NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Proposed Regulations under Section 752 Relating to the Allocation of Partnership Liabilities where a Disregarded Entity is an Obligor

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New York State Bar Association Tax Section

Report on Proposed Regulations under Section 752 Relating to the Allocation of Partnership Liabilities where a Disregarded Entity is an Obligor

This report, prepared by the New York State Bar Association Tax Section Committee on Partnerships,[1] comments on proposed regulations (the "Proposed Regulations"), issued by the Internal Revenue Service and the Treasury Department on August 12, 2004.[2] The Proposed Regulations amend and supplement existing Treasury Regulation §1.752-2,[3] relating to the allocation of partnership recourse liabilities, to address cases where a disregarded entity is a partner obligor in respect of a partnership liability (or a disregarded entity is an obligor that is related to a partner).[4]

We commend the Internal Revenue Service and the Treasury for issuing the Proposed Regulations and we support the adoption of the Proposed Regulations, with certain clarifications and modifications as set forth below. The preamble to the Proposed Regulations solicits comments on certain specific issues. This report provides comments on those issues as well as other comments and suggested clarifications.

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1 Joel Scharfstein was the principal author of this report. Helpful comments were received from William B.Brannan, Kimberly S.Blanchard, Patrick C.Gallagher, Gary B.Mandel, Andrew W.Needham, Michael L. Schler, David H.Schnabel, Lewis R.Steinberg and Willard B.Taylor.

2 REG 128767-04.

3 All references to "Prop Reg. §" are to the Proposed Regulations; references to "Treas. Reg. §" are to the existing Treasury Regulations; references to "Section" are to sections of the Internal Revenue Code of 1986, as amended. References to the "IRS" are to the Internal Revenue Service.

4 The Proposed Regulations also make certain related changes to Treas. Reg. §1.704-2 (allocations attributable to nonrecourse liabilities).

I. Background and Summary of the Proposed Regulations

The Treasury Regulations under Section 752 provide rules for allocating partnership liabilities among the partners. Treas. Reg. §1.752-2 provides the general rules for allocating "recourse" liabilities, and Treas. Reg. §1.752-3 provides the general rules for allocating "nonrecourse liabilities." A partnership liability is considered recourse for this purpose to the extent any partner or related person bears the economic risk of loss with respect to that liability within the meaning of Treas. Reg. §1.752-2.[5] The rules for allocating recourse liabilities differ significantly from the rules for allocating nonrecourse liabilities.

Treas. Reg. §1.752-2(a) provides that, in general, a partner's share of a "recourse" liability is the portion of the liability for which the partner or a related person bears the "economic risk of loss." A partner is considered to bear the economic risk of loss of a liability for this purpose, to the extent that had the partnership sold all of its assets for no consideration and thereafter liquidated, with all of its liabilities becoming due in full upon such liquidation, the partner or a related person would be obligated to pay the liability (or contribute capital to the partnership to pay the liability) and would not be entitled to reimbursement for such payment from another partner or a person related to such other partner.[6] In this regard, since a disregarded entity is disregarded as separate from its owner for all tax purposes,[7] the payment obligation of the disregarded entity would, under the current Treasury Regulations, appear to be treated as a payment obligation of its owner.

In determining the extent to which a partner or a related person has an obligation to pay a liability all "statutory and contractual obligations relating to the partnership liability are taken into account," including contractual obligations outside the partnership agreement and payment obligations imposed by state law.[8] In addition, in

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5 Treas. Reg. §1,752-1(b). Related person is defined in Treas. Reg. §1.752-4(b).

6 Treas. Reg. §1.752-2(b). In connection with the constructive liquidation, special rules are provided for assets securing nonrecourse liabilities and property contributed to secure a partnership liability.

7 Treas. Reg. §301.7701-3(a).

8 Treas. Reg. §1.752-2(b)(3).

making this determination the Treasury Regulations require the partnership to assume that all partners and related persons that have obligations to make payments actually perform those obligations, "irrespective of their actual net worth," unless the facts and circumstances indicate a plan to circumvent or avoid the obligation[9] (this assumption is hereafter referred to as the "Deemed Satisfaction Presumption").

The Proposed Regulations address the extent to which a partner or related person is considered to bear the economic risk of loss with respect to a partnership obligation in a case where the partner or related person is an entity that is disregarded as separate from its owner under (i) Treas. Reg. §301.7701-1 through §301.7701-3 (general classification regulations for business entities), (ii) Sections 856(i) (a qualified REIT subsidiary) or (iii) Section 1361(b)(3) (qualified subchapter S subsidiary). In such cases the Proposed Regulations provide that payment obligations of the disregarded entity are taken into account only to the extent of the "net value" of the disregarded entity on the date on which the partnership determines the partners' shares of partnership liabilities under Treas. Regs. §§1.752-4(d) and 1.705-1(a).[10] Thus, under the Proposed Regulations the Deemed Satisfaction Presumption does not apply to a payment obligation of a disregarded entity. The net value limitation of the Proposed Regulations, however, does not apply to an obligation of a disregarded entity to the extent that the owner of the disregarded entity otherwise has an obligation to make a payment with respect to such obligation (that causes it to bear the economic risk of loss with respect to such obligation).[11] Application of the rules of the Proposed Regulations may cause a partnership liability that would otherwise be treated as

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9 Treas. Reg. §1.752-2(b)(6). The regulation cross references Treas. Reg. §1.752-2(j) (anti-abuse rules). These anti-abuse rules are hereafter referred to in this report as the "Anti-Abuse Rules." See fn 22 infra in respect of the Anti-Abuse Rules.

10 Prop. Reg. §1.752-2(k)(1). In general this will be the end of the partnership's taxable year, but the determination may be required at other times as well. In this regard the IRS may want to clarify that mid-year distributions by a partnership out of anticipated profits will generally be treated as "advances" against a partner's distributive share of income, and a basis computation will accordingly not be required with respect to such distributions prior to year end.

11 Id.

recourse, to be treated as in whole or in part as nonrecourse,[12] or may cause a recourse liability that was otherwise allocable to one partner to instead be allocated (as a recourse liability) to another partner.[13]

The Proposed Regulations define the "net value" of a disregarded entity to be the fair market value of the entity's assets that may be subject to creditors' claims under local law, excluding the value of its interest, if any, in the partnership,[14] less all obligations of the disregarded entity that "do not constitute, and are senior or of equal priority to, obligations of the disregarded entity that may be taken into account under paragraph (b)(1) of this section" (hereafter referred to as "Relevant Obligations"). Under the Proposed Regulations once the net value of the disregarded entity is initially determined,[15] it is not redetermined unless (i) the Relevant Obligations change by more than a de minimis amount or (ii) there is more than a de minimis contribution to or distribution of property from the disregarded entity of other than property pledged to secure a partnership liability under Treas. Reg.§ 1.752-2(h)(1).[16]

The Proposed Regulations provide that a partner allocated a share of partnership recourse liabilities based upon an obligation of a disregarded entity must provide

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12 See Prop. Reg. §1.752-2(k)(6) Example 1 (liability of limited partnership treated as nonrecourse).

13 Under Treas. Reg. §1.752-2(c) a partner is considered to bear the economic risk of loss for a partnership liability to the extent that the partner or a related person is a "nonrecourse" lender to the partnership and the economic risk of loss for the liability is not borne by another partner. The net value limitation of the Proposed Regulations should not affect the allocation of this liability (if the partner or related nonrecourse lender is a disregarded entity) as the economic risk of loss with respect to this liability is not based on a payment obligation of the partner or related person (as it is in the case of a liability where risk of loss is allocated under Treas. Reg. §1.752-2(b)).

14 The Proposed Regulations also exclude the fair market value of property pledged as security for a partnership liability under Treas. Reg. §1.752-2(h)(1) (separate property, other than an interest in the partnership, that is pledged as security for a partnership liability).

15 Reductions in net value are, however, taken into account if the reduction is part of a plan that has as one of its principal purposes "creating the appearance that a partner bears the economic risk of loss for a partnership liability." Prop. Reg. §1.752-2(k)(3).

16 Prop. Reg. §1.752-2(k)(2).

information as to the entity's tax classification and net value to the partnership on a timely basis.[17]

The Proposed Regulations also amend the valuation rules of Treas. Reg. §1.752-2(h)(3) relating to pledged assets to provide that the extent to which a partner bears the economic risk of loss as a result of a direct or indirect pledge is limited to the net fair market value of the property at the time of the pledge or contribution.[18] For this purpose if the property is subject to one or more obligations that are senior or of equal priority to the partnership liability, those obligations must be taken into account in determining the net fair market value of the pledged property.[19]

The Proposed Regulations apply to liabilities incurred or assumed by a partnership on or after the date the regulations are published as final regulations in the Federal Register.[20] However, a grandfathering rule is provided for liabilities incurred or assumed by a partnership pursuant to a written binding contract in effect prior to that date.

The preamble to the Proposed Regulations (the "Preamble") solicits comments on whether the rules of the Proposed Regulations should be extended to payment obligations of other entities, such as entities capitalized with nominal equity, whether there should be additional trigger events for redetermining net value of a disregarded entity and whether partners should have the ability to elect to annually redetermine net value of a disregarded entity and/or an election to annually redetermine the net value of pledged property.

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17 Prop. Reg. §1.752-2(k)(5).

18 Current Treas. Reg. §1.752-2(h)(3) provides the same rule except that it is based on fair market value rather than net fair market value.

19 Id.

20 Prop. Reg. §1.752-2(l).

II. Recommendations.

We recommend the following modifications and clarifications to the Proposed Regulations be adopted in the final regulations:

1. Treas. Reg. §1.752-2(b)(3) should be amended to specifically include consideration of statutory and contractual *limitations* in determining the extent to which a partner or related party bears the economic risk of loss in respect of a partnership liability.
2. The Anti-Abuse Rules of Treas. Reg. §1.752-2(j) should be expanded to specifically cover cases where a substantially undercapitalized consolidated subsidiary or undercapitalized pass-through entity is a partner (or related obligor); provided that, the facts and circumstances indicate that a principal purpose of the use of the subsidiary or other entity is to (i) limit its owners' exposure to the risk of loss in respect of partnership liabilities and (ii) obtain tax benefits for its owners (or other members of the consolidated group) in respect of the partnership that would not be available but for the additional tax basis in the partnership interest that results from treating the partner (or related obligor) as bearing the economic risk of loss with respect to such liabilities.
3. Consideration should be given to providing (or clarifying) that different net values can exist for a disregarded entity in respect of partnership liabilities of differing seniority.
4. The term *obligation*s should be defined for purposes of the Proposed Regulations in a manner consistent with the definition in Prop. Reg. §1.752-1(a)(ii) and the amount of any liability that is not fixed should be determined in accordance with the rules of Prop. Reg. §1.752-7(b)(2)(ii) (determining the amount of share of a "§1.752-2 liability").
5. The following distributions and contributions from and to a disregarded entity should be excluded as events triggering a required redetermination of the net value of the disregarded entity: (i) distributions by the disregarded entity which

correspond to distributions to the disregarded entity from the partnership, (ii) distributions by the disregarded entity of an interest in the partnership and (iii) related distribution and contributions which do not result in more than a de minimis change in the net value of the disregarded entity.

6. Changes in which the net amount of Relevant Obligations does not change (such as refinancing in the same amount) should not trigger redeterminations. Consideration should be given to providing exclusions for payments of and incurrence of ordinary trade debt and similar ordinary course of business obligations. In addition, clarification should be provided as to the extent to which changes in contingent liabilities trigger redeterminations.
7. Elective annual determinations in respect to the net value of disregarded entities and pledged assets should be permitted and that the final regulations should provide rules as to how and when the elections are made. Consideration should be given to allowing a prior year election to be revocable for subsequent years.
8. A trigger should be added to the pledge rules, similar to that for disregarded entities, requiring a redetermination of the net value of the pledged property, for changes in the amount of senior or pari-passu debt.

III. Discussion

We believe that the general approach of the Proposed Regulations, of taking into account payment obligations of a disregarded entity, only to the extent of the disregarded entity's net value, is an appropriate rule; and we strongly endorse it. This approach reflects the economic substance of the arrangement as the equivalent of a pledge of the assets of the disregarded entity. In both the disregarded entity and pledge contexts, the economic substance of the arrangement is that the disregarded entity/pledged assets owner's exposure to the obligation is limited to the net value of the disregarded entity/pledged assets, and as such the obligation should only be considered as recourse to the owner to the extent of such net value.

The preamble to the Proposed Regulations states that the Proposed Regulations "clarify the existing regulations." However, we believe that the Proposed Regulations may well be more than a "clarification"[21] in view of the Deemed Satisfaction Presumption, in contexts where the Anti-Abuse Rules of Treas. Reg. §1.752-2(j) do not apply.[22] While the existing regulations state that the determination of whether a partner or related person bears the economic risk of loss with respect to a partnership liability is based on the facts and circumstances at the time of determination,[23] a facts and circumstances inquiry as to the ability of the obligor to satisfy the liability seems precluded by the Deemed Satisfaction Presumption. We note that while the existing regulations provide that all statutory and contractual *obligation*s relating to the partnership liability are taken into account in determining the extent to which partner or related person bears the economic risk of loss, the existing regulations do not specifically provide that statutory *limitations* are taken into account and it is statutory limitations which shield the owner from the liabilities of the disregarded entity. In this regard, we recommend that Treas. Reg. §1.752-2(b)(3) be amended to specifically include consideration of statutory and contractual limitations in determining the extent to which a partner or related party bears the economic risk of loss in respect of a partnership liability.[24]

We recognize that adoption of the approach of the Proposed Regulations will often result in differences in treatment between disregarded entities and other entities which

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21 Arguably, the Proposed Regulations are a clarification of the existing regulations, in the sense that a payment obligation of a disregarded entity might be analogized to a pledge of the disregarded entity's assets by its owner and accordingly analyzed under the pledge rules. Those rules limit economic risk of loss that a partner or related person is consider to bear as a result of a pledge to the [net] fair market value of the pledged property. See Treas. Reg. §1.752-2(h) and Prop. Reg. §1.752-2(h)(3).

22 The general Anti-Abuse Rules of Treas. Reg. §1.752-2(j)(1) applies only in cases where a principal purpose of the arrangement is to create the appearance of a partner or a related person bearing the economic risk of loss, when the substance of the arrangement is otherwise. Under Treas. Reg. §1.752-2(j)(3) an obligation of a partner to make a payment is not recognized if the fact and circumstances evidence a plan to circumvent or avoid the obligation.

23 Treas. Reg. §1.752-2(b)(3).

24 In the disregarded entity context this would backstop the rules of Prop. Reg. §1.752-2(k).

are not justified by differences in economic result. In particular, there is no equivalent of the net value limitation, applicable to entities which are not disregarded entities and in such cases the Deemed Satisfaction Rule applies, regardless of the net value of the entity. In this regard, the Preamble solicits comments on whether the rules of the Proposed Regulations should be extended to payment obligations of other entities, such as entities capitalized with nominal equity. As a general matter, we do not believe such an expansion would be warranted other than in the context of an expansion of the Anti-Abuse Rules. We recognize, as discussed below, that a failure to extend the approach of the Proposed Regulations to other entities can result in substantial taxpayer electivity. However, the rule of the Proposed Regulations is most strongly justified as an extension of the pledge rules as well as a special case of our recommendation that statutory limitations on liability be taken into account in determining to what extent a partner or related person bears the risk of loss of a partnership liability. Expanding the approach of the Proposed Regulations beyond the disregarded entity context would substantially undercut the Deemed Satisfaction Rule and would raise difficult line drawing issues.

We would, however, recommend expanding the Anti-Abuse Rules to specifically cover cases where a substantially undercapitalized consolidated subsidiary or pass-through entity (other than a disregarded entity) is utilized as the partner (or related obligor) and where the facts and circumstances indicate that a principal purpose of the use of the subsidiary or other entity is to (i) limit its owners' exposure to the risk of loss in respect of existing partnership liabilities and (ii) obtain tax benefits for its owners (or other members of the consolidated group) in respect of the partnership that would not be available but for the additional tax basis in the partnership interest that results from treating the partner (or related obligor) as bearing the economic risk of loss with respect to such liabilities. For this purpose the extent of undercapitalization would be measured by reference to the amount of partnership liabilities in respect of which the consolidated subsidiary or other entity would otherwise be considered to bear the risk of loss.[25] In cases where the expanded Anti-Abuse

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25 The regulations might include a safe harbor or favorable presumption for purpose of determining whether an entity is substantially undercapitalized.

Rules apply the net value limitation would apply to determine the amount of the partnership liability with respect to which the partner or related person was considered to bear the risk of loss.

We recognize that, subject to the application of the Anti-Abuse Rules, the approach of the Proposed Regulations results in a form of taxpayer electivity. This follows because a taxpayer may often be in the position to choose between using, as a partner or related person obligor, either a disregarded entity or an entity that is not a disregarded entity, with little difference to the taxpayer in its economic exposure to the partnership liability. Since the net value rule only applies to payment obligations of disregarded entities and not to payment obligations of entities that are upper tier partnerships or corporations, a taxpayer may be in a position to use one of the latter entities (wholly owned by itself or together with its affiliates) to avoid application of the rule. In addition, a corporate partner or upper tier partnership may elect into the rule of the Proposed Regulations, by transferring its assets to a disregarded entity that it owns and making that entity the partner. While some of these elective cases may be subject to the Anti-Abuse Rules others would arguably, and in some cases clearly, not be subject to the rule. We do not view the potential electivity in this regard as particularly troubling.

We considered whether it would be appropriate to have exceptions to the approach of the Proposed Regulations for certain special cases. For example, an exception might be made for the case where the disregarded entity holds all (or all but a de minimis amount) of the assets of an entity owner. In such a case there is little economic effect, in respect to a partnership liability, to the imposition of the disregarded entity. Having an exception for this case would reduce taxpayer electivity in a context where the actions to effect the election might be easily implemented.[26] Another possible exception would be for a case where the disregarded entity has significant other business operations (as distinguished from passive assets), and the disregarded entity received its partnership interest in exchange

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26 E.g. by transferring the owners assets to the disregarded entity or dissolving the disregarded entity into the owner.

for the transfer of historic assets to the partnership. Providing an exception for that case would eliminate the disparity in treatment between disregarded entities and other entities that is hard to justify, in a context where the use of the disregarded entity does not have as a principal purpose a tax motivation and application of Deemed Satisfaction Rule would seem reasonable.

IV. Technical Comments

1. Subtraction of Equal Priority Obligations in Computing Net Value. In defining net value, the Proposed Regulations subtract from gross asset value (as determined under the Proposed Regulations) "any obligations of the disregarded entity that do not constitute, and are senior or of equal priority to, obligations of the disregarded entity that may be taken into account under paragraph 1(b) of this section." Under this rule obligations of the disregarded entity in respect of liabilities of the partnership (regardless of their priority) are not taken account.[27] In addition, liabilities of the disregarded entity are not taken into account if they are junior[28] to liabilities of the partnership "that may be taken into account under paragraph 1(b) of this section." In this regard the IRS may want to clarify that the reference to liabilities that may taken into account under paragraph (1)(b) is to such liabilities as determined without regard to the application of Prop. Reg. §1.752-2(k), so as to avoid circularity.

As an economic matter it is not clear why pari-passu debt should be subtracted out in computing net value rather than applying a pro ration rule. As a result, some of us

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27 These are liabilities that constitute obligations of the disregarded entity that may be taken into account under paragraph Treas. Reg. 1.752-2(b)(1) (i.e. liabilities of the partnership for which the disregarded entity bears the economic risk of loss).

28 In the case of a disregarded entity acting as a general partner, this limitation on the liabilities of the disregarded entity that are subtracted will generally not be relevant as there would not usually be any liabilities of the disregarded entity that were junior to trade or other general creditor liabilities of the partnership for which the general partner would be liable. A possible exception would be the case of liabilities of another disregarded entity owned by the first disregarded entity and the IRS may want to clarify how and to what extent such liabilities are taken into account (presumably they would be netted against the gross asset value of the second disregarded entity). The limitation on the liabilities that are subtracted out could, however, be important in cases where a disregarded entity is a limited partner or a person related to a partner, the disregarded entity guarantees a partnership liability, and the guarantee is senior to other debt of the disregarded entity.

believe that the Proposed Regulations should be amended to provide that only a pro rata portion of pari-passu debt[29] should be subtracted in computing net value. Others, however, believe that adopting a pro ration rule would introduce too much complexity into the calculation of net value because of the need to determine the pro ration factor and because the existence of the pro ration factor may lead to a need for additional revaluation triggering events.[30]

Example 1. Disregarded Entity, is the sole general partner of partnership P, which has 500X of trade liabilities. Disregarded Entity, in addition to its interest in P has gross assets of 600X and trade liabilities of 400X. Under the rules of the Proposed Regulations Disregarded Entity would have a net value of 200X. Under a pro ration rule Disregarded Entity would have a net value of 333X.[31]

2. Single Net Value. The Proposed Regulations appear to contemplate that a disregarded entity would have only a single net value with respect to a partnership at any given time, rather than differing net values depending on the particular partnership liability at issue. This can produce results which are economically inappropriate.

Example 2. Disregarded Entity, DE, is the sole general partner of partnership P. DE, in addition to its interest in P, has gross assets of 1000X and a liability, L3, of 900X. P has liabilities, L1 and L2, of 750X each, which are

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29 Under a proration rule the net value would be computed by first subtracting from gross asset value all senior liabilities of the disregarded entity to compute an "interim net asset value". The interim net asset value would then be reduced by the lesser of (i) the amount of pari-passu debt of the disregarded entity or (ii) the product of (x) the ratio of the pari-passu debt of the disregarded entity to the combined pari-passu debt of the disregarded entity and the pari-passu debt of the partnership for which the disregarded entity bears the risk of loss times (y) the interim net asset value of the disregarded entity.

30 See the discussion below at Section IV-4. Without proration, changes in the amount of partnership liabilities generally do not affect net value. With proration, changes in the amount of pari-passu liabilities at the partnership level (e.g. from repayments or additional incurrence) will generally affect the proration factor and raise the question of whether such changes should trigger a reevaluation event for purposes of computing net value.

31 The portion of the pari-passu debt subtracted, in computing net value, would 266.67X = 600X(gross asset value) times 400X (pari-passu debt of Disregarded Entity) divided by 900X(pari-passu debt of Disregarded Entity plus 500X pari-passu debt of P). Thus net asset value would be 333.33X=600X-266.67X.

recourse to DE. L2 is expressly subordinated to L1 and L3, and L3 is expressly subordinated to L1. If DE has only a single net value, that net value would be 100X and DE would be allocated only 100X of L1[32]. If instead separate net values are computed for L1 and L2, they should be, respectively, 1000X[33] and zero[34], in which case all 750X of L1 would be allocated to DE. The 750X allocation of L1 to DE appears to be the economically appropriate result[35].

Providing for differing net values depending on the priority of the partnership debt at issue will present additional complexities. However, a failure to allow for differing net values can, as illustrated by the example above, result in inappropriate consequences and in some cases egregious results[36]. Consideration should be given to providing (or clarifying) that different net values can exist for a disregarded entity in respect of partnership liabilities of differing seniority.

3. Meaning of "Obligations" in Computing Net Value. The Proposed Regulations provide, as described above, that certain "obligations" of the disregarded entity are subtracted in computing net value. The term "obligations" is not defined in the Proposed Regulations. We believe that "obligations" should not be limited to those which are fixed liabilities, but should also include contingent liabilities. To that end we recommend that obligations be defined for purposes of the Proposed Regulations in

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32 1000X less 600X ("obligations of the disregarded entity that ...are senior to or of equal priority to obligations of the disregarded entity that may be taken into account under paragraph (b)(1) of this section."

33 1000X less zero (there are no obligations of the disregarded entity that are senior to or of equal priority to DE's obligation with respect to L1).

34 The lesser of (i) zero or (ii) 1000X less (900X +750X). In computing a separate net value for purpose of allocating L2, not only would L3 be subtracted but L1 should also be subtracted.

35 All of DE's gross assets of 1000X would be available to satisfy L1 since both L2 and L3 are subordinated to L1.

36 For example consider the same facts as in example 2 except that L2 is only $1 (fixed or projected contingent value). It would be a serious trap for the unwary and an inappropriate result for the 750X allocation of L1 to DE (vs. a potentially zero allocation of L1 to DE) to depend on the existence (or non existence) of such an L2. A similar inappropriate result would arise if there is a single net value and L2 is of equal priority to L3 (e.g. L2 is a $1 trade payable or small contingent liability not subordinated to L3).

manner consistent with the definition in Prop. Reg. §1.752-1(a)(ii)[37] and that the amount of any liability that is not fixed be determined in accordance with the rules of Prop Reg. §1.752-7(b)(2)(ii) (determining the amount of share of a "§1.752-7 liability").[38]

4. Establishing Net Value. The Proposed Regulations provide that a partner that may be allocated a share of partnership liabilities based upon an obligation of a disregarded entity must provide information as to the entity's tax classification and net value to the partnership on a timely basis.[39] Presumably a partner can provide the relevant information to the partnership based on a good faith valuation and would not be required to obtain a supporting appraisal. Consideration should be given to clarifying the Proposed Regulations to indicate that the partnership can rely on information provided by the partner as to its net value and status unless it knows that the information is false or not prepared in good faith.

5. Redeterminations of Net Value. The Proposed Regulations provide that the net value of a disregarded entity is redetermined if (i) the Relevant Obligations of the disregarded entity change by more than a de minimis amount or (ii) there is a more than de minimis contribution to or distribution from the disregarded entity of property.[40] We believe that the Regulations should provide for certain exclusions from the application of the above rule to avoid unnecessary redeterminations.

With respect to distributions and contributions from and to the disregarded entity, we recommend that there be excluded from triggering events requiring redeterminations of net value: (i) distributions by the disregarded entity to the extent they

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37 "... an obligation is any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code" Under this definition, obligations include, among other things, contingent tort and environmental liabilities.

38 The amount of a §1.752-7 liability is the amount of cash that a willing assignor would pay to a willing assignee to assume the liability in an arm's length transaction.

39 Prop. Reg. §1.752-2(k)(5).

40 Prop. Reg. §1.752-2(k)(2). Other than property pledged to secure a partnership liability described in Treas. Reg. §1.752-2(h)(1).

correspond to distributions from the partnership (as the net effect of these is to leave the net value of the disregarded entity unchanged),[41] (ii) distributions by the disregarded entity of an interest in the partnership (since that interest is not taken into account in computing net value) and (iii) related distribution and contributions which do not result in more than a de minimis change in the net value of the disregarded entity.[42]

With respect to changes in Relevant Obligations, we recommend that the Regulations clarify that changes in which the net amount of Relevant Obligations does not change (such as refinancing in the same amount) do not trigger redeterminations. We also believe that consideration should be given to providing exclusions for payments and incurrences of ordinary trade debt and similar ordinary course of business obligations. Clarification will also be required as to the extent to which changes in contingent liabilities trigger redeterminations. For example, does assertion or settling of a tort claim trigger a revaluation? Consideration should also be given as to whether de minimis is the appropriate standard for triggering revaluations in the context of changes in Relevant Obligations; perhaps the standard should be "significant" changes in the amount of Relevant Obligations.

Consideration should also be given to treating a non de minimis contribution of property by a disregarded entity partner to the partnership as an event that triggers a redetermination of net value.[43] If this rule is adopted, a redetermination should not be

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41 The tracing rules of Treas. Reg. §1.163-8T might be applied for this purpose. Alternatively, the regulations might adopt an annual cumulative approach and disregard any distributions during a year by the disregarded entity in an amount up to the aggregate distributions received by the disregarded entity from the partnership during that year.

42 This would allow for substitution of an asset held by the owner for an equal value asset held by the disregarded entity. Note that the same result could be achieved by the owner and the disregarded entity "selling" the assets. For this purpose, consideration might be given to treating all contributions and distributions during a year as related. This rule would also cover contributions to the disregarded entity which were then recontributed by the disregarded entity to the partnership.

43 If the contribution by the disregarded entity is part of a plan in existence at the time of the value of the disregarded entity is otherwise determined, that contribution may already have been taken into account under Prop. Reg. §1.752-2(k)(3). However, that provision applies only if at the time the net value is determined "it is anticipated that the net value of the disregarded entity will be subsequently reduced and the reduction is part of a plan t hat has as one its principal purposes creating the appearance that a partner bears the economic risk of loss for a partnership liability."

triggered if the contribution to the partnership by the disregarded entity is matched by a corresponding contribution by the owning member to the disregarded entity.[44]

6. Elective Redeterminations. The Preamble requests comments on whether a partner should be able to make an election to revalue a disregarded entity annually regardless of the occurrence of a redetermination event. We believe that given the number of available triggers under the Proposed Regulation and the often low tax and other costs of transfers to and from disregarded entities, that elective revaluation, in practical effect, already exists under the Proposed Regulation. Accordingly, we recommend that elective annual revaluations be formally permitted.[45] The Preamble suggests that any such election would be revocable only with the consent of the Commissioner. We note in that regard that taxpayers may prefer to use triggering events rather than a formal election if the election is made irrevocable. As a result, the IRS and Treasury should consider allowing a prior year's election to be revocable in subsequent years.

If an election is provided the regulations should provide how and when the election is made. One option is to have the election made by the owner of the Disregarded Entity with its federal income tax return for the year with respect to which the election is to be effective. One problem with this approach is that the election may accordingly be made only after the partnership has filed its returns. Another approach is to require the election to be made by the taxpayer by the due date of his return without regard to extensions, but in this case, as well, the partnership may not be advised of the election prior to the filing of its return. In view of these concerns, consideration should be given to requiring the election to

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44 See our recommendation above regarding related distribution and contributions which do not result in more than a de minimis change in the net value of the disregarded entity. A rule triggering redeterminations of net value upon contributions of property by a disregarded entity to a partnership, however, raises the question of whether a similar rule should be adopted in the case of distributions by a partnership to a disregarded entity (which are not matched by corresponding distributions by the disregarded entity to its member). Such a rule would, however, be of less significance than a provision relating to contributions if our recommendations regarding elective redeterminations are adopted.

45 If net value is required to be determined during a year, elective revaluations might also be permitted as of the date such determination is required to be made.

be filed with the partnership's return and consented to by both the partnership and the Disregarded Entity.

If an election is provided the IRS should consider whether any consistency rules should be adopted. For example, should all Disregarded Entities owned by members of the same affiliated group be required to elect; should all Disregarded Entities owned by members of the same affiliated group that are partners in the same partnership be required to elect? In this regard, is there any justification for having the revaluation apply for purposes of one partnership but not another, if the Disregarded Entity owns interests in more than one partnership? In view of these issues and the ready availability of triggering events, the regulations may want to adopt a general anti-abuse rule under which elections and triggering events cannot be used to produce an inappropriate tax result.

7. Timing of Net Value Determinations. The Proposed Regulations provide that the determination of net value is made as of the date that the partnership determines the partner's shares of liabilities pursuant to §§1.752-4(d) and 1.705-1(a).[46] Under those regulations a partner's share of liabilities would generally be required to be determined as of the end of the partnership's taxable year.[47] As a result of this rule, if property is contributed to a disregarded entity during a year, the value of such property taken into account in determining the net value of the disregarded entity will be its value as of the end of the year, rather than its value at the time of contribution.[48] In the general case, this rule has the advantage of requiring only one determination/redetermination of net value of the disregarded entity each year in cases where multiple triggering events occur during the year.

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46 Prop. Reg. §1.752-2(k)(1).

47 Although there may be other times during the year when the determination would also have to be made under those sections; particularly if mid-year distributions are not generally treated as advances. See fn 10 supra.

48 See Prop. Reg. §1.752-2(k)(6) Example 2 where (land has value of $250,000 at time of contribution, but is worth only $175,000 at year end the year end value used in computing net value).

However, in many cases there will only be a single triggering event during the year. The IRS may want to consider allowing disregarded entities to determine (i) their initial net value and (ii) their re-determined net value, at the time of a triggering event, in cases where there is only a single triggering event during the year and the triggering event is a contribution or distribution of property (other than cash). This approach would allow taxpayers to rely on known values in deciding how much to contribute to or distribute from a disregarded entity.

8. Pledges. The current regulations provide rules relating to pledges of property as security for partnership liabilities.[49] Under these rules a partner is considered to bear the economic risk of loss for a partnership liability to the extent of the fair market value of the pledged property at the time of the pledge or contribution.[50] The Proposed Regulations modify the current regulations to provide that value of the property taken into account is the *net* fair market value of the property at the time of pledge or contribution.[51] For this purpose the Proposed Regulations provide that "if property is subject to one or more other obligations that are senior or of equal priority to the partnership liability, those obligations must be taken into account in determining the net fair market value of pledged property."[52]

We note that the language regarding the effect of senior and equal priority obligations under the proposed pledge rule appears more flexible than the rule proposed for disregarded entities in that the words "taken into account" could, for example, be read to sanction a pro rata approach to account for pari-passu liabilities.[53] If this flexibility was not

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49 Treas. Reg. §1.752-2(h). The rules cover both direct pledges (pledges of the partner or related person's separate property) and indirect pledges (contributions of property solely for the purpose of a partnership liability).

50 Treas. Reg. §1.752-2(h)(3).

51 Prop. Reg. §1.752-(h)(3).

52 Id.

53 See the discussion in section IV-1 above. In the case of a disregarded entity senior and equal priority obligations must be subtracted from gross asset value in computing net value.

intended the wording in the Prop. Reg. §1.752-2(h) should be modified to conform with the wording used in Prop. Reg. §1.752-2(k)(2) ("net value of a disregarded entity"). We also note that the Proposed Regulations relating to pledges do not include a revaluation trigger, similar to that for disregarded entities, for changes in the amount of senior or pari-passu debt. We recommend that such a trigger be added to the pledge rules.

The Preamble requests comments on whether partners should be able to make an election, revocable only with the Commissioner's consent, to revalue pledged assets annually. We support such an election under rules that would be consistent with redetermination elections available to disregarded entities as discussed in section IV-6 of this Report, for the same reasons as we support them in the case of disregarded entities.

We also note that in the case of pledged assets, net value is determined at the time of the pledge or contribution while in the case of a disregarded entity net value is generally determined as of the close of the taxable year. We wonder whether this disparity is appropriate, although it may be justified because of greater likelihood of multiple redetermination triggers occurring during a year in the disregarded entity case. Nevertheless, given the potential for multiple revaluation triggers in a pledge context due to changes in senior or pari-passu debt (as recommend above) it may make sense to shift the net value determination date for pledges to conform with that disregarded entities (i.e. generally to year end). If this approach is adopted, as with the case of disregarded entities,[54] the IRS may want to consider allowing taxpayers an election to revalue/value at the time of the pledge or contribution in cases where there is only one revaluation trigger event during the relevant taxable year.

9. Effective Date. The Proposed Regulations apply to liabilities incurred or assumed by a partnership after the date final regulations are published, subject to an exception for binding written contracts in effect prior to that date. The IRS might consider

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54 See section IV-5 supra.

providing a rule under which refinancing of existing debt would be grandfathered up to the amount of the original debt.[55]

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55 Cf. Treas. Reg. §1.707-5(c) (treating a refinanced liability as the old liability for purposes of Treas. Regs. §§1.707-3 through 5)