April 6, 2005

The Honorable Mark W. Everson
Commissioner of Internal Revenue
Internal Revenue Service
Room 5226
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments Concerning Proposed Treasury Regulation Section 1.752-2

Dear Commissioner Everson:

Enclosed are comments concerning proposed Treasury Regulation section 1.752-2 as prepared by members of the Committee on Partnerships and LLCs. These comments represent the individual views of those members who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

Kenneth W. Gideon
Chair, Section of Taxation

Enclosure

cc: Jeannie E. Sullivan, Senior Technician Reviewer, Office of the Associate Chief Counsel (Passthroughs & Special Industries: Branch 3)
Michael J. Goldman, Attorney, Office of the Associate Chief Counsel (Passthroughs & Special Industries: Branch 3)
The following comments represent the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Committee on Partnerships and LLC’s. The principal draftspersons of these comments were Adam Cohen, David Culpepper and Todd Molz, with substantial contributions by Howard Abrams and Martin Pollack. The comments were reviewed by Barbara Spudis DeMarigny for the Section’s Committee on Government Submissions and by Fred T. Witt, Jr., Council Director to the Committee on Partnerships and LLCs.

Although members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Date:   April 6, 2005
I. Executive Summary

We generally commend the approach of the Prop. Treas. Reg. Section 1.752-2. We recommend, however, a number of clarifications and additions. For example, we suggest that a redetermination of the net value of a disregarded entity might be warranted upon a disposition of more than a de minimis asset or more than de minimis change in certain obligations of the disregarded entity, and we propose an alternative approach for such redeterminations. We also recommend that taxpayers be allowed to make an election for annual redeterminations. Finally, we discuss certain information that partners should be required to provide a partnership, and certain presumptions the partnership may make if the required information is not provided.

II. Overview

A. We believe that the proposed regulation generally strikes a proper balance between administrative convenience and taking into account the economic realities of arrangements where disregarded entities bear the payment obligations related to a partnership liability. We would ask that the Internal Revenue Service (IRS) and Treasury Department consider whether, in appropriate circumstances (such as where a disregarded entity holds a significant operating business), the disregarded entity should be entitled to the presumption of Treas. Reg. Section 1.752-2(b)(6) that parties “who 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.”

B. The preamble to the proposed regulation asks “whether the rules of the proposed regulations should be extended to the payment obligations of other entities, such as entities that are capitalized with nominal equity.” We believe that such an extension would be unwarranted and undesirable. The current rules have been in place since 1991, and they have worked well. For abusive situations, the IRS can invoke (and has invoked) the anti-abuse rules of Treas. Reg. Section 1.752-2(j).

III. Circumstances for Net Value Redeterminations

A. We request that consideration be given to clarifying certain aspects of the proposed regulations relating to what events may trigger a redetermination of the net value of a disregarded entity. Prop. Treas. Reg. Section 1.752-2(k)(2) provides that a redetermination generally occurs only if there is more than a non-de minimis contribution or distribution. We think that the regulations should make clear that contributions (from the tax owner to the disregarded entity and then to the partnership) and distributions (from the partnership to the disregarded entity and then to the tax owner) that simply pass through the disregarded entity are not taken into account for this purpose. Otherwise, redeterminations may be triggered when there is no actual change (other than a transitory change) in the assets of the disregarded entity.

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B. We also think that the circumstances that trigger a redetermination should be expanded to include dispositions (including distributions) of a non-de minimis asset. Example 2 of Prop. Treas. Reg. Section 1.752-2(k)(6)) provides a good fact scenario for demonstrating this point. In this example, a disregarded entity holds land with a value of $175,000 at the time of the determination of the net value of the disregarded entity. Suppose the disregarded entity sold that land in a subsequent tax year for $400,000. Under the proposed regulations as drafted, a redetermination of the net value of the disregarded entity would not be triggered. We believe that a redetermination should occur in such a circumstance.

C. To ease the burden on taxpayers, however, we would propose that a redetermination triggered by the disposition of an asset requires an adjustment only to the extent such asset changed in value. For example, suppose a disregarded entity held two pieces of land, Blackacre, which is valued at $175,000 and Greenacre, which is valued at $100,000. If the disregarded entity sold Blackacre for $400,000, the net value of the disregarded entity should be increased by $225,000, the difference between the amount realized with respect to Blackacre and its prior valuation, without the need for a revaluation of Greenacre. We recommend that this approach also apply to situations where a redetermination is required because there has been a more than de minimis change in obligations senior to or of equal priority with the obligation of the disregarded entity that may be taken into account under Prop. Treas. Reg. Section 1.752-2(b)(1). See Prop. Treas. Reg. Section 1.752-2(k)(2).

D. In example 2 of Prop. Treas. Reg. Section 1.752-2(k)(6), a disregarded entity acquires unimproved land for $250,000 on January 1 of year 2. On December 31 of year 2, the land is worth $175,000. In determining the net value of the disregarded entity, the land is considered worth $175,000. Two points appear to be implicit in this example that we believe the regulation should express as explicit rules for determining net value. First, it is the value as of the year end that is the relevant value. Second, the presumption that value equals tax basis does not apply. On this second point, we believe it would be useful to add an example specifying that value is not adjusted simply because of tax or financial accounting depreciation.

E. We also would request that consideration be given to whether the regulation should have an explicit rule addressing a scenario where a disregarded entity holds two partnership interests. For example, assume a disregarded entity holds partnership interests A and B. In determining the net value of the disregarded entity with respect to the allocable debt for partnership interest A, there is a question of how to value partnership interest B. A majority of us believes that partnership interest B should be valued just as any other asset would. A minority, however, believes that the application of Treas. Reg. Section 1.752-2(b)(1) should be considered.

IV. The Election for Annual Valuation

A. We recommend that the owner of a disregarded entity that is a partner in a partnership should be allowed, but not required, to make an annual election to value the
disregarded entity for purposes of Prop. Treas. Reg. Section 1.752-2(k) (an “Election for Annual Valuation”). Similarly, a partner who pledges an asset should be allowed to make an Election for Annual Valuation with respect to the pledged asset. The Election for Annual Valuation would be for the owner of the disregarded entity to make, although, as is further described under “Information Reporting” below, the partnership should be explicitly authorized to presume that no Election for Annual Valuation has been made unless otherwise informed of the election.

B. An Election for Annual Valuation would apply to a given tax partnership, such that an owner of a disregarded entity could make different elections with respect to different tax partnerships. If a disregarded entity had payment obligations with respect to separate tax partnerships, the owner could make an Election for Annual Valuation for one partnership without making an Election for Annual Valuation for the other partnership. If an owner had two or more disregarded entities that had payment obligations with respect to a given tax partnership, however, the Election for Annual Valuation by the owner would be effective as to all such disregarded entities.

C. The Election for Annual Valuation would be specific to the owner and the relevant tax partnership, not the disregarded entity itself. Accordingly, if the owner of a disregarded entity for which an Election for Annual Valuation has been made transferred the disregarded entity to an unrelated third party, the Election for Annual Valuation would not be binding on the new owner of the disregarded entity. In contrast, if the owner of a disregarded entity for which an Election for Annual Valuation has been made causes the disregarded entity to transfer the payment obligation to a different disregarded entity owned by the same owner, the Election for Annual Valuation would remain in effect.

V. Information Reporting

A. A partnership needs information from its partners in order to know the extent to which they bear the economic risk of loss with respect to a particular liability under Prop. Treas. Reg. Section 1.752-2, including whether a particular entity is a disregarded entity. Although Prop. Treas. Reg. Section 1.752-2(k)(5) requires partners to notify the partnership if an entity that bears an obligation of the partnership is a disregarded entity, there is no default rule to assist the partnership in preparing its tax return where no such notification is provided. In such a case, the partnership should be explicitly authorized to presume that the entity is not a disregarded entity.

B. Once the partnership has been notified that an entity bearing a partnership obligation is a disregarded entity, it still needs certain additional information to determine the partner’s economic risk of loss under Prop. Treas. Reg. Section 1.752-2(k). The partnership needs to know (a) the net value of the disregarded entity (and for pledged assets, their net value); (b) whether an Election for Annual Valuation has been made (assuming the regulation permits such an election); and (c) whether the net value has changed. Again, although Prop. Treas. Reg. Section 1.752-2(k)(5) requires partners to notify the partnership of the disregarded entity’s net value, we would propose that this
obligation be expanded to require notification of whether an Election for Annual Valuation has been made and changes in net value. Unless notified otherwise, the partnership should be explicitly authorized to presume that (a) the net value is zero, (b) that no Election for Annual Valuation has been made, and (c) that no adjustment to net value has occurred.

C. Some of us believe that the IRS and Treasury Department should also consider allowing a partner to notify the partnership that the net value of the disregarded entity (or pledged asset) is greater than the amount of the potentially allocable obligations of the partnership. There are two reasons recommending such an approach. First, the owner of the disregarded entity may not want, for valid business reasons, to have to provide the partnership or the other partners information as to the value of the disregarded entity’s assets. (This reticence will be most common when the disregarded entity is an operating business, and is another reason to consider adopting the presumption of Treas. Reg. Section 1.752-2(b)(6) in such a circumstance.) Second, it will reduce the administrative burden in circumstances when the disregarded entity clearly has sufficient assets by obviating the need for a full valuation of all of the assets. Others of us believe that such an approach is unnecessary, both because confidentiality agreements could ameliorate concerns about disclosing net values and because such an approach may create greater administrative burdens as the partnership would have to first notify the partners of the allocable liability (which may change from year to year) and the owner of the disregarded entity would then have to determine whether its net value was greater than the liability and inform the partnership of this fact before the partnership could allocate the liability.