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April 23, 2012

The Honorable Emily S. McMahon
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Douglas H. Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
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Re: Allocating Partnership Liabilities Among Related Persons

Dear Ms. McMahon, Mr. Wilkins, and Mr. Shulman:

We write to suggest possible clarifications and modifications to the portion of the regulations under Section 752 (the "Section 752 Regulations") that govern how a partnership allocates a "recourse" liability among its partners on the basis of the partners' relationships to persons who bear the economic risk of loss (or "EROL") for the liability.

By way of background, a partner is permitted to increase its basis in a partnership by its allocable share of the partnership liabilities. The allocation of these liabilities by a partnership therefore determines the extent to which a partner recognizes gain upon the receipt of a cash distribution, the extent to which a partner recognizes gain or loss on a sale of a partnership interest and the extent to which a partner may deduct partnership losses. The Section 752 Regulations require a partnership to allocate recourse liabilities among its partners based on the extent to which each partner, or any person related to such partner, bears EROL for the liability.

For this purpose, a partnership liability is "recourse" to the extent that a partner or a related person bears EROL for the liability. For purposes of

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these rules, a person is generally treated as “related” to a partner if his percentage of common ownership is 80% or more. If a person is related to more than one partner, the person is treated as related only to the “more related” partner. If two or more partners share this status, the liability is allocated equally among those partners.

An important exception to these rules (the “Related Person Exception”) is at the heart of the report. Under the Related Person Exception, otherwise related persons are not treated as related if they are direct or indirect partners of the partnership. The primary purpose of this exception is to prevent the allocation of a partnership liability to a partner who does not bear direct EROL merely because the partner is related to another partner who does.

As described in the report, the Section 752 Regulations contain many ambiguities. For example, it is unclear whether the Related Person Exception also ignores the “relatedness” of two partners to prevent a partner from being attributed EROL directly borne by a *non-partner* who is otherwise related to such partner by reason of such partner’s common relationship to the other partner. Although the 2004 Tax Court decision in *IPO II v. Comm’r*<sup>39</sup> could be read to support this interpretation, we do not believe it is consistent with the purpose of the statute.

Another ambiguity is the effect of the related party rule on the allocation of a partnership liability for which direct EROL is borne solely by a subsidiary of the partnership. In addition, although the Section 752 Regulations provide general guidance for allocating recourse liabilities to upper-tier partnerships (and their ultimate partners), the proper application of these rules is also unclear in several important respects.

We recommend several modifications to the Section 752 Regulations, including changes to:

- modify the Related Person Exception to make clear that the “relatedness” of related persons is ignored only to the extent necessary to prevent the allocation of a partnership liability *away* from a partner who bears direct EROL for the liability;
- clarify that when a subsidiary of a partnership bears sole EROL on a partnership liability, the liability is nonrecourse and therefore not subject to these rules;
- clarify the manner in which a partnership liability is allocated among direct and indirect partners when one or more partners is both a direct and indirect partner of the same partnership; and
- specify the manner in which a partnership liability is allocated among two or more partners who directly or indirectly bear EROL for the liability.

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<sup>39</sup> 122 T.C. 295 (2004).

Ms. McMahon  
Mr. Wilkins  
Mr. Shulman  
April , 2012  
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We also provide a number of other comments and recommendations.

Respectfully submitted,



Andrew W. Needham  
Chair

Enclosure

cc: Jennifer Alexander  
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