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NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON

PROPOSED REGULATIONS REGARDING THE ALLOCATION OF RECOURSE LIABILITIES

NOVEMBER 14, 2014

NEW YORK STATE BAR ASSOCIATION TAX SECTION

PROPOSED REGULATIONS REGARDING THE ALLOCATION OF RECOURSE LIABILITIES

Introduction

This report[1] of the Tax Section of the New York State Bar Association provides comments on regulations proposed on December 16, 2013 (the "Proposed Regulations") concerning allocations of recourse liabilities under section 752.[2] The Proposed Regulations provide guidance regarding the allocation of a recourse liability with respect to which multiple partners bear the economic risk of loss ("EROL") and special rules for related persons and tiered partnerships.[3]

This report is divided into three parts. Part I provides a summary of our recommendations. Part II provides a summary of current law and the Proposed Regulations. Part III contains a detailed discussion of our recommendations.

I. Principal Recommendations

We commend the Internal Revenue Service (the "IRS") and the Treasury Department ("Treasury") for proposing a comprehensive, thoughtful, and well-drafted set of Proposed Regulations. This Report makes the following recommendations:

1. Future guidance should require partnerships to allocate a liability among partners otherwise subject to the overlapping risk of loss rule ("OROL Rule") or the Per

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1 The principal author of this report is Matthew Lay, with substantial assistance from Eric Sloan. Significant contributions were made by Michael Scaramella. Helpful comments were received from Stephen Foley, Phillip Gall, Amanda Nussbaum, Elliot Pisem, David Schnabel, and Michael Schler. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or its House of Delegates.

2 REG-136984-12, 78 Fed. Reg. 76,092 (Dec. 16, 2013). *See also* 79 Fed. Reg. 29,701 (May 23, 2014) (correction adding language to the preamble of the Proposed Regulations indicating that the rules in current Treas. Reg. § 1.752-4(b)(2) and the example in Treas. Reg. § 1.752-4(b)(2)(iv)(C) are being moved but not changed by the Proposed Regulations). Unless indicated otherwise, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury regulations promulgated under the Code, both as in effect on the date of this report.

3 In 2012, the Tax Section of the New York State Bar Association submitted a report discussing the subjects addressed in the Proposed Regulations. NYSBA Tax Section Report No. 1262, "Allocations of Recourse Liabilities Among Related Partners" (April 23, 2012) (the "Prior Report"). This report, like the Prior Report, assumes that the recourse liabilities should be allocated based on how the partners and related persons bear the economic risk of loss for those liabilities. *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").

Capita Rule (defined below) in a manner analogous to how nonrecourse debt is allocated under Treas. Reg. § 1.752-3.

2. The final regulations should clarify by rule (and not merely by example)–

   a. The extent to which relationships between a partner and a person who is not a partner but has a payment obligation should be disregarded, and how the OROL Rule applies in such cases.

   b. The circumstances under which a payment obligation with respect to only part of a liability effectively bifurcates the liability into two liabilities and when it merely impacts the sharing of the liability.

3. Treas. Reg. § 1.1563-1(a)(2)(i)(A) should be modified so that it does not conflict with the language of section 1563.

4. Prop. Treas. Reg. § 1.752-4(b)(1)(iv) should be modified (i) to provide that attribution under section 1563(e)(2) also must be disregarded and (ii) to apply similar principles where a partner would otherwise be treated as "related" to a subsidiary of a partnership (*e.g.*, where the partner or the subsidiary is itself a partnership).

5. The final regulations should permit partnership liabilities that are modified and/or refinanced and payment obligations that are modified to continue to be subject to the provisions of the current regulations but only to the extent of the amount and duration of the pre-modification (or refinancing) liability or payment obligation.

6. Partnerships should be permitted to elect to apply the Proposed Regulations to all of the partnerships' liabilities to which the regulations otherwise would not apply (*i.e.*, grandfathered liabilities).

II. Summary of Current Law and Proposed Regulations

A. Current Regulations

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's liabilities by reason of the assumption by that partner of partnership liabilities, is considered a contribution of money by the partner to the partnership.[4] Conversely, section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of those individual liabilities, is considered a distribution of money by the partnership to that partner.[5]

[4] Section 752(a); Treas. Reg. § 1.752-1(b).

[5] Section 752(b); Treas. Reg. § 1.752-1(c).

The regulations under section 752 provide rules for determining a partner's share of partnership liabilities. The current version of these regulations was finalized in 1991.[6] Under those regulations, recourse and nonrecourse liabilities are allocated under separate rules. A partnership liability is a recourse liability to the extent that any partner or related person bears the EROL for that liability under Treas. Reg. § 1.752-2.[7] Conversely, a partnership liability is a nonrecourse liability to the extent that no partner or related person bears the EROL for that liability.[8] The amount of an indebtedness is taken into account only once.[9]

1. Allocation of Recourse Liabilities

a. In General

Under Treas. Reg. § 1.752-2(a), a partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the EROL. In general, a partner bears the EROL for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable.[10] The determination of the extent to which a partner or related person has an obligation to make a payment is based on the facts and circumstances at the time of the determination.[11] All statutory and contractual obligations relating to the partnership liability are taken into account, including obligations imposed by the partnership agreement, contracts

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6 T.D. 8380, 56 Fed. Reg. 66,348 (Dec. 23, 1991). The regulations were amended by T.D. 8925, 66 Fed. Reg. 715 (Jan. 4, 2001) (liability netting rule added for partnership mergers); T.D. 9207, 70 Fed. Reg. 30,334 (May 26, 2005) (adding definition of "§ 1.752-1 liabilities" in connection with the promulgation of Treas. Reg. § 1.752-7 regarding contingent liabilities and making minor related changes); and T.D. 9289, 71 Fed. Reg. 59,669 (Oct. 11, 2006 (adding special rules, described below, for partnership interests held by disregarded entities).

7 Treas. Reg. § 1.752-1(a)(1). In January of 2014, the IRS and Treasury issued proposed regulations that, if finalized, would modify some of the rules for allocating both recourse and nonrecourse liabilities under section 752 and would modify certain disguised sale rules under section 707(a)(2)(B). 79 Fed. Reg. 4,826 (Jan. 30, 2014). Those regulations (the "January 2014 Proposed Regulations") are beyond the scope of this report. Note, however, that if the January 2014 Proposed Regulations are issued as final regulations, then conforming changes may need to be made to the Proposed Regulations. The Tax Section of the New York State Bar Association recently submitted a report discussing the subjects addressed in the January 2014 Proposed Regulations. *See* NYSBA Tax Section Report No. 1307, "Report on the Proposed Regulations on the Allocation of Partnership Liabilities and Disguised Sales" (May 30, 2014).

8 Treas. Reg. § 1.752-1(a)(2).

9 Treas. Reg. § 1.752-4(c).

10 Treas. Reg. § 1.752-2(b)(1). The regulations deem the following events to occur simultaneously upon a constructive liquidation: (i) all of the partnership's liabilities become payable in full; (ii) with the exception of property contributed to secure a partnership liability, all of the partnership's assets, including cash, have a value of zero; (iii) the partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditors' right to repayment is limited solely to one or more assets of the partnership); (iv) all items of income, gain, loss, or deduction are allocated among the partners; and (v) the partnership liquidates. *Id*. A partner's or related person's obligation to make a payment with respect to a partnership liability is reduced to the extent that the partner or related person is entitled to reimbursement from another partner or a person who is a related person to another partner. Treas. Reg. § 1.752-2(b)(5).

11 Treas. Reg. § 1.752-2(b)(3).

outside the partnership agreement, and state law.[12] A partner also generally bears the EROL for a partnership liability to the extent that the partner or a related person makes (or acquires an interest in) a nonrecourse loan to the partnership and the EROL for the liability is not borne by another partner[13] or if the partner or a related person pledges property as security for the liability.[14]

In determining the extent to which a partner bears the EROL for a partnership liability, Treas. Reg. § 1.752-2 contains special rules for payment obligations of (i) a business entity that is disregarded as separate from its owner under section 856(i) (qualified REIT subsidiary), (ii) section 1361(b)(3) (qualified subchapter S subsidiary), or (iii) the check-the-box regulations in Treas. Reg. §§ 301.7701-1 through 301.7701-3 (collectively, "disregarded entities" or "DREs"). Under these special rules, a payment obligation of a DRE generally is taken into account only to the extent of the net value of the DRE as determined under the rules of Treas. Reg. § 1.752-2(k) (the "Net Value Rules").[15]

b. Definition of "Related Person"

The definition of a "related person" for purposes of Treas. Reg. §§ 1.752-1 and 1.752-2 is in Treas. Reg. § 1.752-4(b), which provides that a person is related to a partner if the person and the partner bear a relationship to each other that is specified in section 267(b) or 707(b)(1), subject to the following modifications: (i) substitute "80 percent or more" for "more than 50 percent" each place it appears in those sections, (ii) a person's family is determined by excluding brothers and sisters, and (iii) disregard sections 267(e)(1) and 267(f)(1)(A). If a person is related to more than one partner, the person is treated as being related only to the partner with whom there is the greatest percentage of related ownership (the "Greatest Percentage Rule").[16] If two or more partners have the same percentage of related ownership and no other partner has a greater percentage, the liability is allocated equally among the partners having the equal percentages of related ownership (the "Per Capita Rule").[17] Notwithstanding the rules described in this paragraph, however, persons owning interests directly or indirectly[18]

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12 *Id*. It is generally understood by practitioners that the term "state law" includes all applicable jurisdictional law, including the laws of the federal government, municipalities, and foreign governments.

13 Treas. Reg. § 1.752-2(c)(1).

14 Treas. Reg. § 1.752-2(h).

15 The January 2014 Proposed Regulations would extend the Net Value Rules of Treas. Reg. § 1.752-2(k) to apply to all partners or related persons, including grantor trusts, other than individuals and decedents' estates, but would provide an exception for payment obligations associated with liabilities that are trade payables. Prop. Treas. Reg. § 1.752-2(b)(3)(iii)(B).

16 Treas. Reg. § 1.752-4(b)(2)(i).

17 *Id*.

18 Under current law it is unclear whether the term "directly or indirectly" includes indirect ownership through corporations, or only through partnerships. Temporary regulations issued in 1989 once had provided that if related persons own (directly or indirectly *through a partnership*) interests in the same partnership, then those persons were not treated as related persons for purposes of determining the EROL borne by each of them for the liabilities of such partnership. T.D. 8274, 54 FR 48,090 (Nov. 21, 1989) (amending Temp. Treas. Reg. § 1.752-1T(h)(4)).

in the same partnership are not treated as related persons for purposes of determining the EROL borne by each of them for the liabilities of the partnership (the "Related Partner Exception").[19]

c. Special Rules for Tiered Partnerships

If an UTP owns (directly or indirectly through one or more partnerships) an interest in an LTP, the liabilities of LTP are allocated to UTP in an amount equal to the sum of (i) the amount of the EROL that UTP bears with respect to the liabilities, and (ii) any other amount of the liabilities with respect to which partners of UTP bear the EROL.[20] Thus, a UTP is allocated a liability of an LTP if either the UTP or one of its partners bears the EROL for the LTP liability. In addition, UTP's share of the liabilities of an LTP (other than any liability of LTP that is owed to UTP)[21] is treated as a liability of UTP for purposes of applying section 752 and the regulations under section 752 to the partners of UTP.

2. Allocation of Nonrecourse Liabilities

Under Treas. Reg. § 1.752-3, a partner's share of a nonrecourse liability of a partnership is determined under a three-tier system. Under the first tier, a portion of the nonrecourse liability is allocated to the partners first to the extent of each partner's share of partnership minimum gain (as determined under Treas. Reg. § 1.704-2).[22] Under the second tier, any portion of the nonrecourse liability not allocated under the first tier is allocated to the partners to the extent of the amount of gain that would be allocated to each partner under section 704(c)(1)(A) if the partnership disposed of all partnership property that is subject to nonrecourse liabilities in full satisfaction of the liabilities and for no other consideration.[23] Under the third tier, any portion of the nonrecourse liability not allocated under the first or second tiers generally is allocated to the partners in accordance with the partners' relative shares of partnership profits.[24]

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19 Treas. Reg. § 1.752-4(b)(2)(iii).

20 Treas. Reg. § 1.752-2(i).

21 Treas. Reg. § 1.752-4(a). Although, as noted, the regulation states that a loan from an LTP to a UTP is not treated as a liability of the UTP, the regulation does not address the effect of a loan by a UTP to an LTP. Thus, a loan from a UTP to an LTP apparently would be treated as a liability of LTP and UTP under section 752. If so, a single loan of $100 by UTP to LTP could give rise to a receivable with a basis of $100 and increase UTP's adjusted basis in its interest in LTP by $100.

22 Treas. Reg. § 1.752-3(a)(1).

23 Treas. Reg. § 1.752-3(a)(2).

24 Treas. Reg. § 1.752-3(a)(3). The partnership agreement may specify the partners' interests in the partnership profits for purposes of allocating liabilities not allocated under Treas. Reg. § 1.752-3(a)(1) and (2) ("excess nonrecourse liabilities"), provided that the interests so specified are reasonably consistent with allocations that have substantial economic effect of some other significant item of partnership income or gain. *Id*. Treas. Reg. § 1.752-3(a)(3) also provides generally that excess nonrecourse liabilities may be allocated to a partner based on the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. In addition, a partnership may allocate an excess nonrecourse liability to a partner up to the amount of section 704(c) gain that is allocable to the partner to the extent such gain has not already been taken into account

B. The Proposed Regulations

As noted above, the Proposed Regulations provide guidance regarding the allocation of a recourse liability with respect to which there is overlapping risk of loss and the special rules for related persons and tiered partnerships. These three topics are discussed in the following three parts of this report.

1. Overlapping Risk of Loss

a. Base Case

The preamble to the Proposed Regulations notes that "there is uncertainty as to how partners should share a partnership liability if multiple partners bear the EROL with respect to the same liability." The temporary regulations that were withdrawn in connection with the issuance of the current regulations contained a rule specifically addressing overlapping risk of loss that provided as follows:

> 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.[25]

The current regulations do not contain a general rule for allocating liabilities under section 752 if multiple partners bear the EROL with respect to the same liability. The Proposed Regulations, however, adopt the rule from the prior temporary regulations. The following example illustrates the application of the OROL Rule.

> ***Example 1***. A and B are unrelated equal members of limited liability company, AB, which is classified as a partnership for federal tax purposes. AB borrows $1,000 from Bank. A

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under Treas. Reg. § 1.752-3(a)(2). (This optional method is not available in allocating nonrecourse debt for purposes of the disguised sale provisions.) The January 2014 Proposed Regulations would modify these rules.

[25] Former Temp. Treas. Reg. § 1.752–1T(d)(3)(i). *See* T.D. 8237, 53 Fed. Reg. 53,140 (Dec. 30, 1988). This rule is similar to a rule in the current regulations regarding the allocation of partner nonrecourse deductions. Under Treas. Reg. § 1.704-2(i)(1), partnership losses, deductions, or section 705(a)(2)(B) expenditures that are attributable to a particular partner nonrecourse liability ("partner nonrecourse deductions") generally must be allocated to the partner that bears the EROL for the liability. If more than one partner bears the EROL for a partner nonrecourse liability, any partner nonrecourse deductions attributable to that liability must be allocated among the partners according to the ratio in which they bear the EROL (the "<u>Proportionate NRD Allocation Rule</u>"). If partners bear the EROL for different portions of a liability, each portion is treated as a separate partner nonrecourse liability.

> guarantees payment for the entire amount of AB's $1,000 liability, and B guarantees payment for $500 of the liability. Both A and B waive their rights of contribution against each other.
>
> The aggregate amount of A's and B's EROL under Treas. Reg. § 1.752-2(a)(1) ($1,500) exceeds the amount of AB's liability ($1,000). Under the OROL Rule, A's EROL equals $667, which is $1,000 multiplied by $1,000/$1,500, and B's EROL equals $333, which is $1,000 multiplied by $500/$1,500.[26]

This result is consistent with the recommendations in the Prior Report, and we believe that this proposed modification to the regulations would be a welcome improvement to the current regulations. As discussed in section III below, however, we recommend that the IRS and Treasury consider issuing guidance in the future that would require partnerships to allocate a liability in situations otherwise governed by the OROL Rule or the Per Capita Rule in a manner analogous to the manner in which nonrecourse liabilities are allocated under Treas. Reg. § 1.752-3.

b. Tiered Partnerships

The rules under the current regulations with respect to tiered partnerships also can result in overlapping risk of loss. Specifically, when a partner of a UTP also is a partner in the LTP and that partner bears the EROL with respect to a liability of the LTP, it is unclear under the current regulations how to allocate the LTP liability between the UTP and the partner in its capacity (as a partner of the LTP). The preamble notes that the IRS and Treasury believe that in these cases "the lower-tier partnership should allocate the liability directly to the partner" in part because this approach "ensures that the additional basis resulting from the liability is only for the benefit of the partner that bears the economic risk of loss for the liability."[27] To achieve this result, the Proposed Regulations would modify Treas. Reg. § 1.752-2(i) to prevent an LTP liability from being allocated to the UTP when a partner of the LTP and the UTP bears the EROL for the LTP liability. This result is consistent with the recommendations in the Prior Report, and we support this proposed modification.

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[26] This example is based on Prop. Treas. Reg. § 1.752-2(f), Example 9. Another possible way of applying the Proposed Regulations to this fact pattern would be to treat half of the $1,000 liability as guaranteed by only A, and the other half as guaranteed by both A and B. If this were the case, then A would be allocated $500 of the debt outright, and the OROL Rule only would apply to the remaining $500 of the debt. Each partner would be allocated $250 of debt under the OROL Rule. This manner of applying the Proposed Regulations is supported by Example 4, below, in which the $1,200 of partnership debt that is guaranteed by X is treated as a separate debt that is not subject to the OROL Rule.

[27] Preamble to the Proposed Regulations, 78 Fed. Reg. 76,093 (Dec. 16, 2013).

2. Related Party Rules

a. EROL of a Corporate Subsidiary

Section 267(c)(1) provides, in relevant part, that stock owned directly or indirectly by or for a partnership is considered as being owned proportionately by or for its partners. As a result, if a partnership owns all the stock of a corporation, then a partner that owns 80 percent or more of the interests in the partnership is considered to be related to the subsidiary corporation under Treas. Reg. § 1.752-4(b)(1) (which, as noted above, incorporates section 267 with certain modifications). If the subsidiary corporation bears the EROL with respect to a liability of the partnership, for example by being the lender, then any partner that is treated as related to the corporation bears the EROL for the partnership liability.

According to the preamble to the Proposed Regulations, the IRS and Treasury do not believe that partners should be treated as related to a subsidiary corporation through ownership of the partnership that owns the corporation. The preamble to the Proposed Regulations explains that "[a] partner's economic risk of loss that is limited to the partner's equity investment in the partnership should be treated differently than the risk of loss beyond that investment." Consistent with this standard, the Proposed Regulations would disregard section 267(c)(1) in determining whether stock owned, directly or indirectly, by or for a partnership is considered as being owned proportionately by or for its partners if the corporation is a lender as provided in Treas. Reg. § 1.752-2(c) or has a payment obligation with respect to a liability of the partnership.[28] This result is consistent with the recommendations in the Prior Report, and we support this proposed modification.[29]

b. Allocation of a Liability Among Multiple Related Partners

The Proposed Regulations would remove the Greatest Percentage Rule in recognition of the fact that differences in ownership within a 20-percent range do not justify treating one partner as more related to a person than another partner for purposes of determining the ultimate allocation of a partnership liability. Rather, the Proposed Regulations would provide that if a person that is a lender as provided in Treas. Reg. § 1.752-2(c), or that has a payment obligation with respect to a partnership liability (or portion thereof), is related to more than one partner, the partnership liability (or portion thereof) is shared equally among the partners.[30]

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[28] Prop. Treas. Reg. § 1.752-4(b)(1)(iv) provides that, for purposes of determining whether a person and a partner bear a relationship to each other that is specified in sections 267(b) or 707(b)(1), section 267(c)(1) is disregarded in determining whether stock of a corporation owned, directly or indirectly, by or for a partnership is considered as being owned proportionately by or for its partners if the corporation is a lender as provided in Treas. Reg. § 1.752-2(c) or has a payment obligation with respect to a liability of the partnership.

[29] As discussed in section III.D.2., we would recommend a minor technical correction to this provision.

[30] Prop. Treas. Reg. § 1.752-4(b)(3).

c. Related Partner Exception

The preamble to the Proposed Regulations indicates that the IRS and Treasury are aware that taxpayers "are uncertain of the application of the related partner exception following the decision in *IPO II v. Commissioner*, 122 T.C. 295 (2004)."[31] According to the preamble, the IRS and Treasury believe the related partner exception should apply only when a partner has a payment obligation or is the lender with respect to a partnership liability. The preamble further explains that −

> *IPO II* may be read to expand the related partner exception to turn off relationships between related partners in a partnership without limitation. Under this broad interpretation, the related partner exception could be improperly applied to turn off attribution of economic risk of loss between related partners even when none of the related partners directly bears the economic risk of loss for a partnership liability. The IRS and the Treasury Department believe that such an interpretation could have unintended results, including causing intercompany debts to be treated as nonrecourse because no partner alone owns 80 percent or more of the lending company and the partners are not treated as related to each other.

Accordingly, the Proposed Regulations would modify the Related Partner Exception to provide that if a person who owns (directly or indirectly through one or more partnerships) an interest in a partnership is a lender as provided in Treas. Reg. § 1.752-2(c) or has a payment obligation with respect to a partnership liability, or portion thereof, then that person is not treated as related to other persons who own interests (directly or indirectly through one or more partnerships) in that partnership for purposes of determining the EROL borne by each of them for such partnership

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[31] The preamble summarizes the facts of *IPO II* as follows:

> *IPO II* involved an individual, Mr. Forsythe, who owned 100 percent of an S corporation, Indeck Overseas, and 70 percent of a second S corporation, Indeck Energy. Mr. Forsythe's children owned the remaining 30 percent of Indeck Energy. Mr. Forsythe and Indeck Overseas formed a partnership, IPO II, which received a loan from a bank. To secure that loan, Mr. Forsythe, Indeck Energy, and Indeck Power (a C corporation of which Mr. Forsythe owned 63 percent) entered into guarantees with the bank. IPO II allocated 99 percent of the increase in basis attributable to this liability to Indeck Overseas. The Tax Court held that this allocation was incorrect because Indeck Overseas was not directly or indirectly liable for the debt. The court, while stressing that it interprets "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," did not end its analysis by stating that Mr. Forsythe guaranteed the debt, and thus his economic risk of loss could not be shifted to Indeck Overseas which did not guarantee the debt. The court instead examined whether Indeck Overseas indirectly bore the economic risk of loss due to its relationship with a related party, Indeck Energy. The Tax Court held that the relationship between Indeck Overseas and Indeck Energy arose through Mr. Forsythe. Because the related partner exception shuts off the relationship between Mr. Forsythe and Indeck Overseas, it should be turned off for all purposes; therefore, Indeck Energy was not related to Indeck Overseas.

78 Fed. Reg. 76,094 (citations to *IPO II* omitted).

liability, or portion thereof.[32] The application of this rule is illustrated by the following examples, both of which are based on examples in the Proposed Regulations.

> ***Example 2***. A owns 100 percent of two corporations, X and Y. A and Y are members of P, a limited liability company classified as a partnership for federal tax purposes. P borrows $1,000 from Bank. A and X each guarantee payment of the $1,000 debt owed to Bank. A and Y are not treated as related to each other pursuant to the Related Partner Exception because A has the payment obligation with respect to the $1,000 debt pursuant to Treas. Reg. § 1.752-2(b). The example in the Proposed Regulations indicates that Y is therefore not treated as related to X. Because A is the only partner that bears the EROL for P's $1,000 liability, A's share of the liability is $1,000 under Treas. Reg. § 1.752-2(a)(1).[33]

> ***Example 3***. A owns 100 percent of two corporations, X and Y. X owns 79 percent of a corporation, Z, and Y owns the remaining 21 percent of Z. X and Y are members of P, a limited liability company classified as a partnership for federal tax purposes. P borrows $2,000 from Bank. Both X and Z guarantee payment of the $2,000 debt owed to Bank. X has a payment obligation with respect to P's $2,000 liability; therefore the Related Partner Exception applies, and X and Y are not treated as related for purposes of determining the EROL borne by each of them for P's $2,000 liability. Because X and Y are not treated as related, and neither owns an 80 percent or more interest in Z, the example in the Proposed Regulations indicates that neither X nor Y is treated as related to Z under Treas. Reg. § 1.752-4(b)(1). Because X bears the EROL for P's $2,000 liability, X's share of the liability is $2,000 under Treas. Reg. § 1.752-2(a)(1).[34]

> ***Example 4***. Same facts as in Example 3, but X guarantees payment of only $1,200 of the debt owed to Bank and Z guarantees payment of $2,000. Pursuant to the Related Partner Exception, X and Y are not treated as related to the extent of X's $1,200 guarantee. Because X bears the EROL for $1,200 of P's $2,000 liability, X's share of the liability is $1,200 under Treas. Reg. § 1.752-2(a)(1). In addition, because the Related Partner Exception does not apply with respect to the remaining portion of the liability that X did not guarantee, X and Y are treated as related for purposes of the remaining $800 of the liability. Therefore, Z is

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32 Prop. Treas. Reg. § 1.752-4(b)(2).

33 This example is based on Prop. Treas. Reg. § 1.752-4(b)(5), Example 2.

34 This example is based on Prop. Treas. Reg. § 1.752-4(b)(5), Example 3.

> treated as related to X and Y. Under the OROL Rule, the example in the Proposed Regulations indicates that X and Y share the $800 equally; therefore, X's share of P's $2,000 liability is $1,600 and Y's share of P's $2,000 liability is $400.[35]

3. Effective Date

The Proposed Regulations would apply to any liability incurred or assumed by a partnership on or after the date that the regulations are published as final regulations, other than a liability incurred or assumed by a partnership pursuant to a written binding contract in effect before that date.[36]

4. Request for Comments Regarding Certain Transfers of Partnership Interests

The preamble to the Proposed Regulations indicates that the IRS and Treasury "are considering the proper treatment of liabilities when an upper-tier partnership (transferor) bears the economic risk of loss for a lower-tier partnership liability and distributes, in a liquidating distribution, its interest in the lower-tier partnership to one of its partners (transferee) but the partner does not bear the economic risk of loss for the lower-tier partnership's liability." The preamble also requests comments on "the timing of the liability reallocation relative to the transaction that causes the liability to change from recourse to nonrecourse."

III. Detailed Discussion

A. Proposed Alternative to the OROL Rule and Per Capita Rule

In the Prior Report, we suggested that the IRS and Treasury consider adopting a new set of rules that, if more than one partner bears the EROL for a partnership liability, would allocate that liability among those partners in a manner analogous to how nonrecourse debt is allocated under Treas. Reg. § 1.752-3. We renew that suggestion here. The application of this recommendation to a situation otherwise governed by the OROL Rule is illustrated by the following example:

> ***Example 5***. A and B are unrelated members of limited liability company, AB. A owns a 20 percent interest, and B owns an 80 percent interest, in AB. AB is classified as a partnership for federal tax purposes. AB borrows $1,000 from Bank. A and B each guarantees payment for the entire amount of AB's $1,000

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35 This example is based on Prop. Treas. Reg. § 1.752-4(b)(5), Example 4. In effect, the $1,200 guarantee by X bifurcates the $2,000 guarantee into two parts. To the extent of the first $1,200 of Z's guarantee, X and Y are not treated as related to Z and therefore do not bear the EROL for that part of the guaranteed debt. To the extent of the balance of Z's guarantee, or $800, X and Y are treated as related to Z.

36 A termination of the partnership under section 708(b)(1)(B) after the Proposed Regulations are finalized will not cause partnership liabilities incurred or assumed before the termination to be treated as incurred or assumed on the date of the termination. *See* Treas. Reg. § 1.752-5(c).

liability. A and B waive their rights of contribution against each other.

The aggregate amount of A's and B's EROL under Treas. Reg. § 1.752-2(a)(1) ($2,000) exceeds the amount of AB's liability ($1,000). Under the OROL Rule, each member's EROL equals $500, or $1,000 multiplied by $1,000/$2,000.[37] However, if future regulations require the liability to be allocated in a manner analogous to how nonrecourse debt is allocated under Treas. Reg. § 1.752-3, then AB could allocate the debt 20 percent ($200) to A and 80 percent ($800) to B.[38]

Requiring AB to allocate the debt between A and B in accordance with the principles of Treas. Reg. § 1.752-3 generally would cause the partners to allocate partnership liabilities in a manner consistent with their interests in the partnership. This allocation would more closely reflect the economic arrangement and would permit, for example, losses attributable to the debt to be allocated among the partners without any of those losses being suspended under section 704(d).[39] We recommend that future guidance require partnership liabilities to be allocated in this manner in situations that otherwise would be governed by the OROL Rule or the Per Capita Rule.

B. Related Partner Exception

Although the proposed amendment to the related partner exception would be a meaningful improvement over the current regulations, it is not entirely clear that the language of the proposed amendments to Treas. Reg. § 1.752-4(b)(2) fully supports the conclusion in Examples 2 through 4 above. Specifically, to the extent that Examples 3, 4, and 5 above (and the corresponding examples in the Proposed Regulations) treat X and Y as not related, the examples are consistent with our recommendations in the Prior Report, and we support the proposed modification to the Related Partner Exception. To the extent that these examples also disregard relationships between a partner (such as Y in each example) and a person who is not a partner but has a payment obligation, (such as X in Example 2 or Z in Example 3), however, we believe that it may be more appropriate to apply the OROL Rule.

- Example 2 indicates that Y and A are not treated as related under the Related Partner Exception because A has a payment obligation and owns an interest in P. We believe, however, that Y should be treated as related to X, because although X has a payment obligation with respect to P's debt, X is not a partner in P. If X and Y are considered to be related, then Y would be treated as bearing the EROL

37 This example is based on Prop. Treas. Reg. § 1.752-2(f), Example 9.

38 If a partner bears less than 100 percent of the EROL for a liability under Treas. Reg. § 1.752-2(a)(1), the amount of the debt that would be allocable to that partner under our proposed rule would be limited by the partner's EROL. For example, if B guaranteed only $500 of AB's liability, the maximum amount of that liability that could be allocated to B would be $500.

39 Under section 704(d), a partner's share of a partnership's losses and deductions generally is limited to the partner's adjusted basis in its partnership interest.

as a result of X's guarantee, and the OROL Rule would apply to divide the EROL between A and Y.

- Similarly, Example 3 indicates that X and Y are not related under the Related Partner Exception because X has a payment obligation and owns an interest in P. Once again, however, we believe that Y should be treated as related to Z, because although Z has a payment obligation with respect to P's debt, Z is not a partner in P. If Y and Z were related, then Y would be treated as bearing the EROL as a result of Z's guarantee, and the OROL Rule would apply to divide the EROL equally between X and Y.

We recommend that the final regulations clarify by rule (and not merely by example) the extent to which relationships between a partner and a person who is not a partner but has a payment obligation should be disregarded, and how the OROL Rule applies in such cases.

In addition, we recommend that final regulations clarify the circumstances under which a payment obligation with respect to only part of a liability effectively bifurcates the liability into two liabilities (as in Example 4) and when it merely impacts the sharing of the liability (as in Example 1).

In Example 1, which illustrates the OROL Rule, member A guarantees payment for the entire amount of AB's $1,000 liability, and member B guarantees payment for $500 of the liability. Neither of the guarantees causes a bifurcation of the liability for purposes of applying the OROL Rule. In Example 4, however, which illustrates both the Related Partner Exception and the Per Capita Rule, X guarantees payment of $1,200 of the liability, and Z guarantees payment of $2,000. Because the total liability allocated to all of the partners would be $2,800 ($1,200 plus $800 plus $800), the OROL Rule arguably should divide the liability $1,429 to X ($2,000 x $2,000/$2,800) and $571 to Y ($2,000 x $800/$2,800). According to the example, however, the guaranty by X bifurcates the liability into a $1,200 portion guaranteed by X and a $800 portion that is not guaranteed by X. Because the example applies the OROL Rule only to the $800 portion, the example appears to create an ordering rule that is not contained in the text of the Proposed Regulations. Although the proposed OROL Rule, the proposed Per Capita Rule, and the proposed Related Partner Exception all use the phrase "or portion thereof," the examples do not seem to apply that phrase in a consistent fashion.

C. Related Party Rules

1. Treas. Reg. § 1.1563-1(a)(2)(i)(A)

For the reasons discussed below, we recommend that Treas. Reg. § 1.1563-1(a)(2)(i)(A) be revised to conform with the language of section 1563. We have included an example to illustrate how the language of this regulation, as currently drafted, could cause partnerships to misallocate partnership liabilities under section 752 and the Proposed Regulations.

As discussed above, the definition of a "related person" for purposes of Treas. Reg. §§ 1.752-1 and 1.752-2 is in Treas. Reg. § 1.752-4(b), which provides that a person is related to a partner if the person and the partner bear a relationship to each other that is specified in section 267(b) or 707(b)(1), subject to the following modifications: (i) substitute "80 percent or more" for "more than 50 percent" each place it appears in those sections; (ii) a person's family is determined by excluding brothers and sisters; and (iii) disregard sections 267(e)(1) and 267(f)(1)(A). One of the relationships specified in section 267(b) is two corporations that are members of the same controlled group (as defined in section 267(f)).[40] Section 267(f), in turn, defines "controlled group" as having the meaning given to that term by section 1563, with certain modifications.[41]

Section 1563(e)(2) provides that "[s]tock owned, directly or indirectly, by or for a partnership shall be considered as owned by any partner having an interest of 5 percent or more in either the capital or profits of the partnership in proportion to his interest in capital or profits, whichever such proportion is the greater" (the "Partnership-to-Partner Attribution Rule"). Section 1563(d)(1)(B) provides that, for purposes of determining whether a corporation is a member of a parent-subsidiary controlled group of corporations (within the meaning of section 1563(a)(1)), stock owned by a corporation includes (among other things) stock owned with the application of the Partnership-to-Partner Attribution Rule.

Treas. Reg. § 1.1563-3(b) contains various attribution rules. For example, under the option attribution rule of Treas. Reg. § 1.1563-3(b)(1), if a person has an option to acquire any outstanding stock of a corporation, that stock is considered to be owned by that person. Under Treas. Reg. § 1.1563-3(b)(2), stock owned, directly or indirectly by or for a partnership is considered to be owned by any partner having an interest of five percent or more in either the capital or profits of the partnership in proportion to the partner's interest in capital or profits (whichever is higher). Additional rules are provided for attribution from estates and trusts, corporations, spouses, and other family members.[42]

The definition of a parent-subsidiary controlled group is found in section 1563(a)(1) and Treas. Reg. § 1.1563-1(a)(2). Treas. Reg. § 1.1563-3(a) expressly provides that the constructive ownership rules contained in Treas. Reg. § 1.1563-3(b) apply for purposes of Treas. Reg. § 1.1563-1 "to the extent" those rules are referred to in that section. Under Treas. Reg. § 1.1563-1(a)(2)(i)(A), however, only the option attribution rule is invoked in determining whether corporations are members of a parent-subsidiary controlled group; the partnership attribution rule of Treas. Reg. § 1.1563-3(b)(2) is not. This omission is inconsistent with the plain language of section 1563(d)(1)(B), which, as noted above, provides that, for purposes of determining whether a corporation is a member of a parent-subsidiary controlled group of corporations (within the meaning of section 1563(a)(1)), stock owned by a corporation includes (among other things) stock owned with the application of the Partnership-to-Partner Attribution Rule.

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40 Section 267(b)(3).

41 The modifications are that "more than 50 percent" is substituted for "at least 80 percent" each place it appears in section 1563(a), and the determination is made without regard to section 1563(a)(4) and section 1563(e)(3)(C).

42 Treas. Reg. § 1.1563-3(b)(3)-(6).

The potential application of these rules to the allocation of a partnership liability under Treas. Reg. § 1.752-4 is illustrated by the following example.

> ***Example 6***. P, a corporation, owns all of the stock of S1. S1 owns a 99 percent interest in PRS, a partnership. An unrelated investor, X, owns the remaining 1 percent interest in PRS. PRS owns all of the stock of S2. S1 and Y, an unrelated person, are equal members in LLC, a limited liability company classified as a partnership for federal tax purposes. S2 lends $1,000 to LLC.
>
> Based on the language of section 1563, S1 and S2 clearly are members of a controlled group of corporations, because P directly owns 100 percent of S1 and is treated as owning 99 percent of S2 (with the application of section 1563(e)(2), which is made applicable by section 1563(d)(1)(B)).[43] S1 and S2 would be related persons within the meaning of Treas. Reg. § 1.752-4, because they bear a relationship specified in section 267(b)(3). Therefore, LLC's entire $1,000 liability would be allocated to S1 under Treas. Reg. § 1.752-2(c).
>
> Looking only at the regulations under section 1563, however, S1 and S2 would not be members of a controlled group of corporations.[44] Applying the section 1563 regulations as drafted, S1 and S2 would not be related persons and the liability would be a nonrecourse liability that would allocated between S1 and Y under Treas. Reg. § 1.752-3. This result seems to be unintended.

Although it is clear that the language of the Code would supersede any contrary rules in the regulations, to avoid any confusion for taxpayers, we recommend that the regulations under section 1563 be revised to conform to the statutory language.

2. Other Related Party Rules Potentially Treating Partners and Subsidiaries of the Partnership As Related

As discussed above, the Proposed Regulations would disregard section 267(c)(1) in determining whether stock owned, directly or indirectly, by or for a partnership is considered as being owned proportionately by or for its partners if the corporation is a lender as provided in Treas. Reg. § 1.752-2(c) or has a payment obligation with respect to a liability of the partnership.[45] We recommend that Prop. Treas. Reg. § 1.752-4(b)(1)(iv) be modified to provide

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[43] Section 1563(a)(1), section 1563(e)(2), and section 1563(d)(1)(B).

[44] Treas. Reg. § 1.1563-1(a)(2)(i)(A).

[45] Prop. Treas. Reg. § 1.752-4(b)(1)(iv) provides that, for purposes of determining whether a person and a partner bear a relationship to each other that is specified in sections 267(b) or 707(b)(1), section 267(c)(1) is disregarded in determining whether stock of a corporation owned, directly or indirectly, by or for a partnership is considered as being owned proportionately by or for its partners if the corporation is a lender as provided in Treas. Reg. § 1.752-2(c) or has a payment obligation with respect to a liability of the partnership.

that for this purpose, attribution under section 1563(e)(2) also must be disregarded. Without this modification, a corporate partner and a corporation owned by the partnership could be treated as part of a controlled group under section 1563, and thus related to each other under section 267(b)(3).

Other fact patterns may raise the same issue. For example, consider a corporate partner that owns a 90 percent interest in UTP. Assume that UTP and a corporate subsidiary own all of LTP. LTP makes a loan to UTP, or guarantees a debt of UTP. Based on the intention of the Proposed Regulations, it does not appear that LTP and the corporate partner should be treated as related persons for purposes of determining whether the corporate partner bears the EROL.[46] This conclusion should not change if the majority partner in UTP were classified as a partnership, rather than as a corporation.[47] Therefore, we recommend that Prop. Treas. Reg. § 1.752-4(b)(1)(iv) be modified to apply similar principles where a partner would otherwise be treated as "related" to a subsidiary of a partnership (*e.g.*, where the partner or the subsidiary is itself a partnership).

D. Effective Date

1. Liabilities Not Otherwise Subject to the Regulations

We recommend that the final regulations permit partnerships to apply the rules of the final regulations to all of the partnership's liabilities incurred or assumed by a partnership before the date that the regulations are published as final regulations ("Pre-Effective Date Liabilities"). This recommendation would apply to all returns filed after the date on which the final regulations are published, including returns for taxable years ending before the effective date of the regulations, as illustrated by the following example.

> ***Example 7***. C is a 90 percent partner, and D is a 10 percent partner, in partnership CD, which uses the calendar year as its taxable year. On January 1, 2014, CD borrows $1,000 from a corporation owned entirely by CD (the "Debt"). On January 1, 2015 (the "Effective Date"), the Proposed Regulations are finalized and generally apply to liabilities incurred on or after that date.

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46 The language of Prop. Treas. Reg. § 1.752-4(b)(1)(iv) should be clarified on this point. That is, the proposed regulation only provides that, in determining relatedness, taxpayers should "[d]isregard section 267(c)(1) in determining whether ***stock*** of a corporation owned, directly or indirectly, by or for a partnership is considered as being owned proportionately by or for its partners...." (Emphasis added.) Section 267(e)(3) applies the *principles of* section 267(c)(1) to certain lower-tier partnership interests. The extent to which section 267(c)(1) is disregarded for purposes of applying other sections, such as section 267(e)(3), that apply the principles of section 267(c)(1) in determining constructive ownership is not clear.

47 Section 707(b)(3), like section 267(e)(3), applies the *principles of* section 267(c)(1) to certain lower-tier partnership interests. Once again, we believe that the extent to which section 267(c)(1) is disregarded for purposes of applying other sections, such as section 707(b)(3), that apply the principles of section 267(c)(1) in determining constructive ownership should be clarified.

> Under the regulations generally in effect for liabilities incurred before the Effective Date, the Debt would be allocated to C, because C and the lender would be treated as related persons. We recommend that CD be permitted to apply the provisions of the final regulations to all of CD's Pre-Effective Date Liabilities, including the Debt, on its 2014 and future returns. If this election is made, CD would treat the Debt as a nonrecourse liability on its 2014 return (*i.e.*, in accordance with the final regulations).[48]

2. Refinancing Rule

It appears that if a liability is refinanced or significantly modified (so that the modified liability, if a debt instrument, is a new debt instrument under Treas. Reg. § 1.1001-3) or a payment obligation is modified in a manner that causes it to be treated as a new payment obligation for U.S. federal income tax purposes, the liability or payment obligation would become subject to the rules of the final regulations. We recommend that the regulations, when finalized, permit partnership liabilities that are modified and/or refinanced and payment obligations that are modified to continue to be subject to the provisions of the current regulations but only to the extent of the amount and duration of the pre-modification (or refinancing) liability or payment obligation.[49] Without such a rule, the effective date in the Proposed Regulations may discourage partnerships from refinancing debts or may subject partners to unexpected, adverse results, such as triggering gain under section 731 to a partner whose share of partnership debt would be lower under the final regulations than it is under current law.

3. Mergers, Consolidations, and Divisions

We considered whether the effective date provisions of final regulations should contain special rules for partnership mergers and divisions. For the reasons discussed below, we do not believe that any special rules are required.

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[48] A rule permitting such an election would be similar to the rule in Treas. Reg. § 1.752-5(b), which permits a partnership to elect to apply the provisions of Treas. Reg. §§ 1.752-1 through 1.752-4 (as finalized in 1991) to all of its liabilities to which the provisions of those sections did not otherwise apply as of the beginning of the first taxable year of the partnership ending on or after December 28, 1991. If such an election is permitted with respect to the Proposed Regulations when they become final, it may be advisable for the final regulations to specify how the election would apply in a tiered partnership structure. For example, if an LTP makes the election, would an UTP that is allocated liabilities of LTP be bound by that election with respect to UTP's allocation of those liabilities? If the LTP does not make the election, could UTP make the election with respect to UTP's share of LTP's liabilities?

[49] For a similar rule in the disguised sale context, see Treas. Reg. § 1.707-5(c) (to the extent that the proceeds of a partner or partnership liability (the refinancing debt) are allocable under the rules of Temp. Treas. Reg. § 1.163-8T to payments discharging all or part of any other liability of that partner or of the partnership, as the case may be, the refinancing debt is treated as the other liability for purposes of applying Treas. Reg. § 1.707-5). *See also* Temp. Treas. Reg. § 1.163-8T(e)(1) (for purposes of the interest tracing rules, to the extent proceeds of any debt (the "replacement debt") are used to repay any portion of a debt, the replacement debt is allocated to the expenditures to which the repaid debt was allocated).

a. Mergers and Consolidations

Section 708(b)(2)(A) provides that, in the case of the merger or consolidation of two or more partnerships, the resulting partnership is considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership. When two or more partnerships merge or consolidate into one partnership without undertaking a particular form, or undertake a form other than the assets-up form described below, then any merged or consolidated partnership that is considered terminated is treated as contributing all of its assets and liabilities to the resulting partnership in exchange for an interest in the resulting partnership, and immediately thereafter, the terminated partnership is treated as distributing interests in the resulting partnership to its partners in liquidation of the terminated partners (referred to as the "assets-over form").[50] In contrast, the form of a partnership merger or consolidation will be respected for U.S. federal income tax purposes if the merged or consolidated partnership that is considered terminated distributes all of its assets to its partners (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of those assets) in liquidation of the partners' interests in the terminated partnership, and immediately thereafter, the partners in the terminated partnership contribute the distributed assets to the resulting partnership in exchange for interests in the resulting partnership (referred to as the "assets-up form").[51]

If a partnership has liabilities that were incurred before the effective date of the final regulations and merges or consolidates on or after the effective date of the final regulations, causing the partnership to terminate, then those liabilities will be assumed or taken subject to by the resulting partnership regardless of whether the merger or consolidation is characterized under the assets-over form or the assets-up form. Therefore, those liabilities would be subject to the final regulations because they would be incurred by the resulting partnership on or after the effective date. In contrast, if a partnership has liabilities that were incurred before the effective date and merges or consolidates on or after the effective date, but the partnership is treated as the resulting partnership, then that partnership would not be subject to the final regulations, because the merger or consolidation would not affect the date on which that partnership incurred the liabilities. It could be argued that liabilities in either partnership should be grandfathered, regardless of which partnership is treated as surviving the merger. Treating the terminating partnership differently from the resulting partnership as described above, however, also would be reasonable. Therefore, we do not believe that any special rules for partnership mergers and consolidations are necessary in the final regulations.

b. Divisions

Section 708(b)(2)(B) provides that, in the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50 percent or less in the capital and profits of the prior partnership) are considered continuations of the prior partnership. When a partnership divides

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[50] Treas. Reg. § 1.708-1(c)(3)(i).

[51] Treas. Reg. § 1.708-1(c)(3)(ii).

into two or more partnerships without undertaking a particular form, or undertake a form other than the assets-up form described below, the transaction will be characterized under the assets-over form for U.S. federal income tax purposes.[52] In a division under the assets-over form where at least one resulting partnership is a continuation of the prior partnership, the divided partnership contributes certain assets and liabilities to a recipient partnership or partnerships in exchange for interests, and, immediately thereafter, distributes the interests to some or all of its partners in partial or complete liquidation of the partners' interests in the divided partnership.[53] In contrast, in an assets-up division where the partnership distributing assets is a continuation of the prior partnership, the form of a partnership division will be respected for U.S. federal income tax purposes if the divided partnership distributes certain assets (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of those assets) to some or all of its partners in partial or complete liquidation of the partners' interests in the divided partnership, and immediately thereafter, those partners contribute the distributed assets to a resulting partnership or partnerships in exchange for interests.[54]

If a partnership has liabilities that were incurred before the effective date of the final regulations and divides on or after the effective date of the final regulations, there are two possibilities. First, the liabilities could be treated as having been assumed or taken subject to by a ***newly formed partnership*** (regardless of whether the division is characterized under the assets-over form or the assets-up form). Therefore those liabilities would be subject to the final regulations because they would be incurred by the newly formed partnership on or after the effective date. In contrast, if a partnership has liabilities that were incurred before the effective date and divides on or after the effective date and the partnership is treated as the ***divided partnership***, then that partnership would not be subject to the final regulations, because the division would not affect the date on which that partnership incurred the liabilities.[55] Similar to our analysis of partnership mergers, it could be argued that liabilities in either the newly formed partnership or the divided partnership should be grandfathered. Treating the newly formed partnership differently from the divided partnership as described above, however, also would be reasonable. Therefore we do not believe that any special rules for partnership divisions are necessary in the final regulations.

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52 Treas. Reg. § 1.708-1(d)(3)(i).

53 Treas. Reg. § 1.708-1(d)(3)(i)(A). If none of the resulting partnerships is a continuation of the prior partnership, the prior partnership will be treated as contributing all of its assets and liabilities to new, resulting partnerships in exchange for interests, and, immediately thereafter, distributing the interests to the prior partnership's partners. Treas. Reg. § 1.708-1(d)(3)(i)(B).

54 Treas. Reg. § 1.708-1(d)(3)(ii)(A). If none of the resulting partnerships is a continuation of the prior partnership, the form will be respected if the prior partnership distributes certain assets (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of those assets) to some or all of its partners in partial or complete liquidation of their interests in the prior partnership, and immediately thereafter, those partners contribute the distributed assets to a resulting partnership or partnerships in exchange for interests.

55 The divided partnership is the continuing partnership that is treated as transferring the assets and liabilities to the recipient partnership or partnerships, either directly (under the assets-over form) or indirectly (under the assets-up form). Treas. Reg. § 1.708-1(d)(4).

E. Transfers of Partnership Interests Where the Transferor's Share of Partnership Liabilities is Not the Same as the Transferee's Share of Those Liabilities

As noted above, the preamble to the Proposed Regulations indicates that the IRS and Treasury are considering the proper treatment of liabilities when a UTP bears the EROL for an LTP liability and distributes, in a liquidating distribution, its interest in the LTP to one of its partners who does not bear the EROL for the LTP's liability. As noted below, shifts in the recourse nature of a partnership liability that arise in the context of partnership distributions and other transfers raise a number of complicated issues. In our experience, however, these issues arise with considerably less frequency than other issues raised by the Proposed Regulations and other guidance projects underway. As a result, the proper treatment of such shifts is beyond the scope of this report. Nevertheless, some general observations are set forth below.[56]

1. Background

As discussed above, section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's liabilities by reason of the assumption by that partner of partnership liabilities, is considered a contribution of money by the partner to the partnership.[57] Conversely, section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of those individual liabilities, is considered a distribution of money by the partnership to that partner.[58] If, as a result of a single transaction, a partner incurs both an increase in the partner's share of partnership liabilities (or the partner's individual liabilities) and a decrease in the partner's share of partnership liabilities (or the partner's individual liabilities), only the net increase or decrease is treated as a contribution to or distribution from the partnership.[59] Generally, the contribution to or distribution from a partnership of property subject to a liability will require that increases or decreases in liabilities associated with the transaction be netted to determine if a partner is deemed to have made a contribution or received a distribution as a result of the transaction.[60]

Section 752(d) provides that, in the case of a sale or exchange of an interest in a partnership, liabilities are treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships. Similarly, Treas. Reg. § 1.752-1(h) provides that if a partnership interest is sold or exchanged, the reduction in the transferor partner's share of partnership liabilities is treated as an amount realized under section 1001 and the regulations thereunder, as illustrated by the following example:

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[56] We would be happy to submit a different report on those issues if asked to do so.

[57] Section 752(a); Treas. Reg. § 1.752-1(b).

[58] Section 752(b); Treas. Reg. § 1.752-1(c).

[59] Treas. Reg. § 1.752-1(f).

[60] Treas. Reg. § 1.752-1(f). *See also* Rev. Rul. 79-205, 1979-2 C.B. 255 and Rev. Rul. 87-120, 1987-2 C.B. 161 (both concluding that a partner's basis in distributed property is made after the partner's basis in his partnership interest is adjusted to reflect any net increase or decrease in liabilities).

> ***Example 8***. L is a 10 percent limited partner in partnership GL. M purchases L's entire interest in partnership GL. At the time of the sale, L's adjusted basis in its partnership interest ("outside basis") is $20,000, and L's share of GL's nonrecourse liabilities is $15,000. M pays $10,000 in cash for L's interest in the partnership. Under section 752(d), L's share of partnership liabilities, $15,000, is treated as money received. Accordingly, L's amount realized on the sale of the partnership interest is $25,000 ($10,000 plus $15,000). L's gain realized on the sale is $5,000 ($25,000 minus $20,000).[61]

Section 761(e) provides that, except as otherwise provided in regulations, for purposes of (i) section 708 (relating to continuation of partnership), (ii) section 743 (relating to optional adjustment to basis of partnership property), and (iii) any other provision of this subchapter "specified in regulations" prescribed by the Secretary, any distribution of an interest in a partnership (not otherwise treated as an exchange) is treated as an exchange. No regulations have been promulgated under this authority. Because section 761(e) does not enumerate section 752 as a provision for which a distribution of a partnership interest is treated as an exchange, it could be argued that a UTP is not treated for purposes of Section 752(d) as exchanging an LTP interest upon a distribution of the LTP interest.[62]

The 1988 temporary regulations pertaining to section 752(d) provided that section 752(d) applied to a sale, exchange, "or other disposition."[63] The language "or other disposition" was omitted from the current regulations under section 752, which were promulgated in 1991.[64]

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[61] This example is based on Treas. Reg. § 1.1001-2(c), Example 3.

[62] Treas. Reg. § 1.1001-2(a) provides that except as otherwise provided, the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. Treas. Reg. § 1.1001-2(a)(4)(iii) provides that contributions and distributions of property between a partner and a partnership are not sales or other dispositions of property for purposes of Treas. Reg. § 1.1001-2. It seems clear that Treas. Reg. § 1.1001-2(a)(4)(iii) was intended to clarify that the extent to which liabilities trigger gain or loss is determined under subchapter K rather than under section 1001. *See* T.D. 7741, 45 Fed. Reg. 81,743 (Dec. 12, 1980) ("The Treasury decision makes it clear that contributions and distributions of encumbered property between a partner and a partnership are not sales or other dispositions for purposes of section 1001. Thus, such transactions are subject to the partnership rules relating to contributions and distributions.") Accordingly, we do not believe that Treas. Reg. § 1.1001-2(a)(4)(iii) controls or affects the tax consequences under subchapter K of liabilities assumed or taken subject to in connection with a distribution of property from a partnership. In particular, it seems unlikely that this rule was intended to address whether distributions of LTP interests are subject to section 752(d), particularly in light of Treas. Reg. § 1.1001-2(a)(4)(v) ("The liabilities from which a transferor is discharged as the result of the sale *or disposition* of a partnership interest include the transferor's share of the liabilities of the partnership.") (emphasis added). *See also* Rev. Rul. 55-68, 1955-1 C.B. 472 (distribution of property by partnership to partner was treated as sale or exchange for purposes of the Internal Revenue Code of 1939).

[63] Former Temp. Treas. Reg. § 1.752-3T ("For purposes of determining the amount of any gain or loss realized on a sale, exchange, or other disposition of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale, exchange, or other disposition of property not associated with partnerships.) *See* T.D. 8237, 53 Fed. Reg. 53,140 (Dec. 30, 1988).

[64] T.D. 8380, 56 Fed. Reg. 66,348 (Dec. 23, 1991).

If this omission signaled a substantive change from the temporary regulations, it is conceivable that section 752(d) would not apply to the distribution of a lower-tier partnership interest. In our view, however, section 752(d) and its implementing regulation, Treas. Reg. § 1.752-1(h), should be viewed as examples of a broader principle, which is that liabilities allocated to a partner should be treated as liabilities of that partner for purposes of determining the tax consequences of disposing that interest.[65]

For various reasons, when a partnership interest is transferred, the transferor's share of a partnership liability may not be the same as the transferee's share of that liability.[66] For example, one of the partners may have guaranteed all or a portion of the debt. Another possibility is that the Net Value Rules apply to only the transferor or the transferee (because only one is a DRE), or apply differently to both the transferor and the transferee (*e.g.*, because they are both DREs but have different net values). Perhaps the most common situation in which this issue arises is a situation in which the transferor and the transferee have different relationships to the lender, or to a person that has guaranteed the liability. For example, a lender who is not a partner, and who is not related to any partner, could acquire an interest in a partnership that is the borrower, causing the partnership's liability to be allocated entirely to the lender after the purchase. We discuss below two situations in which a transferor's share of a partnership liability is not the same as the transferee's share of that liability − a purchase of a partnership interest and a distribution of an LTP interest by a UTP.

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[65] Even if a sale or exchange is required for section 752(d) to apply, the allocation of partnership liabilities to the transferee of a partnership interest arguably should cause that requirement to be satisfied. The notion that the presence of liabilities can transform a transfer that is not otherwise a sale or exchange into a sale or exchange is not novel. For example, if a person contributes a partnership interest to charity, and debt is shifted from the donor to the charity, a bargain sale is deemed to occur, as illustrated by the following example.

> *Example (4).* In 1976 B becomes a limited partner in partnership BG. In 1978 B contributes B's entire interest in BG to a charitable organization described in section 170(c). At the time of the contribution all of the partnership liabilities are liabilities for which neither B nor G has assumed any personal liability and B's proportionate share of which is $9,000. The charitable organization does not pay any cash or other property to B, but takes the partnership interest subject to the $9,000 of liabilities. Assume that the contribution is treated as a bargain sale to a charitable organization and that under section 1011(b) $3,000 is determined to be the portion of B's basis in the partnership interest allocable to the sale. Under section 752(d) and this section, the $9,000 of liabilities is treated by B as money received, thereby making B's amount realized $9,000. B's gain realized is $6,000 ($9,000 - $3,000).

Treas. Reg. § 1.1001-2(c), Example (4). Another example can be found in Rev. Rul. 93-80, 1993-2 C.B. 239, concerning the abandonment of a partnership interest ("Any decrease in a partner's share of partnership liabilities is deemed to be a distribution of money to the partner under section 752(b)… A loss from the abandonment or worthlessness of a partnership interest will be ordinary if there is neither an actual nor a deemed distribution to the partner under the principles described above. Even a *de minimis* actual or deemed distribution makes the entire loss a capital loss").

[66] For a discussion of this issue in the context of the contribution of a partnership interest to a corporation in a transaction to which section 362(e) may apply, see "ABA Tax Section Comments on Proposed Regs on Limitations on Transfers of Built-in Losses," 2011 TNT 208-21 (Oct. 27, 2011).

2. Purchases of Partnership Interests

When a person purchases a partnership interest from a partner, it is clear that section 752(d) applies. Even in this situation, however, the purchaser's share of partnership liabilities may differ from the selling partner's share of those liabilities, as illustrated by the following example.

> ***Example 9***. X contributes $20 to XY, a limited liability company classified as a partnership, for a 20 percent interest, and Y contributes $80 to XY in exchange for an 80 percent interest. XY borrows $400 (the "Debt") and purchases a nondepreciable capital asset (the "Asset") for $500. The Debt is recourse to XY for purposes of section 1001. In addition, X guarantees the Debt, causing it to be treated as a recourse liability for purposes of section 752 and allocated entirely to X under Treas. Reg. § 1.752-2. When the value of the Asset remains $500, X sells its entire 20 percent interest in XY to Z, an unrelated person, for $20, and X is released from its guaranty. After the purchase, the Debt is a nonrecourse liability for purposes of section 752 and is allocated $80 (*i.e.*, 20 percent) to Z and $320 (*i.e.*, 80 percent) to Y under Treas. Reg. § 1.752-3. Thus, the decrease in the amount of the Debt allocated to the person (first X, then Z) owning the transferred interest (the "Decrease Amount") is $320.

There are several basic approach to addressing the fact that, before the transaction, X's share of the Debt is $400, and after the transaction, Z's share of the Debt is $80. First, there could be a deemed distribution of the Decrease Amount to X before the sale. Second, there could be a deemed distribution of the Decrease Amount to Z after the sale. Third, section 752(d) could be applied asymmetrically to X and to Z.

Deemed distribution before sale. Under the first approach, X would receive a deemed distribution of the Decrease Amount ($320) before the sale. (Y would be treated as making a contribution of $320 under section 752(a), increasing Y's outside basis to $400.) Because X's outside basis is $420, the deemed distribution would reduce X's outside basis to $100. Upon the sale, X's amount realized would be $100 ($20, the cash paid by Z, plus $80, X's share of the Debt after the deemed distribution). X would recognize no gain or loss from the sale under section 741. Z's initial outside basis would be $100.

Deemed distribution after sale. Under the second approach, X would not receive a deemed distribution before the sale. Upon the sale, X's amount realized would be $420 ($20, the cash paid by Z, plus $400, X's share of the Debt). X would recognize no gain or loss from the sale under section 741. Z's initial outside basis would be $420. Then, Z would be deemed to receive a distribution of the Decrease Amount ($320) under section 752(b) (reducing Z's outside basis to $100), and Y would be deemed to make a contribution of $320 under section 752(a) (increasing Y's outside basis to $400).

Asymmetrical approach. Under an asymmetrical approach, X would not receive a deemed distribution before the sale. Upon the sale, X's amount realized would be $420 ($20, the cash paid by Z, plus $400, X's share of the Debt). X would recognize no gain or loss from the sale. Z also would not receive a deemed distribution of the Decrease Amount. Rather, Z's initial outside basis simply would be $100 ($20, the cash paid by Z, plus $80, Z's share of the Debt).

Under all three approaches, the partners' aggregate outside basis after the sale is $500 (the sum of Z's outside basis, $100, and Y's outside basis, $400). Similarly, the partnership's basis in the Asset is $500. In more complicated and realistic fact patterns (such as where, in the example above, X has been allocated losses), however, the differences among the approaches could be very material. For example, the different approaches could result in different basis adjustments under section 734(b) and/or section 743(b).[67]

3. Distributions of Partnership Interests

If a UTP distributes an LTP interest, and the distributee's share of the LTP's liabilities is less than the UTP's share of those liabilities, we believe there are at least four approaches to address the difference. The first three approaches are the same as those discussed above. Specifically, under the first approach, LTP would be treated as distributing the Decrease Amount to UTP under section 752(b) immediately before the Distribution. Under the second approach, LTP would be treated as distributing the Decrease Amount to the distributee partner under section 752(b) immediately after the Distribution. Under the third approach, section 752(d) would apply, but in an asymmetrical manner. Finally, to the extent that the theory that section 752(d) does not apply to the distribution has merit,[68] under a fourth approach, all of the liabilities could be shifted away from the distributed interest immediately before the distribution, and the distributee's share of the liabilities could be shifted back to the distributee immediately after the distribution.[69]

Depending on the facts of a particular distribution, the choice of approach will affect who, if anyone, will recognize income or gain in connection with a distribution. In addition, depending on the facts of a particular distribution, the approach selected may result in the creation of a disparity between the aggregate outside basis of the partners in the UTP and the aggregate inside basis of the UTP's remaining assets, taking into account all basis adjustments under sections 734(b) and 743(b).

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[67] *See generally* Sloan, Sher, Sullivan, and Trossen, "Order in the Court: Why Ordering Matters in Partnership Transactions," 2007 TNT 167-38 (Aug. 28, 2007) (explaining how the order of a series of transaction steps involving more than one partnership transaction can produce different basis adjustments).

[68] *See supra* notes 62 through 65 above and accompanying discussion.

[69] Note that even if section 752(d) does not apply to such a distribution, it is not necessarily the case that the tax consequences would follow the fourth approach.