2005) (“Hubert I”), the Tax Court held that a deficit restoration obligation (“DRO”) imposed on the members of a limited liability company engaged in an equipment leasing business did not increase the at-risk amounts of the members for purposes of section 465 because, pursuant to the operating agreement of the limited liability company, the DROs were not effective until the members’ interests in the limited liability company were liquidated. The taxpayer in Hubert I appealed to the Sixth Circuit Court of Appeals. While there were other issues in Hubert I that were on appeal to the Sixth Circuit, this outline discusses
only the Tax Court’s and the Sixth Circuit’s analysis and holdings with respect to the impact of a DRO on a limited liability company member’s at-risk amount under section 465.

b) On April 27, 2007, the Sixth Circuit found that the Tax Court failed to analyze whether the taxpayer was at risk with respect to the limited liability company’s recourse liabilities under the applicable “payor of last resort” standard. The Sixth Circuit vacated the Tax Court’s decision in Hubert I with respect to the taxpayer’s at-risk amount and remanded the case to the Tax Court for further proceedings. For our previous discussion of Hubert I and the Sixth Circuit’s decision on appeal, see Rubin, Whiteway and Finkelstein, “Hubert Enterprises, Inc.: Does A Capital Account Deficit Restoration Obligation Increase a Partner’s At-Risk Amount or Share of Liabilities,” 9 Journal of Passthrough Entities No. 2 (2006) (“Hubert Article 1”), and Rubin, Whiteway and Finkelstein, “Sixth Circuit Vacates Controversial Hubert Case Dealing with Partner’s Amount at-Risk,” 10 Journal of Passthrough Entities No. 4 (2007) (“Hubert Article 2”).

c) On February 28, 2008, the Tax Court issued its decision in Hubert Enterprises v. Commissioner, T.C. Memo 2008-46 (2008) (“Hubert II”). In Hubert II, the Tax Court, purporting to apply an analysis of the “payor of last resort” standard to the facts at issue in Hubert I, essentially restated its earlier decision and concluded that the taxpayer’s DRO did not cause the taxpayer to be considered the “payor of last resort.” As we have previously discussed, we disagree with the Tax Court’s application of the “payor of last resort” standard.

d) The taxpayer has not appealed Hubert II, and the period for filing an appeal has expired. Rule 190 of the U.S. Tax Court Rules of Practice & Procedure (June 30, 2003) provides for a 90-day period to appeal a Tax Court holding.

e) Although Hubert I and Hubert II involved members of a limited liability company, the Tax Court’s holding would seem to apply equally to limited
partners of a limited partnership. Accordingly, based on the Tax Court’s decision, we believe it is no longer advisable to use a DRO to increase a taxpayer’s at-risk amount under section 465 with respect to a recourse liability of a limited liability company or a limited partnership.

f) We note that Real Estate Investment Trust operating limited partnerships (“OP”) often do not allow limited partners to guarantee specific partnership debt, but rather permit a DRO in order to protect limited partners from recognizing gain as a result of reduction in the limited partner’s at-risk amount or a deemed distribution of cash under section 752 upon a contribution of encumbered property to the OP. In light of Hubert II, these arrangements should be reconsidered.

ii. Hubert I

a) Facts Related to the Members’ DROs

[i] Leasing Company LLC (“LCL”), formed in 1998, was treated as a partnership for Federal income tax purposes. Hubert Commerce Center, Inc. (“HCC”) owned 1% of the units of LCL, which HCC received in exchange for an initial $100 capital contribution, and HBW, Inc. (“HBW”), owned 99% of the units of LCL, which HBW received in exchange for an initial $9,900 capital contribution. HBW also contributed all of HBW’s rights, title and interest in its leases, subject to existing loans.

[ii] LCL was engaged in computer equipment leasing. LCL purchased computer equipment from unrelated parties. The purchase of the computer equipment was financed with debt that was partially recourse to the assets of LCL.

[iii] LCL’s operating agreement provided that “no member shall be liable as such for the liabilities of [LCL].” On March 28, 2001, the operating agreement of LCL was
amended and restated, effective retroactively to January 1, 2000, to provide that “[i]f any partner has a deficit Capital Account following liquidation of his, her or its interest in the partnership, then he, she or it shall restore the amount of such deficit balance to the Partnership by the end of such taxable year or, if later, within 90 days after the date of such liquidation, for payment to creditors or distribution to Partners with positive capital account balances.” During 2000 and 2001, neither HBW nor HCC liquidated its interest in LCL and, according to the Tax Court, neither member had a deficit capital account balance. According to the Tax Court, from LCL’s formation in 1998 through 2001, LCL had a net loss of over $13.9 million.

[iv] The members of LCL claimed that they were at risk under section 465 for portions of LCL’s losses on account of their DROs.

[v] The Service argued that the DRO contained in the LCL operating agreement was not operative during the relevant years because a member’s obligation would not be triggered unless such member’s interest in LCL was liquidated. Alternatively, the Service argued that even if the DROs were operative, the members were not liable for LCL’s recourse liabilities because a third party lender did not have the right to enforce the members’ payment obligations.

b) Tax Court’s Holding in Hubert I

[i] The Tax Court in Hubert I held that LCL’s members were not at risk for LCL’s recourse obligations because the obligations were not personally guaranteed by the members and, under applicable Wyoming law, the members of a limited liability company are not personally liable for the debts, obligations, or liabilities of the limited liability company. The Tax Court stated that, “[b]ecause LCL’s members did not
assume personal liability for the notes, the members are not at risk under section 465(b)(1)(B) and (2)(A) with respect to LCL’s recourse obligations. Cf. Emershaw v. Commissioner, [91-2 USTC ¶50,551], 949 F.2d 841 (6th Cir. 1991), affg. [Dec. 46,589(M)] T.C. Memo. 1990-246.” The Tax Court’s entire analysis with respect to the impact of the members’ DROs on their at-risk amounts was limited to the following paragraph:

[ii] Petitioners seek a contrary result, focusing on the deficit capital account restoration provision in section 7.7 of the revised LCL operating agreement. Petitioners argue that this provision made LCL’s members personally liable for LCL’s recourse obligations for purposes of applying the at-risk rules. We disagree. As observed by respondent, section 7.7 contains a condition that must be met before the deficit capital account restoration obligation arises. In accordance with that condition, an LCL member must first liquidate its interest in LCL before the member has any obligation to the entity. Neither HBW nor HCC liquidated its interest in LCL during the relevant years.

[iii] Without citing any precedent regarding the determination of a partner’s at-risk amount under section 465, the Tax Court in Hubert I held that the DROs could not put LCL’s members at risk until their interests were liquidated.

iii. Appeal to the Sixth Circuit

a) The taxpayer appealed the Tax Court’s decision to the Sixth Circuit, arguing that the Tax Court’s decision in Hubert I was contrary to the Sixth Circuit’s holding in Emershaw. See Brief for Petitioners-Appellants Hubert Enterprises and Subsidiaries and Hubert Holding Company, 2006 TNT 75-46 (Jan. 24, 2006). The Real Estate Roundtable, National Association of Real Estate
Investment Trusts and National Association of Realtors submitted a Brief of Amici Curiae to the Sixth Circuit in support of reversal of the Tax Court’s decision with respect to the impact of a DRO on a taxpayer’s at-risk amount under section 465. See Brief of Amici Curiae Real Estate Roundtable, National Association of Real Estate Investment Trusts and National Association of Realtors In Support of Reversal In Part, 2006 TNT 84-21 (Jan. 24, 2006).

b) In *Emershaw*, the taxpayer invested in Leasing Equipment Associates-83 ("LEA"), which was a state law limited partnership engaged in an equipment leasing business. According to the Tax Court in that case, all of the partners of LEA elected not to be subject to subchapter K of the Code under section 761 for the years at issue. In addition, the LEA partnership agreement provided that any partner could withdraw from the partnership and receive an undivided interest in all of the partnership’s property. The taxpayer agreed to assume a pro rata share of LEA’s recourse note payable to the lessee with respect to LEA’s purchase of its equipment. Pursuant to the equipment lease, the lessee was obligated to make payments to LEA equal to LEA’s payments due under LEA’s recourse note. In addition, the lessee’s payments were guaranteed by the lessee’s parent, which the Tax Court described as a good credit risk. The Sixth Circuit held that the taxpayer was at risk with respect to the taxpayer’s pro rata share of the recourse note because the taxpayer was personally liable on the note and, in a worst case scenario, the taxpayer would be the “payor of last resort.”

c) The taxpayer in *Hubert I* argued to the Sixth Circuit that, consistent with *Emershaw*, pursuant to the DRO contained in LCL’s operating agreement, “with respect to LCL’s recourse debt obligations, LCL’s members are the payors of last resort” because “the effect of a DRO is to personally obligate a member to contribute funds to an entity when its capital account is negative.”

d) In its brief to the Sixth Circuit, the Service noted that the amendment to LCL’s partnership agreement
that added the DRO, which purported to be effective as of January 1, 2000, was not adopted until March 28, 2001. See Final Brief for the Appellee, 2006 TNT 166-25 (May 4, 2006) (the “Service Brief”). The Service stated that LCL’s taxable year ends on July 29. The Service argued that, because the DRO was not adopted prior to 2001, it could not be effective for any taxable year prior to 2001. The Service further argued that, notwithstanding the existence of the DRO, the taxpayer was not at risk with respect to LCL’s recourse liabilities because, under Wyoming law, members of a limited liability company are not personally liable for the company’s liabilities. In addition, the Service argued that taxpayer’s DRO did not cause it to become personally liable for LCL’s recourse liabilities because the taxpayer’s obligations under the DRO were contingent on (1) the taxpayer’s interest in LCL being liquidated, and (2) the taxpayer having a deficit capital account upon such a liquidation.

e) As noted above, the Sixth Circuit found that the Tax Court’s opinion failed to address whether the DRO caused LCL’s members to be at-risk under the “payor of last resort” standard. The Sixth Circuit vacated the decision in Hubert I and remanded the case to the Tax Court for further proceedings.

iv. Tax Court’s Decision in Hubert II

a) On remand, the Tax Court in Hubert II found that the DRO did not cause the members of LCL to be the “payors of last resort” with respect to LCL’s recourse debt.

b) First, the Tax Court agreed with the Service’s argument that, because the DRO’s were not added to the LCL partnership agreement until March 28, 2001, the DRO was not effective for LCL’s 2000 taxable year. Section 761(c) generally provides that “[f]or purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions). . . .” In addition, section 465(a)(1)
provides that a taxpayer's at-risk amount must be determined as of the close of the taxable year. Because LCL's partnership return for its taxable year ended July 31, 2000, was required (absent extension) to be filed by November 15, 2000, the Tax Court concluded that the amendment to the partnership agreement on March 28, 2001, could not impact LCL's members' at-risk amounts for the taxable year ended July 31, 2000.11 T.C. Memo 2008-46 at 270-271.

c) Second, the Tax Court stated that “HBW did not through the DRO make an unconditional promise to contribute additional capital to LCL.” T.C. Memo 2008-46 at 271. The Tax Court found that “the DRO in the LCL operating agreement requires that HBW contribute additional capital only if: (1) HBW liquidates its interest in LCL and (2) then has a deficit in its capital account.” Id. at 271. The Tax Court further found that LCL's recourse creditor does not have a right under Wyoming law to force HBW to liquidate its interest in LCL in order to cause HBW to make an additional capital contribution to LCL and that, even if a liquidation of HBW's interest in LCL could be compelled, HBW would not have to make an additional capital contribution unless it had a negative capital account as of such date. The Tax Court stated:

Given that the DRO requires additional capital contributions only when a member “has a deficit Capital Account following the

10 We note that the Service Brief stated that LCL's taxable year ended on July 29, 2000 while the Tax Court stated in Hubert II that LCL's taxable year ended on July 31, 2000.

11 Query whether, in applying section 761(c) in its determination of the effectiveness of an amendment to LCL's operating agreement in order to alter the at-risk amount of a partner for a taxable year, the Tax Court implicitly acknowledged that a retroactive partnership agreement amendment can be effective under section 465, provided the amendment is consummated on or before the original due date for the partnership's tax return for such year. We note that a similar issue arises with respect to the effect of a retroactive amendment on a partner's allocation of partnership liabilities under section 752 (although unlike section 465, section 752 is in the same subchapter as section 761(c)).
liquidation of "its interest" in LCL and that no creditor of LCL could compel a liquidation of HBW's interest in LCL, we conclude that HBW is not a payor of last resort because HBW is not "personally liable for the repayment" of any of LCL's recourse debt within the meaning of section 465(b)(2)(A). In other words, we conclude that HBW is not personally liable for the repayment of any of LCL's recourse debt because HBW's obligation to contribute additional funds to LCL is not unavoidable in that HBW can avoid contributing additional capital under the DRO simply by not liquidating.

Id. at 273.

d) In addition, the Tax Court stated that the argument that a DRO could cause HBW to be at risk for the repayment of LCL's recourse debt is "illogical" because "a DRO is routinely inserted into a partnership agreement to meet the substantial economic effect requirements of section 704(b)." Id. at 273. The Tax Court concluded that, if a DRO caused a partner to be at risk, then the at-risk rules would have little purpose because every member of a limited liability company would then be at risk under section 465. Id. at 273-274. The Service made the same argument in the Service Brief. The regulations under section 704(b), however, provide that partnership allocations can generally be respected in the absence of a DRO if the partnership agreement meets certain requirements. One of the principal requirements is that the partnership agreement includes a "qualified income offset" provision, which has the effect of allocating items of income to a partner to eliminate the partner's negative capital account. Treas. Reg. § 1.704-1(b)(2)(ii)(d). Contrary to the Tax Court's and the Service's assertion, in our experience, most partnership agreements do not include a DRO as a boilerplate provision, but rather include a qualified income offset provision.
v. Analysis of the Tax Court’s Holding in Hubert II

a) As discussed above, the Tax Court in Hubert II focused on the need for HBW’s interest in LCL to be liquidated in order to trigger HBW’s obligation to make an additional capital contribution pursuant to the DRO. The court noted that “[t]he revised operating agreement states that LCL shall be liquidated upon is ‘dissolution’ and that dissolution occurs ‘only as provided by the Wyoming LLC Act.’” The court stated that, under Wyoming law, a limited liability company is dissolved upon the occurrence of any of the following events:

[i] When the period fixed for the duration of the limited liability company shall expire;

[ii] By the unanimous written agreement of all members; or

[iii] Upon the death, retirement, resignation, expulsion, bankruptcy, dissolution of a member or occurrence of any other event which terminates the continued membership of a member in the limited liability company, unless the business of the limited liability company is continued by the consent of all the remaining members under a right to do so stated in the articles of organization of the limited liability company. T.C. Memo 2008-46 at footnote 7.

b) The Tax Court reasoned that, because none of these three events would necessarily occur upon LCL’s default on the payment of a debt, a creditor of LCL could not force the liquidation of HBW’s membership interest in LCL or of LCL itself. The court stated that “LCL could not be made to liquidate by a creditor in any circumstance, not even by a creditor that forced LCL into receivership or bankruptcy.” Id. at footnote 6. The court concluded that HBW therefore could not be the payor of last resort because HBW would simply choose not to liquidate its membership interest in order to avoid any payment obligations with respect to the DRO.
It is not self-evident to us that the Tax Court’s statement that even a creditor who forced LCL into bankruptcy or receivership could not compel a liquidation, because Federal bankruptcy law and presumably Wyoming receivership law would “trump” the provisions of LCL’s operating agreement. Moreover, the regulations under section 704(b), which include provisions related to deficit restoration obligations of partners, provide that a liquidation of a partner’s interest in a partnership occurs upon the earlier of (1) the date upon which there is a liquidation of the partnership, or (2) the date upon which there is a liquidation of the partner’s interest in the partnership under Treas. Reg. § 1.761-1(d). Treas. Reg. § 1.704-1(b)(2)(g). The regulations further provide that “the liquidation of a partnership occurs upon the earlier of (3) the date upon which the partnership is terminated under section 708(b)(1), or (4) the date upon which the partnership ceases to be a going concern (even though it may continue in existence for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its partners).”

It is not clear whether the DRO in LCL’s partnership agreement is triggered upon a liquidation of LCL under state law or upon a liquidation within the meaning of the section 704(b) regulations. In our experience, the obligation to make a payment under a DRO is typically tied to a liquidation of a partnership within the meaning of the section 704(b) regulations. In that case, the Tax Court’s concern that a creditor could not force a liquidation of LCL under Wyoming law such that HBW could simply avoid its DRO obligation by not causing a liquidation of its interest or LCL may be misplaced. Under the section 704(b) regulations, HBW’s interest in LCL may be deemed liquidated even if LCL has not liquidated under Wyoming law.

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12 Treas. Reg. § 1.708-1(b)(1) provides that “a partnership shall terminate when the operations of the partnership are discontinued and no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.” For additional analysis of when a partnership terminates under section 708, see Blake D. Rubin and Steven B. Teplinsky, “A Comprehensive Guide to Partnership Terminations, Including the Impact of the New Proposed Regulations,” 24 Journal of Real Estate Taxation No. 2 (Winter 1997), and Andrea M. Whiteway and James E. Wrigglesworth, “Planning with and Around the Partnership Termination Rules,” 65 N.Y.U. Federal Tax Institute Ch. 8 (2007).
c) In addition, even if the DRO contained in LCL’s operating agreement requires a state law liquidation of the entity in order to be triggered, we continue to believe that the fact that a DRO does not become operative until the member’s interest in the entity is liquidated should not preclude a finding that the DRO increases the member’s at-risk amount prior to liquidation. As we have previously argued, in determining whether a member of a limited liability company is at risk under section 465 for a state law recourse liability, we believe the Tax Court should have adopted an approach similar to that contained in the regulations under section 752 with respect to the allocation of partnership recourse liabilities. As discussed below, these regulations allocate partnership recourse debt to the partner that bears the economic risk of loss for the debt.

d) Section 465 - Generally

[i] Section 465(a) generally provides that, in the case of an individual and certain closely held corporations, any loss from an activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk at the close of the taxable year. Section 465(e)(1) provides that if a taxpayer’s at-risk amount is reduced below zero then losses previously allowed for a taxable year to which the rules apply are recaptured to the extent of the negative amount.

[ii] Section 465(b) provides that a taxpayer is considered at risk to the extent of any money contributed to an activity by the taxpayer, and with respect to any money borrowed by the taxpayer to be used in the activity, to the extent that the taxpayer is personally liable for repayment, subject to certain exceptions. Prop. Treas. Reg. § 1.465-6(d) provides that if a taxpayer guarantees repayment of an amount borrowed by another person for use in an activity, the guarantee does not increase the taxpayer’s at-risk amount. If the taxpayer repays to the creditor the amount borrowed by the primary obligor,
the taxpayer’s at-risk amount is increased when the taxpayer has no remaining legal rights against the primary obligor. In contrast, Prop. Treas. Reg. § 1.465-24 provides that, when a partnership incurs a state law recourse liability, each partner’s at-risk amount is increased to the extent the partner is not protected against loss. Under this proposed regulation, the increase in the partner’s at-risk amount is effective prior to the time the partner makes any actual payments with respect to the debt. These proposed regulations, which were proposed in 1979, were never adopted as final regulations.

[iii] The case law analyzing the application of section 465 to partnerships generally follows the approach of Prop. Treas. Reg. § 1.465-24 in that it allows a partner’s at-risk amount to be increased prior to the time the partner makes an actual payment. In Abramson v. Commissioner, 86 T.C. 360 (1986), the limited partners of a partnership guaranteed the nonrecourse debt of the partnership. The Tax Court held that the each of the limited partners could increase their bases in the partnership by the amount of the partnership’s nonrecourse debt guaranteed by each partner, notwithstanding the fact that the limited partners may never actually make a payment under their guarantees. Specifically, the Tax Court stated that:

[t]he guarantee of an otherwise nonrecourse note places each guaranteeing partner in an economic position indistinguishable from that of a general partner with liability under a recourse note except that the guaranteeing partner’s liability is limited to the amount guaranteed. . . . Each is obligated to use his personal assets to satisfy pro
rata the partnership liability. Economic reality dictates that [the general partner and limited partners] be treated equally, and we so hold.

Abramson, 86 T.C. at 374.

[iv] Further, the Tax Court held that, because the limited partners were personally and directly liable for the partnership’s nonrecourse debt, the limited partners were at risk for such amount under section 465. Thus, the Tax Court concluded that the guarantee increased the guaranteeing partners at-risk amount even though the guarantee had not yet been called and the guaranteeing partners had not yet made any payment.

[v] Similarly, in Gefen v. Commissioner, 87 T.C. 1471 (1986), a limited partner in a partnership engaged in a computer equipment leasing business guaranteed a recourse debt of the partnership and was obligated under the partnership agreement to make a “special contribution,” equal to the limited partner’s payment obligation under the guarantee, to the partnership in the event of a default by the partnership under the recourse liability. The limited partner had no right to reimbursement from either the partnership or the general partners for any amount paid by the limited partner with respect to the guarantee or the special contribution obligation. The Tax Court held that the limited partner could include the guaranteed amount of the partnership’s recourse debt in her basis under section 752. In addition, the Tax Court stated that

petitioner was not a mere guarantor of her pro rata portion of the Partnership’s recourse indebtedness, but was ultimately liable for it, because there was no primary obligor against whom she had
a remedy to recover amounts paid by her to Sun Life pursuant to the Limited Partner Guarantee or to the Partnership as a Special Contribution . . . . Petitioner was therefore at risk within the meaning of section 465 for the full amount of her pro rata share of the Partnership's recourse indebtedness to Sun Life.

_Gefen, 87 T.C. at 1500-1501._

[vi] In _Melvin v. Commissioner_, 88 T.C. 63 (1987), aff'd, 894 F. 2d 1072, 65 AFTR2d 90-508 (9th Cir. 1990), the Tax Court stated that “[i]t cannot seriously be questioned that debt obligations of a partnership that are payable in later years generally are to be included in the at-risk amounts of the partners that are personally liable therefore. Sec. 465(b)(2)(A). The proposed regulations under section 465 and final regulations under section 752 contemplate that obligations due in later years will be included in the computation of a partner’s at-risk amount and in the computation of his basis.” _Melvin_, 88 T.C. at 73. The Tax Court further explained that, in determining whether a partner is at risk for a partnership liability, “[t]he relevant question is who, if anyone, will ultimately be obligated to pay the partnership’s recourse obligations if the partnership is unable to do so. It is not relevant that the partnership may be able to do so. The scenario that controls is the worst-case scenario, not the best case . . . . The critical inquiry should be who is the obligor of last resort . . . .” _Id._ at 75.

[vii] In _Pritchett v. Commissioner_, 85 T.C. 581 (1985), rev’d and remanded, 827 F.2d 644 (9th Cir. 1987), a limited partnership executed a recourse note in connection with a turnkey drilling agreement. The general
partners were personally liable under the note. The limited partnership agreement, however, provided that, in the event the note was not paid in full at maturity, the limited partners would be personally obligated, if called upon by the general partners, to make additional capital contributions to the partnership sufficient to repay the note in full. The Tax Court found that the limited partners incurred no personal liability to the creditor as a result of their capital contribution obligations and that the limited partners’ obligations were contingent on a default on the note and on a cash capital call by the general partners. As a result, the Tax Court held that the limited partners were not at risk with respect to the recourse note under section 465. Pritchett, 85 T.C. at 589. While the Ninth Circuit agreed that the limited partners were not personally liable to the creditor, the Ninth Circuit reversed the Tax Court, holding that the critical inquiry under section 465 is who is the obligor of last resort. The Ninth Circuit found that the limited partners’ capital contribution obligations under the partnership agreement made them ultimately responsible for the debt, and, in accordance with Melvin, that “economic reality” dictated that the general partners would make the cash capital calls if the partnership’s assets were insufficient to satisfy the debt. Pritchett, 827 F.2d at 647.

Finally, in Pledger v. Commissioner, 236 F. 3d 315 (6th Cir. 2000), a case decided in the same Federal appellate circuit as Hubert, the taxpayer purchased an interest in a trust formed by a corporation (“Corporation A”) that had purchased satellite transponders pursuant to a three-party sale-leaseback transaction. Corporation A was a brother-sister corporation to the lessee of the transponders under a master-lease agreement. Corporation A transferred its interest in the transponders to the trust and offered units in the trust to third-party investors, including the taxpayer. In
connection with the taxpayer’s purchase of an interest in the trust, the taxpayer gave a promissory note to Corporation A, pursuant to which the taxpayer agreed to pay its pro rata share of the payments due from Corporation A to the lessee. The payments due to the lessee from Corporation A were equal to the payments due from the lessee to the trust under the master lease. The payments received by the trust from the lessee were applied to satisfy the payments the taxpayer was required to make under the promissory note. In addition, the lessee’s obligations under the lease were guaranteed by the lessee’s and Corporation A’s parent corporation (“Parent”). The Sixth Circuit found that Corporation A was a mere instrumentality of Parent and that Parent was both the guarantor and payee under the sale-leaseback arrangement. As a result, the Sixth Circuit held that the taxpayer was not at risk with respect to the promissory note because, even if the lessee became insolvent, the taxpayer’s obligations under the promissory note would be cancelled out by Parent’s guaranty of lessee’s obligations. The Sixth Circuit explained that it applies the “payor of last resort” test to determine whether a taxpayer will suffer an economic loss with respect to a transaction. Similar to the analysis applied in Abramson, Gefen, Melvin, and Pritchett, under this test the Sixth Circuit “asks whether, in a worst case scenario, the individual taxpayer will suffer any personal, out-of-pocket expenses.”

Pledger, 236 F.3d at 319.

[ix] Thus, provided that the taxpayer is the obligor of last resort in a worst-case scenario in the event funds generated in the activity are insufficient to repay the debt, and has no rights of indemnification, contribution or subrogation against any other person, the taxpayer is at risk for the amount of the debt.

See also Whitmire v. Commissioner, 178 F.3d 1050, 1053 (9th Cir. 1999) (stating that, for purposes of section 465, a taxpayer is
personally liable for a liability if the “taxpayer would legally be responsible for his debt under a worst-case scenario” (citing American Principals Leasing Corporation v. United States, 904 F.2d 477, 482 (9th Cir. 1990)); Tepper v. Commissioner, 62 T.C.M. 505, 509 (1991), (holding that a taxpayer is personally liable for the repayment of an amount under section 465(b)(2)(A) if the taxpayer has ultimate liability to repay the debt obligation); FSA 200025018 (March 17, 2000) (concluding that a member of a limited liability company that guaranteed a lease obligation of the limited liability company should be considered at risk with respect to such liability under section 465 because “[a] partner who, through a contractual obligation, has ultimate responsibility for the debt is at-risk with respect to such amount”).

e) Risk of Loss Under Section 752 Regulations

[i] Similar to section 465, section 752(a) provides that a partnership liability is a recourse liability to the extent that any partner or related person bears the “economic risk of loss” for that liability under the deemed liquidation analysis described above.

[ii] Accordingly, like section 465, the section 752 regulations employ a worst-case scenario approach to determine whether a partner is “at risk” with respect to a partnership recourse liability. In fact, in the past, the Service has acknowledged that the recourse debt allocation rules under section

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13 Treas. Reg. § 1.752-4(b) generally provides that a person is related to a partner if the person and partner bear a relationship to each other that is specified in section 267(b) or section 707(b)(1), subject to the following modifications: (1) substitute “80 percent or more” for “more than 50 percent” each place it appears in those sections; (2) a person’s family is determined by excluding brothers and sisters; and (3) disregard section 267(e)(1) and section 267(f)(1)(A).
752 should be applied to determine a partner’s at-risk amount with respect to such liabilities under section 465. See FSA 0293 (December 15, 2003) (concluding that liability assumption agreements entered into by limited partners of a partnership caused the partners to have DROs that increased the partners’ bases in their partnership interests under section 752(a) and increased their at-risk amounts under section 465); FSA 0623 (June 21, 1993) (concluding that limited partners’ conditional obligations to make additional capital contributions in the event the partnership is unable to meet its debt service obligations increase the limited partners’ bases under section 752(a) and their at-risk amounts under section 465 and stating that, “the likelihood that the call will be made or repaid is not the standard under section 465 . . . [r]ather, the test is whether, under a worst case scenario analysis, the partner will ultimately be liable”); Priv. Ltr. Rul. 9036013 (applying the economic risk of loss analysis under the temporary regulations under section 752 to determine a partner’s at-risk amount under section 465).

[iii] In addition, the section 752 regulations provide that, in determining whether a partner or related person has an obligation to make a payment in the event of a deemed liquidation of the partnership as described above, all statutory and contractual obligations relating to the partnership liability are taken into account, including obligations to the partnership that are imposed by the partnership agreement, such as the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership. As we have previously discussed, a DRO should generally be effective to cause a limited partner to bear the economic risk of loss within the meaning of the section 752 regulations with respect to a recourse debt of a limited partnership. In contrast, whether a member of a limited liability company is
deemed to bear the economic risk of loss for a recourse debt of a limited liability company may depend on whether a member has a positive or negative “book” capital account with respect to their membership interest in the limited liability company. See Hubert Article 1 and Hubert Article 2, supra.

f) Thus, we continue to believe that, consistent with case law precedent under section 465, Prop. Treas. Reg. § 1.465-24 and the section 752 regulations and as a matter of sound tax policy, a DRO should attract an allocation of partnership recourse debt under section 752 and should also increase a partner’s at-risk amount under section 465 to the extent that the DRO would require the partner to make a payment in the event of a deemed liquidation. Unfortunately, however, the Tax Court disagreed with this conclusion in Hubert II.

vi. Conclusion

a) In applying the “payor of last resort” test as mandated by the Sixth Circuit, we believe the Tax Court should have determined whether the DRO would have obligated the members of LCL to make a payment upon a constructive liquidation of LCL under an analysis that is consistent with recourse liability allocation methodology contained in the regulations under section 752.

b) In addition, as noted above, we believe the Tax Court’s emphasis on the inability of a creditor to force a state law liquidation of LCL may have been misplaced in light of the definition of the phrase “liquidation of a partnership” in the section 704(b) regulations.

c) Although Hubert II involved the at-risk amounts of members of a limited liability company, we believe the Tax Court’s holding applies equally to a limited partnership.

d) Accordingly, in light of Hubert II, it is inadvisable for a limited liability company member or limited partner to enter into a DRO to increase such
member’s or limited partner’s at-risk amount under section 465 with respect to a recourse liability.

i. **Example 9: Nonrecourse Debt; Conventional DRO.** The facts are the same as the facts in Example 7, except that the debt is nonrecourse.

i. **Tax Consequences.** X’s DRO will not cause $10 of debt to be allocated to X. Upon a constructive liquidation of the partnership, the partnership would be deemed to dispose of the Property in a fully taxable transaction for consideration equal to the $100 nonrecourse liability. The partnership would recognize $20 of gain on the disposition. Under the “minimum gain chargeback” requirement of the section 704(b) regulations, the $20 gain would be allocated $ .20 to X and $19.80 to the other partners. See Treas. Reg. § 1.704-2(f). After this allocation, X’s capital account would be $0. Because X would not have a deficit capital account balance, the DRO would not apply. Accordingly, X would not be required to make a capital contribution to the partnership, and X would not bear the economic risk of loss with respect to any portion of the debt.

3. **Managing Liability Allocations in Limited Liability Companies**

a. **Characterization of a Recourse Liability of a Limited Liability Company.**

i. A fundamental state law difference between LLCs that are treated as partnerships for Federal income tax purposes and partnerships is that, in an LLC, by operation of state law, no member is liable for obligations of the LLC merely by virtue of being a member in the LLC. In contrast, in a partnership, a general partner is liable for debts of the partnership unless the debt by its terms relieves the general partner from liability (i.e., the debt is nonrecourse from a state law perspective). This fundamental difference creates important differences in the way the rules of section 752 apply to LLCs compared to partnerships.

ii. Absent special circumstances, a liability that is recourse from a state law perspective to an LLC nevertheless should be treated as nonrecourse for purposes of section 752. This is because, by virtue of the liability shield that the LLC provides, no member is personally obligated to pay the liability. The creditor can reach any and all of the assets of
the LLC, but if those assets are insufficient to pay the liability, the creditor cannot pursue the members personally.

iii. Such a liability is much like a so-called "exculpatory liability" in a partnership, i.e., a liability with respect to which the creditor can reach all assets of the partnership but with respect to which all partners are exculpated from personal liability. See T.D. 8385, 1992-1 C.B. 199.

b.  Guarantee

i.  Recourse Liability. A recourse liability of an LLC should be treated as nonrecourse for section 752 purposes. As is the case with respect to nonrecourse liabilities of partnerships, an enforceable guarantee ("bottom" or otherwise) of all or a portion of such liability, with waiver of any right of subrogation, should cause the guaranteeing member to bear the economic risk of loss for the guaranteed portion. See discussion in Example 3, above.

ii.  Nonrecourse Liability. A similar result should apply with respect to a liability of an LLC that is nonrecourse under state law (i.e., a liability with respect to which the lender's right to enforce payment is limited to specified collateral).

c.  Deficit Restoration Obligation

i.  Recourse Debt. Whether a DRO attracts an allocation of state law recourse debt for a member of an LLC may depend on whether the member has a positive or negative "book" capital account, as shown in Example 10 and Example 11 below.

a)  Example 10 – LLC Members with Negative Capital Accounts. The facts are the same as the facts in Example 7, except that the entity is an LLC rather than a partnership.

[i]  Tax Consequences. X’s DRO will not cause $10 of debt to be allocated to X. Upon a constructive liquidation of a partnership, Treas. Reg. § 1.752-1(b)(1)(iii) specifies that “[t]he partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor’s right to repayment is limited solely to one or more assets of the
partnership.)" In the case of state law recourse debt of an LLC, the creditor's right to repayment is not limited to a specified subset of LLC assets; rather, the creditor may pursue all assets of the partnership but may not enforce the debt against the members personally. Nevertheless, the creditor's right to repayment is limited "solely to one or more assets of the partnership" because that phrase encompasses the situation where the creditor's right to repayment is limited to all assets of the LLC.

(ii) Thus, upon a constructive liquidation, the LLC would be deemed to dispose of the Property in a fully taxable transaction for consideration equal to the $100 liability. The LLC would recognize $20 of gain on the disposition. Under the "minimum gain chargeback" requirement of the section 704(b) regulations, the $20 gain would be allocated $.20 to X and $19.80 to the other members. See Treas. Reg. § 1.704-2(f). After this allocation, X's capital account would be $0. Because X would not have a deficit capital account balance, the DRO would not apply. Accordingly, X would not be obligated to make a capital contribution to the LLC, and X would not bear the economic risk of loss with respect to any portion of the debt.14

b) Example 11 – LLC Members with Positive Capital Accounts. The facts are the same as the facts in Example 10, except the "book" balance sheet of the LLC is as follows:

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14 See generally Starr, Case, Garre-Lohnes, Rosenberg, Schmalz, 725-2nd T.M., Limited Liability Companies, Section IV.B.2.b.(3) ("It is unclear whether a DRO shifts economic risk of loss for an LLC's recourse debt . . .").
[i] **Tax Consequences.** For the reasons discussed in Example 11, upon a constructive liquidation, the LLC would be deemed to dispose of the Property in a fully taxable transaction for consideration equal to the $100 liability. The LLC would recognize $20 of loss on the disposition. Of this amount, $10.20 would be allocated to X and the balance would be allocated to the other partners. After these allocations, X would have a deficit capital account of $10, and would be required to contribute this amount to the LLC. The other members would have positive capital accounts of $10. X’s $10 would either be distributed to the other partners in liquidation or would be paid to the creditor. See generally Treas. Reg. § 1.704-1(b)(2)(ii)(c), which states that the proceeds of a DRO are to “be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances.”

[ii] Note that under the language of the constructive liquidation test, the assumption that all assets of the LLC are worth zero applies with respect to assets that are presumed transferred to the creditor on account of the debt. Thus, because the creditor’s rights are not extinguished, in applying the constructive liquidation test the creditor should be presumed to pursue the $10.

[iii] Regardless of whether the proceeds of the $10 DRO are deemed to be distributed to the other members or paid to creditors, because X would be required to make a capital contribution, X should bear the economic risk of loss with respect to $10.
Accordingly, $10 of the debt would be allocated to X.

[iv] Note, however, that in order for a partner to bear the economic risk of loss with respect to a liability, Treas. Reg. § 1.752-2(b)(1) requires that the partner “be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable . . . .” To the extent that X’s $10 capital contribution would be distributed to other members rather than paid to creditors, it is possible that the Service would argue that this requirement is not met.

d. Capital Contribution Obligation Tied to Value. In light of the uncertainty as to whether a DRO will attract an allocation of state law recourse debt for a member of an LLC, Example 12 illustrates a better way to attract a debt allocation from an LLC.

i. Example 12 – LLC Member with Negative Capital Account. Assume the same facts in Example 10, except that instead of entering into a DRO, X agrees that, upon liquidation of the LLC, to the extent that the fair market value of the assets available to satisfy the $100 debt are less than $10, X will make a capital contribution of up to $10 irrespective of whether X has a deficit capital account balance.

a) Tax Consequences. X’s capital contribution obligation should cause $10 of the debt to be allocated to X. As discussed in Example 10, upon a constructive liquidation, the LLC would be deemed to dispose of the Property in a fully taxable transaction for consideration equal to the $100 liability. The LLC would recognize $20 of gain on the disposition. Under the “minimum gain chargeback” requirement of the section 704(b) regulations, the $20 gain would be allocated $.20 to X and $19.80 to the other members. See Treas. Reg. § 1.704-2(f). After this allocation, X’s capital account would be $0.

b) Even though X would not have a deficit capital account balance, X would be obligated to make a capital contribution to the LLC.
Treas. Reg. § 1.752-2(b)(1)(ii) specifies that, upon a constructive liquidation, "[w]ith the exception of property contributed to secure a partnership liability (see § 1.752-2(h)(2)) all of the partnership's assets, including cash, have a value of zero . . . ." If the Property were worth zero, X would be obligated to make a $10 capital contribution to the LLC, and the creditor would be able to recover this amount (because the creditor would have recourse against all assets of the LLC). Moreover, Treas. Reg. § 1.752-2(b)(3)(ii) specifies 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 . . . ." [Emphasis added.] Accordingly, X bears the economic risk of loss for $10 and is allocated $10 of the debt.

C. TREATMENT OF "NON-TAX BASIS" LIABILITIES: REG. §§ 1.752-6 AND 1.752-7

1. Background. On June 23, 2003, the Service issued temporary and proposed regulations addressing the treatment of certain contractual and other obligations assumed by a partnership that historically have not been treated as "liabilities" for purposes of section 752 and the regulations thereunder. The proposed and temporary regulations were a response to perceived abuses that originated in the corporate area but then migrated to the partnership context.

a. Corporate Abuse and Section 358(h)

i. On December 21, 2000, as part of the Community Renewal Tax Relief Act of 2000 (the "Act"), Congress enacted section 358(h) aimed at curbing the following perceived abuse. A corporation would assume an obligation of a taxpayer who took the position that the obligation was not a liability within the meaning of section 357(c) and thus did not reduce the taxpayer's basis in the stock of the corporation. The transferor would then sell the stock of the corporation for a low amount, reflecting the existence of the obligation, and claim a loss, even though the taxpayer had not incurred any corresponding economic loss. When the corporation paid the obligation, it deducted the payment. Thus, the transferor was able to effectively duplicate a loss in corporate stock and accelerate
deductions that are only allowed upon economic performance of an obligation.

b. Partnership Abuse

i. The Service tried to prevent similar abuses in the partnership context through the issuance of administrative guidance. On September 5, 2000, the Service issued Notice 2000-44, 2000-2 C.B. 255, identifying the so-called “Son of Boss” transaction as a “listed transaction.” The fact pattern discussed in Notice 2000-44 involves a taxpayer that contributes a purchased option to a partnership and writes an option that is assumed by the partnership. The taxpayer takes the position that its basis in its partnership interest is increased by the cost of the purchased call option but is not reduced under section 752 for the assumption of the written call option obligation. Thereafter, upon a disposition of the partnership interest for a low amount, reflecting the existence of the written call option, the taxpayer claims a loss even though the taxpayer has not incurred any corresponding economic loss.

ii. The taxpayer’s position was based on the conclusion that the obligation assumed does not constitute a liability for purposes of section 752. Section 752(a) and (b) provide that when a partnership assumes a liability from a partner or a partner contributes property to a partnership subject to a liability, the partner will be treated as receiving a deemed distribution of money from the partnership to the extent of the difference between the amount of the liability and the
partner’s share of such liability after the partnership’s assumption of the liability. Pursuant to section 733, the partner’s basis in the partnership interest is reduced by the amount of the deemed distribution of money, and pursuant to section 731, the partner may recognize gain as a result of the deemed distribution to the extent that it exceeds the partner’s basis in the partnership interest.

iii. The Code does not contain a definition of “liability” for purposes of section 752. However, case law and revenue rulings generally have established that for this purpose, the term “liability” includes an obligation only if and to the extent that incurring the obligation creates or increases the basis to the partnership of any of the partnership’s assets (including cash attributable to borrowings), gives rise to an immediate deduction to the partnership, or, under section 705(a)(2)(B), currently decreases a partner’s basis in the partner’s partnership interest. See Rev. Rul. 88-77, 1988-2 C.B. 128; Salina Partnership LP, FPL Group, Inc. v. Commissioner, T.C. Memo 2000-352. Thus, the term “liability” for purposes of section 752 generally has not included an obligation the payment of which would give rise to a deduction.

iv. During the course of enacting section 358(h) to preclude the abuse in the corporate context, Congress became aware that taxpayers were attempting to use partnerships to engage in similarly abusive transactions. Accordingly, in Section 309(c) of the Act, Congress directed the Secretary to prescribe rules to provide “appropriate adjustments under subchapter K of chapter 1 of the Code to prevent the acceleration or duplication of losses through the assumption of (or transfer of assets subject to) liabilities described in section 358(h)(3) . . . in transactions involving partnerships.” Section 358(h)(3) defines the term “liability” to include any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Code. The regulations issued pursuant to this directive are to apply to assumptions of liabilities that occur after October 18, 1999, or such later date as may be prescribed in the regulations. Act Section 309(d)(2).

v. In contrast to the corporate abuse targeted by section 358(h), in the partnership context, the duplication of the loss may be viewed as only temporary. For example, if a taxpayer transfers assets with an adjusted basis and fair
market value of $100 to a partnership in exchange for a partnership interest, and the partnership assumes a $40 liability that is not deductible until paid, the taxpayer’s interest in the partnership would have a value of $60 and a basis of $100. Upon the sale of the partnership interest, the taxpayer would claim a $40 loss, in effect accelerating the deduction for the $40 liability. Assuming no election under section 754 (note that these regulations were issued before enactment of the Jobs Act provisions making certain downward basis adjustments under section 743(b) mandatory), the partnership would continue to have a $100 adjusted basis in the contributed asset. If the partnership thereafter satisfied the liability and allocated the $40 deduction to the purchaser, the loss would be duplicated. The purchaser’s adjusted basis in the partnership would initially be its $60 purchase price, but would be reduced to $20 by the $40 allocated deduction. Thus, if the partnership was thereafter liquidated and the purchaser received the $60 value of its partnership interest in cash, the purchaser would recognize $40 of gain under section 731(a).

2. The Final Regulations. On May 26, 2005, the Service issued final regulations in response to the directive from Congress. The final regulations generally follow the temporary and proposed regulations issued on June 23, 2003, with certain modifications. In addition, the Service issued regulations under section 358(h) for assumptions of liabilities by corporations from partners and partnerships. These regulations are intended to prevent the duplication and acceleration of noneconomic tax losses resulting from Son of Boss and similar transactions, but they sweep much more broadly.

a. Treas. Reg. § 1.752-6

i. Treas. Reg. § 1.752-6 applies retroactively to transactions occurring after October 18, 1999, and before June 24, 2003. Treas. Reg. § 1.752-6 generally adopts the approach of section 358(h) for transactions involving partnership assumptions of partners’ liabilities occurring during that time window, but modifies the approach of section 358(h) as necessary to apply the rules to partnerships instead of corporations.

ii. Under Treas. Reg. § 1.752-6, if a partnership assumes a liability of a partner (other than a liability to which section 752(a) and (b) apply) in a transaction described in section 721(a), then, after application of section 752(a) and (b),

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there is an automatic reduction in the partner’s basis in the partnership (but not below the “adjusted value” of such interest) by the amount (determined as of the date of the exchange) of the liability.

iii. Treas. Reg. § 1.752-6 defines “liability” consistently with section 358(h) to include any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for federal tax purposes.

iv. Treas. Reg. § 1.752-6 defines the “adjusted value” of a partner’s interest in a partnership as the fair market value of that interest increased by the partner’s share of partnership liabilities under Treas. Reg. §§ 1.752-1 through 1.752-5.

v. Thus, under section 752(d), the “adjusted value” should equal the amount that would be the partner’s “amount realized” under section 1001(b) if there were a taxable disposition of the partnership interest immediately after the assumption of the liability. As a result, if the partner sold the interest immediately after the liability was assumed, no loss could be recognized.

vi. Treas. Reg. § 1.752-6 adopts by cross reference the exceptions to the automatic basis reduction set forth under section 358(h). Treas. Reg. § 1.752-6(b)(1). Thus, there is no reduction in a partner’s basis if: (1) the trade or business with which the liability is associated is transferred to the partnership assuming the liability as part of the transaction, or (2) substantially all of the assets with which the liability is associated are contributed to the partnership assuming the liability. Section 358(h)(2).

vii. The temporary regulations provide that the exception for contributions of substantially all of the assets with which the liability is associated does not apply in the case of a partnership transaction described in Notice 2000-44, or a partnership transaction that is substantially similar to the transactions described in Notice 2000-44. Treas. Reg. § 1.752-6(b)(2).

b. Treas. Reg. § 1.752-7

i. Treas. Reg. § 1.752-7 generally applies prospectively to transactions occurring after June 23, 2003, unless a taxpayer to which Treas. Reg. § 1.752-6 would otherwise
apply elects to apply the provisions of Treas. Reg. § 1.752-7 to the transaction at issue.

ii. **Liability Defined.** The regulations provide a definition of "liability" for purposes of section 752 and provides that an obligation is a liability if and to the extent that incurring the obligation --

a) creates or increases the basis of any of the obligor’s assets (including cash);

b) gives rise to an immediate deduction to the obligor; or

c) gives rise to an expense that is not deductible in computing the obligor’s taxable income and is not properly chargeable to capital.

An “obligation” is any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Code. Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, and futures contracts. Thus, an “obligation” the incurrence of which creates or increases basis, give rise to an immediate deduction or gives rise to a non-deductible, non-capitalizable expense is treated as a liability.

iii. **Treas. Reg. § 1.752-7 Liability.** The regulations are intended to prevent the acceleration or duplication of loss through the assumption of obligations not described in Treas. Reg. § 1.752-1(a). The regulations refer to any such obligation as a “Reg. § 1.752-7 liability” and to the partner transferring such liability as a “Reg. § 1.752-7 liability partner.” Treas. Reg. § 1.752-7(b)(3) and (5). The final regulations clarify that a liability can be a liability described in Treas. Reg. § 1.752-1(a) in part and a Reg. § 1.752-7 liability in part. Treas. Reg. § 1.752-7(b)(3). Any person who acquires a partnership interest from a Reg. § 1.752-7 liability partner in a transaction in which the transferee’s basis in the partnership interest is determined in whole or in part by reference to the transferor’s basis is also a Reg. § 1.752-7 liability partner. Treas. Reg. § 1.752-7(b)(5); Treas. Reg. § 1.752-7(e)(3).
a) The regulations do not explicitly address whether an obligation under a short sale constitutes a liability or a Reg. § 1.752-7 liability. Arguably, the duty to return stock borrowed to consummate a short sale is the "obligation" under the regulations and does not, in and of itself, give rise to any cash proceeds or basis in any property. Rather, the sale of the borrowed stock gives rise to the cash proceeds but is independent of the borrowing of the stock. Nevertheless, prior to the issuance of the regulations, Salina Partnership v. Commissioner, T.C. Memo 2000-352, held that a short sale gave rise to a liability for purposes of section 752. Moreover, the Service reached the same conclusion in Rev. Rul. 95-26, 1995-1 C.B. 131, and informal discussions with representatives of the Service who were involved in the development of the regulations indicate that a short sale is intended to give rise to a liability in an amount equal to the cash proceeds from the sale.

b) The regulations also do not specifically address whether a variable share prepaid forward contract is a "liability" or even an "obligation." An example of such an arrangement is set forth in Rev. Rul. 2003-7, 2003-5 I.R.B. 363.

[i] In that ruling, Shareholder, an individual, owned common stock of Y Corporation, which was publicly traded. The shares had a value of $20 per share and Shareholder’s basis was less than $20. Shareholder entered into an arm’s length agreement (the "Agreement") with Investment Bank, and received $z of cash upon execution of the Agreement. In return, Shareholder became obligated to deliver to Investment Bank on the third anniversary of the Agreement (the "Exchange Date") a number of shares of common stock of Y corporation to be determined by formula. Under the formula, if the market price of a share of Y Corporation common stock is less than $20 on the Exchange Date, Investment Bank will receive 100 shares of common stock. If the market price of a share is at least $20 and no more than $25 on the Exchange Date,
Investment Bank will receive a number of shares having a total market value equal to $2,000. If the market price of a share exceeds $25 on the Exchange Date, Investment Bank will receive 80 shares of common stock. In addition, Shareholder has the right to deliver to Investment Bank on the Exchange Date cash equal to the value of the common stock that Shareholder would otherwise be required to deliver under the formula. In order to secure Shareholder’s obligations under the Agreement, Shareholder pledged to Investment Bank on the Execution Date 100 shares (that is, the maximum number of shares that Shareholder could be required to deliver under the Agreement). Shareholder retained the right to vote the pledged shares and to receive dividends. Shareholder also had the unrestricted legal right to deliver the pledged shares, cash, or shares other than the pledged shares to satisfy its obligation under the Agreement.

[ii] Rev. Rul. 2003-7 holds that the variable share prepaid contract described therein does not result in an immediate sale of the stock for federal tax purposes, and also does not result in a “constructive sale” of the stock under section 1259.

[iii] Representatives of the Service who were involved in the development of the new regulations have indicated that, in their view, a variable prepaid forward contract like that described in Rev. Rul. 2003-7 gives rise to a “liability” in an amount equal to the cash proceeds received. In addition, as the date for delivery of the stock approaches and the present value of the obligation to deliver the stock exceeds the cash received under the contract, a Reg. § 1.752-7 liability comes into existence. The amount of the Reg. § 1.752-7 liability may also be affected by changes in the value of the stock.
Clearly, application of this analysis to specific variable share prepaid forward contracts (which have become commonplace enough to merit the Service’s issuance of Rev. Rul. 2003-7) will be fraught with complexity and uncertainty.

iv. Timing of Basis Reduction. Unlike Treas. Reg. § 1.752-6, Treas. Reg. § 1.752-7 does not adopt the approach set forth in section 358(h), i.e. immediate reduction in the transferor’s basis. Rather, in the preamble to the proposed regulations, the Service noted that it “do[es] not believe that this is the best approach for partnerships given their passthrough nature.” In explaining this position, the Service noted that the partners’ shares of a partnership’s deductions are limited by the partners’ outside bases in their partnership interests. Thus, if, at the time of an assumption by a partnership of a Reg. § 1.752-7 liability, the Reg. § 1.752-7 liability partner’s outside basis were reduced by the amount of the Reg. § 1.752-7 liability, then the Reg. § 1.752-7 liability partner would not have sufficient outside basis to absorb any deduction with respect to the Reg. § 1.752-7 liability that passed through the partnership. Thus, the regulations do not adopt an approach that would reduce the Reg. § 1.752-7 liability partner’s outside basis immediately upon assumption by the partnership.

v. Treatment of Reg. § 1.752-7 Liability as Section 704(c) Built-in Loss Item. Under the methodology adopted in the regulations, if the partnership satisfies the Reg. § 1.752-7 liability while the Reg. § 1.752-7 liability partner is a partner in the partnership, then the deduction with respect to the portion of the Reg. § 1.752-7 liability assumed by the partnership is allocated to the Reg. § 1.752-7 liability partner under section 704(c)(1)(A) principles, reducing that partner’s outside basis. Treas. Reg. § 1.752-7(c). Thus, the Reg. § 1.752-7 liability is treated under section 704(c) principles as having a built-in loss equal to the amount of such liability at the time of its assumption by the partnership.

a) The final regulations clarify that, if the value of a Reg. § 1.752-7 liability decreases after the assumption of the obligation by the partnership, the “ceiling rule” applies, and the partnership and the partners are entitled to adopt one of the section 704(c) methods to correct the ceiling rule disparity.
Thus, well drafted partnership agreements will need to specify the section 704(c) method to be used with respect to Reg. § 1.752-7 liabilities, and will also need to treat any “savings” realized in satisfying Reg. § 1.752-7 liabilities as “book” income. In addition, the partners will need to negotiate over the allocation of the “book” income that reflects the “savings” realized on satisfaction of any Reg. § 1.752-7 liability.

[i] Example 13. X contributes property to a partnership subject to an environmental liability that constitutes a Reg. § 1.752-7 liability. At the time of the contribution, X and the other partners of the partnership properly estimate that the resolution of the liability will cost $100. In accordance with the regulations, X’s capital account credit is equal to the value of the contributed property, reduced by the $100 Reg. § 1.752-7 liability. X is generally allocated 10% of all partnership profits and losses. Thereafter, the partnership succeeds in resolving the environmental problem for only $80.

[ii] The regulations require that the Reg. § 1.752-7 liability be treated under section 704(c) principles as having a built-in loss equal to the amount of the Reg. § 1.752-7 liability as of the date of the partnership’s assumption, i.e., a built-in loss of $100. Presumably, X should be treated in the same manner as if X had contributed built-in loss property to the partnership with an adjusted basis of $100 and a value of $0. If X had done so and the property were thereafter sold for $20, the partnership would have a “book” gain of $20 and a tax loss of $80. The entire $80 tax loss would be allocated to X under section 704(c). Ten percent of the “book” gain ($2) would be allocated under section 704(b) to X, and the balance ($18) would be allocated to the other partners. A “ceiling rule” problem would result, and under the “traditional method” of Treas.
Reg. § 1.704-3(b), X would be allocated only the $80 tax loss.

[iii] If, however, the partnership elected to employ the “remedial allocation method” of Treas. Reg. § 1.704-3(d), the other partners in the partnership would be allocated remedial taxable gain equal to their “book” gain of $18, and X would be allocated remedial taxable loss in an offsetting amount. Thus, under the remedial allocation method, X’s total deductible loss would be $98, compared to $80 under the traditional method.

vi. “Separation Events” Triggering Basis Reduction.

a) The regulations provide that if one of three “separation events” occurs prior to satisfaction of the Reg. § 1.752-7 liability that has the effect of separating the Reg. § 1.752-7 liability partner from the Reg. § 1.752-7 liability, then there is a basis reduction in the Reg. § 1.752-7 liability partner’s outside basis. The three events identified as giving rise to the basis reduction are as follows: (1) a disposition (or partial disposition) of the partnership interest by the Reg. § 1.752-7 liability partner, (2) a liquidation of the Reg. § 1.752-7 liability partner’s partnership interest, and (3) the assumption (or partial assumption) of the Reg. § 1.752-7 liability by a partner other than the Reg. § 1.752-7 liability partner. Treas. Reg. § 1.752-7(d) through (g). The basis reduction resulting from any of these events is deemed to occur immediately prior to the event.

b) The Reg. § 1.752-7 liability partner’s outside basis is reduced by the lesser of: (1) the excess of the Reg. § 1.752-7 liability partner’s outside basis in its partnership interest over the adjusted value of that interest, or (2) the remaining built-in loss associated with the Reg. § 1.752-7 liability.

c) In the case of a partial disposition of the Reg. § 1.752-7 liability partner’s partnership interest or a partial assumption of the Reg. § 1.752-7 liability by another partner, the Reg. § 1.752-7 liability reduction is pro rated based on the portion of the
interest sold or the portion of the Reg. § 1.752-7 liability assumed. Treas. Reg. § 1.752-7(b)(6)(ii).

## vii. Economic Performance of Reg. § 1.752-7 Liability After a “Separation Event”

a) After the occurrence of a separation event that triggers a basis reduction, the partnership or the assuming partner, as the case may be, is not entitled to any deduction or capital expense on the satisfaction of the Reg. § 1.752-7 liability to the extent of the remaining built-in loss associated with the Reg. § 1.752-7 liability.

b) The partnership, or the assuming partner as the case may be, may notify the Reg. § 1.752-7 liability partner of its satisfaction of the Reg. § 1.752-7 liability, in which case the Reg. § 1.752-7 liability partner is entitled to a deduction or loss. Treas. Reg. § 1.752-7(h).

c) In the case of a complete satisfaction, the amount of the deduction or loss is equal to the remaining Reg § 1.752-7 liability reduction. In the case of a partial satisfaction, the amount of the deduction or loss is equal to the amount paid by the partnership in satisfaction of the Reg. § 1.752-7 liability (but not more than the Reg. § 1.752-7 liability reduction).

d) The character of such deduction or loss is determined as if the Reg. § 1.752-7 liability partner had satisfied the Reg. § 1.752-7 liability. If the Reg. § 1.752-7 liability reduction exceeds the amount paid in satisfaction of the Reg. § 1.752-7 liability, then as to such excess the character of the Reg. § 1.752-7 liability partner’s loss is capital.

e) In the event that the Reg. § 1.752-7 liability is assumed by a partner other than the Reg. § 1.752-7 liability partner, then, upon ultimate satisfaction of the Reg. § 1.752-7 liability, the assuming partner must adjust the basis of its partnership interest, any assets distributed by the partnership to such partner, or gain or loss on disposition of its partnership interest, as the case may be. The adjustment is made as if the assuming partner’s basis in its interest at the time of the assumption were increased
by the lesser of: (1) the amount paid to satisfy the Reg. § 1.752-7 liability; or (2) the remaining built-in loss associated with the Reg. § 1.752-7 liability as of the time of the assumption. Treas. Reg. § 1.752-7(g)(4). In making such adjustment the assuming partner cannot take into account any adjustments to depreciable basis, reduction in gain, or increase in loss until satisfaction of the Reg. § 1.752-7 liability. Treas. Reg. § 1.752-7(g)(4).

viii. Exceptions to Basis Reduction Rules. There are two exceptions that apply to the general basis reduction rules discussed above.

a) The first exception applies where the partnership assumes the Reg. § 1.752-7 liability as part of the contribution of the trade or business with which the liability is associated and the partnership continues to conduct that trade or business after the contribution. The regulations define a trade or business as a specific group of activities carried on by a person for the purpose of earning income or profit if the activities included in that group include every operation that forms a part of, or a step in, the process of earning income or profit. Treas. Reg. § 1.752-7(d)(2)(i)(A); Treas. Reg. § 1.752-7(b)(10). The definition provides that a group of activities ordinarily includes the collection of income and the payment of expenses. Thus, the holding of rental property would presumably satisfy this definition. Because of concerns that certain activities involving financial instruments could be structured to accomplish the types of transactions that the new rules are designed to prevent, the regulations provide that the activity of acquiring, holding, or disposing of financial instruments does not constitute a trade or business.

b) A second exception is a de minimis exception that is not present in section 358(h). Under this exception, the regulations do not apply where, immediately before a “separation event” that would otherwise trigger a basis reduction, the remaining built-in loss with respect to all Reg. § 1.752-7 liabilities assumed by the partnership (other than Reg. § 1.752-7 liabilities that are assumed by the partnership with an associated trade or business)
less than the lesser of 10% of the gross value of the partnership’s assets or $1,000,000.

ix. Coordination With Other Provisions

a) The proposed regulations provided that the assumption of a Reg. § 1.752-7 liability is not treated as an assumption of a liability or as a transfer of cash for purposes of the partnership disguised sale rules of section 707(a)(2)(B). Prop. Treas. Reg. § 1.752-7(a)(2).

b) This would have represented a change compared to the provisions of the existing regulations under the partnership disguised sale rules, which generally provide that recourse and nonrecourse liabilities for purposes of those rules include both amounts that constitute recourse and nonrecourse liabilities under Treas. Reg. § 1.752-1 and also amounts that would be treated as recourse and nonrecourse liabilities under those sections if they were treated as partnership liabilities for purposes of section 752. Treas. Reg. § 1.707-5(a)(2).

c) In response to comments on this provision, the final regulations delete the language contained in Prop. Treas. Reg. § 1.752-7(a)(2).

d) The final regulations attempt to conform these provisions with the section 704(b) regulations by amending Treas. Reg. § 1.704-1(b)(2)(iv)(b) to provide that a partner’s capital account will be reduced by the Treas. Reg. § 1.752-7 liabilities that the partnership assumes from the partner and by amending Treas. Reg. § 1.704-2(b)(3) to treat a Treas. Reg. § 1.752-7 liability as a nonrecourse liability for purposes of the partnership allocation rules.

e) The treatment of the Reg. § 1.752-7 liabilities as nonrecourse liabilities for purpose of the section 704(b) regulations is not explained in the proposed regulations, the final regulations or their preambles, nor are the implications of such treatment illustrated by any example. Presumably, such treatment invokes the whole panoply of rules under the section 704(b) regulations regarding nonrecourse
deductions and minimum gain chargebacks. The conceptual underpinning for this treatment seems dubious at best in cases where the Reg. § 1.752-7 liability is not nonrecourse as a matter of state law.

f) The final regulations clarify that, in determining if a deemed contribution of assets and assumption of liability as a result of a technical termination under section 708(b)(1)(B) is treated as a transfer of a Reg. § 1.752-7 liability that is subject to Treas. Reg. § 1.752-7, only liabilities that were Reg. § 1.752-7 liabilities of the terminating partnership are taken into account and, then, only to the extent of the amount of the liability that was subject to Treas. Reg. § 1.752-7 prior to the technical termination.

c. Treas. Reg. § 1.358-7. In connection with the issuance of final regulations under section 752, the Service also issued regulations under section 358(h) regarding the assumption of liabilities by corporations from partners or partnerships. These provisions are effective for assumptions of liabilities by a corporation occurring on or after June 24, 2003.

i. Treas. Reg. § 1.358-7(a) provides that, for purposes of section 358(h), a transfer of a partnership interest to a corporation is treated as a transfer of the partner’s share of each of the partnership’s assets and an assumption by the corporation of the partner’s share of partnership liabilities, including section 358(h) liabilities. Section 358(h) liabilities are liabilities described in section 358(h)(3), which includes any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account.

ii. Treas. Reg. § 1.358-7(b) provides that if a corporation assumes a section 358(h) liability from a partnership in an exchange to which section 358(a) applies, then, for purposes of determining the basis of the partners’ interests in the partnership under section 705 and Treas. Reg. § 1.704-1(b), any reduction, under section 358(h)(1), in the partnership’s basis in corporate stock received in the transaction is treated as an expenditure of the partnership described in section 705(a)(2)(B). The final regulations provide that this expenditure must be allocated among the partners in accordance with section 704(b) and (c) and Treas. Reg. § 1.752-7(c). If a partner’s share of the reduction, under section 358(h)(1), in the partnership’s
basis in corporate stock exceeds the partner’s basis in the partnership interest, then the partner generally recognizes gain equal to the excess, which is treated as gain from the sale or exchange of a partnership interest.

iii. Treas. Reg. § 1.358-7(c) provides that, where a partnership assumes a section 358(h) liability from a partner and, subsequently, the partner transfers all or part of the partner’s partnership interest to a corporation in an exchange to which section 358(a) applies, then, for purposes of applying section 358(h)(2), the section 358(h) liability is treated as associated only with the contribution made to the partnership by that partner.

D. CONCLUSION

1. Through careful crafting of guarantees, indemnities, deficit restoration obligations and capital contribution obligations, partnership and limited liability company liability allocations may be managed in a way that preserves the desired share of the liability while minimizing the taxpayer’s economic exposure.

III. PROPOSED PARTNERSHIP LIABILITY REGULATIONS

A. INTRODUCTION

1. On January 29, 2014, Treasury and the Service issued far-reaching and extremely taxpayer-adverse proposed regulations addressing the allocation of partnership recourse and nonrecourse liabilities under section 752. Among other things, the proposed regulations specify that so-called bottom guarantees will not increase the guaranteeing partner’s share of partnership liabilities. The proposed regulations have the potential to trigger gain for many partners with negative tax basis capital accounts or limit a partner’s ability to take losses into account.

2. The proposed regulations will apply prospectively from the date they are published in final form. They provide for a seven-year transition period

15 REG-119305-11.
16 The proposed regulations also include changes to the partnership disguised sale rules under section 707, which generally are not problematic. The proposed changes to the section 707 regulations are beyond the scope of this outline.
during which some obligations may still be taken into account under the existing partnership recourse debt allocation rules.

3. It is widely understood that the original motivation for changing the section 752 regulations was to limit taxpayers’ ability to structure a leveraged partnership transaction that complies with the debt-financed distribution exception to the partnership disguised sale rules under section 707. The proposed regulations do little in this regard. Although the regulations may limit the ability of partners without sufficient net worth to take advantage of such a structure, they generally would not prevent taxpayers from receiving distributions of cash in redemption of a large portion of their equity without the recognition of taxable gain.

4. Instead, the proposed regulations would impose subjective – and in many cases, noncommercial – requirements that must be satisfied for any partnership liability to be treated as a recourse liability under section 752. They would create an unadministrable regime and would shift allocations of debt away from partners who bear economic risk for the debt to those who do not. The regulations would fail to overrule the decision in Raphan v. United States, in direct contravention of congressional intent, and they would allow or require allocations of deductions to partners in direct conflict with the fundamental principles of the section 704(b) regulations. Accordingly, we recommend that the proposed regulations be withdrawn. We suggest that any concerns with the current application of the partnership disguised sale rules be addressed through targeted changes to the section 707 regulations rather than the creation of an entirely new regulatory regime under section 752 that is applicable to every partnership and partnership liability.

B. RECOURSE LIABILITIES – CURRENT RULES

1. Since at least 1956, the theory underlying the regulations governing the allocation of partnership liabilities has been that the liabilities should be allocated to partners who would be required to pay the liability if the partnership was unable to do so because those partners are considered to bear the economic burden for the liability. If a lender would have no recourse to any partner if the partnership was unable to repay the liability,

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17 Amy S. Elliot, “Treasury Officials Explain New Bottom-Dollar Guarantee Rules,” Tax Notes, Mar. 3, 2014, p. 904 (quoting Lisa Zarlenaga, Treasury tax legislative counsel, as saying “When we were considering changes in the section 752 rules related to [the debt-financed distribution] exception, we determined that certain principles that were being applied for just section 707 purposes ought to apply equally in non-disguised sale cases”).

18 3 Cl. Ct. 457 (1983), rev’d on this issue, 759 F.2d 879 (Fed. Cir. 1985).
only partnership profits could satisfy the liability. Accordingly, the regulations have allocated partnership nonrecourse liabilities among the partners in the same way the partnership’s profits would be allocated among them.\textsuperscript{19}

2. Consistent with that theory, as described in detail in Section 1.01 above, under the current section 752 regulations, a partnership liability is allocated to a partner as a partnership recourse liability to the extent that the partner bears the economic risk of loss for the liability under a relatively mechanical constructive liquidation test.

C. PROPOSED PARTNERSHIP RECOURSE LIABILITY ALLOCATION REGULATIONS

1. The proposed regulations would generally make three critical changes to the current section 752 regulations regarding partnership recourse liabilities. First, they would impose recognition requirements that must be satisfied for a partner or related person’s payment obligation to be recognized. Among these recognition requirements are provisions that would prevent so-called bottom guarantees from increasing the guaranteeing partner’s share of liabilities. Second, the proposed regulations would reduce the amount of any partner’s or related person’s payment obligation for a partnership liability to the extent of any right of reimbursement from any “person.” Third, the proposed regulations would apply the net value requirement, which is currently applicable only to disregarded entities, to all regarded entities. These proposed changes are summarized below, followed by our analysis and commentary.

2. Recognition Requirements

a. The preamble to the proposed regulations states that the Service and Treasury “are concerned that some partners or related persons have entered into payment obligations that are not commercial solely to achieve an allocation of a partnership liability to such partner.”\textsuperscript{20} It further states that the Service and Treasury believe that section 79 of the Deficit Reduction Act of 1984 (DEFRA) – which overruled the decision in \textit{Raphan}\textsuperscript{21} (discussed below) and


\textsuperscript{20}Preamble to REG-119305-11, at 17.

\textsuperscript{21}3 Cl. Ct. 457. The Federal Circuit’s reversal in \textit{Raphan}, 759 F.2d 879, occurred after the enactment of DEFRA.
directed Treasury to prescribe regulations under section 752 on the
treatment of guarantees and other payment obligations—was
intended to ensure that bona fide, commercial payment obligations
would be given effect under section 752.22 As a result, in contrast
to the current relatively mechanical and administrable partnership
recourse debt allocation rules, the proposed regulations would
impose recognition requirements—some of which are entirely
subjective—that must be satisfied for a partner’s or related
person’s payment obligation to be taken into account in
determining whether a partner bears the economic risk of loss for a
partnership liability. The Service and Treasury intend that the
satisfaction of those requirements will establish that the terms of a
payment obligation are “commercially reasonable and are not
designed solely to obtain tax benefits.”23

b. A payment obligation, other than one imposed by state law
(including the governing state partnership statute), must satisfy the
following seven requirements to be taken into account:24

i. The obligor must maintain a commercially reasonable net
worth throughout the term of the payment obligation or be
subject to commercially reasonable contractual restrictions
on transfers of assets for inadequate consideration.

ii. The obligor must be required to periodically provide
commercially reasonable documentation regarding the
obligor’s financial condition.

iii. The term of the obligation must not end before that of the
partnership liability.

iv. The payment obligation must not require that the primary
or any other obligor on the partnership liability directly or
indirectly hold money or other liquid assets in an amount
that exceeds the reasonable needs of that obligor.

v. The obligor must receive arm’s-length consideration for
assuming the payment obligation.

22 Preamble to REG-119305-11, at 17-18.
23 Id. at 18.
vi. In the case of a guarantee or similar arrangement, the obligor must be liable up to the full amount of its payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.

vii. In the case of an indemnity, reimbursement, or similar arrangement, the obligor must be liable up to the full amount of its obligation if, and to the extent that, any amount of the indemnitee’s or other beneficiary’s payment obligation is satisfied.

3. Right of Reimbursement From Any Person

a. The current partnership recourse liability regulations reduce the amount of a partner’s or related person’s obligation to make a payment for a partnership liability to the extent that the partner or related person is entitled to reimbursement from another partner or a person related to another partner.25

b. The preamble states that the Service and Treasury concluded that a right to be reimbursed for a payment or contribution by an unrelated person (for example, under an indemnification agreement from a third party) should be taken into account in the same manner.

c. Accordingly, the proposed regulations provide that a partner’s or related person’s payment obligation for a partnership liability is reduced to the extent that the partner or related person is entitled to reimbursement from any person.26

4. Net Value Requirement Extended

a. As noted above, the current partnership recourse liability regulations generally presume that all partners and related persons will satisfy their payment obligations unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. This presumption does not apply to entities that are disregarded as separate from their owners for federal income tax purposes. Those entities are treated as bearing economic risk of loss for a partnership liability only to the extent of their net value as determined under Treas. Reg. § 1.752-2(k).

25 Treas. Reg. § 1.752-2(b)(5).
b. The proposed regulations would expand the application of the net value requirement in reg. section 1.752-2(k) to all partners or related persons (including grantor trusts), other than individuals and decedents' estates.

c. The expansion would apply to all payment obligations associated with liabilities that are not trade payables. Further, the proposed regulations would require that an obligor subject to the net value requirement timely give the partnership information about the obligor's net value that is appropriately allocable to the partnership's liabilities.

D. RECOUSE LIABILITIES – COMMENTARY

1. DEFRA and Raphan

a. As noted in the preamble to the proposed regulation, in DEFRA, Congress directed Treasury to issue regulations under section 752 that reject the holding in Raphan. However, as explained below, the proposed regulations do not reject the holding in Raphan, but adopt it. This raises a serious question about the validity of the regulations. Moreover, the proposed regulations would allow – in fact they would require – that many nonrecourse liabilities guaranteed by one or more partners be included in the tax basis of the partnership interest of non-guaranteeing partners, creating the same potential for abuse that Congress sought to preclude when it directed Treasury to issue regulations rejecting the holding in Raphan.

b. The regulations issued in 1956 under section 752, which were in effect during the tax year involved in Raphan, contained only a few sentences concerning the sharing of partnership liabilities. Those regulations generally provided that a partner's share of partnership liabilities would be determined in accordance with the partner's ratio for sharing losses under the partnership agreement. However, a limited partner generally could be allocated a share of liabilities only to the extent it had an obligation to make a future capital contribution to the limited partnership. An exception applied “where none of the partners have any personal liability

29 Treas. Reg. § 1-752-1(e), before removal by T.D. 8237 (Dec. 29, 1988).
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)." In that case all partners, including limited partners, shared the liability in the same proportion as they shared profits.

c. In *Raphan*, a limited partnership borrowed money on a nonrecourse basis (that is, the terms of the debt limited the lender’s recourse to specified assets of the partnership). The general partners, who were individuals, guaranteed the debt. The Claims Court held that the guarantee did not cause the general partners to be personally liable on the debt and that the limited partners could therefore include a share of the debt in basis. In 1985 the Federal Circuit reversed, but before it did, Congress addressed the issue in DEFRA.

d. Section 79 of DEFRA, titled “Overruling of *Raphan* Case,” provided as follows:

(a) GENERAL RULE.—Section 752 of the Internal Revenue Code of 1954 (and the regulations prescribed thereunder) shall be applied without regard to the result reached in the case of *Raphan* vs the United States, 3 Cl. Ct. 457 (1983).

(b) REGULATIONS.—In amending the regulations prescribed under section 752 of such Code to reflect subsection (a), the Secretary of the Treasury or his delegate shall prescribe regulations relating to liabilities including the treatment of guarantees, assumptions, indemnity agreements and similar arrangements.

e. The legislative history of the provision stated as follows:

Under the agreement, the decision in the *Raphan* case is not to be followed for purposes of applying section 752 or the regulations thereunder. . . [T]he conferees intend that the revisions to the section 752 regulations will be based largely on the manner in which the partners, and persons related to the partners, share the economic risk of loss with

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30 *Id.*
f. Despite that clear directive from Congress, the proposed regulations would not reject the holding of the Claims Court in *Raphan*, but instead would adopt it. The Federal Circuit in *Raphan* stated:

Examining the substance here establishes that the [general partners] did not act at arm’s length in guaranteeing the construction loan. They did not charge [the partnership] for the guarantee, as would an unrelated person, nor did [the partnership] agree to pay [the general partners’] interest if they were called upon to meet their guarantee.  

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32 *Raphan*, 759 F2d, at 885.
2. The Recognition Requirements

a. According to the preamble, the satisfaction of the seven recognition requirements listed in Prop. Treas. Reg. § 1.752-2(b)(3)(ii) is intended to establish that an obligation entered into by a partner or related person regarding a partnership liability is "commercial." As noted, the theory underlying the partnership recourse liability allocation rules is that liabilities should be allocated to partners that would be required to fund them if the partnership were unable to do so. Whether or not an obligation meets a "commercial" standard does not change the fact that a partner with a legally enforceable payment obligation for a partnership liability bears economic risk for that liability, and under the theory described above, that economic risk should be taken into account. As noted above, under the antiabuse rule in the current regulations, an obligation would be disregarded in circumstances that the Service and Treasury deem abusive.

b. Moreover, unlike the existing objective and administrable section 752 regulations, recognition requirements 1, 2, 4, and 5 involve a determination of the meaning of the terms "commercially reasonable," "reasonable needs," or "arm's length." These amorphous and subjective tests will require partners and partnerships to make difficult, if not impossible, judgments in order to determine whether a particular obligation can be taken into account. Given the amorphous and subjective nature of these tests, we expect that Service agents will challenge many payment obligations on the grounds that the commercially reasonable, reasonable needs, or arm's-length requirement is not met, if a challenge would result in an increase in tax. We are particularly surprised that the proposed regulations would require a subjective analysis of an obligation for it to be taken into account, given the public statements by the Service and Treasury representatives preceding the issuance of the proposed regulations that any new rules concerning such a determination under section 752 would be objective and mechanical.34

34 See Elliott, "Guarantors May Need to Document Net Worth, Katz Says," Tax Notes, Sept. 30, 2013, p. 1528 ("Craig Gerson, attorney-advisor, Treasury Office of Tax Legislative Counsel, said the government is designing the test in the regs to be mechanical in nature," and Clifford Warren, senior counsel for the Service’s Office of Associate Chief Counsel (Passthroughs and Special Industries), “added that the government is trying to avoid using phrases like ‘business purpose’ and ‘commercially reasonable’ in the guidance. ‘We want it to be a more objective test,” Footnote continued on next page
c. What does it mean to be required to maintain a commercially reasonable net worth, to be subject to commercially reasonable contractual restrictions on transfers without consideration, or, for a primary obligor to hold money or other liquid assets in excess of its reasonable needs? Those terms will clearly have different meanings depending on the obligor, borrower, partnership’s activities, and assets securing the loan. Similarly, what is arm’s-length consideration for entering into a guarantee or other obligation? In our experience, a partner is often willing to enter into a guarantee of partnership debt because the partner will benefit from the loan to the partnership and does not require additional consideration. Does that mean that the arm’s-length consideration may be zero? Will taxpayers be forced to require lenders to impose net worth documentation and maintenance requirements, or partnerships to pay a guarantee fee, just to satisfy these requirements even if they would not exist in an otherwise commercial transaction? Even if taxpayers believe they can establish that the commercially reasonable or arm’s-length requirement has been met, these subjective standards open the door for challenges by the Service and will surely result in litigation.

d. The third recognition requirement—that the term of the obligation must not end before the term of the partnership liability—also does not comport with the commercial reality in many situations. For example, loans in the real estate development context are often required to be fully guaranteed by a partner only until the property reaches a specified level of stabilization (that is, a specified occupancy or rental income level is reached). Further, if the partnership sells the property that secures a partnership liability, and the liability is assumed by the purchaser that guarantees it, a partner-guarantor typically has the right to be released from the guarantee. Even if the guarantor manages to satisfy the other five recognition requirements are listed above, if a guarantee includes these common commercial release terms, the proposed regulations would require the guarantee to be disregarded and the partnership debt treated as nonrecourse, even though the guarantor bears the true economic risk for the debt.

e. The sixth and seventh recognition requirements are extremely broad and would prevent any obligation that is not a top guarantee

Footnote continued from previous page

to be frank. We don’t want to be litigating about what’s right and what’s wrong in this area,” he said.”).
or similar arrangement from being taken into account. The Service has expressed concerns about whether a bottom guarantee of the last dollars of a liability should be taken into account as an obligation, because that guarantee is of the least risky portion of the liability, is not typically sought out by lenders and is entered into solely for tax reasons. That is, it is non-commercial. Example 14 illustrates the application of this provision.

f. Example 14

i. A, B, and C are equal members of ABC LLC, which is treated as a partnership for federal income tax purposes. ABC borrows $1,000 from Bank. A guarantees payment of up to $300 of the ABC liability if any portion of the $1,000 is not recovered by Bank. Accordingly, A's guarantee is a top guarantee. B guarantees payment of up to $200 of the ABC liability, but only if Bank otherwise recovers less than $200. Accordingly, B's guarantee is a bottom guarantee. A and B each waive rights of contribution against each other, and each of their guarantees satisfies recognition requirements 1 through 5 described above. Because A is obligated to pay up to $300 if, and to the extent that, any amount of the $1,000 partnership liability is not recovered by Bank, A's guarantee satisfies the sixth recognition requirement and is recognized as an obligation for purposes of section 752. However, because B is obligated to pay up to $200 only if, and to the extent that, Bank otherwise recovers less than $200 of the $1,000 liability, B's guarantee does not satisfy the sixth recognition requirement and is disregarded.35

ii. In fact, B's guarantee would be disregarded under the proposed regulations even if B guaranteed $999 of the $1,000 liability. Does it make sense to treat a guarantor of $999 of a $1,000 liability as bearing no economic risk of loss for the liability while a guarantor of the top $200 of a $1,000 liability is given full credit for the guarantee? Moreover, there are circumstances under which a bottom guarantee may expose the guarantor to more economic risk than a full or top guarantee. For example, a top $200 guarantee of a $50,000 liability secured by an asset with a $1 million value may be less likely to have to be satisfied

than a bottom $200 guarantee of a $300 liability secured by an asset with a $500 value. That Treasury and the Service do not view the bottom guarantee as being "commercial" does not change the fact that a bottom guarantor truly may bear greater economic risk for a partnership liability than a top guarantor.

g. The broad language in the sixth recognition requirement would also cause a vertical slice guarantee to be disregarded (for example, 50 percent of every dollar of shortfall) because the guarantor would not be liable for 100 percent of every dollar of shortfall.\footnote{See Prop. Treas. Reg. § 1.752-2(f), Example 12.} Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F) further provides that in determining whether an obligation satisfies the sixth recognition requirement, the terms of a guarantee or similar arrangement will be treated as modified by any right of indemnity, reimbursement, or similar arrangement regardless of whether that arrangement would be recognized as an obligation for purposes of section 752. That rule does not apply, however, to a right of proportionate contribution running between partners or related persons that are co-obligors on a payment obligation for which each is jointly and severally liable. Accordingly, under the proposed regulations, if there is more than one obligor for a partnership liability, even a top guarantee or similar obligation would be disregarded unless the obligors are jointly and severally liable. Similarly, a top guarantee must be disregarded if the obligor has any right of indemnification from any person regarding the guarantee. These points are illustrated in Example 2.

h. Example 15

i. The facts of Example 15 are the same as in Example 14, except that C agrees to indemnify A up to the $50 that A pays under its guarantee. Under the proposed regulations, C’s indemnity is treated as modifying A’s guarantee such that A is treated as liable for only $250 of A’s $300 guarantee. Accordingly, because A is not liable up to the full amount of the $300 guarantee if, and to the extent, any amount of the partnership liability is not otherwise satisfied, A’s guarantee is completely disregarded.\footnote{See Prop. Treas. Reg. § 1.752-2(f), Example 11.} This is true even if C’s indemnification obligation does not
satisfy all the recognition requirements. Based on the literal language of Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F), it seems to be the case even if C’s indemnity is a bottom indemnity that applies only to the extent that A’s payment on the guarantee exceeds $250. Thus, a $250 top guarantee would be respected, but a $300 top guarantee that is subject to a $50 bottom indemnity would not be, even though the latter arrangement involves greater economic risk for the guarantor.

i. Contrary to the stated intention to recognize commercial obligations for purposes of section 752, the proposed regulations fail to respect guarantees that are entered into solely for nontax reasons, even if they satisfy the other five recognition requirements set forth above. For example, a lender may require that there be multiple guarantors of a partnership liability on a joint, but not several, basis. That common commercial obligation is disregarded under the proposed regulations, which results in the debt being treated as nonrecourse. Further, as illustrated in Example 3, it is common in many purely commercial, non-tax-motivated transactions for a majority partner that guarantees a partnership liability to have a right of partial indemnification against specified minority partners.

j. Example 16

i. A is the 90 percent managing member of ABC LLC, which is in the trade or business of developing and renting office buildings. B and C are key employees, and each owns a 5 percent membership interest. ABC LLC borrows $100 million from Bank under a construction loan. For non-tax-related reasons, Bank requires that A guarantee repayment of the construction loan. A agrees to guarantee the construction loan, if B and C each indemnify A for 5 percent of any payments that A is required to make under the guarantee so that they bear an economic risk for the construction loan commensurate with their economic interests in ABC LLC.

ii. Even though B’s and C’s agreement to indemnify A was negotiated as part of a non-tax-related transaction, the proposed regulations would cause the construction loan to be treated as a nonrecourse partnership liability. Depending on the determination of the ABC LLC members’ shares of profits under Prop. Treas. Reg. § 1.752-3(a)(3), the allocation of the construction loan among A, B, and C may be very different from their shares of
economic risk for the construction loan on account of the guarantee and indemnity arrangement.

k. As noted above, the proposed regulations provide that the recognition factors do not apply to payment obligations imposed by state law, including the governing state partnership statute. As shown in Examples 17 and 18, this may cause payment obligations in economically identical situations to be treated differently.

l. Example 17

i. A is the general partner in the AB limited partnership, which borrows $1,000 from Bank on a recourse basis. Under state law, A is liable for the debts and obligations of the AB limited partnership.

ii. Accordingly, under the proposed regulations, A’s state law payment obligation is respected regardless of whether it satisfies any of the seven recognition requirements.

m. Example 18

i. A is the managing member of AB LLC, which borrows $1,000 from Bank on a basis that is recourse to AB LLC but not to any members. A, as the managing member, guarantees the AB LLC debt.

ii. Even though A’s economic risk is identical to its economic risk in Example 4, A’s payment obligation will not be taken into account unless A satisfies all the recognition requirements.

n. It is also unclear whether a DRO can ever be taken into account as a payment obligation under the proposed regulations. Prop. Treas. Reg. § 1.752-2(b)(3)(i) states that an obligation to make a payment described under Prop. Treas. Reg. § 1.752-2(b)(3)(i)(A) or (B) will not be recognized unless the seven recognition requirements are satisfied. Obligations described in Prop. Treas. Reg. § 1.752-2(b)(3)(i)(B) include the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership. Accordingly, a DRO must satisfy all seven recognition requirements to be taken into account as a payment obligation, which is unlikely. As illustrated in Example 19, this will cause DROs to be disregarded for section 752 purposes.

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Example 19

i. As in Example 7 above, assume that X is a limited partner in a limited partnership and is generally allocated 1 percent of partnership profits and losses. The partnership's only debt is a recourse debt of $100 from a third party. Assume that X must maintain a share of the debt equal to at least $10 to avoid receiving a deemed distribution under section 752(b) that will exceed X's basis in its partnership interest and trigger gain under section 731(a). X enters into a DRO for $10. Under the DRO, upon liquidation of X's interest in the partnership, X will be obligated to make a capital contribution to the partnership equal to the lesser of $10 or the amount of X's deficit capital account. Assume further that the partnership agreement meets the requirements of the safe harbor of Treas. Reg. § 1.704-1(b)(2) and that in lieu of the 1 percent allocation of losses to X, the partnership agreement requires that X be allocated all losses until X's capital account equals negative $10. Finally, assume that the book balance sheet of the partnership reflects the following:

<table>
<thead>
<tr>
<th>Property</th>
<th>80</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability</td>
<td>100</td>
</tr>
<tr>
<td>( .20)</td>
<td>X</td>
</tr>
<tr>
<td>(19.80)</td>
<td>Other Partners</td>
</tr>
</tbody>
</table>

As described in Example 7 above, under the current section 752 regulations, X's DRO should cause $10 of the debt to be allocated to X. Upon a constructive liquidation of the partnership, the property would have a zero value and the partnership would be deemed to dispose of it for no consideration, resulting in an $80 loss. Of this amount, $9.80 would be allocated to X, and the balance would be allocated to the other partners. X would have a deficit capital account of $10 and would be required to contribute this amount to the partnership. As a result, X would bear the economic risk of loss for $10 of the debt.\(^\text{38}\)

\(^{38}\) *See* Treas. Reg. § 1.752-2(f), Example 2.
iii. It is unlikely that X’s DRO could satisfy all seven of the recognition requirements. The DRO would become due and payable upon liquidation of X’s interest in the partnership. For a DRO to be effective, the section 704(b) regulations require that it be satisfied by the later of the end of the tax year in which the partner’s interest in the partnership is liquidated or within 90 days of that liquidation. As a result, X’s obligation may end before the termination of the partnership’s liability, in violation of the third recognition requirement. Also, it would be highly unusual for X to be paid any consideration for entering into a DRO, so the DRO may fail the fifth recognition requirement.

iv. It is also unclear whether the sixth recognition requirement applies to a DRO or capital contribution obligation. If it does, X’s DRO would fail. As noted above, Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F) states that it applies to a guarantee or similar arrangement, while Prop. Treas. Reg. § 1.752-2(b)(3)(i) states that no payment obligation will be recognized if it fails to satisfy the seven recognition requirements. The reference to a guarantee or similar arrangement as opposed to a payment obligation may indicate that the sixth recognition requirement is intended to apply to a narrower category of payment obligations. If the sixth recognition requirement in the proposed regulations applies to DROs, however, X’s DRO would presumably be disregarded. That is because if the property’s value was more than $70.20 but less than the full $100 liability amount, on liquidation of the partnership, X would be allocated less than $9.80 of loss and would be required to make a capital contribution of less than $10, even if the partnership’s assets were insufficient to satisfy more than $10 of the partnership liability. Accordingly, X would not be liable up to the full amount of its payment obligation if, and to the extent that, any amount of the partnership liability were not otherwise satisfied.

v. DROs are commonly entered into to allow partners to be allocated losses in compliance with the section 704(b) regulations. Also, to the extent that a partnership

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refinances a nonrecourse loan encumbering contributed property with a recourse loan or line of credit, the contributing partner may enter into a DRO to prevent the recognition of gain as a result of a reduction in the partner’s allocable share of partnership liabilities.

vi. Real estate investment trust operating partnerships (REIT OPs) often finance their activities through a recourse line of credit rather than property-specific nonrecourse debt. As a result, many REIT OPs refinance nonrecourse debt secured by contributed properties in their recourse line of credit as part of their normal commercial operations. In those cases, the contributing partner may enter into a DRO to ensure that it can retain sufficient debt to avoid a deemed distribution in excess of tax basis. The proposed regulations would require REIT OPs to disregard such an obligation.

p. The proposed regulations further modify the existing antiabuse rule in Treas. Reg. § 1.752-2(j) to provide that 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. Example 20 explores the application of that rule.

q. Example 20

i. A, B, and C are equal members of ABC LLC, which is the sole member of Property LLC, a disregarded entity that owns property. Property LLC borrows $300 from Bank, secured by a mortgage on the property. ABC LLC borrows $700 from Bank, secured by its membership interest in Property LLC (mezzanine financing). B enters into a full guarantee of Property LLC’s $300 mortgage debt, which contains provisions that satisfy recognition requirements 1 through 5.

ii. B’s guarantee appears to satisfy the sixth recognition requirement because B will be obligated to make a payment

on its guarantee to the extent that Property LLC’s mortgage debt is not fully satisfied.

iii. However, because B’s guarantee is of the mortgage debt, which is senior in priority to the mezzanine financing, the risk that B’s guarantee will be called is the same as the risk of B’s bottom guarantee in Example 14, which was disregarded under the sixth recognition requirement. Is this arrangement subject to the modified antiabuse rule in Prop. Treas. Reg. § 1.752-2(j)(4)?

iv. Presumably, the modification to the antiabuse rule in Prop. Treas. Reg. § 1.752-2(j)(4) would cause a financing transaction to be closely scrutinized that consists of both fully guaranteed first mortgage debt and one or more tiers of mezzanine or other subordinate debt because the guarantee would be of the least risky portion of the financing package. Mortgage and mezzanine financing structures, which are common commercial arrangements, will be subject to scrutiny and potential challenge under the proposed regulations to the extent that less than all the tiers of mortgage and mezzanine financing are fully guaranteed.

3. Right of Reimbursement From Any Person

a. As noted above, the proposed regulations reduce the amount of a partner’s or related person’s payment obligation for a partnership liability if that obligor has any right to reimbursement from any person.

41 At a conference on February 24, 2014, Craig Gerson, attorney-advisor in the Office of Tax Legislative Counsel, said that “tranche debt – the different components of it – are respected as separate debt instruments . . . So if you guarantee only the senior debt in tranche debt and you comply with all of the requirements of the regulation, that debt guarantee would be respected.” Gerson added, however, that the arrangement would need to pass muster under general tax principles and the reg. section 1.752-2 antiabuse rule. Elliot, supra note 3.

At a conference on March 31, 2014, Clifford Warren, special counsel to the Service associate chief counsel (passthroughs and special industries), said, “If it’s a true tiered loan and there really is a first and second – it was not artificially contrived through some intermediary – I think we would respect that.” Asked whether the tranches could be issued by the same lender and still be respected as separate, Warren responded “Yes, if it’s real . . . I’d probably know it if I saw it.” Elliott, “Tranched Debt May be Respected Under New Bottom-Dollar Guarantee Rules,” Tax Notes, Apr. 7, 2014, p. 35.

42 Prop. Treas. Reg. § 1.752-2(b)
term “person” is not defined in the proposed regulations, the general meaning of the term as set forth in section 7701(a)(1) includes a partnership. In describing the current regulations, the preamble states that “in determining the amount of any obligation of a partner to make a payment to a creditor or a contribution to the partnership with respect to a partnership liability, section 1.752-2(b)(1) reduces the partner’s payment obligation by the amount of any reimbursement that the partner would be entitled to receive from another partner, a person related to another partner, or the partnership” (emphasis added). Accordingly, the Service and Treasury apparently believe that the current regulations reduce the amount of a payment obligation on account of a right to be reimbursed by the partnership. In fact, the preamble misstates Treas. Reg. § 1.752-2(b)(1), which only reduces the amount of an obligor’s payment obligation that is taken into account for purposes of section 752 to the extent of any right of reimbursement from another partner or a person related to another partner. The current regulations do not reduce the amount of an obligor’s payment obligation as a result of a right to be reimbursed by the partnership. This is consistent with the constructive liquidation test of Treas. Reg. § 1.752-2(b). Under the assumptions made in that test, any right of reimbursement from the partnership would be worthless.

b. A commercial, non-tax-motivated guarantee of a partnership liability typically entitles the guarantor to step into the shoes of the lender under a right of subrogation so that the guarantor is entitled to pursue the partnership’s assets. As noted above, however, application of the current regulations’ constructive liquidation test, which would generally be retained in the proposed regulations, requires that the partnership’s assets be deemed worthless. If a guarantor’s subrogation rights against the partnership are taken into account under the proposed regulations to reduce the amount of a payment obligation for purposes of section 752, the constructive liquidation test would effectively be ignored, and a commercial guarantee with subrogation rights against the partnership would never be taken into account as an obligation.

c. As illustrated in Example 21, the reduction of a partner’s or related person’s obligation on account of any reimbursement right from any person, as opposed to a reimbursement right from another partner or person related to another partner, arguably may negate any payment obligation of an entity that is supported by a capital contribution obligation from its owners.
d. Example 21

i. A, B, and C are equal members of ABC LLC, which borrows $1,000 from Bank. A, a corporation, guarantees payment of up to $300 of the ABC liability if any amount of the $1,000 is not recovered by Bank (a top guarantee). One of A’s shareholders, individual X, agrees to make a capital contribution to A to the extent that A becomes liable to make a payment on its $300 top guarantee of ABC’s liability. X’s agreement ensures that A is treated as having sufficient net value to satisfy the expanded net value requirement in the proposed regulations, discussed in detail below.

ii. Under the current regulations, A would be allocated $300 of the ABC liability on account of its guarantee.

iii. However, when applying the proposed regulations to this structure, even if A’s guarantee satisfies all the recognition requirements, it would be disregarded if X’s capital contribution obligation is deemed to be a reimbursement right from X. In that case, the $300 of ABC’s liability would be treated as a nonrecourse liability. Presumably, this is not the intended result because it is inconsistent with the purpose of the net value requirement, but it nevertheless appears consistent with the language of the proposed regulations.

e. We also note that the right to be reimbursed by a person other than another partner or a person related to another partner does not change the fact that a partner that undertakes a payment obligation for a partnership liability bears more economic risk of loss than the partners that have no payment obligation. For example, a guarantor with a right of reimbursement from a third party bears the risk of collection on the indemnity. Accordingly, if risk of loss is the touchstone, it makes more sense to allocate the liability to that partner than to treat the liability as a partnership nonrecourse liability and allocate it to partners that bear no economic risk of loss for the liability. Further, if a partner or related person purchases insurance to cover its risk of having to make a payment under a guarantee of a partnership liability, the insurance represents an asset purchased by the partner-guarantor and should not be viewed as a reduction in the guarantor’s economic risk of loss.
4. **Interaction With Section 704(b)**

a. The section 704(b) regulations contain special rules for “partner nonrecourse debt,” which are designed to require that losses attributable to that debt be allocated to the partner that will bear any economic burden corresponding to the allocation. The proposed regulations would *sub silentio* dramatically alter the partner nonrecourse debt rules in the section 704(b) regulations. Moreover, as discussed below, that change is inconsistent with the fundamental principles of section 704(b). Given the importance of this interaction between the proposed and section 704(b) regulations, it is surprising that the preamble to the proposed regulations does not discuss it.

b. Treas. Reg. § 1.704-2(b)(ii) provides:

(ii) Economic Effect.—(a) Fundamental principles.—In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. That means that *in the event there is an economic benefit or burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.* [Emphasis added.]

c. One of the ways that the section 704(b) regulations effectuate this fundamental principle is through a series of rules concerning partner nonrecourse debt. Treas. Reg. § 1.704-2(b)(4) defines partner nonrecourse debt as “any partnership liability to the extent the liability is nonrecourse for purposes [of] section 1.1001-2, and a partner or related person (within the meaning of section 1.752-4(b)) bears the economic risk of loss under section 1.752-2 because, for example, the partner or related person is the creditor or a guarantor.” The section 704(b) regulations identify partner nonrecourse deductions that are attributable to partner nonrecourse debt and require those deductions to be allocated to the partner that bears the economic risk of loss for the liability. 43 The concept is that any economic burden corresponding to specified deductions (typically, depreciation deductions) will be borne by the partner that bears the economic risk of loss for the partner nonrecourse debt (for example, a partner that has guaranteed an otherwise nonrecourse debt). Accordingly, consistent with the fundamental

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43 Treas. Reg. § 1.704-2(i).


principles articulated above, those partner nonrecourse deductions must be allocated to that partner. Example 22 illustrates these provisions under current law.

d. Example 22

i. A and B form AB partnership, each contributing $100,000. The AB partnership borrows $800,000 on a nonrecourse basis, and A guarantees the debt. The partnership uses the $1 million to purchase depreciable property for which $100,000 of annual depreciation is allowable. The depreciable property secures the debt, and no principal payments on the debt are due for 10 years. The partnership agreement provides that all items are to be allocated equally to A and B.

ii. The $200,000 of depreciation deductions claimed in years 1 and 2 are, in effect, attributable to the capital of A and B and may be allocated equally to them. If there were an economic burden corresponding to the $200,000 of depreciation deductions, the property would decline in value to $800,000. If the property were sold for $800,000, the proceeds would be sufficient only to repay the debt, and A and B would receive nothing. Thus, A and B would each bear $100,000 of the economic burden corresponding to the depreciation deductions, and the equal allocation of those depreciation deductions is valid.

iii. In year 3, however, the additional depreciation deductions of $100,000 constitute partner nonrecourse deductions that must be allocated solely to A, notwithstanding the contrary provision in the partnership agreement. If there were an economic burden corresponding to the additional $100,000 of depreciation deductions, the property would decline in value to $700,000. If the property were sold for $700,000, the proceeds would be insufficient to repay the $800,000 debt, and A would be required to pay $100,000 under its guarantee. Thus, as a result of the guarantee, A would bear the economic burden corresponding to the $100,000 of depreciation deductions in year 3, and only A may be allocated those deductions. A similar analysis would apply for depreciation deductions in future years.

e. Because the proposed regulations would change the analysis regarding the extent to which a partner bears the economic risk of loss under Treas. Reg. § 1.752-2, they would effectively change the partner nonrecourse debt rules of the section 704(b)

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regulations. Moreover, as illustrated by the following examples, those changes are inconsistent with the fundamental principle of section 704(b) that if there is an economic burden that corresponds to an allocation of deductions, the partner to whom the allocation is made must bear that economic burden.

Example 23

i. The facts are the same as in Example 22, except that the proposed regulations apply, and A does not receive arm’s-length consideration for providing the guarantee. Alternatively, any of the other recognition requirements of Prop. Treas. Reg. § 1.752-2(b)(3)(ii) are not present. Because A does not bear the economic risk of loss for the debt under the proposed regulations, the debt is not a partner nonrecourse debt within the meaning of Treas. Reg. § 1.704-2(b)(4), but a nonrecourse liability within the meaning of Treas. Reg. § 1.704-2(b)(3). Further, the year 3 depreciation deductions are not partner nonrecourse deductions, but nonrecourse deductions within the meaning of Treas. Reg. § 1.704-2(c). As a result, the year 3 depreciation deductions may be allocated equally between A and B. Indeed, under these facts, it is unlikely that the year 3 depreciation deductions could be allocated any other way. 44

ii. Even though the proposed regulations do not treat A as bearing the economic risk of loss for the liability, the economic reality is the same as in Example 22. If there were an economic burden corresponding to the $100,000 of year 3 depreciation deductions, the property would decline in value to $700,000. And if the property were then sold for $700,000, the proceeds would be insufficient to repay the $800,000 debt, and A would be required to pay $100,000 under the guarantee. Thus, as a result of the guarantee, A would bear the economic burden corresponding to the $100,000 of additional depreciation deductions in year 3. Nevertheless, the depreciation

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44 See Treas. Reg. § 1.704-2. The analysis assumes that the minimum gain charge-back requirements of Treas. Reg. § 1.704-2 are met. Treas. Reg. § 1.704-2(e)(2) generally requires that nonrecourse deductions be allocated in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liability.
deductions would be allocated equally between A and B, in violation of the fundamental principles of section 704(b).

g. **Example 24**

i. Assume the same facts as in Example 22, except that A guarantees only the bottom $500,000 of the $800,000 nonrecourse debt. Under the terms of the guarantee, A is required to pay only if the creditor receives less than $500,000 in proceeds after pursuing foreclosure or other appropriate creditor remedies.

ii. Under the current section 752 regulations, the $800,000 liability is bifurcated and treated as a $300,000 nonrecourse liability and a $500,000 recourse liability for which A bears the economic risk of loss.\(^{45}\) Under the section 704(b) regulations, the $100,000 of depreciation deductions in each of years 3, 4 and 5 are nonrecourse deductions and may be allocated equally to A and B.\(^{46}\) However, additional depreciation deductions in year 6 and thereafter that reduce the basis of the property below the $500,000 guaranteed portion of the liability are partner nonrecourse deductions and must be allocated solely to A.\(^{47}\)

iii. This result is consistent with the stated fundamental principles of section 704(b). If there were an economic burden corresponding to the $100,000 of year 6 depreciation deductions, the property would decline in value from $500,000 to $400,000. If the property were sold for $400,000, the proceeds would be insufficient to repay the $800,000 debt, and A would be required to pay $100,000 under the bottom guarantee.

iv. Thus, as a result of the guarantee, A would bear the economic burden corresponding to the $100,000 of depreciation deductions in year 6, and only A may be allocated those deductions.

h. **Example 25**

\(^{45}\) See Treas. Reg. § 1.752-1(i); and Treas. Reg. § 1.752-2.

\(^{46}\) See Treas. Reg. § 1.704-2(d)(ii); and Treas. Reg. § 1.704-2(m), Example 1(vii).

\(^{47}\) Id.
The facts are the same as in Example 24, except that the proposed regulations apply. A's bottom guarantee does not meet the requirements of prop. reg. section 1.752-2(b)(3)(ii)(F) and thus is not recognized. Because A does not bear the economic risk of loss for the debt under the proposed regulations, the debt is not a partner nonrecourse debt within the meaning of Treas. Reg. § 1.704-2(b)(4), but a nonrecourse liability within the meaning of Treas. Reg. § 1.704-2(b)(3). Further, the year 6 depreciation deductions are not partner nonrecourse deductions, but nonrecourse deductions within the meaning of Treas. Reg. § 1.704-2(c). As a result, the year 6 depreciation deductions may be allocated equally between A and B. Indeed, under these facts, it is unlikely that the year 6 depreciation deductions could be allocated any other way. 48

Even though the proposed regulations do not treat A as bearing the economic risk of loss for the portion of the liability subject to the bottom guarantee, the economic reality is the same as in Example 11: If there were an economic burden corresponding to the $100,000 of year 6 depreciation deductions, the property would decline in value to $400,000. And if the property were then sold for $400,000, the proceeds would be insufficient to repay the $800,000 debt, and A would be required to pay $100,000 under the bottom guarantee. Thus, as a result of the bottom guarantee, A would bear the economic burden corresponding to the $100,000 of depreciation deductions in year 6. Nevertheless, the depreciation deductions would be allocated equally between A and B.

Thus, the proposed regulations would allow or even require allocations that violate the fundamental principles of section 704(b). Moreover, they would allow or even require the very abuse that the section 704(b) regulations are intended to preclude—namely, allocations of tax losses to a partner that will not bear any corresponding economic burden. As a result, the proposed regulations will encourage abusive trafficking in noneconomic tax losses.

48 See supra note 43.
5. Net Value Requirement Extended

a. Under the current section 752 regulations, the determination of whether a partner or related party has an obligation to make a payment is based on the facts and circumstances at the time of the determination.\(^{49}\) With the exception of disregarded entities, the current regulations provide that all partners and related persons that have payment obligations for a partnership liability are presumed to satisfy their obligations that become due and payable under the constructive liquidation test irrespective of their actual net worth unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.\(^{50}\) This presumption limits the extent to which a partnership is required to evaluate a partner’s current or future ability to satisfy a payment obligation in determining how liabilities should be allocated, except in potentially abusive circumstances.

b. Notwithstanding that presumption, the current regulations contain an antiabuse rule under which a partner’s or related person’s obligation to make a payment may be disregarded or treated as an obligation of another person for purposes of section 752. The antiabuse rule may apply if the facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner’s economic risk of loss for that obligation, or create the appearance of a partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise.\(^{51}\) Treas. Reg. § 1.752-2(j) contains an example of a plan to circumvent or avoid an obligation, involving a thinly capitalized corporate partner that is a member of a consolidated return group and enters into a DRO to allow the group to enjoy tax losses while at the same time limiting its monetary exposure for those losses. The example concludes that the rules of section 752 must be applied as if the DRO did not exist.

c. As noted above, Treas. Reg. § 1.752-2(k) does impose a net worth requirement for a payment obligation of a disregarded entity.\(^{52}\) The regulations generally provide that such an obligation is taken

\(^{49}\) Treas. Reg. § 1.752-2(b)(3).
\(^{50}\) Treas. Reg. § 1.752-2(b)(6).
\(^{51}\) Treas. Reg. § 1.752-2(j).
\(^{52}\) Treas. Reg. § 1.752-2(k).
into account only to the extent of the net value of the disregarded entity, which is measured on specified dates. Because the existence of a legal entity that is disregarded as separate from its owner limits the owner's liability for state law purposes, this rule is consistent with the underlying premise of the section 752 regulations that a taxpayer should be treated as bearing the economic risk of loss for a partnership liability to the extent that it could be required to make a payment in the event that the partnership's assets become worthless.

d. The proposed regulations expand the Treas. Reg. § 1.752-2(k) net value requirement to apply to any partner, other than an individual or decedent's estate, that enters into an obligation for a partnership liability (other than a trade payable). Accordingly, to the extent that an obligation is taken into account after the application of the recognition requirements described above, the allocation of a partnership liability on account of the obligation entered into by the partner or related person will be limited to that obligor's net value. Also, the proposed regulations require that an obligor subject to the net value requirement timely give the partnership information about the obligor's net value that is appropriately allocable to the partnership's liabilities.

e. We believe it is unnecessary to expand the net value requirement to every regarded entity obligor. A regarded business entity that enters into a payment obligation for a partnership liability is fully exposed to the extent of the entity's assets. Treasury and the Service have not suggested that they are aware of taxpayers circumventing the current rules by structuring limited value entities that enter into payment obligations. In the only litigated case we know of involving a guarantee by an entity with limited value, the Service successfully argued that the guarantee should be disregarded under the existing antiabuse rule of Treas. Reg. § 1.752-2(j).\(^{53}\) The expansion of that rule and the resulting information sharing and collection requirements will significantly increase the administrative burden on partners and partnerships in circumstances in which the requirements are unnecessary. Moreover, the extent of the information that must be provided to the partnership to establish an obligor's net value that is allocable to a partnership liability is unclear. Is a third-party appraisal required? Is an internal valuation sufficient? Will it suffice to

\(^{53}\) *Canal Corp. v. Commissioner*, 135 T.C. 199 (2010).
simply provide a statement to the partnership that the obligor has net worth that is at least equal to its payment obligation?

f. The preamble to the proposed regulations states that Treasury and the Service decided not to extend the net worth requirement to individuals because of the nature of personal guarantees. Presumably, they were concerned that extending the net worth requirement to individuals would be burdensome and intrusive. We agree with that conclusion. We would note, however, that although individuals will not need to provide financial information to their partnerships under the net value requirement, they are subject to all the recognition requirements of Prop. Treas. Reg. § 1.752-2(b)(3) discussed above. Accordingly, individuals will need to provide financial information to lenders or their partnerships, or be subject to restrictions on dispositions of assets, in circumstances in which the lender or partnership may not have otherwise required the delivery of such information. Further, if a regarded business entity owned by an individual enters into an obligation for a partnership liability that is supported by a capital contribution obligation of the individual, the entity may be required to deliver financial information about the individual owner of the entity in order to prove its net value that is allocable to the partnership liability.

6. Effective Date and Transition Rule

a. The changes to the partnership recourse liability rules will apply prospectively for liabilities incurred or assumed by a partnership, and for payment obligations imposed or undertaken, on or after the date the final regulations are published – with the exception of liabilities incurred or assumed and payment obligations imposed or undertaken pursuant to a written binding contract. Thus, in general, it appears that the proposed regulations would apply to any liability incurred after the effective date, even if that liability refinances a pre-effective-date liability that was subject to a guarantee.

b. It is unclear how the prospective effective date would apply to a guarantee or other payment obligation for a term of years entered into before the date the final regulations are published that contains

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54 Preamble to REG-119305-11, at 21.
an elective or automatic extension, subject to the right to terminate
the obligation with sufficient notice and satisfaction of specified
terms. Arguably, if those provisions are in a written binding
contract, an extended payment obligation should continue to be
subject to the existing section 752 regulations. Accordingly,
although the precise scope of this rule is unclear, it may allow
some existing guarantees for a term of years that may be extended
under debt maintenance agreements to be grandfathered if they are
not altered after the date the final regulations are published.
However, if a guarantee is amended on or after that date, the
guarantee would likely be treated as a new obligation subject to the
new section 752 regulations. The application of the effective date
rules is explored in the following examples.

c. Example 26

i. Before the effective date of the proposed regulations, a
partnership enters into a nonrecourse loan from Bank X
with a 10-year term. To maintain A's allocable share of the
liability to avoid gain recognition as a result of a deemed
distribution under section 752(b) in excess of A's basis in
the partnership interest, A enters into a full guarantee of the
liability.

ii. A's guarantee provides that it has an initial term of three
years and is thereafter automatically extended for
successive one-year terms unless A provides six-months
prior written notice to Bank X, and the partnership satisfies
specified financial requirements. Assume the proposed
regulations become effective on the second anniversary of
the partnership incurring the Bank X debt. Presumably,
A's guarantee would be grandfathered for the balance of
the initial term because the liability was incurred, and A's
payment obligation was imposed or undertaken, pursuant to
a written binding contract entered into before the date the
proposed regulations became effective.

iii. Would the automatic one-year extensions of A's guarantee
also be grandfathered? Arguably, they should be because
they were imposed or undertaken pursuant to a written
binding contract entered into before the effective date of
the proposed regulations.

d. Example 27

i. The facts are the same as in Example 26, except that the
partnership and A also enter into a debt maintenance
agreement that obligates the partnership to maintain a specified level of debt that must be guaranteed by A for a 10-year period. A’s guarantee of the Bank X liability is for the full 10-year term. Assume the proposed regulations become effective on the second anniversary of the partnership incurring the Bank X liability. On the third anniversary, the partnership refinances the Bank X liability with a loan from Bank Y. Under the debt maintenance agreement, A is required to enter into a guarantee of the Bank Y liability.

ii. Is A’s guarantee of the Bank Y liability grandfathered under the current section 752 regulations because both the Bank Y liability and the guarantee were undertaken pursuant to the debt maintenance agreement, which is a written binding contract entered into before the date the proposed regulations became effective?

e. Example 28

i. The facts are the same as in Example 27, except that A has the right, but not the obligation, to guarantee the partnership’s debt for a 10-year period under the debt maintenance agreement. If A enters into a guarantee of the Bank Y liability one year after the proposed regulations become effective, is A grandfathered under the existing section 752 regulations because the guarantee was undertaken pursuant to a written binding contract entered into before the date the proposed regulations became effective?

f. To ease their potential effect when they become effective, the proposed regulations provide for a seven-year transition period. During that period, if a partner (the transition partner) has a share of recourse liabilities under existing Treas. Reg. § 1.752-2(b), the partnership may choose not to apply the new partnership recourse debt allocation rules to an amount of partnership liabilities equal to the excess of the transition partner’s share of recourse liabilities over its adjusted basis in the partnership interest. The amount of partnership liabilities to which the transition rule applies is reduced to the extent that the built-in gain attributable to the transition partner’s negative tax basis capital account is recognized. Further, if the transition partner is a partnership, S corporation, or disregarded entity, a 50 percent or greater change in ownership of the transition partner will terminate the transition period. Because the seven-year transition rule applies only if elected by the partnership, partners that have entered into or will enter into
guarantees and similar obligations for partnership liabilities should take steps now to require that the partnership make that election if the proposed regulations become effective, and the partner so requests. As illustrated in Example 16, some taxpayers may find that the seven-year transition period is not long enough.

g. Example 28

i. Before the effective date of the proposed regulations, A contributed property to a partnership subject to debt in excess of basis. To obtain an enhanced share of partnership liabilities and avoid gain recognition as a result of a deemed distribution under section 752(b) in excess of A’s basis in the partnership interest, A enters into a guarantee or DRO. The partnership and A also enter into a lockout agreement that generally provides that the partnership will not sell the contributed property (which would trigger A’s gain under section 704(c)) for a specified period. Also, to further protect A’s tax deferral, the lockout agreement contains debt maintenance provisions that obligate the partnership during the same period to maintain a specified level of debt that may be guaranteed by A.

ii. As discussed above, it is unclear whether that arrangement would be grandfathered under the binding contract exception of Prop. Treas. Reg. § 1.752-2(l)(1). If the specified period extends beyond the seven-year transition period, A will be denied the benefit of its bargain because of a change in the regulations that is not truly prospective only. We are familiar with many real-world cases in which the specified period exceeds seven years, including those in which A is an individual, and the period ends only on A’s death (at which time the tax liability is absolved by virtue of the step-up in basis at death).

h. Other taxpayers may find that the seven-year transition rule is inadequate because it limits relief to an amount equal to the excess of the taxpayer’s share of recourse liabilities over basis in the partnership interest immediately before the proposed regulations become effective.

i. Example 29

i. The facts are the same as in Example 28, except that the contributed property is depreciable, and A enters into the guarantee not because A needs an enhanced share of the liabilities at the time of contribution, but because A
anticipates needing an enhanced share in the future. This often occurs with contributions of depreciable property subject to nonrecourse debt because of the phenomenon known as “section 704(c) burn-off.” Section 704(c) burn-off refers to the fact that the amount of section 704(c) gain on depreciable property contributed to a partnership declines annually as depreciation deductions are claimed.  

ii. As discussed above, as the section 704(c) gain declines annually, so does the amount of nonrecourse debt allocated to the contributing partner under the second tier of Treas. Reg. § 1-752-3(a)(2).

iii. In the context of the seven-year transition rule, the point is that if A has a sufficient share of nonrecourse liabilities to avoid gain recognition immediately before the effective date of the proposed regulations but, nevertheless, has guaranteed debt to prevent gain recognition in the future from an anticipated reduction of nonrecourse liabilities, seven-year transition relief will be unavailable for the guaranteed liability.  

j. Still other taxpayers may find that the rule terminating seven-year transition relief when there is a change in ownership to a transition partner that is a partnership causes them to lose relief as a result of events they cannot control.

k. Example 30

i. A is a 49 percent partner, and B is a 51 percent partner, in an upper-tier partnership (UTP). UTP is a 30 percent partner in a lower-tier partnership (LTP). To maintain an enhanced share of LTP liabilities, UTP has entered into a guarantee of specified LTP liabilities. Further, A and B

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57 To illustrate, immediately before the effective date of the proposed regulations, A might have a negative $100 tax basis capital account, $100 share of nonrecourse liabilities, and $20 share of recourse liabilities on account of a guarantee entered into to prevent future gain recognition, as A’s section 704(c) gain burns off and A’s share of nonrecourse liabilities declines. A’s tax basis in the interest would be $20, and the seven-year transition rule would be inapplicable because A’s $20 share of recourse liabilities does not exceed the basis in its interest. Relief might be available initially under the general effective date rule of Prop. Treas. Reg. § 1.752-2(l)(1) but would be lost if the debt subject to the guarantee were refinanced.
have entered into a capital contribution obligation requiring that if UTP must pay on its guarantee, A will contribute 49 percent, and B will contribute 51 percent of the required funds to UTP. B sells its interest to C, which also assumes B’s capital contribution obligation.

ii. Under Prop. Treas. Reg. § 1.752-2(l)(B)(ii), A loses the benefit of the seven-year transition rule and recognizes gain on account of a deemed distribution under section 752(b) that exceeds the basis in A’s interest. Thus, A loses the benefit of the seven-year transition rule even though its payment obligation is unchanged, there is no change in the partnership liability, and it has no control over B’s sale. The policy justification for this seems particularly opaque, even under a set of proposed regulations whose policy justification is obscure at best.

E. NONRECURSWE LIABILITIES – CURRENT RULES

1. As discussed above, a partnership liability is a nonrecourse liability if no partner or related person bears the economic risk of loss for that liability. Under Treas. Reg. § 1.752-3(a), a partner’s share of partnership nonrecourse liabilities equals the sum of three tiers of allocations. First, a partner is allocated an amount of a partnership’s nonrecourse liabilities equal to the amount of that partner’s share of partnership minimum gain determined under section 704(b). The partnership minimum gain is generally the excess of the amount of a nonrecourse liability over the section 704(b) book value of the property securing the liability.

2. Second, a partner is allocated an amount of a partnership’s nonrecourse liabilities equal to 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) if partnership property is revalued), if the partnership disposed of all partnership property subject to nonrecourse liabilities for no

58 Even if the arrangement might otherwise be grandfathered under the general effective date rule of Prop. Treas. Reg. § 1.752-2(l)(1), it appears that that status would be lost as a result of the technical termination of UTP that would occur under section 708(b)(1)(B). New UTP would not have incurred any liability or payment obligation prior to the effective date. The relief for technical terminations provided by the general effective date rule of Prop. Treas. Reg. § 1.752-2(l)(2)(B) applies only for purposes of the seven-year transition rule.

59 Treas. Reg. § 1.752-3(a)(1).
consideration other than full satisfaction of the liabilities. The second tier amount is often referred to as “section 704(c) minimum gain.”

3. Finally, a partner’s share of the amount of nonrecourse liabilities that is not allocated to partners under the first or second tiers (excess nonrecourse liabilities) is determined in accordance with the partner’s share of partnership profits. The partner’s interest in partnership profits is determined by taking into account all facts and circumstances regarding the partners’ economic arrangement.

4. The current regulations provide that the partnership agreement may specify the partner’s interest in partnership profits for purposes of allocating excess nonrecourse liabilities so long as the specified interest is reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some significant item of partnership income or gain (significant item method). Alternatively, the current regulations provide that excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated (alternative method). Also, the partnership may first allocate excess nonrecourse liabilities to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property or property for which reverse section 704(c) allocations are applicable by virtue of a book-up (as described in Treas. Reg. § 1.704-3(a)(6)(i)) where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the amount of gain taken into account under the second tier for that property (excess section 704(c) method).

F. PROPOSED NONRECOURSE LIABILITY REGULATIONS

1. While the proposed regulations retain the excess section 704(c) method for allocating excess nonrecourse liabilities, the significant item and alternative methods would both be eliminated. Instead, the proposed regulations would allow a partnership to allocate excess nonrecourse liabilities based on the partners’ liquidation value percentages. A partner’s liquidation value percentage is the ratio (expressed as a percentage) of the liquidation value of the partner’s interest in the

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60 Treas. Reg. § 1.752-3(a)(2).
61 Treas. Reg. § 1.752-3(a)(3).
62 Id.
partnership to the aggregate liquidation value of all the partners' interests in the partnership. A partner's liquidation value percentage must be determined upon formation of the partnership and is required to be redetermined whenever a revaluation event occurs, as set forth in Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5) (such as a disproportionate capital contribution or distribution), regardless of whether the partnership revalues its assets. The liquidation value of a partner's interest in a partnership is the amount of cash the partner would receive with respect to the interest if, immediately after the formation of the partnership or the occurrence of a section 704(b) revaluation event, the partnership sold all its assets for a cash amount equal to the fair market value of those assets (taking into account section 7701(g)); satisfied all its liabilities (other than those described in Treas. Reg. § 1.752-7); paid an unrelated third party to assume all of its Treas. Reg. § 1.752-7 liabilities in a fully taxable transaction; and then liquidated. A partner's liquidation value percentage is thus equal to the partner's interest in partnership capital.

2. Like the proposed regulations on partnership recourse liabilities, the proposed changes to the partnership nonrecourse liability regulations would apply to liabilities incurred or assumed by a partnership on or after the date the proposed regulations are published as final regulations.

G. NONRECOURSE LIABILITIES - COMMENTARY

1. The preamble states that the Service and Treasury believe that the significant item and alternative methods may not properly reflect a partner's share of partnership profits that are generally used to repay nonrecourse liabilities because the allocation of the significant item may not necessarily reflect the overall economic arrangement of the partners. If the interest in partnership profits is to be the touchstone for allocating nonrecourse liabilities (as it has been since 1956), it seems that allocating partnership nonrecourse liabilities in accordance with the partners' liquidation value percentages fails to reflect that approach. Except for a simple partnership in which each partner's share of profits and losses corresponds to that partner's percentage share of capital contributions, the partners' liquidation value percentages will not correspond to their share of profits or losses. Consequently, valid allocations of losses to partners under the section 704(b) regulations may be subject to the section 704(d) basis limitation, as shown in Example 19.

64 Id. The liquidation value used to determine a partner's liquidation value percentage is similar to that for the determination of the liquidation value of a profits interest partner under Rev. Proc. 93-27, 1993-2 C.B. 343.

2. **Example 31**

   a. A and B each make $1,000 capital contributions to AB Partnership, and each has a 50 percent share of AB Partnership's profits, losses and distributions. AB Partnership borrows $9,000 from Bank on a nonrecourse basis and acquires property with a value of $11,000. Following the formation of the AB Partnership and at a time when the value of the partnership's property is still $11,000, C is admitted to the AB Partnership for a profits interest in exchange for services provided by C to or for the benefit of the AB Partnership. The profits interest complies with the safe harbor in Rev. Proc. 93-27. The AB Partnership agreement is amended to provide that operating distributions will be made first to A and B until they have received an 8 percent cumulative compounded return on each of their unreturned capital contributions, and thereafter 33 percent to each of A, B, and C. Distributions from capital events will be made first to A and B pro rata until their unreturned capital contributions are reduced to zero; second to A and B until they have received an 8 percent cumulative compounded return on each of their unreturned capital contributions; and thereafter 33 percent to each of A, B, and C. Upon liquidation of the AB Partnership, distributions to the partners are to be made in accordance with partners' positive capital accounts. C enters into a DRO so it may be allocated a 33 percent share of losses in accordance with the section 704(b) regulations.

   b. Taking into account A's and B's right to a preferred return on their unreturned capital contributions, it is unclear what C's share of the AB Partnership's profits is when allocating the partnership's nonrecourse liabilities under Treas. Reg. § 1.752-3(a)(3) according to the general facts and circumstances test. Under the existing regulations, the AB Partnership could apply the significant item method and allocate 33 percent of the $9,000 liability to C based on the residual distribution of the AB Partnership's profits in accordance with the partners' percentage interests, which would increase C's basis to $3,000 under section 752(a). As a result, C would be able to deduct losses allocated to it under the section 704(b) regulations and would not be prohibited from deducting those losses under section 704(d). However, in applying the

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liquidation value percentage method in the proposed regulations, because C’s liquidation value percentage would be zero, C would not be allocated any of the $9,000 liability. Accordingly, under the liquidation value percentage safe harbor, until a revaluation event occurs, and C’s liquidation value percentage is recomputed, C would be unable to deduct any losses validly allocated to it under the section 704(b) regulations because it would be subject to the section 704(d) basis limitation.

3. Similarly, partnership nonrecourse deductions may be validly allocated among partners in a manner that is inconsistent with the partners’ liquidation value percentages under section 704(b). The inability to allocate nonrecourse debt under the alternative method will result in unnecessary shifts in the allocation of nonrecourse debt among partners. This is because the nonrecourse debt allocated under Treas. Reg. § 1.752-3(a)(3) in accordance with the partners’ liquidation value percentages becomes subject to Treas. Reg. § 1.752-3(a)(1) and is allocated in accordance with the partners’ shares of partnership minimum gain. Among other things, that shift in a partner’s share of nonrecourse debt may have adverse consequences under section 751(b). 68

4. The proposed regulations also would impose an additional burden on partnerships: They must revalue their assets to determine the partners’ liquidation value percentages even if the partnership would not otherwise elect to revalue its assets.

5. Fundamentally, the proposed regulations would limit flexibility in the allocation of excess nonrecourse liabilities based on an unpersuasive rationale. The current section 752 regulations intentionally allocate or allow for the allocation of partnership nonrecourse debt to partners to prevent the recognition of built-in gain by partners and allow them to recognize losses allocated under section 704(b). 69 The statement in the


69 The current regulations generally ensure that upon a contribution of property to a partnership, the contributing partner is allocated an amount of nonrecourse debt under Treas. Reg. § 1.752-3(a)(2) that is at least equal to the amount of nonrecourse debt in excess of the partner’s tax basis in the contributed property. After their initial issuance, the regulations were amended to further minimize the likelihood of a deemed distribution under section 752(b) in excess of a partner’s basis in a partnership. The regulations were modified in 2000 to give a partnership the flexibility to allocate debt secured by multiple properties among those properties in a manner that maximizes the allocation of that nonrecourse debt back to the contributing partner. See T.D. 8906. Also, as noted above, the regulations were amended to allow a partnership to allocate excess nonrecourse debt under the excess section 704(c) method to the extent of any section 704(c) gain unaccounted for under Treas. Reg. § 1.752-3(a)(2). Id.
preamble that the Service and Treasury believe that the significant item and alternative methods "may not properly reflect a partner’s share of partnership profits" seems particularly unconvincing given that the liquidation value percentage safe harbor in the proposed regulations does not reflect the partner’s interest in profits at all, but reflects the partner’s interest in capital.

6. One of the primary motivations for changing the way in which partnership excess nonrecourse liabilities are allocated under Prop. Treas. Reg. § 1.752-3(a)(3) may have been to limit the ability to structure a leveraged partnership transaction with nonrecourse debt when the significant item method is used to allocate the entire amount allocable under that section to the distributee-partner in accordance with a preferred return allocation. The Service has attacked that structure in LTR 200436001 and ILM 200513022. If the goal was to prevent that structure, it could be achieved by simply changing the manner in which the allocation of partnership nonrecourse debt is taken into account for purposes of the debt-financed distribution exception to the disguised sale rules. That approach was already taken to exclude allocations of partnership debt under Treas. Reg. § 1.752-3(a)(1) or (2) or the excess section 704(c) method from being taken into account for purposes of the debt-financed distribution exception. The approach would specifically target the Service’s and Treasury’s concerns while preserving the intended flexibility in the allocation of partnership nonrecourse debt.

H. CONCLUSION

1. If finalized, the amendments to the partnership debt allocation rules in the proposed regulations would be among the most significant changes in partnership tax law in more than 20 years. In many cases, they would result in the recognition of taxable gain by partners or limit partners’ ability to take losses into account as a result of a reduction in their allocable share of partnership liabilities.

2. In contrast to the existing regulations on the allocation of partnership recourse liabilities, which are largely mechanical and administrable, the proposed regulations would impose unclear, subjective, and in some cases, noncommercial requirements on payment obligations commonly entered into by partners in order for those obligations to be taken into account under section 752. The proposed regulations are inconsistent with both Congress’s directive as stated in the legislative history of DEFRA and the structure and policy of the section 704(b) regulations. Moreover, the

proposed regulations on nonrecourse liabilities unnecessarily limit the intended flexibility of the current regulations.

3. The American Law Institute, in its 1984 detailed analysis and proposals concerning subchapter K, noted that “once it is decided to apply relatively strict rules to profit-and-loss allocations . . . there seem to be no important policies served by a strict rule for allocating liabilities among partners in computing their basis for their partnership interests. This is particularly true when there appears to be more than one justifiable allocation with no single one being clearly correct.” The section 704(b) regulations provide strict rules for allocating profits and losses, and the proposed regulations serve no important policy apart from their indirect attack on leveraged partnerships.

4. We suggest that the proposed regulations under section 752 be withdrawn. If the Service and Treasury believe changes to the partnership debt allocation rules are necessary to target specific concerns with partnership disguised sale structures, the agencies should propose changes in the section 707 regulations rather than imposing an unworkable regime on every partnership and partnership liability.

71 ALI report, supra note 5, at 270.