REPORT #620

TAX SECTION

New York State Bar Association

REPORT ON ALLOCATION OF PARTNERSHIP DEBT REGULATIONS

July 5, 1989

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July 5, 1989

The Honorable Michael J, Murphy
Acting Commissioner of Internal
Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Murphy:

Enclosed is a Report on the Allocation of Partnership Debt Regulations by our Committee on Partnerships. The principal draftsmen of this Report are Stephen L. Millman, John P. Oswald and Steven C. Todrys.

The Report supports the central concept of the regulations, but advocates a simpler, less detailed style. Among the recommendations in the Report are that the regulations be revised to:

(1) set forth explicitly the applicable underlying principles, with the detailed rules of the present draft serving as presumptive tests of economic risk or lack thereof,

(2) make the related party debt rules fully prospective by also eliminating the immediate gain chargeback for previously allocated deductions funded by nonrecourse debt,

(3) add an anti-abuse provision to prevent the intent of the rules being circumvented by the use of worthless intermediary entities,

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(4) exclude from the "tantament to a guarantee” provision cases where payment by a partner or related party is conditioned on delivery by the partnership of actual goods or services on normal commercial terms, and

(5) provide expressly that deemed distributions resulting from the changes in the allocation of debt do not give rise to further consequences under Section 751.

The Report makes a number of other recommendations, including defining related party by using the rules of Code Sections 267(b) and 707 (b) (l) using a more than 50% ownership test (rather than an 80% test) applied to complex chains on a pass-through basis, making changes in the implementation of the present-value concept for delayed contribution obligations and guarantees, and adding a substantiality requirement to supplement the "economic effects" test in allocating deductions from "partner nonrecourse debt.*

Sincerely,

Wm. L. Burke
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Tax Report #620

July 5 , 1989

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Committee on Partnerships*

REPORT ON ALLOCATION OF PARTNERSHIP DEBT REGULATIONS

This report considers the proposed and temporary §752 regulations[1] relating to allocation of partnership debt. In addition, some aspects of the related temporary and proposed regulations regarding allocations of partnership income issued simultaneously are also discussed.[2]

I. Overview

The new §752 regulations were prompted by Congressional concern that the former S752 regulations often permitted partners to allocate debt to basis, and thus avoid the §704 (d) limitation on the use of partnership losses, in

* The principal draftsmen of this Report are Stephen L. Millman, John P. Oswald and Steven C. Todrys. Helpful coments were received from William Burke, Richard Cohen, Arthur A. Feder, Stuart Gross, Carolyn Ichel, Leslie Loffman, Sanford Preeant, Richard Reinhold, Robert Schachat, Donald Schapiro, Michael Schler, Donald Turlington and William Weigel.

[1] Temporary Regulations §§1.752-OT through 1. 752-4T, published December 29, 1988.

[2] Temporary Regulation §1.704-1T.

ways that did not reflect the true economic risks of the partners. The Claims Court decision in Raphan v.Commissioner focused attention on the allocation of partnership debt in the context of a limited partnership where a general partner had guaranteed a nonrecourse partnership debt purportedly not in his capacity as a partner.[3] Al though the Claims Court treated the debt as nonrecourse, Congress overruled the court and instructed Treasury to issue new regulations relating to the treatment of liabilities based on economic risk and specifically directing that loans made or guaranteed by partners or by persons related to partners be treated as recourse loans.

The new regulations provide specific rules for determining when a partner or a person related to a partner bears the economic risk of loss on a partnership debt, and for allocating the debt in the way the risk is shared. The regulations also provide new rules for allocating debt for which no partner has economic risk. The new regulations create a strong correlation between the allocation of debt and the allocation of deductions attributable to the debt. As a consequence, some amendments also had to be made to the §704 regulations on allocating partnership income.

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[3] Raphan v. Commissioner, 83-2 USTC 19613 (Cl. Ct. 1983), rev'd & 759 F.2d 879 (Fed. Cir. 1985).

II. Summary and Recommendations

The new regulations provide a good foundation for analyzing partnership debt. In light of the conceptual thrust of the regulations, this report focuses primarily on general issues that we believe might better be dealt with differently rather than considering smaller technical details. The report addresses the following major issues:

1. The regulations lack a general statement of basic principles even though a set of such principles appears to be consistently applied, The absence of an explicit statement of such principles adds unnecessary complexity for the reader and invites both abusive manipulation by the more aggressive and lack of clear guidance to those taxpayers trying to comply with the intention of the regulations. With an appropriate statement of the underlying principles of the Regulations, the detailed rules of the present draft could be retained as presumptive tests of economic risk or lack thereof.

2. The treatment of debt from a related party as debt for which a partner bears the economic risk permits nonrecourse treatment in a number of situations in which a person related to a partner clearly is bearing the economic risk of loss. We have proposed an expanded analysis to decide which persons are actually bearing the risk of loss for a partnership debt.

3. The regulations generally apply the related party rules prospectively only. However, the income allocation regulations appear to require, on the effective date of the regulations, the immediate chargeback of allocations of deductions that were properly treated as funded by nonrecourse debt at the time the allocation was made, but would now be treated as recourse debt because the lender is a person related to a partner. We have recommended that the effective date provision be clarified to prevent this result.

4. We are concerned about the use of third party obligations to give the appearance of economic risk. We recommend a rule permitting the Service to take into account all of the contractual arrangements of the parties (including persons who are not partners but who

otherwise have an economic interest in the transaction or the partnership) that are part of a deliberate plan so as to reflect the extent to which partners or persons related to partners actually expect to bear the economic risk that partnership assets will be worthless. Conversely, we feel that arrangements with partners and persons related to partners where payment is conditioned on the delivery by the partnership of actual goods or services on normal commercial terms should not be treated as equivalent to a guarantee.

5. The regulations make present-value concepts relevant in two circumstances--delayed contribution obligations and guarantees of partners debts. We have recommended some changes in the way the present-value concept is implemented in each case.

6. The rules for allocating "partner nonrecourse debt" under Reg. §1.704-1T correspond to the "economic effect" portion of the substantial economic effect test for recourse debt that is not further characterized as partner nonrecourse debt. We believe that restrictions similar to the substantiality requirement are also needed.

7. Because the new regulations tend to track economic risk very closely, there are a number of provisions that can cause the allocation of partnership debt to vary substantially from year to year without any change in the partnership agreement or loan documents. The reduction in a partner's share of debt will result in a deemed distribution to the partner under §752. We believe that such distributions are not meant to be governed by §751 and that an express statement to this effect should be included in the regulations.

In addition, the Report also recommends several technical changes to sections of the regulations.

Before parsing to the substance of the proposed regulations, a comment on the drafting approach of the regulations seems warranted. We believe that an approach that focused more on stating and illuminating the basic principles and less on detailed rules in particular cases could be

considerably briefer without sacrificing guidance unduly and is to be preferred. The detail of the regulations reflects a considerable expenditure of effort to provide effective guidance, and that effort should be acknowledged. These regulations, however, implement a statute that does not otherwise appear in the Code. They are, therefore, the only guidance on the subject and as such should be readily accessible to any conscientious tax practitioner. In the style of many recent regulations, the length, complexity and detail of the rules effectively require a tax adviser to have invested a long time in study to have confidence even in relatively common situations. While there may be some areas of the tax law where it is appropriate to assume that only persons who spend a large percentage of their time in the area will need to understand the rules, partnerships are not such a discrete area and the drafting approach of these regulations impose a heavier burden on the general body of tax practitioners than seems warranted.[4]

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[4] We challenge the estimate in the Paperwork Reduction Act Statement accompanying the proposal that "the estimated annual burden per respondent varies from three to eight minutes depending on individual circumstances" and the estimate of 5,000 "respondents". we do not see how a person to whom the regulations are relevant could possibly read them in this time frame. If the Paperwork Reduction Act Statement is meant to suggest that the relevant tax form instructions will contain a more abbreviated statement of guiding principles that can usefully guide a respondent, it argues strongly for adopting our recommendation that the regulations focus on a short and coherent statement of principles applicable to most situations.

III. Summary of the Regulations

In order to put the discussion of issues into context, the basic approach of the regulations is outlined below.

The fundamental test of the regulations for whether any partner has the risk of loss on a loan at any date, and the device for measuring that risk, is the constructive liquidation.[5] For this purpose, the partnership is deemed to be liquidated on the specified date. Almost all its assets (with a few special exceptions) are deemed to be worthless, Debt as to which the "creditor's recourse is limited to one or more assets of the partnership" is treated as satisfied for purposes of the partnership accounting

Once all the assets have been deemed worthless and sold or delivered to the lenders who have security interests in them in taxable exchanges, the fundamental question is what remaining obligations the partners have to the partnership, the other partners or the creditors. In effect, a partner can bear the economic risk of paying a loan in three different ways:

[5] Reg. §1.752 1T (d)(3)(iii).

1. A partner can have an obligation to make an additional contribution to the partnership a t the deemed liquidation and the funds so provided can be available to a creditor.

2. A partner can have a direct obligation to the creditor.

3. Finally, a partner can have a reimbursement obligation--he can be required to reimburse some other partner or the partnership for all or some part of what the other partners or the-partnership is required to pay to the creditor.[6]

There is another basis upon which a partner can bear the economic risk of a partnership debt. If the lender or any guarantor is a partner or is related to any partner, that partner is deemed to bear the economic risk for the part of the debt for which no other partner bears the risk of loss.[7]

There are also new rules for allocating nonrecourse debt--debt for which no partner has the risk of loss. Simplified some, they are:

1. To the extent that any partner has been allocated losses funded by the nonrecourse debt under the minimum gain chargeback provisions of Reg. §1.704-1, an amount of nonrecourse debt equal to the minimum gain must be allocated to the partner.

2. Then, an amount of debt equal to any §704(c) gain that would be taxable t o a partner if the property securing nonrecourse debt were sold for the amount of the debt must be allocated to that partner.

3. The rest of the debt can be allocated among the partners by agreement in any manner which is consistent with the way any substantial item of partnership income or gain is allocated.[8]

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6 Reg. §1.752-1T(d)(3).
7 Reg. §1.752-1T(d)(3)(iv).
8 Reg. §1.752-1T(e)

The principal change to the §704 allocations corresponds to the allocation of basis for debt which is not recourse insofar as the partnership is concerned but as to which some partner or a related party bears the risk of loss. This is called "partner nonrecourse debt" in the new §1.704-1T regulations. Any deductions attributable to such debt are allocable, based on minimum gain calculations, only to the partners who (or whose related parties) have the economic risk of the deductions.

Special rules are needed because the "substantial economic effect" test will not operate in this context. Substantial economic effect depends on how a partner's capital account and his rights on liquidation will be affected by the deductions. However, for a deduction funded by this kind of debt, any effect on capital accounts is temporary.

> Example. Partnership A purchases a building for $1,000,000 financed 100% by a borrowing from X. The loan is nonrecourse to the Partnership and is secured only by the building. Partner B, however, has guaranteed the entire balance of the loan.
>
> During the first year, there is $100,000 of depreciation on the building. At the end of the year, X forecloses on the property and the building is sold for $900,000. Partner B pays $100,000 to X in satisfaction of her guarantee

Although the partnership transferred the building in the foreclosure for no gain or loss, under SS7701 and 1001, it is deemed to have a $100,000 gain, which will exactly offset the $100,000 depreciation deduction.

The rule in the regulations for allocation of this type of deduction is adapted from the rule for nonrecourse debt. "Partner nonrecourse debt" has deductions attributable to it and a built-in minimum gain just like debt for which no partner bears the economic risk. However, the debt can in fact be paid by a partner, so the deductions attributable to partner nonrecourse debt and which increase the minimum gain are allocable only to partners who have the risk and only as their risk is increased (assuming the value of the property is its tax basis). In the example the minimum gain at the end of the first year is $100,000, so the entire $100,000 increase in minimum gain has to be allocated to the partner who guaranteed the loan, B. Conversely, as the minimum gain (and the corresponding risk to these partners outside the partnership) declines, these partners must be allocated income.

IV. General Principles For Determining Economic Risk

The regulations provide a series of detailed rules for determining economic risk of partners in a partnership.[9]

[9] Reg. §1.752-1T (d)(3).

There are also a series of special rules for cases not otherwise covered by the primary rule. In addition, there are two broader prophylactic restrictions. One treats a partner as not having economic risk if there is a "plan or circumstance" intended to prevent the partner from bearing economic risk on an obligation.[10] The other extends the concept of economic risk by treating an arrangement "tantamount to a guarantee" as a guarantee.[11]

Both of the prophylactic rules implicitly assume that the person interpreting the rule understands a concept of economic risk more general than the detailed rules in the regulations. Because the principal regulation rules are highly technical, they consider only a limited group of arrangements that shift economic risk. For an obligation to be recognized as conveying economic risk, it must fit into one of three narrowly-defined categories--an obligation to contribute to the partnership, an obligation to pay the creditor or an obligation to reimburse some other person who has made a payment in one of the three categories.

We believe that written general principles are needed. While the regulations' detailed rules can be made to work in most instances, there is enough ambiguity that certain

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[10] Reg. §1.752-1T(d) (3) (ii) (D) (3).

[11] Reg. §1.7S2-1T(d) (3) (iv).

interpretations will have to be formed by the interpreter's understanding of unstated premises.

We believe that the statement of principles should make several basic points. For this purpose, the initial inquiry should be into who actually would suffer if the assets of the partnership were worthless. The analysis should start by identifying all the "losers", whether they are partners, lenders or some other outsider. Once this is done, the economic risk would be borne by a partner for purposes of allocating debt to the extent that the partner or any person related to the partner bears the risk under this analysis.

This analysis, like the constructive liquidation rule, would start with the assumption that most partnership assets had become worthless and all partnership debts had become due. Unlike the constructive liquidation rule, however, the inquiry as to who suffers the loss on the debts should not be restricted to specific mechanisms, but should look to the reality of the situation. The "plan or circumstance to avoid liability" and the "tantamount to a guarantee" rules are attempts to apply this basic principle.

In making this analysis, as in the constructive liquidation analysis, it is generally necessary to assume that intermediate partners can be reached and have assets sufficient to meet their obligations, so as to call into play any

reimbursement obligations such a person may have. In some instances, however, it is appropriate to assume that an intermediate entity will not have sufficient assets to meet its obligations and thus can not be expected to satisfy a call for a reimbursement obligation. For an artificial entity such as a partnership or a corporation, the assumption that the entity has other assets from which to make a required payment does not make sense where substantially all the assets of the entity are dependent on the value of partnership assets.

> Example. Limited Partnership GL borrows $1,000,000 on a full recourse basis. L, a limited partner in Partnership GL indemnifies G, the sole general partners from any liability on the loan. (The lender is not notified of the indemnity.) G is a corporation with no assets.

It is not realistic to presume that L will be called upon to pay the indemnity because neither G nor its shareholders will suffer any loss if the debt is not paid at a time when the partnership interest is worthless. Indeed, other than in very limited circumstances, the general partner would have little or no incentive not to hold L to his indemnity since G would keep no part of any indemnity it might collect.

Thus, the presumption that the general partner will pay the debt and seek recourse against the limited partner does not appear to make sense. The general partner may therefore release L from his indemnity as things are deteriorating but before

any creditor's rights to enforce the indemnity vest.[12]

Even where the indemnity may not create any creditor's rights to enforce the general partner is not a shell, the real risk.

> _Example_. Limited Partnership GL borrows $1,000,000 on a full recourse basis. L, a limited partner in Partnership GL indemnifies G, the sole general partner from any liability on the loan. The partnership assets consist of a fractional interest in a producing oil well. G is a corporation worth $1,500,000. Its only asset other than its interest in the partnership, however, is the right to be paid $400,000 each year by the partnership for operating the well, which is treated as a S707 (a) payment.

In the disaster scenario, where all the partnership assets are worthless and the lender seeks to collect from G, the lender will be able to seize G's right to payments, In that event, G can sue L for the value of the property seized by the lender. It is unrealistic, however, to assume GIs right to receive payments from the partnership has any value when the partnership's assets are worthless. The regulations should make it clear that a legal right will be disregarded unless a person other than the partnership (or an entity having no significant assets other than interests in, or claims on, the partnership) has both the ability to enforce the right and a substantial economic interest in enforcing the right even in the disaster scenario.

[12] If the general partner and the indemnitor wait until the general partner is actually insolvent, a release of the indemnity may not be valid.

A corollary of this approach would be that an artificial entity whose assets are dependent on partnership assets for their value or which exists solely to be part of the transaction should not be treated as the "real loser."In the simplest case, if a group of lenders form a partnership to make a nonrecourse loan to another partnership, the lending partnership should not be viewed as the person bearing the risk of the loan. If the borrowing partnership is unable to pay the loan, the burden will fall immediately and directly on the partners of the lending partnership because the only asset of the lending partnership is the loan that is assumed to be worthless.

V. Related Parties

A. Tracking True Economic Risk

If a person related to a partner makes a loan to the partnership or guarantees partnership debt, the debt is treated as recourse to the partner related to the lender or the guarantor except to the extent that it is recourse to other partner.[13] Under the regulations, a person is related to a partner if the two would be related under §267(b) or §707(b)(l) using an 80% common ownership test instead of 50%. For this purpose,

[13] There is an exception for "qualified nonrecourse financing" within the meaning of §465(b)(6) if the lender is related to a partner who has less than a 10% interest in any item of partnership income, gain, loss, deduction or credit. Reg. §1.752-lT (d)(3)(vii).

the §267(e)(1) modification to §267(b) that sometimes treats all partners in one partnership as related is ignored and brothers and sisters are excluded from being members of a person's family.[14]

We believe that the use of an 80% benchmark is too generous a standard to apply for testing relatedness. If a partner owns , directly or indirectly, more than half of the economic value of a lender or guarantor, it is appropriate to consider the potential loss of the lender or guarantor to be more like a loss by a partner than a loss by an unrelated person. Moreover, without regard to the percentage of common ownership question, the mechanics of the related person rule do not work properly when applied to entities whose principal assets are debt or equity of the partnership under consideration.

> Example: A, B and C (each of whom is unrelated to the other) form Partnership ABC as equal partners, each contributing $100. A and B form Partnership AB, contributing $500,000 each. AB lends the $1,000,000 to ABC on a nonrecourse basis.

Under the regulations Partnership AB is not related to any of the partners in ABC. Hence the loan is nonrecourse and C may share some of the basis.

Part of the problem is the failure of the regulations to look to whether the lender is related to a group of partners.

[14] Reg. §1.752-1T(h).

However, the issue remains even if B is replaced by a lender unrelated to any partner.

> Example: A, B and C (each of whom is unrelated to the other) form Partnership ABC as equal partners, each contributing $100. The partnership intends to buy land for $1,000,000. A has agreed to provide $700,000 as a nonrecourse loan and a person, L, unrelated to A, B or C, has agreed to lend the additional $300,000.
>
> Instead of this, however, A and L form Partnership AL, with A contributing $700,000 as a 70% partner and L contributing $300,000 as a 30% partner. Partnership AL then lends the $1,000,000 to ABC on a nonrecourse basis secured only by the land.

If the partnership is unable to pay the debt and the land is worthless, AL will lose $1,000,000 and A will be out-of pocket $700,000 and L will be out-of-pocket $300,000. Hence, as to $700,000, A is the partner who really bears economic risk of loss. Under the regulations, however, the loan is nonrecourse and ABC can allocate less than $700,000 of the loan to A because A has less than an 80% interest in AL.

Although the example is presented as a design to circumvent the related party rules, the concern is broader. There may well be valid business reasons why a partner enters into a partnership with other investors to make a single loan to a partnership. If A were only a 25% participant in the loan in the example above and the other partners in AL were three unrelated lenders, it would still be true that to the extent of A's contribution to the lending partnership, he is the

person who has the economic risk of loss on his 25% share of the loan.

We believe that a more appropriate standard for testing relatedness would be to apply the standards of §267 (b) and S707 (b) (1) utilizing the enunciated 50% common ownership test. Thus, we recommend that the regulations be modified in this regard.

We are also concerned with other methods by which a partner or someone related to a partner may indirectly be the person who bears the economic risk that the partnership's assets are worthless, such as a loan to an intermediate entity secured by the collateral that entity receives by making a loan to the partnership:

> Example: L lends $1,000,000 to Partnership X, on a ten-year nonrecourse note at 10% interest, secured by a mortgage on all the property of the partnership. One year later, L borrows $200,000 from A, a partner in X, for 1 year at 11% interest. The loan from A is nonrecourse and is secured by an assignment of L1s mortgages on Partnership X property.

The example evidences no plan to avoid the partner loan rules, but if the partnership's assets become worthless during the term of A's loan to L, A will suffer a $200,000 loss. Thus, no other partner in Partnership X should be allocated basis from this $200,000 of L’s loan.

One approach that would identify the economic risk correctly in these examples is to break the analysis into two steps. The first step would be to analyze what entities or

persons (whether or not related to a partner) actually bear the economic risk that the partnership assets are not adequate to pay the partnership's debts. Only then would the related party test be applied to see if any of the persons who bear the economic risk of loss is a partner or is a person related to any partner. The economic risk of loss of persons other than partners cannot, unfortunately, be completely analyzed within the framework of the present regulations because of the absence of general principles. The broader principles we have discussed would be useful for this purpose, however. In particular, the analysis should look through any entity if, at the inception of the loan, it has no significant assets that would not automatically be worthless if the partnership assets were worthless.[15]

We are also concerned that the related party rules can be circumvented by making a loan outside the partnership.

> Example. A and B form Partnership AB. A contributes $100,000. B, who is to manage the partnership, also contributes $100,000 and the two are equal partners. However, while A paid for his contribution out of his assets, B borrowed the $100,000 from A on a nonrecourse basis, securing the debt only by a pledge of his interest in Partnership AB.

[15] This rule is largely directed against deliberate misuse of the debt allocation rules. We do not, therefore, feel that a continuous review of the "outside assets" of each partner is necessary. If a partner has significant assets unrelated to the partnership at the time the loan is first taken out, the partner should not later be looked through in determining risk of loss, even though at a later time those assets may have declined substantially.

In this example, there is no partnership debt to be allocated and B gets $100,000 of basis in the partnership. Rev. Rul. 72-135 held on similar facts that the loan to B is to be treated as a loan from A to the partnership.[16] There is substantial doubt, however, as to the authority for this ruling. Moreover, small changes in the facts would make the ruling much harder to apply. For example, suppose the lender was a person related to a partner and not a partner himself. Whether the relationship is close enough to justify the same conclusion should depend on whether the lender is related to the partner within the meaning of Reg. §1.752-1T(h).

Rev. Rul. 72-135 effectively applies an economic risk analysis to this situation. It would be appropriate to formalize this approach under the broader principles we have proposed, which would result in the lending partner being allocated the debt.[17]

B. Transition Rule

One of the fundamental purposes of §79 of the 1984 Tax Reform Act was to prevent partners from claiming that

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[16] 1972-1 C.B. 200.

[17] A similar approach is already incorporated in the at-risk rules. Section 465(b) (3) (A) generally provides that a person will not be considered at risk with respect to amounts borrowed from any person who has an interest in the activity or from a person related to such interested person.

there was partnership nonrecourse debt when a partner or a person related to a partner had guaranteed debt or, indeed, made the loan itself. The rules that apply to a partner loan or a partner guarantee are therefore effective as of the date of enactment of the statute. On the other hand, the legislative history provides no guidance as to what persons would be. considered to be related to partners for this purpose. That guidance is given in the new regulations. Consequently, under the §752 regulations the related party rules are effective only from the date of the regulations.[18]

Treating loans from or guaranteed by a person related to a partner as recourse debt has a consequence in the §704 regulations as well as in the §752 regulations. Under new Reg. §1.704-1T, deductions attributable to a loan which is not, on its face, recourse to the partnership but which is nonetheless a recourse loan because some partner bears the economic risk of loss (a "partner nonrecourse loan”)[19] is subject to a special allocation rule. The special rule requires deductions equal to the annual increase in minimum gain on such debt to be allocated to partners who bear the economic risk of loss on the

[18] Reg. §1.752-4T(b).

[19] The choice of the term “partner nonrecourse loan” to describe a loan which is facially nonrecourse but for which some partner has the economic risk of loss is not felicitous. Since the point of the characterization is that the loan is a recourse loan, calling it partner nonrecourse debt creates a great deal of confusion. A better term might be "partner risk loan."

debt and requires income to be allocated to the same partners when any reduction in the minimum gain on such debt occurs. One type of partner nonrecourse loan is a nonrecourse loan to a partnership made or guaranteed by a person related to a partner. The appropriate effective date provision for partner nonrecourse loans that become recourse loans only because of the related person rules is that past allocations of losses should be unaffected and that for 1989 and future years, allocations should be based on changes after the loan is first treated as recourse.

All of the changes in Reg. §1.704-1T for partnership years beginning after December are effective 29, 1988.[20] Arguably, this means that for loans directly from a partner to a partnership deductions improperly taken before 1989 should give rise to immediate recapture as a result of the change in minimum gain, since partner loans were immediately treated as recourse loans. Regardless of the rule for recapturing prior allocations of partner loan deductions, we believe that the legislative history and the §752 effective date clearly should protect pre-1989 allocations of deduction8 attributable to loans made or guaranteed by a person related to a partner from automatic recapture in 1989. We recommend that the regulations clearly state that deductions properly allocated under the

[20] Rep. §1.704-1T(m).

nonrecourse debt rules prior to the ,issuance of the proposed regulations not be recaptured immediately just because the nonrecourse debt itself is to be treated as recourse under the regulations because the lender is related to a partner.

VI. Third-Party Insurance and Other Restrictions on Real Recourse

A. Methods of Reducing Real Risk

The determination of a partner's share of a partnership liability depends on whether that liability is recourse or nonrecourse. A partnership liability is recourse to the extent that any partner bears the economic risk of loss for the liability. The regulations also provide that certain contractual arrangements between partners or persons related to partners and creditors will be considered an "arrangement tantamount to a guarantee." If one or more partners or persons related to a partner undertakes the obligation in order to reduce substantially or eliminate the risk to the creditor and one of the principal purposes of the arrangement is to permit other partners to include a portion of the partnership liability in basis, the partners entering into such arrangement are considered to bear the economic risk of lo88 with respect to the liability in the manner that reflects their relative economic burdens pursuant to the terms of the arrangement. This provision applies only to arrangements by partners or persons related to partners.

Certain third-party contractual arrangements could result in a similar reduction in the amount of risk borne by a partner or the partnership and in some instances may shift nearly all true economic risk of the partnership liability out of the partnership. The constructive liquidation rule fails to take such arrangements into account in determining the sharing of economic risk because on a constructive liquidation the arrangements are deemed to be worthless. We believe that this assumption may be inappropriate in certain instances where the partners have secured certain contracts to modify the partners' risk for tax avoidance purposes.

1. Partnership Collateral and Non-Partner Guarantees

The assumption that all the partnership assets -- even partnership cash -- is worthless at the date of the constructive liquidation makes sense only in some contexts. The deemed liquidation is a fictional device used to estimate the risk that a partner will be required to pay a debt at some unknown future date. At that future date, cash now in the partnership may well have been converted to an asset that has become worthless. Hence, for purposes of determining the risk of loss that a partner may have, it is appropriate to treat cash and most other assets of the partnership as worthless.

There are some circumstances in which the presumption of worthlessness does not make sense, however. One extreme example is the commercial equivalent of a passbook loan:

> Example. Partnership X borrows $1,000,000 on a recourse basis from L. As collateral for the loan, X gives L a pledge of U.S. Treasury obligations in the face amount of $1,000,000. The Treasury obligations mature on the maturity date of the loan. The Treasury obligations are delivered to L.

On these admittedly unusual facts, the chances of the pledged Treasury obligations being converted into a different asset which is worthless at the debt's maturity are negligible and it would be odd to treat this as a recourse loan. A more common version of this transaction is where only part of the debt is secured by "assured" collateral such as an offsetting account balance or a pledge of Treasury obligations.

Transactions with certain third parties can also be structured to eliminate the partners' risk on partnership liabilities.

> Example. Partnership P, a general partnership, borrows $1,000,000 on a fully recourse basis to purchase an office building, which it immediately leases to Corporation C under a triple net lease. Corporation C agrees to make lease payments that will cover the debt service. Corporation C also provides as security for its obligations U.S. Treasury securities which have coupons and maturities adequate to make all payments on the lease when due. The lease payments are due in all events without regard to whether the leased space is available for use by the corporation and without regard to any other rights or obligations of the lessor against the corporation. P assigns to the lender the rents under the lease and the partnership's rights in the security. The lender agrees to look first to the lease payments and the lease security, but does not release P from liability.

Under these facts it is highly unlikely that A and B will ever be called upon to satisfy this loan. Thus, it is unclear whether this loan is a recourse debt of the partnership and how it should be shared by the partners.

Although these examples indicate that at some level of low risk collateral, the collateral should not be assumed to be worthless, we do not recommend changing the regulations to add such a general rule. We are concerned that there is no good dividing line for determining what types of collateral are certain to hold their value (such as cash) and what types may lose value even if they are not changed into some other asset. If the Treasury bonds in this example were corporate bonds instead, the risk of default would depend on the creditworthiness of the issuer. Even if the bonds are presently rated Aaa, future events may increase the risk of the company not paying. In general, therefore, we agree that the regulations should ignore the effect of such protection on the partner's risk of loss.

A non-partner can also agree to assume the risk for a portion of a partnership's liabilities to enhance his indirect interest in the venture, however. For example, a promoter, who ie not a partner in a partnership, may agree to guarantee (without subrogation) a portion of the partnership's

recourse debt in order to enhance tax benefits to potential investors. As a result, the promoter's return from the venture may increase through increased sales of partnership units. The partners, however, may never be called on to satisfy the portion of the debt guaranteed by the promoter, at least where the promoter's guarantee remains valuable. As currently drafted, the provision relating to arrangements tantamount to a guarantee would not encompass this arrangement since the promoter is not a related party.

For the reasons given above, we believe, consistent with the concept of treating partnership assets as worthless on a hypothetical liquidation, it is generally inappropriate to apply the rules applicable to related parties under the arrangements tantamount to a guarantee provision to third parties. We propose, however, that the regulations adopt a "tax-avoidance purpose" rule that would permit the Service to take into account contractual arrangements of the parties which are part of a single plan so as to reflect the extent to which partners actually expect to bear the economic risk that partnership assets will be worthless. Where it is determined that the principal purpose of the arrangement is to permit some partners to include a portion of a liability in basis that they would not otherwise

have by shifting the real risk of loss to a nonpartner who has an economic interest in the transaction, the Service should have authority to reallocate the liabilities based on the actual risk of loss that will be experienced by the partners.

We recognize that this will create a degree of uncertainty as to the effect of collateralization arrangements and other devices, such as insurance, that can be used to minimize the partners' risks. We are concerned, however, about the potential for abuse. Because the economic reality of many of these collateralization arrangements is that risk is removed from partners, we believe that failing to include some type of anti-abuse rule will invite manipulation of the debt allocations. In a typical commercial context, the lender's interest in obtaining the security and the extent to which such security either caused the loan to be made or permitted the borrower to get a lower interest rate or less restrictions will usually be clear enough that the participants can feel comfortable that tax avoidance is not the principal purpose of the arrangement.

B. Partner Transactions

An arrangement between a partnership and a partner or a person related to a partner which is "tantamount to a guarantee" is treated as a guarantee under the proposed regulations.

The one illustration of this concept in the regulations is a lease by a partner of partnership property under which the partner agrees to make the lease payments in all events.[21] Although we agree with the thrust of this rule, we are concerned that it may be very difficult for partners to decide what arrangements are "tantamount to a guarantee." Clearly, there are transactions whose entire purpose is to provide the equivalent of a guarantee. On the other hand, there are numerous commercial transactions between partners and partnerships, It is not uncommon, for example, for the owners of a new building to offer an equity interest in the building to prospective tenants. If a tenant does demand and receive an interest in the partnership that owns the building, is its space lease automatically tantamount to a guarantee? The answer to this question will determine how the tenant and the other partners allocate the partnership debt.

A clear dividing line is needed. We have previously explained why we feel that a contractual arrangement with a person unrelated to any of the partners in a partnership should not be treated as a guarantee unless the economic interests of that person and the partnership or the partners are otherwise

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[21] Reg. §1.752-1T(k), Example 20.

intertwined. We likewise believe that a contract for the actual performance of service, delivery of goods or the lease or use of property (that would not be treated as a guarantee if entered into with an unrelated party) should not be treated as a guarantee merely because the payor is a partner or is related to a partner.

We therefore suggest that wherever (i) a partner or a person related t o a partner enters in to a contract with a partnership which requires as a condition of payment that the partnership provide goods services, and (ii) the contract itself is on the terms similar to those obtained e it her by the partnership or similarly situated vendors from unreleated parties, then the contract ought not to be treated as tantamount t o a guarantee.[22] The fact that the payor's obligation to pay is contingent upon receiving goods or services generally indicates that the contract is something more than a mere guaranty. Thus, absent provisions in a contract that make payment mandatory even if no goods or services are received or that otherwise make payment more certain than under a commercial contract

[22] This assumes that the contract under consideration is of a type frequently entered into among parties with no other economic interrelationship. In those industries where such contracts are rarely entered into with unrelated persons, a contract still might pass scrutiny but in such cases, normal terms for contracts among related parties should not automatically be taken as indicating the absence of a guarantee.

with outsiders, the contract should not be treated as tantamount to a guarantee.

VII. Present-value Determinations

The regulations contain two provisions that measure the present value of a partner's obligation. First, if a partner guarantees more than 20% of the interest on an otherwise nonrecourse debt, the partner will be treated as a guarantor of the principal of a debt equal to the present value of the interest guarantee.[23] Second, if a partner has an obligation to make a payment which is not required to be made within the time frame set in the regulations, and if the obligation does not bear adequate interest, the economic risk associated with the obligation will be in an amount equal to the present value of the obligation.[24] The time frame set forth in the regulations is: (i) in the case of an obligation to contribute to the partnership, the later of 90 days after a partnership liquidation or the end of the taxable year in which the liquidation occurs or (ii) in the care of an obligation to a creditor or other person, a reasonable time. While we agree with the purposes of both of

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[23] Reg. §1.752-1T(d) (3)(v).

[24] Reg. §1.752-1T(d) (3)(ii)(E).

these provisions, we believe that some changes in the way the present value concept is implemented are advisable.[25]

A. Delayed Obligations Which Should be Subject to Discounting

If an obligation can be delayed beyond the requisite time and if it does not bear interest at an adequate rate, the obligation will be discounted. For this purpose, an obligation bears adequate interest if the rate is at least equal to the applicable Federal rate (the "AFRN) at the time of valuation. This means that the effect of the partner's agreement is subject to change as interest rates change. An obligation that creates economic risk equal to its face amount when entered into may later create less economic risk because the AFR has risen.

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[25] We read the 90 day rule as applicable only to a partnership agreement that explicitly provides that payment is not required until a specified period after liquidation or a specific date. Most partnership agreements that provide for restoration of deficits, on the other hand, merely state that upon liquidation the partners will be required to restore their deficit capital accounts and do not discuss timing. In such instances, the partnership's and the creditors' rights arise on the date of liquidation and the creditors or the bankruptcy trustee of the partnership are entitled to enforce this right as soon as it may be practicable. We therefore feel that it should be irrelevant whether the amounts of the individual capital accounts deficits are required to be restored within a set time period. Moreover, it is unlikely that the amount of the capital account deficits will be determined within 90 days since it is often impractical to expect financial statements to be finalized within such a period.

There are two different types of delayed contribution obligations. One is an obligation to make a contribution at a fixed future date:

> Example. A contributes $100,000 to Partnership X on formation. B contributes her note for $100,000 due in four years, with interest at 10%. The partnership borrows $100,000 secured by B's note.

Under the regulations, B's note is a contribution obligation. In a constructive liquidation at any date before B's note is due, B's amount of risk is tested by considering whether B would owe the contribution evidenced by the note within the requisite time period. Since this will not be true until the last 90 days prior to the maturity of the note, B's note would be discounted if the AFR at the date of the constructive liquidation were greater than 10%.

The other type of delayed obligation is one where the partner has a right to delay its contribution for a specified time period following liquidation:

> Example. Partnership AB borrows $100,000. The partnership keeps capital accounts that govern liquidation. However, if a limited partner has a deficit in its capital account on liquidation, the limited partner need not pay that deficit for two years after liquidation.

Whenever the partnership liquidates, each limited partner will have a delayed contribution obligation.

We believe that if the agreement under which the partner undertakes an obligation provides for interest at least equal to the AFR at the time the agreement is entered into,

the obligation should not later be discounted. Except in exceptional circumstances, the current AFR should correspond to the market's expectation of the future AFR. Hence, the room for manipulation is small. Given this fact, there is a no reason to deny partners the convenience of being able to fix a fair rate at the date of the agreement instead of having to use a floating rate to stay within the safe harbor.

There may be more incentive for manipulation where the delay involved is a fixed period following liquidation of the partnership. In that event, no partner is actually paying interest currently; hence the choice of rate is somewhat suspect. However, absent special circumstances that make rate changes predictable, it is unlikely that an election to use the AFR at the date of agreement could be abused, as long as the election must be made at the date of the agreement.

B. Election to Share in a Fixed Percentage Based on Date of Agreement Values

Granting partners the right to fix the interest rate to be applied to present value calculations of a given obligation would facilitate tax planning. It would not, however, prevent debt shares from changing over time.

> Example: Partnership X borrows $1,000,000 at 10% for 10 years from L. Annual interest is payable currently. The note its nonrecourse, but Partner A guarantees the payment of the first 5 years' interest.

At the date of the loan, the applicable Federal rate is 10%. Under the regulations, A's initial economic risk on the debt is the present value of five payments of $100,000 at 10%, or about $379,000. Over time, A's share of the debt will decline as his economic risk declines, although it is not possible to compute the year-by-year amounts since they depend on the changing AFR. If the partnership is permitted to elect to use 10% as the discount rate for all future years and if the partnership pays the interest currently, A's economic risk will decline to about $317,000 at the beginning of the second year, $248,000 at beginning of the third year, $173,000 at the beginning of the fourth year, $91,000 at the beginning of the fifth year, and zero after five years.

We have considered whether it would be appropriate to let the partnership elect to fix A's share of the debt throughout its ten year term. Although this may provide the partnership and A with certain advantages, we do not believe this is an appropriate solution. As the example illustrates, the economics change substantially over time. The economic risk to the guaranteeing partner should depend upon whether the partnership is actually making payments on the debt. It is not clear whether a fixed allocation to A would allow substantial manipulation. Finally, although guarantees of interest do occur in commercial transactions, this is a relatively sophisticated device and it is appropriate to expect the guarantor and his partners to

seek tax advice before structuring the transaction this way.

In the case of obligations to contribute or pay a creditor which can be delayed, fixing the present value rate will fix the share of debt if the potential delay is constant. On the other hand, where the potential for delay arises because the obligation has a fixed maturity, the economic situation is similar to the guarantee of interest discussed above and we therefore do not believe that an election to fix partners' shares of the debt is appropriate in these contexts.

VIII. Substantiality of Partner Nonrecourse Debt Allocations

The §704 regulations issued simultaneously with the §752 regulations contain new rules for allocating debt for which a partner has the risk of: Loss but which is not recourse to the partnership, so called "partner nonrecourse debt". Basically the rules look to how the risk of loss on the minimum gain inherent on such debt is shared and therefore apply nonrecourse principles to debt which is effectively recourse.

The rules for partner nonrecourse debt make basic sense. These rules correspond to the "economic effect" of maintaining capital accounts that govern liquidation. Capital account adjustments resulting from partner nonrecourse debt are

recaptured automatically at the partnership level as a result of the phantom gain resulting from the treatment of the debt as nonrecourse debt for purposes of §7701(g). Hence, the new S704 regulations look to the question of who would bear the cost if the partnership were to sell all its assets at tax basis and liquidate.

The substantial economic effect regime, however, does not rely solely on the capital account mechanism. In order to prevent some abuses, there is an additional restriction that applies even to allocations that have economic effect--the "substantiality requirement. One abuse that the substantiality requirement prevents is "transitory allocations."

> Example: Partnership AB borrows $1,000,000 on a fully recourse basis. Interest is payable only at maturity, which is two years. The interest rate is 10% per year, compounded annually, so the debt when due in two years will be $1,210,000, The partnership agreement provides that all of the first year's interest deduction is allocated to A, a 50% partner, and that all of the second year's interest deduction is allocated to the other 50% partner, B. The partnership maintains capital accounts in accordance with the regulations which govern liquidation.

The allocations of interest have economic effect. If the partnership were in fact liquidated at the end of year one or the debt otherwise became due, A would suffer a full $100,000 detriment, However, the allocation lacks substantial economic effect because the partnership is not expected to liquidate at the end of year one and the probability that the debt

will become due before the end of year two is slight. Thus, under normal circumstances the first year allocation to A will essentially be offset by the second year allocation to B.

Because the new §704 regulation on partner nonrecourse debt essentially substitutes minimum gain for economic effect, it is possible to create transitory allocations of deductions funded by partner nonrecourse debt.

> Example: Partnership AB borrows $1,000,000 on a nonrecourse basis. Interest is payable only at maturity, which is two years. The interest rate is 10% per year, compounded annually, so the debt when due in two years will be $1,210,000.
>
> A and B have agreed with the lender to be liable on the debt as follows:
>
> Each will guarantee 50% of the original principal. A will guarantee the first $100,000 of interest accrued at the date the guarantee is enforced. B will guarantee the next $110,000. Any other interest will be owed 50-50.

The partner nonrecourse debt rules mandate that A be allocated the $100,000 first-year interest deduction and B the $110,000 second-year interest deduction. Yet, the economics of this debt are nearly identical to the recourse debt in the previous example. For example, if the debt were to become due at the end of the first year, A would owe the entire $100,000 of accrued interest. However, the debt is no more likely to be due early than in the previous example, and at the end of the two years, A and B will have effectively traded deductions. The potential for abuse is the same as for explicitly recourse debt. Hence,

the partner nonrecourse debt rules should not permit this allocation any more than the substantial economic effect rules do.

IX. Automatic Shifting of Debt Allocation

A. Causes of Change in Sharing Ratios

The §752 regulations determine how partnership liabilities are reflected in the bases of partners' interests. Often a partner's basis in a partnership has no relevance except on sale or liquidation. However, a partner's share of debt in his overall basis can be relevant to a partnership annually or more frequently. Section 704(d) limits the deduction of partnership losses to the partner's basis in the partnership. In addition, a decrease in a partner's share of partnership debt is treated under S752 as a distribution of money to the partner. Section 731 taxes distributions of cash in excess of basis. Even where S731 does not apply, there may be other tax consequences of a deemed distribution under §752.

The new regulations create the possibility of a partner's share of debt changing over time even if the sharing of income and loss remains the same, none of the contractual relationships among the partners and lender change, and no debt is repaid. One such instance is the rule for allocating nonrecourse debt. Reg. §1.752-1T (e) requires

nonrecourse debt to be allocated first to partners who have minimum gain, then, in the absence of §704(c) property, generally as the partners may agree, provided the agreed allocation corresponds to the allocation of some item of partnership income or gain which has substantial economic effect. Thus, an increase in partnership minimum gain can change the sharing of debt.

> Example. A and B form general partnership AB. A is the managing partner. Pursuant to the terms of the partnership agreement, operating income is allocated 60% to A and 40% to B. Capital gain and losses (and distributions relating to refinancings) are shared by the partners equally. The partnership owns a parcel of real property which was purchased through a $1,000,000 nonrecourse loan.
>
> On day one, under the allocation rules for nonrecourse debt, the partners elect to divide the nonrecourse liability fifty-fifty. For the first year the partnership has an operating loss of $100,000 which it allocates between A and B, 60-40.

At the end of the first year the debt is no longer divided 50-50 because A and B will have different shares of the partnership's minimum gain. The first $100,000 of the nonrecourse debt must be allocated $60,000 to A and $40,000 to B. The remaining $900,000 is still allocated equally between A and B. Thus, B is deemed to have received a $10,000 distribution because of the decrease in his share of the partnership’s liabilities.

There are several other circumstances that can cause automatic shifts of debt over time. For example, if

the debt in the preceding example had been recourse debt, the constructive liquidation rule would have divided the debt $500,000 each on day one; however, after one year the debt would be $510,000 to A and $490,000 to B (just as for nonrecourse debt) because A's capital account deficit would be $20,000 larger than B's as a result of the allocation of $60,000 of the loss to A.

There are at least two other circumstances under the 5752 regulations where a partner's share of partnership debt can change without any new action by a partner: (i) in the situation where a partner guarantees interest payments on partnership debt and (ii) where partners have delayed contribution obligations. In both cases, the regulations require that the determination of the economic risk of loss of a partner be made by taking into account the present value of the partner's obligation.

> Example. Partnership AB borrows $100,000 at 10% from L. The loan is due in five years with interest to be paid annually. The loan is nonrecourse but partner B guarantees payment of the first three years' interest. At the date of the loan the applicable federal rate is 10%.

Under the regulations, B's initial economic risk on a debt is the present value of $10,000 for three years at 10% or about $25,000. Over the life of the loan, as the partnership pays the interest, B's amount at risk will decline and his share of the debt will therefore decline.

These fluctuations will result in a shift in the allocation of debt and a deemed distribution to B under §752 (b).

B. Consequences of Shifting Sharing Ratios

The intrinsic shifting of sharing ratios described above has the intended consequence of restricting use of losses. However, if there are other adverse consequences of changes in the sharing ratio that do not seem to be justified, there would be reason to allow partners to elect a fixed sharing ratio. Other adverse consequences that have been suggested to us are: (i) that §751 (b) might apply to the deemed cash distribution and (ii) that §731 might apply to the excess deemed cash distributions.

1. Section 751(b)

We have considered whether a decrease in a partner's share of partnership liabilities due to such automatic shifting of debt allocations could be a deemed distribution subject to §751 (b). Section 751 generally provides that certain distributions by a partnership to a partner in exchange for a portion of the partner's interest in unrealized receivables or inventory items will be treated as a sale or exchange between the partner and the partnership. While §751 will treat a deemed distribution under §752 as a payment, we believe that §751 does not apply to deemed distributions attributable to these shifts in the partner's debt sharing allocations because there is not an

exchange of all or part of the partners' interest in the partnership. However, the allocation of deductions attributable to nonrecourse debt under the minimum gain rules could arguably meet the technical conditions of §751(b):

> Example. Partnership X borrows $100,000 on a nonrecourse basis and uses the money to buy improved land that is the only security for the debt. The depreciation deduction is allocated 99% to Partner A and 1% to the other partner, B. Except as provided by the minimum gain chargeback rules, all other items of contribution, income, loss or deduction in the partnership are allocated 50% to each partner.
>
> For its first year of operation, the partnership has $10,000 of depreciation deductions.

When the $100,000 is borrowed, it is allocated $50,000 to each partner. One year later, it is allocated $59,900 to A and $40,100 to B because the special allocation of depreciation to A has increased A's share of the partnership's minimum gain. Hence, B has received a $9,900 distribution under §752. Because A must be allocated $9,900 of the first $10,000 gain on sale to charge back the allocation of nonrecourse deductions, A bears the cost of 99% of the depreciation recapture. Depreciation recapture is a §751 asset, so one partner has received cash and another has increased his interest in a §751 asset. Thus, an argument could be made that §751 applies.

Yet the purpose of §751 is not implicated here. A has taken 99% of the partnership's depreciation deductions and is taking the ordinary income because of depreciation

recapture. There has not been a change in the sharing of §751 assets because of a sale or exchange of an interest in the partnership but because A has taken excess ordinary deductions. There is no visible abuse. Moreover, if the partners shared any substantial item of partnership income or gain 99-1, they could have elected to share the nonrecourse debt 99-1 from the beginning eliminating the deemed distribution.

We believe that in the absence of a significant change in the economic agreement among the partners, or a profit and loss shift, the deemed distributions caused by the automatic shifts in debt under the regulations do not relate to an attempt to exchange capital gain and ordinary income property between the partners and that §751 should not apply to these deemed distributions even where, as in the example,it could be argued that the technical requirements of §751 are met.

It would be appropriate for the regulations to contain a provision expressly stating that §751 (b) will not apply to shifts in debt allocations in the absence of a change in the economic agreement or a shift in the sharing of profit or loss among the partners. This will alleviate any concern of whether a distribution pursuant to §752 (b) will result in sale or exchange consequences under §751(b).

2. Section 704(c) and Refinancings

The constructive liquidation rule and §731 can also have an unexpected tax consequence in partnerships where a partner has contributed property subject to §704(c).

> Example. A and B form partnership AB. A contributes $1,000,000 to the partnership. B contributes land worth $1,000,000 but having a basis of $40,000. AB's partnership agreement provides that the operating profits and losses will be allocated between A and B 60-40, respectively, and that capital gain, including proceeds from a refinancing, will be allocated 50-50.
>
> At the end of year two, the partnership has incurred deductible losses in the amount of $100,000 -- $60,000 has been allocated to A and $40,000 has been allocated to B. During year three, AB borrows $1,000,000 from lender on a nonrecourse basis (secured by partnership property other than the land contributed by B) and distributes the proceeds equally to A and B.

A distribution of the refinancing proceeds will not result in tax to either A or B since each will be allocated an equal share of the refinanced debt in their bases immediately prior to the distribution. However, since AB's partnership agreement allocates additional operating losses to A, A's share of the partnership's minimum gain will increase over time and he will be allocated additional nonrecourse debt. This will result in B being deemed to receive a distribution at a time when he had no basis. Thus, B will be subject to tax. Although this result may appear harsh since B is effectively paying tax on the unrealized appreciation

of his contributed property prior to a Sale, it is our view that it is correct.

C. Recommendations

Because the new regulations tend to track economic risk very closely, several provisions can cause the allocation of partnership debt to vary substantially from year to year. We have considered the consequences of a continuous reallocation of partnership debt to determine whether such reallocation causes unjustified tax consequences. We believe that the results obtained under the regulations are generally correct and should be maintained. We do, however, recommend that a sentence be added to the §752 regulations (or an amendment made to the §751 regulations) that these "automatic" shifts do not create §751 exchanges in the absence of modifications in the partnership agreement or ancillary documents or a shift in the sharing of the partnership's profit or loss.

X. Technical Comments

A. Section 704(c) and Nonrecourse Debt

1. Relevant Debt

Reg. §1.752-1T (e) (1) (ii) requires that after nonrecourse debt is allocated to each partner in an amount equal to his share of minimum gain, additional nonrecourse debt is next allocated to partners who would be allocated §704 (c)

gain (or the equivalent gain from a revaluation) in the amount of such gain that would be allocated if the partnership disposed of all partnership property subject to nonrecourse debt "in full satisfaction of such liabilities and for no other consideration." It is possible to read this language as applying to all property securing nonrecourse debt against all nonrecourse debts, not merely the debts secured by any particular property.

> Example. B has contributed stock in Company C to Partnership X. At the time of the contribution, the stock had a basis of $100 and a value of $10,000. It was contributed subject to nonrecourse indebtedness of $5,000. Partnership X has another $100,000 of nonrecourse indebtedness outstanding, secured by other property of the partnership currently worth only $95,000, but not by the stock.

B has §704(c) gain of $9,900. The intent of Reg. §1.752-1T (e) (1) (ii) is that the $5,000 nonrecourse debt secured by the stock be allocable to B on account of §704(c). However, if all the assets securing nonrecourse debt were disposed of in one transaction for the total nonrecourse debt of $105,000, the stock might be deemed sold for its full $10,000 value, so the regulation might require allocating a portion of the $100,000 note to B on account of the §704(c) gain. The regulation should clarify that the allocation is made on a debt-by-debt basis by treating each debt as satisfied by disposition of the property in exchange for the face amount of the debt.

2. <u>Multiple Property Security</u>

Another potential issue relating to the allocation of nonrecourse debt is how to apply the rules of Reg. §1.752-1T(e)(l)(ii) in allocating nonrecourse debt when multiple §704(c) assets are used to secure a loan.

> <u>Example</u>. A and B form partnership AB. A contributes a parcel of real property with a fair market value of $1,000 and a basis of zero. B contributes a parcel of real property with a fair market value of $1,000 and a basis of $500. The partnership borrows $1,000 from L, an unrelated third party. The loan is nonrecourse and is secured by both parcels of property.

It is unclear how the $1,000 nonrecourse debt is to be allocated between A and B under the regulations. Regulation §1.752-1T(e)(l)(ii) requires that the debt be allocated to the partner or partners who would be allocated §704(c) gain in the amount of the gain that will be allocated if the partnership disposed of all partnership property subject to nonrecourse debt in satisfaction of the liabilities and for no other consideration. In this example, A has $1,000 of 704(c) gain. B has $500 of 704(c) gain. There is, however, only $1,000 of nonrecourse debt.

We recommend that in situations where nonrecourse liabilities are secured by multiple assets that the debt be allocated based upon the relative amounts of the 704(c) gain of the partners contributing the property at the time of the contribution (or at the time of a revaluation). Thus, in the above example, A would be allocated approximately 67% ($1,000

divided by $1,500) of the nonrecourse debt and B would be allocated approximately 33% ($500 divided by $1,500) of the nonrecourse debt. If the partnership later disposes of one of the §704(c) assets, the built-in §704(c) gain on that asset will disappear, of course, and the allocation of the debt may change to reflect the fact that there is only one §704(c) asset in the partnership.

B. Duplicate Obligations

The regulations contemplate that there may be situations in which the portion of a liability each partner may ultimately bear is indeterminate. This is illustrated by an indemnity given by a limited partner to the lender of a recourse partnership loan. The lender can proceed against either the partnership (and through the partnership to the general partner) or against the limited partner.[26] The regulations state that it is not possible to determine whether the general partner would owe the limited partner if the indemnity were called or whether the limited partner would owe the general partnership if he were sued. The example splits the obligation evenly between the general partner and the limited partner.

While we are not able to state the result in any given jurisdiction, we believe that there is a determinable answer to what would happen if, in fact, the lender's claims

[26] Reg. §1.752-1T(k) , Example (9).

against the partnership, the general partner and the limited partner and all the cross-claims were adjudicated in one court. The allocation of the debt should follow the result of that hypothetical proceeding, whatever it might be, rather than arbitrarily dividing the responsibility for the debt. Even if the applicable law really is unclear, the economic risk is really being borne by the general partner and the limited partner proportionately to their estimates of the likelihood of such a case being decided against each of them.

The rule in the regulations offers partners the opportunity to agree to split debt by arrangements that they believe have different consequences economically. For example, the regulations permit partners to use the limited partner indemnity for this purpose even if the partners believe that a court would interpret the indemnity as subrogating the limited partner who pays the indemnity to the lender's rights against the partnership. We do not believe that partners should be allowed to deliberately arrange misallocations in this fashion. The partners can and should be required to clarify their rights inter se when the lender's rights are created. If they do not, there is no reason for the regulations to provide them with certainty as to the effect on basis. Instead, the debt should be allocated in the manner the Service later determines reflects the expectations of the partners as to how the cost would have been

borne if the assets were worthless based on the objective evidence.

C. Application of the Ten Percent Test to Tiered Partnerships

Reg. §1.752-1T(d)(3)(vii) exempts from the related party loan rules qualified nonrecourse financing by a person related to a less than 10% partner. While this rule appears to be appropriate, we are not sure it works correctly in conjunction with the tiered partnership rules.

> Example. A is a 19% partner in Partnership U. Partnership U is in turn a 50% partner in Partnership V. L, an affiliate of A, makes a loan to Partnership V which is qualified nonrecourse financing.

The tiered partnerships rules of Reg. §1.752-lT(j) apply the 752 regulations by treating the upper-tier partnership (U in this example) as having a share of the debt of the lower tier partnership (V in the example) and then applying the regulations to this deemed debt. Whatever share of the debt is allocable to Partnership U is therefore recourse since A is a more than 10% partner in U. Thus, even though A's indirect interest in the partnership that owes the qualified nonrecourse debt is less than 10%, the other partners in Partnership U may not be allocated any share of the debt. We recommend that the application of the related lender rule to tiered partnerships be clarified by testing only the percentage interest that a person who is related

to the lender or guarantor has as an indirect partner in the partnership that actually borrows the money.

D. Nonrecourse Debt and §707(a)(2)

Generally, gain or loss is not recognized on the contribution of property to a partnership in return for a partnership interest.[27] Moreover, distributions of money from a partnership to a partner are generally tax free to the extent the distribution does not exceed the recipient partner's adjusted basis in his partnership interest.[28]

Section 707(a)(2) was enacted to avoid situations where partners structured facto sales of property through partnerships as tax free contributions, followed or proceeded by a tax free distribution from the partnership.[29]

> Example: A owns a parcel of real property with a tax basis of $0 and a fair market value of $100,000. A and B agree to form partnership AB. A contributes the property to the partnership. B will not make a contribution to the Partnership but will manage the property. Immediately thereafter, the Partnership borrows $100,000 from L (secured only by the property) which it distributes to A.

Under these facts, §707(a)(2)(B) can be applied to treat the transaction as a sale of one-half the property to B.

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[27] Section 721.

[28] Section 731.

[29] See, for example, Otey v. Commissioner 72 T.C., 312, (1978), aff'd, 634 F. 2d 1046 (6th Cir. 1980) and Jupiter Corp. v. U.S, 2 Cl. Ct. 61 (1983).

We are concerned that the provisions relating to the sharing of certain nonrecourse debt could be used to circumvent the intent of §707(a)(2)(b). The legislative history to §707(a)(2)(b) indicates that the contribution of encumbered property to a partnership is not a disguised sale to the extent responsibility for the debt is not shifted, directly or indirectly, to the partnership (or its assets) or to the non-contributing partner. Thus, as currently drafted partners could agree to share nonrecourse debt in a manner that permits a partner to claim the benefit of this exception to disguised sale treatment.

> Example. A owns a parcel of real property with a basis of $0 and a fair market value of $100,000. A and B agree to form partnership AB whereby A will contribute his parcel. B will not make any contribution but will manage the property. Immediately before the contribution, A borrows $100,000 on a nonrecourse basis from L. The loan is secured by the property. As previously planned, A then contributes the property, subject to the nonrecourse debt, to the partnership.

This should be a classic situation for the application of §707 (a) (2). However, under the §752 nonrecourse debt sharing rules, the $100,000 of debt will be allocated to A because it is equal to A's §704(c) gain in the property securing the loan. Thus, the legislative history can be used to claim exemption from §707(a)(2)(b) because responsibility for the nonrecourse debt has not shifted and the purpose of §707(a)(2)(b) may be

frustrated.[30] We are concerned that the §752 rule for allocating nonrecourse debt may have an unintended impact on the application of §707(a)(2)(B).

E. Application of the Wrap Debt Rule to Debt Incurred Prior to 1989

1. General Rule

One of the special rules in the proposed regulations is that "wrap around" debt is divided into two debts:[31]

> Example. In 1981, A purchased Blackacre from X for a $50,000 nonrecourse, 10 year, 10% purchase money note. In 1985, A sells Blackacre to Partnership Y for $200,000, $50,000 cash and a $150,000 nonrecourse note for 10 years at 15% interest. A does not prepay the underlying purchase money mortgage but agrees that it will be his responsibility.

The $150,000 Partnership Y note is wrap debt. Under the regulations it will be considered as two debts: a $50,000 debt owed to X and the remaining $100,000 owed to A.

The splitting of a wrap debt into two debts has an effect if one of the two lenders i8 a partner or a person related to a partner. For example, if A is a partner in Partnership Y but X is not related to any partner, the $100,000 portion of the note is treated as a loan from A. Thus, A is deemed to have the risk of 108s on the loan and the debt is allocable only to A.

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[30] This result could also be obtained by an agreement among the partners to share excess nonrecourse debt so as to allocate all the debt to the contributing partner.

[31] See Reg. §1.752-1T(k), Example 19.

The remaining $50,000 is treated as a nonrecourse loan from X, a portion of which may be allocable to other partners.

2. Rationale

The wrap debt rule is essentially an application of the risk-of-loss principles. In the example above, if the fact that A has the benefit of a low-interest loan is disregarded, A's loss if the partnership can not pay is really only $100,000. X will lose $50,000 if the property becomes worthless and the partnership and A do not pay the debt. Since the partnership is treated as having risk of loss only to the extent that a partner or a person related to a partner has such a risk, this means that only $50,000 of the debt should be "recourse" debt.

There are several theoretical problems with this rule. The first is that on facts like the Example the intermediate lender's economic risk may really be larger than the difference between the face amount of the wrap debt and the underlying debt. The reason A has left the underlying debt in place is because, with market interest rates at 15%, the $50,000 note at 10% interest is worth less than its face. In reality, A's economic risk is the excess of the $150,000 face amount of the Partnership Y note over the present value of the $50,000 note to X.

3. Impact of intermediate actions

Although arguments that the wrap rule is wrong as a matter of principle have some at traction, there is substantial justice in the proposed rule and we do not think that the added complexity of present value analyses is warranted. The rule of the regulations makes a great deal of sense, is reasonably simple to apply and provides a useful clear rule.

A more practical concern is that the wrap rule can cause partnership debt to shift over time (and thus give rise to deemed distributions) without any partnership action. Suppose that in the prior example A uses $1,000 of the interest he receives from the partnership to prepay $1,000 of principal of the X loan. The payment by A changes the division of the $150,000 wrap loan. Now it is deemed a $101,000 loan from A to the partnership and a $49,000 loan from X. Hence, there is $1,000 1988 debt allocable among the other partners.

4. Wrap Debts That Predate The Proposed Regulations

The change in the proportions of partner debt and nonrecourse debt is outside the control of (and possibly outside the knowledge of) the other partners. It is odd that this should have an adverse impact on them. Of course, if the partners understood the wrapped debt rules before they entered into the transaction, they could be viewed as having agreed to

assume this burden. Indeed, if partners want to prevent deemed distributions, they can usually do so by structuring the allocation of the nonrecourse part of the wrapped debt to match the recourse allocation--that is by allocating the nonrecourse deductions to the lending partner and by allocating the excess nonrecourse debt to the partner related to the lender.

The proposed regulations would apply the wrapped debt rule to any debt of a partnership. A partnership that entered into a wrapped debt transaction before the regulations were proposed may very well have deemed distributions or recapture of prior deductions as a result of the underlying debt being paid down. It is now too late to avoid the adverse impact because the deductions have already been taken.

The effective dates of the proposed regulations generally try to make a distinction between rules whose nature and extent reasonably could be anticipated from the legislative history and rules whose details were not implicit in Congress' directive to the Service. It is for this reason that only new loans by persons related to a partner are treated as recourse. We do not feel that partners should have assumed that the regulations would treat wrapped debt in this manner. Indeed, the most reasonable conclusion a partner could have drawn from the case law would have been that the entire wrap debt is a single loan by the intermediate lender and the underlying debt is irrelevant to the partnership.[32] Consequently, we recommend that the regulations apply only to wrapped debt incurred after the date the regulations were proposed.

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[32] The Service lost a series of §453 cases in which it contended that the appropriate treatment of wrapped debt for purposes of §453 was as an assumption of the underlying debt and a new loan for the excess. Ultimately, the Service acquiesced in the courts' interpretation of a wrap debt as a single new loan from the Gap debt lender in-professional equities. Inc., 89 T.C. 165 (1987), acaq. 1988-2 C.B. 1.