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The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service, Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

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Proposed Section 752 Regulations

Dear Commissioner Rossotti and Mr. Talisman:

This letter comments on the recently proposed regulations that would amend Treasury Regulation § 1.752-3, which deals with the allocation of partnership nonrecourse liabilities among partners for purposes of Subchapter K.[1] The proposed regulations would effect two changes to the existing regulations by (1) modifying the third tier of the nonrecourse liability allocation rules and (2) specifying how to apportion a nonrecourse liability secured by multiple properties among such properties.

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[1] This letter was written by William B. Brannan and Patrick C. Gallagher. Helpful comments were received from Andrew Berg, Sherwin Kamin, Deborah Paul and Michael Schler.

A. Background

Any increase or decrease in a partner's share of partnership liabilities (as determined for purposes of Section 752) is treated as a contribution or distribution of money which increases or decreases the partner's basis in the partner's partnership interest under Sections 752, 722 and 733.[2] Under Section 731(a), a deemed distribution arising from a reduction of a partner's share of liabilities reduces a partner's basis in the partner's partnership interest and results in gain recognition to the partner to the extent the partner's basis would otherwise be reduced below zero.

For purposes of these rules, current Treasury Regulation § 1.752-3 provides a three-tier system for allocating partnership nonrecourse liabilities among partners. The first tier allocates to each partner an amount of nonrecourse liabilities equal to the partner's share of partnership minimum gain determined under Section 704(b) (i.e., the partner's share of any book gain the partnership would recognize if the partnership sold all its assets subject to one or more nonrecourse liabilities for only the amount of such liabilities). The second tier allocates to each partner an amount of any remaining nonrecourse liabilities equal to any taxable gain the partner would recognize under Section 704(c) as a result of such a sale. The third tier currently provides several methods (summarized below) for allocating any nonrecourse liabilities remaining after tiers one and two ("excess nonrecourse liabilities").

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[2] All "Section" references herein are to the Internal Revenue Code of 1986, as amended to date.

B. Comments to Proposed Regulations

While the Tax Section generally supports the proposed regulations, the Tax Section would like to make the following comments:

1. Third Tier Liability Allocation. The proposed regulation permits, as an additional third tier allocation method, allocating excess nonrecourse liabilities to a partner up to the partner's share of any Section 704(c) built-in gain (i.e., book value less basis) inherent in contributed property securing such liabilities to the extent such built-in gain exceeds the tier two Section 704(c) gain. This proposed regulation is beneficial in helping to minimize the potential for income recognition under Section 731 due to ongoing liability shifts relating to Section 704(c) property, as illustrated by the following example:

> Example (1). A and B form a partnership, with A contributing $900 of cash and B contributing a piece of land that has a gross fair market value of $200 and is subject to a nonrecourse liability in the amount of $100. A receives a 90% partnership interest, and B receives a 10% partnership interest. The land has a tax basis of $50. The nonrecourse liability amortizes at the rate of $10 per year; the partnership has no other liabilities.
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> Upon contribution, B does not have any gain recognition under Section 731 and current Section 752 law, because B has contributed property with a basis of $50 and has a net relief of liabilities of $45 ($100 of liability taken subject to by the partnership, less a first tier share of that liability of $0, a second tier liability share of $50 and a third tier liability share of $5 (assuming an allocation under the third tier based on

B's overall profits interest of 10%)). That leaves B with a $5 basis in his interest. Over time, however, B would recognize gain under Section 731 as his debt share is reduced under current Section 752 law. For example, at the end of year one, the liability amount will be reduced to $90, which causes B's second tier liability allocation to be reduced to $40 (but no changes under tier one or tier three). Thus, B would have a constructive cash distribution of $10, $5 of which would be taxable. The proposed regulation would avoid that result, because the partnership would be able to elect to allocate up to all $50 of the debt to be allocated under tier three to B. That follows because only $40 of the $150 of Section 704(c) gain inherent in the property has been taken into account under the tier two allocation.

While the proposed regulation is helpful to taxpayers, the Tax Section is concerned that the law regarding the third tier of nonrecourse liability allocation is becoming unduly complex. The current regulations already embody (1) a general rule that the third tier liability allocation should be based upon the overall interests of the partners in partnership profits, (2) an election to allocate a liability under the third tier based upon the allocation of any "significant" item of partnership income or gain, (3) an alternative election to make the third tier liability allocation in accordance with the manner in which deductions attributable to the liability will be allocated (as determined under complex Section 704(b) rules), (4) special rules for applying rules (1) and (3) above where the property subject to the liability is Section 704(c) property and (5) the ability to change the third tier liability method from year to year. This patchwork of rules is already quite daunting, even for experienced practitioners. The proposed regulations

would increase this complexity by adding yet another election.

All the complexity associated with the current regulations and now the proposed regulation is intended to achieve a nonrecourse liability allocation that minimizes the potential for gain recognition under Section 731 (particularly for partners that have contributed low basis property) and to provide sufficient basis for allocation of deductions attributable to the subject property. Moreover, the current regulations and the proposed regulation provide a fairly high degree of electivity to achieve that result, both in terms of the express elections that are available and the opportunities for structuring the relevant underlying facts.[3]

Because the foregoing policy decisions have been made, the Tax Section believes that there is an opportunity for simplification in this area. Accordingly, we recommend that the Section 752 regulations provide that liabilities may be allocated under the third tier based upon the overall interests of the partners in partnership book profits (based upon all the relevant facts and circumstances) or any other reasonable method. The regulations also should state (perhaps by way of example) that it is presumptively reasonable to allocate liabilities in a manner consistent with the prior Section 752 regulations or in any other manner intended to minimize gain recognition under Section 731 to a contributing partner or to provide adequate basis to allocate deductions attributable

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[3] Such opportunities for structuring would include (a) adding a special allocation of a "significant" item of income, (b) adding a special allocation of deductions attributable to the subject property, (c) choosing the Section 704(c) method that optimizes the debt allocation and (d) having partners guarantee portions of partnership liabilities.

to the subject property. This approach would better achieve the purposes of the regulations while at the same time sweeping away a large amount of complexity. We recognize that the "any reasonable method" rule may provide somewhat more flexibility in allocating liabilities under the third tier as compared to current law, but, as indicated above, current law provides a high degree of flexibility already and any truly abusive allocation would not satisfy the requirement of reasonableness. The "any reasonable method" rule would be broader than the specific rule in the proposed regulation, but we believe such additional breadth would better effectuate the purpose behind the proposed regulation.[4]

The following simplified example illustrates the limitations of the specific rule in the proposed regulations:

> Example (2). A and B form a partnership, with A contributing $950 of cash and B contributing a building that has a gross fair market value of $200 and is subject to a nonrecourse liability in the amount of $150. A receives a 95% partnership interest, and B receives a 5% partnership interest. The building has a tax basis of $50 and has a five year depreciation life. The nonrecourse liability amortizes at the rate of $10 per year; the partnership has no other liabilities.
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> Upon contribution, B does not have any gain recognition under Section 731 and

[4] The preamble to the proposed regulation acknowledges that the proposed regulation does not solve all concerns relating to liability shifts away from a contributing partner. The preamble states that more complicated approaches to better address such concerns were rejected as being too complicated.

current Section 752 law, because B has contributed property with a basis of $50 and has a net relief of liabilities of $47.50 ($150 of liability taken subject to by the partnership, less B's $102.50 share of that liability, which is comprised of a first tier share of $0, a second tier share of $100 and a third tier share of $2.50 (assuming an allocation under the third tier based on B's overall profits interest of 5%)). During the first year, the book basis of the property will decrease to $160 and the tax basis to $40, and the liability will decrease to $140. B will not experience gain recognition in the first year, because B's liability share will only decrease to $102 (comprised of a first tier share of $0, a second tier share of $100 and a third tier share of $2), resulting in only a $0.50 constructive distribution. However, after year one, B will experience taxable liability share reductions under current law. For instance, at the end of year two, when the book basis of the property decreases to $120, its tax basis decreases to $30 and the liability decreases to $130, B's liability share will decrease to $92 (comprised of a first tier allocation of $0.50, a second tier liability allocation of $90 and a third tier allocation of $1.50). That reduction results in a taxable constructive cash contribution of $10, $8 of which is taxable.

Even the proposed regulation would not appear to protect B in this case. The reason is that the Section 704(c) gain inherent in the building at the end of year two is only $90 ($120 book basis less $30 tax basis) and all $90 of that Section 704(c) gain is taken into account under

> the tier two liability allocation. Hence, there is no further Section 704(c) gain to take into account in making a special allocation of debt under tier three pursuant to the proposed regulation.[5] However, under the "any reasonable method" rule that we recommend, the partnership would be permitted to allocate sufficient debt to B under tier three to avoid gain recognition due to Section 752 effects.

The "any reasonable method" rule would allow extra liabilities to be allocated to B under the third tier to avoid gain recognition.

If the "any reasonable method" approach is not adopted and the approach of the proposed regulation is retained, we would recommend one modification. Treasury Regulation § 1.752-3(a)(2) by its terms encompasses not only taxable gain that would be allocated under Section 704(c), but also so-called "reverse Section 704(c)" tax allocations resulting from a revaluation of partnership property for Section 704(b) purposes. In contrast, the proposed regulation covers only "built-in gain on section 704(c) property (as defined under section 1.704-3(a)(3)(ii))," which includes built-in gain (book value less basis) attributable to contributed property, but not built-in gain attributable to property subject to a revaluation. We see no policy reason for this disparate treatment of revaluations under the tier two liability

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[5] We assume that the reference to "built-in gain on section 704(c) property (as defined under section 1.704-3(a)(3)(ii))" in the proposed regulation refers to the original amount of built-in gain, as reduced over time to reflect the convergence of book and tax basis, as described in the second sentence of such Section 704(c) regulation. This might be clarified in the final Section 752 regulation.

allocation rules as compared to the tier three rules, and we recommend that the final regulations expand the proposed tier three rules to cover built-in gain arising from a revaluation.

Regardless of whether the Tax Section recommendation or the approach of the proposed regulation is followed, the new third tier liability allocation rule in the Section 752 regulations must be coordinated with the disguised sale regulations. Under current law, the third tier nonrecourse liability allocation rule is incorporated by reference for purposes of allocating nonrecourse liabilities for disguised sale purposes.[6] Hence, any change to the third tier liability allocation rule would have implications for disguised sale purposes. The best approach would be for the disguised rule regulations to be amended to include their own self-contained liability allocation rule.[7] However, if the approach of the proposed regulation is followed, the cross-referencing approach could still be used, provided the disguised sale regulations are amended to indicate that the portion of the new Section 752 regulations referring to the built-in gain inherent in Section 704(c) property is to be disregarded for this purpose.[8]

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[6] See Treas. Reg. § 1.707-5(a)(2)(ii).

[7] That approach would also allow reconsideration of the appropriateness of incorporating by reference all aspects of the third tier liability allocation rule for disguised sale purposes.

[8] If the Tax Section's recommendation is accepted, the cross-referencing approach would not be appropriate in the Tax Section's opinion, since the "any reasonable method" approach would seem to grant too much flexibility in allocating nonrecourse liabilities as compared to current law, where there is at least some theoretical linkage between the third tier nonrecourse liability allocation and the

2. Allocating a Liability Among Multiple Properties. We have three technical comments to Proposed Treasury Regulation § 1.752-3(b)(1) regarding the apportionment of a single nonrecourse liability among multiple properties.

The proposed regulation does not expressly address the effect of a senior liability in apportioning a junior liability. As a safeguard against unreasonable allocations among multiple properties where such properties are subject to more than one class of liability, we suggest revising the second sentence of this regulation along the following lines: "A method is not reasonable if it allocates to any item of property an amount of the liability in excess of the fair market value of the property (net of any liability allocated to such property that is senior in priority to the liability being allocated) at the time the liability is incurred." Cf. Treasury Regulation § 1.704-2(d)(2)(ii).

The last sentence of the proposed regulation provides that, if a property ceases to be subject to a liability, the portion of the liability allocated to that property is reallocated among the properties still subject to the liability so that the amount of the liability allocated to any property does not exceed the fair market value of the property at the time of the reallocation. This fair market value limitation could result in a portion of the liability not being allocated to any property if, at the time of the reallocation, the liability amount exceeds the aggregate value of the remaining properties. To address this fact pattern, we suggest creating an exception to the fair market value limitation providing that, in such a case, the portion of the liability to be reallocated must be reallocated among the remaining properties so that the amount of the liability allocated to any

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economic arrangement of the partners.

property does not exceed the product of (1) the amount of the liability times (2) a fraction, the numerator of which is the fair market value of that property and the denominator of which is the aggregate fair market value of all properties still subject to the liability.

We recommend adding to the final regulations a rule (perhaps comparable to the reallocation rule described in the preceding paragraph) providing for the reallocation of a nonrecourse liability among properties where an additional partnership property becomes subject to the liability after the initial allocation. The proposed regulation states that generally a partnership may not change its initial method of allocating a liability among properties, which can be read to suggest that allocating any portion of an existing liability to a new property is prohibited. This issue can arise whenever (1) a new partnership property becomes additional collateral for a secured, nonrecourse partnership debt or (2) an additional property is acquired by a partnership which has outstanding (secured or unsecured) debt that is recourse to the partnership but nonrecourse to its partners (and therefore is nonrecourse debt for Section 752 purposes).[9]

3. Effective Date. Under Proposed Treasury Regulation § 1.752-3(d), the new regulations would only be effective for liabilities incurred or assumed on or after the date on which final regulations are promulgated. The Tax Section recommends that this rule be modified by either

[9] Situation (2) is common for limited liability companies, since as a matter of law no member has personal for entity liabilities. However, situation (2) also is not uncommon for ordinary partnerships, because the general partners of ordinary partnerships often seek to be exculpated in the loan documents.

adding an express election to apply the new regulations to a preexisting liability or, alternatively, by adding a statement that the IRS will not challenge a partnership that applies the principles of the new regulations to a preexisting liability (provided in either case that such liability is otherwise subject to Treasury Regulations §§ 1.752-1 through 1.752-4).

Both aspects of the proposed regulations seem appropriate for retroactive application. First, the proposed regulation regarding the third tier of nonrecourse liability allocation represents a refinement and extension of certain concepts already embodied in Rev. Rul. 95-41, 1995-1 C.B. 132. Hence, that aspect of the new regulation is not entirely new. Second, the proposed regulation regarding the apportionment of a single liability among multiple properties fills a void that presently exists in the Section 752 law, and the proposed regulation reflects what many practitioners have thought the law should be. Making the proposed regulation available on a retroactive basis will help minimize the number of controversies over this issue for preexisting liabilities.

In view of the foregoing, the Tax Section recommends that the final regulations either include an election to apply them retroactively to a preexisting liability or state that the IRS will not challenge application of the principles of the final regulations to a preexisting liability. We would note that similar considerations led to a comparable election being made available in the current Section 752 regulations when they first appeared. See Treasury Regulation § 1.752-5.

If you have any questions regarding this report or would like any additional input, please let us know and we will be glad to assist.

Very truly yours,

Robert H. Scarborough,
Chair

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