

**Please Sir, May I Have Some More...Liabilities:
An Analysis of the Partnership Nonrecourse Debt Allocation Rules**

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The dictionary definition of the word “liability” is “the state of being responsible for something, especially by law.” While people generally shirk responsibility, a partner in a partnership may desperately *want* to be allocated partnership liabilities. Since a partner’s tax basis in his partnership interest includes his share of the partnership’s liabilities, an allocation of liabilities to a partner may (i) enable the partner to avoid recognizing gain from a distribution (or deemed distribution) from the partnership and/or (ii) enable the partner to be allowed a deduction for his share of any losses of the partnership.¹ An allocation of partnership *nonrecourse* liabilities can enable a partner to get the benefit of an increased basis in his partnership interest without bearing any personal responsibility for the debt.

The rules that govern the allocation of partnership nonrecourse liabilities are relatively brief, but an almost endless number of questions arise in applying them. This article provides a background of the basic rules for allocating partnership nonrecourse liabilities, and then considers selected issues and planning opportunities.

BACKGROUND

Overview: Impact of Partnership Liability Allocation

Under section 752 of the Internal Revenue Code (the “Code”), any increase in a partner's share of the liabilities of a partnership is treated as a contribution of money by the partner to the partnership, and any decrease in a partner's share of the liabilities of a partnership is treated as a

distribution of money to the partner by the partnership.² Similarly, an assumption by a partner of liabilities of a partnership is treated as a contribution of money by the partner to the partnership, and an assumption by a partnership of liabilities of a partner is treated as a distribution of money to the partner by the partnership.³

The implications of a deemed contribution of money to, and a deemed distribution of money from, a partnership are provided by sections 722 and 731, respectively. If a partner is considered to contribute money to a partnership under section 752, the partner's basis in his partnership interest is increased by the amount of the contribution.⁴ If a partnership is considered to distribute money to a partner under section 752, the distribution will generally reduce the partner's basis in his partnership interest—and the partner would recognize gain to the extent of any excess of the amount of money deemed to be distributed over the partner's tax basis in his partnership interest.⁵ Thus, the deemed *contribution* that results from an allocation of liabilities by a partnership to a partner can enable the partner to avoid recognizing gain from a deemed *distribution* that results from an assumption of a liability by the partnership from the partner.

The inclusion of a partner's share of partnership liabilities in the tax basis of his partnership interest can also be important with respect to his ability to deduct his share of any losses of the partnership. Under section 704(d), a partner's distributive share of partnership losses is allowed only to the extent of the partner's tax basis in his partnership interest at the end of the partnership year in which the loss occurred.

The following example illustrates the basic application of the rules involving the role of liabilities in determining a partner's basis in his partnership interest.

EXAMPLE 1

Partner X contributes a property with a \$10,000 value and a \$4,000 tax basis to a partnership, subject to \$6,000 of mortgage debt that was incurred in connection with the partner's acquisition of the property.

The tax basis that Partner X receives in his partnership interest would be equal to the following: (i) the \$4,000 tax basis in the contributed property, (ii) *minus* the \$6,000 deemed distribution to Partner X upon the partnership's assumption of the liability from Partner X, and (iii) *plus* the amount of the partnership's liabilities that are allocated to Partner X (from both the debt assumed from Partner X and any other liabilities of the partnership). Thus, in order for Partner X to avoid recognizing gain under section 731 from a deemed distribution in excess of basis, he would need to be allocated at least \$2,000 of partnership liabilities (i.e., an amount equal to the excess of (i) the \$6,000 debt assumed by the partnership over (ii) the \$4,000 tax basis in the contributed property).

Where a new partner contributes property to a partnership subject to debt, the tax basis in the property (\$4,000 in this example) *minus* the debt assumed by the partnership (\$6,000 in this example) generally equals what is commonly referred to as the partner's "tax basis capital account" or amount of "tax capital" (negative \$2,000 in this example). The partner generally must be allocated an amount of partnership liabilities equal to at least his negative tax capital account in order to avoid recognizing gain from a deemed distribution in excess of basis. As described below, the partner at first should generally be allocated at least this amount of liabilities, but a subsequent reduction in the partner's debt share may cause a deemed distribution in excess of basis.⁶

Definition of Recourse and Nonrecourse Partnership Liabilities

The Treasury Regulations provide one set of rules for allocating "recourse liabilities" for purposes of section 752 and another set of rules for allocating "nonrecourse liabilities" for purposes of section 752. Under section 752, a "recourse liability" is a partnership liability to the extent that any

partner or related person “bears the economic risk of loss” under Reg. § 1.752-2.⁷ A “nonrecourse liability” is a partnership liability to the extent that no partner or related person “bears the economic risk of loss” under Reg. § 1.752-2.⁸

In general, a partner is considered to bear the economic risk of loss for a partnership liability to the extent that, under a constructive liquidation scenario (described below), the partner or related person (i) would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and (ii) would not be entitled to reimbursement from another partner or person that is a related person to another partner.⁹ The constructive liquidation scenario assumes that the partnership’s liabilities become payable in full, the partnership’s assets (including cash) have a value of zero, and the partnership disposes of all of its property in a taxable transaction for no consideration and liquidates. Under the Treasury Regulations currently in effect, the net worth of a partner (or related person) that has a payment obligation with respect to a liability of the partnership generally has no impact on the extent to which the partner is considered to bear the economic risk of loss from the liability.¹⁰ There is an exception under which a payment obligation of a disregarded entity is taken into account only to the extent of the net value of the disregarded entity.¹¹

Basic Rules for Allocation of Partnership Liabilities

The following is an overview of the basic rules set forth in the Treasury Regulations which provide for how recourse and nonrecourse partnership liabilities are allocated. The remainder of this article will address the allocation of partnership nonrecourse liabilities in greater depth.

Reg. § 1.752-2(a) provides that a partner’s share of a recourse liability of a partnership generally equals the portion of that liability, if any, for which the partner or a related person bears the economic risk of loss.

Reg. § 1.752-3(a) provides that a partner's share of the nonrecourse liabilities of a partnership is equal to the sum of the following (commonly referred to as the three "tiers"):

1. The amount of the partner's share of "partnership minimum gain" under section 704(b) and the regulations thereunder.¹² (This category for allocating partnership nonrecourse liabilities is commonly referred to as the "First Tier.")
2. The amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration.¹³ (This category for allocating partnership nonrecourse liabilities is commonly referred to as the "Second Tier.")
3. A partner's share of the "excess nonrecourse liabilities" of a partnership (i.e., nonrecourse liabilities which are not allocated under the First Tier or Second Tier) is determined as described below. (This category for allocating partnership nonrecourse liabilities is commonly referred to as the "Third Tier.") Excess nonrecourse liabilities are not required to be allocated under the same method each year.¹⁴
 - a. In general, a partner's share of the excess nonrecourse liabilities of a partnership is equal to the partner's share of the partnership's profits (taking into account all facts and circumstances relating to the economic arrangement of the partners).¹⁵
 - b. The partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities—provided the interests so specified are "reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain."¹⁶
 - c. 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.¹⁷
 - d. The partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property (or property for which reverse section 704(c) allocations are applicable) where "such property is subject to the nonrecourse liability"—to the extent that this built-in gain exceeds the amount of gain described in the Second Tier.¹⁸ To the extent that a partnership uses this additional method and the entire amount of the excess nonrecourse liability is not allocated to the contributing partner, the partnership must allocate the remaining amount

of the excess nonrecourse liability under one of the methods described above.¹⁹

FIRST TIER NONRECOURSE LIABILITIES

For the “First Tier” of nonrecourse liability allocation, a partnership allocates to each partner an amount of nonrecourse liabilities of the partnership equal to the partner’s share of any “partnership minimum gain.”²⁰ Under Reg. § 1.704-2(d)(1), a partnership’s total amount of partnership minimum gain is determined by computing for each partnership nonrecourse liability the amount of gain (if any) the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains. If partnership property has a book value under section 704(b) that differs from its adjusted tax basis, the determination of partnership minimum gain is made with reference to the property’s 704(b) book value.²¹ In general, a partner’s share of partnership minimum gain is equal to the sum of (i) nonrecourse deductions allocated to the partner (or his predecessors in interest) up to that time and (ii) the distributions made to the partner (or his predecessors in interest) up to that time of proceeds of a nonrecourse liability allocable to an increase in partnership minimum gain.²²

At the time of the initial contribution of property to a partnership subject to a nonrecourse liability, no portion of the liability will generally be allocated under the First Tier (since the property’s book value will be equal to its fair market value).²³ Eventually, book depreciation may cause the property’s book value to be less than the amount of the nonrecourse liability. At that time, there would be partnership minimum gain with respect to the nonrecourse liability, since the partnership would have book gain if it were to sell the property for an amount equal to the nonrecourse debt. Each partner would be allocated an amount of the nonrecourse liabilities of the partnership under the First Tier equal to his share of the partnership minimum gain.²⁴

SECOND TIER NONRECOURSE LIABILITIES

For the “Second Tier” of nonrecourse liability allocation, a partnership allocates to each partner nonrecourse liabilities of an amount equal to the taxable gain that would be allocated to the partner under section 704(c) if the partnership disposed of (in a taxable transaction referred to herein as the “Hypothetical Sale”) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration.²⁵ The amount of liabilities allocated to each partner under the Second Tier also includes the taxable gain that would be allocated to the partner with respect to “reverse 704(c) gain” (i.e., gain that is allocated in the same manner as section 704(c) in connection with a revaluation of partnership property) upon the Hypothetical Sale.²⁶

Allocation of Second Tier Liabilities upon Contribution of a Property

The amount of gain that would be allocated to a contributor partner under section 704(c) from the Hypothetical Sale depends on which method the partnership uses for making 704(c) allocations with respect to the property. Therefore, the amount of liabilities that will be allocated to a partner under the Second Tier also depends on which 704(c) method is used. Revenue Ruling 95-41²⁷ considered how Second Tier liabilities are allocated under the “traditional method,” the “traditional method with curative allocations,” and the “remedial method” for making 704(c) allocations. The Revenue Ruling considered the following example.

EXAMPLE 2

Partner A and Partner B form a partnership, PRS, and agree that each will be allocated a 50% share of all partnership items. Partner A contributes depreciable property subject to a nonrecourse liability of \$6,000, with a fair market value of \$10,000 and a tax basis of \$4,000. Partner B contributes \$4,000 of cash.

Upon the initial contribution, there would be no partnership minimum gain and, therefore, no liabilities would be allocated under the First Tier.²⁸

The allocation of Second Tier liabilities of the partnership is based on the allocation of taxable gain under section 704(c) upon the Hypothetical Sale where the property is sold for an amount equal to the \$6,000 liability. Upon a sale of the property for \$6,000, PRS would have \$2,000 of taxable gain (i.e., the excess of the \$6,000 amount realized on the sale over the \$4,000 tax basis in the property). PRS would have a \$4,000 book loss upon the sale (i.e., the excess of the \$10,000 book value of the property over the \$6,000 amount realized on the sale).

If PRS uses the traditional method, the amount of taxable gain that would be allocated to Partner A under section 704(c) upon the Hypothetical Sale for \$6,000 would be equal to the \$2,000 of total taxable gain that PRS would recognize. Therefore, PRS would allocate \$2,000 of nonrecourse liabilities to Partner A under the Second Tier if it uses the traditional method.

There would be a \$2,000 “ceiling rule” amount under the traditional method upon the Hypothetical Sale, since Partner B would have a \$2,000 share of the book loss of PRS, but there would be no tax loss from the sale to allocate to Partner B. If PRS were to use the remedial method, it would make a \$2,000 remedial allocation of a tax loss to Partner B and an offsetting \$2,000 remedial allocation of a tax gain to Partner A. The total tax gain allocated to Partner A under section 704(c) with the remedial method would be \$4,000 (i.e., the sum of PRS’s \$2,000 of “actual” tax gain and its \$2,000 remedial allocation of tax gain). Therefore, Revenue Ruling 95-41 provides that if PRS uses the remedial method, it would allocate \$4,000 of the nonrecourse liability to Partner A under the Second Tier.

If PRS uses the traditional method with curative allocations, it would make curative allocations upon the Hypothetical Sale to reduce or eliminate the \$2,000 ceiling rule amount to the extent possible. For example, PRS could specially allocate to Partner B extra tax depreciation from another property, or PRS could specially allocate to Partner A extra income from another property. If PRS had sufficient tax items in order to make the full \$2,000 of curative allocations, then Partner A would be

allocated \$4,000 of net taxable income under section 704(c) upon the Hypothetical Sale (i.e., the sum of PRS's \$2,000 of tax gain from sale of the property and the \$2,000 of extra income or reduced deductions allocated to Partner A as a curative allocation). However, as Revenue Ruling 95-41 explains, "PRS's ability to make curative allocations would depend on the existence of other partnership items and could not be determined solely from the hypothetical sale of the contributed property." Therefore, the Revenue Ruling concludes, curative allocations may not be taken into account for purposes of determining Second Tier debt allocations, and only \$2,000 of liabilities are allocated to Partner A under the Second Tier (i.e., the same amount as under the traditional method).²⁹

Impact of Repayment or Refinancing on Second Tier Debt

In the example considered by Revenue Ruling 95-41 (described above), Partner A is allocated an amount of Second Tier liabilities equal to at least his \$2,000 negative tax capital account under any of the 704(c) methods (and therefore he will not recognize any gain from a deemed distribution in excess of basis). In general, a partner that contributes property to a partnership subject to a nonrecourse debt will be allocated an amount of Second Tier liabilities at least equal to his negative tax capital account upon the initial contribution.³⁰ However, that result will only continue to be the case if the contributed property continues to be subject to the liability. Suppose, for example, that the partnership repays the debt on the contributed property immediately after the contribution. If so, then no Second Tier liabilities would be allocated to the partner, and he may recognize gain from a deemed distribution in excess of basis (depending on his share of any Third Tier liabilities of the partnership).³¹

The following example will be used to consider scenarios where debt on a contributed property is repaid with proceeds from other debt.

EXAMPLE 3

Partner C contributes to a new partnership land ("Property #1") with a value of \$20,000, subject to a \$10,000 nonrecourse liability ("Liability #1"), with a tax basis of \$2,000.

Partner D contributes \$90,000 of cash, which the partnership uses to buy land (“Property #2”) with a value of \$105,000, subject to a \$15,000 nonrecourse liability (“Liability #2”).

The partnership agreement provides that (i) all partnership items are shared 10% by Partner C and 90% by Partner D and (ii) the partnership will use the traditional method under section 704(c).

Figure 1 shows the partnership’s initial balance sheet.

| FIGURE 1 | | | |
|------------------------------|----------------|----------------|---------------------|
| Initial Balance Sheet | | | |
| | Book | Tax | Book-Tax Difference |
| Property #1 | 20,000 | 2,000 | 18,000 |
| Property #2 | 105,000 | 105,000 | - |
| | <u>125,000</u> | <u>107,000</u> | <u>18,000</u> |
| | | | |
| Liability #1 | 10,000 | 10,000 | - |
| Liability #2 | 15,000 | 15,000 | - |
| | | | |
| Capital | | | |
| - Partner C | 10,000 | (8,000) | 18,000 |
| - Partner D | 90,000 | 90,000 | - |
| | <u>125,000</u> | <u>107,000</u> | <u>18,000</u> |
| | | | |

Upon the initial contribution by Partner C of Property #1 to the partnership, \$8,000 of Liability #1 would be allocated to Partner C under the Second Tier, equal to Partner C’s \$8,000 of 704(c) gain from the Hypothetical Sale (i.e., the excess of the \$10,000 amount realized upon the Hypothetical Sale over the \$2,000 tax basis in Property #1).³² The debt allocated to Partner C under the Second Tier would be equal to his \$8,000 of negative tax capital (i.e., the \$2,000 tax basis in the property contributed by Partner C minus the \$10,000 of debt assumed by the partnership from Partner C).

Suppose that the partnership subsequently (i) refinances Liability #2 with a new \$25,000 liability (secured by only Property #2) and (ii) uses the \$10,000 of excess refinancing proceeds to repay

the entire \$10,000 amount of Liability #1. Although the partnership will continue to have the same \$25,000 of total nonrecourse liabilities outstanding, no Second Tier liabilities will now be allocated to Partner C since the property contributed by Partner C is no longer subject to any debt. If the partnership allocates 10% of its Third Tier liabilities to Partner C based on his 10% share of profits, Partner C would be allocated \$2,500 of liabilities under the Third Tier (i.e., 10% of the \$25,000 of nonrecourse debt, all of which would be allocated under the Third Tier). Assuming that Partner C still has the same \$8,000 of negative tax capital at that time, he would recognize \$5,500 of gain from a deemed distribution in excess of basis (i.e., an amount equal to the excess of his \$8,000 of negative tax capital over his new \$2,500 debt share).

Alternatively, suppose that the partnership repays both Liability #1 and Liability #2 in full with the proceeds from a new \$25,000 nonrecourse liability that is secured by all of the assets of the partnership (“blanket debt”). For purposes of determining the Second Tier debt allocation, the partnership would need to allocate the blanket debt between its two properties under Reg. § 1.752-3(b)(1), which provides the following:

If a partnership holds multiple properties subject to a single nonrecourse liability, the partnership may allocate the liability among the multiple properties under any reasonable method. A method 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. The portion of the nonrecourse liability allocated to each item of partnership property is then treated as a separate loan [for purposes of determining the Second Tier debt allocation of the partners].³³

One simple method under Reg. § 1.752-3(b)(1) could be to allocate the blanket debt between the two properties based on their relative fair market values, in which case \$4,000 (16%) would be allocated to Property #1 and \$21,000 (84%) would be allocated to Property #2. Upon sale of Property #1 for an amount equal to the \$4,000 portion of the liability allocated thereto under this method, the partnership’s \$2,000 of tax gain (i.e., the excess of the \$4,000 amount realized over the \$2,000 tax basis in

Property #1) would be allocated to Partner C under section 704(c). Therefore, Partner C's share of the Second Tier liabilities would decrease from \$8,000 to \$2,000. Together with Partner C's \$2,300 share of the Third Tier liabilities (i.e., 10% of \$23,000), Partner C would be allocated a total of \$4,300 of the blanket debt. Partner C would recognize \$3,700 of gain from a deemed distribution in excess of basis (i.e., the excess of his \$8,000 of negative tax capital over his new \$4,300 debt share).

In PLR 200340024, the IRS considered a partnership that intended to use proceeds from unsecured debt to repay debt secured by properties contributed by partners with 704(c) built-in gain. The IRS ruled that, for purposes of Second Tier debt allocation, the unsecured debt could be allocated under Reg. § 1.752-3(b)(1) first to the properties that were acquired with or had their existing mortgage debt repaid by proceeds of the unsecured debt (to the extent of such proceeds), with any remaining portion allocated based on the fair market value of each property.³⁴ Under this approach, Property #1 would still be considered to be subject to the same \$10,000 of nonrecourse debt for purposes of Second Tier liability allocation. Therefore, Partner C would continue to be allocated the same \$8,000 of debt under the Second Tier and would have no gain from a deemed distribution in excess of basis.³⁵

Impact of 704(c) Burn-Off on Second Tier Liability Allocation

In addition to repayment of debt, another way in which a partner's Second Tier debt allocation may be reduced is through "burn off" of his 704(c) gain over time. Consider the following example:

EXAMPLE 4

Suppose that in Example 2 (where Partner A contributes depreciable property subject to a nonrecourse liability of \$6,000, with a fair market value of \$10,000 and a tax basis of \$4,000), this property has a 10-year recovery period, six years of which have elapsed at the time of the contribution to the partnership. Assume that the partnership uses the traditional method under section 704(c).

The property's \$10,000 book value and \$4,000 tax basis will each be depreciated over the four remaining years of the property's recovery period. The table that follows on the next page shows the tax basis and book value of the property with depreciation over time.

| <i>1. Number of Years Elapsed</i> | <i>2. Book Value</i> | <i>3. Tax Basis</i> | <i>4. Book-Tax Difference</i> |
|-----------------------------------|----------------------|---------------------|-------------------------------|
| 0 years (initial contribution) | \$10,000 | \$4,000 | \$6,000 |
| 1 years | \$7,500 | \$3,000 | \$4,500 |
| 2 years | \$5,000 | \$2,000 | \$3,000 |
| 3 years | \$2,500 | \$1,000 | \$1,500 |
| 4 years | \$0 | \$0 | \$0 |

Under the traditional method, the amount of gain allocated to Partner A under section 704(c) upon sale of the property cannot exceed the total book-tax difference with respect to the property at the time of the sale. After three years, if the property were sold for an amount equal to the \$6,000 liability upon the Hypothetical Sale, there would be \$5,000 of tax gain (i.e., the excess of the \$6,000 amount realized over the \$1,000 tax basis at that time). However, only \$1,500 of this gain would be allocated to Partner A under section 704(c) (i.e., an amount equal to the property's book-tax difference at that time). Thus, Partner A's Second Tier debt allocation would be reduced to \$1,500 after three years. After four years, when the property's book-tax difference is reduced to \$0, no portion of the liability would be allocated under the Second Tier. At that time, the entire \$6,000 liability would be allocated under the First Tier.³⁶

The 704(c) gain would burn off at the same rate under the traditional method with curative allocations as under the traditional method. Under the remedial method, however, the 704(c) gain would burn off ratably over the entire 10-year recovery period of the property (instead of over the four years

remaining on the recovery period). Thus, the remedial method can be used to slow the rate of burn-off of 704(c) gain and thereby delay a decrease in Second Tier debt allocation caused by burn-off of 704(c) gain.³⁷

Interaction Between the First Tier and Second Tier

Although Reg. § 1.752-3(a)(1) is commonly referred to as the “first tier” and Reg. § 1.752-3(a)(2) is commonly referred to as the “second tier,” the Regulations themselves do not provide an ordering mechanism for allocating debt between these two tiers.³⁸ However, the preamble in the Treasury Decision which enacted these Regulations in 1991 stated that “[t]he proposed and final regulations require that the nonrecourse liabilities of a partnership be allocated among the partners *first* to reflect the partners’ shares of any partnership minimum gain, *then* to reflect any gain that would be allocated to the partners under section 704(c), and *finally* in accordance with the partners’ interests in partnership profits.”³⁹ Even more explicitly, the background section in the preamble to the Treasury Decision that made certain modifications to Reg. § 1.752-3 in 2000 stated the following:

Treasury regulation § 1.752-3 currently provides a three-tiered system for allocating nonrecourse liabilities. The three-tiered system applies sequentially. Under the first tier, a partner is allocated an amount of the liability equal to that partner's share of partnership minimum gain under section 704(b). See § 1.704-2(g)(1). Under the second tier, to the extent the entire liability has not been allocated under the first tier, a partner will be allocated an amount of liability equal to the gain that partner would be allocated under section 704(c) if the partnership disposed of all partnership property subject to one or more nonrecourse liabilities in full satisfaction of the liabilities (section 704(c) minimum gain).⁴⁰

Thus, the Treasury Department seems to have intended for a nonrecourse liability to be allocated first under the First Tier and then under the Second Tier up the amount not allocated under the First Tier. However, in what may have been an oversight, the Regulations do not actually provide for this result, and they are silent as to whether a nonrecourse liability should first be allocated under Reg. § 1.752-3(a)(1) (i.e., the First Tier) or under Reg. § 1.752-3(a)(2) (i.e., the Second Tier).

This question is strictly academic in almost all cases, since the sum of the amounts described under the First Tier and Second Tier generally will not be greater than the total amount of a nonrecourse liability. If there is both partnership minimum gain and 704(c) gain with respect to a property, then (i) the First Tier debt allocation will generally be equal to the excess of the amount of the debt over the book value of the property and (ii) the Second Tier debt allocation will generally be equal to the excess of the book value of the property over its tax basis.⁴¹ For example, if a property is subject to a \$10,000 nonrecourse liability and has a book value of \$6,000 and a tax basis of \$2,000, (i) the amount allocated under the First Tier will generally be equal to the \$4,000 excess of the \$10,000 amount of the liability over the \$6,000 book value of the property and (ii) the amount allocated under the Second Tier will generally be equal to the \$4,000 excess of the \$6,000 book value over the \$2,000 tax basis.

However, consider the following example, where the sum of the amount described under the First Tier and the amount described under the Second Tier appears to be *less* than the total amount of a nonrecourse liability.

EXAMPLE 5⁴²

In Example 2 (above), Partner A and Partner B formed a partnership and agreed that each will be allocated a 50% share of all partnership items. Partner A contributed depreciable property subject to a nonrecourse liability of \$6,000, with a fair market value of \$10,000 and a tax basis of \$4,000. Partner B contributed \$4,000 of cash.

Assume that this partnership fully depreciates both the \$10,000 book value and the \$4,000 tax basis down to \$0 over time, while the amount of the debt remains equal to \$6,000. Assume that the partnership uses the traditional method with curative allocations made only upon sale of the property.⁴³

The partnership will have allocated its \$10,000 of book depreciation \$5,000 to Partner A and \$5,000 to Partner B, and it will have allocated its entire \$4,000 of tax depreciation to Partner B. The \$1,000 excess of Partner B's book depreciation over his tax depreciation represents the "ceiling rule"

amount which resulted from using the traditional method with respect to depreciation (since this partnership will make curative allocations only upon sale of the property).

If the partnership were to sell the property for an amount equal to the \$6,000 nonrecourse liability, it would have \$6,000 of book gain and \$6,000 of tax gain. The book gain would be allocated \$3,000 to Partner A and \$3,000 to Partner B (since all of the book depreciation deductions will have been split 50-50). The tax gain would be allocated \$4,000 to Partner A and \$2,000 to Partner B (with an extra \$1,000 of tax gain allocated to Partner A as a curative allocation under section 704(c) in order to eliminate the \$1,000 ceiling rule amount). Thus, the traditional method with curative allocations made only upon sale of the property has the effect of preserving \$1,000 of 704(c) gain that would have “burned off” under the traditional method and preventing the occurrence of a \$1,000 ceiling rule problem upon sale of the property.

Under Reg. § 1.752-3(a)(1), the partnership should allocate \$3,000 of debt to Partner A and \$3,000 of debt to Partner B based on their respective shares of the \$6,000 of partnership minimum gain.⁴⁴ Under Reg. § 1.752-3(a)(2), the partnership should allocate \$1,000 of debt to partner A since, although the book value of the property is equal to its tax basis, the partnership would make a \$1,000 curative allocation of gain to Partner A under section 704(c) upon sale of the property for an amount equal to the \$6,000 liability.⁴⁵ Thus, a literal application of Reg. § 1.752-3(a)(1) and § 1.752-3(a)(2) would seem to provide that \$6,000 of liabilities would be allocated under the First Tier and \$1,000 of liabilities would be allocated under the Second Tier. However, that would mean allocating \$7,000 of liabilities, when the total amount of liabilities is only \$6,000!

Based on the approach described in the preambles cited above, the entire \$6,000 debt would be allocated under the First Tier (50-50 to the partners), and there would be no remaining debt to allocate under the Second Tier. However, the overall approach of Reg. § 1.752-3 seems to be to allocate

nonrecourse liabilities in the manner in which tax gain will be shared when the liabilities are repaid, and disregarding the manner in which the 704(c) curative allocation would be made in the above example would cause the debt to be allocated in a different manner.⁴⁶ In addition, it is notable that the Treasury Department would not have been concerned about curative allocations when the section 752 final Regulations were released in 1991, since the traditional method with curative allocations under section 704(c) did not even appear as a proposed regulation under 1992. This fact may minimize the significance of the ordering language in the preamble to the 1991 Treasury Decision.⁴⁷

McKee Nelson suggests that a solution to this quandary is to allocate to each partner liabilities equal to the sum of (i) the partner's share of the partnership minimum gain and (ii) the gain *or loss* that would be allocated to the partner under section 704(c) in the Hypothetical Sale where the partnership sells the property for an amount equal to the liability.⁴⁸ Under this approach, the partnership would allocate \$4,000 of the liability to Partner A (i.e., his \$3,000 share of partnership minimum gain *plus* the \$1,000 of tax gain that would be allocated to him under section 704(c) upon the Hypothetical Sale as a result of the curative allocation). The partnership would allocate only \$2,000 of the liability to Partner B (i.e., his \$3,000 share of partnership minimum gain *minus* the \$1,000 reduction in his taxable gain under section 704(c) by means of the curative allocation).⁴⁹ As McKee Nelson acknowledges, this approach somewhat stretches the words of Reg. § 1.752-3(a)(2) in that it requires the reduction of a partner's nonrecourse debt allocation by the amount of a tax loss (or by the reduction in tax gain) that would be allocated to the partner under section 704(c). However, the advantage of this approach is that it causes the liabilities to be shared in the manner in which tax gain will ultimately be allocated upon satisfaction of the debt (i.e., it seems to get to the "right result"). While it would seem unlikely that the IRS would challenge a taxpayer that follows the language in the preambles and allocates nonrecourse debt

first under Reg. § 1.752-3(a)(1), query whether a partnership should be able to use the McKee Nelsen approach.⁵⁰

Second Tier Allocations Based on Negative Tax Capital Accounts

As described above, the amount of liabilities allocated to each partner under the Second Tier depends on how gain would be allocated under section 704(c) upon the Hypothetical Sale. While this sounds like a clear rule, determining how to allocate gain under section 704(c) may be less than clear in many situations. The analysis of the following example is intended to support the proposition that, where a partner has a negative tax capital account, any Second Tier debt may be allocated first to that partner up to the full amount of his negative tax capital account.

EXAMPLE 6

Partner F and Partner G each contributes \$10,000 to a new partnership, which borrows \$80,000 and uses its aggregate \$100,000 of cash to purchase depreciable property. The partnership agreement provides that each of Partner F and Partner G has a 50% share in all partnership items.

After a period of time, the property still has a value of \$100,000 and is subject to the same \$80,000 of debt, but the tax basis of the property has been depreciated down to \$0. At that time, Partner G makes an additional cash contribution of \$40,000, which the partnership uses to repay \$40,000 of the debt (leaving \$40,000 of debt outstanding). The partnership agreement is amended to provide that Partner F now has a 16.667% share in all partnership items (based on his 10,000 / 60,000 share of aggregate capital contributions) and Partner G now has an 83.333% share in all partnership items.

Immediately prior to the \$40,000 additional contribution by Partner G, each of Partner F and Partner G has a tax capital account (and a book capital account) of negative \$40,000 (i.e., \$10,000 of initial contribution, minus the partner's 50% share of the \$100,000 of depreciation deductions). See Figure 2, below.

When Partner G makes his \$40,000 additional contribution, the partnership would restate ("book up") the book value of the property from \$0 to its \$100,000 fair market value (and the partnership would correspondingly adjust the book capital accounts). This book-up results in \$100,000 of reverse

704(c) gain (i.e., the excess of the \$100,000 book value over the \$0 tax basis), which is shared 50-50 by Partner F and Partner G. See Figure 3, below.

| FIGURE 2 | | | | FIGURE 3 | | | |
|--|----------|----------|---------------------|---|---------|----------|---------------------|
| Balance Sheet Immediately <i>Before</i> Partner G's \$40,000 Additional Contribution | | | | Balance Sheet Immediately <i>After</i> Partner G's \$40,000 Additional Contribution | | | |
| | Book | Tax | Book-Tax Difference | | Book | Tax | Book-Tax Difference |
| Assets | - | - | - | Assets | 100,000 | - | 100,000 |
| Debt | 80,000 | 80,000 | - | Debt | 40,000 | 40,000 | - |
| Capital | | | | Capital | | | |
| - Partner F | (40,000) | (40,000) | - | - Partner F | 10,000 | (40,000) | 50,000 |
| - Partner G | (40,000) | (40,000) | - | - Partner G | 50,000 | - | 50,000 |
| | - | - | - | | 100,000 | - | 100,000 |

Under the Second Tier, each partner is allocated debt equal to the gain that would be allocated to the partner under section 704(c) upon the Hypothetical Sale where the partnership sells the property for an amount equal to the \$40,000 debt.⁵¹ Upon such a sale, the partnership would recognize \$40,000 of gain (i.e., the excess of its \$40,000 amount realized over the \$0 tax basis in the property), all of which would be allocated under section 704(c).⁵² Thus, the entire \$40,000 liability would be allocated to the partners under the Second Tier (and each partner's share of the liability would be equal to the portion of the \$40,000 of gain from the Hypothetical Sale that would be allocated to the partner).

One simple approach (referred to herein as the "Pro Rata 704(c) Approach") might be to allocate the \$40,000 of 704(c) gain from the Hypothetical Sale 50-50 to the two partners, based on the fact that they each have a 50% share of the \$100,000 of reverse 704(c) gain. If 704(c) gain upon the Hypothetical Sale were allocated in this manner, then each partner would be allocated \$20,000 of liabilities based on the amount of 704(c) gain that would be allocated to them upon the Hypothetical Sale.

This method of liability allocation would cause Partner F to recognize \$20,000 of gain from a deemed distribution in excess of basis (i.e., an amount equal to the excess of his \$40,000 negative tax capital account over his \$20,000 debt share at the time of repayment of \$40,000 of the debt).

However, one could question the Pro Rata 704(c) Approach based on the fact that, after using this method to allocate 704(c) gain from the Hypothetical Sale, (i) Partner F would still have a \$20,000 negative tax capital account⁵³ and (ii) Partner G would have a \$20,000 positive tax capital account.⁵⁴ In contrast, if the entire \$40,000 of gain from the Hypothetical Sale were allocated to Partner F based on his \$40,000 negative tax capital account, then each partner would have a tax capital account of \$0 after the allocation of 704(c) gain from the Hypothetical Sale. (This approach of allocating 704(c) gain from the Hypothetical Sale first to the partner with a negative tax capital account up to the amount of his negative tax capital account is referred to herein as the “Negative Tax Capital 704(c) Approach.”) The Negative Tax Capital 704(c) Approach appears to operate in a manner that is more consistent with the principles of Section 704(c), since it would “zero out” the capital accounts through the allocation of 704(c) gain upon the Hypothetical Sale—thereby fully resolving the book-tax difference.

Assuming that the Negative Tax Capital 704(c) Approach is at least an acceptable method for allocating 704(c) gain upon the Hypothetical Sale, then the partnership should be able to allocate its entire \$40,000 of liabilities to Partner F.⁵⁵ This would mean that Partner F would be allocated liabilities equal to his \$40,000 negative tax capital account, and he would not recognize any gain from a deemed distribution in excess of basis. Allocating the debt in this manner seems to be consistent with the general approach of the Treasury Regulations toward enabling the allocation of nonrecourse debt in a manner that defers gain recognition as long as the gain will ultimately be recognized when the debt is repaid. Generalizing the foregoing discussion, it appears that it should always be permissible for a partnership to

allocate Second Tier liabilities first to a partner with a negative tax capital account up to the amount of his negative tax capital account.⁵⁶

THIRD TIER NONRECOURSE LIABILITIES

Reg. § 1.752-3(a)(3) provides the rules for allocating excess nonrecourse liabilities (referred to herein as “ENR liabilities” or “Third Tier” liabilities), defined as liabilities which are not allocated under the First Tier or Second Tier. The general rule set forth by Reg. § 1.752-3(a)(3) (subject to certain exceptions described below) is that a partner’s share of the ENR liabilities of a partnership is “determined in accordance with the partner's share of partnership profits” taking into account all facts and circumstances relating to the economic arrangement of the partners.⁵⁷

In some very simple cases, it may be easy to determine a partner’s share of partnership profits. For example, suppose that two partners form a partnership and share all partnership items 50-50. In that case it is clear that each partner should be considered to have a 50% share of partnership profits. However, consider the arrangement in the following example:

EXAMPLE 7

Partner L contributes a property with a \$100,000 value subject to \$60,000 of debt to a newly formed partnership. Partner M contributes \$60,000 of cash to the partnership. The partnership agreement provides that distributions upon sale of the property or a refinancing are made as follows:

1. First, 100% to Partner M, until he has received a 10% IRR on his \$60,000 initial capital contribution.
2. Then, 100% to Partner L, until he has received a 5% IRR on his \$40,000 initial capital contribution.
3. Then, 40% to Partner L and 60% to Partner M, until Partner M has received a 14% IRR on his \$60,000 contribution.
4. Then, 50% to Partner L and 50% to Partner M, until Partner M has received an 18% IRR on his \$60,000 contribution.
5. Thereafter, 60% to Partner L and 40% to Partner M.

What are the partners' shares of the profits of the partnership taking into account the facts and circumstances? There does not appear to be a clear answer. Many tax practitioners would look to the back-end share of profits (i.e., 60% to Partner L and 40% to Partner M). However, one might question whether that makes sense in certain cases, such as a situation where the parties consider it to be unlikely that distributions will ever be made in that tranche.

Significant Item and Nonrecourse Deduction Third Tier Approaches

The following discussion addresses two approaches under Reg. § 1.752-3(a)(3) through which it may be possible to allocate 100% of the ENR liabilities to Partner L in Example 7. As described below, there are proposed regulations that would eliminate both of these methods of Third Tier liability allocation.

Significant Item Third Tier Approach

Perhaps recognizing that it may be unclear what a partner's share of partnership profits is, Reg. § 1.752-3(a)(3) provides that a partnership agreement may specify the partners' interests in partnership profits for purposes of allocating ENR liabilities provided that "the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain." (This method of allocating ENR liabilities is referred to herein as the "Significant Item Third Tier Approach.") In the above example, the partnership's profits would be allocated in a different manner in each tranche (e.g., in the first tranche 100% of profits are allocated to Partner M, in the second tranche 100% of profits are allocated to Partner L, etc.). It appears that each separate manner in which the profits are allocated would be considered to be allocations "of some other significant item of partnership income or gain."⁵⁸ Therefore, it would seem (for example) that the partnership should be able to allocate 100% of its ENR liabilities to Partner L under the Significant Item Third Tier Approach. This allocation of ENR liabilities

would be based on the fact that once Partner M has received a 10% IRR on his initial capital contribution, 100% of the next profits will be allocated to Partner L (until he has received a 5% IRR on his initial capital contribution).⁵⁹

In both TAM 200436011 and CCA 200513022, the IRS considered an arrangement where a partner was entitled to a preferred return and would be allocated 100% of the first profits of the partnership. In each case, the IRS concluded that the allocation of the first profits to one partner did not constitute a “significant item of partnership income or gain” under the Third Tier liability allocation regulations. In TAM 200436001, the IRS explained that the reference in Reg. § 1.752-3(a)(3) to “a significant item of partnership income or gain” looks to “a significant class of partnership income or gain,” such as “gain from the sale of property or tax exempt income,” rather than to a “tranche of bottom-line gross or net income.” In CCA 200513022, the IRS stated that “[t]o consider a single allocation of a preferred return, in isolation” as a significant item of partnership income or gain “does not encompass this concept of sharing in a significant economic item of partnership income or gain,” and that the allocation of the preferred return “did not reflect the overall economic relationship among the parties for that item of partnership gain.”

However, the reasoning of the CCA and the TAM appears to be in conflict with the Treasury Department’s own interpretation of similar language relating to the allocation of nonrecourse deductions.⁶⁰ Reg. § 1.704-2(e) provides that allocations of nonrecourse deductions are deemed to be made in accordance with the partners’ interests in the partnership only if certain requirements are satisfied. One of these requirements is that the partnership agreement provides for allocations of nonrecourse deductions 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 liabilities.”⁶¹ This reference to “allocations... of some other significant partnership item” in the

nonrecourse deduction regulations is very similar to the reference to “allocations...of some other significant item of partnership income or gain” in the Third Tier liability allocation regulations. One would expect that the term “significant item” should be understood in the same manner in each case.

Reg. § 1.704-2(m), Example 1(ii), considers the allocation of nonrecourse *deductions* in a scenario where two partners (LP and GP) form a partnership, to which LP contributes \$180,000 and GP contributes \$20,000. The partnership then obtains an \$800,000 nonrecourse loan and purchases a building for \$1,000,000. The partnership agreement allocates all items 90% to LP / 10% to GP until the point in time when cumulative losses are equal to cumulative income and gain, after which the partnership allocates all items 50% to LP / 50% to GP. Example 1(ii) provides that at the time the partnership agreement is entered into, “there is a reasonable likelihood that over the partnership’s life it will realize amounts of income and gain significantly in excess of amounts of loss and deduction (other than nonrecourse deductions).” Example 1(ii) concludes that the partnership’s nonrecourse deductions may be allocated in *any ratio* between (i) 90% to LP / 10% to GP and (ii) 50% to LP / 50% to GP.⁶²

Thus, Example 1(ii) does not require that a significant partnership item must reflect the overall economic relationship among the parties. It therefore appears that the IRS’s interpretation of “significant item of partnership income or gain” with respect to Third Tier liability allocation in TAM 200436011 and CCA 200513022 conflicts with the Treasury Department’s interpretation of the similar phrase in Example 1(ii) in Reg. § 1.704-2(m)—which seems to support the ability of the partnership in our Example 7 to allocate 100% of its Third Tier liabilities to Partner L under the Significant Item Third Tier Approach.⁶³

Nonrecourse Deduction Third Tier Approach

Reg. § 1.752-3(a)(3) provides that ENR 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.” (This method of allocating ENR liabilities is referred to herein as the “Nonrecourse Deduction Third Tier Approach.”) As noted above, a partnership agreement may provide for allocations of nonrecourse deductions 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 liabilities."⁶⁴

Under Reg. § 1.704-2(e), it appears that the partnership in Example 7 should be able to allocate 100% of its nonrecourse *deductions* to Partner L based on the following two separate allocations of significant partnership items:⁶⁵

1. 100% of the partnership’s first losses will be allocated to Partner L; and
2. 100% of the partnership’s profits will be allocated to Partner L (i) after Partner M has received a 10% IRR on his initial capital contribution and (ii) until Partner L has received a 5% IRR on his initial capital contribution.

If the partnership allocates 100% of its nonrecourse deductions to Partner L, it should also be able to allocate 100% of its ENR liabilities to Partner L under the Nonrecourse Deduction Third Tier Approach. Thus, the Nonrecourse Deduction Third Tier Approach may provide a second manner through which 100% of the ENR liabilities can be allocated to Partner L (provided that Partner M is willing to agree to have 100% of nonrecourse deductions allocated to Partner L).⁶⁶

An advantage of using the Nonrecourse Deduction Third Tier Approach to support the allocation of 100% of ENR liabilities to Partner L is that Example 1(ii) in Reg. § 1.704-2(m) seems to be *directly* on point in terms of supporting the allocation of 100% of nonrecourse deductions to partner L. If the allocation of 100% of nonrecourse deductions to Partner L is permissible, then the allocation of 100% of ENR liabilities to Partner L should definitely be permissible under the Nonrecourse Deduction Third Tier Approach. (In contrast, as described above, under the Significant Item Third Tier Approach,

Example 1(ii) in Reg. § 1.704-2(m) supports the allocation of 100% of ENR liabilities to Partner L only by *analogy* based on similar language.⁶⁷⁾

704(c) Third Tier Approach

Reg. § 1.752-3(a)(3) provides that a partnership may first allocate an ENR liability 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), where such property is subject to the nonrecourse liability. The amount of liabilities that may be allocated to the partner under this provision is equal to the excess of (i) the full amount of built-in gain allocable to the partner on the 704(c) property subject to the nonrecourse liability over (ii) the amount of the 704(c) gain that is taken into account for purposes of allocating liabilities under the Second Tier.⁶⁸ (This method of allocating Third Tier liabilities, which was added to the Regulations in 2000, is referred to herein as the “704(c) Third Tier Approach.”) To the extent that a partnership uses the 704(c) Third Tier Approach and the entire amount of an ENR liability is not allocated to the contributing partner(s), the partnership must allocate the remaining amount of the ENR liability under one of the other Third Tier methods.⁶⁹ The 704(c) Third Tier Approach cannot be used for purposes of determining a partner’s share of a partnership liability under the disguised sale rules.⁷⁰

Where built-in gain is allocable to more than one partner on section 704(c) property (or property for which reverse section 704(c) allocations are applicable) subject to a nonrecourse liability, the Regulations do not direct how the liability should be allocated between the partners under the 704(c) Third Tier Approach. (The Regulations just provide that a partnership may allocate an ENR liability to a partner up to the amount of built-in gain allocable to the partner on 704(c) property to the extent not taken into account under the Second Tier.) A simple approach would be to allocate the ENR liability first between the partners pro rata based on the total amount of their 704(c) gain on the property subject to the

liability (to the extent not taken into account under the Second Tier). However, the language used by Reg. § 1.752-3(a)(3) seems to open up the possibility of allocating an ENR liability in other ways under the 704(c) Third Tier Approach.⁷¹

Applying the 704(c) Third Tier Approach under Traditional Method with Curative Allocations

As noted above, Revenue Ruling 95-41 provides that curative allocations which would be made under the 704(c) traditional method with curative allocations are not taken into account for purposes of determining Second Tier liability allocation. The rationale given by the Revenue Ruling is that the partnership's ability to make curative allocations "would depend on the existence of other partnership items and could not be determined solely from the hypothetical sale of the contributed property." The 704(c) Third Tier Approach was not contained in the Regulations when the Revenue Ruling was released in 1995.

Unlike the Second Tier, the 704(c) Third Tier Approach does not consider a deemed sale, but rather looks to the total amount of built-in gain allocable to a partner on 704(c) property. Since curative allocations generally have no impact on the total amount of a partner's 704(c) gain, they generally would have no impact on the ENR liabilities allocated to a partner under the 704(c) Third Tier Approach. However, if the partnership uses the 704(c) traditional method with curative allocations made only upon sale of the property, there can be circumstances where a partner's entire 704(c) gain would have fully burned off but for the curative allocation that would be made upon sale of the property. It appears that such 704(c) gain should be taken into account under the 704(c) Third Tier Approach notwithstanding that it is based on curative allocations that would be made upon sale of the property since, unlike the Second Tier debt allocation, the amount of liabilities allocated under the 704(c) Third Tier Approach is not based on a deemed sale.

Repayment of Debt on a Contributed Property with Blanket Debt or Unsecured Debt

As described above, Reg. § 1.752-3(b) provides that if a partnership holds multiple properties subject to a single nonrecourse liability, the partnership may allocate the liability among the multiple properties under any reasonable method for purposes of Second Tier liability allocation. As also described above, the IRS has issued private letter rulings under which, where proceeds from unsecured debt are used to repay mortgage debt on properties, the unsecured debt could be allocated first to the properties that were acquired with or had their existing mortgage debt repaid by the unsecured debt.⁷²

For purposes of allocating ENR Liabilities under the 704(c) Third Tier Approach where a partnership repays debt on separate properties with proceeds from a single new liability, Example 3 in Reg. § 1.752-3(c) demonstrates that the new debt does not need to be allocated among the properties. Rather, the partnership can allocate to the 704(c) partner the full amount of the new debt up to the amount of the partner's 704(c) gain that was not taken into account under the Second Tier—if the new debt is secured by all of the properties (i.e., blanket debt) or recourse to all of the assets (i.e., unsecured debt).

Potential Impact of Proposed Regulations

The Treasury Department released proposed regulations in January 2014, which would eliminate both the Significant Item Third Tier Approach and the Nonrecourse Deduction Third Tier Approach. The preamble to these proposed regulations states that the IRS and the Treasury Department believe that an allocation of ENR liabilities in accordance with the Significant Item and Nonrecourse Deduction Third Tier Approaches “may not properly reflect a partner's share of partnership profits that are generally used to repay such liabilities because the allocation of the significant item may not necessarily reflect the overall economic arrangement of the partners.”⁷³

The preamble acknowledges that “[t]he IRS and the Treasury Department, however, are aware of the difficulty in determining a partner's interest in partnership profits in other than very simple partnerships and, therefore, recognize the need to have a bright-line measure of a partner's interest in

partnership profits.” In response to this concern, the proposed regulations would create a new method through which ENR liabilities may be allocated—based on “liquidation value percentages.” Under the proposed regulations, a partnership “may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are in accordance with the partners' liquidation value percentages.”⁷⁴ This would in effect create a safe harbor under which a partnership could allocate its ENR liabilities in accordance with the partners' liquidation value percentages (defined below). As the preamble explains, the IRS and the Treasury Department believe that, for purposes of allocating ENR liabilities, liquidation value percentages are “an appropriate proxy of a partner's interest in partnership profits, and one that can provide the needed certainty.”⁷⁵

The proposed regulations define “liquidation value percentage” for a partner as the ratio (determined at the times described below) of the “liquidation value of the partner's interest in the partnership” divided by the aggregate liquidation value of all of the partners' interests in the partnership. 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 the partnership sold all of its assets for cash equal to the fair market value of such assets, satisfied all of its liabilities, and then liquidated. In order to use the safe harbor of allocating ENR liabilities in accordance with liquidation value percentages, the liquidation value percentages of the partners must be determined immediately after the formation of the partnership and upon the occurrence of any of the “book-up” events described in Reg. § 1.704-1(b)(2)(iv)(f)(5) (whether or not the capital accounts are “booked-up”).⁷⁶

In terms of effective date, these provisions of the proposed regulations are proposed to apply to nonrecourse liabilities incurred or assumed by a partnership on or after the date the regulations are published as final regulations in the Federal Register. Thus, if a partnership owns property subject to a nonrecourse debt at the time when the proposed regulations are finalized, the proposed regulations

should have no impact on the partnership's allocation of the debt as long as the debt remains outstanding. However, if the debt were to be refinanced after the proposed regulations are finalized, then proposed regulations presumably would apply.⁷⁷

CONCLUSION

The nonrecourse liability allocation rules are brief, but the issues presented by them are plentiful. The stakes can be high, with these rules often driving the potential recognition of gain without cash. Putting in the effort to understand these rules, with all of their nuances, can be richly rewarding.

¹ See I.R.C. §§ 704(d); 731.

² I.R.C. § 752(a) - (b). Code section 752 and the regulations thereunder apply only to a "liability," defined as an obligation "if, when, 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." Treas. Reg. § 1.752-1(a)(4)(i). An obligation is defined as "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." Treas. Reg. § 1.752-1(a)(4)(ii). The terms "liability" and "debt" are used interchangeably in this article.

³ I.R.C. § 752(a) - (b).

⁴ I.R.C. § 722.

⁵ I.R.C. § 731(a)(1). Under certain circumstances, the contribution of property to a partnership subject to debt (or the distribution of property by a partnership to a partner subject to debt) may constitute a taxable "disguised sale" of property. For an analysis of the partnership disguised sale rules, see Dyckman, Ezra and Stahl, Daniel, "Uncovering Disguised Sales: An Analysis of the Partnership Disguised Sale Rules," Bloomberg BNA Tax Management Real Estate Journal Vol 28, No. 6, p. 135 (June 6, 2012).

⁶ If Partner X is allocated an amount of liabilities that is exactly equal to his \$2,000 negative tax capital account, the tax basis in his partnership interest would be \$0 and he would not be able to deduct his share of any losses of the partnership.

⁷ Treas. Reg. § 1.752-1(a)(1).

⁸ Treas. Reg. § 1.752-1(a)(2).

⁹ Treas. Reg. § 1.752-2(b)(1).

¹⁰ *Id.* There are proposed regulations which, if finalized in their current form, would radically change the circumstances under which a partner is considered to bear the economic risk of loss for a partnership liability. The impact that these proposed regulations, if finalized in their current form, would have on the determination of what constitutes a partnership recourse liability is beyond the scope of this article.

¹¹ See Treas. Reg. § 1.752-2(k).

¹² Treas. Reg. § 1.752-3(a)(1).

¹³ Treas. Reg. § 1.752-3(a)(2).

¹⁴ Treas. Reg. § 1.752-3(a)(3).

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.* This additional method does not apply for purposes of the disguised sale rules under Reg. § 1.707-5(a)(2)(ii).

¹⁹ *Id.*

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- ²⁰ Treas. Reg. § 1.752-3(a)(1).
- ²¹ Treas. Reg. § 1.704-2(d)(3). All references herein to “book value” refer to book value under section 704(b).
- ²² Treas. Reg. § 1.704-2(g)(1).
- ²³ A discussion of property contributed to a partnership subject to nonrecourse debt that exceeds the book value (i.e., fair market value) of the property is beyond the scope of this article.
- ²⁴ Example 5, below, considers the interaction between the First Tier and Second Tier.
- ²⁵ Treas. Reg. § 1.752-3(a)(2).
- ²⁶ The amount of taxable 704(c) gain or reverse 704(c) gain that would be allocated to a partner upon the Hypothetical Sale is often referred to as the partner’s “704(c) minimum gain.” The term “704(c) minimum gain” is not used in the Regulations or in the Treasury Decision for the original release of Reg. § 1.752-3 (T.D. 8380), but it is used in the preamble to T.D. 8906, which made certain modifications to Reg. § 1.752-3 in 2000.
- ²⁷ 1995-1 C.B. 132.
- ²⁸ Upon the initial contribution, the \$10,000 book value of the property is greater than the \$6,000 amount of the liability. Therefore, the partnership would have a book loss in a hypothetical transaction where the property is sold for the amount of the liability.
- ²⁹ The discussion below will address whether curative allocations should be taken into account under the Third Tier if excess nonrecourse liabilities are allocated to the partners first based on their share of 704(c) gain not taken into account under the Second Tier.
- ³⁰ The amount of Second Tier liabilities that are allocated to a partner upon the initial contribution of property to a partnership subject to nonrecourse debt is generally equal to the excess (if any) of (i) the amount of the debt over (ii) the tax basis in the property. Since the partner’s tax capital account is equal to the (i) the tax basis in the property minus the amount of the debt, the partner should generally be allocated an amount of liabilities under the Second Tier that is sufficient to “cover” his negative tax capital account.
- ³¹ If the partner contributed other property subject to debt which remains outstanding, he could continue to be allocated Second Tier debt on that property.
- ³² No portion of Liability #2 will be allocated under the Second Tier, since there would be no 704(c) gain upon sale of that property.
- ³³ In general, a partnership may not change its method of allocating a single nonrecourse liability between multiple properties for purposes of this rule. If one or more of the multiple properties subject to the liability is no longer 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).
- ³⁴ Under Treas. Reg. § 1.752-3(a)(2), a partner’s share of Second Tier debt is equal to the amount of taxable gain that would be allocated to the partner under section 704(c) if the partnership sold all partnership property “subject to” one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration. The IRS’s ruling in PLR 200340024 clarified that where a partnership has unsecured debt, its assets are considered to be “subject to” the unsecured debt for purposes of Second Tier debt allocation. Thus, the procedure set forth in Reg. § 1.752-3(b)(1) for allocating debt among multiple properties is applicable not only with respect to blanket debt, but also with respect to unsecured debt.
- ³⁵ Similar to PLR 200340024, the IRS ruled in PLR 200120020 that new unsecured debt of a partnership could be allocated among its properties “in any amounts determined by it; provided that the aggregate allocation of the [unsecured debt] to each property does not exceed the lesser of (a) the fair market value of the property, or (b) the amount of debt (previously allocated to the property) repaid with the proceeds of the [unsecured debt].” PLR 200120020 seems to go even further than PLR 200340024, in allowing the unsecured debt to be allocated in *any* manner provided that the partnership complies with these two restrictions.
- ³⁶ After four years in this example, when the property’s book value is reduced to \$0, there would be \$6,000 of partnership minimum gain (i.e., the excess of the \$6,000 amount of the liability over the \$0 book value of the property). Since, the partnership minimum gain would be shared 50-50 between the partners, they each would be allocated \$3,000 of liabilities under the First Tier at that time. Thus, the entire \$4,000 of second tier debt (that was all allocated to Partner A) has been “converted” into first tier debt (that is allocated 50-50).
- ³⁷ Example 5, below, considers how the debt in this example would be allocated after four years under the traditional method with curative allocations made only upon sale of the property. *See* Treas. Reg. § 1.704-3(c)(3)(iii)(B).
- ³⁸ As described above, Reg. § 1.752-3(a) provides that a partner’s share of the nonrecourse liabilities of a partnership includes both the partner’s share of partnership minimum gain and the amount of taxable gain that would be allocated to

the partner under section 704(c) upon the Hypothetical Sale. A partner's Third Tier debt allocation is the amount of nonrecourse liabilities that are not allocated under the First Tier or Second Tier.

39 T.D. 8380. (Emphasis added.) Example 3 of Reg. § 1.752-3(c) includes table headings that show the debt as being allocated under "Tier 1," "Tier 2," and "Tier 3." When viewed together the preamble, these table headings seem consistent with the proposition that the Treasury Department and IRS intended for debt to be allocated first to the First Tier. However, as noted above, the Regulations do not actually provide for this result.

40 T.D. 8906.

41 The amount of a nonrecourse liability that is allocated under the Second Tier is generally equal to the excess (if any) of (i) the lesser of (A) the book value of the property and (B) the amount of debt the property is subject to over (ii) the tax basis of the property.

42 This example is based on McKee Nelson's Example 8-11 in ¶ 8.03[3][a].

43 See Treas. Reg. § 1.704-3(c)(3)(iii)(B).

44 The amount of partnership minimum gain is equal to the \$6,000 of book gain that the partnership would have upon sale of the property for an amount equal to the \$6,000 debt.

45 Whereas the IRS provided in the example in Revenue Ruling 95-41 that curative allocations should not be taken into account for purposes of the Second Tier debt allocation, there is an important distinction between our case and the Revenue Ruling. The Revenue Ruling stated that curative allocations were not taken into account in determining Second Tier liability allocation since it was uncertain whether there would in fact be other partnership items in order to make the curative allocations upon the Hypothetical Sale. In contrast, in our case where the property has been fully depreciated down to \$0, there is a certainty that the partnership will be able to make sufficient curative allocations to fully address the ceiling rule problem by just using the gain from the sale of this property. Therefore, there does not seem to be any reason to ignore the curative allocation in our case. See McKee Nelson, ¶ 8.03[3][a].

46 See McKee Nelson ¶ 8.03[3][a] (explaining that allocating the entire debt under the First Tier in this example "has the unfortunate (from a policy standpoint) consequence of severing the connection between the allocation of nonrecourse liabilities and the manner in which gain will flow when the liability is settled").

47 As noted above, the background section in the preamble to T.D. 8906, which made certain modifications to Reg. § 1.752-3 in 2000, also included language which described nonrecourse liabilities as being first allocated under Reg. § 1.752-3(a)(1). Although this Treasury Decision was released *after* the traditional method with curative allocations had become an available 704(c) method, perhaps the Treasury Department was merely repeating its language from the earlier preamble without considering whether the tiered approach is still appropriate in all cases given the potential impact of 704(c) curative allocations.

48 See McKee Nelson, ¶ 8.03[3][a].

49 If this approach is permissible, then the traditional method with curative allocations made only upon sale of the property could be used in certain cases as an approach to prevent what would otherwise be a deemed distribution in excess of basis resulting from "burn-off" of 704(c) gain.

50 Alternatively, another theoretical way in which the liabilities in Example 5 might be allocated would be to (i) ignore the language in the preambles and choose to first allocate \$1,000 of debt to Partner A under the Second Tier based on the fact that the Regulations do not provide whether Reg. § 1.752-3(a)(1) or Reg. § 1.752-3(a)(2) comes first and then (ii) allocate the remaining \$5,000 of the debt 50-50 to the partners based on their 50-50 share of the partnership minimum gain. However, this approach is inconsistent with both (i) the approach described in the preambles and (ii) the "right result" where the liabilities are shared in the manner in which tax gain will ultimately be allocated upon satisfaction of the debt.

51 As a result of the book value of the property being adjusted to its \$100,000 fair market value, there would be no book gain upon sale of the property for an amount equal to the debt. Therefore, there would be no partnership minimum gain and no portion of the debt would be allocated under the First Tier. A book-up to fair market value can have the effect of converting First Tier debt into Second Tier debt.

52 The \$40,000 of gain upon the Hypothetical Sale is less than the \$100,000 of total reverse 704(c) gain after the book-up of the assets to fair market value.

53 The allocation of \$20,000 of 704(c) gain to Partner F would increase his tax capital account from negative \$40,000 to negative \$20,000.

54 The allocation of \$20,000 of 704(c) gain to Partner G would increase his tax capital account from \$0 to \$20,000.

55 The Regulations under section 704(c) mandate that a partnership must use "a reasonable method that is consistent with the purpose of section 704(c)."

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- ⁵⁶ Similarly, if more than one partner has a negative tax capital account, it appears that it should always be permissible for a partnership to allocate Second Tier liabilities first to the partners with negative tax capital accounts (in proportion to their respective negative tax capital accounts).
- ⁵⁷ In Revenue Ruling 95-41, the IRS provided that section 704(c) built-in gain that was not taken into account under the Second Tier is one factor (but not the only factor) to be considered under the Third Tier. The Revenue Ruling explains that “[t]he amount of the section 704(c) built-in gain that is not considered in making allocations under section 1.752-3(a)(2) must be given an appropriate weight in light of all other items of partnership profit.”
- ⁵⁸ The allocations of “some other significant item of partnership income or gain” need to have “substantial economic effect” in order to be the basis for allocating ENR liabilities under the Significant Item Third Tier Approach. One of the requirements for allocations of partnership items to have substantial economic effect is that, upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2). Since tax practitioners (and their clients) generally prefer to have liquidating distributions made based on the capital event waterfall in the operating agreement, it is common to (i) have allocations made based on a “target allocation provision” and (ii) have liquidating distributions made based on the capital event waterfall.
- Reg. § 1.704-1(b)(2)(ii)(i) has an “economic effect equivalence” provision under which “[a]llocations made to a partner that do not otherwise have economic effect under this paragraph (b)(2)(ii) shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if [the requirements for allocations to have economic effect are satisfied], regardless of the economic performance of the partnership.” Assuming that (i) a partnership will have significant gross items of income and deduction (e.g., rental income and depreciation expense) and (ii) the target allocation provision allocates gross items to the extent necessary, then the “economic effect equivalence” test should generally be satisfied. Therefore, the allocations in such a partnership should generally be considered to have substantial economic effect even if the operating agreement does not provide that liquidating distributions are required to be made in accordance with positive capital account balances.
- ⁵⁹ Similarly, it would appear that Partner L could also be allocated 60%, 50%, 40%, or 0%, of the ENR liabilities, based on the allocation of profits in the other tranches of the waterfall.
- ⁶⁰ Moreover, the arguments made by the CCA and the TAM may not even be entirely consistent with each other!
- ⁶¹ Treas. Reg. § 1.704-2(e)(2). The partnership agreement must provide for nonrecourse deductions to be made in this manner beginning in the first taxable year of the partnership that it has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain.
- ⁶² Example 1(ii) gives an allocation of nonrecourse deductions 75% to LP / 25% to GP as an example of a permissible allocation.
- ⁶³ It may be relevant whether it is anticipated that a material amount of profits will in fact be allocated to Partner L in the tranche where 100% of the profits would be allocated to Partner L. As noted above, Example 1(ii) provided that at the time the partnership agreement is entered into, “there is a reasonable likelihood that over the partnership’s life it will realize amounts of income and gain significantly in excess of amounts of loss and deduction (other than nonrecourse deductions).”
- ⁶⁴ *See* Treas. Reg. § 1.704-2(e) for other requirements which must be satisfied in order for allocations of nonrecourse deductions to be deemed to be in accordance with partners’ interests in the partnership (and therefore respected).
- ⁶⁵ One of the requirements that must be satisfied in order for a partnership’s allocation of nonrecourse deductions to be respected is that liquidating distributions be made in accordance with positive capital account balances. *See* Treas. Reg. § 1.704-2(e)(1). If an operating agreement uses a target allocation provision and has liquidating distributions made in accordance with the capital event waterfall, then the requirement that liquidating distributions be made in accordance with positive capital account balances technically may not be satisfied. However, if the allocations are deemed to have economic effect under the “economic effect equivalence” provision (see Footnote 59), then the individual requirements for allocations to have economic effect—including that liquidating distributions be made in accordance with positive capital account balances – should be considered to be satisfied.
- ⁶⁶ There will be no nonrecourse deductions until the book value of the property is reduced from its initial \$100,000 to below the \$60,000 amount of the debt.
- ⁶⁷ Another advantage of using the Nonrecourse Deduction Third Tier Approach may be that the allocation of 100% of the nonrecourse deductions to Partner L (which would be the basis for the allocation of ENR liabilities under this approach) can be based on treating the allocation of 100% of the first losses to Partner L as a significant item. There may be a stronger case for treating the allocation of 100% of the *first* losses to Partner L as a significant item, compared to treating

the allocation of 100% of the profits to Partner L in the *second* tranche of the waterfall as a significant item (which would be the basis for allocating 100% of the ENR liabilities to Partner L under the Significant Item Third Tier Approach).

In addition, it may be possible in certain cases to use the Nonrecourse Deduction Third Tier Approach to support allocations of ENR liabilities that clearly would not be permissible under the Significant Item Third Tier Approach. To illustrate, suppose that in Example 7, the second tranche of the waterfall is modified such that Partner L recovers his \$40,000 of capital contributions without any return thereon. Since Partner L would not be allocated 100% of the profits in any tranche of this modified waterfall, there would be no basis to allocate 100% of the ENR liabilities to Partner L under the Significant Item Third Tier Approach. However, the partnership should be able to allocate 100% of the nonrecourse deductions to Partner L based on the fact that Partner L bears the first losses of the partnership. The partnership could use the allocation of 100% of nonrecourse deductions to Partner L as a “back door” approach to enable it to allocate 100% of its ENR liabilities to Partner L under the Nonrecourse Deduction Third Tier Method.

⁶⁸ As noted above, Revenue Ruling 95-41 provides that a partner’s share of section 704(c) built-in gain not taken into account under the Second Tier is taken into account in determining the partner’s share of partnership profits for purposes of Third Tier debt allocation. The preamble to the Treasury Decision for the Regulations that created the 704(c) Third Tier Approach demonstrates that, if a partnership does not use the 704(c) Third Tier Approach, then a partner’s share of 704(c) gain should still be taken into account in determining the partner’s share of partnership profits. However, 704(c) gain for a partner that is taken into account under the 704(c) Third Tier Approach may not be taken into account for purposes of determining the partner’s share of partnership profits. *See* T.D. 8906.

⁶⁹ Treas. Reg. § 1.752-3(a)(3).

⁷⁰ *Id.*

⁷¹ Based on the language of Reg. § 1.752-3(a)(3), it appears that it may be permissible to allocate an ENR liability first 100% to only one of multiple partners with 704(c) gain on property of a partnership subject to an ENR liability, up to the full amount of that partner’s 704(c) gain not taken into account under the Second Tier. After that liability allocation under the 704(c) Third Tier Approach, it appears that it may then be permissible to allocate the remaining portion of the ENR liability under one of the other Third Tier methods, without allocating first to other partners with 704(c) gain on property subject to the ENR liability.

⁷² *See* PLRs 200340024, 200120020.

⁷³ Notably, the preamble does *not* state that the IRS and Treasury Department believe that, under the current regulations, allocations under the Significant Item and Nonrecourse Deduction Third Tier Approaches must reflect the overall economic arrangement of the partners in order to be respected. The omission of such a statement indicates that the proposed regulations should not restrict the ability of a partnership to take a position contrary to TAM 200436011 and CCA 200513022 – and may even be tacit support for the ability of a partnership to take such a position under the current regulations—unless or until the proposed regulations are made effective (see below).

⁷⁴ Prop. Treas. Reg. § 1.752-3(a)(3).

⁷⁵ The logic of using liquidation value percentages as a proxy for the partners’ interests in partnership profits may seem questionable. It is not uncommon for there not to be any connection between the partners’ shares of liquidation value and the partners’ interests in partnership profits. For example, consider a partnership where one partner contributes \$90,000 and another partner contributes \$10,000, and (i) the first \$100,000 of distributions are made pro rata 90-10 and then (ii) all subsequent distributions are made 50-50. All of the profits would be shared 50-50, but yet the liquidation value safe harbor would only guarantee the partnership the ability to allocate its ENR liabilities 90-10. The partnership in this simple example should still be able to allocate its ENR liabilities 50-50 based on the partners’ interests in partnership profits under the facts and circumstances. In other cases, though, it may be unclear what the partners’ interests in partnership profits are. Thus, the proposed regulations would remove the Significant Item and Nonrecourse Deduction Third Tier Approaches, while creating a new safe harbor that may have no relationship whatsoever to the partners’ interests in partnership profits.

⁷⁶ The “book-up” events described in Reg. § 1.704-1(b)(2)(iv)(f)(5) include the following: (i) a contribution of money or other property (other than a de minimis amount) to the partnership as consideration for an interest in the partnership, (ii) the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a partner as consideration for an interest in the partnership, (iii) the grant of an interest in the partnership (other than a de minimis interest) on or after May 6, 2004, as consideration for the provision of services to or for the benefit of the partnership, (iv) the issuance by the partnership of a noncompensatory option (other than an option for a de minimis partnership interest).

⁷⁷ Query whether liabilities of a partnership would be considered to be newly incurred for purposes of determining whether the proposed regulations apply upon a technical termination triggered by the sale or exchange of a 50% or more interest in the partnership after the proposed regulations are finalized.