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December 12, 2016

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Re: *Report No. 1361 on Proposed and Temporary Regulations under Sections 707 and 752*

Dear Messrs. Mazur, Koskinen and Wilkins:

This letter[1] responds to the request by the Internal Revenue Service (the "**IRS**") and the Department of the Treasury ("**Treasury**") for comments in Treasury Decision 9788,[2] which contains proposed, tempo-

[1] The principal drafters of this letter were Eric Sloan and James Jennings, with substantial contributions from Phillip Gall. Helpful comments were received from Stephen Land, Stuart Rosow, Michael Schler, and Karen Sowell.

[2] T.D. 9788, 81 Fed. Reg. 69282 (Oct. 5, 2016).

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rary, and final regulations regarding the disguised sale rules of section 707(a)(2)(B) and the allocation of liabilities under section 752.[3]

The first part of this letter comments on the "proviso" in the temporary regulations regarding disguised sales (the "**Temporary Regulations**"). The second part of this letter comments on the proposed deletion of Treas. Reg. § 1.752-2(k) in the proposed regulations addressing the allocation of partnership liabilities (the "**Proposed Regulations**").

I. THE "PROVISO" IN TEMP. TREAS. REG. § 1.707-5T(a)(2)(i)

A. Background on Treatment of Liabilities under Sections 707 and 752

Treas. Reg. § 1.707-5 contains special rules for determining a partner's share of partnership liabilities under the disguised sale rules that follow, with certain modifications, the section 752 regulations, which prescribe separate rules for determining a partner's share of a partnership's recourse and nonrecourse liabilities.[4] Under Treas. Reg. § 1.707-5(a)(2)(i), a partner's share of a partnership's recourse liability equals the partner's share of the liability under section 752. Under Treas. Reg. § 1.707-5(a)(2)(ii), by contrast, a partner's share of a partnership's nonrecourse liability is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under Treas. Reg. § 1.752-3(a)(3), with certain modifications.[5] By referencing only Treas. Reg. § 1.752-3(a)(3), the disguised sale rules disregard the "minimum gain" and "704(c) minimum gain" rules of Treas. Reg. § 1.752-3(a)(1) and (a)(2), respectively.

[3] Unless indicated otherwise, all "**section**" references are to the Internal Revenue Code of 1986, as amended (the "**Code**"), and all "**regulation**" and "**Treas. Reg. §**" references are to the Treasury regulations promulgated under the Code, all as in effect on the date of this letter.

[4] Under Treas. Reg. § 1.752-1, a partnership liability is a recourse liability to the extent that a partner bears the "economic risk of loss" for that liability. For a background discussion of the rules regarding disguised sales and the allocation of partnership liabilities, see N.Y. ST. B. ASS'N, TAX SEC., *Report on the Proposed Regulations on the Allocation of Partnership Liabilities and Disguised Sales* (May 30, 2014) (the "**Prior Report**").

[5] Since October 30, 2000, the "additional" method under Treas. Reg. § 1.752-3(a)(3) has not been available for use under Treas. Reg. § 1.707-5(a)(2)(ii). The "additional" method provided that "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 . . . where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the gain described in [Treas. Reg. § 1.752-3](a)(2) with respect to such property."

B. Background on the Temporary Regulations

On January 30, 2014, the IRS and Treasury released proposed regulations under sections 707 and 752.[6] On May 30, 2014, in response to a request for comments in the preamble to those proposed regulations, the Tax Section submitted the Prior Report, in which we made numerous recommendations, including:

> Specifically, we recommend that the IRS and Treasury consider providing in the final regulations that, solely for disguised sale purposes, a partner's allocable share of a partnership liability (including a liability assumed or taken subject to by the partnership in connection with the contribution of property by the partner to the partnership) equals the portion of the liability that would be allocated to the partner if the entire liability were allocable among the partners under the provisions of Treas. Reg. § 1.752-3(a)(3) (but excluding for this purpose the Significant Item Method and the Alternative Method); provided, however, that the partner's allocable share of any such liability should not include any portion of the liability with respect to which another partner bears the economic risk of loss.[7]

Although not stated in the Prior Report, the rationale for the inclusion of the proviso was to ensure that our recommendation not allow a leveraged distribution (or contribution of property subject to a nonqualified liability) to be tax-free in situations in which it would not have been tax-free under the current rules.

C. The Temporary Regulations

On October 5, 2016, the IRS and Treasury issued T.D. 9788, which included the Temporary Regulations. Adopting the Tax Section's recommendation, the Temporary Regulations provided:

> For purposes of § 1.707-5, a partner's share of a liability of a partnership, as defined in § 1.752-1(a) (whether a recourse liability or a nonrecourse liability) is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under § 1.752-3(a)(3) (as limited in its application to this paragraph (a)(2)), without including in such partner's share any amount of the liability for which another partner bears the economic risk of loss for the partnership liability under § 1.752-2.

[6] 79 Fed. Reg. 4826 (Jan. 30, 2014).

[7] Prior Report, at 36.

The Temporary Regulations are effective for any transaction with respect to which all transfers occur on or after January 3, 2017.[8]

The preamble makes clear that partners are generally required to determine their shares of any partnership liability, whether recourse or nonrecourse under section 752, in the manner in which excess nonrecourse liabilities are allocated under Treas. Reg. § 1.752-3(a)(3), as limited for disguised sale purposes in the section 752 regulations. According to the preamble, the government believes that this method (rather than the recourse allocation rules of Treas. Reg. § 1.752-2) generally accurately reflects the economic arrangement of the partners because, in most cases, a partnership will satisfy its liabilities with partnership profits, and the payment obligations of partners or related persons will not be called upon.[9]

Shortly after the issuance of the Temporary Regulations, concern arose in the tax community that the phrase "without including in such partner's share any amount of the liability for which another partner bears the economic risk of loss for the partnership liability under § 1.752 2" (commonly referred to as the "**proviso**")[10] could, in certain situations, cause an inappropriately large portion of a debt-financed distribution to be treated as disguised sale proceeds.[11] In response to those concerns, on November 17, 2016, the IRS and Treasury issued a correction[12] to the Temporary Regulations. As a result of the correction, the Temporary Regulations now provide as follows:

> For purposes of § 1.707-5, a partner's share of a liability of a partnership, as defined in § 1.752-1(a) (whether a recourse liability or a nonrecourse liability) is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under § 1.752-3(a)(3) (as limited in its application to this paragraph (a)(2)), but such share shall not exceed the partner's share

[8] Temp. Treas. Reg. § 1.707-9T.

[9] T.D. 9788, 81 Fed. Reg. 69282, 69283–84 (Oct. 5, 2016).

[10] Although the tax community has taken to calling the final clause of Temp. Treas. Reg. § 1.707-5T(a)(2)(i) the "proviso," the text of the regulation does not contain the word "provided." Nevertheless, for the sake of clarity, this letter will continue to use the term "proviso" to refer to the final clause.

[11] *See, e.g.*, Amy Elliott, *New Disguised Sale Rules Penalize Partners for Guarantees,* TAX NOTES TODAY (Oct. 18, 2016).

[12] 81 Fed. Reg. 80993–94 (Nov. 17, 2016). Conforming changes were also made to the preamble to the Temporary Regulations and Temp. Treas. Reg. § 1.707-5T(f), *Ex. 7*.

> of the partnership liability under section 752 and applicable regulations (as limited in the application of § 1.752-3(a)(3) to this paragraph (a)(2)).[13]

D. Recommendations

As currently drafted, the proviso could be interpreted in a manner that would make the allocation of partnership liabilities under Treas. Reg. § 1.752-3(a)(1) and (a)(2) (*i.e.*, "tier one" and "tier two" liabilities) relevant to the disguised sale rules. The following example illustrates how the possible interpretations of the proviso (*i.e.*, whether the proviso incorporates all three tiers of Treas. Reg. § 1.752-3(a) or only tier 3) can impact the portion of a distribution that is treated as disguised sale proceeds:

> X contributes appreciated property with a fair market value of $300 to a partnership, and Y contributes to the partnership property with a basis of $0 and a fair market value of $200. The partnership borrows $100 on a nonrecourse basis secured by all of its property and distributes all of the proceeds to X. After the distribution, X and Y are equal partners.
>
> Under Treas. Reg. § 1.752-3(b), to determine whether either partner has any section 704(c) minimum gain, the partnership allocates the entire liability to Y's contributed property. This results in Y having $100 of section 704(c) minimum gain, and the partnership allocating the entire liability to Y under Treas. Reg. § 1.752-3(a)(2), and $0 of the liability to X under section 752. Under the general rule of Temp. Treas. Reg. § 1.707-5T(a)(2)(i), X's share of the liability is $50 (its share of excess nonrecourse liabilities under Treas. Reg. § 1.752-3(a)(3).
>
> If all three tiers of Treas. Reg. § 1.752-3(a) were relevant under the proviso, the proviso would cause X's share of the liability for purposes of section 707 to be zero, because its share of the liability under section 752 ($0) would be less than its share of the liability under Temp. Treas. Reg. § 1.707-5T(a)(2)(i).
>
> If, on the other hand, only tier 3 is relevant, the proviso would not change the allocation made under the general rule because X's share of the liability under Treas. Reg. § 1.752-3(a)(3) ($50) is not less than its share of the liability under Temp. Treas. Reg. § 1.707-5T(a)(2)(i).

[13] Temp. Treas. Reg. § 1.707-5T(a)(2)(i). The following shows the changes made by the correction: ~~without including in~~ but such share shall not exceed the partner's share ~~any amount of the liability for which another partner bears the economic risk of loss for~~ of the partnership liability under ~~§1.752-2~~ section 752 and applicable regulations (as limited in the application of § 1.752-3(a)(3) to this paragraph (a)(2)).

We do not believe that the IRS and Treasury intended for all three tiers to be relevant for this purpose. Since it was first promulgated in 1992, Treas. Reg. § 1.707-5(a)(2) (relating to nonrecourse liabilities) has referenced only Treas. Reg. § 1.752-3(a)(3). This was a conscious decision on the part of the government,[14] and there is no evidence in the correction to the Temporary Regulations to suggest that the government intended to reverse this policy choice. Indeed, one Treasury official has specifically stated that the government "didn't intend to pull in tiers 1 and 2."[15] To ensure that the proviso is interpreted consistently with the government's intention, we recommend that the Temporary Regulations be further clarified by modifying the proviso in the manner set forth below and adding three examples. (We have included suggested examples in Appendix A to this letter.)

The revised proviso (in italics, below) and the examples have been drafted consistent with our understanding that the proviso is intended to ensure that, although for disguised sale purposes, a partner's share of a partnership liability generally is determined under the nonrecourse liability allocation rules of Treas. Reg. § 1.752-3(a)(3) (as modified for purposes of the disguised sale rules), if a partnership liability is a recourse liability under section 752, the partner's share of the liability may not exceed the partner's share under section 752:

> For purposes of § 1.707-5, a partner's share of a liability of a partnership, as defined in § 1.752-1(a) (whether a recourse liability or a nonrecourse liability) is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under § 1.752-3(a)(3) (as limited in its application to this paragraph (a)(2)); *provided, that if a liability of a partnership is a*

[14] 56 Fed. Reg. 19055 (Apr. 25, 1991) ("The Service and the Treasury Department considered numerous approaches for determining a partner's share of a nonrecourse liability before adopting the approach taken in the proposed regulations. One alternative considered was to adopt the rules provided in section 752 and the regulations thereunder. Under this approach, a transferring partner's share of a nonrecourse liability would reflect the full amount of built-in gain under section 704(c). This approach would produce an inverse relationship between the gain inherent in the contributed property and the extent to which a disguised sale of the property results from the encumbrance. This would be an inappropriate result."). One could fairly argue that the government's decision in 1991 to prevent a partner's built-in-gain from minimizing disguised sale treatment does not necessarily entail a decision to prevent another partner's built-in-gain causing (or increasing) a disguised sale. It seems clear, however, that the decision to focus on Treas. Reg. § 1.752-3(a)(3) reflects the government's desire to follow the economics of the partnership arrangement with respect to nonrecourse liabilities.

[15] *See, e.g.*, Amy Elliott, *Clarification to Disguised Sale Rules Causing Confusion,* TAX NOTES TODAY (Nov. 28, 2016).

recourse liability, a partner's share of the liability may not exceed the partner's share of the liability determined under § 1.752-2.

II. PROPOSED REMOVAL OF TREAS. REG. § 1.752-2(k)

The existing section 752 regulations contain a rule governing the extent to which a partner is treated as bearing the economic risk of loss for partnership liabilities when a disregarded entity of the partner or related person has a payment obligation (the "**DRE Rule**"). In essence, the DRE Rule provides that a payment obligation of a disregarded entity is taken into account in determining the extent to which a partner bears the economic risk of loss for a partnership liability only to the extent of the net value of the disregarded entity (which for this purpose does not include the entity's interest in the partnership).

According to the preamble to the Proposed Regulations, Treasury and the IRS are "concerned with ensuring that a partner or related person only be presumed to satisfy its payment obligation to the extent that such partner or related person would be able to pay on the obligation."[16] Toward that end, the Proposed Regulations would delete the DRE Rule in its entirety and rely instead on Prop. Treas. Reg. § 1.752-2(j)(3), an anti-abuse rule that would provide that "[a]n obligation of a partner or related person to make a payment is not recognized under paragraph (b) of this section if the facts and circumstances evidence a plan to circumvent or avoid the obligation." The removal of the DRE Rule in favor of the anti-abuse rule is apparently intended to be a compromise that covers payment obligations of all persons, but only in the abusive situations with which the government is concerned, so as not to burden taxpayers unduly.

While we appreciate the government's desire to simplify the regulations, we believe the DRE Rule should be retained in its existing form. If the government believes that an enhanced anti-abuse rule is necessary, such a rule could be adopted without removing the DRE Rule. The DRE Rule provides a great deal of clarity and certainty to taxpayers.[17] The Proposed Regulations, on the other hand, introduce uncertainty.

For example, one of the uncertainties inherent in the Proposed Regulations is that it is styled as an anti-abuse rule that, by its literal terms, applies only when "the facts and circumstances evidence a plan to circumvent or avoid the obligation." In many commonplace partnership arrangements in which a partner holds its interest through a disregarded entity, no plan exists to avoid any particular obligation. Moreover, because Prop. Treas. Reg. § 1.752-

[16] 81 Fed. Reg. 69301, 69305 (Oct. 5, 2016).

[17] Indeed, in the Prior Report, we suggested that the DRE Rule be expanded "to all partners and related persons other than individuals." *See* Prior Report, page 50.

2(j)(3) is styled as an anti-abuse rule, it is not clear whether taxpayers can invoke the rule themselves. In this regard, it appears that Prop. Treas. Reg. § 1.752-2(j)(3)(iii) is intended to add clarity by deeming a plan to exist "if facts and circumstances indicate that there is not a reasonable expectation that the payment obligor will have the ability to make the required payments if the payment obligation becomes due and payable." (Prop. Treas. Reg. § 1.752-2(j)(3)(iii), Example 2, illustrates the application of the rule.) Neither the regulatory language nor Example 2, however, provides sufficient certainty because neither makes clear whether taxpayers can assert the application of the rule.

If, contrary to our suggestion, the IRS and Treasury eliminate the DRE Rule in final regulations, we strongly recommend that the regulations provide taxpayers with the same results as under the DRE Rule. Specifically, we recommend that the regulations provide that, if a "payment obligor" is a disregarded entity, taxpayers may proactively assert the anti-abuse rule in Prop. Treas. Reg. § 1.752-2(j)(3), that motive and intent are not relevant, and that there need not be an actual plan to avoid any particular obligation.[18]

Respectfully submitted,

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[18] Conforming changes should then be made to Prop. Treas. Reg. § 1.752-2(j)(4), *Ex. 2*.

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APPENDIX A – PROPOSED EXAMPLES

Example 1 – Distribution Financed by a Single Nonrecourse Liability. (i) *Facts.* X and Y form LLC, which is classified as a partnership for tax purposes. X contributes Property X, with a fair market value of $300 and an adjusted basis of $18, and Y contributes Property Y with a fair market value of $200 and an adjusted basis of $40. LLC borrows $100 on a nonrecourse basis from an unrelated financial institution and distributes all of the proceeds to X. The debt is secured by Property X and Property Y. X and Y are equal members in LLC, and neither has any reimbursable preformation capital expenditures (within the meaning of Treas. Reg. § 1.707-4(d)(1)) with respect to the contributed property. LLC elects to use the traditional method under Treas. Reg. § 1.704-3(b) for making section 704(c) allocations.

(ii) *Application of § 707(a)(2)(B).* For purposes of the disguised sale rules under Temp. Treas. Reg. § 1.707-5T, the liability is allocated equally between X and Y (*i.e.*, $50 to each). As noted above, LLC distributes the entire $100 to X. Because X's share of the liability for disguised sale purposes is only $50, $50 of the distribution is treated as disguised sale proceeds. X allocates $3, or one-sixth ($50/$300), of its adjusted basis in Property X to the portion of Property X that X is treated as having sold to LLC, which results in X recognizing $47 of gain. X is treated as contributing the balance of Property X, with a fair market value of $250 and an adjusted basis of $15, in exchange for a 50 percent interest in LLC and a debt-financed distribution of $50.

(iii) *Allocation of liability under § 752 and determination of gain under § 731(a).* To determine the tax consequences of the debt-financed distribution, it is necessary to determine X's basis in its LLC interest, which, in turn, requires allocating the $100 liability between X and Y under section 752.

Because the amount of the liability ($100) is not greater than the section 704(b) book basis of the assets securing the liability ($500), there is no partnership minimum gain, and, thus, no portion of the liability is allocable under Treas. Reg. § 1.752-3(a)(1).

To determine the amount of the liability allocable under Treas. Reg. § 1.752-3(a)(2), LLC must first apply Treas. Reg. § 1.752-3(b), under which LLC may allocate the liability between Property X and Property Y under any reasonable method. (A method is not reasonable if it results in the allocation of a liability to a property in an amount that, when combined with any other liabilities allocated to the property, exceeds the fair market value of the property.) Consistent with Treas. Reg. § 1.752-3(b), LLC chooses to allocate the liability among the portion of Property X deemed sold to LLC, the portion of Property X deemed contributed to LLC, and Property Y in proportion to their fair market values at the time of transfer. Thus, $10 of the liability is allocated to the portion of Property X that X is treated as having sold to LLC ($50/$500

x $100); $50 of the liability is allocated to the portion of Property X that X is treated as having contributed to LLC ($250/$500 x $100); and $40 is allocated to Property Y ($200/$500 x $100).

The allocation of $50 of the liability to the contributed portion of Property X results in there being $35 of section 704(c) minimum gain and a $35 liability allocation to X under Treas. Reg. § 1.752-3(a)(2). The allocation of $40 of the liability to Property Y results in there being no section 704(c) minimum gain and no liability allocation to Y. (The allocation of $10 of the liability to the portion of Property X deemed sold to LLC cannot result in any section 704(c) minimum gain because section 704(c) minimum gain can arise only with respect to contributed or revalued property.)

Because only $35 of the liability is allocated under Treas. Reg. § 1.752-3(a)(2), $65 of the liability is allocable under Treas. Reg. § 1.752-3(a)(3). Under the "additional method" of Treas. Reg. § 1.752-3(a)(3), LLC chooses to allocate $5 of the remaining $65 portion of the liability to X (which is not greater than X's $200 of remaining section 704(c) gain, after reduction for the $35 taken into account under Treas. Reg. § 1.752-3(a)(2)), and the remaining $60 to Y. The allocation of the liability under section 752 is summarized in the table below:

Treas. Reg. § 1.752-3 tier	**Amount allocated to X**	**Amount allocated to Y**
(a)(1)	$0	$0
(a)(2)	$35	$0
(a)(3)	$5	$60
Total	$40	$60

As shown in the table, LLC allocates $40 of the liability to X, causing X's basis in its LLC interest to increase from $15 to $55 immediately before the distribution. Therefore, X will not recognize gain under section 731(a)(1) as a result of the $50 distribution.

Example 2 – Distribution Financed by One Liability That Is Partially Recourse and Partially Nonrecourse. *(i) Facts*. The facts are the same as in Example 1, except that Y guarantees repayment of $60 of the liability. The terms of the guaranty are sufficient to ensure that Y bears the economic risk of loss with respect to the $60 portion of the liability it guarantees.

(ii) Application of § 707(a)(2)(B). Under the general rule of Temp. Treas. Reg. § 1.707-5T(a)(2)(i), X would be allocated $50 (50 percent of the liability, which is X's share of excess nonrecourse liabilities under Treas. Reg. § 1.752-3(a)(3)). However, this allocation is reduced to $20 by the proviso in Temp. Treas. Reg. § 1.707-5T(a)(2)(i), because, with respect to the $60 recourse portion of the liability (see the discussion in *(iii)* below), X's share of the liability is $0 under section 752, leaving X with only a $20 share of the nonrecourse portion of the liability. X's share under Temp. Treas. Reg. § 1.707-5T(a)(2)(i) is therefore $20.

As noted above, LLC distributes the entire $100 to X. Because X's share of the liability for disguised sale purposes is only $20, $80 of the distribution is treated as disguised sale proceeds. X allocates $4.80, or $^{4}/_{15}$ ($^{\$80}/_{\$300}$), of its adjusted basis in Property X to the portion of Property X that X is treated as having sold to LLC, which results in X recognizing $75.20 of gain. X is treated as contributing the balance of Property X, with a fair market value of $220 and an adjusted basis of $13.20, in exchange for a 50 percent interest in LLC and a debt-financed distribution of $20.

(iii) Allocation of liability under § 752 and determination of gain under § 731(a). To determine the tax consequences of the debt-financed distribution, it is necessary to determine X's basis in its LLC interest, which, in turn, requires allocating the $100 liability between X and Y under section 752.

For purposes of section 752, the liability is treated as two separate liabilities, one $40 nonrecourse liability and one $60 liability that is recourse to Y. Treas. Reg. § 1.752-1(i).

The recourse portion of the liability is allocated to Y because Y bears the economic risk of loss with respect to the recourse portion of the liability.

Because the amount of the nonrecourse portion of the liability ($40) is not greater than the section 704(b) book basis of the assets securing the liability ($500), no portion of the liability is allocable under Treas. Reg. § 1.752-3(a)(1).

To determine the amount of the nonrecourse portion of the liability allocable under Treas. Reg. § 1.752-3(a)(2), LLC must first apply Treas. Reg. § 1.752-3(b), under which LLC may allocate the nonrecourse portion of the liability between Property X and Property Y under any reasonable method. (A method is not reasonable if it results in the allocation of a liability to a property in an amount that, when combined with any other liabilities allocated to the property, exceeds the fair market value of the property.) Consistent with Treas. Reg. § 1.752-3(b), LLC chooses to allocate the nonrecourse portion of the liability among the portion of Property X deemed sold to LLC, the portion of Property X deemed contributed to LLC, and Property Y in proportion to their relative fair market values at the time of transfer. Thus, $6.40 of the nonrecourse portion of the liability is allocated to the portion of Property X that X is treated as having sold to LLC ($^{\$80}/_{\$500}$ x $40); $17.60 of the nonrecourse portion of the liability is allocated to the portion of Property X that X is treated as having contributed to LLC ($^{\$220}/_{\$500}$ x $40); and $16.00 is allocated to Property Y ($^{\$200}/_{\$500}$ x $40).

The allocation of $17.60 of the nonrecourse portion of the liability to the contributed portion of Property X results in there being $4.40 of section 704(c) minimum gain and a $4.40 liability allocation to X under Treas. Reg. § 1.752-3(a)(2). The allocation of $16 of the nonrecourse portion of the liability to Property Y results in there being no section 704(c) minimum gain and no liability allocation to Y. (The allocation of $6.40 of the nonrecourse portion of the

liability to the portion of Property X deemed sold to LLC cannot result in any section 704(c) minimum gain because section 704(c) minimum gain can arise only with respect to contributed or revalued property.)

Because $4.40 of the nonrecourse portion of the liability is allocated under Treas. Reg. § 1.752-3(a)(2), $35.60 remains to be allocated under Treas. Reg. § 1.752-3(a)(3). Under the "additional method" of Treas. Reg. § 1.752-3(a)(3), LLC chooses to allocate $19.60 of the remaining $35.60 portion of the liability to X (which is not greater than X's $202.40 of remaining section 704(c) gain, after reduction for the $4.40 taken into account under Treas. Reg. § 1.752-3(a)(2)), and the remaining $16 to Y. The allocation of the nonrecourse portion of the liability under section 752 is summarized in the table below:

Treas. Reg. § 1.752-3 tier	**Amount allocated to X**	**Amount allocated to Y**
(a)(1)	$0.00	$0
(a)(2)	$4.40	$0
(a)(3)	$19.60	$16
Total	$24.00	$16

As shown in the table, LLC allocates $24 of the nonrecourse portion of the liability to X, causing X's basis in its LLC interest to increase from $13.20 to $37.20 immediately before the distribution. Therefore, X will not recognize gain under section 731(a)(1) as a result of the $20 distribution.

Example 3 – Two Distributions, Each Financed by a Separate Liability Fully Guaranteed by the Distributee Partner. *(i) Facts*. X and Y form LLC, which is classified as a partnership for tax purposes. X contributes Property X, with a fair market value of $300 and an adjusted basis of $18, and Y contributes Property Y with a fair market value of $300 and an adjusted basis of $40. LLC borrows $100 from an unrelated financial institution ("**Liability X**") and $100 from another unrelated financial institution ("**Liability Y**"). X guarantees repayment of Liability X, and Y guarantees repayment of Liability Y. In each case, the terms of the guaranty are sufficient to ensure that each of X and Y bears the economic risk of loss for Liability X and Liability Y, respectively. LLC distributes the proceeds of Liability X to X and the proceeds of Liability Y to Y. X and Y are equal members in LLC, and neither has any reimbursable preformation capital expenditures (within the meaning of Treas. Reg. § 1.707-4(d)(1)) with respect to the contributed property.

(ii) Application of § 707(a)(2)(B). Under Treas. Reg. § 1.707-5(b)(2)(ii), Liability X and Liability Y are treated as a single $200 liability. Under the general rule of Temp. Treas. Reg. § 1.707-5T(a)(2)(i), X is allocated $100 (50 percent of Liability X and 50 percent of Liability Y),

and Y is also allocated $100 (50 percent of Liability X and 50 percent of Liability Y). The proviso in Temp. Treas. Reg. § 1.707-5T(a)(2)(i) does not change this allocation because the $100 allocation to each does not exceed the amount that is allocable to each under section 752. Specifically, under Treas. Reg. § 1.752-2, X would be allocated $100 (100 percent of Liability X and 0 percent of Liability Y), and Y would also be allocated $100 (100 percent of Liability Y and 0 percent of Liability X). Because the $100 allocated to each of X and Y under the general rule of Temp. Treas. Reg. § 1.707-5T(a)(2)(i) does not exceed the $100 cap imposed by the proviso, the proviso does not reduce the allocation to X or Y.

Because each of X and Y is allocated $100 of the liability under Temp. Treas. Reg. § 1.707-5T and each receives a $100 debt-financed distribution, there is no disguised sale.

(iii) Allocation of liability under § 752 and determination of gain under § 731(a). To determine the tax consequences of the debt-financed distribution, it is necessary to determine X's and Y's bases in their LLC interests, which, in turn, requires allocating the two $100 liabilities between X and Y under section 752. (For purposes of section 752, the liabilities are respected as separate.)

Because X bears the economic risk of loss with respect to Liability X, all of Liability X is allocated to X. Likewise, because Y bears the economic risk of loss with respect to Liability Y, Liability Y is allocated to Y.

LLC allocates all $100 of Liability X to X, causing X's basis in its LLC interest to increase from $18 to $118 immediately before the distribution. LLC allocates all $100 of Liability Y to Y, causing Y's basis in its LLC interest to increase from $40 to $140 immediately before the distribution. Therefore, neither X nor Y will recognize gain under section 731(a)(1) as a result of the $100 distribution to each.