REPORT #640

TAX SECTION

New York State Bar Association

REPORT ON SIMPLIFICATION OF
SECTION 752 REGULATIONS

JANUARY 18, 1990

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TAX SECTION
New York State Bar Association

January 18, 1990

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Goldberg:

Enclosed is a Report on Simplification of Section 752 Regulations that recommends and demonstrates a radically different drafting approach to that which has been employed in recent regulations. The principal draftsman of this Report was Gordon D. Henderson.

Sincerely,

Wm. L. Burke
Chair

Enclosure

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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON SIMPLIFICATION OF SECTION 752 REGULATIONS[1]

JANUARY 18, 1990

This report presents a completely revised version of the temporary Section 752 regulations.[2] The revised version employs a radically different drafting approach to that which has been employed in recent regulations. Our aim was to produce a regulation far shorter (17 double-spaced typewritten pages) than the temporary regulations (74 typewritten pages, 29 of them single-spaced) and far easier for the great majority of tax professionals, within and without the government, to read, understand and apply.

Two versions are attached. The first version makes every effort to reflect all the essential substance of the temporary regulations, without change. Appendix A shows where particular

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[1] The principal drafter of this report was Gordon D. Henderson, who received substantial assistance from Stephen Millman, Steven C. Todrys, William L. Burke, Arthur A. Feder, Richard G. Cohen and Peter L. Faber. Helpful comments were received from Renato Beghe and Robert A. Jacobs.

[2] Temporary Regulations §§ 1.752-0T through 1.752-4T, published December 29, 1988, as amended November 20, 1989.

rules in the temporary regulations are reflected in this draft. The second version, which follows as Appendix B, is the same as the first version except that it includes those changes necessary to stake certain amendments recommended in our July 5, 1989 report.[3]

The highly specific style of the present regulations and their examples has two faults. The regulations are difficult to understand and their very specificity leads to a host of further questions. We strongly believe that the ends of effective and efficient tax administration and enforcement are best served by straightforward statements of rules and principles, rather than by the more extended and complicated approach used in the temporary regulations.

We recommend that the Treasury substitute for the present temporary regulations a new regulation based on one of the two attached drafts.

We further recommend that the Treasury and the Service adopt the style of drafting used in these drafts wherever possible in preparing future regulations in the partnership area and elsewhere.

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[3] Report on Allocation of partnership Debt Regulations. Available through Tax Notes, AccServ & Microfiche: Doc 89-5450; Electronic: 89 TNT 140-26.

Proposed Revision of
Section 752 Regulations

§ 1.752-1. Treatment of certain liabilities –

(a) Increase in partner's share of liabilities. Any increase in a partner's share of partnership liabilities, or any increase in a partner's individual liabilities by reason of the partner's assumption of a partnership liability, shall be treated as a contribution of money by that partner to the partnership.

(b) Decrease in partner's share of liabilities. Any decrease in a partner's share of partnership liabilities, or any decrease in a partner's individual liabilities by reason of a partnership's assumption of such partner's individual liabilities, shall be treated as a distribution of money by the partnership to that partner.

(c) Assumption of liability. For purposes of section 752, a person is considered to assume a liability to the extent, but only to the extent, that as a result of the assumption --

(1) The assuming person is personally liable to pay such liability; and

(2) Where a partner (or a person related to a partner) assumes a partnership liability, the person to whom the liability is owed knows of the assumption and can directly

enforce the partner's (or related person's) obligation for the liability, and no other partner or person related to another partner would bear the economic risk of loss for the liability immediately after the assumption if the liability were treated as a partnership liability.

(d) Liability to which property is subject. If property is contributed by a partner to the partnership or distributed by the partnership to a partner and the property is subject to a liability of the transferor, the amount of the liability, to an extent not exceeding the fair market value of the property at the time of the contribution or distribution, shall be considered as having been assumed by the transferee.

(e) Sale or exchange of a partnership interest. If a partnership interest is sold or exchanged, liabilities shall be treated as liabilities are treated upon the sale or exchange of property not associated with a partnership. For example, if a partner sells his interest in a partnership for $750 cash and transfers to the purchaser his share of partnership liabilities amounting to $250, the seller realizes $1,000 on the transaction.

§ 1.752-2. Partner's share of partnership liabilities –

(a) Partner's share of recourse liabilities. A partner's share of the recourse liabilities of the partnership equals the portion of such liabilities for which the partner (or person related to the partner) bears the economic risk of loss. The following example illustrates this rule:

Example. A and B each contribute $500 in cash to the capital of a new general partnership. The partnership purchases Greenacres from an unrelated seller for $1,000 in cash and a $9,000 mortgage note. The note is a personal obligation of the partnership. The partnership agreement provides that profits and losses are to be divided 40% to A and 60% to B. A and B are required to make up any deficit in their capital accounts. For purposes of section 752, the $9,000 mortgage note is a recourse liability because the general partners together bear the full economic risk of loss for that liability. A's share of the $9,000 partnership liability is $3,500 and B's share is $5,500, because if Greenacres became valueless and the partnership were then liquidated, A's capital account would reflect a deficit that A would have to make up of $3,500 ($500 initial capital contribution less $4,000 share of loss on Greenacres) and B's capital account would reflect a deficit that B would have to make up of $5,500 ($500 initial capital contribution less $6,000 share of loss on Creenacres).

(b) Partner's share of nonrecourse liabilities. A partner's share of any nonrecourse liability of the partnership shall be the sum of --

(1) To the extent of the basis of the property subject to the liability, the portion of the basis allocable under section 704(b) to the partner (i) as depreciation (amortization or depletion) deductions over the depreciable (amortizable or depletable) life of the property and (ii) as recovery of basis upon disposition of the property at the end of such life (or upon current disposition of the property, if the property is not depreciable, amortizable, or depletable); and

(2) To the extent of any excess of the liability over the basis of the property subject to the liability, the portion of the excess that would be taxable to the partner as minimum gain under the section 704(b) regulations or as gain allocable to the partner under section 704(c) if the property were disposed of for no consideration other than satisfaction of the liability.

(c) Recourse and nonrecourse liabilities defined. A liability is a recourse liability of the partnership to the extent that any partner bears the economic risk of loss for that liability; a liability is a nonrecourse liability of the partnership to the extent that no partner bears the economic risk of loss for that liability.

(d) Economic risk of loss defined. In general, a person bears the economic risk of loss for a partnership debt to the extent the person would suffer the financial loss if partnership assets were not sufficient at the test date to pay the debt. The following rules shall be applied to determine whether a partner bears the economic risk of loss for a partnership liability.

(1) Obligation of partner or related person to make payment. (i) A partner bears the economic risk of loss for a partnership liability to the extent that the partner (or related person) would be obligated to pay anyone because a partnership liability becomes due (and would not be entitled to be reimbursed by another partner, or person related to another partner, or the partnership) if all the partnership's liabilities were due and payable, all the partnership's assets (including money) were worthless, the partnership disposed of all its assets in a fully taxable transaction for no consideration (other than relief from

certain liabilities), and the partnership allocated all its items of income, gain, loss, deduction, and credit among the partners and liquidated. The following example illustrates this rule:

Example. A partnership borrows $10,000, secured by a mortgage on Whiteacres. The mortgage note contains an exoneration clause which provides that in the event of default, the holder's only remedy is to foreclose on Whiteacres; the holder may not look to any other partnership asset or to any partner to pay the debt. However, to induce the lender to make the loan, C, a partner, guarantees payment of $200 of the loan principal. The exoneration clause does not apply to C's guarantee. If C paid pursuant to the guarantee, C would be subrogated to $200 of the mortgage debt, but C is not otherwise entitled to reimbursement from the partnership or any partner. For purposes of section 752, $200 of the $10,000 mortgage liability is treated as a partnership recourse liability; $9,800 is treated as a partnership nonrecourse liability; and C's share of the $200 partnership recourse liability is $200.

(ii) For purposes of the preceding paragraph, it is to be assumed that every partner (or related person) will discharge any obligation such person has to pay a partnership liability or make a contribution to the partnership, even if such person's net worth is less than the amount of the obligation, unless the facts and circumstances indicate a plan to avoid such obligation. The following examples illustrate this rule:

Example (1). G and L form a limited partnership. G, the general partner, contributes $20,000 and L, the limited partner, contributes $80,000 in cash to the partnership. G is obligated to restore any deficit in its partnership capital account.

The partnership agreement allocates losses 20% to G and 80% to L until L's capital account is reduced to zero, after which all losses are allocated to G. The partnership purchases depreciable property for $250,000 using its $100,000 cash and a $150,000 recourse loan from a bank. L guarantees payment of the $150,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership. If the property became valueless, G's capital account would reflect a $150,000 deficit (initial contribution of $20,000 less $170,000 share of loss) and L's capital account would be zero. Were the partnership then liquidated, G would be obligated to contribute $150,000 to the partnership. Because G is assumed to satisfy that obligation, it is also assumed that L would not have to make good on L's guarantee. Accordingly, the $150,000 mortgage is treated as a partnership recourse obligation. G's share of the liability is treated as $150,000, and L's share is treated as zero. This would be so even if G's net worth at the time of the determination is less than $150,000, unless the facts and circumstances indicate a plan to avoid G's obligation to contribute to the partnership.

Example (2). The facts are the same as in Example (1) , except G is a subsidiary formed by a parent of a consolidated group with capital limited to $20,000 to allow the consolidated group to enjoy the tax losses it expected the property to generate while at the same time limiting its monetary exposure for such losses. These facts, when considered together with L's guarantee, indicate a plan to avoid G's obligation to contribute to the partnership. In such event the rules of section 752 must be applied as if G's obligation to contribute did not exist. Accordingly, in such case the $150,000 liability is a partnership recourse liability that is allocated entirely to L.

(2) Arrangements tantamount to a guarantee. If one or more partners (or related persons) --

(i) Undertake one or more contractual obligations to facilitate a partnership's obtaining a loan;

(ii) Such obligations eliminate substantially all risk to the creditor that the partnership will not repay that loan (assuming that such partners or related persons satisfy their obligations); and

(iii) One of the principal purposes of the arrangement is to permit partners other than the partners giving such undertaking to include a portion of such liability in the basis of their partnership interests;

then the partners giving the undertaking shall be considered to bear the economic risk of loss for such liability in accordance with their relative economic burdens for that liability pursuant to such contractual obligations, and no other partner shall be considered to bear the economic risk of loss from such liability.

(3) Special Rule for nonrecourse debt with interest guaranteed by partner. If --

(i) One or more partners (or related persons) have guaranteed payment of more than 20% of the total interest that will accrue over the future life (or expected life if the term is indefinite) of any partnership nonrecourse liability; and

(ii) It is reasonable to expect that the guarantor or guarantors will be required to pay substantially all such guaranteed future interest if the partnership fails to pay it;

then the liability shall be treated as two obligations: one a partnership recourse obligation for which such guarantors bear the economic risk of loss equal to the present value of the guaranteed future interest payments; and the other a partnership nonrecourse obligation equal to the present value of the future principal and any unguaranteed interest payments. Present value shall be computed by using the interest rate applicable to the liability for federal income tax purposes. For purposes of this rule, where the lender can enforce the guarantee only by first foreclosing on the property, it generally will not be reasonable to expect that the guarantor will be required to pay substantially all the future interest subject to the guarantee unless substantially all the interest and principal are payable only at the end of the term of the liability. This rule can be illustrated by the following examples:

Example (1). On January 1, 1991, a partnership obtains a $4,000,000 nonrecourse loan secured by a shopping center. Interest accrues at a 15 percent annual rate and is payable on December 31 of each year. The principal is payable in a lump sum on December 31, 2005. A partner guarantees payment of 50 percent of each interest payment required by the loan. The guarantee can be enforced without first foreclosing on the property. When the partnership obtains the loan, the present value (discounted at 15 percent, compounded annually) of the future interest payments is $3,508,422, and of the future principal payment is $491,578. If tested on that date, the loan would be treated as a partnership recourse liability of $1,754,211 for which the guaranteeing partner bears the economic risk of loss, and a partnership nonrecourse liability of $2,245,789.

Example (2). The facts are the same as in Example (1), except that the interest guarantee can be enforced only by first foreclosing on the property. If tested on the date the loan was obtained, the loan would be treated as a $4,000,000 partnership nonrecourse liability.

(4) Partner as creditor. (i) A partner bears the economic risk of loss for a partnership liability to the extent the partner (or related person) is the creditor who would bear the consequences of nonpayment of the liability and, but for this fact, the liability would be a nonrecourse partnership liability. This rule shall not apply if the creditor is a partner (or related person) whose interest (directly or indirectly through one or more partnerships, including the interest of any person related to the partner) in each item of partnership income, gain, loss, deduction or credit for any taxable year while the loan is outstanding is 10 percent or less, and the obligation constitutes qualified nonrecourse financing within the meaning of section 465(b)(6) (determined without regard to the type of activity involved). For purposes of this subparagraph, if a partnership liability owed to a partner (or related person) includes or reflects an obligation owed to another person to which property owned by the partnership is subject ("wrapped debt"), then such other person, and not such partner or related person, shall be treated as the person to whom the portion of the partnership liability corresponding to the wrapped debt is owed. This can be illustrated by the following example:

Example. Individual A purchases Yellowacres from unrelated seller X for $10,000 paying $1,000 in cash and giving a $9,000 purchase mortgage note on which A has no personal liability and as to which X can look only to Yellowacres for satisfaction. A sells Yellowacres to a partnership in which A is a general partner for $15,000 payable by a partnership purchase money mortgage note of $15,000 on which neither the partnership, nor any partner (or person related to a partner) has personal liability. The $15,000 mortgage note is a "wrapped debt" that includes the $9,000 obligation owed to X. Pursuant to this subparagraph, $6,000 of the $15,000 obligation is treated as a partnership recourse obligation because partner A bears the economic risk of loss on the $15,000 obligation to the extent of $6,000. For the same reason, A's share of this $6,000 recourse obligation is $6,000. The remaining $9,000 of the obligation is treated as a partnership nonrecourse obligation.

(5) Partner providing property as security _f.or partnership liability -- (i) Direct pledge. A partner shall be deemed to bear the economic risk of loss for any partnership liability to the extent of the fair market value of any money or other property (other than his interest in the partnership) belonging to the partner (or related person) which is used as security for that liability.

(ii) Indirect Pledge. If a partner contributes money or other property to a partnership that is used solely to secure payment of a partnership liability, then the partnership's obligation to use such money or other property to discharge the liability shall be treated as an obligation of the partner to pay the liability. Property securing a partnership liability is presumed to be used solely for this purpose if substantially all the items of income, gain, loss and deduction from the property are allocated to the contributing partner and this allocation is greater than the proportion of any other significant item of partnership income, gain, loss or deduction allocated to the partner.

(iii) Promissory notes. For purposes of (i) and (ii), property of a partner (or related person) does not include a promissory note of the partner (or related person) unless it is readily tradable on an established securities market.

(6) Time-value-of-money considerations. Any obligation of a partner, a person related to a partner, or the partnership to pay a partnership liability, or make a contribution to the partnership, shall be taken into account only to the extent of the value of the obligation. That value is determined as follows:

(i) An obligation to pay a partnership liability that must be satisfied within a reasonable time after it becomes due and payable by the partnership shall be valued at its outstanding principal amount. If it is not required to be paid within a reasonable time after it becomes due and payable by the partnership, it shall be discounted by valuing such obligation from the date it becomes due and payable by the partnership at

the applicable Federal rate (within the meaning of section 1274(d)) at the time of valuation (unless the interest rate provided by the obligation is at least equal to such Federal rate).

(ii) An obligation to contribute to a partnership shall be valued at its outstanding principal amount if it must be satisfied within a reasonable time after the partner’s partnership interest is liquidated. If it is not required to be satisfied within a reasonable time, it shall be discounted by valuing such obligation at the applicable Federal rate (within the meaning of section 1274(d)) at the time of valuation (unless the interest rate provided for such obligation is at least equal to such Federal rate). An obligation to contribute to a partnership must be satisfied within a reasonable time after a partner's interest is liquidated only if --

(A) It must be satisfied pursuant to an obligation under state law, or

(B) It must be satisfied by contract by the later of (i) the end of the partnership taxable year in which the partner's interest in the partnership is liquidated, or (ii) 90 days after the date of such liquidation.

(iii) An obligation to make a payment or contribution is not satisfied by the delivery of a promissory note of the partner (or a related person) unless the promissory note is readily tradable on an established securities market.

(e) Related Person -- (1) General rule. A person is related to a partner if the relationship is specified in section 267(b) or section 707(b)(1), subject to the following modifications:

(i) Substitute "80 percent or more" for "more than 50 percent" each time it appears.

(ii) A person's family shall not include the person's brothers and sisters.

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

(iv) A person shall be treated as related only to the partner as to whom there is the highest percentage of related ownership, determined using the constructive ownership rules in sections 267(b) and 707(b)(1) with the modifications in (i) through (iii) above. If more than one partner bears such highest percentage, the liability shall be allocated equally among the partners bearing such equal percentages of related ownership.

(2) Exception. Notwithstanding subparagraph (1), persons owning interests directly or indirectly in the same partnership shall not be treated as related persons for purposes of determining the economic risk of loss borne by each of them for such partnership's liabilities.

(3) Special rule where entity structured to avoid related party status. If --

(i) A partnership liability is owed to or guaranteed by another entity that is a partnership, corporation, or trust;

(ii) A partner (or related person) owns, directly or indirectly, a 20 percent or greater interest in the other entity; and

(iii) The other entity became the creditor or guarantor with a principal purpose of avoiding a determination that the partner bears the economic risk of loss for part or all of the liability;

then the partner shall be treated as holding the other entity's interest as a creditor or guarantor to the extent of the partner's (or related person's) interest in the entity. For purposes of this rule, a person's interest in a partnership shall equal his highest percentage in any item of partnership loss or deduction for any year; in an S corporation shall equal his percentage of the outstanding stock; in a C corporation shall equal his percentage of the fair market value of the outstanding stock; and in a trust shall equal his percentage of the actuarial interests.

(f) Tiered partnerships. Debt of a lower-tier partnership allocated to a partner that is an upper-tier partnership shall, for purposes of further applying section 752, be treated as debt (recourse or nonrecourse, as the case may be) of the upper-tier partnership.

(g) Effective dates and transition rules. [To be supplied by the Treasury.]

APPENDIX A

Sources for Proposed Section 752 Regulations

§ 1.752-1(a).

Similar to new § 1.752-1T(b), without cross reference. Similar to old § 1.752-l(a).

§ 1.752-1(b).

Similar to new § 1.752-1T(c), but without cross reference. Similar to old § 1.752-1(b).

§ 1.752-1(c)

New § 1.752-1T(f)(1).

§ 1.752-1(d)

Similar to old § l.752-1(c) and new § 1.752-2T.

§ 1.752-l(e)

Similar to old § 1.752-1(d). Same in substance as new § 1.752-3T.

§ 1.752-2(a)

New § 1.752-1T(d)(1).

§ 1.752-2(b)

New Modifies rule in New § 1.752-1T(e) while reaching essentially the same result.

§ 1.752-2(c)

New § 1.752-1T(a)(1) and (2), § 1.752-1T(d)(2), and § 1.752-1T(e)(2).

§ 1.752-2(d)(1)(i)

New § 1.752-1T(a)(1)(ii), and § 1.752-1T(d)(3)(i)(A), with an example added.

§ 1.752-2(d)(1)(ii)

New § 1.752-1T(d)(3)(ii)(D)(2) and (3), and Example 11.

§ 1.752-2(d)(2)

New § 1.752-1T(d)(3)(iv).

§ 1.752-2(d)(3)

New § 1.752-1T(d)(3)(v), and Example 21.

§ 1.752-2(d)(4)

New § 1.752-1T(d)(3)(i)(B).

§ 1.752-2(d)(5)

New § 1.752-1T(d)(3)(ii)(F), and § 1.752-1T (d)(3)(ii)(A)(2)(ii).

§ 1.752-2(d)(6)

New § 1.752-1T(d)(3)(ii)(E).

§ 1.752-2(e)(1) and (2)

New § 1.752-1T(h)(1) through (4).

§ 1.752-2(e)(3)

New § 1.752-1T(h)(5).

§ 1.752-2(f)

New § 1.752-1T(j)(1).

APPENDIX B

Changes to Reflect Earlier NYSBA
Tax Section Substantive Recommendations

The attached version is the same as the preceding version, except that it contains the substantive changes recommended by the Tax Section in its July 5, 1989 Report: deletions from the preceding version are struck-through; additions are underlined. The changes appear on pages B-5, B-9, B—10, B-12, B-15, B-16, B-17, B-18 and B-19.

Proposed Revision of
Section 752 Regulations

§ 1.752-1. Treatment of certain liabilities --

(a) Increase in partner's share of liabilities. Any increase in a partner's share of partnership liabilities, or any increase in a partner's individual liabilities by reason of the partner's assumption of a partnership liability, shall be treated as a contribution of money by that partner to the partnership.

(b) Decrease in partner's share of liabilities. Any decrease in a partner's share of partnership liabilities, or any decrease in a partner's individual liabilities by reason of a partnership's assumption of such partner's individual liabilities, shall be treated as a distribution of money by the partnership to that partner.

(c) Assumption of liability. For purposes of section 752, a person is considered to assume a liability to the extent, but only to the extent, that as a result of the assumption --

(1) The assuming person is personally liable to pay such liability; and

(2) Where a partner (or a person related to a partner) assumes a partnership liability, the person to whom the liability is owed knows of the assumption and can

directly enforce the partner's (or related person's) obligation for the liability, and no other partner or person related to another partner would bear the economic risk of loss for the liability immediately after the assumption if the liability were treated as a partnership liability.

(d) Liability to which property is subject. If property is contributed by a partner to the partnership or distributed by the partnership to a partner and the property is subject to a liability of the transferor, the amount of the liability, to an extent not exceeding the fair market value of the property at the time of the contribution or distribution, shall be considered as having been assumed by the transferee.

(e) Sale or exchange of a partnership interest. If a partnership interest is sold or exchanged, liabilities shall be treated as liabilities are treated upon the sale or exchange of property not associated with a partnership. For example, if a partner sells his interest in a partnership for $750 cash and transfers to the purchaser his share of partnership liabilities amounting to $250, the seller realizes $1,000 on the transaction.

§ 1.752-2. Partner’s share of Partnership liabilities -- (a) Partner's share of recourse liabilities. A partner's share of the recourse liabilities of the partnership equals the portion of such liabilities for which the partner (or person related to the partner) bears the economic risk of loss. The following example illustrates this rule:

Example. A and B each contribute $500 in cash to the capital of a new general partnership. The partnership purchases Greenacres from an unrelated seller for $1,000 in cash and a $9,000 mortgage note. The note is a personal obligation of the partnership. The partnership agreement provides that profits and losses are to be divided 40% to A and 60% to B. A and B are required to make up any deficit in their capital accounts. For purposes of section 752, the $9,000 mortgage note is a recourse liability because the general partners together bear the full economic risk of loss for that liability. A's share of the $9,000 partnership liability is $3,500 and B's share is $5,500, because if Greenacres became valueless and the partnership were then liquidated, A's capital account would reflect a deficit that A would have to make up of $3,500 ($500 initial capital contribution less $4,000 share of loss on Greenacres) and B's capital account would reflect a deficit that B would have to make up of $5,500 ($500 initial capital contribution less $6,000 share of loss on Greenacres).

(b) Partner's share of nonrecourse liabilities. A partner's share of any nonrecourse liability of the partnership shall be the sum of --

(1) To the extent of the basis of the property subject to the liability, the portion of the basis allocable under section 704(b) to the partner (i) as depreciation (amortization or depletion) deductions over the depreciable (amortizable or depletable) life of the property and (ii) as recovery of basis upon disposition of the property at the end of such life (or upon current disposition of the property, if the property is not depreciable, amortizable, or depletable); and

(2) To the extent of any excess of the liability over the basis of the property subject to the liability, the portion of the excess that would be taxable to the partner as minimum gain under the section 704(b) regulations or as gain allocable to the partner under section 704(c) if the property were disposed of for no consideration other than satisfaction of the liability.

(c) Recourse and nonrecourse liabilities defined.

A liability is a recourse liability of the partnership to the extent that any partner bears the economic risk of loss for that liability; a liability is a nonrecourse liability of the partnership to the extent that no partner bears the economic risk of loss for chat liability.

(d) Economic risk of loss defined. In general, a person bears the economic risk of loss for a partnership debt to the extent the person would suffer the financial loss if partnership assets were not sufficient at the test date to pay the debt. The following rules shall be applied to determine whether a partner bears the economic risk of loss for a partnership liability.

(1) Obligation of partner or related person to make payment. (i) A partner bears the economic risk of loss for a partnership liability to the extent that the partner (or related person) has made or would be obligated to pay anyone because a partnership liability becomes due (and would not be entitled to be reimbursed by another partner, or person related to another partner, or the partnership) if all the partnership's liabilities were due and payable, all the partnership's assets (including money) were worthless, the partnership disposed of all its assets in a fully taxable transaction for no consideration

(other than relief from certain liabilities), and the partnership allocated all its items of income, gain, loss, deduction, and credit among the partners and liquidated. The following example illustrates this rule:

Example. A partnership borrows $10,000, secured by a mortgage on Whiteacres. The mortgage note contains an exoneration clause which provides that in the event of default, the holder's only remedy is to foreclose on Whiteacres; the holder may not look to any other partnership asset or to any partner to pay the debt. However, to induce the lender to make the loan, C, a partner, guarantees payment of $200 of the loan principal. The exoneration clause does not apply to C's guarantee. If C paid pursuant to the guarantee, C would be subrogated to $200 of the mortgage debt, but C is not otherwise entitled to reimbursement from the partnership or any partner. For purposes of section 752, $200 of the $10,000 mortgage liability is treated as a partnership recourse liability; $9,800 is treated as a partnership nonrecourse liability; and C's share of the $200 partnership recourse liability is $200.

(ii) For purposes of the preceding paragraph, it is to be assumed that every partner (or related person) will discharge any obligation such person has to pay a partnership liability or make a contribution to the partnership, even if such person's net worth is less than the amount of the obligation, unless the facts and circumstances indicate a plan to avoid such obligation. The following examples illustrate this rule:

Example (1). G and L form a limited partnership. G, the general partner, contributes $20,000 and L, the limited partner, contributes $80,000 in cash to the partnership. G is obligated to restore any deficit in its partnership capital account. The partnership agreement allocates losses 20% to G and 80% to L until L's capital account is reduced to zero, after which all losses are allocated to G. The partnership purchases depreciable property for $250,000 using its $100,000 cash and a $150,000 recourse loan from a bank. L guarantees payment of the $150,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership. If the property became valueless, G's capital account would reflect a $150,000 deficit (initial contribution of $20,000 less $170,000 share of loss) and L's capital account would be zero. Were the partnership then liquidated, G would be obligated to contribute $150,000 to the partnership. Because G is assumed to satisfy that obligation, it is also assumed that L would not have to make good on L's guarantee. Accordingly, the $150,000 mortgage is treated as a partnership recourse obligation. G's share of the liability is treated as $150,000, and L's share is treated as zero. This would be so even if G's net worth at the time of the determination is less than $150,000, unless the facts and circumstances indicate a plan to avoid G's obligation to contribute to the partnership.

Example (2). The facts are the same as in Example (1), except G is a subsidiary formed by a parent of a consolidated group with capital limited to $20,000 to allow the consolidated group to enjoy the tax losses it expected the property to generate while at the same time limiting its

monetary exposure for such losses. These facts, when considered together with L's guarantee, indicate a plan to avoid G's obligation to contribute to the partnership. In such event the rules of section 752 must be applied as if G's obligation to contribute did not exist. Accordingly, in such case the $150,000 liability is a partnership recourse liability that is allocated entirely to L.

(2) Arrangements tantamount to a guarantee. If one or more partners (or related persons) --

(i) Undertake one or more contractual obligations to facilitate a partnership's obtaining a loan;

(ii) Such obligations eliminate substantially all risk to the creditor that the partnership will not repay that loan (assuming that such partners or related persons satisfy their obligations); and

(iii) One of the principal purposes of the arrangement is to permit partners other than the partners giving such undertaking to include a portion of such liability in the basis of their partnership interests;

then the partners giving the undertaking shall be considered to bear the economic risk of loss for such liability in accordance with their relative economic burdens for that liability pursuant to such contractual obligations, and no other partner shall be considered to bear the economic risk

of loss from such liability. An obligation that is not dependent upon the future provision of substantial goods or services or the right to use property is tantamount to a guarantee, but an obligation so contingent is not. The following examples illustrate this rule:

Example (1). A and B form a partnership to acquire a building for $10.000 with the expectation that A will occupy the building and pay an arm's-length rent. A contributes $100 and B contributes $500 as their capital contributions, respectively, and they agree to share profits and losses equally. The partnership borrows the $9.400 balance of the purchase price from a bank on a recourse loan, pledging as security a lease of the building to A that obligates A to pay rent equal to the debt service requirements for the term of the borrowing, and providing that A will pay the rent in all events, even if it is prevented from using the property through no fault of its own. Assuming that the terms of the lease, the loan and the accompanying commercial arrangements, taken together have as a principal purpose permitting B to include a portion of the borrowing in its basis, the arrangement is tantamount to a guarantee Accordingly, the loan is reclassified as a recourse debt allocable entirely to A. The bases of A and B in their partnership interests therefore are $9.500 and $500, respectively.

Example (2). The facts are the same as in Example m. except that A is not required to pay rent for and period during which it cannot occupy the premises through no fault of its own. The arrangement is not tantamount to a guarantee Accordingly A includes $4.900 of the bank debt in its basis and B includes $4.500 in its basis (see the Example in § 1.752-2(a) above). Each therefore will have a basis in its partnership interest of $5,000.

(3) Special Rule for nonrecourse debt with interest guaranteed by partner. If --

(i) One or more partners (or related persons) have guaranteed payment of more than 20% of the total interest that will accrue over the future life (or expected life if the term is indefinite) of any partnership nonrecourse liability; and

(ii) It is reasonable to expect that the guarantor or guarantors will be required to pay substantially all such guaranteed future interest if the partnership fails to pay it;

then the liability shall be treated as two obligations: one a partnership recourse obligation for which such guarantors bear the economic risk of loss equal to the present value of the guaranteed future interest payments; and the other a partnership nonrecourse obligation equal to the present value of the future principal and any unguaranteed interest payments. Present value shall be computed by using the interest rate applicable to the liability for federal income tax purposes. For purposes of this rule, where the lender can enforce the guarantee only by first foreclosing on the property, it generally will not be reasonable to expect that the guarantor will be required to pay substantially all the future interest subject to the guarantee unless substantially all the interest and principal are payable only at the end of the term of the liability. This rule can be illustrated by the following examples:

Example (1). On January l, 1991, a partnership obtains a $4,000,000 nonrecourse loan secured by a shopping center. Interest accrues at a 15 percent annual rate and is payable on December 31 of each year. The principal is payable in a lump sum on December 31, 2005. A partner guarantees payment of 50 percent of each interest payment required by the loan. The guarantee can be enforced without first foreclosing on the property, i.nen the partnership obtains the loan, the present value (discounted at 15 percent, compounded annually) of the future interest payments is $3,508,422, and of the future principal payment is $491,578. If tested on that date, the loan would be treated as a partnership recourse liability of $1,754,211 for which the guaranteeing partner bears the economic risk of loss, and a partnership nonrecourse liability of $2,245,789.

Example (2). The facts are the same as in Example (1), except that the interest guarantee can be enforced only by first foreclosing on the property. If tested on the date the loan was obtained, the loan would be treated as a $4,000,000 partnership nonrecourse liability.

(4) Partner as creditor. (i) A partner bears the economic risk of loss for a partnership liability to the extent the partner (or related person) is the creditor who would bear the consequences of nonpayment of the liability and, but for this fact, the liability would be a nonrecourse partnership liability. This rule shall not apply if the creditor is a partner (or related person) whose interest (directly or indirectly through one or more partnerships, including the interest of any person related to the partner) in each item of partnership income, gain, loss, deduction or credit for any taxable year while the loan is outstanding is 10 percent or less, and the obligation constitutes qualified nonrecourse financing within the meaning of section

465(b)(6) (determined without regard to the type of activity involved). In the case of tiered partnerships, this IQ percent test shall be applied at the level of the obligor partnership. For purposes of this subparagraph, if a partnership liability owed to a partner (or related person) includes or reflects an obligation owed to another person to which property owned by the partnership is subject ("wrapped debt”), then such other person, and not such partner or related person, shall be treated as the person to whom the portion of the partnership liability corresponding to the wrapped debt is owed. This can be illustrated by the following example:

Example. Individual A purchases Yellowacres from unrelated seller X for $10,000 paying $1,000 in cash and giving a $9,000 purchase mortgage note on which A has no personal liability and as to which X can look only to Yellowacres for satisfaction. A sells Yellowacres to a partnership in which A is a general partner for $15,000 payable by a partnership purchase money mortgage note of $15,000 on which neither the partnership, nor any partner (or person related to a partner) has personal liability. The $15,000 mortgage note is a "wrapped debt" that includes the $9,000 obligation owed to X. Pursuant to this subparagraph, $6,000 of the $15,000 obligation is treated as a partnership recourse obligation because partner A bears the economic risk of loss on the $15,000 obligation to the extent of $6,000. For the same reason, A's share of this $6,000 recourse obligation is $6,000. The remaining $9,000 of the obligation is treated as a partnership nonrecourse obligation.

(5) Partner providing property as security for partnership liability -- (i) Direct pledge. A partner shall be deemed to bear the economic risk of loss for any partnership liability to the extent of the fair market value of any money or other property (other than his interest in the partnership) belonging to the partner (or related person) which is used as security for that liability.

(ii) Indirect pledge. If a partner contributes money or other property to a partnership that is used solely to secure payment of a partnership liability, then the partnership's obligation to use such money or other property to discharge the liability shall be treated as an obligation of the partner to pay the liability. Property securing a partnership liability is presumed to be used solely for this purpose if substantially all the items of income, gain, loss and deduction from the property are allocated to the contributing partner and this allocation is greater than the proportion of any other significant item of partnership income, gain, loss or deduction allocated to the partner.

(iii) Promissory notes. For purposes of (i) and (ii), property of a partner (or related person) does not include a promissory note of the partner (or related person) unless it is readily tradable on an established securities market.

(6) Time-value-of-money considerations. Any obligation of a partner, a person related to a partner, or the partnership to pay a partnership liability, or make a contribution to the partnership, shall be taken into account only to the extent of the value of the obligation. That value is determined as follows:

(i) An obligation to pay a partnership liability that must be satisfied within a reasonable time after it becomes due and payable by the partnership shall be valued at its outstanding principal amount. If it is not required to be paid within a reasonable time after it becomes due and payable by the partnership, it shall be discounted by valuing such obligation from the date it becomes due and payable by the partnership at the applicable Federal rate (within the meaning of section 1274 (d)) at the date of the partnership agreement (unless the interest rate provided by the obligation is at least equal to such Federal rate).

(ii) An obligation to contribute to a partnership shall be valued at its outstanding principal amount if it must be satisfied within a reasonable time after the partner's partnership interest is liquidated. If it is not required to be satisfied within a reasonable time, it shall be discounted by valuing such obligation at the applicable Federal rate (within the meaning of section 1274(d)) at the date of the partnership agreement (unless the interest rate provided for such obligation is at least equal to such Federal rate). An obligation to contribute to a partnership must be satisfied within a reasonable time after a partner's interest is liquidated only if --

(A) It must be satisfied pursuant to an obligation under state law, or

(B) It must be satisfied by contract by the later of (i) the end of the partnership taxable year in which the partner's interest in the partnership is liquidated, or (ii) 90 days after the date of such liquidation.

(iii) An obligation to make a payment or contribution is not satisfied by the delivery of a promissory note of the partner (or a related person) unless the promissory note is readily tradeable on an established securities market.

(e) Related person -- (1) General rule. A person is related to a partner if the relationship is specified in section 267(b) or section 707(b)(1), subject to the following modifications:

(i) A person's family shall not include the person's brothers and sisters.

(ii) Disregard sections 267(e)(1) and 267(f)(1)(A).

(iii) A person shall be treated as related only to the partner as to whoa there is the highest percentage of related ownership, determined using the constructive ownership rules in sections 267(b) and 707(b)(1) with the modifications in (i) through (ii) above. If more than one partner bears such highest percentage, the liability shall be allocated equally among the partners bearing such equal percentages of related ownership.

(2) Exception. Notwithstanding subparagraph (1), persons owning interests directly or indirectly in the same partnership shall not be treated as related persons for purposes of determining the economic risk of loss borne by each of them for such partnership's liabilities.

(3) Special rule where entity structured to avoid related party status. If --

(i) A partnership liability is owed to or guaranteed by another entity that is a partnership, corporation, or trust;

(ii) A partner (or related person) owns, directly or indirectly, a 20 percent or greater interest in the other entity; and

(iii) The other entity became the creditor or guarantor with a principal purpose of avoiding a determination that the partner bears the economic risk of loss for part or all of the liability;

then the partner shall be treated as holding the other entity's interest as a creditor or guarantor to the extent of the partner's (or related person's) interest in the entity. For purposes of this rule, a person's interest in a partnership shall equal his highest percentage in any item of partnership loss or deduction for any year; in an S corporation shall equal his percentage of the outstanding stock; in a C corporation shall equal his percentage of the fair market value of the outstanding stock; and in a trust shall equal his percentage of the actuarial interests.

(f) Tiered partnerships. Debt of a lower-tier partnership allocated to a partner that is an upper-tier partnership shall, for purposes of further applying section 752, be treated as debt (recourse or nonrecourse, as the case may be) of the upper-tier partnership.

(g) Correlation with section 751. Changes in the amount of debt allocated to a partner shall not give rise to a sale or exchange pursuant to section 751(b) in the absence of a change in the economic agreement or a shift in the sharing of profit or loss among the partners.

(h) Effective dates and transition rules. [To be supplied by the Treasury.]