August 8, 2014

The Honorable John A. Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Comments on Proposed Regulations under Sections 707 and 752

Dear Commissioner Koskinen:

Enclosed are comments on the proposed regulations on the allocation of partnership recourse and nonrecourse liabilities under section 752 and partnership disguised sales under section 707 (“Comments”). These Comments represent the view of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

The Section would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

Michael Hirschfeld
Chair

Enclosure

cc: William J. Wilkins, Chief Counsel, Internal Revenue Service
Curt Wilson, Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
Benjamin Weaver, Office of Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
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Craig Gerson, Attorney-Advisor, Office of Tax Policy, Department of the Treasury
AMERICAN BAR ASSOCIATION
SECTION OF TAXATION
COMMENTS ON PROPOSED REGULATIONS
UNDER SECTIONS 707 AND 752

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Jon Finkelstein, John Schmalz, Jeanne Sullivan, and James Wreggelsworth of the Section’s Partnerships and LLCs Committee and the Section’s Real Estate Committee (each, a “Committee” and together the “Committees”). Substantive contributions were made by Howard Abrams, Ossie Borosh, Rachel Brown, Samuel Greenberg, Brian Masterson, Eric Matuszak and David Sherwood. The Comments were reviewed by Adam M. Cohen, Outgoing Chair of the Partnerships and LLCs Committee, and Wayne Pressgrove, Chair of the Real Estate Committee. The Comments were also reviewed by Bahar Schippel, Council Director for the Partnerships and LLCs Committee and the Real Estate Committee and by William H. Caudill, Committee on Government Submissions by designation.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these comments, no such member (or the firm or the 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: August 8, 2014
EXECUTIVE SUMMARY

1. Background

The Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) issued proposed regulations on the allocation of partnership recourse and nonrecourse liabilities under section 752 (the “Proposed Section 752 Regulations”) and partnership disguised sales under section 707 (the “Proposed Section 707 Regulations”) on January 29, 2014 (together the “Proposed Regulations”). The purpose of the Proposed Regulations is to address certain deficiencies and technical ambiguities in the current Regulations and to revise the approach of the current section 752 regulations with respect to the allocation of partnership liabilities. Treasury and the Service expressed concern that the approach of the current Regulation section 1.752-2 (which allocates partnership recourse liabilities in accordance with each partner’s “economic risk of loss”) may not be appropriate given that, in most cases, the payment obligations that support the liability allocation are not called upon. Treasury and the Service explained that, as a result, they “are concerned that some partners or related persons have entered into payment obligations that are not commercial solely to achieve an allocation of a partnership liability to such partner.”

In the Preamble to the Proposed Regulations, Treasury and the Service also requested comments regarding specific issues. We appreciate the opportunity to provide comments both in response to these specific requests from Treasury and the Service and on other aspects of the Proposed Regulations. In particular, we appreciate the opportunity to provide our view of the appropriate functioning and fundamental interrelationships among the current regulations and statutory provisions relating to the economic risk of loss and to make suggestions to address potential abuses with targeted changes to the current section 752 regulations.

2. Proposed Section 752 Regulations

The Proposed Section 752 Regulations make fundamental changes to the way recourse and nonrecourse liabilities are allocated under section 752. We agree with the stated purpose of providing objective rules for determining when a liability is considered recourse under that section. We have significant concerns about the approach of the Proposed Section 752 Regulations, however, which we believe would impose subjective and, in many cases, noncommercial requirements on partners and partnerships for purposes of analyzing whether a partnership liability constitutes a recourse liability under section 752. As will be explained, we believe that these requirements would prove very difficult to administer, cause unnecessary controversy and uncertainty, and would shift allocations of debt away from partners who bear economic risk for partnership liabilities to partners that bear no economic risk, contrary to congressional intent. In addition, we

2 References to a “section” herein are to sections of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.
believe the proposed changes to the partnership nonrecourse liability allocation rules are unwarranted and, in all but the most straightforward partnership arrangements, would be inconsistent with the sharing of economics agreed to among partners. Finally, we believe that the lack of coordination of the Proposed Section 752 Regulations with section 704(b) and section 465 would lead to tax results that are inconsistent with the purposes of those provisions and may lead to potential abuse.

On these grounds, we recommend that the Proposed Section 752 Regulations be withdrawn and new regulations be proposed to address the transactions that Treasury and the Service identify as objectionable. In this connection, we understand that Treasury and the Service are concerned about the interaction of partnership liability allocation rules under section 752 and the partnership disguised sale rules under section 707 and that this concern was the original impetus for this regulatory project. As a result of this understanding, we are recommending targeted revisions of the rules relating to recourse liability allocations solely for purposes of disguised sales, as discussed below.

In summary, we recommend that the Proposed Section 752 Regulations be reconsidered for the following reasons, which are discussed in more detail at the pages indicated and elsewhere in this Comment:

1. The current section 752 regulations are administrable, consistent with the legislative history, as well as with current regulations and cases under section 704(b) and section 465 (see discussion of economic risk of loss beginning at page 9);

2. A fundamental change in the section 752 regulations (such as that proposed in the Section 752 Proposed Regulations) should involve consideration of appropriate coordinating changes to the nonrecourse debt allocation regulations under Reg. § 1.704-2 and the economic risk of loss regulations under Reg. §1.704-1, as well as finalization of consistent regulations under section 465, addressing the results in the cases that incorporate the “worst case scenario” of the current section 752 regulations (see, e.g. discussion at pages 16 through 21) before any such change is finalized;

3. The nonrecourse debt regulations are incomplete (see, e.g., discussion of exculpatory liabilities beginning at page 39) and should be updated to take current business arrangements into account before they are made applicable more broadly; and

4. A more tailored or nuanced change to the section 752 regulations to address abusive disguised sale transactions could achieve Treasury’s and the Service’s objectives in a way that would be less disruptive to business transactions and involve considerably less cost (in time and money) for both the government and the private sector (see discussion beginning at page 21).

In the alternative, if Treasury and the Service decide not to withdraw the Proposed Section 752 Regulations, we respectfully request that the Proposed Section 752
Regulations be substantially revised to take into account the following concerns and recommendations, as discussed in more detail below:

- Fundamentally, we believe and recommend that the “economic risk of loss” standard for allocating partnership recourse liabilities should continue to be defined in a manner that is consistent with the “worst case” scenario (rather than by a “commercial reasonableness” standard) for reasons that we explain below and in order that the rules of section 704, section 752, and section 465 continue to be coordinated.

- We recommend that the “recognition requirements” be modified as follows:
  - The “commercially reasonable” standard provided in the Proposed Section 752 Regulations in the first requirement (relating to commercially reasonable net worth or restrictions on transfers) and second requirement (relating to commercially reasonable documentation) provides inadequate guidance, as discussed below. We recommend that these recognition requirements be eliminated and that the section 752 anti-abuse regulation be modified to include examples to illustrate situations that cause concern.
  - The third requirement (that the payment obligation last through the full term of the partnership liability) is not consistent with commercial arrangements, and we recommend that it be eliminated. So long as the payment obligation is one upon which the creditor and other partners can rely during the term of the obligation, the fact that the obligation does not extend to the full term of the partnership debt should not cause the obligation to be disregarded in determining whether a partner has the economic risk of loss while the obligation is outstanding.
  - The fourth requirement (relating to maintenance of assets) should be made more specific to explain the meaning of the “reasonable needs” of the obligor or modified to include an example to illustrate the situation that causes concern.
  - The fifth requirement (relating to an arm’s length fee) is not consistent with commercial practice, and we recommend that it be eliminated. If the objective of the fifth requirement is to assure that the payment obligation is bargained-for and enforceable, that objective can be achieved by mandating that the lender or other partners be aware of and able to enforce the obligation under state law.
  - The sixth requirement (relating to no “bottom-dollar” guarantees) and the seventh requirement (relating to reimbursements) should be eliminated or modified to address specific concerns under, and to be applied solely with respect to, section 707.
  - The “net value” requirement should not be expanded to apply to entities other than disregarded entities. However, if our broad recommendation is not adopted, the “net value” requirement should be modified to make the
regulation more administrable as described in these Comments and should apply only in the context of debt-financed distributions under the partnership disguised sale rules.

- The transition rules should be clarified by the addition of examples and modified to prevent the termination of Transition Partner status as described in these Comments.

3. Proposed Section 707 Regulations

We commend Treasury and the Service on their efforts to provide greater clarity around the rules regarding disguised sales of property to or by a partnership. We believe that most of the proposed changes to the partnership disguised sale regulations provide needed clarity and promote the fair administration of the policies behind the disguised sale rules and have made a number of recommendations to extend the rules to other common non-abusive situations.

4. Specific Issues Raised by the Service and Treasury

What follows is a list of the specific issues raised by the Service and Treasury in the preamble to the Proposed Regulations and a summary of our observations and recommendations with respect to each issue:

Below each request, we provide the summary of our response.

- Whether the rules under Regulation section 1.707-6 should be amended to provide that a transferee partner’s share of an assumed liability immediately before a distribution is taken into account for purposes of determining the consideration transferred to the partnership only to the extent of the partner’s lowest share of the liability within some meaningful period of time (e.g., 12 months).

  We recommend an amendment to the section 752 regulations as they relate to debt-financed distributions and support a change in Regulations section 1.707-6 that is targeted to the partnership disguised sale rules as discussed in these Comments.

- Whether other structures or arrangements might be used to circumvent the rules regarding bottom-dollar guarantees, and whether the final regulations should broaden the anti-abuse rule further to address any such structures or arrangements.

  We recommend against a general rule that would disregard all bottom-dollar guarantees for the reasons explained in these Comments and note that bottom-dollar guarantees generally do not allow a partner to avoid partnership disguised sale treatment under the current rules. Nevertheless,

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4 See discussion below.
as explained in these Comments, we support imposing certain additional restrictions related to the determination of a partner’s allocable share of partnership debt for purposes of section 707.

- Whether, and under what circumstances, the final regulations should permit recognition of vertical guarantees and indemnities.

  Vertical guarantees and indemnities are commercial and are economically similar to joint and several liability arrangements which are recognized under the Proposed Section 752 Regulations. We recommend that vertical guarantees and indemnities continue to be recognized as payment obligations.

- Whether the special rule under Regulation section 1.752-2(e) (and related Regulation section 1.752-2(f), Example 7) should be removed from the final regulations or revised to require that 100 percent of the total interest that will accrue on a partnership nonrecourse liability be guaranteed.

  We recommend that no change be made to the special rule of Regulation section 1.752-2(e).

- Whether it would be clearer if all of the net value requirement rules were consolidated in Regulation section 1.752-2(k) and whether the final regulations should extend the net value requirement of Regulation section 1.752-2(k) to all partners and related persons.

  We recommend that there be no expansion of the current net value requirement regulations to recognized entities as provided in the Proposed Section 752 Regulations. However, if our recommendation is not adopted, we believe it would be clearer if all of the net value requirement rules were consolidated in a single regulation and we strongly recommend simplification of the net value requirement regulations, as discussed in these Comments.

- How the net value requirement of Regulation section 1.752-2(k) should apply to tiered partnerships.

  If the net value requirements of Regulation section 1.752-2(k) are extended in a simplified form, they should apply to tiered partnerships, which should be treated as aggregates for this purpose.

- Whether there are other methods that reasonably measure a partner’s interest in partnership profits that are not overly burdensome.

  There are multiple ways to measure a partner’s interest in partnership profits, including annually, over a term of years, and over the life of the partnership. We recommend that the rules allow any reasonable method of measuring partnership profits for purposes of allocating partnership
excess nonrecourse liabilities. We also recommend the retention of the current Significant Item Method and Alternative Method (each defined below) for allocating partnership excess nonrecourse liabilities, which we believe are reasonable methods.

- Whether exceptions should be provided to exclude certain events from triggering a redetermination of the partners’ liquidation values.

To the extent the liquidation value method for allocating partnership excess nonrecourse liabilities is retained as a safe harbor method, we recommend that a partnership be permitted, but not required, to redetermine its liquidation values at the end of each tax year, unless the partnership actually revalues its assets under section 704(b) during the tax year.
DISCUSSION

I. PARTNERSHIP RECOURSE LIABILITIES

The Proposed Section 752 Regulations make fundamental changes to the way partnership recourse liabilities are allocated under section 752, upending the current relatively mechanical and administrable rules. Given the pervasive consequences of how liabilities are treated under subchapter K, there is a need for certainty for all parties involved: taxpayers, advisors, and the government. Moreover, as discussed below, we believe the development of the law under section 752 and the development of the related law under section 704(b) are indicative of the principle that the allocations under both sections should be made on the basis of an objective standard that is tied to economics rather than subjective intent or motivation. The subjective motivation for undertaking real economic risk should be irrelevant.

The existing rules have, in most cases, provided a workable framework for allocating partnership recourse liabilities under section 752. The current, relatively mechanical constructive liquidation analysis should be retained. This framework was derived from the legislative history and numerous court decisions preceding the promulgation of the existing regulations. Although we recognize that Treasury and the Service are concerned about situations that defer gain in certain transactions that may be economically close to a sale (and we suggest a change in the regulations under section 707 to address those transactions), we don’t believe that a fundamental change in the regulations under section 752 is warranted. The current partnership recourse debt allocation rules provide a significant measure of certainty for taxpayers and advisors and are administrable. Moreover, the current rules are consistent with the analytical framework under section 704(b). Given the strong conceptual relationship and interdependence between sections 704 and 752, the rules under both sections should continue to be based on the same general principles.

A basic theory underlying both of these sections and subchapter K in general is that tax generally should follow economics. Section 752 provides partners with tax basis for all partnership liabilities, both recourse and nonrecourse liabilities. The issue raised by the Proposed Section 752 Regulations is whether, in certain cases in which a partner has the economic risk of loss (as currently defined under the section 752 regulations) for a partnership liability, it is a better policy choice to allocate that liability among partners as if none had such risk of loss, and hence in part to partners with no such risk of loss, as though the liability were a nonrecourse partnership liability. As will be discussed below, that is the effect of the Proposed Section 752 Regulations. We believe that it would be inconsistent with the economics of a partnership arrangement under which a partner may be required to make a payment with respect to a partnership liability to allocate that liability in part to other partners as if it were nonrecourse and to allow loss allocations and basis for distributions to partners with no risk with respect to the liability.

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5 See cases discussed below.
A partnership is a flexible vehicle that allows the partners to decide how to arrange their economic deal. In particular, the parties have the right to allocate perceived economic benefits and burdens in any way they see fit. We believe that the tax rules should be consistent with the economic arrangement.

Under section 704(b), tax items are generally allocated in accordance with how the benefit or burden of the associated economic item would be allocated. Income or gain is generally allocated in the manner in which the economic benefit of such item would be shared by the partners. Likewise, loss or deduction is generally allocated in the manner in which the associated economic burden would be allocated. The fundamental concept ensuring that tax allocations follow economics is the capital account, which ensures that allocations have a direct impact on what partners receive upon a liquidation of the partnership. The existing regulations under section 752 contain simplifying assumptions to add certainty and administrability to what otherwise would be a difficult and subjective analysis.

To ensure the regulations under both section 752 and section 704 continue to be based on the same general principles, the regulations under section 752 should continue to allocate partnership liabilities to those partners who would bear the ultimate financial responsibility if the liability were to become due and payable by the partner, rather than the partnership. Again, certain appropriate assumptions are necessary to make this analysis work in a way that achieves certainty for all the parties.

We believe that the rules for allocating partnership liabilities under section 752 should not operate to prevent a partner from receiving an allocation of debt where that partner has a real economic exposure, and we are concerned that the Proposed Section 752 Regulations would have that effect. The policy behind taking a liability allocation away from a partner who has a real economic risk and providing that liability allocation to other partners who have no economic risk is inconsistent with the tax follows economics principles upon which subchapter K is based, and is inconsistent with the clear directive of Congress in response to Raphan v. United States, as discussed below. Moreover, such a rule is subject to abuse and manipulation.

A. The Economic Risk of Loss Standard

Except with regard to a payment obligation imposed by state law, the Proposed Section 752 Regulations impose seven “recognition requirements” (set forth below at page 24) that must be satisfied in order for a partner’s payment obligation relating to a partnership liability to be taken into account. The Preamble states that Treasury and the Service “are concerned that some partners or related persons have entered into payment obligations that are not commercial solely to achieve an allocation of a partnership

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6 The section 704(b) regulations’ focus on what happens upon liquidation of the partnership, as an indicator that tax follows economics, carries over to the economic risk of loss concept under section 752 (discussed below), which is also concerned with what happens upon a liquidation of the partnership.

7 3 Cl. Ct. 457 (1983), aff’d in part, rev’d in part by 759 F.2d 879 (Fed. Cir. 1985).

liability to such partner.” These recognition requirements are intended to establish that the terms of a payment obligation are “commercially reasonable and are not designed solely to obtain tax benefits.” If all of the recognition requirements are not satisfied, a partner’s payment obligation is disregarded and the liability would be treated as nonrecourse under section 752.

The current section 752 regulations were written under the authority granted to Treasury under Section 79 of the Deficit Reduction Act of 1984 (the “1984 Act”). As noted in the Preamble to the Proposed Section 752 Regulations, the 1984 Act overruled the conclusion reached by the Court of Claims in Raphan v. United States. The Preamble also states that Treasury and the Service believe that the intent of the 1984 Act was to “ensure that bona fide, commercial payment obligations would be given effect under section 752.”

We believe Treasury’s and the Service’s focus on whether a payment obligation is “commercial” is misplaced. As discussed below, we believe that Congress mandated that “economic risk” should be the touchstone for analyzing whether a partnership liability should be treated as a recourse or nonrecourse partnership liability under section 752, and the courts over the years have honed the meaning of that term to emphasize the element of risk rather than attempting to measure its likelihood. Whether a payment obligation satisfies a vague standard of commerciality or was entered into to obtain a tax benefit is irrelevant to the analysis.

Rather, we believe that Congress intended that partners be able to assume the economic risk of a payment obligation in order to achieve certain tax consequences — such as, nonrecognition -- in appropriate circumstances in order to foster economic combinations and expansion of business activities. Nevertheless, if the partner receives cash as well as a partnership interest in the exchange, different rules may be appropriate, in accordance with the legislative history of section 707, as noted below.

For example, when a partner contributes property subject to nonrecourse debt to an operating partnership of a REIT, the benefits of combination and synergy are made possible by the flexible rules of subchapter K that allow the contributing partner to avoid gain recognition if the partner is willing to assume the risk of payment of the appropriate portion of the operating partnership’s liabilities. Otherwise, the contributing partner may well refuse to enter the arrangement because he cannot do through the partnership what he could do outside the partnership (i.e., hold property subject to debt without immediate tax recognition). If a partner is unable to join a partnership and avoid gain recognition

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11 Supra.
12 79 Fed Reg, 4826, 4830 (January 29, 2014) (Preamble to the Section 707 Regarding Disguised Sales, Generally Proposed Regulations).
when the partner would be able to avoid recognition of gain outside a partnership, that inability is contrary to the legislative history of section 707.  

We understand that Treasury and the Service have a very difficult task in trying to police transactions that are abusive while not impeding genuine business transactions. However, as explained below, we believe that the fundamental change in the Proposed Section 752 Regulations that favors nonrecourse liabilities over recourse liabilities is inconsistent with the legislative history of section 752 and will adversely affect businesses operated through partnerships.

1. Pre-1984 Act Regulations

Before analyzing Raphan and the statutory amendment Congress adopted in response to Raphan, it may be helpful to reflect on what the regulations under section 752 looked like before the revisions that were made pursuant to the 1984 Act. In contrast to the current detailed regulations, former regulation section 1.752-1(e) was strikingly short and simple. Essentially these regulations consisted of three sentences:

(e) Partner’s share of partnership liabilities. A partner’s share of liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement. In a limited partnership, a limited partner’s share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total which he is obligated to make under the limited partnership agreement. However, where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real property acquired without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits.

The first two sentences dealt with the allocation of recourse debt, whereas the third dealt with the allocation of nonrecourse debt. In distinguishing between the two types of debt, the regulation was open to the interpretation that the recourse versus nonrecourse distinction would be made solely on the basis of the four corners of the debt instrument without reference to any guarantees, side agreements or reimbursement rights. A recourse debt was generally to be allocated to the general partner(s), and a nonrecourse debt was allocated to all partners based on the sharing of profits. As stated above, the regulation was silent regarding the effect of other arrangements like guarantees, indemnifications and other agreements that shifted the economic risk from one partner to another.

13 See, e.g., Reg. § 1.701-2(d), Example 4 (choice of entity, avoidance of gain recognition under sections 351(c) and 357(c)) for an analysis of a tax-motivated transaction that is consistent with the intent of subchapter K. See also H.R. Conf. Rep. 98-861 (1983) quoted at footnote 44.
In the *Raphan* case before the Court of Claims, the debt at issue was a nonrecourse liability as to the partnership, meaning that the general partner was not automatically exposed to the debt economically under state law in its status as a general partner. This characterization of the liability as nonrecourse was favorable to the limited partners of the partnership because it allowed the lion’s share of the liability to be allocated to them based on their share of partnership profits. The Court of Claims rendered its decision allocating the bulk of the liability to the limited partners under the nonrecourse liability rule, despite the fact that the general partner had undertaken the economic risk of loss by guaranteeing the debt. The decision of the Court of Claims elevated form over substance by dismissing the relevance of any arrangements that existed outside the confines of the partnership agreement. In doing so, the Court of Claims gave no effect to the economic risk of loss undertaken by the general partner pursuant to its guarantee, despite the fact that, if the general partner were called upon to pay on the guarantee, the general partner had no right to be reimbursed by any partner. It is ironic that the position taken by Treasury and the Service in the Proposed Section 752 Regulations to force more liabilities to be characterized as partnership nonrecourse liabilities, despite the fact that a partner bears economic risk for the liability, is essentially the same position that the Raphans argued for in their case and is the same position to which Congress objected, as expressed in the 1984 Act.

2. **Congressional Response to Raphan**

In response to the Court of Claims decision in *Raphan*, Congress mandated that the analysis upon which the Court of Claims rendered its decision be reversed. The legislative history to the 1984 Act is very clear in indicating the intent of Congress. The House Report contains the following directive to Treasury:

> Thus, the regulations will specify that a partnership debt for which a partner is primarily or secondarily personally liable, whether in his capacity as a partner or otherwise, is not a nonrecourse debt, and thus generally does not provide limited partners with additional basis for their partnership interests. Similarly, when a limited partner guarantees what is otherwise a nonrecourse debt of the partnership, the regulations will not shift the basis attributable to that debt away from the limited partner as a result of the guarantee.\(^{14}\)

The Conference Report further explains the intent of Congress. First, Congress made clear that the decision in *Raphan* was not to be followed for purposes of applying section 752. Second, Treasury was directed to promulgate new regulations:

> The Treasury is to revise and update its regulations under Section 752 (as soon as practicable) to take into account of [sic] current commercial practices and arrangements, such as assumptions, guarantees, indemnities, etc.\(^{15}\)

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It is interesting to note that the term “commercial” in the preceding cite is the only time that term or its derivation is used throughout the legislative history. The Preamble to the Proposed Section 752 Regulations makes clear that Treasury and the Service sought to incorporate a “commercially reasonable” standard for guarantees and other undertakings, but the legislative history is devoid of any reference to a “commercially reasonable” standard. Instead, the reference to “commercial” is merely in the context of ensuring that the forthcoming regulations take into account current commercial practices and arrangements such as assumptions, guarantees, indemnifications, and similar undertakings of economic risk outside the four corners of the debt instrument.

Because partners have basis for both recourse and nonrecourse partnership debt, the critical issue is which partner is allocated debt, not whether any partner can use debt basis to defer gain or take losses. We believe that Congress made its intent clear in directing Treasury to revise its regulations, explicitly stating that the regulations were to be based on the “economic risk of loss,” rather than any standard of commercial reasonableness:

Finally, 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 (other than bona fide nonrecourse debt, as defined by such regulations).16

The key word in the phrase “economic risk of loss” is the word “risk.” The emphasis is on the risk of loss undertaken by the partner. The legislative history does not base its standard on a finding of an economic loss that is certain or highly likely to occur. Nor does it specify that there be a probable economic loss. We believe that the term “risk,” in reference to an economic loss, has been construed appropriately to refer to a possibility that a loss might occur regardless of whether the risk might be unlikely to occur.

3. Courts’ Interpretation of Economic Risk of Loss

This interpretation of the economic risk of loss standard is corroborated by certain court decisions that were rendered in the wake of the statutory directive, including the Court of Appeals decision in *Raphan v. United States*.17 The Federal Circuit, in reversing the Court of Claims, concluded that the guarantee by the general partner did indeed shift the liability away from the limited partners despite the fact that the liability was nonrecourse as to the partnership on its face, and despite the fact that the loss undertaken by the guarantor might never occur.

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16 *Supra* note 15.
17 759 F.2d 879 (Fed. Cir. 1985).
The Pomponios, as general partners, were personally liable for the construction loan when they guaranteed its payment. The Raphans, as limited partners, do not share in that liability.\textsuperscript{18}

The clearest and most emphatic statement of this concept is found in the Tax Court’s decision in \textit{Melvin v. Commissioner},\textsuperscript{19} where for purposes of section 465 the court specifically rejected any argument that the economic undertaking should not be respected because of the possibility that the liability would be paid by the partnership in due course without the economic undertaking ever resulting in an actual payment, citing \textit{Raphan} as a basis for its decision:

Recent cases establish that with respect to a particular debt obligation a partner will be regarded as personally liable within the meaning of section 752 (for basis purposes) and section 465(b)(2)(A) (for at-risk purposes) if he has the ultimate liability to repay the debt obligation of the partnership in the event funds from the partnership’s business and investments are not available for that purpose.\textsuperscript{20}

The Tax Court adopted an explicit standard of following the “worst case scenario” under section 465, which is the forerunner of the constructive liquidation test later adopted by the current section 752 regulations, citing cases that dealt with both section 752 and 465:\textsuperscript{21}

The relevant question is who, if anyone, will ultimately be obligated to pay the partnership’s recourse obligations if the partnership is unable to do so. \textit{The scenario that controls is the worst-case scenario, not the best case}. Furthermore, the fact that the partnership or other partners remain in the ‘chain-of-liability’ should not detract from the at-risk amount of the parties who do have the ultimate liability. The critical inquiry should be who is the obligor of last resort, and in determining who has the ultimate economic responsibility for the loan, the substance of the transaction controls.\textsuperscript{22}

\textsuperscript{18} Id. at 886.
\textsuperscript{19} 88 T.C. 63 (1987), aff’d per curiam, 894 F. 2d 1072 (9th Cir. 1990).
\textsuperscript{20} \textit{Melvin}, 86 T.C. at 75 (citing \textit{United States v. Raphan}, 759 F.2d 879, 886 (Fed. Cir. 1985); \textit{Gefen v. Commissioner}, 87 T.C. 1471 (Dec. 30, 1986) (slip op. at 44-48); \textit{Abramson v. Commissioner}, 86 T.C. 360, 375-376 (1986); \textit{Smith v. Commissioner}, 84 T.C. 889, 907-908 (1985), aff’d without published opinion 805 F.2d 1073 (D.C. Cir. 1986)).
\textsuperscript{21} See cases cited in footnote 20 above.
\textsuperscript{22} \textit{Melvin}, 86 T.C. at 75 (citing \textit{Raphan}, 759 F.2d at 885) (emphasis added). \textit{Accord, Follender v. Commissioner}, 89 T.C. 943 (1987); \textit{Tepper v. Commissioner}, T.C. Memo. 1991-402. In \textit{Melvin}, a partnership in which the taxpayer was general partner (Medici Film Partners), invested in a limited partnership by contributing $35,000 cash as a downpayment and agreeing to make additional capital contributions of $70,000. The obligation to contribute $70,000 was evidenced by a recourse note given to the limited partnership. The limited partnership obtained a $3,500,000 recourse loan from a bank and pledged, among other things, the $70,000 promissory note. The issue was the extent to which \textit{Melvin} was at risk within the meaning of section 465 on the bank loan. The court adopted the “worst case” scenario to
In embracing this worst case standard, the Tax Court specifically cited the 1984 Act legislative history:

Of interest to our resolution of this question is the direction given to the Treasury by Congress in the Deficit Reduction Act of 1984, in response to the decision of the Claims Court in *Raphan v. United States*. In *Raphan*, the Claims Court made a determination of liability, or lack thereof, based primarily on the form of the transaction and on certain labels used by the parties to the transaction. In response to the Claims Court decision in *Raphan*, in 1984 Congress specifically directed the Treasury to promulgate regulations under section 752 to consider the substance, and not merely the form, of financing, and particularly to consider current commercial lending practices with respect to guarantees, assumptions, and indemnities. We also believe it appropriate herein to take into account the substance and realities of the financing arrangements presented to us.\(^{23}\)

This line of reasoning is also shown in *Abramson v. Commissioner*,\(^{24}\) where the Tax Court held:

The guarantee of an otherwise nonrecourse note places each guaranteeing partner in an economic position indistinguishable from that of a general partner with liability under a recourse note — except that the guaranteeing partner's liability is limited to the amount guaranteed. While recognizing that under state law there may be differences between the obligations of a general partner and those of a limited partner guarantor, such differences should not be controlling for Federal tax purposes. Each is obligated to use his personal assets to satisfy pro rata the partnership liability. In effect, the limited partners are the equivalent of general partners to the extent of their pro rata guarantees especially since, as to this obligation, the liability of the general partners is limited. Economic reality dictates that they be treated equally, and we so hold. Consequently, both general and limited partners will be entitled to include such liabilities in their basis to the extent of their pro rata guarantees. The $1,525,000 liability is apportioned to them in accordance with their loss ratios under the partnership agreement.\(^{25}\)

We specifically note the several references to “to the extent of the guarantee.” Clearly, the court assumed that a partial guarantee (at least in the case of a vertical

\(^{23}\) *Melvin*, 88 T.C. at 75-76 (citations omitted).

\(^{24}\) 86 T.C. 360 (1986).

\(^{25}\) *Id.* at 374.
guarantee, as involved in the case before the court) of a debt would be respected “to the extent of the guarantee.”

In rejecting the contrary argument that the economic risk is not certain because the partnership might pay off the liability in the ordinary course through partnership revenues, the Tax Court concluded:

Where, as here, the partner becomes ultimately liable to pay the debt, it is irrelevant for purposes of section 752(a) that the partnership or its property remains liable to the mortgagee. . . . By taking on ultimate and unconditional liability, petitioner constructively contributed the amount of the indebtedness to the partnership, and was thus entitled to increase his basis. 26

It is also worth mentioning that the Court of Appeals in Raphan noted that the general partner did not charge a fee for its guarantee because the general partner was acting in its capacity as a partner in the partnership. 27 As discussed in more detail below, among the recognition requirements contained in the Proposed Section 752 Regulations that are intended to establish the “commerciality” of a payment obligation is that the obligor must receive an arm’s length fee from the partnership for entering into the payment obligation. The general partner in Raphan would fail this recognition requirement and, as a result, the guarantee would be disregarded. Thus, the Proposed Section 752 Regulations would fail to reverse the holding of the Court of Claims in Raphan as expressly directed by Congress. Furthermore, regardless of whether the recognition requirements under the Proposed Section 752 Regulations are indicative of commercial reasonability, many of these requirements are formalistic in nature, which stands in contrast with Congress’ directive to the Treasury and the Service to go beyond the formalistic analysis in Raphan. As a result, we have serious concerns that the approach of the Proposed Section 752 Regulations is contrary to congressional intent.

Finally, because the recourse or nonrecourse characterization of a partnership liability turns on satisfaction of all seven of the recognition requirements, we are concerned that the Proposed Section 752 Regulations allow for the inclusion of liabilities in the basis of partners who bear no economic risk of the debt under circumstances in which another partner, or other partners, do bear economic risk. The characterization of the liability can be improperly manipulated simply by intentionally failing one or more of the recognition requirements.

Thus, we believe that it is not good policy as well as inconsistent with congressional intent in amending section 752 and the cases that have interpreted both section 752 and section 465 to adopt a “commercial reasonableness” standard in place of the “worst case” scenario that informs the current regulations under section 752.

26 Id. at 374-375 (citing Smith v. Commissioner, 84 T.C. 889 (1985)).
27 Raphan, 759 F.2d 879, at 885.
B. Other Issues

1. Lack of Coordination with Section 704(b)

We realize that sections 704(b) and 752 are separate Code sections. Nevertheless, the theory underlying the analysis used in both sections is very similar. For example, the concept under section 704(b) that partnership property declines in accordance with its depreciation or amortization schedule (i.e., the value-equals-basis rule) and the constructive liquidation analysis under section 752, under which partnership property is deemed to be worthless, both derive from the same rationale. Under section 704(b), a partner is entitled to an allocation of a loss or deduction attributable to partnership equity if that partner would bear such loss if it were real, despite the fact that the partnership may be able to sell the property at a gain that would reverse out the loss.

As another example, it is clear that by undertaking a valid deficit restoration obligation (“DRO”), the partners with the DRO can be allocated the losses attributable to partnership equity up to the amount of the DRO. The motivation in undertaking the DRO is irrelevant under the section 704(b) regulations. Moreover, it is clear that a loss allocation supported by a DRO is respected even though it might be likely that the partnership will reverse out the negative capital account with gain from the property.

Consider the following fact pattern, which considers the application of a DRO in the context of equity deductions under section 704(b):

A and B each contribute $100 to a partnership, which incurs a nonrecourse debt of $800. This debt is allocated equally between A and B. Desiring an allocation of 100 percent of the equity deductions, A enters into a valid DRO and the partnership agreement is amended to allocate the first $200 of losses to A. The agreement also provides a chargeback of the first $200 of gain to A to reverse out the original loss allocations.

The allocation of the losses to A creates a negative capital account for A, while B has a positive capital account of $100. This allocation would generally be respected under the value-equals-basis rule of section 704(b), even if everyone agrees that the partnership property is still actually worth $1,000. A gain chargeback of the $200 of gain that would be recognized by the partnership back to A would ensure that the DRO would never come into being.

As currently written, the section 704(b) regulations would respect this special allocation of losses, even though it might be highly likely that no economic loss will ever be suffered by A. The constructive liquidation analysis in the current section 752 regulations works in a very similar manner, creating a consistency in the theory between these two regulations. The Proposed Section 752 Regulations would sever this connection, with consequences as described below.

Moreover, given the close integration in the theory between sections 704(b) and 752, it is appropriate to look to how the economic risk of loss concept has developed
under section 704(b). Both sections are concerned with reflecting the economic deal struck by the partners as to how the benefits and burdens of partnership items are to be shared. The current version of section 704(b) reflects amendments of that section made by the Tax Reform Act of 1976.\textsuperscript{28} Prior to that amendment, the section provided that an allocation of partnership items under the partnership agreement would not be respected if its principal purpose was to avoid or evade federal income tax. The regulations under this version of the statute provided that in determining whether an allocation has been made principally for a tax avoidance purpose, an analysis would be made as to whether: (i) the allocation had substantial economic effect, (ii) whether there was a business purpose for the allocation, (iii) whether related items from the same source were subject to the same allocation, and (iv) whether the allocation ignored normal business factors.\textsuperscript{29}

The 1976 statutory amendment elevated the substantial economic effect test to the primary test for determining the validity of an allocation. The conference committee report accompanying the statutory amendment acknowledged that while the House bill would disallow an allocation if it lacked a business purpose or a significant avoidance or evasion of tax resulted from the allocation, the Senate bill would disallow the allocation only if it lacked substantial economic effect.\textsuperscript{30} The conference committee report states that the conference agreement follows the Senate amendment.\textsuperscript{31} This resolution of the difference is a strong indication of the congressional desire to move from a purpose-based test to an objective test that is based upon the associated economic consequences of the allocation of partnership items of income, gain, loss, and deduction. The section 704(b) regulations reflect the congressional intent to focus on the economic effect of an allocation rather than the subjective motivation for an allocation by adopting the substantial economic effect test as a safe harbor rule for respecting partnership allocations.

As a general rule, with allocations attributable to nonrecourse debt being a notable exception, the substantial economic effect analysis assumes that the partnership items of income, gain, loss, and deduction are matched by the corresponding economic benefits and burdens, and focuses on whether the partner receiving the allocation would receive the associated economic benefit or burden with respect to such item if it existed. For example, a partner desiring an allocation of partnership loss can generally receive an allocation of that loss as long as the loss is reflected in the partner’s capital account. In that case, such resulting capital account controls the liquidating distributions from the partnership. If the partner ends up with a capital account that is negative, the rules would require that partner to satisfy the negative balance in that partner’s capital account. The possibility that the partnership may be able to reverse out the detriment of the loss allocation by a subsequent allocation of gain resulting from the disposition of property is generally irrelevant under this analysis.

In describing the standard to be used in determining whether an allocation has economic effect, the Senate Finance Committee report makes reference to the decision of

\footnotesize{\textsuperscript{28} Pub. L. No. 94-455, 90 Stat. 1520.  
\textsuperscript{29} Reg. § 1.704-1(b)(2) under the 1954 Code.  
\textsuperscript{31} Id.}
the Tax Court in *Orrisch v. Commissioner*, in which the Tax Court disallowed a
deduction of 100 percent of the depreciation by one of the partners in a two-person
partnership. In discussing the existence of a gain chargeback provision under the
partnership agreement, the Tax Court determined:

> To find any economic effect of the special allocation agreements aside
> from its tax consequences, we must, therefore, look to see who is to bear
> the economic burden of the depreciation if the buildings should be sold
> for a sum less than their original cost.33

This language, which is based on the hypothetical scenario that the partnership
asset is sold at a loss equal to the amount of the depreciation taken, is the basis of how
allocations are tested under section 704(b). The hypothetical liquidation model upon
which section 704(b) is based and the constructive liquidation model that is used under
section 752 are both related conceptually. In each case, the model assumes an economic
loss and asks who would bear that loss if it were real. An approach that would disregard
the undertaking of an economic loss under section 752 simply because the partnership
may in fact satisfy its obligation through income would create a divergence between the
manner in which allocations of income, gain, loss, and deduction are analyzed under
section 704(b) and the manner in which liabilities are allocated under section 752.34

2. Technical Issues and Lack of Coordination with Section 465

If the Proposed Section 752 Regulations are adopted without substantial revision,
there are certain technical issues and inconsistencies that should be corrected. The
current regulations under section 704(b) must be carefully conformed to the new
approach of the section 752 regulations. For example, Regulation section 1.704-2(g)(3)
creates shares of minimum gain when recourse debt is converted to nonrecourse debt, as
follows:

> [I]f a recourse liability becomes a nonrecourse liability, a partner has a share of the
> partnership’s minimum gain that results from the conversion equal to the partner’s deficit
> capital account…to the extent the partner no longer bears the economic burden for the
> entire deficit capital account as a result of the conversion.

The current section 704 regulations were written on the assumption that the regulations
under section 704(b) and section 752 are fundamentally consistent, that liabilities for
which a partner bears the economic risk of loss under section 704(b) are characterized as
recourse debt under section 752. As noted above, the Proposed Section 752 Regulations
sever the link between the two provisions. As a result, if a partner continues to have a
DRO (or guarantee) for purposes of section 704(b), conversion of what had been section
752 recourse debt to section 752 nonrecourse debt makes the operation of the regulation

33 Id. at 403.
34 We note that currently both section 752 and section 704 look to whether obligations are enforceable
(within a reasonable time in the case of a DRO at liquidation under Reg. § 1.704-1(b)(2)(ii)(c)), rather than
to the likelihood of the loss occurring. Changing the focus of section 752 to the likelihood of the loss
causes the provisions to diverge.
quoted above problematic: increasing a partner’s share of minimum gain under Treas. Reg. §1.704-2 does not seem appropriate when another partner continues to have a DRO under Regulation section § 1.704-1 in respect of the same amount. A change to the economic risk of loss analysis under section 752 may inappropriately change the timing of a minimum gain chargeback. See, e.g., discussion of exculpatory liabilities below.

Section 465 is another Code section that looks to “economic risk of loss” to limit an individual’s or closely held C corporation’s ability to recognize losses to the amount such partner has at risk. One of the more serious problems with the Proposed Section 752 Regulations is the lack of coordination with the at-risk rules of section 465.

Section 465 is historically more restrictive than section 704(d), which limits a partner’s ability to recognize an allocated loss to the extent of the partner’s basis in the partnership interest. For example, a partner’s basis in a partnership is increased by such partner’s allocation of traditional nonrecourse debt but the partner does not have at-risk basis unless the partner is personally obligated to make a payment on the debt under section 465(b)(2), or the debt is qualified nonrecourse debt, as defined in section 465(b)(6). Treasury and the Service have not finalized a complete set of regulations under section 465. As a result, the courts have interpreted the meaning of the statutory terms.

In Abramson v. Commissioner, Gefen v. Commissioner, Melvin v. Commissioner, and Pritchett v. Commissioner, among others, the courts have consistently applied a worst-case-scenario analysis to determine whether a partner has a personal obligation to make a payment with respect to debt that increases the partner’s at-risk amount. It is unclear whether the guarantees and indemnification obligations analyzed in these cases would satisfy the requirements of the Proposed Section 752 Regulations. The seven factors (listed at page 24) are not discussed generally in these cases.

As a result, if the Proposed Section 752 Regulations are finalized substantially as proposed, it is likely that there will be a mismatch between debt allocations under section 752 and partners’ at-risk basis under section 465, causing suspension of some deductions to all partners, under either section 465 or section 704(d), despite the fact that a partner is at risk for the losses. This result is contrary to the intent of Congress in enacting the at-risk rules, which are intended to allow a taxpayer who is at risk (as defined by section 465) to deduct losses and to deny those losses to taxpayers who are not at risk. The following example illustrates the problem.

35 See also Reg. § 1.704-2(f)(2) which defers a minimum gain chargeback if the partner has the economic risk of loss under Reg. § 1.752-2.
36 86 T.C. 360 (1986).
37 87 T.C. 1471 (1986).
39 827 F.2d 644 (9th Cir. 1987).
40 Note that debt allocated to partners under section 752 is treated as a contribution of money by the partner to the partnership under section 752(a), increasing the partner’s basis under section 704(d).
A and B are individuals who each contribute $25,000 to AB LLC. The partnership agreement provides that all income, gain, loss and deduction must be allocated equally between A and B except that A will be allocated all deductions related to any debt which A guarantees (partner nonrecourse deductions). Under the AB LLC arrangement, B performs services in connection with the AB LLC business activities and A agrees to guarantee any debt incurred by AB LLC. AB LLC borrows $100,000 and A guarantees the debt but receives no arm’s length fee for the guarantee.

Under Proposed Regulation section 1.752-2(b)(3)(ii), A’s guarantee does not satisfy the requirements for A’s payment obligation to be recognized because A does not receive a fee for entering into the guarantee (or it may fail to satisfy another of the factors listed at page 24). As a result, the debt would be treated as nonrecourse debt under the Proposed Section 752 Regulations. If the debt were allocated in accordance with the liquidation value safe harbor or in accordance with profits, the debt would be allocated 50% to A and 50% to B. Therefore, A and B, would each have a basis of $75,000 ($25,000 contributed capital + $50,000 debt). In contrast, under section 465, A has $125,000 at risk ($25,000 contributed capital + $100,000 on account of the guarantee) and B has $25,000 at risk ($25,000 contributed capital).

In years 1 through 3, AB LLC sustains cumulative net losses of $150,000 and the AB LLC agreement allocates $125,000 to A and $25,000 to B ($25,000 each in accordance with capital percentages, and then $100,000 to A because of A’s guarantee). A will lack section 704(d) basis for $50,000 of the losses ($125,000 loss allocation - $75,000 basis) despite having at-risk basis for all $125,000 of the losses. Thus, under this scenario, at the end of year 3, A would have $50,000 of losses suspended under section 704(d) and consequently, $50,000 of remaining at-risk basis.

Another possibility is that the allocations in the AB LLC agreement would not be respected under section 704(b) (because the guarantee does not satisfy the section 752 regulations, as amended, and assuming the section 704(b) regulations have been made consistent with the section 752 regulations) and the net losses would be allocated $75,000 each to A and B because the debt is treated as nonrecourse under section 752. In this case, A would have $50,000 of at-risk basis remaining (A is allocated only $75,000 of losses) and B would have $50,000 of losses suspended under section 465 because of lack of at-risk basis (loss allocation of $75,000-$25,000 B’s amount at risk).

The courts have interpreted section 465(b) to resolve the ambiguity in the statutory language in a manner that is consistent with the current regulations under section 752.41 If the Proposed Section 752 Regulations are finalized substantially in their current form, the rules of the two provisions will be materially inconsistent. In that case, the at-risk investment would often lie with one partner while outside basis would be

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41 See notes 36-39 and accompanying text.
given to another partner, thereby suspending deductions even though there is both adequate basis and at-risk investment.

C. Specific Recommendations

1. Targeted Revisions of Section 752 Regulations

As noted above, we recommend that the Proposed Section 752 Regulations be withdrawn and new regulations be proposed to address the transactions Treasury and the Service identify as objectionable. In this connection, we understand that Treasury and the Service are concerned about the interaction of the partnership liability allocation rules under section 752 and the partnership disguised sale rules under section 707. We understand that this concern was the original impetus for this regulation project. As a result, we recommend targeted revisions of the rules relating to liability allocations with respect to disguised sales.

In order to address what we understand to be the concern of Treasury and the Service that certain partners are effectively cashing out of their investments tax-free by using the disguised sale regulations under section 707, combined with the recourse debt allocations rules of section 752, we recommend that the Proposed Section 752 Regulations be revised and applied to narrow the circumstances under which a partner can qualify for the debt-financed distribution exception to the partnership disguised sale regulations.

In the Tax Reform Act of 1984, Congress enacted section 707(a)(2)(B), which provides that transactions which are properly characterized as a sale or exchange will be treated as occurring between a partnership and a non-partner or between two partners not acting in their capacity as partners. The problem that Treasury, the Service and taxpayers face in interpreting this provision is that there is often little economic difference between a contribution and distribution under sections 721 and 731 and a sale or exchange of property under section 1001. The issue becomes more clouded if borrowed funds are involved. Under the Supreme Court’s rulings in Crane and Tufts, taxpayers receive full basis credit for borrowed funds, even if the taxpayer is not personally liable for repayment of the money. The partnership rules are intended to allow a partner to borrow through a partnership in the same manner as the partner could borrow outside the partnership.44

42 Crane v. Commissioner, 331 U.S. 1 (1948).

The Conferees wish to note that when a partner of a partnership contributes property to the partnership and that property is borrowed against, pledged as collateral for a loan, or otherwise refinanced, and the proceeds of the loan are distributed to the contributing partner, there will be no disguised sale under the provision to the extent the contributing partner, in substance, retains liability for repayment of the borrowed amounts (i.e., to the extent the other partners have no direct or indirect risk of loss with respect to such amounts) since, in effect, the partner has simply borrowed through the partnership. However, to the extent the other partners directly or indirectly
In this connection, we note that it is clear that Congress clearly contemplated allowing partners some ability to contribute leveraged property to a partnership without triggering gain. Business combinations can be economically advantageous, and the partnership rules are intended to allow, rather than to impede, business expansion. Treating all partnership liabilities as nonrecourse (other than those for which another partner has the economic risk of loss) would effectively trigger gain on many contributions of leveraged property to a partnership, even if the contributing partner remains personally liable on the contributed debt. We do not believe that such a rule is consistent with one of the primary objectives of subchapter K, to allow flexible business arrangements that promote economic growth.

Nevertheless, we recognize that there is a concern with partners’ ability to convert their investments to cash through use of a partnership without triggering gain. We recognize that the issue is complex and difficult to resolve. We would be willing to work with Treasury and the Service to develop an approach that would narrow the application of the debt-financed distribution exception to the partnership disguised sale rules to deter such arrangements.

As discussed below, we do not think that the seven recognition requirements of the Proposed Section 752 Regulations would effectively address Treasury’s and the Service’s concerns with the scope of the debt-financed distribution exception to the partnership disguised sale rules. For example, so-called bottom guarantees do not allow partners to receive debt-financed cash on contribution of property to a partnership without triggering a disguised sale of the contributed property. In contrast, bottom guarantees are used properly, in our opinion, to facilitate business combinations when encumbered property is contributed to a partnership and the contributed liabilities are refinanced. A blanket proscription against such guarantees does not prevent inappropriate disguised sale transactions and frustrates commercial business combinations.

In contrast, it may be more appropriate, for example, to apply a net value requirement (simplified as we recommend below) to support guarantees (and similar arrangements) undertaken to allow debt-financed distributions of money to a contributing partner.

45 Under Reg. § 1.707-5(b), a partner’s allocable share of a liability is determined by a fraction that takes into account the total amount of the liability. These rules operate to create disguised sale proceeds if all partners do not take a distribution of their pro rata share of the liability. As a result, a bottom guarantee does not avoid sale treatment.

46 For example, if an individual contributes property with a fair market value of $100 and an adjusted basis of $50 encumbered by nonrecourse debt of $80 to a partnership and the partnership refinances $200 of partnership liabilities in order to obtain better terms, the individual may provide a bottom guarantee of $80 in order to mimic the individual’s pre-contribution economics and risk profile and to avoid gain on the deemed distribution that could otherwise occur under section 752(b). This seems fully consistent with the legislative history quoted in footnote 46 directly above. See also S. Rep. No. 1622, 83rd Cong., 2nd Sess., page 96 (1954) for the general proposition that Congress intended to limit the circumstances in which gain or loss is recognized in order to facilitate the movement of property into and out of partnerships as business reasons dictate.
partner. Such a rule may achieve the objective of restricting a partner’s ability to cash out of the partnership without gain recognition unless the partner has real economic exposure to the guaranteed debt. In other words, such an arrangement may approximate allowing the partner to borrow through the partnership in a manner analogous to the partner’s ability to borrow on the security of the property outside of the partnership.

2. Suggested Revisions to the Proposed Section 752 Regulations

In the alternative, if Treasury and the Service decide not to withdraw the Proposed Section 752 Regulations, we respectfully request that the regulations be substantially revised to take into account the concerns we address below.

a. The Recognition Requirements

As noted above, the Proposed Section 752 Regulations provide for seven requirements that must be satisfied before the payment obligation of a partner is recognized. Because those requirements do not provide objective standards that are consistent with commercial practice, the Proposed Section 752 Regulations would cause most partnership liabilities to be treated as nonrecourse, despite the fact that a partner or related person may well have to make a payment if the partnership suffers a loss, and would allow partners to manipulate the contractual arrangements to achieve a tax result that is not consistent with economics. Rather than these requirements certain of which include formalisms and others of which create complexity, we recommend that the standard be that the lender or other beneficiary of the obligation be aware of and able to enforce any payment obligation that is recognized for purposes of section 752. If there is concern about whether the parties intend to enforce a payment obligation, we recommend that an example be added to the current anti-abuse regulation to illustrate the facts and circumstances that raise the concern.

We also have specific comments with respect to each of the recognition requirements.

The Proposed Section 752 Regulations provide that an obligation of a partner or related person to make a payment with respect to a partnership liability is not recognized unless all of the following requirements are satisfied:47

1. The partner or related person is required to maintain a commercially reasonable net worth throughout the term of the payment obligation or subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration.

2. The partner or related person is required periodically to provide commercially reasonable documentation regarding the partner’s or related person’s financial condition.

3. The term of the payment obligation does not end prior to the term of the partnership liability.

4. The payment obligation does not require that the primary obligor or any other obligor with respect to the partnership liability directly or indirectly hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor.

5. The partner or related person received arm’s length consideration for assuming the payment obligation.

6. In the case of a guarantee or similar arrangement, the partner or related person is, or would be liable up to the full amount of such partner’s or related person’s payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. This requirement does not apply to co-obligors who are jointly and severally liable.

7. In the case of an indemnity, reimbursement agreement, or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner’s or related person’s payment obligation if, and to the extent that, any amount of the indemnitee’s or other benefitted party’s payment obligation is satisfied. This requirement does not apply to co-obligors who are jointly and severally liable.

In the case of the first, second, and fourth recognition requirements, a determination must be made as to whether a “commercially reasonable” or “reasonable needs” standard has been met. These vague, subjective terms will require partnerships to make difficult judgments as to whether the requirements have been met prior to allocating any partnership liability involving a payment obligation.

With respect to the first and second recognition requirements, we agree that the obligor should have the wherewithal to make a payment to the extent required for the entire duration of its obligation. However, we believe that this concern is substantially alleviated by the existing anti-abuse rule in Regulation section 1.752-2(j). The anti-abuse rule could be improved by additional examples that provide illustrations of the situations considered abusive or problematic.

The third recognition requirement, which would not recognize a payment obligation that does not last throughout the full term of the partnership’s loan, is contrary to commercial practice in many cases. In the real estate context, it is common for a construction loan to be guaranteed until the property reaches a required level of stabilization. In addition, a guarantee of a partnership liability may be subject to release.

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48 See Canal Corp. v. Commissioner, 135 T.C. 199, 205 (“no provision of the indemnity obligation mandated that WISCO [the partner] maintain a certain net worth”).
provisions upon certain events outside the control of the obligor and it is reasonably common to permit a release based on satisfaction of certain debt covenants.

Fundamentally, this recognition requirement would deprive a partner of the allocation of a recourse liability even in those situations where there is real economic exposure during a significant portion of the term of the loan, thereby violating the “tax follows economics” framework upon which subchapter K, generally, and section 752, in particular, is based. The failure to recognize a partner’s payment obligation with respect to a partnership liability for which the partner’s obligation does not last throughout the full term of the loan, therefore, should be limited solely to abusive situations that are indicative of the fact that the partner does not bear real economic risk of loss with respect to such liability for a significant portion of the term of the loan.

For example, we think a payment obligation should be disregarded if the guarantor or other obligor has an unrestricted unilateral right to terminate the obligation at will, including immediately before the obligation becomes due and payable. We believe that such a structure is already subject to the anti-abuse rule in Regulation section 1.752-2(j), but would support adding an example to make this point clear. However, a partner who has economic exposure for a payment obligation for a specified term or until an objective milestone is achieved should not be deprived of a liability allocation for such time period simply because such partner’s obligation does not endure for the full term of the loan. As with certain other recognition requirements discussed below, this particular requirement is also subject to manipulation and abuse and allows partners and partnerships to convert what otherwise would (and should) constitute a partnership recourse liability into a nonrecourse liability with a relatively insubstantial change to the applicable partner’s payment obligation.

With respect to the fourth recognition requirement, which mandates that the payment obligation must not require that the primary obligor or any other obligor with respect to the partnership liability hold assets in an amount that exceeds the reasonable needs of the obligor, we question whether this recognition requirement can be feasibly administered as currently drafted. Partnership agreements often include restrictions on distributions before certain hurdles are satisfied for a variety of reasons, such as to protect the interests of preferred partners or for prudent business management. These are non-abusive, common arrangements and should not violate the fourth recognition requirement. An example illustrating the kind of restriction on distributions that violates this requirement would be helpful.

We also believe that the fifth recognition requirement, specifying that arm’s length consideration must be received for undertaking a payment obligation, is not commercial in many cases. A partner is often willing to enter into a guarantee or other payment obligation with respect to a partnership liability because the partner will benefit from the liability in the obligor’s capacity as a partner, as was the case in Raphan. Further, we do not see how the existence or lack of a fee is probative of the economic risk of loss borne by a partner who undertakes such a payment obligation, and are concerned that such a rule would be a source of uncertainty and unequal application of the rule without achieving any real benefit.
Finally, we are concerned that the sixth and seventh recognition requirements will deprive a partner of a liability allocation even in situations where there is real economic risk. These broad requirements would prevent any obligation that is not a “top” guarantee or similar payment obligation from being taken into account, including arrangements that are found in non-tax motivated commercial transactions.

The category of obligations that are disregarded as “bottom guarantees” is extremely broad under the Proposed Section 752 Regulations and includes arrangements that are found in non-tax motivated commercial transactions, such as full or top guarantees with any right of indemnification (even for $1) from another person. We note that the Proposed Section 752 Regulations may be read to disregard even a top guarantee with a right of indemnification pursuant to a bottom indemnity agreement. For example, if a partner enters into a full guarantee of a $1 million liability with a right to be reimbursed only to the extent the guarantor is required to pay more than $900,000, the guarantee may be disregarded under the language of the Proposed Section 752 Regulations.

It appears that the concept underlying this restriction is based on the perception that a payment obligation relating to the safest portion of the debt is fictitious and unlikely to ever result in a payment. This perception is misplaced given the many situations where parties undertaking such an obligation thinking it would never come into play actually had to make a payment. A substantial portion of the risk under any guarantee lies in the risk of the liability itself. For example, a guarantee of the bottom $4 million of a $10 million liability that is secured by equipment worth $10 million may be more likely to become due and payable than a guarantee of all $4 million of a liability that is secured by an office building worth $10 million. Prejudging all payment obligations to be remote and fictitious merely because the obligations do not cover 100 percent of any shortfall in repayment is, therefore, not appropriate. The effect of this rule will be to force a partner to recognize income attributable to a negative tax basis capital account before the partner receives the economic benefit of being relieved of its payment obligation.49

We also believe that vertical-slice guarantees are found in non-tax motivated commercial transactions and should be taken into account as payment obligations. A guarantor providing a vertical-slice guarantee would be required to pay if the partnership defaults on any dollar of its liability. The guarantor obviously would not be required to pay the full amount of the liability, but a percentage of each dollar of the liability that the partnership is unable to satisfy. Therefore, we agree that the guarantor’s obligation with respect to a vertical-slice guarantee should not be the full amount of the partnership’s liability but simply the percentage of the partnership’s liability that the guarantor is obligated to pay pursuant to the guarantee. Respecting the vertical-slice guarantee as an obligation of the partner in the amount of its guarantee (e.g., the relevant percentage of the partnership liability) represents the exact same economic risk as a guarantee of 100

49 “Book” capital accounts are capital accounts maintained in accordance with the capital account maintenance rules set forth in Reg. § 1.704-1(b)(2). “Tax basis” capital accounts are maintained in the same manner as “book” capital accounts, except that contributed (or revalued) property is reflected at its adjusted tax basis and thereafter adjusted to reflect depreciation allowable for tax purposes.
percent of a particular liability. For example, a vertical-slice guarantee of 25 percent of a $1 million liability represents at least the same risk as (and quite possibly more risk than) a guarantee of 100 percent of a $250,000 liability. It is not uncommon for multiple guarantors to each guarantee a slice of a partnership liability commensurate with their interest in the partnership without being liable on a joint and several basis for the entire partnership liability. Therefore, we recommend that a vertical-slice guarantee of a partnership liability be respected as an obligation of the partner up to the amount of the guarantee.

Furthermore, the second sentence of the seventh recognition requirement is overly broad. Under that second sentence, indemnities and similar arrangements are not recognized as payment obligations if (and to the extent) the payment obligation of the indemnitee (or other benefited party) fails any of the recognition requirements or the net value requirement. At first glance, this second sentence appears to serve as a backstop for the seventh recognition requirement, ensuring that seemingly genuine indemnities of illusory guarantees are treated as illusory themselves. However, in practice, this second sentence will serve to disregard wholly genuine indemnity obligations. For example, regardless of whether the lack of a guarantee fee is any indication that a guarantee is not commercially reasonable, the lack of such a fee certainly has no bearing on the commercial reasonability or economic reality of an indemnity of such a guarantee. Even a guarantee’s failure of the net value requirement may not have any bearing on the economic reality of an indemnity of such a guarantee. While most indemnities are triggered by payments made by an indemnitee (which would not take place if the indemnitee were a guarantor with zero net value), other indemnities cover the liabilities incurred by the indemnitee in addition to payments made. However, as written, the second sentence of the seventh requirement would cause an indemnity to fail the seventh requirement regardless of which type of indemnity it is.

b. The Anti-Abuse Regulation

The Proposed Section 752 Regulations also modify the anti-abuse rule in Regulation section 1.752-2(j) to provide that a payment obligation will not be taken into account if the facts and circumstances indicate that the partnership liability is part of a plan or arrangement involving the use of tiered partnerships, intermediaries, or similar arrangements to convert a single liability into more than one liability with a principal purpose of circumventing the sixth and seventh recognition requirements.\(^50\) As with many of the other recognition requirements, loan structures involving mortgage and mezzanine financing are common in commercial, non-tax motivated transactions. To the extent that the sixth and seventh recognition requirements are maintained in final regulations, we recommend that several examples be included to illustrate under what circumstances a tiered partnership, intermediary or similar arrangement will be deemed to be used to convert a single liability into more than one liability for a principal purpose of circumventing the sixth and seventh recognition requirements.

\(^{50}\) Prop. Reg. § 1.752-2(j)(4).
c. Deficit Restoration Obligations

We are concerned that a DRO would be disregarded under the Proposed Section 752 Regulations. DROs are expressly permitted, and in some cases required, under the section 704(b) regulations and are commonly entered into by partners to the extent needed to support valid loss allocations.\(^{51}\) In addition, a partner may also enter into a DRO to defer the recognition of gain upon a contribution of property to a partnership subject to debt in excess of basis. This is particularly true when the debt will be refinanced into the partnership’s recourse line of credit. In such a case, a guarantee may not cause the guarantor to bear the economic risk of loss for the partnership’s liabilities because the general partner is generally considered to bear the economic risk of loss pursuant to the general partner’s state law obligations. This is often the case in the UPREIT context where a REIT is the general partner of an operating partnership. An UPREIT structure enables partners to contribute property to an operating partnership without triggering built-in gain while at the same time providing investment diversification and liquidity in the form of the ability later to convert operating partnership units into REIT stock in a taxable transaction. This structure is expressly blessed in the section 701 regulations, which state that “[s]ubchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. . . . The decision to organize and conduct business through [an UPREIT operating partnership] . . . is consistent with this intent.”\(^{52}\) Many operating partnerships finance their properties through general recourse lines of credit.

A DRO is unlikely to satisfy the seven recognition requirements. For example, under the section 704(b) regulations, a DRO must become due and payable by the later of the end of the taxable year in which the obligor partner’s partnership interest is liquidated or within 90 days of such liquidation. Therefore, the obligor partner’s DRO may become due and payable prior to the term of the partnership’s liability in violation of the third recognition requirement. In addition, we are unaware of a partnership ever paying a fee for a DRO from a partner. Accordingly, the fifth recognition requirement would not be satisfied. Finally, a DRO would likely fail the sixth recognition requirement. Consistent with the constructive liquidation test in the current section 752 regulations and the Proposed Section 752 Regulations, a DRO is structured to become due and payable in full upon a constructive liquidation of the partnership when the partnership’s assets are deemed worthless. In that case, a loss would be allocated to the obligor partner that would result in a negative capital account equal to the obligor’s full DRO. However, although the DRO would become fully due and payable upon such a constructive liquidation, the amount of the DRO that would become due and payable may not equal the shortfall in the repayment of a partnership liability to the extent the partnership’s assets have a value at least equal to tax basis. As a result, a DRO may fail the sixth recognition requirement. Therefore, the Proposed Section 752 Regulations would seem to disregard a DRO, notwithstanding that such an obligation is clearly contemplated under the section 704(b) regulations and is required in many cases to allow partners to

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\(^{51}\) Reg. § 1.704-1(b)(2)(ii)(b)(3).

\(^{52}\) Reg. § 1.701-2(d), Example 4.
contribute property to an UPREIT structure or other partnerships on a tax deferred basis consistent with the section 701 regulations. We believe it is inappropriate to disregard DROs under the section 752 regulations when they are a fundamental aspect of the section 704(b) regulations.

d. Acceleration of Gain

We understand that a major reason for imposing the seven recognition requirements is to end the ability of a partner to defer the recognition of a negative tax basis capital account.\(^53\) We note that many of the rules that have been promulgated over the last three decades have recognized the appropriateness of deferral of gain recognition in cases where there is real economic risk.\(^54\) It is true that all partners hope that a payment obligation will never become due and payable because the associated partnership liability will be satisfied by the economic success of partnership investments or business activities. To the extent that a partnership’s obligations are satisfied out of the proceeds of the partnership’s business, a partner will ultimately recognize income under section 704(c), the minimum gain chargeback, or some other general allocation. No income consequences will be escaped.

The recognition requirements in the Proposed Section 752 Regulations, particularly the sixth and seventh recognition requirements, would accelerate the recognition of income equal to a partner’s negative tax basis capital account in a manner that ignores the associated economic risk related to a payment obligation under the apparent perception that such economic risk is fictitious. Requiring a partner to recognize income attributable to a negative tax basis capital account despite the partner entering into a payment obligation that causes the partner to bear real economic risk of loss with respect to a partnership liability, as described above, has the effect of forcing a partner to recognize income before the partner receives the economic benefit of being relieved of the risk of loss associated with the partner’s guarantee or other potential payment obligation. We do not think this is appropriate.

\(^{53}\) A partner’s basis is increased by the amount of debt allocated to the partner. A partner’s basis (including basis attributable to debt) is reduced for losses and deductions that pass through to the partner and for distributions to the partner. Losses, deductions, and distributions that reduce the partner’s basis attributable to debt can drive a partner’s tax basis capital account below zero (negative tax capital). If the debt is then reallocated to another partner and away from the partner with negative tax capital, the deemed distribution under section 752(b) causes gain recognition to the extent it exceeds the partner’s remaining basis in the partnership. Many of the current rules under section 752 have been promulgated to avoid such debt allocation shifts.

\(^{54}\) See, e.g., Reg. § 1.752-1(f) (allowing netting of increases and decreases in liabilities); Rev. Rul. 79-205, 1979-2 C.B. 255 and Rev. Rul. 87-120, 1987-2 C.B. 161 (treating liability changes as occurring simultaneously in distributions of encumbered property and citing congressional intent to limit narrowly the area in which gain or loss is recognized upon a distribution so as to remove deterrents to property being moved in and out of partnerships as business reasons dictate. See S. Rep. No. 1622, 83rd Cong., 2nd Sess. page 96 (1954)); Rev. Rul. 94-4, 1994-1 C.B. 195 (deemed distribution of money under section 752(b) resulting from a decrease in a partner’s share of liabilities is treated as an advance or drawing of money under Reg. § 1.731-1(a)(1)(ii) to the extent of the partner’s distributive share of income for the taxable year).
We also note that so long as partners have basis for partnership recourse and nonrecourse liabilities, some partners will be able to protect the negative tax basis capital accounts that arise because of loss allocations and distributions. The difference that the Proposed Section 752 Regulations will make, by expanding the universe of obligations treated as nonrecourse, is to shift that protection from partners who share some economic risk of loss to those partners who have no economic risk of loss. We do not believe that this is an appropriate policy choice for the reasons discussed in this Comment.

e. The Right of Reimbursement from any Person

Currently, Regulation section 1.752-2(b)(1) provides that:

Except as otherwise provided in this section, a partner bears the economic risk of loss 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 and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner.

In addition, Regulation section 1.752-2(b)(5) provides that “[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.” The Proposed Section 752 Regulations modify Regulation section 1.752-2(b)(1) to treat a partner or related person as bearing the economic risk of loss for a partnership liability on account of a payment obligation to the extent that the partner or related person would not be entitled to reimbursement from another “person.” The Preamble to the Proposed Section 752 Regulations explains this modification by stating that Treasury and the Service concluded that a right to be reimbursed for a payment obligation by an unrelated person that effectively eliminates the partner’s payment risk should cause a payment obligation to be disregarded.

As an initial matter, we note that the Preamble to the Proposed Section 752 Regulations misstates the text of the current regulations. The Preamble paraphrases Regulation section 1.752-2(b)(1) as providing that a partner’s payment obligation is reduced by the amount of any reimbursement that the partner would be entitled to receive from “another partner, a person related to another partner, or the partnership.” [Emphasis added]. As noted above, neither Regulation section 1.752-2(b)(1) nor Regulation section 1.752-2(b)(5) reduces a partner’s payment obligation on account of a right to be reimbursed by the partnership. Disregarding a right to be reimbursed by the partnership is consistent with the constructive liquidation test set forth in Regulation section 1.752-2(b) and the “worst case” scenario, as outlined in Melvin,55 Abramson,56 and other cases, because, in such a liquidation, the regulations assume that all assets of

the partnership are worthless. Applying the constructive liquidation test, any right to be reimbursed by the partnership must also be deemed to be worthless and should not be taken into account as a reduction to a partner’s or related person’s payment obligation.\(^57\) A typical commercial guarantee of a partnership liability will entitle the guarantor to pursue its subrogation rights once the partnership liability has been satisfied. If these subrogation rights are taken into account to reduce a partner’s or related person’s payment obligation with respect to a guarantee of a partnership liability, the constructive liquidation test would be ignored and a commercial guarantee that provides subrogation rights to the guarantor could never be taken into account as a payment obligation. The Proposed Section 752 Regulations should be clarified to prevent a right to be reimbursed by the partnership from reducing a partner’s or related person’s payment obligation.

In addition, we are concerned that the Proposed Section 752 Regulations may cause a payment obligation of an entity that is funded with a capital contribution obligation or indemnification obligation from one or more of its owners to be disregarded. For example, if a corporate partner guarantees a partnership liability and one of the corporation’s shareholders has an obligation to make a capital contribution to fund or reimburse the corporation for any payments the corporation is obligated to make under the guarantee, the Proposed Section 752 Regulations could be read to disregard the guarantee. We do not believe that this is the intent of Proposed Regulation section 1.752-2(b)(1) and it would clearly be inconsistent with the net value requirements set forth in Proposed Regulation section 1.752-2(b)(3)(iii)(B). The net value requirements would take into account such a capital contribution obligation as increasing the net value of the corporate guarantor.

**f. Expansion of Net Value Requirement**

The Proposed Section 752 Regulations turn off the presumption that partners and related persons (other than individuals and estates) will satisfy their payment obligations and propose to adopt the rules included in Regulation section 1.752-2(k) (the “Net Value Regulations”) for partners and related persons. A “payment obligation” is an obligation that is recognized under Regulation section 1.752-2(k)(1). Under the Net Value Regulations, a disregarded entity’s payment obligation is recognized only to the extent of the partner’s or related person’s net value as of the Allocation Date.\(^58\)

The Net Value Regulations were finalized in 2006 and apply in very limited situations. Treasury and the Service explained that they were aware that, in certain circumstances, the regulations allowed taxpayers to choose whether a payment obligation would be respected (by using a regarded obligor) or ignored (by using a disregarded

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\(^57\) See, e.g., Reg. § 1.752-2(f), Example (5), which illustrates that under the current regulations a guarantor’s right of subrogation to the partnership is ignored for purposes of determining whether the partnership liability is recourse or nonrecourse.

\(^58\) “Allocation Date” is defined in Reg. § 1.752-2(k)(2)(iv) as the earlier of – (A) the first date occurring on or after the date on which the requirement to determine the net value of a disregarded entity arises under §1.752-2(k)(2)(ii)(A) or (B) on which the partnership otherwise determines a partner’s share of partnership liabilities under §§ 1.705-1(a) and 1.752-4(d); or (B) the end of the partnership’s taxable year in which the requirement to determine the net value of a disregarded entity arises under § 1.752-2(k)(2)(ii)(A) or (B).
Nevertheless, the rules were clear and, at that time, Treasury and the Service noted that further study was warranted before a similar rule was proposed to be applied to regarded partners and related persons.

Since that time, in our experience, taxpayers have often avoided the Net Value Regulations (by using only regarded partners) or have applied them only when the disregarded entity has minimal or no assets. We believe that the reason is clear: the regulations are complex and difficult to apply. Thus, while the Net Value Regulations may have achieved the narrow objective of dissuading taxpayers from using a disregarded entity to avoid payment obligations that are recognized under Regulation section 1.752-2(b)(1), use of the same approach across the wide spectrum of business enterprises conducted in partnership form would impose a significant burden on business operations without achieving the objective of assuring that the obligor is capable of satisfying a payment obligation.

It is worth noting that the Net Value Regulations do not purport to measure accurately the net value that may be available for a payment obligation. Because of the complexities associated with quantifying the resources available to creditors, the Net Value Regulations attempt to simplify the calculation. For example, where one entity is a partner in two partnerships, the same value is allowed to be used to measure net value for separate payment obligations to each partnership -- despite the fact that, if the entity satisfied its obligations with respect to one partnership, the assets would not be available to satisfy the obligations with respect to the other partnership. See Regulation section 1.752-2(k)(6), Example 4. In addition, the Allocation Dates are generally limited to times when the partnership is otherwise required to determine a partner’s share of partnership liabilities, or the end of the year, despite the fact that value can change considerably between the time of the “valuation event” and the “allocation date.”

If the regulations are broadened to apply generally to taxpayers, it is consistent with the current approach to simplify the valuation further (as suggested below) in order to make the rules administrable as applied to the broader class of partners.

In addition, the Valuation Events in the Net Value Regulations are not always events where the affected parties would naturally have adverse interests in terms of the

59 See Reg. § 1.752-2(k)(2).

60 “Valuation Events” are identified in Reg. § 1.752-2(k)(2)(iii) as:

(A) A more than de minimis contribution to a disregarded entity of property other than property pledged to secure a partnership liability under paragraph (h)(1) of this section, unless the contribution is followed immediately by a contribution of equal net value by the disregarded entity to the partnership for which the net value of the disregarded entity otherwise would be determined, taking into account any obligations assumed or taken subject to in connection with such contributions.

(B) A more than de minimis distribution from a disregarded entity of property other than property pledged to secure a partnership liability under paragraph (h)(1) of this section, unless the distribution immediately follows a distribution of equal net value to the disregarded entity by the partnership for which the net value of the disregarded entity otherwise would be determined, taking into account any obligations assumed or taken subject to in connection with such distributions.

(C) A change in the legally enforceable obligation of the owner of the disregarded entity to make contributions to the disregarded entity.
valuation and could be manipulated. Under the section 704(b) regulations, valuations are either under GAAP principles or are limited to situations where the partners should naturally police the valuation. For example, if a partner contributes property to an existing partnership, it is in the historic partners’ interest to ascertain the correct value of the interest transferred to the contributing partner because, as the value increases, the value retained by the historic partners decreases. Similar considerations attend distributions in liquidation of a partnership and issuance of an interest for services. In contrast, certain of the Valuation Events are entirely within the control of the entity being valued and there is no competing interest to police the value or the triggering of a Valuation Event. In the case of a disregarded entity that has a payment obligation to the partnership, the effect of this potential for manipulation is limited. If the rules requiring net value are extended to all partners in partnerships, then the attempt to achieve more realistic substance would be accompanied by a corresponding increase in the potential for manipulation.

Because of their administrative complexity, as well as the ability of taxpayers to manipulate the rules in ways that may lead to inappropriate results, we recommend that the Net Value Regulations not be extended as proposed in the Proposed Section 752 Regulations. If Treasury and the Service determine to extend the Net Value Regulations despite these issues, however, we recommend that any extension of the Net Value Regulations should apply only in the context of disguised sales of property to the partnership (and vice versa) where money is distributed to the contributing partner or the distributing partnership, as discussed below. Moreover, if the Net Value Regulations are extended, we recommend that the rules be included in one provision, rather than maintained as a regulation applicable to disregarded entities and a second regulation applicable to regarded entities.

We recommend that the regulations be significantly simplified. The regulations should provide that, with respect to both regarded and disregarded entities, no appraisal is required and that the partnership may rely on the written representation of a partner that the partner’s net value is at least equal to the amount of the payment obligation on any allocation date, unless the partnership has reason to know that the representation is not correct. As an administrative backstop, we recommend that, if the Service determines on audit that the net value of an entity with a payment obligation was insufficient to satisfy the payment obligation undertaken, the liability will be reallocated and reclassified as appropriate, with the tax consequences that follow. Under these circumstances, all of the parties to the transaction are exposed to a reallocation risk if a partner’s or related person’s representations are not correct.

(D) The incurrence, refinancing, or assumption of an obligation of the disregarded entity that does not constitute a § 1.752-2(b)(1) payment obligation of the disregarded entity.

(E) The sale or exchange of a non-de minimis asset of the disregarded entity (in a transaction that is not in the ordinary course of business). In this case, the net value of the disregarded entity may be adjusted only to reflect the difference, if any between the fair market value of the asset at the time of the sale or exchange and the fair market value of the asset when the net value of the disregarded entity was last determined. The adjusted net value is taken into account for purposes of § 1.752-2(k)(1) as of the allocation date.
g. Transition Rules

The Proposed Section 752 Regulations provide that they will apply prospectively to liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken on or after the date final regulations are published, other than liabilities incurred or assumed and payment obligations imposed or undertaken pursuant to a written binding contract. The extent to which the “written binding contract” exception applies to the Proposed Section 752 Regulations is not clear. For example, would an obligation entered into prior to the effective date of the regulations that provides that it may be extended at the option of the obligor, or that automatically renews for specified periods subject to the right of the obligor to terminate the obligation prior to a renewal, be excepted from the application of the final regulations for the entire extended term of the obligation? Would a springing guarantee entered into prior to the effective date of the final regulations pursuant to which an obligor has a right to guarantee a partnership liability in the future be subject to the final regulations? We believe that neither of these obligations should be subject to the final regulations because they were imposed or undertaken pursuant to a written binding contract entered into prior to the effective date of the Proposed Section 752 Regulations. Moreover, if a partner entered into a long-term tax-protection agreement allowing the contributing partner to guarantee partnership debt to cover an existing negative capital account, those agreements should be respected throughout their term regardless of whether a liability is refinanced. To the extent that the Proposed Section 752 Regulations are finalized, we recommend that these results be clarified with examples.

The Proposed Section 752 Regulations also provide for a seven-year transition rule during which the partnership may elect not to apply the existing regulations to a partnership liability to the extent a partner’s (a “Transition Partner”) share of partnership recourse liabilities prior to the effective date of the Proposed Section 752 Regulations exceeds the Transition Partner’s adjusted basis in the partnership as determined under Regulation section 1.705-1 at such time (the “Grandfathered Amount”). However, if the Transition Partner is a partnership, S corporation, or disregarded entity, the partner will cease to be a Transition Partner if the direct or indirect ownership of the Transition Partner changes by more than 50 percent. We are concerned that Transition Partner status may terminate with respect to an indirect partner in the partnership even if neither the partnership liability nor the indirect partner’s payment obligation has changed. For example, assume the AB partnership is a Transition Partner with respect to the CD partnership and A is a 40% partner in the AB partnership and has guaranteed a CD partnership liability. Accordingly, the CD partnership liability would be treated as a recourse partnership liability allocable to the AB partnership, and such allocated liability would be treated as a recourse partnership liability of the AB partnership allocable to A. If B sells B’s 60% interest in the AB partnership, the AB partnership’s status as a Transition Partner would terminate notwithstanding that A continues to guarantee the CD partnership liability. To the extent the Proposed Section 752 Regulations are finalized,

we recommend that the transition rule be modified to prevent such a termination of Transition Partner status.

II. PARTNERSHIP NONRE COURSE LIABILITIES

In addition to the proposed changes to the partnership recourse debt allocation regulations, the Proposed Section 752 Regulations would also significantly alter the manner in which partnership “excess nonrecourse liabilities” are allocated among partners under Regulation section 1.752-3(a)(3).

The Proposed Section 752 Regulations retain the general rule that such excess nonrecourse liabilities are to be allocated to the partners in accordance with their interests in the partnership’s profits and that a partner’s share of a partnership’s profits is determined by taking into account all facts and circumstances related to the economic arrangement of the partners.

The theory underlying the general rule regarding allocation of nonrecourse liabilities in accordance with profit shares is that, because no partner would be required to pay a partnership nonrecourse liability if the partnership is unable to do so, the source of any repayment for the partnership liability would be out of the partnership’s profits. The current regulations recognize that, in all but the most straightforward partnership agreements, determining a partner’s exact share of partnership profits can be a difficult, if not impossible, undertaking. For example, in a partnership that distributes operating cash flow or capital proceeds to pay one or more partners a preferred return on capital contributions with the balance to be distributed in accordance with each partner’s percentage of capital contributions made to the partnership, the determination of each partner’s share of partnership profits will depend on the timing and amount of available distributions. In recognition of the difficulty of determining a partner’s share of profits, the current regulations provide three safe harbors for allocating partnership excess nonrecourse liabilities that correspond to the allocation of items of income or gain that will be made to partners. These safe harbors provide certainty to partnerships that their allocation of partnership nonrecourse liabilities will be respected and administrable by the Service. At the same time, the safe harbors provide flexibility to allocate liabilities in a manner that will allow losses validly allocated to partners under section 704(b) to be recognized and prevent the recognition of gain due to a decrease in a partner’s share of liabilities.

We note that the allocation of partnership nonrecourse liabilities under Regulation sections 1.752-3(a)(1) and (2) are designed to ensure that a partner has sufficient tax basis to enable the partner to recognize allocations of nonrecourse deductions under section 704(d) and to prevent the recognition of built-in gain by a partner upon the contribution of property with nonrecourse debt in excess of the partner’s basis in the property. We believe that the flexibility afforded to partners in the determination of the allocation of partnership excess nonrecourse liabilities should be consistent with these provisions.

As noted in the Preamble, the current regulations provide that the partnership agreement may specify the partner’s interest in partnership profits for purposes of
allocating excess nonrecourse liabilities provided the interest so specified is reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some significant item of partnership income or gain (the “Significant Item Method”). Alternatively, the current regulations provide that excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated (the “Alternative Method”). Additionally, the partnership may first allocate excess nonrecourse liabilities to a partner up to the amount of built-in gain that is allocable to the partner with respect to section 704(c) property or property for which reverse section 704(c) allocations are applicable by virtue of a book-up (as described in Regulation section 1.704-3(a)(6)(i)) where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the amount of gain taken into account under the second tier of nonrecourse debt allocations with respect to such property (the “Excess Section 704(c) Method”).

While we agree with the position taken in the Proposed Section 752 Regulations to allow partnerships to determine a partner’s interest in profits by any reasonable method under Regulation section 1.752-3(a)(3), we have concerns about the changes proposed and the liquidation value percentage safe harbor.

A. Liquidation Value Percentages

The Proposed Section 752 Regulations retain the Excess Section 704(c) Method, but would eliminate the Significant Item Method and the Alternative Method. Instead, the Proposed Section 752 Regulations allow a partnership to allocate excess nonrecourse liabilities based on the partners’ “liquidation value percentages.” A partner’s liquidation value percentage is the ratio (expressed as a percentage) of the liquidation value of the partner’s interest in the partnership divided by the aggregate liquidation value of all of the partner’s interests in the partnership. A partner’s liquidation value percentage must be determined upon formation of the partnership and is required to be redetermined whenever a revaluation event occurs, as set forth in Regulation section 1.704-1(b)(2)(iv)(f)(5) (e.g., a disproportionate capital contribution or distribution). The redetermination of the partners’ liquidation value percentages must occur regardless of whether the partnership actually revalues its assets. The liquidation value of a partner’s interest in a partnership is the amount of cash the partner would receive with respect to the interest if, immediately after the formation of the partnership or the occurrence of a section 704(b) revaluation event, the partnership sold all of its assets for cash equal to the fair market value of such assets (taking into account section 7701(g)), satisfied all of its liabilities (other than those described in Regulation section 1.752-7), paid an unrelated third party to assume all of its Regulation section 1.752-7 liabilities in a fully taxable transaction, and then liquidated. A partner’s liquidation value percentage is thus equal to the partner’s interest in partnership capital in this deemed liquidation.

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64 Id.
65 Prop. Reg. § 1.752-3(a)(3).
66 Id.
We agree with the decision to retain the Excess Section 704(c) Method. This method for allocating partnership excess nonrecourse liabilities may defer the recognition of a partner’s built-in gain with respect to property contributed to a partnership when there has been no realization event with respect to the contributed property, but the amortization of the nonrecourse debt reduces the amount of nonrecourse debt allocable to the contributing partner under Regulation section 1.752-3(a)(2). This is consistent with the purposes of Regulation section 1.752-3(a)(2). We disagree, however, with the decision to remove the Significant Item Method and the Alternative Method.

According to the Preamble,

[the IRS and the Treasury Department believe that the allocation of excess nonrecourse liabilities in accordance with the significant item method and the alternative method may not properly reflect a partner’s share of partnership profits that are generally used to repay such liabilities because the allocation of the significant item may not necessarily reflect the overall economic arrangement of the partners].

This statement is inconsistent with the general rule that partnership nonrecourse liabilities are to be allocated in accordance with the partners’ share of profits. If the general rule is going to be retained under the theory that partnership profits will be the source of repayment for the liability, then the safe harbor methods for making this determination should in fact reflect the partner’s potential share of the partnership’s profits. In all but the simplest of partnerships, the partners’ liquidation value percentages may have little or no relationship to the partners’ shares of profits. Therefore, allocating excess nonrecourse liabilities in accordance with the partners’ liquidation value percentages is inconsistent with the theory underlying the general rule for allocating partnership excess nonrecourse liabilities. In addition, allocating partnership excess nonrecourse liabilities in accordance with the partners’ liquidation value percentages may prevent partners from recognizing valid allocations of losses under the section 704(b) regulations. For example, a service partner that has a share of profits and losses that is higher than the partner’s share of capital contributions may be subject to the section 704(d) limitation on recognizing a loss allocation because the partner will be allocated a smaller share of excess nonrecourse liabilities based on the partner’s liquidation value percentage. This would be the case even if the service partner has entered into a DRO to support the loss allocation as required under Regulation section 1.704-1(b)(2)(ii)(b)(3).

In addition, the section 704(b) regulations permit a partnership to allocate partnership nonrecourse deductions in a manner that is not consistent with the partners’ liquidation value percentages. The allocation of partnership excess nonrecourse liabilities in accordance with the partners’ liquidation value percentages instead of the Alternative Method will result in unnecessary shifts in the allocation of such liabilities as partnership minimum gain increases and liabilities are allocated under Regulation section 1.752-3(a)(1) (in accordance with the partner’s share of partnership minimum gain) instead of Regulation section 1.752-3(a)(3). We are also concerned that, by eliminating

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68 The partner’s share of partnership minimum gain equals (i) the sum of nonrecourse deductions allocated to that partner (and to that partner’s predecessors in interest) up to that time and the distributions made to
the Significant Item Method and the Alternative Method, the Proposed Section 752 Regulations would compel many partnerships to allocate excess nonrecourse liabilities pursuant to the new liquidation value safe harbor to avoid the uncertainty of determining whether some other allocation would satisfy the general “facts and circumstances” method of allocating such liabilities. This would impose an additional burden on partnerships because they must engage in a revaluation of the partnership’s assets in order to determine the partners’ liquidation value percentages even when the revaluation is not required by the section 704(b) regulations. This is a particularly compelling concern in light of the proposed changes to Regulation section 1.752-2, which are generally designed to cause more partnership liabilities to be treated as nonrecourse liabilities.

We understand that a primary motivation for modifying the allocation of partnership excess nonrecourse liabilities was to eliminate the ability to avoid a partnership disguised sale under section 707(a)(2)(b) in connection with a distribution of proceeds of partnership nonrecourse debt and the application of the Significant Item Method to allocate the partnership debt entirely to the distributee partner in accordance with a preferred return allocation. We note that the Service has taken the position that such an application of the Significant Item Method is not permissible.\(^69\) To the extent the motivation for changing the allocation of partnership excess nonrecourse liabilities was to prevent such a structure, this could be achieved by simply changing the manner in which the allocation of partnership nonrecourse debt is taken into account for purposes of the debt-financed distribution exception to the disguised sale rules. Treasury and the Service have previously taken this approach with respect to the allocation of nonrecourse partnership liabilities by modifying the allocation of such liabilities solely for purposes of section 707.\(^70\) Such a change to the section 707 regulations would address the Service’s and Treasury’s concerns with the application of the Significant Item Method and would not adversely impact the flexibility of the current rules.

Nevertheless, if Treasury and the Service decide to retain the liquidation value percentage safe harbor in the final regulations under section 752, we recommend that partnerships be allowed, but not required, to redetermine liquidation values at the end of a partnership tax year, unless a revaluation event occurs under section 704(b). The

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\(^69\) See CCA 200513022 (April 1, 2005).

\(^70\) Reg. § 1.707-5(a)(2)(ii) provides that a partner’s allocable share of a partnership nonrecourse liability for purposes of the partnership disguised sale rules is determined by solely applying the allocation rules applicable to excess nonrecourse liabilities under Reg. § 1.752-3(a)(3). The allocation of partnership nonrecourse liabilities under Reg. § 1.752-3(a)(1) and (2) is disregarded for this purpose. In addition, the allocation of excess nonrecourse liabilities is modified for purposes of the partnership disguised sale rules by disregarding any allocation of excess nonrecourse liabilities on account of built-in gain that is allocable to a partner under section 704(c). Reg. § 1.752-3(a)(3).
revaluation events under section 704(b) are limited to transactions in which the partners would naturally have an interest in and tools for accurately valuing the partnership. Nevertheless, if the partnership has the ability to redetermine the value of its capital (perhaps because certain of its assets have been sold or there has been a refinancing), allowing such a partnership to redetermine liquidation values for purposes of the safe harbor seems appropriate.

B. Exculpatory Liabilities

If adopted without significant change, the Proposed Regulations will result in substantially more debt being characterized as nonrecourse debt for purposes of section 752. In particular, more so-called exculpatory liabilities will be characterized as nonrecourse partnership debt. While the lack of guidance relating to exculpatory liabilities has caused uncertainty in the past, that uncertainty will be exacerbated if the Proposed Regulations are finalized as currently written. Guidance on the proper treatment of exculpatory liabilities under section 704 will become even more important.

Exculpatory liabilities are debts that are recourse to an entity (such as a limited liability company or a limited liability partnership), but are treated as nonrecourse debt under the current section 752 regulations because no partner bears the “economic risk of loss.” As stated in T.D. 8385, the final regulations relating to partnership nonrecourse liabilities that were adopted in 1991:

A partnership may have a liability that is not secured by any specific property and that is recourse to the partnership as an entity, but explicitly not recourse to any partner (exculpatory liability). Section 1.704-2(b)(3) of the final regulations defines nonrecourse liability by referring to the definition of nonrecourse liability in the regulations under section 752. Under that definition, an exculpatory liability is a nonrecourse liability. The application of the nonrecourse debt rules of §1.704-2—more specifically, the calculation of minimum gain—may be difficult in the case of an exculpatory liability, however, because the liability is not secured by specific property and the bases of partnership properties that can be reached by the lender in the case of an exculpatory liability may fluctuate greatly. Section 1.704-2 does not prescribe precise rules addressing the allocation of income and loss attributable to exculpatory liabilities. Taxpayers, therefore, are left to treat allocations attributable to these liabilities in a manner that reasonably reflects the principles of section 704(b). Commentators have requested that the treatment of allocations attributable to exculpatory liabilities under the nonrecourse debt rules be clarified. The Service and the Treasury solicit further suggestions on the appropriate treatment of allocations attributable to these liabilities. Suggestions should take into account the practical concerns of partnerships as well as the Service's concerns about the proper allocation of loss and gain items attributable to these liabilities.
The uncertainties relating to exculpatory liabilities include the following:

1. **Application of Nonrecourse Debt Rules to Exculpatory Liabilities**

   Commentators have taken different positions on the question of whether the regulations under Regulation section 1.704-2 (the “Nonrecourse Liability Regulations”) apply to exculpatory liabilities.\(^{71}\)

   We believe that it is preferable to treat exculpatory liabilities as nonrecourse liabilities and to apply the Nonrecourse Liability Regulations to the arrangement. Regulation section 1.704-2(b)(3) appears to include liabilities as defined in Regulation section 1.752-1(a)(2) as a liability that is subject to the regulations. The definition of a nonrecourse liability under Regulation section 1.752-1(a)(2) includes exculpatory liabilities to the extent no partner or a related person has an obligation to satisfy the liabilities or otherwise bears economic risk of loss for the liability. In this connection, we recommend that the language of Temporary Regulation section 1.752-1T(d)(3)(ii)(B)(4)(ii), which was omitted when the original temporary section 752 regulations were finalized in 1991, be reinstated in order to clarify the role of exculpatory liabilities in the constructive liquidation test. That provision read:

   For example, if an entity that is treated as a partnership for federal income tax purposes is organized and operated under a local law which provides that none of the members of that entity is liable for its debts and other obligations, then all the liabilities of that entity will generally constitute liabilities for which the creditor's right to repayment is limited to one or more assets of the partnership because the members of that entity are not required to make contributions to the entity to discharge its liabilities.

   In contrast to Regulation section 1.704-2(b)(3), Regulation section 1.704-2(b)(4) defines a partner nonrecourse liability as “a partnership liability to the extent the liability is non-recourse for purposes of § 1.1001-2 and a partner or related party (within the meaning of § 1.752-4(b)) bears the economic risk of loss because, for example, the partner is the creditor or guarantor.” In the case of a limited liability company member’s loan that is recourse to the limited liability company, it is unclear whether the separate regime under Regulation section 1.704-2(i) applies because the debt is not “nonrecourse for purposes of § 1.1001-2.”

   Guidance on which portions of the Nonrecourse Liability Regulations apply to exculpatory liabilities would be helpful, particularly in light of the increase in partnership liabilities that would be treated as partnership nonrecourse liabilities under the Proposed Section 752 Regulations if finalized in their current form.

2. **Calculation of Minimum Gain**

   Assuming the Nonrecourse Liability Regulations apply to exculpatory liabilities, including those liabilities arising from a partner loan that is recourse to the entity.

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guidance should be provided on the proper calculation of minimum gain to reduce the uncertainty and ambiguity that currently exists.

The classification of recourse liabilities of an entity that provides its owners with limited liability and is treated as a partnership (a “limited liability entity”) differs under section 1001 and section 752. For purposes of section 1001, if the borrower is personally liable on the debt, the debt is treated as recourse (“section 1001 recourse”). In contrast, debt is nonrecourse under section 1001 (“section 1001 nonrecourse”) if the lender’s recourse is limited solely to certain assets that are pledged to secure the debt. The classification of the borrower as an individual, a corporation or a partnership is not relevant to the classification of the debt under section 1001. The treatment of the discharge of section 1001 recourse and section 1001 nonrecourse debt is distinctly different. Under *Tufts*, if the property securing section 1001 nonrecourse debt is transferred to the creditor in satisfaction of the debt, the property is treated as sold or exchanged and the amount realized is the full amount of the outstanding debt (regardless of the fair market value of the collateral). In contrast, if property securing section 1001 recourse debt is transferred to the creditor in satisfaction of the debt and the creditor cancels any remaining obligation on the debt, the borrower recognizes gain or loss on disposition of the property for its fair market value and cancellation of indebtedness income (“COD income”) for the balance of the discharged debt. If the balance of the section 1001 recourse debt is not discharged, then no COD income is recognized until discharge.

In contrast, if the borrower is a partnership, the regulations under section 752 classify partnership liabilities as recourse (“section 752 recourse”) if a partner or a related person has economic risk of loss for the liability, and nonrecourse (“section 752 nonrecourse”) if no partner or related person has the economic risk of loss. In order to determine economic risk of loss, the “worst case scenario” analysis is applied.

As the Preamble to the Nonrecourse Liability Regulations indicates, the regulations were not crafted with exculpatory liabilities in mind. Rather, partnership minimum gain is calculated as though foreclosure would trigger gain equal to the amount of the liability (*Tufts* gain). The calculation is awkward in the case of exculpatory liabilities, however, because the gain recognized on foreclosure of recourse debt is limited to the fair market value of the asset transferred to the creditor. Only if COD income is also triggered is the full amount of *Tufts* gain realized. Despite this technical glitch, the calculation can be done if (and we recommend guidance be issued confirming that), assuming all of the assets in the entity are subject to the exculpatory liability in a

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72 Reg. § 1.1001-2.
75 See, e.g., *Aizawa v. Commissioner*, 99 T.C. 197 (1992) where the taxpayer recognized a loss on the deemed disposition of the property securing the debt and no COD income because the debt was not cancelled.
76 Reg. § 1.704-2(d)(1) provides that the amount of partnership minimum gain is determined by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability....
kind of “floating lien,” minimum gain is calculated on an aggregate basis. Thus, minimum gain and nonrecourse deductions arise as total section 704(b) book basis of the assets (excluding assets pledged to specific liabilities) decreases below the total amount of the exculpatory liability.

3. Deferral of the Minimum Gain Chargeback

A consequence of the “floating lien” approach to exculpatory liabilities is that the minimum gain chargeback may be significantly deferred. Regulation section 1.704-2(f) provides that, if there is a net decrease in partnership minimum gain for a taxable year, the minimum gain chargeback requirement applies and each partner must be allocated items of partnership income and gain for that year equal to that partner’s share of the net decrease in partnership minimum gain.

Where there is a traditional section 1001 nonrecourse debt, the minimum gain chargeback generally occurs at the time the property is sold or the debt is otherwise satisfied.77 In contrast, in the case of an exculpatory liability, if one partnership asset is sold, the liability is included in the amount realized only if the transferee agrees to pay the liability. Moreover, no minimum gain chargeback is likely to occur until overall partnership minimum gain is decreased. In fact, a minimum gain chargeback with respect to exculpatory liabilities may be deferred until the partnership disposes of all of its assets, repays the debt, and liquidates.

Given the creditor’s access to all of the assets of the entity, such deferral may be appropriate. However, consideration should be given to whether there are situations in which the timing of the recovery of nonrecourse deductions may be inappropriately delayed. If the Proposed Section 752 Regulations are finalized in substantially the same form as proposed, considerably more exculpatory liabilities will be treated as nonrecourse debt, potentially resulting in considerably more delay in gain recognition with respect to partnership debt.

III. DETAILED COMMENTS ON PROPOSED SECTION 707 REGULATIONS

We generally agree with the provisions of the Proposed Section 707 Regulations and make selected suggestions as follows.

A. Debt-Financed Distributions.

We agree with the approach in the Proposed Regulations that the debt-financed distribution exception should apply before other exceptions from disguised sale treatment. We found the example added by the Proposed Regulations regarding the treatment of multiple liabilities as a single liability for purposes of applying the debt-financed distribution rule to be helpful.

77 Reg. §§ 1.1001-2(a)(1) and -2(a)(4)(i).
B. Preformation Capital Expenditures

We agree with the approach in the Proposed Regulations that the 20 percent fair market value limitation on reimbursable capital expenditures and the exception to the limitation should be applied on a property-by-property basis. However, we ask that Treasury and the Service provide examples of what is meant by “property” in this context. Clearly, some aggregation of assets is permissible and examples or references to other regulatory provisions (such as the Unicap or ITC rules) where similar concerns are addressed would serve to illustrate the rule.

We agree with the approach in the Proposed Regulations that the term “capital expenditures” should have the same meaning in the disguised sale context as it does in the Code and applicable regulations. We further agree that the term should include capital expenditures that taxpayers elect to deduct and should not include deductible expenses taxpayers elect to treat as capital expenditures.

We agree with the approach in the Proposed Regulations that the application of the capital expenditure qualified liability rule should be integrated with the capital expenditure reimbursement rule, which should help eliminate the perceived potential for abuse when the rules are applied independently.

C. Qualified Liabilities in a Trade or Business

We agree with the addition in the Proposed Regulations of a fifth category of qualified liability that includes any liability incurred in connection with the conduct of a trade or business, provided that it was not incurred in anticipation of the transfer and all of the assets material to the that trade or business are transferred to the partnership. That addition fills a significant gap in the definition of a qualified liability under the existing regulations. We further believe that it is appropriate to require disclosure to the Service of any such qualified liability if it was incurred within two years prior to the transfer of assets to the partnership.

D. Determination of Partner’s Share of Partnership Liabilities

We agree with the definitional changes to Regulation section 1.707-5(a)(2) in the Proposed Regulations, which effectively exclude contingent liabilities and other obligations that have not yet matured into a liability that is described under either Regulation section 1.752-1(a)(1) or (2) from consideration in determining a partner’s share of partnership liabilities for purposes of applying the disguised sale regulations. Nevertheless, because this could be viewed as a change that simply conforms the definition in the disguised sale regulations to the definition under section 752, we ask that Treasury and the Service clarify the manner in which contingent liabilities are taken into account, if at all, for purposes of the disguised sales regulations.

E. Anticipated Reduction in Liabilities

We agree with the change in the Proposed Regulations that provides that a reduction of a partner’s share of a liability that is subject to entrepreneurial risks of
partnership operations should not be treated as an anticipated reduction in that liability that must be taken into account in determining the partner’s share of a liability assumed or taken subject to by a partnership. However, we recommend that the Net Value Regulations not be expanded in their present form beyond the scope of disregarded entities. Rather, we have recommended significant simplification of the Net Value Regulations. While we understand the government’s concern about perceived cases of abuse, we think that this is more appropriately addressed through the expansion of the anti-abuse provisions of the regulations. We recommend adding examples to the anti-abuse regulations to illustrate areas of concern.

F. Tiered Partnerships

We agree with the clarification in the Proposed Regulations that the debt-financed distribution exception applies in a tiered partnership context. We also agree with the rules set forth in the Proposed Regulations regarding the characterization of liabilities attributable to the contribution of a partnership interest to another partnership. While these rules are helpful and appropriate, given the complexities raised by tiered partnership structures, we believe that examples illustrating the application of these tiered partnership rules would be very helpful.

In addition, we believe that there are additional situations involving tiered partnerships that would benefit from clarification. Specifically, the existing regulations and the Proposed Regulations are silent regarding the reimbursement of preformation capital expenditures within certain tiered partnership structures. For example, the rules do not address a situation in which (1) a partner incurs a capital expenditure with respect to property, (2) the partner contributes that property to an upper-tier partnership (UTP), (3) at some point thereafter, the UTP further contributes the property with the capital expenditure to a lower-tier partnership (LTP), and (4) proceeds from the LTP are used to reimburse the partner who incurred the capital expenditures (the “incurring partner”) and contributed the property to the UTP. In this situation, although that partner incurred the capital expenditure with regard to property contributed to the UTP, the UTP did not, itself, incur the capital expenditure with respect to the property contributed to the LTP. Consequently, the existing regulations technically do not address the first distribution made by the LTP to the UTP.

This situation involving tiered partnerships commonly arises in typical commercial arrangements. For example, a large real estate partnership may (1) receive a contribution of assets that are the subject of preformation capital expenditures and (2) wish to introduce a partner with respect to those assets in order to equity finance a portion of the economic burden related to reimbursing the preformation capital expenditures. In this situation, the owner of the asset that is the subject of the preformation capital expenditures will contribute the assets to the UTP, and that UTP will then contribute those assets to a LTP into which the new partner will be introduced. If the new partner had been admitted to the UTP, the proceeds contributed could be distributed to the property contributor as a reimbursement of preformation capital expenditures. The new partner, however, could not easily isolate its economic participation solely to the contributed assets without the formation of the LTP that holds solely those assets. There
seems to be no policy reason for creating a disguised sale in this situation by denying qualification for the preformation expenditure exception in the distribution by the LTP to the UTP.

Other situations exist where, for valid business reasons, all assets are held through a pre-existing tiered partnership structure. If a property-owner wishes to contribute assets that will be used in a business held in an isolated LTP but wishes to participate economically in all of the businesses operated under the UTP, it must contribute the assets to the UTP (so as to obtain an equity interest that participates in all of the businesses). Because the LTP will be the ultimate recipient of the assets, it often makes sense for the LTP (and indirectly the partner in the lower-tier partnership) to bear the cost of any reimbursement to the property contributor. Again, in this situation, there seem to be good policy reasons for applying the preformation capital expenditure exception at both levels of the tiered structure.

The current rules also do not address a situation in which a partner incurs a capital expenditure with respect to property, contributes that property to a partnership (LTP), then contributes its interest in LTP to another partnership (UTP), and the incurring partner, in a related transaction, receives a distribution as reimbursement from UTP. In that situation, it often will be the case that the distribution is attributable to a reimbursement from LTP to UTP that properly should flow up to the incurring partner.

There seem to be two technical issues that arise in this situation. First, the incurring partner did not contribute the property that is the subject of the capital expenditure to UTP. Also, as in the situation described above, UTP receives an initial reimbursement from LTP, but UTP itself did not incur the capital expenditure, but rather succeeded to it. This situation may arise when a party purchases a property as part of a plan to enter into a joint venture and receive a reimbursement for the purchased property prior to determining the most appropriate holding structure within its organizational structure and subsequently moves the interest after the contribution of the property to the partnership.

The stated purpose of the exception for preformation capital expenditures is to permit a partnership to reimburse a contributing partner for expenditures incurred with respect to contributed property.\textsuperscript{78} In both of the situations above, a partner is incurring expenditures with respect to contributed property, but it is a subsequent transfer of such contributed property within a tiered structure that raises a question as to the application of the exception. We believe that subsequent transfers within a tiered partnership structure described in the two situations above do not alter the circumstances under which the expenditure was incurred. As stated in Revenue Ruling 2000-44:

The rules regarding preformation expenses and qualified liabilities contained in the disguised sale regulations recognize that certain expenditures will be incurred, under circumstances that do not violate the disguised sale rules. Where a corporation incurs preformation expenses or undertakes a borrowing and another corporation acquires assets of the corporation in a §381 transaction, the transfer does not alter the circumstances

\textsuperscript{78} 79 Fed. Reg. 4826.
under which the expenditures or indebtedness were originally incurred or otherwise raise concerns that would justify not treating the transferee corporation as having incurred the expenditures or undertaken the liabilities at the time they were incurred or undertaken by the predecessor corporation.79

Although the situations described above are not equivalent to section 381 transactions, the subsequent transfer in such cases does not alter the circumstances under which the expenditures were incurred. In both of the situations above, a partner incurred expenses with respect to contributed property. Note that the two situations above are analogous to the two situations described in Regulation section 1.704-3(a)(9) with respect to section 704(c) contributed property in which the upper-tier partnership must allocate its distributive share of lower-tier partnership items with respect to that section 704(c) property in a manner that takes into account the contributing partner’s remaining built-in gain or loss.

We recognize that a rule extending the preformation expenditure reimbursement exception to such tiered situations would need to be carefully tailored to ensure that the reimbursement ultimately would be made to the partner or partners that actually contributed the capital expenditure, and that no undue benefit results relating to the time between incurring the expenditure and the contribution to the lower-tier partnership. 80 We think that such a rule could be crafted in an administrable manner and, properly drafted, would represent a natural extension of the purpose of the preformation reimbursement exception without creating undue benefit or potential for abuse.

G. Treatment of Liabilities in Assets-Over Merger

We agree with the approach in the Proposed Regulations that the netting rules in section 752 should likewise apply for purposes of determining the effect of a merger under the disguised sale rules. Again, however, we recommend examples be provided. As is often the case under subchapter K, the operation of the rules can be obscure in specific cases. Examples are helpful to illustrate the intent, operation, and the reach of the regulatory language.

H. Disguised Sales of Property by a Partnership to a Partner

In general, the current regulations allow a partnership to distribute property subject to a liability to a partner without triggering sale treatment if the liability is a qualified liability or if the liability assumed or taken subject to does not exceed the partner’s share of the liability immediately before the distribution. The intent of the

80 For example, consider a situation where a party contributes property that is the subject of preformation capital expenditures to an upper-tier partnership, and the upper-tier partnership then contributes the property to a lower-tier partnership. Assume that, in connection with the property contribution, the lower-tier partnership makes a cash distribution to the upper-tier partnership which the upper-tier partnership uses to redeem a historic partner. This situation seems to more resemble a partial sale of the newly-acquired asset to the lower-tier partnership in order to fund cash needs of the upper-tier partnership that are unrelated to the contribution of the new property. Presumably, the preformation capital expenditure exception would not apply to the distribution from the lower-tier partnership to the upper-tier partnership in this situation.
regulations appears to be to not trigger tax if the contribution or distribution is merely a change in the form under which the business is conducted.

On the other hand, under certain circumstances, the distribution moves closer to a transaction that should be treated as a sale. For example, if the partnership borrows money pursuant to a nonqualified liability and immediately distributes an asset subject to the nonqualified liability to a partner, the transaction more closely resembles a sale transaction.

We would support a rule that looks to the transitory nature of a nonqualified partnership liability for purposes of Regulation section 1.707-6. A nonqualified liability that is incurred in anticipation of the distribution and that is assumed by the distributee ("transitory liability") would be subject to a special rule that presumes sale treatment. However, if the distributee partner has an increased share of other partnership liabilities after the distribution, a liability netting rule should apply to treat only the net amount (i.e., pre-distribution share of partnership liabilities + assumed transitory liability – post-distribution share of partnership liabilities) as sale proceeds.