September 2, 2014

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Proposed Regulations Issued Under Section 752

Dear Commissioner Koskinen:

Enclosed please find comments on proposed regulations issued under section 752, addressing recourse liabilities of partnerships and related parties (“Comments”). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

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

Sincerely,

Armando Gomez
Chair, Section of Taxation

Enclosure

cc: Hon. William J. Wilkins, Chief Counsel, Internal Revenue Service
Curtis G. Wilson, Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
Deane M. Burke, Office of Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
Caroline E. Hay, Office of Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
Hon. Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
Emily S. McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Lisa Zarlenga, Tax Legislative Counsel, Office of Tax Policy, Department of the Treasury
Craig Gerson, Attorney-Advisor, Office of Tax Policy, Department of the Treasury
The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation 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 Erich P. Hahn, Jeffrey S. Arbeit and Alexandra R. West. Substantive contributions were made by Jennifer H. Alexander, William P. O’Shea, and Todd D. Keator. The Comments were reviewed by Martin D. Pollack, Vice-Chair of the Partnerships and LLCs Committee, and Adam M. Cohen, immediate past Chair of the Partnerships and LLCs Committee. The Comments were further reviewed by James Wreggelsworth, of the Section’s Committee on Government Submissions, and by Bahar A. Schippel, the Council Director for the Partnerships and LLCs Committee.

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 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: September 2, 2014
EXECUTIVE SUMMARY

Section 752\(^1\) generally provides that an increase in a partner’s share of the liabilities of a partnership (or an increase in a partner’s individual liabilities by reason of the assumption by the partner of partnership liabilities) is treated as a contribution of property to the partnership, and a decrease in a partner’s share of the liabilities of a partnership (or a decrease in a partner’s individual liabilities by reason of the assumption by the partnership of the individual liabilities) is considered a distribution of money to the partner by the partnership. The regulations promulgated under section 752, in turn, provide additional rules regarding the manner in which this general concept applies. In particular, the regulations distinguish between two categories of liabilities – recourse liabilities and nonrecourse liabilities. In general, a partnership liability is a recourse liability to the extent a partner or a person related to a partner bears economic risk of loss (“EROL”) as provided in Regulation section 1.752-2. Partnership liabilities are nonrecourse liabilities to the extent no partner or related person bears EROL.

On December 16, 2013, the U.S. Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) issued a notice of proposed rulemaking in the Federal Register containing proposed regulations under section 752 (the “Proposed Regulations”) concerning the determination and allocation of recourse liabilities.\(^2\) Very generally, the Proposed Regulations provide guidance as to when and to what extent a partner is considered to bear EROL for a partnership liability when multiple partners bear EROL for the same partnership liability or when a single partner bears EROL in multiple ways, as well as guidance on the allocation of liabilities when a partner has a payment obligation with respect to the partnership or lends money to the partnership on a nonrecourse basis and such partner is related to another partner in the partnership.

The preamble to the Proposed Regulations (the “Preamble”) invites comments on the proposed changes to the current regulations under section 752 (the “Current Regulations”). In addition, the Preamble specifically requests comments regarding the proper treatment of liabilities when an upper-tier partnership (“UTP”) bears EROL for a liability of a lower-tier partnership (“LTP”), and the UTP makes a liquidating distribution of its LTP interest to one of its partners (the transferee) but such transferee does not bear the EROL for the LTP’s liability.

We commend Treasury and the Service for clarifying the manner in which recourse liabilities are allocated in these cases, and we appreciate the opportunity to provide comments with respect to the proposals and other issues that arise under the Proposed Regulations. Specifically, we recommend that Treasury and the Service, in the course of promulgating final Regulations:

1. Reconsider its approach to the application of the tiered partnership rule when a person is a partner of both a UTP and an LTP, and give the LTP the ability to elect to allocate such a liability between the UTP and the

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\(^1\) References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

LTP in any reasonable manner; the rule of the Proposed Regulations could continue to apply as a default rule in the event that the LTP does not make the election;

2. Add alternative fact patterns to the example applying the Proposed Regulations for overlapping EROL illustrating the inapplicability of the Proposed Regulations when (i) a partner’s or partners’ EROL is not respected, (ii) the parties have by valid agreement resolved the overlap in a manner contrary to the result provided by the Proposed Regulations, and (iii) a contrary result is provided for by local law;

3. Clarify that a UTP that is allocated a liability under Proposed Regulation section 1.752-2(i) is considered to bear EROL for purposes of Regulation section 1.704-2(i);

4. Extend disregard of the constructive ownership rules to include constructive ownership provided by section 1563(e)(2) and extend disregard of constructive ownership to ownership of interests in partnerships as well as corporations; and

5. Modify Proposed Regulation section 1.752-4(b)(2) to incorporate the lender *de minimis* exception contained in Regulation section 1.752-2(d) as well as the pledging rules contained in Regulation section 1.752-2(h) for purposes of determining the circumstances under which the related partner exception applies.

In addition to our recommendations, we also provide our general observations regarding the treatment of liabilities of an LTP when the distribution of the LTP interest by a UTP causes the classification of the liabilities to change.
DISCUSSION

I. The Section 752 Regulations

Regulation section 1.752-1(a)(1) provides that a partnership liability is a recourse liability to the extent a partner or a person related to a partner bears EROL for the liability as provided in Regulation section 1.752-2. Regulation section 1.752-2 contains rules for determining whether a partner or a person related to a partner bears EROL for a partnership liability and for allocating that liability among the partners in the partnership.

Under the Current Regulations, a partner bears the EROL for a partnership liability to the extent that the partner or related person would be obligated to make a contribution or payment with respect to the partnership liability (and would not be entitled to be reimbursed for the contribution or payment by another partner, a person related to another partner, or the partnership) if the partnership constructively liquidates. In a constructive liquidation, the following events are deemed to occur: (A) all of the partnership’s liabilities become due and payable in full, (B) with the exception of property contributed solely to secure a partnership liability, all of the partnership’s assets (including money) become worthless, (C) the partnership disposes of all of its assets in a fully taxable transaction for no consideration (other than relief from certain liabilities), (D) the partnership allocates its items of income, gain, loss, deduction, and credit for the year among the partners, and (E) the partnership completely liquidates. The constructive liquidation approach is used to determine who bears the EROL for a partnership liability taking into account the manner in which the partners have agreed to share economic losses and taking into account all arrangements among the partners, related persons, and the partnership.

Determining the amount of each partner’s share of a partnership liability is important for many reasons, but a principal reason is because the amount is included in the basis of the partner’s partnership interest. The basis of a partnership interest is relevant, among other things, for determining the taxability of distributions to the partner, the deductibility of the partner’s distributive share of partnership losses and deductions, as well as for determining gain or loss upon a sale, exchange, or other disposition of the partnership interest.

For the most part, the Proposed Regulations focus on rules contained in Regulation sections 1.752-2 and 1.752-4 that address the allocation of recourse liabilities among partners in various scenarios. Our discussion below addresses each of the proposals. The discussion below of the Current Regulations is limited to the provisions that the Proposed Regulations seek to amend or supplement.

II. Overlapping Risk of Loss

Under Regulation section 1.752-2(a), a partner’s share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the EROL. While Regulation section 1.752-4(c) makes clear that the amount of an

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3 Reg. § 1.752-2(b)(1).
indebtedness is taken into account only once, there has been uncertainty as to how partners should share a partnership liability if multiple partners bear the EROL with respect to the same liability.

While the Current Regulations do not provide a rule for allocating such a liability among the multiple partners bearing EROL, the temporary regulations that preceded the Current Regulations had addressed the issue by providing the following rule (the “Proportionality Rule”):

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\text{If the aggregate amount of the EROL... that all partners are determined to bear with respect to a partnership liability (or portion thereof)... exceeds the amount of such liability (or portion thereof), the EROL... borne by each partner with respect to such liability shall equal the amount determined by multiplying the amount of such liability (or portion thereof) by the fraction obtained by dividing the amount of the EROL... that such partner is determined to bear with respect to that liability (or portion thereof) by the sum of such amounts for all partners.}^4
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Although the Proportionality Rule was not included in the final regulations when the temporary regulations were withdrawn, the only stated reason for this omission was simplicity; there was no indication that the Proportionality Rule was flawed or otherwise inappropriate.\(^5\)

In light of requests for guidance in the area, Treasury and the Service have re-evaluated the balance between simplicity and uncertainty and, having concluded that the Proportionality Rule is a reasonable approach to allocating a liability for which multiple partners bear the EROL, the Proposed Regulations incorporate the Proportionality Rule from the prior temporary regulations.\(^6\)

We commend Treasury and the Service for reviving the Proportionality Rule, which makes sense in a situation in which partners otherwise have an aggregate EROL in excess of the recourse liability; and we agree that any disadvantage, in terms of lost simplicity from the adoption of this rule, is more than offset by the advantage of the reduced uncertainty that the rule will provide. However, we do offer the following comments and drafting suggestions.

A. Overlapping EROL Involving Unrelated Parties

At first blush, one might think that the circumstances in which the Proportionality Rule is necessary to resolve the potential uncertainty are common; however, on


\(^6\) See Temp. Reg. § 1.752-1T(d)(3)(i) (1988); T.D. 8237, 1989-1 C.B. 180. See also T.D. 8380, 1992-1 C.B. 218 (removing the temporary regulations effective December 27, 1991). Prior to the issuance of T.D. 8380, Treasury and the Service had published proposed regulations on July 26, 1991 that simplified the temporary regulations and addressed several issues raised by commentators with respect to such temporary regulations (written comments were received and a public hearing was held on September 17, 1991). See 56 Fed. Reg. 36704 (July 31, 1991) (proposed regulations).
reflection, it seems unlikely that unrelated parties would ever intentionally put themselves in a situation where the Proportionality Rule would be needed.\(^7\) This is not to say that lenders do not often request multiple guarantees; of course they do. But multiple guarantors often reach agreement as to how they would share responsibility for a guaranty payment demanded by the lender against only one of them, either explicitly through the execution of a separate document, or implicitly through their agreement for the sharing of losses and commitments to restore deficit capital account balances arising from the allocation of those losses.\(^8\) If such an agreement has been executed, or if local law (or the partnership agreement) provides for the allocation of responsibility, so long as the guarantors’ agreement is \textit{bona fide} and is otherwise respected for purposes of determining EROL (a “Valid Sharing Agreement”), there should not be overlapping EROL because a Valid Sharing Agreement, or local law, will eliminate the overlap. In other words, to have overlapping EROL, it would need to be the case that there is no allocation of EROL among co-guarantors under local law, and there is no Valid Sharing Agreement.

In light of the foregoing, we believe it would be beneficial to emphasize the limited scope envisioned for the Proportionality Rule by revising Example 9 under Proposed Regulation section 1.752-2(f) as follows:

- Replace “[b]oth A and B waive their rights of contribution against each other” in subdivision (i) with the following:

  A and B have not entered into a loss sharing agreement in respect of their status as co-guarantors and local law does not clearly establish responsibility as between them for the liability.

- Add three new subdivisions (iii), (iv), and (v) after existing subdivision (ii) to read as follows:

  (iii) Alternatively, assume the same facts as in (i) except that B’s guaranty does not satisfy the economic risk of loss requirements and therefore B does not have economic risk of loss. Under these circumstances, the rule in paragraph (a)(2) of this section has no application because there is not overlapping economic risk of loss.

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\(^7\) Overlapping EROL can also arise when an LTP has one or more UTPs as partners as well as another partner (“G”) who is a guarantor of LTP debt and also a member of one or more of the UTPs. We address this situation in Section III below.

\(^8\) The manner in which the partners have agreed to share losses in excess of partnership equity may also define the EROL of the partners relative to each other because losses may only be allocated to a partner in an amount in excess of the partner’s capital account to the extent the partner has agreed to restore the partner’s deficit capital account balance. Upon a constructive liquidation of the partnership, the partnership would be deemed to collect from the partners an amount equal to their deficit restoration obligations, and that amount would be available to pay the partnership’s creditors as well as to make distributions to partners having positive capital account balances. A guarantor partner that has satisfied a partnership liability in an amount that exceeds the losses allocated to the partner may enforce the lender’s rights against the partnership.
(iv) Alternatively, assume the same facts as in (i) except that A and B have entered into a legally enforceable loss sharing agreement (that is recognized under this section for purposes of determining economic risk of loss) setting forth their respective shares (totaling exactly 100 percent) of each payment that potentially could be made on either guaranty. Under these circumstances, the rule in paragraph (a)(2) of this section has no application because there is no overlapping economic risk of loss.

(v) Alternatively, assume the same facts as in (i) except that local law provides for contribution between A and B as co-guarantors and specifies their respective shares (totaling exactly 100 percent) of each payment that potentially could be made on either guaranty. Under these circumstances, the rule in paragraph (a)(2) of this section has no application because there is no overlapping economic risk of loss.

B. Overlapping EROL Caused By Multiple Partners Being Related To A Single Non-Partner Guarantor

In contrast to the circumstances described in Section II.A above, even well-advised parties cannot help but confront overlapping EROL where a single non-partner guarantor is related to multiple partners. A common situation arises where corporation X has two wholly owned corporate subsidiaries, Y and Z, that are partners in a partnership, and X is the guarantor of otherwise nonrecourse debt (the “Debt”). For example, in Partnership DYZ (illustrated below), corporation X owns corporate subsidiary partners Y and Z, Y owns an 80-percent interest in the profits, losses and capital of DYZ, Z owns a ten-percent interest in DYZ profits, losses and capital, and D, an individual unrelated to X, Y or Z, owns the remaining ten-percent interest in DYZ.

![Diagram of Partnership DYZ]

Under these circumstances, because both Y and Z are related to X (the guarantor), both Y and Z are treated as having the EROL in respect of the Debt.9 Unlike the types of

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9 Reg. § 1.752-2(b)(1).
situations discussed in Section II.A above involving unrelated parties, this situation does not lend itself to the use of a loss sharing agreement that would avoid overlapping EROL because as an economic matter there is only a single party responsible for the debt. Thus, in this situation, even well-advised taxpayers will be confronted with overlapping EROL. The Proportionality Rule will, without question, resolve any uncertainties attributable to this overlapping EROL by allocating 50 percent of the Debt to Y and 50 percent of the Debt to Z.

However, we believe that, in this and other similar circumstances, an even split may not correspond to the parties’ expectations or desires with respect to how the debt is actually to be shared, and mandating an even allocation may conflict with those desires. For example, the parties may wish to distribute the debt proceeds to the partners in accordance with their economic interests in the partnership with the understanding that the debt would be repaid from partnership operating income. In the simple structure described above, this would mean that 80 percent of the loan proceeds would be distributed to Y and ten percent would be distributed to each of Z and D. As profits are earned and allocated, the reduction in the basis of X and Y’s partnership interests caused by the debt distribution is restored with allocated income. In this case, adherence to the Proportionality Rule to allocate the debt would result in uneconomic section 731 gain recognition. This seems unwarranted. Provided the partners bearing overlapping EROL agree to some reasonable means of allocation of the debt as between or among them which is consistently applied, there does not appear to be a compelling rationale for limiting taxpayer flexibility. As this same issue is discussed in detail in our comments to the tiered partnership rules (Section III below), we will not repeat that discussion here. However, for the reasons discussed in Section III, we respectfully request that Treasury and the Service consider permitting partners related to the same non-partner guarantor to opt out of the Proportionality Rule and to elect the more flexible approach described below.10

10 In addition, as discussed in greater detail in Section V below, the Proposed Regulations would modify the rules in Regulation section 1.752-4(b)(2)(i) providing for the allocation of a liability in the case where a person that bears EROL is related to more than one partner. Under the proposal, Regulation section 1.752-4(b)(2)(i), which provides generally that if a person is related to more than one partner, such person will be treated as related only to the partner with whom there is the highest percentage of related ownership, and that if two or more partners have the same percentage of related ownership and no other partner has a greater percentage of related ownership, the liability is allocated equally among the partners having equal percentages of related ownership, would be modified so that all partners whose related ownership meets or exceeds the 80-percent threshold would share the partnership liability equally. If the Proportionality Rule contained in Proposed Regulation section 1.752-2(a)(2) is adopted as proposed, it may overlap with Proposed Regulation section 1.752-4(b)(3) in cases where a person that bears EROL is related to more than one partner, and if the flexible approach to the Proportionality Rule for which we believe consideration should be given were to be adopted, the flexible approach may conflict with the equal allocation mandated by Proposed Regulation section 1.752-4(b)(3). Because the Proportionality Rule is robust enough to provide guidance in the instance where two or more partners are equally related to a person that bears EROL, the rule in Proposed Regulation section 1.752-4(b)(3) that provides for equal allocation of a liability where a person is related to more than one partner may be unnecessary.
III.  **Tiered Partnerships**

Tiered-partnership structures can produce situations in which the Current Regulations leave uncertainties as to how a partnership’s recourse liability should be allocated among the partners. Under the Current Regulations, if a UTP owns (directly or indirectly through one or more partnerships) an interest in an LTP, the liabilities of the LTP are allocated to the UTP in an amount equal to the sum of: (1) the amount of the EROL that the UTP bears with respect to the liabilities; and (2) any other amount of the liabilities with respect to which partners of the UTP bear the EROL.11 This rule is applicable regardless of whether a UTP partner that bears EROL for a liability of the LTP is a direct partner in the LTP.

The paradigm case involves a liability of an LTP that is guaranteed by G where G is a partner in the LTP and is also a partner in a UTP that owns a partnership interest in the LTP.12 In sum, although it is clear that the liability should be allocated to G because he bears the EROL, the Current Regulations are ambiguous in answering the questions of whether:

1. LTP should allocate the liability to G solely by reason of his direct partnership interest in LTP;
2. LTP should allocate the liability solely to UTP (after which UTP, in turn, would itself allocate the liability to G); or
3. LTP should allocate a portion of the liability each way.

Not surprisingly, the ambiguity is compounded if an LTP has multiple UTPs as partners and G is a partner in more than one of them.13

The Proposed Regulations seek to eliminate the uncertainty in these situations by adopting the first of the three alternative approaches described above, namely, allocating the LTP liability for which G bears the EROL 100 percent to G by reason of his direct partnership interest in LTP; as a result of this rule, no portion of the liability is allocated to UTP notwithstanding the fact that one of UTP’s partners also bears the EROL. While we commend Treasury and the Service for taking decisive action to eliminate the uncertainties presented by these common tiered-partnership structures, we respectfully request that Treasury and the Service reconsider the possibility of adopting the more flexible approach discussed below.

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11 Reg. § 1.752-2(i).
12 For purposes of this discussion, assume the following: UTP and G own 90 percent and ten percent, respectively, of the interests in LTP; G owns 90 percent of the interests in UTP; and X (unrelated to G) owns the remaining ten-percent interest in UTP. A diagram depicting this ownership structure is also provided below.
13 The Current Regulations clearly provide that if G is not a direct partner in LTP and UTP is the only upper-tier partnership of which G is a partner that owns an interest in LTP, LTP would allocate the liability to UTP. Unfortunately, this does not inform the decision of how to deal with the ambiguities created where G has multiple interests (direct and indirect) in LTP.
What makes this issue particularly nettlesome is that there is no single correct answer. Rather, there are a handful of policy considerations that need to be weighed, and we recognize that there will be differences of opinion as to the weight to be given to the different considerations.

Based upon the discussion in the Preamble, as well as the analysis of other commentators, we believe that the following policy considerations are relevant to the appropriate resolution of this issue:

- **Avoiding Inappropriate Shifting of Basis from G to Other Persons.** The Preamble notes that allocating an LTP’s liability to a partner that is not a UTP “ensures that the additional basis resulting from the liability is only for the benefit of the partner that bears the economic risk of loss for the liability.” This seems to suggest a concern that allocating the liability to the UTP by reason of G’s EROL could lead to inappropriate utilization of the UTP’s basis in its LTP interest for the benefit of other partners in the UTP.

- **Certainty and Administrability.** A rule requiring allocation of an LTP’s liability to a direct partner, rather than permitting the liability to be allocated between a direct partner having EROL and a UTP that has the direct partner as a partner is easier to administer than a rule that requires allocation of the liability between the partners and tracking of the portion of the liability allocated to a UTP.

- **Avoiding Inappropriate Utilization of Basis by G.** Where a UTP has assets unrelated to its interest in an LTP, a rule permitting allocation of a portion of the liability to the UTP (by reason of G’s EROL and his ownership of an interest in the UTP) could lead to a situation in which G’s basis in its UTP interest attributable to the LTP may be used by G:
  
  a. To permit G to deduct losses attributable to the UTP’s non-LTP assets, which losses would otherwise have been deferred by section 704(d); and/or

  b. To enjoy non-taxable return of basis treatment in respect of cash distributions attributable to the UTP’s non-LTP assets in circumstances under which G would not have had sufficient basis in his UTP partnership interest to avoid gain recognition under section 731 absent the allocation of the liability from the LTP.

- **Avoiding Inappropriate Recognition of Gain by G.** This consideration is best illustrated by the following example:

  G and X (who is unrelated to G) contribute $810,000 and $90,000 to UTP in exchange for a 90-percent and a ten-percent interest in UTP, respectively. UTP contributes the $900,000 to LTP in exchange for a 90-percent interest in
LTP, and G contributes $100,000 of capital directly to LTP in exchange for a 10-percent interest. UTP has no assets or activities other than its ownership of the 90-percent interest in LTP. LTP generated losses in its initial years that have reduced all partners’ bases in their partnership interests to zero; however, LTP’s activities are very successful and its assets have appreciated markedly. As a result, LTP borrows $10 million which it distributes ratably to its partners, and UTP, in turn, distributes the $9 million distribution it receives ratably to its partners, G and X. At the request of the lender, G provides its personal guaranty for this loan. If 100 percent of the $10 million LTP liability must be allocated by LTP to G (as required under the Proposed Regulations), then UTP will recognize $9 million of section 731 gain by reason of the distribution of the loan proceeds, and UTP will allocate this gain to X and G in a 1:9 ratio. While this result may be reasonable to X (who is not a guarantor), it is an exceedingly harsh result to G who is personally liable for repayment of the loan, and who would not have recognized gain if G had contributed his LTP interest to UTP. Further, G will have a remaining $9 million basis in its direct interest in LTP.

In weighing the relative importance of these four policy considerations, we have the following observations:

- Regarding the first policy consideration listed above, namely, that the allocation of all or part of the liability to UTP would permit inappropriate shifting of basis from G to other partners, we do not believe that this concern provides meaningful support for the approach of the Proposed Regulations. Under the rules of the Proposed Regulations, if UTP were allocated some or all of the liability, UTP would be required to allocate the entire amount
allocated to it (and the basis attributable thereto) solely to G because only G bears the EROL in respect of the liability. As a result, there should be no basis shifting to other partners. Therefore, we do not believe this concern to be well-founded. However, even if there is a mechanism that would permit UTP to allocate the liability to partners other than G contrary to the policy underlying section 752, our recommendation would be to fix this problem directly. Accordingly, we do not believe that this policy consideration should be viewed as providing meaningful support for the approach of the Proposed Regulations.

- Regarding the second policy consideration listed above, namely, simplicity and administrability, we acknowledge that the rule of the Proposed Regulations is simpler than a rule that would permit some of the liability to be allocated to UTP, which would then have to allocate that liability to its partner G. However, given the complexity in sections 752 and 704 generally, we do not believe that this gain in simplicity is material or compelling if there are other policy considerations supporting a different rule.

- Regarding the third policy consideration listed above, namely, “inappropriate” utilization of basis by G, it is not clear that G’s ability to utilize basis derived from the LTP liability in respect of his interest in UTP’s activities other than LTP is “inappropriate.” If G were to contribute his interest in LTP to UTP, there would be no question that this utilization of basis would be available to G. Given this, we do not believe that adopting our interpretation of the EROL concept promotes impropriety because it enables G to utilize the basis to the same extent as if he had contributed his LTP interest to UTP.

- Regarding the fourth policy consideration listed above, namely, avoiding inappropriate gain recognition by G, we believe that this consideration is compelling. G should not recognize section 731 gain in respect of a debt-financed distribution when he has guaranteed the debt. While we recognize that G could avoid this result by contributing his LTP interest in to UTP, we do not believe that the tax law should compel G to do this to avoid gain recognition.

In light of the foregoing analysis, we urge Treasury and the Service to reconsider its approach to the application of the tiered-partnership rule where G is a partner of both UTP and LTP and instead give LTP the ability to elect to allocate such a liability between UTP and LTP in any reasonable manner in this limited circumstance (i.e., where G is a partner of both UTP and LTP).14 The rule of the Proposed Regulations could continue to apply as a default rule in the event that LTP does not make the election with respect to a liability.

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14 To avoid having the election become a trap for the unwary, we recommend that the rules permit the partnership to make the election for a liability by attaching a written statement to the partnership’s return for the first taxable year in which the allocation of the liability is relevant to the determination of any partner’s taxable income.
We also encourage Treasury and the Service to consider whether a disconnect may have inadvertently been created between the rules for allocating partner nonrecourse deductions under section 704 and the rules under section 752. The EROL analysis employed in the section 752 regulations generally corresponds to, and further develops, the EROL analysis employed in the regulations under section 704(b). The coordination of these two sections reflects the fact that one of the principal purposes for including partnership liabilities in the bases of the partners’ interests in the partnership is to support the deductions that will be claimed by the partners for the items attributable to those liabilities.\textsuperscript{15}

Consistent with this principle, in respect to partner nonrecourse debt, Regulation section 1.704-2(i)(1) provides:

Partnership losses, deductions, or section 705(a)(2)(B) expenditures that are attributable to a particular partner nonrecourse liability (“partner nonrecourse deductions,” as defined in [Regulation section 1.704-2(i)(2)]) must be allocated to the partner that bears the economic risk of loss for the liability. If more than one partner bears the economic risk of loss for a partner nonrecourse liability, any partner nonrecourse deductions attributable to that liability must be allocated among the partners according to the ratio in which they bear the economic risk of loss.

There may be a disconnect, however, between Proposed Regulation section 1.752-2(i) and Regulation section 1.704-2(i)(1) in the case in which a partner of UTP (who is NOT also a partner of LTP) guarantees a liability of LTP. Under these circumstances, both the Current Regulations and the Proposed Regulations require LTP to allocate this liability to UTP (assuming no other partners of LTP also bear the EROL for this liability). However, neither the Current Regulations nor the Proposed Regulations state that, under these circumstances, UTP should be treated as bearing the EROL for this liability for purposes of Regulation section 1.704-2(i)(1). If UTP is not treated as bearing the EROL for this liability, however, the rule of Regulation section 1.704-2(i)(1), which allocates partner nonrecourse deductions to the partner that is bearing the EROL for that liability, will not operate to cause UTP to be allocated these deductions in respect of the liability that section 752 allocates to it. We suspect that this is an unintended language glitch that could easily be remedied with a clarifying statement.

\textbf{IV. Related Party Rules – Constructive Stock Ownership}

Under the Current Regulations, if a person that bears EROL for a partnership liability is related to a partner and such person is not related to any other partner, that partner is allocated the liability.\textsuperscript{16} The Current Regulations provide mechanical rules to determine whether a person is related to a partner. Under Regulation section 1.752-4(b)(1) (the “General Related Party Rule”), a person is related to a partner if the person

\textsuperscript{15} See T.D. 8237, 1989-1 C.B. 180.
\textsuperscript{16} Reg. § 1.752-2(a).
and the partner bear a relationship to each other that is specified in section 267(b) or section 707(b)(1), subject to three modifications:

1. Section 267(b) and section 707(b)(1) are applied substituting “80 percent or more” for “more than 50 percent” each place it appears in those sections;

2. A person’s family is determined by excluding brothers and sisters;\(^\text{17}\) and

3. Section 267(e)(1) and (f)(1)(A) are disregarded.\(^\text{18}\)

As an example, assume A and B, two unrelated individuals, own 99 percent and one percent, respectively, of the membership interests of LLC, an entity classified as a partnership for U.S. federal income tax purposes, and that LLC owns all of the stock of Z, a corporation that has made a nonrecourse loan to LLC.

A relationship specified in section 267(b) includes the relationship described in section 267(b)(2) – an individual and a corporation, more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the individual. Under section 267(c)(1), for purposes of applying section 267(b), stock owned directly by a partnership is considered as being owned proportionally by its partners. Thus, A is considered to own 99 percent of the stock of Z, and B is considered to own one percent of the stock of Z. Because A is considered to own 80 percent or more of the stock of Z, A is related to Z. Under Regulation section 1.752-2(c)(1), therefore, A is deemed to bear EROL for the LLC liability because Z, a person related to A, has made a loan to LLC and EROL for the liability is not borne by another partner.

The Preamble states that Treasury and the Service believe that partners in a partnership that owns stock in a corporation that is a lender to such partnership or has a payment obligation with respect to a liability of its partnership owner (i.e., the corporation bears EROL for a partnership liability) should not be attributed ownership of the partnership’s corporate stock. That is because the assets of that partner or partners (other than the partners’ interests in the partnership) are not subject to EROL for the partnership liability.\(^\text{19}\) The justification underlying the treatment of partnership liabilities

\(^{17}\) Section 267(c)(4) provides that the family of an individual includes the individual’s brothers and sisters (whether by whole or half-blood), spouse, ancestors, and lineal descendants.

\(^{18}\) Section 267(e)(1) generally defines partnerships and S corporations, their owners, and certain other persons as being described in section 267(b) for purposes of applying the section 267(a)(2) mandate that the timing of a deduction match the inclusion of the related income for payments between related parties. Section 267(b)(3) includes, as persons who have a relationship described in section 267(b), two corporations that are members of the same controlled group (as defined in section 267(f)). Section 267(f)(1)(A) redefines the relationship threshold in section 1563(a) to “more than 50 percent” from “80 percent or more” in determining whether a controlled group exists for purposes of section 267. Thus, while the section 752 relatedness ownership threshold is raised to 80 percent or more in applying section 267 generally, the section 752 relatedness ownership thresholds set forth in section 1563(a) are not changed by Regulation section 1.752-4(b)(1).

\(^{19}\) See, e.g., Reg. § 1.752-2(k)(1) (providing that, in determining the extent to which a partner bears EROL, the obligations of a disregarded entity are only taken into account to the extent of the net value of the disregarded entity as of the allocation date that is allocated to the partnership liability). See
The Preamble states that a partner’s EROL that is limited to the partner’s equity investment in the partnership should be treated differently than EROL beyond such investment. We agree with the proposed limitation. In these cases, the partner’s equity investment is already exposed to the risk of partnership operations, and the partner’s basis in its partnership interest already reflects its equity investment. Ascribing EROL for a partnership liability to a partner in excess of the partner’s equity investment where no other partner assets are at risk invokes the wrong standard for allocation of the liability. That liability should be considered a nonrecourse liability. The rule of the Proposed Regulations aligns the allocation outcome with economic reality.

We also agree that the language in Proposed Regulation section 1.704-4(b)(1)(iv) that directs section 267(c)(1) to be disregarded in determining whether stock of a corporation owned, directly or indirectly, by or for a partnership is considered owned proportionally by or for its partners if the corporation is a lender or has a payment obligation with respect to a partnership liability accomplishes the desired result in cases where section 267(c)(1) provides the operative rule. To fully implement Treasury’s and the Service’s intent, however, we recommend that the language of the Proposed Regulations be extended to turn off analogous constructive ownership provisions that apply to other provisions of section 267(b) and 707(b) in similar circumstances. Another such provision is section 267(b)(3). That is, a person may be related to a partner under Regulation section 1.752-4(b) because they bear a relationship to each other described in section 267(b)(3) – e.g., two corporations that are members of the same controlled group, as defined in section 267(f). For purposes of section 267(f), a “controlled group” generally has the meaning given to it by section 1563(a). Section 1563 provides its own constructive ownership rules. For purposes of determining whether a corporation is a member of a parent-subsidiary controlled group of corporations or of a brother-sister controlled group, section 1563(e)(2) applies. Section 1563(e)(2) provides that stock

also Reg. § 1.752-2(k)(2)(i) (providing that net value of a disregarded entity is determined excluding the disregarded entity’s interest in the partnership for which the net value is being determined).

See Reg. § 1.752-2(b)(1).

See STAFF OF J. COMM. ON TAX’N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 544 n.23 (Comm. Print 1984) (“In determining whether corporations are members of the same controlled group, the constructive ownership rules of section 1563 (and not those of section 267(c) are to apply’’); TAM 9538002 (May 16, 1995) (legislative history suggests that Congress intended to replace section 267 attribution rules with the section 1563 rules for purposes of determining ownership by individuals).

But see Reg. § 1.1563-1(a)(2)(i)(A) (attribution of stock ownership in determining the existence of a parent-subsidiary controlled group determined with the application only of option attribution under Regulation section 1.1563-3(b)(1)); cf. Reg. § 1.1563-1(a)(3)(i) (attribution of stock ownership to determine existence of a brother-sister controlled group determined with the application of all of the rules of Regulation section 1.1563-3(b)).
owned (directly or indirectly) by or for a partnership will be considered as owned by any partner having an interest of five percent or more in either the capital or profits of the partnership in proportion to the partner’s interest in capital or profits, whichever is greater. While the attribution standard in section 1563(e)(2) is slightly different than the standard provided in section 267(c)(1), a corporate lender and a corporate partner may be considered related under the controlled group test for purposes of Regulation section 1.752-4(b) because the stock of the corporate lender is attributed to the corporate partner pursuant to section 1563(e)(2), even though the stock of the corporate lender is not attributed to the partner under section 267(c)(1).

For example, assume that A owns 100 percent of the stock of X, a corporation, and that A and X own 90 percent and ten percent, respectively, of the interests in LLC, an entity classified as a partnership. Assume further that LLC owns all of the stock of Y, a corporation that has made a loan to LLC. For purposes of determining whether X and Y are members of a controlled group of corporations described in section 267(b)(3), under section 1563(d)(1) and (2), “stock owned” means stock owned with the application of the specified provisions of section 1563(e), which, in each case, includes section 1563(e)(2). Under section 1563(e)(2), A is deemed to own 90 percent of the stock of Y. A’s actual ownership of 100 percent of the stock of X and deemed ownership of 90 percent of the stock of Y results in X and Y being considered members of the same brother-sister controlled group. Thus, X and Y are related within the meaning of Regulation section 1.752-4(b), and the LLC liability would be treated as a recourse liability. If the Proposed Regulations are finalized in their current form, the LLC liability would be treated as a recourse liability even though X is not exposed to the liability beyond the amount of its equity investment. The same policy considerations that support disregarding section

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23 Section 1563(a)(2) defines a brother-sister controlled group to mean two or more corporations if five or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation. However, under a special rule provided in section 1563(f)(5), the brother-sister controlled group definition is modified when invoked outside of Part II of Subchapter B of Chapter 6. Under section 1563(f)(5), except as specifically provided in an applicable provision, the definition of a brother-sister controlled group is applied to an applicable provision as if it read as follows:

(2) Brother-sister controlled group. Two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2) stock possessing—

(A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote, or at least 80 percent of the total value of shares of all classes of stock, of each corporation, and

(B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.

Under section 1563(f)(5)(B), an applicable provision is any provision of law (other than this part) that incorporates the definition of controlled group of corporations under subsection (a). Under section 1563(d)(2), for purposes of determining whether a corporation is a member of a brother-sister controlled group of corporations, stock owned by a person who is an individual, estate, or trust means (A) stock owned directly by such person, and (B) stock owned with the application of subsection (e). Section 1563(e)(2) further provides that stock owned, directly or indirectly, by or for a partnership is considered as owned by any partner having an interest of five percent or more in either the capital or profits of the partnership in proportion to his interest in capital or profits, whichever is greater.
267(c)(1) also support disregarding section 1563(e)(2) in this case. We recommend that the Proposed Regulations be amended to disregard section 1563(e)(2) in those cases where its consideration results in the treatment of a partnership liability as recourse even though no partner’s or related person’s capital external to the partnership is exposed to EROL.

Additionally, we believe Treasury and the Service should consider extending Proposed Regulation section 1.752-4(b)(1)(iv) to address situations in which an LTP is a lender to a UTP or has a payment obligation with respect to a liability of a UTP in situations where under the current constructive ownership rules the lending partnership would be a related person to a partner of the borrowing partnership on account of the application of the constructive ownership rules. For example, assume that, in the structure described above, LLC and corporation Y owned 99 percent and one percent, respectively, of the interests in LLC2, an entity classified as a partnership, and LLC2 made the loan to LLC. Under the Proposed Regulations, LLC2 would be related to A because, under the Proposed Regulations, section 267(c)(1) is not disregarded for purposes of determining whether a partnership interest owned by a borrowing partnership is considered as being owned proportionally by the borrowing partnership’s partners. The Proposed Regulations could be extended to make clear that A would not be attributed ownership of any of the partnership interests in LLC2 through LLC.

In summary, we generally agree with limiting the application of the constructive ownership rules attributing ownership through partnerships. We recommend expanding the scope of the limitation to reach the attribution rule in section 1563(e)(2) and to reach lenders and other entities having payment obligations other than corporations.

V. Related Party Rules – Person Related to Multiple Partners

As stated above, under the General Related Party Rule, a person is only related to a partner if the person and the partner bear a relationship to each other specified in section 267(b) or section 707(b), subject to certain modifications, one of which requires that the provisions be applied by substituting “80 percent or more” for “more than 50 percent” each place it appears in those sections. As a result of this modification, the scope of this rule is significantly narrowed.

The Current Regulations also provide rules for allocating liabilities among partners each of whose ownership percentage meets or exceeds the 80-percent threshold. Under Regulation section 1.752-4(b)(2), if a person is related to more than one partner under section 267(b) or 707(b)(1), as modified by Regulation section 1.752-4(b)(1), such person will be treated as related only to the partner with whom there is the highest percentage of related ownership (the “Greatest Percentage Rule”). The Current Regulations further require that if two or more partners have the same percentage of related ownership, and no other partner has a greater percentage of relatedness, the

24 Reg. § 1.752-4(b)(1)(i).
liability is allocated equally among the partners having equal percentages of related ownership (the “Same Percentage Rule”).

The Proposed Regulations remove the Greatest Percentage Rule and effectively modify the Same Percentage Rule such that all partners whose related ownership meets or exceeds the 80-percent threshold would share the partnership liability equally. According to Treasury and the Service, this proposed change is consistent with recent commentary noting that differences in ownership within a 20-percent range do not justify treating a person as related to one partner over another. The Preamble also notes that such change would relieve the Service from the administrative burden of determining precise ownership percentages above the 80-percent threshold imposed by Regulation section 1.752-4(b)(1) (the General Related Party Rule, as discussed above).

We agree with the elimination of the Greatest Percentage Rule and the extension of the Same Percentage Rule, although as noted in Section II above, if the Proportionality Rule is adopted, the modified Same Percentage Rule may become superfluous. These changes are consistent with the comments of tax practitioners who have criticized the application of the Greatest Percentage Rule in certain circumstances. For example, some practitioners have commented that the Greatest Percentage Rule may create arbitrary answers in situations in which the differences in relatedness beyond the 80-percent threshold are minimal at best.

Furthermore, it is unclear what the rationale was for the Greatest Percentage Rule. In this regard, it is important to note the higher standard imposed by the rules under Regulation section 1.752-4(b) defining relatedness. While certain practitioners have observed that the Greatest Percentage Rule may be aimed at allocating the liability to the partner most closely connected to the person to whom EROL is attributed, in light of the already increased threshold of 80 percent, such rule, in its current form, would appear unnecessary.

Accordingly, we are in agreement with the proposed change as it is our belief that the Proposed Regulations reach the correct result.

VI. Related Party Rules – Exception to Related Party Rules

In determining whether and the extent to which a partner bears EROL, the Current Regulations and the Proposed Regulations require attribution from related persons (as defined by the General Related Party Rule) yet, in certain circumstances, prohibit attribution from related partners (the “Related Partner Exception”). Regulation section 1.752-4(b)(2)(iii) provides that “notwithstanding paragraph (b)(1) of this section (which defines related person), persons owning interests directly or indirectly in the same

25 Reg. § 1.752-4(b)(2).
27 See supra note 10.
29 See id.
partnership are not treated as related persons for purposes of determining the economic risk of loss borne by each of them for the liabilities of the partnership.” The purpose of the Related Partner Exception is to prevent the shifting of basis (as a result of the attribution of EROL) from a partner bearing direct EROL to a related partner not bearing direct EROL.30

In response to the Tax Court’s interpretation of the Related Partner Exception in IPO II, the Proposed Regulations seek to narrow the circumstances in which the Related Partner Exception applies.31

As explained below, the problem with a broad interpretation of the Related Partner Exception is that a partnership liability, which as a result of attribution appropriately would be treated as recourse, might be treated as nonrecourse as a result of the Related Partner Exception. That is, a partnership liability might be treated as nonrecourse notwithstanding that certain partners indirectly bear all or a part of the economic burden of any potential loss with respect to that liability.32 To avoid that result, the guiding principle behind Proposed Regulation section 1.752-4(b)(2) is that the Related Partner Exception should apply if and only if at least one partner bears direct EROL for a partnership liability.33

We agree with, and intend our comments to be consistent with, that guiding principle.

A. IPO II

As stated above, under Regulation section 1.752-4(b)(2)(iii), “persons owning interests directly or indirectly in the same partnership are not treated as related persons for purposes of determining the economic risk of loss borne by each of them for the liabilities of the partnership.” Since the decision in IPO II, however, the interpretation of that provision has been uncertain.

In IPO II, Mr. Forsythe, an individual, owned (1) all the stock of Indeck Power Overseas Ltd., an S corporation (“Overseas”), (2) 70 percent of the stock of Indeck Energy Services, Inc., also an S corporation (“Energy”), with the rest of the stock held by his children, and (3) 63 percent of the stock of the stock of Indeck Power Equipment Co., a C corporation (“Power”), with the rest of the stock held by unrelated persons. Mr. Forsythe and Overseas owned all the membership interests in an LLC treated as a partnership for Federal income tax purposes (IPO II), with profits and losses allocated one percent to

32 See Preamble, Part 3.C. (“The [Service and Treasury] believe that such an interpretation could have unintended results, including causing intercompany debts to be treated as nonrecourse because no partner alone owns 80 percent or more of the lending company and the partners are not treated as related to each other.”).
33 See Preamble, Part 3.C (“Under this broad interpretation, the [Related Partner Exception could be improperly applied to turn off attribution of economic risk of loss between related partners even when none of the related partners directly bears the economic risk of loss for a partnership liability.”) (emphasis added).
Mr. Forsythe and 99 percent to Overseas, and with no member having liability for any debt of IPO II solely by reason of being a member. IPO II borrowed money from a third party to purchase an aircraft. Mr. Forsythe, Energy, and Power each fully guaranteed the loan, and each waived all rights of contribution against the others.

The question before the Tax Court was the application of the Related Partner Exception, and in particular whether any of the liability could be allocated to Overseas by reason of its being related to Energy through common ownership by Mr. Forsythe. The Tax Court answered in the negative, and held that the entire liability must be allocated to Mr. Forsythe (a holding with which we, other commentators, Treasury and the Service all agree), but certain statements in the analysis made the interpretation of the Related Partner Exception uncertain. 34

The Tax Court first stated:

We interpret the policy behind the Related Partner Exception as preventing the shifting of basis from a party who bears actual economic risk of loss to one who does not. This means that losses are allowed, to the extent of basis, to the party who is actually exposed to the risk of economic loss through the application of statute, organizational documents, or other contractual arrangements. It also means that, with regard to recourse liabilities, the shifting of basis cannot occur without a concomitant shifting of the underlying risk of economic loss. 35

The Tax Court concluded that because Mr. Forsythe bore direct EROL as a result of his guarantee of the loan, the Related Partner Exception prohibited Mr. Forsythe and Overseas from being treated as related persons for purposes of determining EROL. That much of the analysis is clear, is the subject of general agreement, and forms the basis for the rule under the Proposed Regulations. 36

The Tax Court continued its analysis, however, stating that the Related Partner Exception “severed” any relationship between Overseas and Mr. Forsythe for purposes of determining whether Overseas bore EROL for any of the liability. As a result, Overseas could not be related to Energy for that same purpose. 37 Thus, language in IPO II

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34 But see Susan Kalinka, IPO II v. Commissioner and the Allocation of an LLC’s Recourse Liabilities, 2004 TAX NOTES TODAY 193-50 (Oct. 5, 2004). Noting that the guarantees in IPO II were “unusual” because each guarantor waived all rights of contribution, Professor Kalinka argues that, at the time the parties entered into the agreement, “which of the guarantors would actually bear the economic risk of loss” could not be determined. Because neither Mr. Forsythe nor Overseas was related to Power, had Power been required to pay the loan, no partner of IPO II would have borne EROL with respect to the liability. Professor Kalinka suggests that there might be a few different ways to treat the loan, including as a nonrecourse debt. Any uncertainty under current law notwithstanding, however, Proposed Regulation section 1.752-2(a)(2) (regarding overlapping EROL, discussed above in Section II) and in particular Example 9 under Proposed Regulation section 1.752-2(f) confirm the result in IPO II, and make clear that when unrelated persons (1) guarantee a partnership liability and (2) waive their rights of contribution against each other, they bear EROL proportionately, even though one of them might in fact bear the entire loss, while another might not bear any.

35 IPO II, 122 T.C. at 303.


37 IPO II, 122 T.C. at 304.
arguably suggests that the Related Partner Exception applies in every case in which two
or more partners are related (the “Broad Interpretation”), rather than being limited to only
those cases in which at least one partner bears direct EROL (the “Direct Partner
Interpretation”).

The implication of the Broad Interpretation is easy to illustrate by modifying the
facts of Example 3 of Proposed Regulation section 1.752-4(b)(5) as follows:

A owns 100 percent of two corporations, X and Y. X owns
79 percent of a corporation, Z, and Y owns the remaining
21 percent of Z. X, Y, and Q (unrelated to A, X, or Y) are
members of P, a limited liability company treated as a
partnership for federal tax purposes. P borrows $2,000
from Bank. Z guarantees payment of the $2,000 debt owed
to Bank.

In the modified example above, Q is a member of P, and only Z has guaranteed
the debt. Under the Direct Partner Interpretation, because neither X nor Y bears direct
EROL with respect to the liability, the Related Partner Exception does not apply for
purposes of determining the EROL borne by X or Y. Under Proposed Regulation
section 1.752-4(b)(1), X and Y are treated as related for purposes of the entire $2,000
liability. Therefore, Z is treated as related to X and Y under Proposed Regulation
section 1.752-4(b)(1) because Z is included in the same brother-sister controlled group
that includes X and Y, and thus, X, Y and Z bear a relationship to each other specified in
section 267(b) as required by Regulation section 1.752-4(b)(1). Pursuant to Proposed
Regulation section 1.752-4(b)(3), X and Y share the $2,000 equally. Q is allocated none
of the liability.

Under the Broad Interpretation, however, notwithstanding that neither X nor Y
bears direct EROL with respect to the liability, the Related Partner Exception would
apply. Therefore, X and Y would not be treated as related for purposes of determining
EROL borne by each of them for P’s $2,000 liability. Because X and Y are not treated as
related, the stock of Z is not attributed to A to cause X, Y and Z to become members of
any controlled group, and because neither X or Y owns directly an 80 percent or more
interest in Z, neither X nor Y is treated as related to Z under Proposed Regulation
section 1.752-4(b)(1), and neither X nor Y is treated as bearing EROL with respect to the
liability. As a result, the rules governing the allocation of nonrecourse debt would

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38 For purposes of convenience, we use many of the same defined terms as the NYSBA 2012
Report.

39 In Example 3, X and Y own all of the interests in P, and both X and Z guarantee the $2,000
debt.

40 A clarification of the rationale for the conclusion in Example 3 of Proposed Regulation
section 1.752-4(b)(5) may be beneficial. That is, it may be helpful to make clear that as a result of X and Y
being unrelated to each other, the stock owned by X and Y may not be attributed for purposes of
determining whether Z is related to either X or Y.
control, and Q may be allocated some of the liability even though X and Y, through their joint ownership of Z, bear 100 percent of the economic burden of Z’s loss.41

B. Recommendations for the Provision

Proposed Regulation section 1.752-4(b)(2) provides:

Notwithstanding paragraph (b)(1) of this section (which defines related person), if a person who owns (directly or indirectly through one or more partnerships) an interest in a partnership is a lender as provided in [Regulation section] 1.752-2(c) or has a payment obligation with respect to a partnership liability, or portion thereof, then other persons owning interests directly or indirectly (through one or more partnerships) in that partnership are not treated as related to that person for purposes of determining the economic risk of loss borne by each of them for such partnership liability, or portion thereof.

As drafted, the provision limits the Related Partner Exception to two circumstances: when a direct or indirect partner either (1) is a lender under Regulation section 1.752-2(c) or (2) has a payment obligation (presumably under Regulation section 1.752-2(b), as modified by the rest of Regulation section 1.752-2). We have two comments, each of which is consistent with our understanding of the guiding principle implemented by Proposed Regulation section 1.752-4(b)(2). As stated above, that principle holds that the Related Partner Exception should apply if, and only if, at least one partner bears direct EROL for a partnership liability.42

First, we suggest that the language invoking the limitation based on the status of the direct or indirect partner as a lender incorporate the de minimis rule in Regulation section 1.752-2(d) in determining whether the partner is treated as a lender. The rule in Regulation section 1.752-2(d) (regarding partners that are lenders) is modified by Regulation section 1.752-2(d)(1) (the lender de minimis exception), which provides that the general rule in Regulation section 1.752-2(d) does not apply in certain cases. There is an analogous rule in Regulation section 1.752-2(d)(2) that modifies the rule in Regulation section 1.752-2(b)(1) regarding guarantees being treated as payment obligations (the guarantor de minimis exception). Although the guarantor de minimis exception seems to apply to limit the circumstances in which a partner has a payment obligation under Proposed Regulation section 1.752-4(b)(2), because of the specific reference to

42 See supra note 33 and accompanying text. Other commentators also agree with the guiding principle. See, e.g., NYSBA 2012 Report, Part III.1.A. (“In our view, … under the Related-Person Exception direct and indirect partners are not treated as related for purposes of (and only for purposes of) attributing direct EROL from one partner (whether direct or indirect) to another partner (the ‘Direct Partner Interpretation’).”); Walton Harris, supra note 41, at 32 (2011) (“Thus, by its terms, the Regulation arguably provides only that a relationship between two partners will be ‘turned off’ only for purposes of determining the [EROL] (if any) borne directly by those partners. When no partner directly bears the [EROL] for the liability, however, their relationship should continue to be acknowledged for purposes of determining relatedness to other entities. In other words, if no direct or indirect partner bears the [EROL], the related-partner exception should not cause a relationship to be ignored when that relationship is relied on only for determining how to allocate a non-partner’s [EROL] among the two partners.”).
Regulation section 1.752-2(c), the lender *de minimis* exception arguably does not apply to limit the circumstances in which a partner is a lender under Proposed Regulation section 1.752-4(b)(2). Because we do not believe that Treasury and the Service intended that result (and because that result is inconsistent with the guiding principle), we suggest removing the specific reference to Regulation section 1.752-2(c) and including only a general reference to Regulation section 1.752-2.

Second, we suggest that the language invoking the limitation based on the status of the direct or indirect partner as having a payment obligation be expanded to include other means by which a direct or indirect partner may bear EROL. There is at least one other way for a partner to bear direct EROL with respect to a partnership liability other than acting as a lender or having a payment obligation. Under Regulation section 1.752-2(h), a partner is treated as bearing direct EROL to the extent of the value of certain pledges of property. We do not see any reason to distinguish between a partner that guarantees a partnership liability and a partner that pledges property to secure a partnership liability. Because we do not believe that Treasury and the Service intended that result (and because that result is inconsistent with the guiding principle), we suggest adding to Proposed Regulation section 1.752-4(b)(2) a reference to pledging property as security, and an explicit reference to directly bearing EROL.

In light of those two comments, we recommend the following changes to the language of the first sentence of Proposed Regulation section 1.752-4(b)(2). We intend the changes to be fully consistent with Treasury’s and the Service’s articulated purpose.

Notwithstanding paragraph (b)(1) of this section (which defines related person), if a person who owns (directly or indirectly through one or more partnerships) an interest in a partnership is, as provided in [Regulation section] 1.752-2, a lender as provided in §1.752-2(c) or, or has a payment obligation or has pledged property as security with respect to a partnership liability, or portion thereof, or otherwise directly bears economic risk of loss for a partnership liability, or portion thereof, then other persons owning interests (directly or indirectly (through one or more partnerships) in that partnership are not treated as related to that person for purposes of determining the economic risk of loss borne by each of them for such partnership liability, or portion thereof.

In addition, we agree with the choice of examples. While Example 2 confirms the holding in *IPO II*, Example 1 rejects the Broad Interpretation.

**VII. Liquidating Distributions of Partnership Interests**

**A. Background**

In the Preamble, Treasury and the Service indicated that they are considering the proper treatment of liabilities in connection with a specific transaction – when a UTP (the transferor) bears the EROL for an LTP liability and makes a liquidating distribution of its interest in the LTP to one of its partners (the transferee) but the transferee partner does
not bear EROL for the LTP’s liability. The Preamble requests comments regarding the timing of the liability reallocation relative to the transaction that causes the liability to change from recourse to nonrecourse.\textsuperscript{43}

The Preamble does not indicate whether in Treasury’s and the Service’s view, the transferring UTP may continue to bear EROL for the liability of the LTP after the distribution. As a preliminary matter, we recommend that Treasury and the Service consider clarifying whether (as opposed to simply when) such a distribution results in a decrease in the distributing partnership’s share of the liabilities of the LTP. In \textit{Weiss v. Commissioner},\textsuperscript{44} the Service asserted that the taxpayer, who had personally guaranteed a partnership liability, was relieved of that liability upon the taxpayer’s forfeiture of his partnership interest incident to the taxpayer’s failure to meet a capital call, even though there was no evidence that the creditor or the remaining partners had agreed to relieve the taxpayer of his obligations under the guarantee. The Tax Court held that the subsequent reduction of the taxpayer’s partnership interest to zero reduced his share of partnership liabilities to zero and that the reduction triggered a deemed cash distribution in the amount of his share of those liabilities, resulting in short term capital gain. In the view of the Tax Court, the continuation of business by the new partnership triggered an assumption of liabilities by the other partners sufficient to cause a decrease in the taxpayer’s share of liabilities under section 752(b).

Reversing the Tax Court, the Eleventh Circuit held that because the taxpayer had not been relieved of his guarantee obligations, there was no deemed distribution of cash under section 752(b) triggering gain.\textsuperscript{45} The Eleventh Circuit declined to infer that the taxpayer had been discharged from his obligations under the guarantee absent clear indications that the creditor had released the taxpayer or the other partners had assumed his obligations.\textsuperscript{46} Although the basis for the Eleventh Circuit’s decision in \textit{Weiss} is not clear, it may be that the taxpayer was treated as assuming the obligation of the partnership, although assumption of the obligation would be inconsistent with the taxpayer’s status as a guarantor and not as the primary obligor.

The Eleventh Circuit’s decision in \textit{Weiss} creates the seemingly untenable result that a partnership liability extended or guaranteed by a partner can create basis both to a prior partner that bears EROL under the Current Regulations, protecting that partner from

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{43} Uncertainty associated with shifting liability shares in carryover basis transactions was identified in prior comments from the American Bar Association’s Section of Taxation addressing the application of section 362(e) to contributions of partnership interests. \textit{See} ABA Tax Section, \textit{Comments on Proposed Regs on Limitations on Transfers of Built-in Losses}, 2011 \textit{TAX NOTES TODAY} 208-21 (Oct. 27, 2011). These comments, which address the phantom tax loss inherent in a partnership interest contributed to a corporate transferee resulting solely from the inclusion of partnership liabilities in the basis (but not the value) of the contributed interest, note that it is not clear whether an adjustment to the amount of liabilities included in the basis of the transferred interest in the hands of the transferee should occur before or after the transfer.
\item \textsuperscript{44} 60 T.C.M. (CCH) 746, 1990 T.C.M. (RIA) ¶ 90,942, \textit{rev’d}, 956 F. 2d 242 (11th Cir. 1992) (discussed below).
\item \textsuperscript{45} \textit{Weiss v. Comm’r}, 956 F. 2d 242 (11th Cir. 1992).
\item \textsuperscript{46} \textit{Id. See also} \textit{Jackson v. Comm’r}, 708 F.2d 1402 (9th Cir. 1983); \textit{McDaniel v. Comm’r}, 77 T.C.M. (CCH) 1880, 1999 T.C.M. (RIA) ¶ 99,133.
\end{itemize}
\end{footnotesize}
gain recognition even though that prior partner is no longer a partner in the partnership,
while at the same time providing basis to the remaining partners of the partnership.
Treasury and the Service, however, have not issued any guidance regarding their view of
the issue subsequent to the Eleventh Circuit’s opinion. It is important to resolve whether
the transferor should be treated as having been relieved of the liability to be able to
analyze the impact of a transfer by a UTP that bears EROL for the liability.

Given that the general objective of section 752 is to create basis parity between a
partnership’s basis in its assets and the partners’ bases in their partnership interests, it is
arguably unnecessary to defer the deemed distribution to an exiting partner under section
752. We recommend that Treasury and the Service clarify the circumstances under
which a prior partner should be considered to continue to bear EROL for purposes of
applying section 752 to facilitate a meaningful discussion of the transactions for which
comments are sought. To advance the discussion, for purposes of our analysis below, we
assume that the distributing UTP is not entitled to include the LTP liability in
determining its tax consequences after the distribution.

We also note that partnership distributions of partnership interests that cause a
change in the classification of a partnership liability from recourse to nonrecourse are not
the only types of transactions that may alter the allocation of partnership liabilities
attributable to the distributed interest. For example, if two unrelated partners in a three-
member UTP (none of whom are direct members of LTP) validly guarantee a liability of
an LTP such that the amount of the LTP liability is included in the basis of the LTP
interest held by the UTP (and in the combined basis of the two partners in their UTP
interests), and UTP distributes the LTP interest to one of the guarantor partners, a
question exists regarding whether UTP’s basis in the distributed interest immediately
before the distribution includes the entire LTP liability.

Moreover, a change in the share of partnership liabilities allocated to an interest
can arise in connection with a routine sale or exchange of that interest. Consider the
following example:

X and Y, a person unrelated to X, own equal interests in the
XY partnership. X bears EROL for a legally nonrecourse
liability of the XY partnership owed to an unrelated bank
because X has validly guaranteed the liability. Because X
bears EROL, the liability is treated as a recourse liability
for purposes of section 752, and X includes the amount of
the liability in the basis of its partnership interest. Later, X
sells its XY partnership interest to Z, a person unrelated to
X or Y. Assume the bank releases X from its guaranty
obligation in connection with the sale.

As explained below, the Regulations applicable to sales or exchanges of
partnership interests are different than those that relate to other types of transactions.
Under section 752(d), “in the case of a sale or exchange of an interest in a partnership,
liabilities shall be treated in the same manner as liabilities in connection with the sale or
exchange of property not associated with partnerships.” Regulation section 1.752-1(h) provides that “[i]f a partnership interest is sold or exchanged, the reduction in the transferor partner’s share of partnership liabilities is treated as an amount realized under section 1001 and the regulations thereunder.” Thus, section 1001 is applicable in determining the amount realized by the seller of a partnership interest. Regulation section 1.1001-2(a)(4)(v) provides that the liabilities from which a transferor is discharged as a result of a sale or other disposition of a partnership interest include the transferor’s share of the liabilities of the partnership.47

Therefore, under these provisions, X includes the entire amount of the debt in the amount realized. However, because neither Z nor Y is related to X, upon the sale of the interest to Z, no partner or person related to a partner bears EROL for the partnership liability, and the partnership liability becomes a nonrecourse liability for purposes of section 752. Under Regulation section 1.752-3, Z may include only a portion of the liability in the basis of its interest.

B. Distributions of Partnership Interests

Section 752(b) provides in part that a reduction in a partner’s share of a partnership liability is treated as a distribution of money to such partner. Regulation section 1.752-1(e) further states that, if property is contributed by a partner to the partnership or distributed by the partnership to a partner and the property is subject to a liability of the transferor, the transferee is treated as having assumed the liability to the extent that the amount of the liability does not exceed the fair market value of the property at the time of the contribution or distribution.48 In contrast, as stated above, Regulation section 1.752-1(h) provides that “[i]f a partnership interest is sold or exchanged, the reduction in the transferor partner’s share of partnership liabilities is treated as an amount realized under section 1001 and the regulations thereunder.”

The limitation in the application of section 752(d) to sales or exchanges of partnership interests appears to be statutorily based. The temporary regulations to section 752(d) initially provided that section 752(d) applied to a sale, exchange, “or other disposition.”49 The final regulations, however, do not include any reference to other dispositions.

In addition, section 761(e) limits the circumstances in which a distribution of a partnership interest is treated as an exchange. It provides:

(e) Distributions of partnership interests treated as exchanges. – Except as otherwise provided in regulations, for purposes of –

(1) section 708 (relating to continuation of partnership),

47 As further discussed below, Regulation section 1.1001-2(a)(4)(iv) provides that contributions and distributions of property between a partner and a partnership are not sales or other dispositions of property.
48 See, e.g., Reg. § 1.752-1(g), Ex. (1).
section 743 (relating to optional adjustment to basis of partnership property), and
any other provision of this subchapter specified in regulations prescribed by the Secretary,
any distribution of an interest in a partnership (not otherwise treated as an exchange) shall be treated as an exchange. 50

Thus, only for purposes of section 708, section 743, or any other provision of Subchapter K specified in regulations is a distribution of a partnership interest treated as an exchange of the interest. 51

Support for the conclusion that a distribution of a partnership interest is not a sale or exchange of the interest also can be found in section 731. Section 731(b) provides that no gain or loss is recognized by a partnership on a distribution to a partner of property, including money. In contrast, Regulation section 1.731-1(b) provides that “gain or loss may result to the partnership from certain distributions which, under section 751(b), must be treated as a sale or exchange of property between the distributee partner and the partnership.” 52 Similarly, Regulation section 1.731-1(c)(3) provides that if there is a contribution of property to a partnership and within a short period (i) before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or (ii) after such contribution, the contributed property is distributed to another partner, such distribution may not fall within the scope of section 731. Thus, section 731 does not apply to a distribution of property if, in fact, the distribution was made to effect an exchange of property between two or more of the partners or between the partnership and a partner. Such transaction will be treated as an exchange of property. 53

Finally, under section 731(a), a partner that recognizes gain or loss on a distribution from a partnership is treated as recognizing gain or loss from the sale or exchange of the partnership interest. Arguably, this provision would have been unnecessary if distributions already constituted sales or exchanges. 54

In summary, we believe a distribution of partnership property, including a distribution of an interest in an LTP, generally should not be treated as a “sale or exchange of the interest.”

50 I.R.C. § 761(e).
51 See also H.R. REP. NO. 98-861, at 864 (1984), as reprinted in 1984 U.S.C.C.A.N. 1445, 1552 (“The conference agreement follows the Senate amendment with technical changes affecting the placement of the new provision within the [Code] and providing that for purposes of section 708, section 743, or any other provision of Subchapter K specified in regulations (not just section 743 as in the House bill and Senate amendment) a distribution of a partnership interest by a partnership or corporation will be treated as a sale or exchange of the interest.”)
52 (emphasis added).
53 See also Rev. Rul. 2007-40, 2007-1 C.B. 1426 (a transfer of partnership property to a partner in satisfaction of a guaranteed payment is a sale or exchange under section 1001 and not a distribution under section 731).
54 We also note that Regulation section 1.1001-2(a)(4)(iv) states that contributions and distributions of property between a partner and a partnership are not sales or other dispositions of property. This provision suggests that contribution and distributions are types of transfers that are mutually exclusive from transfers that constitute sales or other dispositions.
exchange” of the distributed property. Further, because section 752(d) applies solely to sales or exchanges, section 752(d) generally should not apply to a partnership distribution, unless the distribution is otherwise treated as an exchange. Thus, in general, a change in the amount of liabilities with respect to a partnership interest arising from a distribution of the interest should be analyzed under section 752(a) and (b).

C. Timing Considerations

Deemed contributions and distributions of money to or from a partnership affect the basis of the contributing partner’s and distributee partner’s interest in the partnership. The timing of these deemed transactions is important for a number of reasons. Most importantly, the timing matters in applying section 731, which governs the recognition of gain by the partner and the partnership in connection with partnership distributions, and section 732, which governs the distributee’s basis in distributed partnership property. 55

With respect to the latter provision, under section 732(a)(1), the basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner’s interest is generally equal to its adjusted basis to the partnership immediately before such distribution. 56 However, under section 732(a)(2), the basis to the distributee partner in such cases cannot exceed the adjusted basis of the partner’s interest in the partnership, reduced by any money distributed in the same transaction. Under section 732(b), the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner’s interest is equal to the adjusted basis of the partner’s interest in the partnership, reduced by any money distributed in the same transaction.

If the amount of a liability allocable to an LTP interest held by a UTP is reduced immediately before a distribution of that interest, the liability reduction is treated as a deemed distribution of cash to the UTP partners allocated that liability. In the case of a distribution that causes the character of the liability to change from recourse to nonrecourse, presumably the distributee is not allocated any pre-distribution share of the liability and thus would not be treated as receiving a deemed distribution of cash. However, if the amount of the liability allocable to an LTP interest is reduced immediately after the distribution, the distributee may be treated as receiving a deemed distribution of cash coincident with the liability reduction that may result in gain recognition by the distributee under section 731. Moreover, if the amount of a liability

55 The amount of liabilities included in the basis of the distributed interest is important for other Code sections as well. For example, under the disguised sale rules, a disguised sale of property by a partnership to a partner may occur in connection with a distribution of property subject to non-qualified liabilities, and the amount of any such liability assumed can affect the portion of the transaction treated as a part of a sale. Under Regulation section 1.707-6(b)(1), if the partner assumes or takes subject to a liability that is not a qualified liability, the amount treated as consideration transferred to the partnership is the amount that the liability assumed or taken subject to by the partner exceeds the partner's share of that liability (determined under the rules of Regulation section 1.707-5(a)(2)) immediately before the transfer. Other provisions that may be implicated by a change in the amount of liabilities allocated to an interest include section 737, which addresses distributions of property to certain contributing partners, as well as section 751(b), which treats certain distributions as exchanges.

56 See also Reg. § 1.732-1(a).
allocable to an LTP interest is not reduced until after a distribution, the basis of the
distributed interest immediately before the distribution may exceed the distributee
partner’s basis in its UTP interest, causing one of the limitations to the basis of
distributed property provided for by section 732(a)(2) or section 732(b) to apply.  

If under either of section 732(a)(2) or section 732(b), the adjusted basis to UTP of
an interest in LTP immediately before a distribution is different than the adjusted basis of
the LTP interest in the distributee’s hands, in addition to an adjustment to the basis of the
distributed property itself, as explained below, adjustments to the basis of the remaining
property of the distributing partnership as well as to the basis of property of the
partnership whose interest is distributed may be required pursuant to section 734 and
section 743, respectively.

Section 734(a) provides that the basis of partnership property of the distributing
partnership is not adjusted as a result of a distribution of partnership property unless a
section 754 election is in effect with respect to the distributing partnership or unless there
is a substantial basis reduction. If, however, either a section 754 election is in effect or
there is a substantial basis reduction, the distributing partnership is required to: (1)
increase the adjusted basis of partnership property by (a) the amount of any gain
recognized to the distributee partner with respect to such distribution under section
731(a)(1), and (b) in the case of distributed property to which section 732(a)(2) or (b)
applies, the excess of the adjusted basis of the distributed property to the partnership
immediately before the distribution (as adjusted by section 732(d)) over the basis of the
distributed property to the distributee, as determined under section 732; or (2) decrease
the adjusted basis of partnership property by (a) the amount of any loss recognized to the
distributee partner with respect to such distribution under section 731(a)(2), and (b) in the
case of distributed property to which section 732(b) applies, the excess of the basis of the
distributed property to the distributee, as determined under section 732, over the adjusted
basis of the distributed property to the partnership immediately before such distribution
(as adjusted by section 732(d)). If the distributing partnership is required to adjust the
basis of its remaining property, that basis adjustment is allocated pursuant to section 755
and applicable regulations.

Similarly, under section 743(a), the basis of the property of a partnership the
interest in which is distributed generally is not adjusted as the result of the sale or
exchange deemed to result from the distribution. However, if an election under section
754 is in effect with respect to the transfer or the partnership has a substantial built-in loss

57 See example in part D below.
58 In general, a “substantial basis reduction” is considered to exist with respect to a distribution if
the sum of (i) the amount of any loss recognized by the distributee partner with respect to the distribution,
plus (ii) the excess of the amount of the basis of the distributed property to the distributee under section
732(b) over the distributing partnership’s basis in the property immediately before the distribution exceeds
$250,000.00. I.R.C. § 734(d)(1).
59 I.R.C. § 734(c).
60 As highlighted above, pursuant to section 761(e)(2), for purposes of section 743, the distribution
of an interest in a partnership is treated as an exchange. See also Reg. § 1.761-1(e).
immediately after the transfer,\textsuperscript{61} the partnership must increase the adjusted basis of partnership property by any excess of the transferee’s basis in its interest over the transferee’s share of the partnership’s basis in partnership property or decrease the basis of partnership property by any excess of the transferee’s share of the partnership’s basis in partnership property over the transferee’s basis in its interest.\textsuperscript{62} If the transferee of a partnership interest receives a basis adjustment under section 743(b), that basis adjustment is allocated among the partnership’s assets pursuant to section 755 and applicable regulations.\textsuperscript{63}

For distributions of a partnership interest, the determinations required by sections 734 and 743 depend upon the distributing partnership’s basis in the distributed interest immediately before the distribution, as well as the distributee’s basis in the interest received. The following example helps illustrate this concept:

X, Y and Z each invest $50 in exchange for equal interests in the profits and capital in UTP. X, Y and Z are unrelated. UTP contributes $50 to LTP in exchange for a 50-percent interest in LTP. A, an individual unrelated to X, Y or Z, contributes $50 to LTP in exchange for the remaining 50-percent interest in LTP. LTP borrows $100 from a bank that, absent any credit enhancement, is treated as nonrecourse debt allocated between A and UTP under Regulation section 1.752-3. However, X validly guarantees the $100 liability of LTP. Under Regulation section 1.752-2(i)(2), the $100 liability is treated as a recourse liability of LTP for purposes of section 752 and is allocated by LTP to UTP, and by UTP entirely to X. UTP’s LTP interest has a book value of $50 and a basis of $150.

Assume that UTP distributes its entire interest in LTP to Y. As a result of the transfer, the LTP liability becomes a nonrecourse liability of LTP because neither a partner of LTP nor any person related to a partner of LTP bears the EROL for the liability.\textsuperscript{64} The LTP liability is then subject to allocation by LTP as a nonrecourse liability pursuant to Regulation section 1.752-3. Assume that, pursuant to Regulation section 1.752-3(a)(3), A and Y are each allocated $50 of the LTP liability.

Absent any adjustment arising from a change in the classification (and allocation) of the LTP liability from recourse to nonrecourse, UTP’s basis in the LTP interest

\textsuperscript{61} Under section 743(d)(1) a partnership has a substantial built-in loss with respect to a transfer of an interest in a partnership if the partnership’s adjusted basis in the partnership property exceeds the fair market value of the property by more than $250,000.00.

\textsuperscript{62} I.R.C. § 743(b).

\textsuperscript{63} I.R.C. § 743(c).

\textsuperscript{64} See Reg. § 1.752-1(a)(2).
immediately before the distribution equals $150. Y’s basis in its UTP interest immediately before the distribution is $50. Should UTP’s basis be adjusted to account for the change in the character of the liability from recourse to nonrecourse for purposes of determining UTP’s basis in the distributed LTP interest immediately before the distribution? Does it matter whether the share of liabilities included with respect to the distributed interest changes because of a change in the liability from recourse to nonrecourse instead of for another reason?

D. Approaches to the Problem

If the LTP liability is reclassified and its allocation is redetermined after the distribution – that is, if the $100 of LTP liability is included in UTP’s basis in its LTP interest immediately before the distribution, but Y’s outside basis in its UTP partnership interest is only $50 – then, under either section 732(a)(2) or section 732(b), the basis of the distributed LTP interest in Y’s hands is reduced from $150 to $50.\footnote{See Reg. § 1.732-1(a). The impact of the basis reduction under a section 754 election is considered below.} Further, a post-distribution redetermination of the share of the LTP liability allocated to the LTP interest in the hands of Y would result in an additional net basis reduction of $50, consisting of (i) a $100 gross decrease in Y’s basis in its LTP interest under section 752(b) resulting from the decrease in Y’s share of LTP’s $100 recourse liability, plus (ii) a $50 gross increase in Y’s basis in the LTP interest under section 752(a), reflecting Y’s increase in the share of the $100 in LTP’s nonrecourse liabilities.\footnote{If, as a result of a single transaction, a partner incurs both an increase in the partner’s share of the partnership liabilities (or the partner’s individual liabilities) and a decrease in the partner’s share of the partnership liabilities (or the partner’s individual liabilities), only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership. See Reg. § 1.752-1(f).} Because Y’s basis in its interest had already been limited to $50 pursuant to section 732, this net $50 reduction would further reduce Y’s basis in its LTP interest to $0, even though Y’s equity investment in LTP is $50 and its share of the LTP liabilities is $50.

We believe that this is clearly an inappropriate result. In this case, the initial $100 basis reduction to the LTP interest mandated by section 732 duplicates the $100 basis reduction that section 752(b) accomplishes to reflect the elimination of $100 gross allocation of recourse debt. The application of section 752 then further reduces Y’s basis, leaving Y without any basis in its interest in LTP. This actually creates a $100 disparity between Y’s outside basis in its LTP interest ($0) and its share of the basis in the LTP property ($100). If LTP had a section 754 election in effect or were a substantial built-in loss partnership, the LTP would be required to reduce the basis of its assets to restore inside-outside parity, but ultimately in a manner inconsistent with Y’s economic investment. Further, if UTP had a section 754 election in effect, the $100 reduction in the basis of the distributed LTP interest would result in an $100 increase in the basis of UTP’s remaining partnership property of like character even though no adjustment to the basis of UTP’s remaining partnership property is required to maintain parity between X and Z’s outside bases in their UTP interests ($100) and UTP’s basis in its remaining assets ($100).
Alternatively, if the liability is reclassified and the allocation is redetermined before the distribution, UTP’s share of the LTP’s recourse liability would initially decrease by $100 under section 752(b), and under Regulation section 1.752-3 and the facts of the example, half of the LTP nonrecourse liability would be allocated to UTP, and by UTP, to the partners of UTP (and half to A). Now, Y would receive the LTP interest having a basis immediately before the distribution of $100 (consisting of $50 of equity and an allocation of $50 of the LTP nonrecourse debt) against Y’s outside basis in its UTP interest of $66.67, consisting of $50 plus Y’s share of the LTP nonrecourse debt ($16.67, assuming the debt is treated as excess nonrecourse liability under Regulation section 1.752-3(a)(3) allocated in accordance with profit percentages). Similar to the conclusion above with respect to a post-distribution redetermination, even in a pre-distribution redetermination, UTP’s basis in the LTP interest of $100, exceeds Y’s outside basis of $66.67, and under section 732, Y’s basis is limited to $66.67. In this case, however, a post-distribution redetermination of the share of the LTP liability allocated to the LTP interest in the hands of Y would result in a basis increase of $33.33, which is the increase in Y’s share of the nonrecourse liability from $16.67 to $50.

Even though reclassifying the liability before the distribution can address an unwarranted reduction in outside basis, a further step seems appropriate to avoid possible creation of inside-outside basis disparities. To that end, while Y’s share of the LTP nonrecourse debt of $50 that is treated as a nonrecourse liability of UTP initially may be less than $50 under Regulation section 1.752-3, in this case, it may be appropriate to further allocate the LTP liability treated as a liability of UTP solely to Y (and away from X and Z), in anticipation of the distribution to Y, although no current rule provides for this. In this case, the share of X and Z in the LTP liability would be reduced to zero, and Y’s share would be $50 immediately prior to the distribution of the LTP interest.

If the LTP liability were required to be allocated by UTP solely to Y immediately before the receipt of the LTP interest, Y’s basis in its UTP interest would equal $100, consisting of Y’s historic $50 equity investment plus the allocation of $50 of the LTP nonrecourse liability. Now, a distribution of the LTP interest, having a basis of $100 in UTP’s hands, to Y at a time when Y’s outside basis in UTP is $100 would not result in a reduction in the basis of the LTP interest in the hands of Y. Y ends up with a basis in the LTP interest of $100. No basis adjustment is made to the interest in LTP pursuant to section 732. Moreover, no section 743 adjustment to LTP’s assets or section 734(b) adjustment to the remaining assets of UTP is required, regardless of whether LTP and UTP have section 754 elections in effect or are substantial built-in loss partnerships, and no inside-outside basis disparities are created.

Another approach that arrives at the same result would be to reduce UTP’s share of LTP’s liability to zero on account of the conversion of the debt from a recourse liability to a nonrecourse liability and treat the LTP interest distributed as having a basis equal to UTP’s equity basis in its LTP interest of $50. In this case, immediately before the distribution of the LTP interest, UTP’s basis in the interest would be $50, and Y’s basis in its UTP interest would also equal $50, no adjustment would be made to the basis.

See Reg. §§ 1.752-4(a), -3(a)(3).
of the distributed LTP interest under section 732. Upon Y’s receipt of the LTP interest, under section 752(a), Y would be deemed to contribute $50 to LTP to account for Y’s increase in Y’s share of the LTP nonrecourse debt.\(^{68}\)

The removal from the basis of the distributed partnership interest of that portion of the debt as to which the allocation changes as a result of the distribution prevents such changes from affecting the rules that seek to reestablish inside-outside basis parity, such as sections 743 and 734, and avoids creating disparities where they do not exist. This approach is also consistent with the “final outcome” approach of Regulation section 1.752-1(f), which provides that if, as a result of a single transaction, a partner incurs both an increase in the partner’s share of the partnership liabilities (or the partner’s individual liabilities) and a decrease in the partner’s share of the partnership liabilities (or the partner’s individual liabilities), only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership.

E. **Recommendation**

We believe that liabilities associated with a distributed partnership interest should not be treated in the same manner as liabilities in connection with the sale or exchange of property and that the impact of changes in the shares of liabilities is appropriately handed by applying sections 752(a) and 752(b) to the changes in the shares of liabilities immediately before and after the distribution. We also believe the better approach is that which minimizes the creation or increase in disparities between inside and outside basis arising solely from changes in the share of partnership liabilities associated with an interest due to a change in the nature of the liability from recourse to nonrecourse. Such disparities are minimized if the UTP is deemed relieved of any liability allocated with respect to the distributed interest in the hands of the UTP that is not also allocated with respect to the interest held by the distributee partner while that interest is owned by the UTP.

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\(^{68}\) A similar approach was adopted by the Service in Revenue Ruling 84-53, 1984-1 C.B. 159. In that ruling, the Service determined the amount of basis attributable to the sale of a portion of a partner’s partnership interest. The Service concluded that in cases where the partner’s share of all partnership liabilities does not exceed the adjusted basis of such partner’s entire interest (including basis attributable to liabilities), the transferor partner should first exclude from the adjusted basis of such partner’s entire interest an amount equal to such partner’s share of all partnership liabilities, as determined under Regulation section 1.752-1(e). The transferor partner should then allocate a part of the remaining adjusted basis (if any) to the transferred portion of the interest according to the ratio of the fair market value of the transferred portion of the interest to the fair market value of the entire interest. The sum of the amount allocated plus the amount of the partner’s share of liabilities that is considered discharged on the disposition of the transferred portion of the interest (under section 752(d) and Regulation section 1.1001-2) equals the adjusted basis of the transferred portion of the interest.