NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

ALLOCATIONS OF RECOURSE LIABILITIES AMONG RELATED PARTNERS

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Report No. 1262

New York State Bar Association Tax Section
Allocations of Recourse Liabilities Among Related Partners

Introduction

This report[1] discusses the rules under Section 752[2] that allocate a "recourse" partnership liability on the basis of the partners' relationships to persons that bear "economic risk of loss" (or "EROL") for the liability.[3] A liability is "recourse" to the extent that a partner or a "related person" bears EROL for the liability,[4] and a person is treated as bearing such EROL to the extent such person would be obligated to make payment, without reimbursement from another partner or related person, if the liability were due, the partnership's assets and cash were sold for no consideration (other than relief from liabilities for which the creditors' right to repayment is limited solely to the assets of the partnership) and the partnership were liquidated.[5] Very generally, a recourse liability is allocated among partners based on their direct and attributed EROL for such liability (the "General EROL Rule").[6]

For purposes of this report, "actual EROL" means EROL borne directly by a person whether or not such person is a direct or indirect partner in a partnership, but does not include EROL attributed to such person from another person by reason of their relationship to each other. "Direct EROL" means EROL borne directly by a partner (or partner in a partnership that is, directly or through one or more other partnerships, a partner) and does not include EROL borne by a person that is not a direct or indirect partner. "Attributed EROL" means EROL directly borne by a person related to a partner

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[2] Section refers to a section of the Internal Revenue Code of 1986, as amended, or the regulations thereunder.

[3] Articles discussing these rules include Sloan & Alexander, *Economic Risk of Loss: The Devil We Think We Know*, 84 *Taxes* 217 (Mar. 2006); Kalinka, *IPO II v. Commissioner and the Allocation of an LLC's Recourse Liabilities*, 2004 *TNT* 193-50; Feeley & McCurry, *Non-Economic Risk of Loss: Allocating Partnership Debt in Controlled Groups*, 27 *Tax Mgmt. Real Est.* J. 463 (December 2011); Todrys, *Recourse Debt Is Usually Nonrecourse: A Comment*, 84 Taxes 251 (Mar. 2006); Harris, *I Am Not My Brother's Keeper and Other Lessons From the Related-Party Rules of Section 752*, 114 *J. of Tax'n* 23, (January 2011); Kehl, *Tax Court's Decision in "IPO II" Addresses Some Outstanding Issues Regarding Related Party Rules*, 23 *Tax Mngt. Wkly. Rpt.* 1290 (Aug. 24, 2004).

[4] Treas. Reg. § 1.752-1(a)(1).

[5] Treas. Reg. § 1.752-2(b)(1).

[6] "A partner's share of a recourse liability equals the portion of that liability, if any, for which the partner or a related person bears economic risk of loss." Treas. Reg. § 1.752-2(a).

(or an upper-tier partner) that is attributed to that partner by reason of that relationship. For each of these terms, a partner or related person is not treated as bearing EROL for a liability to the extent that the partner or related person is entitled to reimbursement (by contract, statute or otherwise) from another partner or person related to another partner.[7]

The report accepts, without evaluation, that the touchstone for allocating recourse liabilities is how the partners and related persons bear the EROL with respect to partnership liabilities.[8] It also does not evaluate the rules for determining the extent to which a person is treated as bearing actual EROL for this purpose. The sole focus of this report is on *when* EROL for a liability should be attributed to one or more partners by reason of such partners' relationship with another partner or other person who bears actual EROL for the liability and *how* any attributed liability should be allocated among partners based on their direct and attributed EROL. Though simple in concept, the current rules for making these determinations are susceptible to differing interpretations, some of which can lead to inappropriate allocations of recourse debt and inappropriate treatment of debt as either recourse or nonrecourse. In addition, some of these rules, while clear in their application, conflict with each other. For these reasons, we recommend that the Internal Revenue Service (the "Service") and the Treasury Department ("Treasury") amend the current regulations under Section 752 in a number of respects.

This report is divided into four parts. Part I of this report provides background and a general summary of the current regulations governing the allocation of recourse debt under Section 752, and briefly notes a number of ambiguities under the current regulations. Part II lists our recommended changes to these regulations. Part III describes in greater detail various ambiguities, gaps and odd results under the current regulations. Part IV discusses the reasons for our recommended changes.

I. Background and Summary of Current Regulations

How partnership liabilities are allocated is fundamental to subchapter K because a partner's share of liabilities increases the partner's basis in its partnership interest.[9] The amount of a partner's basis in the partner's partnership interest in turn determines the extent to which gain is recognized by a partner upon receipt of a

[7] Treas. Reg. § 1.752-2(b)(5).

[8] *See*, *e.g.* , *H.R. Conf. Rep.* No. 98-861, at 869 (" . . . the conferees intend that the revisions to the section 752 regulations will be based largely on the manner in which the partners, and persons related to the partners, share the economic risk of loss with respect to partnership debt . . . ."). We note, however, that commentators and practitioners have questioned the soundness of that tax policy conclusion. *See*, *e.g.*, Todrys, *Recourse Debt Is Usually Nonrecourse: A Comment*, 84 *Taxes* 251 (Mar. 2006).

[9] Under Section 752, an increase (or decrease) in a partner's share of partnership liabilities is treated as a cash contribution by (or distribution to) the partner to (or from) the partnership, which in turn has the effect of increasing (or decreasing) the partner's basis in its partnership interest under Sections 722 and 733.

distribution of cash from the partnership under Section 731,[10] the amount of gain or loss recognized by a partner upon the sale of the partnership interest under Section 1001, the deductibility by a partner of partnership losses under Section 704(d),[11] and in certain cases a partner's basis in distributed property under Section 732(a) and (b).[12]

Recourse liabilities are allocated according to how partners (or related persons) share EROL because EROL reflects how these liabilities would be borne if partnership capital is insufficient to satisfy the liabilities.[13] Nonrecourse liabilities (*i.e.*, all liabilities other than recourse liabilities)[14] are generally allocated according to how the partners share profits.[15] Additionally (and very generally), once a debt-financed tax benefit is derived by a partner from a nonrecourse liability of the partnership, the allocation of the liability associated with such tax benefit is allocated in the same manner as the tax benefit.[16] Thus, because a partner's relative share of any tax benefit derived from nonrecourse liabilities depends in substantial part upon such partner's relative share of the profits, the allocation of nonrecourse liabilities follows this general model.

The current regulations governing allocations of recourse liabilities were issued in response to the legislative override of the *Raphan* decision in 1984.[17] In *Raphan*, the U.S. Claims Court held that a personal guarantee by a limited partnership's general partner of the partnership's nonrecourse liability did not preclude the liability from being allocated to the limited partners as a nonrecourse liability where the general partner's guarantee was not made part of the partnership agreement. Describing the

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[10] Section 731(a)(1) generally provides that no gain is recognized to a partner upon receipt of a partnership distribution to the extent of the partner's outside basis in the partnership interest.

[11] Section 704(d) generally provides that a partner's distributive share of partnership loss is allowed as a deduction only to the extent of the partner's adjusted outside basis at the end of the partnership year in which the loss is incurred. Losses disallowed to a partner under § 704(d) may be carried forward indefinitely until sufficient outside basis is available to permit their deduction.

[12] For current (nonliquidating) distributions, Section 732(a)(2) generally limits the carryover basis rule of Section 732(a)(1) to the partner's pre-distribution outside basis in its partnership interest (reduced by any money distributed in the same transaction). For property (other than money) distributed by a partnership in complete liquidation of a partner's partnership interest, Section 732(b) generally provides that the basis of such property in the partner's hands is equal to the partner's pre-distribution outside basis in its partnership interest (reduced by any money distributed in the same transaction).

[13] *See generally* Burke & Friel, *Allocating Partnership Liabilities*, 41 *Tax L. Rev.* 173 (1986); Postlewaite & Bialosky, *Liabilities in the Partnership Context—Policy Concerns and the Forthcoming Regulations*, 33 *U.C.L.A. L. Rev.* 733, 744-46 (1986); Utz, *Partnership Taxation in Transition: Of Form, Substance, and Economic Risk*, 43 Tax Law. 693, 694, 705-07 (1990).

[14] Treas. Reg. § 1.752-1(a).

[15] Treas. Reg. § 1.752-3(a)(3) (allocation of "excess" nonrecourse liabilities).

[16] Because only lenders bear actual EROL on nonrecourse liabilities, any current or future tax benefit derived by a partner from the allocation of such liabilities is subject to recapture under the "minimum gain" rules. *See* Treas. Reg. § 1.704-2(f)(1). *See also Crane v. Comm'r*, 331 U.S. 1 (1947) (rules requiring inclusion of liabilities in basis and amount realized apply to nonrecourse as well as recourse debt).

[17] *Raphan v. United States*, 3 Cl. Ct. 457 (1983), *aff'd in part and rev'd in part,* 759 F.2d 879 (Fed. Cir. 1985).

holding as "inappropriate,"[18] Congress legislatively overrode *Raphan* in the Deficit Reduction Act of 1984 ("DEFRA").[19] Congress further directed Treasury to amend the Section 752 regulations in effect at that time (the "Old Regulations")[20] to address the effect of "guarantees, assumptions, indemnity agreements, and similar arrangements,"[21] based "largely on the manner in which the partners, and persons related to the partners, share the economic risk of loss with respect to partnership debt . . . ."[22]

In response to this directive, Treasury issued Proposed and Temporary Regulations in 1988,[23] which were amended in 1989 (as amended, the "Temporary Regulations").[24] While the Temporary Regulations provided comprehensive rules for allocating partnership liabilities in accordance with the 1984 directive, they were widely criticized for their length and complexity.[25] In response, Treasury simplified and then

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[18] *H.R. Rep. No. 432*, 98th Cong., 2d Sess. 1235 (1984).

[19] P.L. 98-369 (1984). Section 79(a) provided that "Section 752 . . . (and the regulations prescribed thereunder) shall be applied without regard to the results reached in the case of Raphan . . . ."

[20] T.D. 6175, 1956-1 C.B. 211 (January 1956). The Old Regulations were relatively brief and provided, in relevant part, that:

> [a] partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement. . . . However, where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits.

Treas. Reg. § 1.752-1(e) (1956). *See generally* Burke & Friel, *Allocating Partnership Losses*, 41 *Tax L. Rev*. 173 (1986).

[21] DEFRA, § 79(b).

[22] H.R. Rep. No. 861, 98th Cong., 2d Sess. 869 (1984).

[23] T.D. 8237, 1989-1 C.B. 180 (Dec. 30, 1988).

[24] T.D. 8274, 1989-2 C.B. 101 (Nov. 21, 1989).

[25] *See*, *e.g.*, Abrams, *Long Awaited Regulations under Section 752 Provide Wrong Answer*s, 44 *Tax Law Rev.* (Summer 1989) at note 26 ("In their broadest strokes and simplest examples, the temporary regulations continue the [EROL] principles elucidated in [post- *Raphan* case law]. However, elaborate detail fills page after page and terms are defined endlessly. Somewhere in this mass of detail, the broad principles were lost."); New York State Bar Association Tax Section, *Report on Allocation of Partnership Debt Regulation* s (July 5, 1989) ("In the style of many recent regulations, the length, complexity and details of the rules effectively require a tax adviser to have invested a long time in study to have confidence even in relatively common situations."); *Millman, A Critical Analysis of the New Section 752 Regulations*, 43 *Tax Law.* 1 (Fall 1989), at 32 ("The regulations present an intricate pattern of complex rules. As a result, the regulations are long and difficult to understand."); Levine, Hoffman & Presant, *A Practical Guide to the Section 752 Temp. Regs.—Part I*, 70 *J. Tax'n* 196 (April 1989) ("The Regulations are both lengthy and extremely complex as a result of the current regulatory trend that attempts to address nearly every conceivable transaction."); Henderson, *Controlling Hyperlexis*, 43 *Tax Law.* 177 (1989) ("The complicated regulations under Section[s] . . . 752 should be rewritten and simplified."). Though simpler than the Temporary Regulations, the Current Regulations are generally not substantively different. *See generally* Sloan & Alexander, *Economic Risk of Loss: The Devil We Think We Know*, 84 *Taxes* 217 (Mar. 2006).

finalized the regulations in 1991 (the "Current Regulations" or simply the "Section 752 Regulations").[26]

Under the Current Regulations, a partner is treated as related to a person bearing EROL for a partnership liability if their relationship to each other is specified in Section 267(b) or 707(b)(1), substituting (among other modifications) an "80% or more" threshold for the "more than 50%" thresholds under those sections (the "General Related-Party Rule").[27] If a person is related to more than one partner under the General Related-Party Rule, the person is treated as related *only* to the partner with whom such partner shares the highest percentage of related ownership (the "Greatest Relatedness Rule").[28] If two or more partners share the highest percentage of related ownership, the liability is allocated equally among such partners, regardless of their relative ownership interests in the partnership (the "Per Capita Rule").[29] As described more fully in Part III below, because the Greatest Relatedness and Per Capita Rules ignore the partners' relative economic interests in the partnership, they may result in an uneconomic and/or arbitrary allocation of the liability.

Under an important exception to these rules, persons "owning interests directly or indirectly in the same partnership are *not* treated as related persons for purposes of determining the economic risk of loss borne by each of them for the liabilities of the partnership" (the "Related-Person Exception").[30] The objective of the Related-Person Exception is to prevent the allocation of a partnership liability to a partner who does *not* bear direct EROL merely because the partner happens to be related to a direct or indirect partner who *does* bear direct EROL.[31] As described in Part III below, the scope of the Related-Person Exception is unclear in several respects, including with regard to how the exception limits the General Related-Party Rule as well as whether it is broad enough to prevent a partner from being treated as related to a subsidiary of the partnership by reason of the partner's ownership in the partnership.

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[26] T.D. 8380, 1992-1 C.B. 218 (Dec. 20, 1991).

[27] Treas. Reg. §§ 1.752-1(a)(3), -4(b)(1). More specifically, under Section 267(b) (as modified) (i) an individual owning (directly, indirectly or constructively) 80% or more by value of a corporation's stock is related to the corporation, (ii) two corporations are related if they are connected by stock ownership of at least 80 percent at each link (iii) a corporation and a partnership are related if the same persons own (directly, indirectly or constructively) 80% or more of both the corporation's stock (by value) and the capital or profits interest of the partnership and (iv) an individual is related to spouses, ancestors, and lineal descendants (but not to brothers and sisters). Under Section 707(b) as modified, a partner and a partnership are related if the partner owns (directly, indirectly or constructively) an interest of 80% or more in the partnership capital or profits, and two partnerships are related if 80% or more of the profits or capital interests in the two partnerships are owned (directly indirectly or constructively) by the same persons.

[28] Treas. Reg. § 1.752-4(b)(2)(i).

[29] Id.

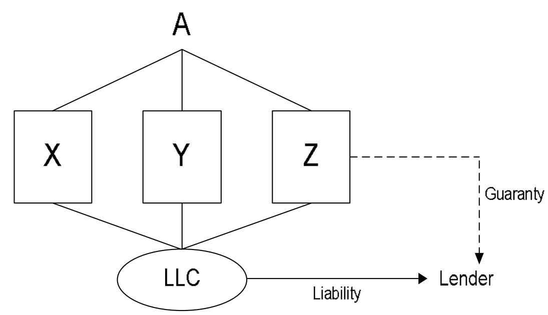
[30] Treas. Reg. § 1.752-4(b)(2)(iii).

[31] *See* discussion at note 40, *infra* .

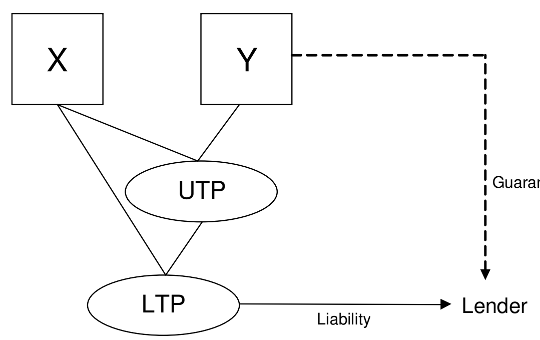
Finally, special allocation rules apply in cases of tiered partnerships (collectively, the "Tiered-Partnership Rules"). If a partnership (a "UTP") is a direct or indirect partner of another partnership (an "LTP"), the UTP is allocated liabilities of the LTP to the extent that it and its partners bear EROL of the LTP.[32] A UTP's share of liabilities of an LTP is treated as a liability of the UTP for purposes of allocating the UTP's liabilities among the partners of the UTP, except that a liability of the LTP owned by the UTP is ignored for this purpose.[33]

The following examples illustrate the application of these rules:

Example 1: Individual A owns all of corporations X, Y and Z, which together form LLC.[34] Under the Related-Person Exception, if Z guarantees an LLC liability, the liability will be allocated only to Z because X and Y are treated as not related to Z for purposes of determining their EROL.



Example 2: Unrelated corporations X and Y form UTP,[35] which together with X form LTP. Y then guarantees a liability of LTP. Under the Tiered-Partnership Rules, LTP allocates the entire liability to UTP, which in turn allocates the entire liability to Y under the General EROL Rule.



The Related-Party Exception also ensures that, if an upper-tier partner of a UTP bears EROL for a liability of an LTP, such EROL will not be attributed to partners of the LTP that are otherwise related to such upper-tier partner. This is because the Related-Person Exception "turns off" relatedness between the upper-tier partner (as an indirect partner of LTP) and the other partners of the LTP. In a simple case, therefore, the application of the Tiered-Partnership Rules in conjunction with the Related-Party Exception is relatively straightforward: they operate to ensure that the LTP will allocate all of the liability to UTP, which in turn will allocate it to the upper-tier partner under the General EROL Rule.

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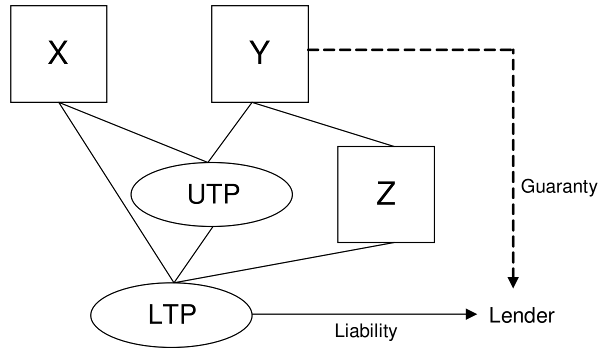
[32] Treas. Reg. § 1.752-2(i).

[33] Treas. Reg. § 1.752-4(a).

[34] "LLC" refers to a limited liability company classified as a partnership for Federal tax purposes. Except as otherwise specified in any example in this report, every member of the LLC has limited liability.

[35] For purposes of this report, every UTP and LTP is assumed to be an LLC.

Example 3: Assume the same facts as in Example 2, except that Y also owns corporation Z, which is also a partner of LTP. Under the Related-Person Exception, Y and Z are treated as not related. Therefore, all of the liability continues to be allocated first to UTP under the Tiered-Partnership Rules and then to Y under the General EROL Rule.



As described in more detail in Part III below, the application of the Tiered-Partnership Rules is less clear in other cases. For example, there is significant ambiguity under the Tiered-Partnership Rules regarding how a liability should be allocated from an LTP to its partners when an upper-tier partner has direct EROL and may therefore be allocated the associated liability in more than one way.

In addition, the original Temporary Regulations provided that, if two or more partners bear EROL for a partnership liability and the aggregate amount of their risks (determined individually) exceeds the total amount of the liability, the EROL deemed to be borne by each partner is based on the ratios that their individually determined amounts of EROL bear to the sum of all such amounts (the "Proportionality Rule").[36] The Current Regulations neither preserved nor replaced the Proportionality Rule. It is unclear whether, in its effort to simplify the Temporary Regulations, Treasury unintentionally omitted or deliberately rejected the Proportionality Rule, leaving practitioners with uncertainty as to how to apply the General Related-Party Rule in certain circumstances.[37]

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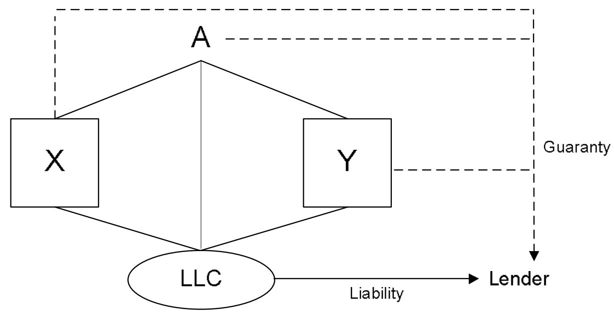
[36] Temp. Reg. § 1.752-1T(d)(3)(i) ("If the aggregate amount of the economic risk of loss that all partners are determined to bear with respect to a partnership liability (or portion thereof) . . . exceeds the amount of such liability (or portion thereof), then the economic risk of loss borne by each partner with respect to such liability shall equal the amount determined by multiplying the amount of such liability (or portion thereof) by the fraction obtained by dividing the amount of the economic risk of loss that such partner is determined to bear with respect to that liability (or portion thereof) . . . by the sum of such amounts for all partners."). *See also* Temp. Reg. § 1.752-1T(k), *Example* 9(iv).

[37] *See*, *e.g.*, *Letter of Renato Beghe to House Ways and Means Committee on Simplification of the Section 752 Regulations*, 90 *TNT* 233-16 (April 18, 1990); NYSBA Tax Section, *Report on the Allocation of Partnership Debt Regulations,* 89 *TNT* 140-26 (July 5, 1989); *NYSBA Offers Simplified Partnership Liability Allocation Regulations*, 90 *TNT* 13-6 (January 12, 1990); Harris, *I Am Not My Brother's Keeper and Other Lessons From the Related-Party Rules of Section 752,* 114 *J. of Tax'n* 23, at note 15 (January 2011).

Example 4: Assume individual A owns corporations X and Y, that A, X and Y form LLC and that each of A, X and Y guarantee the liabilities of LLC.[38] Assume further that A, X and Y have no right of contribution or reimbursement from each other with respect to the guarantee. Under the Proportionality Rule, one third the liability would be allocated to each of A, X and Y.



II. Summary of Recommendations

We recommend that Treasury and the Service modify the Section 752 Regulations governing allocations of recourse liabilities in the following manner:

1. Replace the Related-Person Exception with two more narrowly tailored exceptions to the General Related-Party Rule:

   - First, clarify that, if a partner bears direct EROL for a liability, such partner is not treated as related to any other partner for purposes of attributing such EROL to such other partner (the "Direct Partner Exception"). This recommendation ensures that the liability will be allocated to only that partner, except when two or more partners bear direct EROL for the liability, in which case it will be allocated among them based on the Proportionality Recommendation (described below).

   - Second, clarify that, if a partner of a UTP bears direct EROL for a liability of an LTP, such upper-tier partner is not treated as related to any (direct or indirect) partner of the LTP for purposes of attributing such upper-tier partner's direct EROL to any partner of the LTP (the "Upper-Tier Partner Exception"). This recommendation ensures that the direct EROL of an upper-tier partner is not attributed to a direct partner of the LTP, as the Section 752 Regulations now provide.

2. Clarify that, under the General Related-Party Rule, a partner of a partnership is not treated as owning any interest in the partnership for purposes of attributing to such partner the EROL of an entity owned in whole or in part by

[38] This example assumes all the partners are under common control because it would be unlikely that unrelated partners would have direct EROL for the same liability. As a business matter, unrelated partners would likely insist on legal clarity about how they share EROL for the liability as among themselves, and each partner's reimbursement right from the other partners would reduce the partner's EROL. Treas. Reg. § 1.752-2(b)(5).

such partnership (the “Partnership Subsidiary Recommendation”). This ensures that a liability owed by partnership to its subsidiary (or owed to a third party and guaranteed by the subsidiary) is not treated as recourse to a partner solely by reason of the partner’s interest in the partnership and the attribution of EROL for such liability from the subsidiary to the partner.

3. Adopt a new rule clarifying that, to the extent that a liability would be allocated to a direct partner under the General EROL Rule (after applying the General Related-Party Rule as qualified by the above recommendations), the Tiered-Partnership Rules will not apply to allocate the liability in another manner (the “Recommendation for Limiting the Tiered-Partnership Rules”). This ensures that, if a partner of a UTP is also a partner in the LTP and bears EROL for a liability of the LTP, the LTP will allocate all of such liability to such partner in its capacity as a direct partner in the LTP.

4. Adopt a new rule specifying that, if two or more partners have direct EROL for the same liability, the liability is allocated among them based on the Proportionality Rule (the “Proportionality Recommendation”). This fills a gap in the Section 752 Regulations by providing a method for allocating such liabilities.

5. Withdraw the Greatest Relatedness Rule so that a liability for which two or more partners have attributed EROL is allocated under the Per Capita Rule regardless of the partners’ relative relationships to the person that bears actual EROL for the liability (the “Enhanced Per Capita Recommendation”). This avoids the potential cliff effect of the Greatest Relatedness Rule, which can radically shift the allocation of a liability among two or more partners with attributed EROL based on small changes in their relative relationships to the person with actual EROL.

6. In lieu of adopting the Recommendation for Limiting the Tiered-Partnership Rules, the Proportionality Recommendation and the Enhanced Per Capita Recommendation, consider withdrawing the Greatest Relatedness and Per Capita Rules and adopting a new set of rules that would allocate a liability among partners similarly situated with respect to the direct or attributed EROL for such liability in manner analogous to how nonrecourse debt is allocated under Treas. Reg. § 1.752-3 (the “Overlapping EROL Recommendation”), recognizing that the complexity of such rules may outweigh their benefit.

III. Current Law Ambiguities, Gaps and Odd Results

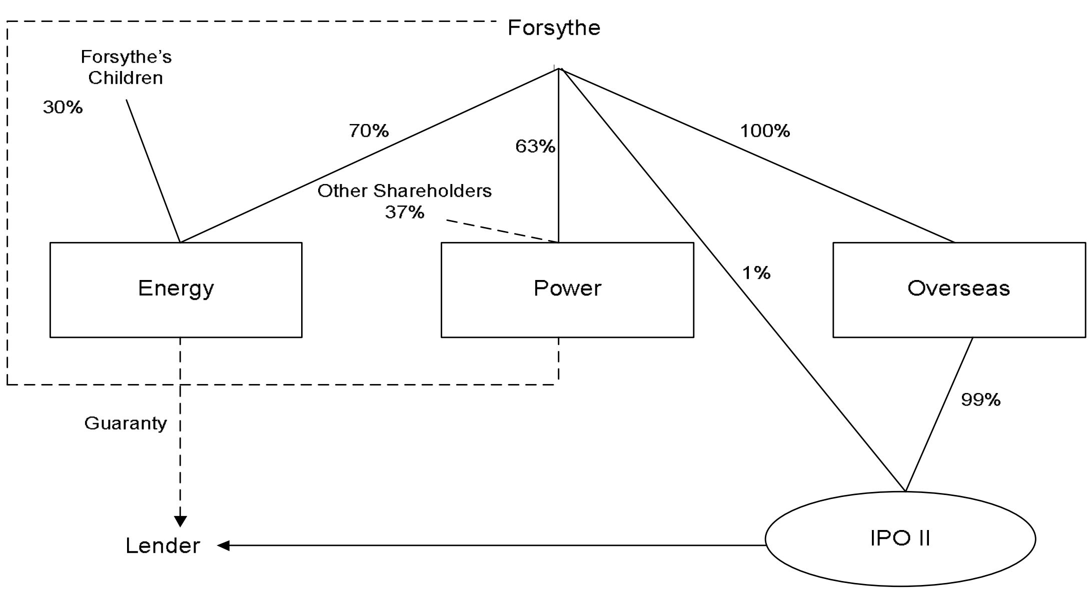
1. Ambiguities with the Scope of “Relatedness”.

The manner in which the General Related-Party Rule modifies and applies Sections 267(b) and 707(b)(1) is generally clear. Even clearer, as confirmed by the Tax

Court in *IPO II v. Comm'r*,[39] is the core purpose of the Related-Person Exception – to prevent direct EROL of a direct or indirect partner from being attributed to another partner merely because they are related.[40] In several respects, however, precisely how the Related-Person Exception limits the General Related-Party Rule is unclear, an ambiguity that the court's reasoning in *IPO II* did little to clarify. In addition, it is very unclear whether the Related-Person Exception is broad enough to prevent a partner from being treated as related to a subsidiary of the partnership (and thus attributed EROL from the subsidiary) by reason of the partner's ownership in the partnership.

A. <u>The Related-Person Exception as Interpreted in *IPO II.*</u>

The relevant facts of *IPO II* were as follows: Mr. Forsythe, an individual, owned all of the stock of Indeck Power Overseas Ltd., an S corporation ("Overseas"), 70% of the stock of Indeck Energy Services, Inc. ("Energy"), also an S corporation, and 63% of the stock of Indeck Power Equipment Co. ("Power"), a C corporation. The balance of the Energy stock was held by Mr. Forsythe's children. Mr. Forsythe and Overseas owned all of the membership interests of a limited liability company classified as a partnership for Federal tax purposes ("IPO II"). Under the IPO II operating agreement, no member of IPO II had any liability for the obligations of IPO II solely by reason of being a member, and IPO II's profits and losses were allocated 99% to Overseas and 1% to Mr. Forsythe.



[39] 122 T.C. 295 (2004).

[40] *IPO II*, 122 T.C. at 303. ("We interpret the policy behind the related partner exception as preventing the shifting of basis from a party who bears actual economic risk of loss to one who does not. This means that losses are allowed, to the extent of basis, to the party who is actually exposed to the risk of economic loss through the application of statute, organizational documents, or other contractual arrangements. It also means that, with regard to recourse liabilities, the shifting of basis cannot occur without a concomitant shifting of the underlying risk of economic loss.").

During the tax year at issue, IPO II borrowed money from an unrelated lender, and each of Mr. Forsythe, Energy and Power guaranteed the loan. In addition, the guarantors waived their rights of contribution with respect to the debt. The question facing the court was whether this recourse liability of IPO II should be allocated in part to Overseas by reason of Overseas' relationship (through Mr. Forsythe's common ownership) with Energy, which, as a non-member guarantor, bore actual EROL for the liability, along with Mr. Forsythe and Power. The Tax Court concluded that the entire liability should be allocated only to Mr. Forsythe rather than between Mr. Forsythe and Overseas because Overseas and Energy were not related parties under the Related-Person Exception. The court reasoned that:

> Indeck Overseas is only related to Indeck Energy via its 'relationship' with Mr. Forsythe . . . . Pursuant to the related partner exception, this 'relationship' between Indeck Overseas and Mr. Forsythe is severed for purposes of determining whether Indeck Overseas bears an economic risk of loss for *any* of IPO II's recourse liability . . . . We conclude that Indeck Overseas and Indeck Energy are not related parties *for purposes of determining whether Indeck Overseas bore any economic risk of loss* with regard to IPO II's liability . . . because: (1) Indeck Overseas is not related to Mr. Forsythe pursuant to the related partner exception; and (2) Indeck Overseas is related to Indeck Energy only through Mr. Forsythe, and that relationship is not recognized for purposes of our determination. To hold otherwise would be to allow attribution of economic risk of loss indirectly even though it cannot be attributed directly.[41]

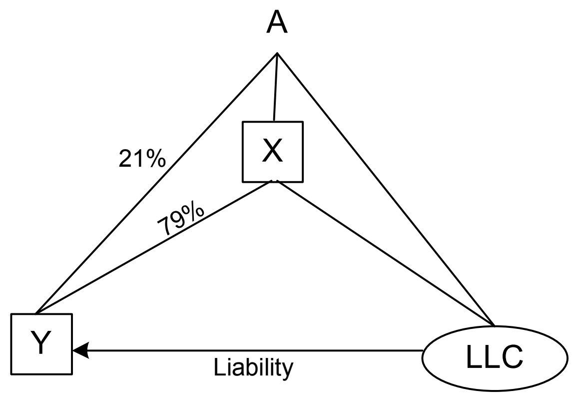
Although we agree with the Tax Court's finding that the entire liability was properly allocable solely to Mr. Forsythe, we do not agree with how the Tax Court reached this conclusion. In our view, the entire liability was allocable to Mr. Forsythe because he bore direct EROL for the liability, and under the Related-Person Exception direct and indirect partners are not treated as related for purposes of (and *only* for purposes of) attributing direct EROL from one partner (whether direct or indirect) to another partner (the "Direct Partner Interpretation").

In other words, the Related-Person Exception, by its terms, turns off relatedness "for purposes of determining the economic risk of loss borne by each [person owning interests directly or indirectly in the same partnership] for the liabilities of the partnership." We interpret the quoted language to mean that the Related-Person Exception does not cause relatedness to be ignored for purposes of attributing EROL to a partner from a person who has actual EROL and is neither a direct partner nor an indirect partner (through a UTP), including if such relatedness between the partner and other person depends on a direct or indirect partner's ownership in such other person. Since Mr. Forsythe was a direct partner bearing actual EROL, the Direct Partner Interpretation would attribute none of such direct EROL to another partner (*i.e.*, Overseas). By contrast, if in *IPO II* actual EROL for the liability had been borne solely by Energy (and

[41] *IPO II*, 122 T.C. at 304 (emphasis added).

by neither Overseas nor Mr. Forsythe, except by attribution), then we believe that, since Energy was not a partner of IPO II, the Related-Person Exception should not ignore the relationship among any of them and that such EROL for the liability should therefore be attributed to both Mr. Forsythe and Overseas, with the liability being allocated between them under the Per Capita Rule. This interpretation is illustrated more graphically below.

Example 5: Individual A owns all of corporation X. A and X form LLC. Corporation Y, which is 21% owned by A and 79% owned by X, makes a loan to LLC. Under the Direct Partner Interpretation, the Related-Person Exception would not apply because neither A nor X has direct EROL. Accordingly, the liability would be allocated to X and A under the Per Capita Rule.



The Tax Court, however, did not adopt the Direct Partner Interpretation, which is arguably inconsistent with the reasoning (but not the holding) of *IPO II*. Again, the Direct Partner Interpretation would treat the entire liability as allocable to Mr. Forsythe because it would sever relatedness between partners (whether direct or indirect) when a partner bears direct EROL for the liability (*i.e.*, Mr. Forsythe) and the other partner (*i.e.*, Overseas) does not and such relatedness would otherwise result in the other partner being attributed such EROL. By contrast, the Tax Court in *IPO II* allocated the entire liability to Mr. Forsythe because it interpreted the Related-Person Exception to prohibit a partner (*i.e.*, Overseas) from claiming related-party status with a non-partner (*i.e.*, Energy) on the basis of the ownership of such non-partner (*i.e.*, Energy) by a partner (*i.e.*, Mr. Forsythe).[42] One possible implication of this reasoning (the "Broad Interpretation") is that the Related-Person Exception precludes attribution of EROL from a non-partner to a partner if their relatedness depends on their ownership of or by another direct or indirect partner, even if the other direct or indirect partner does not have direct EROL for the liability.[43]

[42] As noted above, the Tax Court's stated rationale for its holding argued that "… Overseas is related to … Energy only through Mr. Forsythe, and that relationship is not recognized for purposes of our determination."

[43] In addition, some have also suggested that Related-Person Exception's reference to "indirect" ownership includes ownership through corporations as well as through partnerships, making this interpretation even broader. For example, if, in Example 1, A instead of Z guaranteed the LLC debt, this version of the Broad Interpretation would arguably cause the debt to be nonrecourse because it would turn off relatedness between A and each of its subsidiaries. We disagree with this interpretation. Although not explicit in the Current Regulations, in our view "indirectly" means indirectly through a partnership. This interpretation is supported by the preamble to the 1989 amendments to the Temporary Regulations. *See* T.D. 8274, 1989-2 C.B. 101 (Nov. 21, 1989) ("The use of the term "indirectly" in the parenthetical has caused some confusion. The term is intended to refer only to interests owned indirectly through one or more partnerships and the regulations are amended accordingly.").

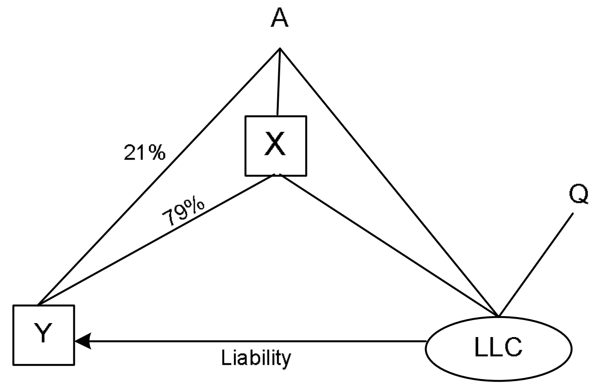
When applied to allocations of the liability among partners one or more of which is otherwise (without regard to common ownership of a direct or indirect partner) related to a partner bearing actual EROL, the Broad Interpretation produces results that seem unobjectionable (and, in some cases, might arguably reflect more accurately how economic risk associated with the attributed EROL is economically borne than do the results under the Direct Partner Interpretation). For example, if X owned all of Y in Example 5, A would not be attributed any EROL under the Broad Interpretation since A would not be treated as related to X, causing X to be allocated 100% of the liability even though X did not have direct EROL.

By contrast, where the partners are otherwise (without regard to common ownership of a direct or indirect partner) unrelated to the person bearing actual EROL, the Broad Interpretation could potentially have unintended consequences. In Example 5, for example, Corporation Y would not be treated as related to A or X under the Broad Interpretation, causing the loan to be nonrecourse and therefore not subject to the Per Capita Rule.

We believe that this aspect of the Broad Interpretation, which would potentially recast a recourse liability as a nonrecourse liability, is technically wrong. Specifically, under Section 267(b)(11) (as modified by Section 1.752-4(b)), the two S corporations in *IPO II* were related because the same person owned 80% or more of both. In our view, when there is common ownership of this kind, as in *IPO II*, the relevant relationship is the direct relationship between the two S corporations, which relationship does not depend on either S corporation (here, Overseas and Energy) being "related" to the common owner (*i.e.*, Mr. Forsythe) but instead depends only on the common owner having the requisite ownership. Therefore, we do not believe that the Related-Person Exception should be interpreted to mean that a partner's relationship with a non-partner who bears actual EROL is severed merely because their relationship depends on them being owned by a direct or indirect partner.

More importantly, however, we believe that the Broad Interpretation is inconsistent with the purpose of the Related-Person Exception, which is to sever related party status only to prevent the attribution of actual EROL of a direct or indirect partner to another partner. In addition, we believe the Broad Interpretation is inconsistent with the broader purposes of Section 752, which is to allocate recourse liabilities only to those partners who have direct or attributed EROL. By preventing EROL from being attributed to a partner from a person who is otherwise related to the partner and not itself a direct or indirect partner, the Broad Interpretation would permit a partnership to allocate an otherwise recourse liability away from a partner who would otherwise be attributed EROL to a partner who does not bear EROL (either directly or indirectly).

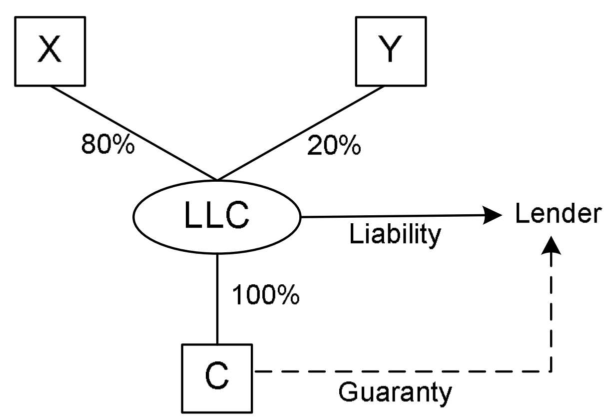
Example 6: Assume the facts as in Example 5 except that Q, which has no relationship to A, X or Y, is also a member of LLC. Since the Broad Interpretation would attribute none of Y's EROL to any partner, Q would be allocated a portion of the liability under the rules governing the allocation of nonrecourse debt, even though A and X, through their joint ownership of Y, bear 100% of the economic burden of Y's loss.



B. Potential Attribution of EROL from a Partnership Subsidiary.

The Related-Person Exception seems by its terms not to prevent partners from being attributed EROL from entities owned by the partnership solely by reason of the partners' status as partners. This is because the literal language of the General Related-Party Rule appears to treat partners as related to entities owned by the partnership solely as a result of the partners' ownership of the partnership,[44] and the literal language of the Related-Person Exception seems not to sever that relationship. As a result, under a literal reading of these rules, a partner could be attributed EROL for a partnership liability for which only a subsidiary of the partnership bears actual EROL.

Example 7: Assume unrelated Corporations X and Y own 80% and 20% of LLC, respectively. Assume further that LLC owns 100% of corporation C and that C guarantees a liability of LLC. Absent an exception, X would be treated under the Greatest Relatedness Rule as bearing 100% of the EROL directly borne by C and would therefore be allocated 100% of the LLC liability.[45]



[44] For example, under Section 267(b)(3) (as modified by Treas. Reg. § 1.752-4(b)(1)) a corporation (*e.g.*, X in Example 7) is related to another corporation (*e.g.*, C in Example 7) in which the first corporation has (direct, indirect or constructive) stock ownership of 80% or more (by vote or by value), and under the constructive ownership rules of Section 267(c)(1) stock owned by a partnership (*e.g.*, LLC in Example 7) is treated as owned proportionately by its partners.

[45] Note that were the facts of Example 7 changed such that X and Y were each part of the same control group (and if it is assumed that the General Related-Party Rule applies with respect to EROL borne directly by partnership subsidiaries), the results would vary depending on whether the Broad Interpretation or the Direct Partner Interpretation was applied. Under the Broad Interpretation, only X would be treated as related to C and thus the loan would be allocated entirely to X. Under the Direct Partner Interpretation, in contrast, C would be treated as related to both X and Y and as a result the loan would be allocated 50/50

In our view, this result is inconsistent with the entire premise of the separate rules under Section 752 for allocating recourse and nonrecourse liabilities, which is that risk of loss that is limited to a partner's equity investment in the partnership should be treated differently than risk of loss beyond that investment. Attributing EROL to partners from related persons simply ensures that EROL of a related group is aggregated in determining whether risk of loss extends beyond the group's investment in the partnership. In Example 7, C's guarantee of LLC's liability does not extend the risk of loss to X and C (*i.e.*, the group of related persons) beyond the group's investment in the LLC.[46] Accordingly, X should not be attributed C's EROL. To put the same point more simply, there should be no attribution because C's guarantee does not change the extent to which the risk of loss of X or Y (or the two groups of persons related to each) extends beyond their respective investments in the LLC.[47]

Although we believe the policy basis for this view is clear, the Related-Person Exception appears by its terms not to prevent the attribution of EROL from a subsidiary of a partnership to its partners under the General Related-Party Rule. The only way to invoke the Related-Person Exception in Example 7 would be to treat the subsidiary as "owning directly or indirectly" an interest in the partnership by partially "inverting" the ownership relationship between the subsidiary and the partnership. We nevertheless believe a court would apply the General Related-Party Rule in a manner consistent with its purpose.

2. <u>Shortcomings of the Per Capita and Greatest Relatedness Rules.</u>

The Per Capita and Greatest Relatedness Rules cause attributed EROL to be allocated among partners based on their relative relationships to the person with actual EROL. They do not do so on the basis of either the partners' relative economic exposure to EROL[48] or their relative ownership of the partnership. They instead allocate recourse

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pursuant to the Per Capita Rule. *See also* Feeley & McCurry, *Non-Economic Risk of Loss: Allocating Partnership Debt in Controlled Groups*, 27 *Tax Mgmt. Real Est. J. 463*, Ex. #5 (December 2011).

[46] Although the guarantee certainly benefits the creditors of LLC, the partners of LLC would bear the same EROL on the liability with or without the guarantee.

[47] Note that if X and Y in Example 7 owned C *directly* in the same proportions, the result under the General Related-Party Rule would be the same. In such a case, however, because the LLC would not own the asset that provides credit support for its liability, X and Y would bear risk of loss in excess of their investment in LLC.

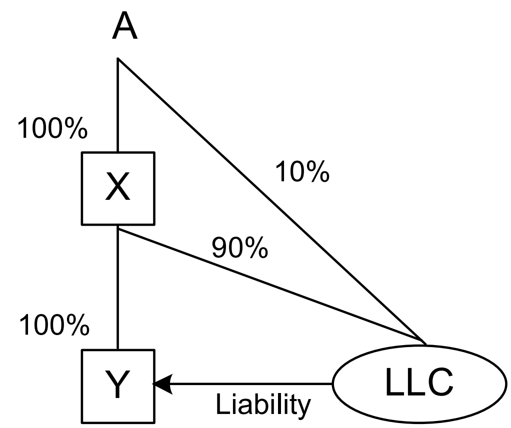
[48] The Temporary Regulation's version of these rules permitted more flexibility to take into account real economic exposure:

> If more than one partner holds the same percentage of related ownership with respect to such person and no partner holds a greater percentage, any such obligation, right to reimbursement, or liability shall be allocated equally among such partners *unless the facts and circumstances establish that the partners would share any economic burden or benefit* corresponding to any such obligation, right to reimbursement, or liability *in a different manner*.

Treas. Reg. § 1.752-1T(h)(3)(i) (1988) (emphasis added). *See generally* Feeley & McCurry, *Non-Economic Risk of Loss: Allocating Partnership Debt in Controlled Groups*, *27 Tax Mgmt. Real Est. J. 463*, at n.32 (December 2011).

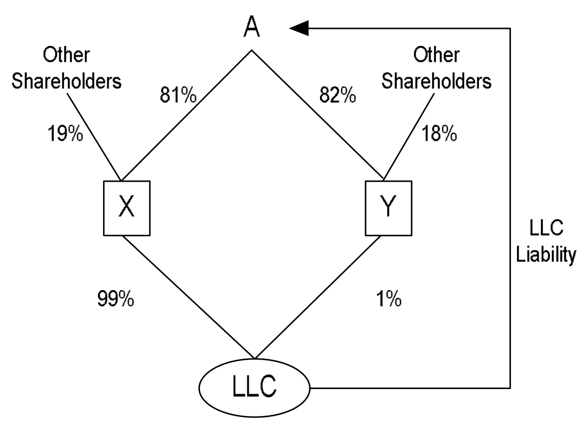
liabilities either on a per capita basis or solely to the partner with the highest degree of relatedness to the person with EROL.

Example 8: Assume that individual A owns all of corporation X, which owns all of corporation Y. A and X own 10% and 90%, respectively, of LLC, which borrows from Y. Under the Direct Partner Interpretation, the Related-Person Exception does not apply to turn off Y's relationship with A and X because neither A nor X bears direct EROL. Since Y is equally related to both A and X, the debt would be allocated under the Per Capita Rule 50% to each of A and X. This would be so even if X had funded the entire loan by Y to LLC from X's distributive share of LLC income.



By disregarding the partners' relative economic interests in the partnership, both the Per Capita and Greatest Relatedness Rules allocate liabilities among related partners in an uneconomic (even arbitrary) manner. The cliff effect of these rules only exacerbates this problem.

Example 9: Assume that individual A owns 81% of corporation X and 82% of corporation Y and that X and Y form LLC and agree to share profits and losses 99% and 1% respectively. LLC borrows from A in year 1. The liability is allocated 100% to Y under the Greatest Relatedness Rule despite the partners' agreement for allocating losses (including losses funded by the liability). If A's ownership of Y was reduced to 81% in year 2, however, X and Y would be equally related to A in year 2, with the liability being allocated equally to X and Y under the Per Capita Rule.

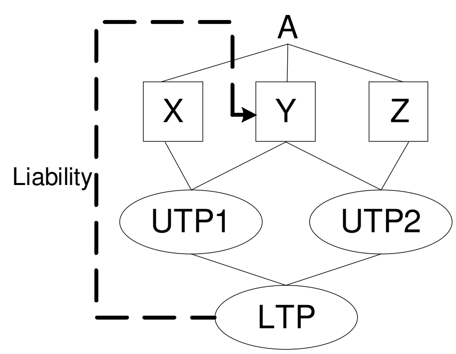


In addition to creating traps for the unwary and placing a premium on tax planning, these rules may encourage some taxpayers to interpret the Related-Person Exception expansively, causing recourse debt to be treated as nonrecourse debt subject to an entirely different (and more flexible) set of rules. In our view, the only real virtue of these rules is their administrability because they unambiguously specify how to allocate a liability among two or more partners with attributed EROL.

3. Ambiguities Relating to the Tiered-Partnership Rules.

The Tiered-Partnership Rules generally operate to funnel recourse partnership liabilities up chains of partnerships in a manner that preserves for those partnerships the basis associated with the liabilities for which EROL exists in those chains, as illustrated in Example 2. However, the Tiered-Partnership Rules provide no guidance on how a liability should be allocated from an LTP to its partners if an upper-tier partner with direct EROL can be allocated the associated liability in more than one way. In particular, it is unclear the extent to which this allocation should be affected by the policy considerations underlying either of the Greatest Relatedness and Per Capita Rules or the Related-Person Exception.

Example 10: Assume Individual A owns all of corporations X, Y and Z, that X and Y form UTP1, that Y and Z form UTP2 and that UTP1 and UTP2 form LTP. If Y lends to LTP, how should LTP allocate the liability between UTP1 and UTP2?



In this example the general rule for allocating recourse liabilities of an LTP to a UTP bearing EROL for the liability provides no guidance because it does not identify *which* UTP should be allocated the liability, even though it is clear that in either case Y would be ultimately allocated the liability (and allocated that liability only once).[49] This determination may be important because it affects Y's ultimate utilization of any depreciation, deductions or other tax attributes arising from the liability, since each of the UTPs' respective economic participation in the LTP may be very different.[50] If regarded as relevant, the Greatest Relatedness and Per Capita Rules would not help to preserve tax attributes for Y (which is the apparent purpose of the Tiered-Partnership Rules) and in fact would likely undermine this goal, because these rules ignore the relative economic participation in the partnership of related partners for purposes of allocating attributed EROL among them.

[49] *See* Treas. Reg. § 1.752-4(c).

[50] For example, assume in Example 10 that UTP1 and UTP2 own 99% and 1%, respectively, of the capital and profits of LTP, and that Y and X own 99% and 1%, respectively, of the capital and profits of UTP1. If 99% of the losses attributable to the LTP liability is allocated at the LTP level to UTP1 but the LTP liability is allocated 50% to UTP1 and 50% UTP2, a substantial portion of the losses allocated to UTP1 may ultimately be suspended for Y under Section 704(d) because Y may not have sufficient basis in its UTP1 interests to claim the deductions.

More troubling is the case where a partner of a UTP is also a partner of the LTP and bears direct EROL for a liability of the LTP. In this case, no "tie-breaker" rule is available to resolve the conflict between how the liability is allocated under the Tiered-Partnership Rules and how it is allocated under the General EROL Rule. One might ask if the policy underlying the Related-Person Exception, which generally allocates direct EROL only to the partner with direct EROL, should bear on how the LTP allocates the liability among its partners. For example, if Y were a direct partner of the LTP in Example 10, one could argue that the policy underlying the Related-Person Exception should inform whether all of the liability should be allocated directly to Y, recognizing that doing so would have no necessary relationship to the utilization of the related tax attributes by Y and thus may be contrary to the purposes of the Tiered-Partnership Rules.

The Proportionality Rule of the Temporary Regulations might have resolved these conflicts. Again, however, that resolution would not necessarily relate to how losses of partnership capital are shared among the partners, and in any case the final Section 752 Regulations did not adopt the Proportionality Rule.

IV. Discussion of Recommendations

1. Replace the Related-Person Exception.

The Related-Person Exception ensures the sensible result that, under the General Related-Party Rule, actual EROL of a direct or indirect partner will never be attributed to a related partner. In the case of tiered partnerships, this means that, if a partner in a UTP bears direct EROL for a liability of an LTP, none of that EROL will be attributed to a partner of the LTP other than the UTP (which will be allocated the liability by reason of the Tiered-Partnership Rules) even if the upper-tier partner is otherwise related to a partner of the LTP. To ensure that the Related-Person Exception is not interpreted to extend beyond these situations, we propose that it be replaced with the Direct Partner Exception and the Upper-Tier Partner Exception.

More specifically, the Broad Interpretation may turn off relatedness in a manner that converts a recourse liability to a nonrecourse liability, potentially causing part of the liability to be allocated to a partner that has no relationship to the person with actual EROL, as illustrated in Example 6. If this interpretation is correct, it would eviscerate the General EROL Rule. While we recognize that the merits of the General EROL Rule may be worth reconsidering, we believe that the Related-Person Exception was not intended to allow taxpayers to override the General EROL Rule.

The Direct Partner Exception preserves the core purpose of the Related-Person Exception in its current form by ensuring that if a partner lends or guarantees (or otherwise has EROL by contract with respect to) a liability of the partnership, the liability will not be allocated under the General EROL Rule away from the partner with direct EROL by reason of that partner's relationship with another partner. This recommendation is consistent with the basic premise of the Section 752 Regulations, which is that liabilities should be allocated on the basis of partner EROL. So long as this policy objective is to be preserved, we believe that it should be applied consistently as among related partners so that partners with direct EROL for a liability are allocated such liability and that such liability is not allocated to partners with attributed but not direct EROL. Our Proportionality Recommendation (discussed below) addresses how a liability should be allocated where more than one partner bears direct EROL.

Consistent with the policy objective of the Direct Partner Exception, the Upper-Tier Partner Exception preserves the current rule that, if a partner of a UTP bears direct EROL for a liability of an LTP, such upper-tier partner is not treated as related to any partner of the LTP for purposes of attributing such upper-tier partner's direct EROL to any partner of the LTP under the General Related-Party Rule, as illustrated in Example 3. This recommendation extends the rationale for the Direct Partner Exception to tiered partnerships so that an upper-tier partner's direct EROL for the liabilities of an LTP are effectively treated as though the upper-tier partner was a direct partner of the LTP (*i.e.*, as though the UTP was an "aggregate" of its partners) for the purpose of allocating the LTP liability. Under this approach to allocating LTP liabilities, an upper-tier partner's direct EROL for an LTP liability is allocated by the LTP to the UTP under the Tiered-Partnership Rules, and the liability is then allocated by the UTP only to the upper-tier partner bearing such direct EROL under the General EROL Rule. This result also allows the person bearing direct EROL for an LTP liability to more fully utilize the tax basis associated with that liability and thus serves to better match partnership-level and partner-level recognition of items of deductions and income.

2. Adopt the Partnership Subsidiary Recommendation.

The Partnership Subsidiary Recommendation addresses the second flaw in the Related-Person Exception, which is its apparent failure to prevent attribution of EROL borne solely by a subsidiary of a partnership to its partners. In our view, a partner's interest in the partnership should not be the basis for attributing to such partner the EROL of a partnership liability that is borne by an entity owned by the partnership.

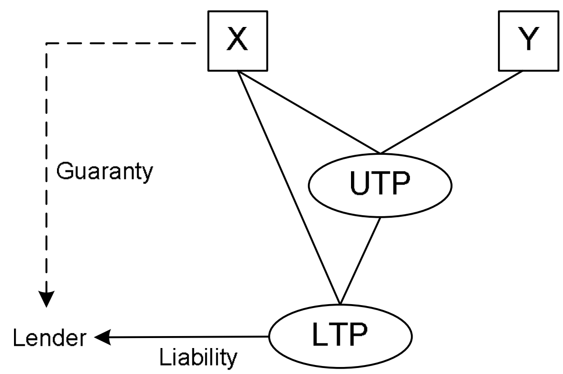
The partner's risk of loss in these situations remains limited to the partner's equity interest in the partnership, which is why the liability should be treated as nonrecourse under the EROL construct. Allowing the EROL of a partnership subsidiary to be attributed to the partners would effectively convert an otherwise nonrecourse liability into recourse liability even though no partner would otherwise have direct or attributed EROL. For example, by treating an otherwise nonrecourse liability as a recourse liability the allocation of deductions related to the liability may be treated as having substantial economic effect even though they have no economic effect at all. To address this concern, we propose that the General Related-Party Rule be changed to clarify that a partner of a partnership is not treated as owning any interest in the partnership for purposes of attributing the EROL of an entity owned in whole or in part by the partnership.[51]

[51] If a partner is related to a partnership subsidiary under the General Related-Party Rule independently of its ownership of the interest in the partnership, the Partnership Subsidiary Recommendation would not prevent the attribution of EROL from that subsidiary to such partner.

3. Adopt the Recommendation for Limiting the Tiered-Partnership Rules.

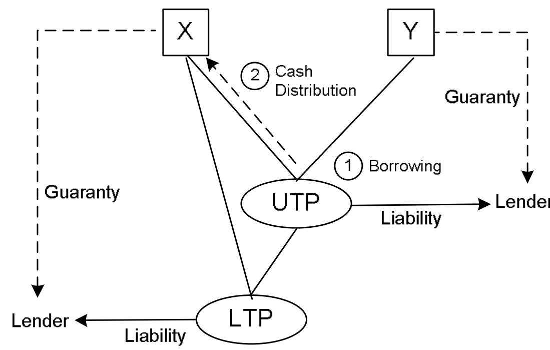
The Tiered-Partnership Rules and the General EROL Rule conflict when a partner of a UTP is also a direct partner of the LTP and bears direct EROL for a liability of the LTP. The Current Regulations provide no guidance on the issue of how the LTP should allocate the liability between the UTP and the partner bearing direct EROL for the liability. The General EROL Rule would allocate the liability directly to such partner in its capacity as a direct partner in the LTP. The Tiered-Partnership Rules, on the other hand, would allocate the liability first to the UTP, which the General EROL Rule would then allocate to the direct partner in its capacity as a partner of the UTP. The Proportionality Rule (if it were in effect) would split the liability evenly and allocate half of the liability directly to the partner as a direct partner in the LTP and the remaining half of the liability to the UTP, (which in turn would allocate such liability to the same partner).

Example 11: Assume that unrelated corporations X and Y form UTP, UTP and X form LTP, and that X guarantees a $100 liability of LTP. The General EROL Rule would allocate the $100 liability from LTP directly to X. The Tiered-Partnership Rules would allocate the $100 liability to UTP and then to X. The Proportionality Rule would allocate $50 of the liability directly to X and $50 first to UTP and then to X.



Our Recommendation for Limiting the Tiered-Partnership Rules resolves this conflict by allocating all of the liability in Example 11 to X in its capacity as a direct partner of LTP. The recommendation thus ensures that, when a partner in an LTP has direct EROL and is also a partner in a UTP, all of the liability will be allocated by the LTP to the partner with direct EROL instead of any portion of it being allocated to the UTP and then to such partner. This recommendation is consistent with the general principle that a partner with direct EROL should be allocated the associated liability. It also ensures that none of the tax basis attributable to that liability is allocated to a UTP with other investments and activities unrelated to the LTP.

Example 12: Assume the same facts as in Example 11, except that in addition UTP borrows cash guaranteed by Y and distributes the cash to X. If LTP allocates to UTP a portion of the liability guaranteed by X, X could use the associated basis to potentially avoid gain on loan proceeds obtained from Y's credit support. Under our recommendation, in contrast, all of the liability guaranteed by X would be allocated to X in its capacity as a direct partner of LTP.



A minority of our members disagree with this recommendation and in Examples 11 and 12 would instead allow LTP to allocate its liability either entirely to X, entirely to UTP or between UTP and X in accordance with the Proportionality Rule. Under this minority view, the Tiered-Partnership Rules are premised on an "aggregate" approach to taxing partnership items (*i.e.*, in these cases, treating LTP and UTP as aggregates of their respective partners with respect to liabilities for which X bears direct EROL for the liability of LTP), and allowing LTP the flexibility to allocate the liability to UTP and then on to X is more consistent with that aggregate approach since such an allocation methodology recognizes that an allocation to UTP is not in this circumstance economically inconsistent with allocating the liability directly to X.[52] Allowing LTP flexibility in allocating the liability directly to X or indirectly to X through UTP is also more consistent with the flexibility permitted in the allocation of nonrecourse liabilities under Treas. Reg. § 1.752-3, than is requiring that the entire liability be allocated directly to X.

In addition, this minority view would avoid the cliff effect inherent in the majority recommendation. This cliff effect could arise in a number of ways, including, for example, by allowing an upper-tier partner with direct EROL for a liability of an LTP to deprive the UTP of tax basis attributable to the liability by acquiring a small interest in the LTP.

Example 13: Assume unrelated corporations X and Y form UTP which owns 98% of LTP and that unrelated corporation Q owns the other 2% of LTP. LTP borrows cash to buy a depreciable asset and X guarantees the loan. While the loan is outstanding and after LTP's asset has been largely depreciated, X buys 1% of LTP from Q. Under the minority view, LTP could continue to allocate all of the liability to UTP or shift it all to X or split it between X and UTP; whereas, under our majority view, all of the liability would be reallocated.

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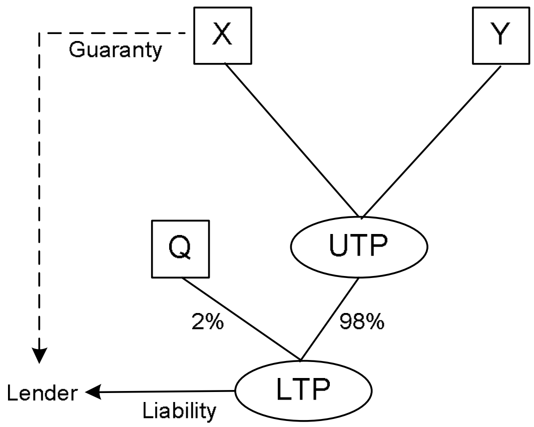
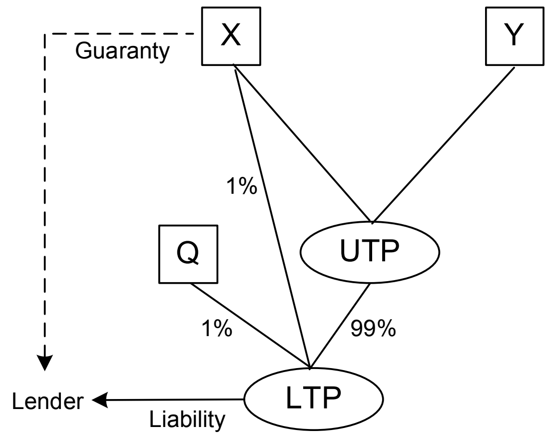
[52] For example, under this minority view, allowing some of the LTP liability to be allocated to UTP is not abusive since, if LTP and UTP were collapsed into a single partnership, the basis allocation would be the same, and the single partnership could isolate the liabilities of LTP and UTP through the use of single-member LLCs that are disregarded entities.

Initial Ownership



Post-Acquisition Ownership



4. Adopt the Proportionality Recommendation.

It would be unusual for more than one partner in a partnership consisting entirely of unrelated partners to bear actual EROL for the same liability because unrelated partners would negotiate by contract how they would share the economic consequences of their joint credit support to the partnership. For example, if a partner satisfies debt of the partnership pursuant to a guarantee provided by all partners, the partner paying the debt would generally have a state law right to seek contribution from the other guarantors, and each partner's EROL with respect to the liability being guaranteed should thus be reduced by the partners' reimbursement rights under Treas. Reg. § 1.752-2(b)(5). It is possible, however, for two or more partners to bear actual EROL for the same liability ("Direct EROL Partners"), just as the guarantors of the liability in *IPO II* each bore actual EROL for the liability since they waived their rights of contribution against each other. The Current Regulations do not address how such liabilities should be allocated in this situation.

In addition, it is possible for an upper-tier partner to bear actual EROL for a liability of an LTP and be a partner of two of more UTPs that are themselves partners in the LTP, as illustrated in Example 10. Again, there are no rules specifying how LTP should allocate the liability among the UTPs in this situation. While the Tiered-Partnership Rules treat the liability for which an upper-tier partner bears EROL as a liability of the UTP, they do not address how the liability should be treated when the upper-tier partner is a partner of two or more UTPs that are also partners of the LTP. In addition, the Greatest Relatedness and Per Capita Rules address allocations of liabilities with overlapping attributed EROL *only* when the overlap results from the General Related-Party Rule and thus provide no guidance for allocating overlapping attributed EROL under the Tiered-Partnership Rules, as illustrated in Example 10.

To fill this void, we recommend that Treasury modify the Section 752 Regulations to incorporate the Proportionality Rule from the former Temporary Regulations. This rule would allocate the liability among Direct EROL Partners based on their relative amounts of direct EROL for the liability. For this purpose, when two UTPs are both attributed a liability under the Tiered-Partnership Rules by reason of a shared upper-tier partner bearing EROL for an LTP (as illustrated in Example 10), we would propose treating both UTPs as Direct EROL Partners of the LTP and requiring the LTP to allocate the liability between the two partnerships in accordance with the Proportionality Rule.

5. Adopt the Enhanced Per Capita Recommendation.

The Per Capita Rule and Greatest Relatedness Rule govern how a liability is allocated when two or more partners are attributed EROL for the same liability under the General Related-Party Rule ("Attributed EROL Partners"). The argument for maintaining the Greatest Relatedness Rule is that the partner allocated a liability under that rule is more closely connected to the attributed EROL than the other partners with attributed EROL (who are less related to the person with actual EROL) and therefore, arguably, should perhaps be allocated more (or all) of the liability.

In our view, however, given that any relatedness requires an 80% threshold, the differences in relatedness within a 20% range does not justify the cliff effect of the Greatest Relatedness Rule, especially when the margin of greater relatedness among the Attributed EROL Partners can be extremely small (as illustrated in Example 9). In other words, since all Attributed EROL Partners are much more related to the person bearing direct EROL than they are not related to that person, they are more similar to each other with respect to the attributed EROL than they are different from each other. For that reason, we believe that allocating the liability under the Per Capita Rule is superior because it treats the Attributed EROL Partners more similarly. Moreover, since the Per Capita rule would allocate the liability to all of the Attributed EROL Partners, it may better enable the Attributed EROL Partners to utilize the tax basis resulting from such liability in a way that reduces the likelihood of mismatches between how items of income and loss are recognized at the partnership and partner levels, which is a separate but important policy objective of Subchapter K.

6. Consider Alternatives for Allocating Recourse Liabilities with Overlapping EROL.

Our recommendations, if adopted, would resolve existing ambiguities about how to allocate liabilities for which two or more Direct EROL Partners bear direct EROL or for which two or more Attributed EROL Partners have attributed EROL. That in itself would be a significant improvement to the Section 752 Regulations. In our view, however, other possible alternatives exist for allocating such liabilities among Direct EROL Partners or Attributed EROL Partners. We recommend that Treasury and the Service consider whether the potential merits of these alternatives outweigh the complexity associated with a more flexible and elective regime.

By requiring recourse liabilities to be allocated based solely on how partners bear EROL, the Current Regulations (whether or not modified to reflect our recommendations) allow partners little or no flexibility in deciding how to share among themselves the utilization of the tax basis attributable to such liabilities. When determining how to allocate a recourse liability as between a group of partners with direct or attributed EROL and a group of partners with neither direct nor attributed EROL, this seems entirely appropriate and consistent with the principles underlying the General EROL Rule. When determining how to allocate the liability as among Direct EROL Partners (who all bear direct EROL for the same liability) or as among Attributed EROL Partners (who are all attributed EROL for the same liability), however, this approach does not necessarily further these principles. The reason is that, within each of these groups, the partners are similarly situated with respect to the EROL.

Just as all partners are similarly situated with respect to EROL for a nonrecourse liability (*i.e.*, they have no EROL), all Direct EROL Partners are similarly situated with respect to EROL for a recourse liability (*i.e.*, they all bear it equally).[53] Likewise, all Attributed EROL Partners are similarly situated with respect to the liability for which they have attributed EROL. For these reasons, Treasury and the Service may wish to consider whether Direct EROL Partners or Attributed EROL Partners should be any more constrained in allocating the recourse liability among themselves than they would be if the liability were nonrecourse. Another alternative for allocating a recourse liability among such partners is pursuant to the principles of the current rules for allocating nonrecourse liabilities under Treas. Reg. § 1.752-3 (the "Nonrecourse Allocation Regulations").

The virtue of this approach is perhaps clearest in the case of allocations of recourse liabilities among Attributed EROL Partners. These partners do not bear actual EROL. Therefore, allocations of deductions attributable to such liabilities cannot have economic effect when they are made to such partners, just as allocations of deductions attributable to nonrecourse liabilities cannot have economic effect as to those partners.[54] The reason is that every Attributed EROL Partner bears the same *relative* EROL for a recourse liability as every other Attributed EROL Partner, just as every partner bears an equal relative amount of EROL for a nonrecourse liability (*i.e.*, zero). On this basis, therefore, the same flexibility permitted for allocations of nonrecourse liabilities might be extended to the allocation of recourse liabilities among Attributed EROL Partners. The merits of this approach apply equally to allocating a recourse liability among Direct EROL Partners that bear direct EROL for the liability.

On the other hand, adapting this approach will inevitably introduce additional complexity that may not be justified. Any such regime, for example, would

[53] For this purpose, if an upper-tier partner of a UTP bears direct EROL for a liability of an LTP of which the UTP is a partner (such that the liability is allocated to the UTP under the Tiered-Partnership Rules), we would treat the UTP as a Direct EROL Partner of the LTP for purposes of allocating the liability between the UTP and any other partner of the LTP (including the upper-tier partner or another UTP) that also bears direct EROL for such liability.

[54] Treas. Reg. § 1.704-2(b)(1).

have to be accompanied by rules addressing exculpatory liabilities, rules that prevent "snap-back" gain to a partner from a reallocation of the liability in a year after the year in which basis for the liability was utilized by the partner and rules that ensure priority allocations of income to partners that are protected from such gain. Even with such rules, the potential for abuse in an elective regime available only to related parties may be greater. Finally, we recognize that Treasury and the IRS may decide that revamping these rules to accommodate these relatively unusual fact patterns is not an efficient use of their limited resources.