ALLOCATION OF PARTNERSHIP LIABILITIES AND NONRECOERCSE DEDUCTIONS

April 2000

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Adjusted basis is a vital aspect in determining the taxation of a partner's receipt of a partnership distribution.

3. Limitation on Current Deductibility of Losses.

Section 704(d) limits a partner's distributive share of partnership loss for any year to the adjusted basis of his or her interest in the partnership at the end of that year.

B. Effect of Liabilities.
The allocation of partnership liabilities plays a significant role in determining a partner's adjusted basis in its partnership interest. Section 752 includes in a partner's adjusted basis the partner's share of partnership liabilities.

**Illustration:**

AB Partnership; A and B each contribute $10,000. AB Partnership purchases property for $100,000 with a ten-year depreciation period, paying $20,000 in cash and $80,000 borrowed under a note requiring no principal payments for 10 years. In each of the first 5 years, the partnership has a net loss of $5,000 after depreciation.

The net cash flow of $5,000 each per year is distributed equally to partners A and B.

If liabilities are not included in basis, the original basis of $10,000 would decrease to zero at the end of the second year, because adjusted basis is reduced each year by the partner's share of the $5,000 loss and the $2,500 in cash distributed to each partner.
Section 704(d) would bar each partner from deducting partnership losses, unless the partner makes additional capital contributions or engages in some other transaction increasing basis.

If the liability is allocated equally between the partners, each partner's original basis of $10,000 is increased by $40,000 as a result of the loan to the partnership. Thus, each partner has sufficient basis to absorb the share of partnership losses allocated to that partner.

C. Distinction between Cash Distributions and Taxable Income.

1. Taxable Income.

Each partner includes its distributive share of each item of partnership income, gain, deduction, loss and credit in its separate taxable income or loss. I.R.C. ' 702. The distributive share of a partner includes amounts allocable to a partner whether or not distributed. Regardless of any reason for nondistribution, each partner pays taxes on his or her distributive share. United States v. Basye, 410 U.S. 441, 454 (1973).

II. Basis

A partner's basis in its partnership interest is significant in the event the interest is transferred or liquidated. It is also important in ascertaining the consequences of partnership distributions under sections 731 and 732 and in determining the deductibility of partnership losses, as prescribed by section 704(d).

A. Computational Rules.

1. Initial Basis.

Section 722 states the basis of a partnership interest acquired by contribution of property, including money, is equal to the amount of money or the adjusted basis of other property contributed to the partnership.

2. Adjustments.
Section 705(a) contains the computational rules the adjusting a partner's basis in its partnership interest over the life of the partnership.

a. **Aggregate Approach.**

These rules reflect an aggregate approach that is consistent with the overriding notion of the partnership as a conduit for the taxation of partnership income and loss directly to the partners. This approach is in contrast to the entity approach of corporate tax provisions under which income and loss at the corporate level are neither taxed to the shareholders nor reflected in the basis of their shares.

b. **Specific Adjustments.**

Under section 705, the following specific adjustments are made:

The partner’s adjusted basis in its partnership interest is increased by the partner's share of:

i. taxable income of the partnership
ii. income of the partnership exempt from tax; and
iii. the excess of the deductions for depletion over the basis of property subject to depletion; and

decreased (but not below zero) by the partner's share of:

i. losses of the partnership;
ii. partnership expenditures not deductible in computing taxable income and not properly chargeable to capital account; and
iii. the amount of the partner's deduction for depletion for any partnership oil and gas property, as limited by the adjusted basis of such property allocated to the partner.

3. **Comparison of Inside and Outside Basis.**

Despite the clear distinction between the basis of a partner's interest in a partnership and the partnership's basis in its assets, the aggregate of the partners' adjusted basis in the partnership interest generally equals the aggregate of the adjusted basis of partnership assets. This fundamental equity between the aggregate basis of partnership assets and the aggregate basis of partners is reflected in the "alternative rule" of section 705(b), which provides for the determination of a partner's basis in its interest by reference to its proportion share of the basis of partnership assets. A partner has a single unified basis in its
partnership interest for tax purposes even if a partner holds different classes of interest (e.g., general and limited) or interests that were acquired at different times. Rev. Rul. 84-53, 1984-1 C.B. 160.

4. **No Negative Basis Rule.**

Sections 705(a)(2) and 705(a)(3) prohibit reduction of a partner's basis below zero. This floor under a partner's basis reflects the limitation of section 704(d) for deducting losses to an amount not greater than a partner's basis in the partnership at the end of the year in which the loss is incurred.

**B. Timing of Basis Calculations and Adjustments.**

1. **When Basis Computation Required.**

A partner is only required to compute its basis in its partnership interest if the computation is necessary to determine tax liability. Typically, basis computations are necessary at the following times:

- the end of a partnership year during which the partnership suffered a loss, to determine the deductibility of the partner's share of the loss under section 704(d);
- upon the liquidation or disposition of a partner's interest, in order to determine gain or loss under section 731(a) or section 741 and the basis of property received from the partnership under section 732(b) as part of a liquidating distribution;
- upon the distribution of cash or property to a partner in order to ascertain the basis of the distributed property under section 732(a)(2) or the taxability of cash distributed under section 731(a).

2. **Ordering Rules.**

The order in which the various section 705 basis adjustments are made can be important in applying the loss limitation rule and the current distribution rules. The section 704(d) limitation is based on the partner's basis at the end of the partnership year. In contrast, section 731 through 733 operate with respect to the partner's basis "immediately before" the partnership distribution.

a. **Cash before loss.**

Revenue Ruling 66-94, 1966-1 C.B. 166, illustrates the general ordering rules with respect to section 704(d). A has a basis of $50 in her partnership interest at the beginning of the year. She
receives cash distributions of $30 and is allocated a $60 distributive share of partnership loss. In determining what portion of the loss will be deductible, basis is first adjusted for the $30 cash distribution, so that her deductible loss is limited to the remaining $20.

b. Advances.

In Revenue Ruling 94-4, 1994-1 C.B. 196, the Service treated a deemed distribution of money under section 752(b) (resulting from a decrease in a partner's share of liabilities) as an advance or drawing of money under Reg. 1.731-1(a)(1)(ii) to the extent of the partner's distributive share of partnership income for the taxable year. Advances or drawings are taken into account at the end of the taxable year.

C. Effect of Basis on Property Distributions in Nonliquidating Distribution.

The timing rules also affect the basis determination for property distributed in a nonliquidating distribution. If money and property are distributed as part of the same distributions, the distributee's basis in its partnership interest is first reduced by any money distributed and then by the basis of the distributed property to the partnership.

Illustration:

A receives a distribution of $30 in cash and property with a basis of $40 to the partnership. Prior to the distribution, A has a basis of $50 in her partnership interest. Under sections 705(a)(2) and 733, the partner's basis is first reduced by the $30 cash distribution. Next, A's remaining $20 basis ($50-30) in her partnership interest is reduced (but not below zero) by the partnership's $40 basis in the distributed property. After the distribution, A's basis in her interest is zero and so she would be limited by section 704(d) as to any loss that is allocable to her for the year. Under section 732(a)(2), the basis of the distributed property in the hands of A is limited to her pre-distribution adjusted basis (after taking into account the cash distribution), or $20.

These timing rules provide taxpayers with some flexibility in planning, subject to the Service invoking the step transaction doctrine when all of the events are preplanned and dependent upon one
another. For example, if the partners are considering distributions of both cash and property, they should ordinarily distribute the cash either prior to or at the same time as the property if the sum of the cash and the adjusted basis of the property to be distributed exceed the basis for their interest. A cash distribution made subsequent to a distribution of property would trigger unnecessary recognition of gain.


Prior to the 1997 Act, section 732(a) provided that a distributee partner took a basis in property received in a nonliquidating distribution equal to the property’s basis in the hands of the partnership, capped at the partner’s adjusted basis in its partnership interest and reduced by any money distributed. In the event multiple properties were distributed by the partnership and the total carryover basis of the properties exceeded the partner’s basis in its partnership interest, the partner’s basis in its partnership interest was allocated among the assets with the partner’s basis first allocated to unrealized receivables and inventory items, and the remainder of the partner’s basis allocated among the remaining properties in proportion to their adjusted bases to the partnership.

To prevent taxpayers from engaging in basis shifting transactions that increased basis artificially and thereby creating inflated depreciation deductions, Congress amended section 732(c) to require an allocation of basis among distributed properties using fair market values. Under the 1997 Act, when multiple properties are distributed by a partnership, the partner’s basis in its partnership interest is allocated:

C  first, to unrealized receivables and inventory items in an amount equal to their bases in the hands of the partnership, subject to the limitation that basis in the distributed properties cannot exceed the distributee’s basis in its partnership interest; and

C  as to any remaining amount, among the other properties by first assigning each property a carryover basis and then increasing or decreasing the basis under the rules described below.

Any required reduction in the basis of the distributed properties is first made for those properties with unrealized depreciation in proportion to such unrealized depreciation, and any additional required basis reduction is made in proportion to the respective bases of the properties, as adjusted.

Any increase in the basis of distributed properties is first made for those properties with unrealized appreciation in proportion to such unrealized appreciation, and any additional basis increase remaining is allocated among the distributed properties, in proportion to their fair market values.
Illustration

A partnership distributes two of its assets, C and D, in a nonliquidating distribution to a partner with a basis in its partnership interest of $20. C and D are not unrealized receivables or inventory items. C has a basis and fair market value to the partnership of $15; D has a basis to the partnership of $15 and a fair market value of $5. The combined basis of C and D to the partnership exceed the partner's basis in its partnership interest by $10 ($30 combined basis of assets - $20 basis of partnership interest). Each of the properties is first assigned a carryover basis of $15. Since a $10 decrease is required, the decrease is allocated solely to D's basis. Thus, C has a basis of $15 and D has a basis of $5 to the distributee partner.

E. Inclusion of Liabilities.

The other major component of the basis adjustment rule relates to the inclusion of partnership liabilities in basis. Increases in a partner's share of partnership liabilities are treated as cash contributions (section 752(a)) and decreases in shares of partnership liabilities are treated as a cash distribution to the partner (section 752(b)). If, as a result of a single transaction, a partner incurs both an increase in his or her share of partnership liabilities and a decrease in his or her share of partnership liabilities, only the net increase or the net decrease will be treated as a cash contribution or a cash distribution. Reg. 1.1752-1(f). In determining what constitutes a single transaction, the Service has shown some indication that the term may be construed broadly. For example, the Service has ruled that the following events constitute a single transaction for purposes of Reg. 1.1752-1(f): (1) a partnership contributes property to an UPREIT in exchange for interests in the UPREIT, (2) the partnership distributes the UPREIT interests to its partners, and (3) the debt secured by the contributed property is refinanced. TAMs 199943005; 199943006; 199943007.

Assumptions of a partnership liability by a partner is also treated as a cash contribution by the partner and the assumption of a partner's liability by the partnership is likewise treated as a cash distribution to the partner.

Illustration:

Partnership buys property for $100,000, paying the price with $20,000 contributed by the partners and $80,000 from borrowed funds. The partnership has a $100,000 basis for the property; and section 752 causes
the original bases for all partners to total $100,000. Thus, the partnership's basis for the assets, and the aggregate of the bases for the individual partners, are the same.

III. Liabilities

Currently, the term "liability" is not defined in Internal Revenue Code, nor in the Regulations.

Illustration:

ABC Partnership purchases property for $1,000, paying $200 in cash, and the balance by a purchase money mortgage of $800. The note is a "liability" because the liability accounts for $800 of the property's cost basis of $1,000.

Prior regulations under section 752 defined an obligation to be a liability only to the extent that the obligation gave rise to (i) the creation of, or an increase in the, basis of property owned by the obligor, (ii) a deduction taken in computing the obligor's taxable income, or (iii) an expenditure that is not deductible in computing the obligor's taxable income. Temporary Reg. 1.752-1T(g)(1991).

Examples given in Temporary Reg. 1.752-1T(k) concluded that accrued but unpaid expenses for a partnership that uses the cash method of accounting are not liabilities under section 752 (example 2). That result was consistent with the holding in Revenue Ruling 88-77, 1988-2 C.B. 129. An underlying premise of the classification of an obligation as a liability is that it is a "legally enforceable" obligation of the partnership and has economic substance.

Compare La Rue v. Commissioner, 90 T.C. 465, 478 (1988) which holds that for an accrual method partnership, the test of whether an incurred expense is a "liability" under section 752 depends on whether the expense is deductible. Therefore, an account payable for a deductible expense is a liability if a partnership uses the accrual method of accounting, but not if the partnership account is on a cash basis.

IV. Distinction between Recourse and Nonrecourse Liabilities and Deductions

A nonrecourse liability is a partnership liability for which no partner or related person bears the economic risk of loss. Reg. 1.752-1(a)(2). A liability which is treated as a nonrecourse liability for other tax and business purposes may constitute a recourse liability for purposes of section 752. For example,
a partner is treated as bearing the economic risk of loss for a liability (and therefore the liability is treated as recourse) to the extent that the partner (or related person) holds or guarantees the liability, even if the liability would be treated as nonrecourse for purposes of Reg. 1.1001-2. The distinction between recourse and nonrecourse liabilities can generally be made based upon:

i. whether the creditor's right to repayment of a partnership liability is limited solely to one or more assets of the partnership; and

ii. whether the liability is extinguished by a transfer (whether voluntarily or involuntarily) of the security for the debt to the lender.

If the answer to both questions is yes, the debt would be classified as nonrecourse.

However, in several recent private letter rulings the Service has classified a general partnership liability as nonrecourse debt even where the debt was not secured by any particular partnership assets. PLRs 199906025; 199903017; 9815022; 9815001. The partnership issued or undertook debt that was a general obligation of the partnership, with no recourse to any of the partners, any related person, or any assets of a related person. The debt was not secured by any particular partnership assets. The Service ruled that the debt was a nonrecourse liability to which more than one item of partnership property was subject. For purposes of determining section 704(c) minimum gain, the partnership may allocate the debt among its properties that are subject to the debt in any amount that does not exceed the lesser of (i) the fair market value of the property or (ii) the amount of debt previously allocated to the property and repaid with the proceeds of the debt.

Reg. 1.752-2(a) establishes the concept that a partner's share of a partnership liability includes the portion of the liability for which the partner or person related to the partner bears the economic risk of loss. If any partner or person related to a partner bears the economic risk of loss with respect to a liability, that liability is recourse. If economic risk of loss exists only with respect to a portion of the liability, then the liability is bifurcated into a recourse liability to the extent of the economic risk of loss and a nonrecourse liability for the remainder. To determine who, if anyone, bears the economic risk of loss, the regulations first employ a mechanical test based upon a constructive liquidation of the partnership, which involves the following hypothetical events, all of which are deemed to occur simultaneously:

1. All of the partnership liabilities become payable in full.

2. With the exception of property contributed to secure a partnership liability, all of the partnership's assets, including cash, have a zero value.
3. The partnership disposes of all of its properties for no consideration (except relief from nonrecourse liabilities).

4. All items of partnership income, gain, loss or deduction are allocated among the partners.

5. The partnership liquidates.

When a partnership holds depreciable property subject to nonrecourse debt and allocations of depreciation deductions have created deficit capital accounts for one or more partners, allocation of the deemed gain on the hypothetical disposition effectively eliminates negative capital account of the partners. Since the debt obligation is extinguished by the disposition, there is, therefore, no remaining payment obligation to be satisfied as the result of any deficit restoration obligation imposed upon a partner. In other words, a deficit capital account restoration obligation with respect to nonrecourse deductions is illusory.

Illustration:

A and B form a general partnership, each contributing $100 in cash. The partnership purchases an office building on leased land for $1,000 from an unrelated seller, paying $200 in cash and executing a note to the seller for the balance of $800. The note is nonrecourse to the partnership, but the seller requires B to guarantee repayment of the obligation. The partnership agreement provides that all items are allocated equally except that tax losses are specially allocated 90% to A and 10% to B and that capital accounts will be maintained in accordance with the regulations under section 704(b). A has a DRO. In a constructive liquidation, the following should be deemed to occur:

(i) The partnership's liability of $800 becomes payable in full;

(ii) All of the partnership's assets have a zero value;

(iii) The partnership disposes of all of its property in a fully taxable transaction.

Applying Reg. 1.752-2(b)(2), the creditor's right to repayment of the $800 partnership liability is not limited solely to one or more assets of the partnership, since B has guaranteed
the debt. Therefore, a loss equal to the remaining tax basis of the partnership's assets, $1,000, is recognized. The $1,000 loss is allocated to the partners' capital accounts as follows:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
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</thead>
<tbody>
<tr>
<td>Initial Capital</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>Allocation of Loss</td>
<td>(900)</td>
<td>(100)</td>
</tr>
<tr>
<td></td>
<td>($800)</td>
<td>$-0-</td>
</tr>
</tbody>
</table>

Thereafter, B would be required to pay on her guarantee. Since B has paid on her guarantee, she would have an economic incentive to enforce the deficit restoration obligation of A. A would have an obligation to restore his deficit capital account in the amount of $800, which would then be distributed to B. Adjustments to the capital accounts for these events would be:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Account at Liquidation</td>
<td>$(800)</td>
<td>$-0-</td>
</tr>
<tr>
<td>Deemed Contribution for Assumption</td>
<td>--</td>
<td>800</td>
</tr>
<tr>
<td>Contribution for DRO</td>
<td>$800</td>
<td>--</td>
</tr>
<tr>
<td></td>
<td>$-0-</td>
<td>$800</td>
</tr>
<tr>
<td>Distribution</td>
<td>--</td>
<td>(800)</td>
</tr>
<tr>
<td></td>
<td>$-0-</td>
<td>$-0-</td>
</tr>
</tbody>
</table>

1 B's guarantee should be treated as an "assumption" under Reg. 1.704-1(b)(2)(iv)(c).

Thus, a critical aspect in applying the regulations is determining whether all obligations related to the partnership liability will be extinguished by the deemed conveyance of property. Even if a partner's payment obligation "with respect to a partnership liability" would not be legally extinguished by the deemed conveyance, however, the obligation will be recognized, in applying the economic risk of loss analysis, only if the obligation satisfies the criteria of Reg. 1.752-2(b)(3).
V. Economic Risk of Loss

A. Background.

The 1956 version of the section 752 regulations provided rules for allocation of a partnership liability based upon whether the liability was recourse or nonrecourse, and whether the partner was a limited partner or a general partner. If the liability was nonrecourse, then all partners, including limited partners, shared the liability in the same proportion as they shared the profits of the partnership. The rationale was that a nonrecourse obligation can be satisfied only out of partnership profits, since the partners are not personally liable.

If the liability was recourse, then all partners shared in the liability in the same proportion that they shared partnership losses. However, a limited partner shared in recourse liabilities only to the extent of the difference between his actual contribution to the partnership and the total contribution which he was obligated to make under the partnership agreement. To the extent that a limited partner's share of a recourse liability exceeded such difference, that liability was allocated to the general partners in proportion to their respective loss-sharing ratios.

In Raphan v. United States, 3 Cl. Ct. 457 (1983), rev'd on this issue, 759 F.2d 879 (Fed. Cir. 1985), the Claims Court held that a liability that was nonrecourse to the partnership but guaranteed by the general partner would still be treated as nonrecourse for purposes of the sharing rules under the 1956 regulations. In response, Congress directed the Service to write new regulations under section 752 to address the basis effects of "guarantees, assumptions, indemnity agreements and similar arrangements." Congress also stated that the new regulations should be based "largely on the manner in which the partners, and persons related to the partners, share the economic risk of loss with respect to partnership debt (other than bona fide nonrecourse debt)." H.R. Rep. No. 861, 98th Cong., 2d Sess. 869 (1984), reprinted in 1984 U.S.C.C.A.N. 1445, 1557 and 1984-3 C.B. Vol. 2, at 123.

In 1988, the Service issued temporary regulations to add an "economic risk of loss" analysis to determine which partners are allocated liabilities. Under those regulations, a partner bears the economic risk of loss with respect to a liability to the extent that the partner (or a related person) would be legally obligated to make the payments, or contributions to the partnership to satisfy the liability, if the partnership's liabilities were due and payable in full, and the partner would not be entitled to reimbursement. To simplify the regulations, they were rewritten, reproposed and then finalized in 1991.
B. Elements of the Regulations.


In general, a partner's share of a recourse liability equals the portion of the debt for which the partner "bears the economic risk of loss." Reg. ' 1.752-1(a)(1); ' 1.752-2(a). A partner bears the economic risk of loss for what he would have to pay if the partnership's assets become worthless and its liabilities are immediately payable. A partner may also have the economic risk of loss for her obligation to make an additional contribution to cover a partnership liability or from an obligation to pay the creditor directly in the event of a partnership default. Economic risk of loss arises in cases such as:

- a general partner's liability for partnership debts under partnership law;
- a partner's obligation under the partnership agreement to make a contribution on liquidation to cover any deficit in the partner's capital account;
- a partner's personal guarantee of a nonrecourse liability of the partnership assuming no rights of subrogation against another partner or person related to a partner; and
- a partner's agreement to reimburse another partner if the other partner is required to pay the partnership debt.

2. Effect of Other Agreements.

The amount of a partner's economic risk of loss takes into account all rights of contribution and reimbursement.

a. Limited Partners.

A limited partner generally does not bear the economic risk of loss for any partnership liability unless the partner is obligated to make further contributions to the partnership or has made a special agreement to pay a creditor or another partner directly in the event of a partnership default.

b. General Partners.

While a general partner is responsible for all partnership debts, he bears the economic risk of loss only for the net amount he would be required to pay after all rights of contribution
among partners are satisfied. The economic risk test assumes that the obligations of persons related to a partner are generally treated as an obligation of that partner.

Illustration:

Each partner in the ABCD Partnership has a 25% interest in profits and losses. A bears the economic risk of loss on 25% of partnership recourse liabilities.

Illustration:

A, the general partner, is a corporation that is a subsidiary of X Corporation. ABC limited partnership obtains a loan without recourse, but the loan is guaranteed by A's parent, X Corporation. A is deemed to bear the economic risk of loss on the loan; the partnership's liability for the loan is allocated to A alone.

An interesting question raised by this second illustration is whether, if X Corporation were called upon to make a payment on the guarantee, the payment would constitute a capital contribution to A or a cancellation of indebtedness. The Service addressed this issue in Field Service Advisory 199921008. This ruling involved a limited partnership between Q, an S corporation, and the Q shareholders, where Q was the general partner. The limited partners, acting in their capacity as Q shareholders, guaranteed recourse financing obtained by the limited partnership. The Service stated that any payments made by the limited partners as a result of the guarantee would be made in their capacity as Q shareholders. The payments would constitute a contribution of capital to Q and would not result in cancellation of indebtedness income.

In a 1996 Private Letter Ruling (PLR 9622014), the Service ruled that a partner must include its proportionate share of a partnership liability which it continued to personally guarantee in the amount realized on the sale of its partnership interest. The purchaser of the interest had agreed to indemnify the seller for any losses suffered on account of the liability. Because of the indemnification agreement between the selling partner and the purchaser, the Service determined that the partner's guarantee had no economic effect and that the selling partner was effectively relieved from the partnership liability upon the sale of the partnership interest.
C. Allocation of Recourse Liabilities among the Partners.

1. Constructive Liquidation of Partnership.

Recourse liabilities are allocated among the partners based on who bears the economic risk of loss on a constructive liquidation. Reg. \textsuperscript{1} 1.752-2(b)(1) expresses the concept that economic risk of loss is to be determined by engaging in the fiction that the partnership is constructively liquidated, and all of the following events are deemed to occur simultaneously:

\begin{itemize}
  \item All partnership liabilities are payable in full;
  \item Except for property contributed to secure a partnership liability, all partnership assets including cash, have a value of zero;
  \item All partnership property is disposed of in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to specified partnership assets);
  \item All items of income, gain loss and deduction are allocated among the partners; and
  \item The partnership liquidates.
\end{itemize}


The assumption of worthlessness extends to all partnership assets, including cash, contractual rights and insurance policies. Reg. \textsuperscript{1} 1.752-2(b)(i)(ii). For the purpose of making the calculations for the constructive liquidation,

\begin{itemize}
  \item[(a)] if the creditor's right to repayment is limited solely to specified partnership assets (nonrecourse debt), gain or loss is recognized to the extent of the difference between the amount of liability that is extinguished by the deemed disposition and the tax basis (or book value if section 704(c) or its regulation applies) of those assets;
  \item[(b)] a loss is recognized equal to the remaining tax basis (or book value if section 704(c) applies) of all partnership assets not taken into account in paragraph (b)(2)(i) of this section.
\end{itemize}
Illustration:

A and B form a partnership with A contributing $100,000 and B contributing $0. They agree to share losses: A-10%, B-90%. AB Partnership purchases a building for $1 million, paying $100,000 in cash and borrowing $900,000. The lender takes a mortgage on the building and partner B guarantees the loan. The guarantee is deemed to be an obligation to make a contribution to the partnership in satisfaction of the mortgage. For constructive liquidation purposes, the building is treated as being sold for $0, resulting in a loss of $1 million to the partnership.

<table>
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<th>Deemed sale</th>
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<tbody>
<tr>
<td>Amount realized</td>
<td>$0</td>
</tr>
<tr>
<td>Basis</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Loss</td>
<td>(1,000,000)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial contribution</td>
<td>$100,000</td>
</tr>
<tr>
<td>Loss allocation</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Deemed contribution</td>
<td>$0</td>
</tr>
</tbody>
</table>

D. Obligations Recognized.

All facts and circumstances determine whether a partner is obligated to make a payment. Obligations include those by contract outside the partnership such as guarantees, indemnities, and other reimbursement arrangements; obligations imposed by the partnership agreement, including contribution to and restoration of capital accounts; and payment obligation imposed by state law. Contingent obligations are disregarded if it is unlikely that they will be discharged, or if occurrence of contingent event is not determinable, the obligation is ignored until the event occurs. Reg. ' 1.752-2(b)(3),(4).

1. Reimbursement Rights.
The obligation to make a payment with respect to a partnership liability is reduced to the extent that the partner or related person is entitled to reimbursement from another partner or person related to that partner. Reg. § 1.752-2(b)(5).

2. Partner as a Lender.

A partner bears the economic risk of loss for that partner's nonrecourse loan to the partnership, if the economic risk of loss is not borne by another partner. If what the partnership owes to that partner includes wrapped debt, that is, a nonrecourse obligation owed to another person, encumbering partnership property, the partnership debt is bifurcated, the amount corresponding to the wrapped debt is treated as a liability owed to a nonpartner. Reg. § 1.752-2(c).

a. Exception.

An exception to this rule exists when the partner's interest in each item of partnership income, gain, loss, deduction or credit for every taxable year of being a partner is 10% or less, and the loan constitutes qualified nonrecourse financing under section 465(b)(6).

b. Debt vs. Equity.

At times, the IRS has contended that loans from partners are not really debts, but equity. Hanbuechen v. Commissioner, 43 T.C. 90, 98 (1964) held that each case must be determined on the applicable facts and circumstances, and the question is whether, looking at all of them, a valid debtor-creditor relationship was established. In Butler v. Commissioner, 36 T.C. 1097 (1961), acq., 1962-2 C.B. 4, the Tax Court allowed an attorney, who advanced $50,000 to a limited partnership of which he was a member, to claim his losses as fully deductible business bad debts. At times, the Service has taken the position that a "loan" is equity instead of debt, when there is thin capitalization. See PLR 8140017 (1981).

c. Loans by Related Persons.

Except for some de minimis transactions, Reg. § 1.752-2(c) provides that a partner bears the economic risk of loss to the extent that the partner or a related person makes a nonrecourse loan to the partnership, and the economic risk of loss is not borne by another partner. As with direct partner loans for the de minimis exceptions to apply, the interest of a partner or related party must be 10% or less in each item of partnership income, gain, loss, deduction or credit and the loan must constitute qualified nonrecourse financing under section 465(b)(6).

3. Obligation to Restore Capital Account.
Reg. ¹ 1.752-2(b)(3)(ii) includes, as one of the obligations which is taken into account for determining the extent to which a partner has a payment obligation, the existence of a deficit capital account restoration obligation upon liquidation of the partnership.

Illustration:

A&B form equal general partnership AB.

<table>
<thead>
<tr>
<th>Capital Accounts</th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>AB borrows $80,000 on a recourse note;</td>
<td></td>
<td></td>
</tr>
<tr>
<td>AB buys property for $100,000. In a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>constructive liquidation:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Partnership loss of $100,000 on</td>
<td>(50,000)</td>
<td>(50,000)</td>
</tr>
<tr>
<td>hypothetical sale of property</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deficits in capital accounts</td>
<td>(40,000)</td>
<td>(40,000)</td>
</tr>
</tbody>
</table>

If the partnership agreement or partnership law requires each partner on liquidation to cover any capital account deficit, each partner would be required to make a $40,000 contribution in the constructive liquidation and, therefore, share the economic risk of loss for the debt equally. Reg. ¹ 1.752-2(g)(4).

The obligation to contribute additional capital is an important factor in determining economic risk of loss. See Reg. ¹ 1.752-2(b). When a limited partner is obligated to make an additional capital contribution to satisfy recourse partnership liabilities, the limited partner is entitled to an allocation of the liability to the extent of the obligation.

Illustration:

ABC limited partnership incurs a $300,000 recourse liability. Limited partners B and C obligate themselves to contribute no more than $250,000 to ABC partnership in the future. A, B and C share profits and losses equally. Accordingly, each is entitled to allocation of 1/3 of the recourse liability ($100,000). If B and C were obligated to contribute only $50,000 each, the $300,000 liability would be allocated $50,000 each to B and C and $200,000 to A, the general partner.
If a partner has a contingent obligation to contribute to the partnership, for example, to cover an overage in construction costs, the obligation is not deemed a liability under Reg. \textsuperscript{4} 1.752-2(b)(4). The obligation is disregarded if taking into account all facts and circumstances, the contingencies make it unlikely that it will ever be discharged. If payment is contingent upon an event which is not determinable with reasonable certainty, the obligation is ignored until the event occurs.

In Revenue Ruling 97-38, 1997-38 I.R.B. 14, the Service ruled that if an allocation to a partner creates a deficit in that partner’s capital account in excess of the partner’s restoration obligation, then the partner has no repayment obligation to the extent of the excess. As a result, the allocation does not have economic effect because the partner does not bear the economic risk of loss.

**Illustration**

A and B each contribute $100 to a limited partnership. A and B share profits and losses equally, but A, as the general partner, is allocated all depreciation deductions. The partnership purchases depreciable property for $1,000, paying $200 cash and borrowing $800 on a recourse basis. The loan is secured by the depreciable property. The building depreciates $200 per year, and the partnership recognizes no other items of income or loss in the first year. At the end of the first year, A’s capital account has a deficit of $100. Reg. \textsuperscript{4} 704-1(b)(2) presumes the value of the property to be equal to its basis, $800. At that value, the partnership’s obligation to the lender could be satisfied by transferring the property to the lender. Therefore, A will have no obligation to contribute any amount to cover the partnership’s shortfall. Since A has no contribution obligation at the end of year one, the allocation creating the $100 capital account deficit will have no economic effect because A does not bear the economic risk of loss for that amount.

4. **Related Persons.**

A person is related to a partner if the relationship between them is as specified in section 267(b) or section 707(b)(1), except (i) 80% or more replaces more than 50%; and (ii) brothers and sisters are excluded. Reg. \textsuperscript{4} 1.752-4(b).

The exceptions are more favorable to taxpayers than the general rules of sections 267(b) and 707(b)(1).
a. Shareholders, partners and beneficiaries are treated as owning proportionately the stock and partnership owned (directly or indirectly) by or for their corporations, partnerships, estates or trusts. I.R.C. '267(c)(1) and 707(b)(3).

b. An individual is treated as owning the stock and partnership interest owned (directly or indirectly) by or for his or her spouse, ancestors and lineal descendants. Brothers and sisters are excluded. I.R.C. '267(c)(2), (4), (5); 707(b)(3).

c. An individual who owns stock in a corporation (disregarding what would be attributed through his or her spouse, ancestors or lineal descendants), shall also be treated as owning the stock in the corporation owned (directly or indirectly) by or for his or her partner. I.R.C. '267(c)(3),(5).

d. The following persons are related to the partner:

(i) Spouse, ancestors and lineal descendants;

(ii) Any corporation if 80% or more, in value, of the outstanding stock of which is owned (directly or indirectly) by or for the partner. Value, and not voting power, is the test. If there are several classes of stock, value is still the test;

(iii) Any partnership of which 80% or more of the capital interest or profits interest is owned by the partner;

(iv) If the partner is a corporation:

(a) the individual owning 80% or more in value of the outstanding stock;

(b) other members of the controlled group of which the corporate partner is a member;

(c) If an S corporation, any other S or C corporation of which 80% or more in value of the outstanding stock is owned by the same persons who own 80% or more in value of the outstanding stock of the corporate partner. If a C corporation, any S corporations of which 80% or more in value of the outstanding stock is owned by the same persons who own 80% or more in value of the outstanding stock of the corporate partner;
(d) Any partnership of which 80% or more of the capital interest or profits interest is owned by the same persons who 80% or more in value of the outstanding stock of the corporate partner;

(e) Any trust, or grantor of a trust, which or who owns (directly or indirectly) 80% or more in value of the outstanding stock of the corporate partner which is the fiduciary of the trust.

(v) If the partner is another partnership:

(a) Any person owning (directly or indirectly) 80% or more in value of the capital interest or the profits interest in the other partnership;

(b) Any corporation of which 80% or more in value of the outstanding stock is owned by the same persons who own 80% or more of the capital interest or profits interest in the other partnership;

(c) Any partnership of which 80% or more of the capital interest or profits interest is owned by the other partnership.

(vi) If the partner is the grantor of a trust, all fiduciaries of that trust.

(vii) If the partner is a fiduciary of a trust:

(a) The grantor and all beneficiaries of the trust;

(b) If the grantor of the trust is also the grantor of another trust, the fiduciaries and all beneficiaries of the other trust;

(c) Any corporation of which the trust or the grantor of the trust owns (directly or indirectly) 80% or more in value of the outstanding stock of a corporation.

(viii) If the partner is the beneficiary of a trust:

(a) The fiduciary of the trust;

(b) The fiduciary of any other trust having the same grantor.
(ix) Any organizations, exempt under section 501, controlled (directly or indirectly) by the partner or the partner’s spouse, ancestors and lineal descendants.

(x) If the partner is an organization exempt under section 501, any person who controls the exempt organization (directly or indirectly) or whose spouse, ancestors or lineal descendants control such organization (directly or indirectly).

e. Persons related to more than one partner.

(i) General rule. When a person is related to more than one partner, as a general rule, the related partner determination of Reg. 1.752-4(b)(1) is applied by treating the person as related only to the partner with whom there is the highest percentage of related ownership. If two or more partners have the same percentage of related ownership and no other partner has a greater percentage, the liability is allocated among all partners having the equal percentages of related ownership. Reg. 1.752-4(b)(2)(i).

(ii) Natural persons who are members of the same family are treated as having a percentage relationship of 100 percent with respect to each other. Reg. 1.752-4(b)(2)(ii).

(iii) An exception is made for persons owning interests directly or indirectly in the same partnership; they are not treated as related persons for purposes of determining the economic risk of loss. This exception does not apply when determining a partner's interest under the de minimis rules in Reg. 1.752-2(d), (e), 1.752-4(b)(2)(iii).

(iv) A special rule disregards any entity structured to avoid related partner status, when:

(a) A partnership liability is owed to or guaranteed by another partnership, or an S corporation, a C corporation or a trust;
(b) A partner or related person owns directly or indirectly 20% or more ownership interest in the other entity; and
(c) A principal purpose of the other entity acting as a lender or guarantor of the liability is to avoid the determination that the partner that owns the interest bears the economic risk of loss for federal income tax purposes for all or part of the liability; then the partner is treated as holding the other entity's interest as a creditor or guarantor to the extent of the partner's or related person's ownership interest in the entity.
"Ownership interest" in (1) a partnership equals the partner's highest percentage interest in any item of partnership loss or deduction for any taxable year; (2) an S corporation equals the stockholder's percentage of the outstanding stock; (3) a C corporation equals the stockholder's percentage of the fair market value of the issued and outstanding stock; and (4) a trust equals the percentage of the actuarial interests owned by the beneficial owner of the trust. Reg. \textsuperscript{1} 1.752-4(b)(2)(iv).

**Illustration:**

A, B and C form a general partnership. A, B and C each contribute $1,000 to ABC partnership; they are equal partners.

A and B form second partnership - each contributes $50,000. They share losses equally. The purpose is to have the loan to ABC treated as nonrecourse under section 752.

AB loans ABC $100,000 on nonrecourse basis secured by property which ABC purchases.

A and B bear equally the economic risk of loss for the ABC partnership liability based on their percentage interests in losses of AB. Reg. \textsuperscript{1} 1.752-4(c).

**E0 Time-Value-of-Money Considerations.**

The regulations provide that the extent to which a partner or related person bears the economic risk of loss takes into account any time delay when a payment or contribution obligation is to be satisfied. Reg. \textsuperscript{1} 1.752-2(g)(1). If payment is not required to be made within a reasonable time, or if the contribution obligation does not have to be satisfied before the later of (i) the end of the year, or (ii) 90 days after liquidation, the obligation is recognized only to the extent of the value of the obligation.

The value of the delayed payment or contribution obligation equals face value only if it bears interest at a rate at least equal to the applicable federal rate under section 1274(d) at, the time of valuation. If the interest rate is less (or none), the face value is discounted to present value of all payments due (i.e., the imputed principal amount computed under section 1274(b). Reg. \textsuperscript{1} 1.752-2(g)(2).

A partner's promissory note does not constitute a payment obligation unless the note is readily tradeable on an established securities market. Reg. \textsuperscript{1} 1.752-2(g)(3).
Illustration:

AB limited partnership – A is general partner; B is limited partner; profits and losses shared equally. Each required to make up deficits in capital accounts: A has 90 days grace, while B has 2 years after liquidation without interest:

<table>
<thead>
<tr>
<th>Contribution</th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>10,000</td>
<td>10,000</td>
</tr>
</tbody>
</table>

AB buys property for $20,000 in cash plus a $70,000 recourse purchase money note.

In a constructive liquidation, with all assets deemed worthless and all liabilities due and payable, Loss on hypothetical sale:

\[
\begin{array}{ccc}
(45,000) & (45,000) \\
(35,000) & (35,000) \\
\end{array}
\]

Each partner's capital accounts would have a deficit of $35,000. However, B's obligation is recognized only to extent of present fair market value. Since B's obligation does not have to be satisfied within 90 days after liquidation, and it does not bear interest, the fair market is the imputed principal amount computed under 1274(b). If the applicable federal rate is 6%, compounded semiannually, the present value is $31,100. To the extent B's deficit restoration obligation is not recognized, A, the general partner, is deemed to bear that obligation ($3,900). Accordingly, A bears the economic risk of loss of $38,900, and B's economic risk of loss is $31,100. Reg. 1.752-2(g)(4).

F0 Partner Providing Security for Partnership Liability.

A partner bears the economic risk of loss for a partnership liability to the extent that property of the partner or a related person is pledged as security for a partnership liability. Contributed property is not deemed to be pledged as security unless all items of income, gain, loss and deduction attributable to that property are allocated to the contributing partner; and this allocation is greater than the partner's share of other such items. The amount of economic risk of loss is limited to the fair market value of all the property at the time of pledge or contribution. Reg. 1.752-2(h).
VI. Nonrecourse Deductions

A. Effective Dates. There are three separate sets of nonrecourse debt regulations applicable to partnerships depending on the date of their formation:

1. The original final regulations ("Original Regulations" or "Orig. Reg.") found at Reg. 1.704-1(b)(4)(iv) (before December 28, 1991) continue to apply indefinitely to partnerships entered into on or before December 29, 1988 which complied with the provisions thereof until a subsequent material modification of the partnership agreement, unless either:

   (a) The partnership elected to apply the temporary regulations ("Temporary Regulations" or "Temp. Reg.") (referred to in 2 below) pursuant to Temp. Reg. 1.704-1T(b)(4)(iv)(m)(l) commencing with its first taxable year ending after December 28, 1988, e.g., usually calendar year 1988; or,

   (b) The partnership elects to apply the new final regulations ("Final Regulations" or "Reg.") (referred to in 3 below) to it commencing with its first taxable year ending on or after December 28, 1991. This election is made by attaching a written statement to the partnership return for its first taxable year ending on or after December 28, 1991, with the statement including the name, address and identification number of the partnership and that it makes an election under Reg. 1.704-2(l)(4).

2. The Temporary Regulations (1.704-1T(b)(4) December 29, 1988) apply to any partnership formed on or before December 29, 1988, which has elected to apply them (see 1(a) above) and to any partnership entered into after December 29, 1988 and before December 28, 1991 which complied with the Temporary Regulations unless it elects to be governed by the Final Regulations under Reg. 1.704-2(l)(4).

3. The Final Regulations (Reg. 1.704-2(l)(4), December 27, 1991) apply to partnerships which elect them for their first year ending after December 28, 1991 and to taxable years beginning on or after that date.

B. General Rules.

1. The Original, Temporary and Final Regulations take the position that deductions attributable to the portion of the adjusted basis of an asset or of an expenditure financed with nonrecourse debt cannot have substantial economic effect because the nonrecourse creditor bears the economic risk of

However, because nonrecourse creditors cannot be allocated with any deductions or losses, those financed
with nonrecourse debt must be allocated among the partners in accordance with their interests in the
partnership.

2. The regulations provide that the portion of a deduction attributable to nonrecourse
debt ("nonrecourse deduction") is an amount which results in an increase in the "minimum gain" which the
partnership would realize on a foreclosure or sale of the applicable property for the nonrecourse mortgage
balance. Orig. Reg. '1.704-1(b)(4)(iv)(b) and (c); Temp. Reg. '1.704-1T(b)(4)(iv)(a)(2) and (c); Reg. '1.704-2(c). Any deduction funded with nonrecourse debt, which did not result in a depreciable,
depletable or amortizable asset, is determined for characterization purposes as a pro rata share of all
partnership deductions, losses and Section 705(a)(2)(B) expenditures for the applicable year. Orig. Reg. '1.704-1(b)(4)(iv)(b); Temp. Reg. '1.704-1T(b)(4)(iv)(b); Reg. '1.704-2(c).

3. An allocation of a deduction attributable to nonrecourse debt will be treated as
made in accordance with a partner's interest in the partnership if:

   (1) Capital accounts are properly maintained and liquidating distributions are
to be made in accordance with positive capital account balances in accordance with the rules of Reg. '1.704-1(b)(2)(ii)(b)(1) and (2) and, under the Final Regulations the partner either has a deficit make up
obligation or there is a qualified income offset (Reg. '1.704-1(b)(2)(ii)(b)(3), 1.704-1(b)(2) (ii)(d)(3));

   (2) The allocations of deductions attributable to nonrecourse debt throughout
the term of the partnership are "reasonably consistent" with allocations of some other significant partnership
item (which have substantial economic effect) attributable to the property securing the nonrecourse debt
(other than allocations of minimum gain). Some "other significant" partnership item apparently includes other
taxable income or loss (other than attributable to nonrecourse debt) and, presumably, significant specially
allocated items of deduction (other than attributable to nonrecourse debt) and significant gain on sale other
than the minimum gain, and "reasonably consistent" apparently means that the nonrecourse deduction
allocation must be virtually identical to the allocation of the relevant "other significant" item. Orig. Reg. '1.704-1(b)(5) Ex. 20 (ii) and (iii); Reg. '1.704-2(m), Ex. 1(ii);

   (3) (a) Under the Original Regulations, either the partner has an obligation
to eliminate the deficit balance in his capital account on liquidation of the partnership or of his interest or the
partnership agreement contains a "minimum gain chargeback";
(b) Under the Final and Temporary Regulations: In the first taxable year of the partnership in which it has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in minimum gain and thereafter throughout the full term of the partnership, the partnership agreement contains a "minimum gain chargeback"; and

(4) All other material allocations and capital account adjustments are recognized.

Orig. Reg. ' 1.704-1(b)(4)(iv)(d); Temp. Reg. ' 1.704-1(b)(4)(iv)(d); Reg. ' 1.704-2(e). The stated rationale of the change made to the Original Regulations by the Temporary Regulations was that it was necessary to require a minimum gain chargeback since an allocation of minimum gain has no substantial economic effect.

4. If the above requirements are satisfied, a partner not having an obligation to eliminate the deficit in his capital account on liquidation may be allocated deductions attributable to nonrecourse debt even if they cause a deficit in his capital account balance, provided that deficit is not in excess of his share of partnership minimum gain. Orig. Reg. ' 1.704-1(b)(5) Ex. 22; Reg. ' 1.704-2(m) Ex. 1(ii). Does the partnership agreement itself have to limit allocations of deductions and losses so that the deficit of limited partners will not exceed the sum of their shares of minimum gain and their negative capital account contribution obligation (if any)?

C. Minimum Gain Chargeback and Nonrecourse Debt.

1. (a) Under the Original Regulations, a "minimum gain chargeback" is a provision in the partnership agreement which requires that if there is a net decrease in partnership minimum gain for a taxable year any partner having a deficit capital account balance (computed net of his obligation to eliminate any portion of his deficit balance and his share of remaining minimum gain) will be allocated gross income and gain thereafter in the amount and proportions needed to eliminate such deficits as quickly as possible. The deficit balance is computed net of the items which have to be considered as distributed or charged under the qualified income offset provision (Reg. ' 1.704-1(b)(2)(ii)(d)(4), (5) and (6)) and the amount of minimum gain chargeback in any year is deemed to consist first of gains realized on the disposition of items of partnership property subject to one or more nonrecourse liabilities to the extent of the decrease in minimum gain attributable to the disposition of such items with the remainder made up of a pro rata portion of other items of income and gain. Orig. Reg. ' 1.704-1(b)(4)(iv)(e); Reg. ' 1.704-2(f)(6).

(b) The Temporary Regulations (Temp. Reg. ' 1.704-1T(b)(4)(iv)(e)(2)) modified the above formulation by requiring, in the event of a required minimum gain chargeback, that each partner be
allocated items of income and gain (for the years of the decrease and subsequent years, if necessary) in proportion to, and to the extent of, an amount equal to the greater of:

1. The portion of such partner's share of the net decrease in partnership minimum gain during such year which is allocable to the disposition of partnership property subject to one or more nonrecourse liabilities of the partnership; or

2. The deficit balance in such partner's capital account at the end of such year (before allocations of income, gains, deductions and losses, but net of his deficit restoration obligation, share of partnership minimum gain, share of minimum gain with respect to partner nonrecourse debt and the adjustments in \( 1.704-1(b)(2)(ii)(d)(4),(5) \) and \( (6) \)).

(c) The Final Regulations merely require that each partner (whether or not he has a deficit in his capital account balance) must be allocated items of partnership gross income and gain for the year in which minimum gain is reduced equal to that partner's share of the net decrease in partnership minimum gain. Reg. \( 1.704-2(f)(1) \). Note that the amount of minimum gain chargeback is only the "net" decrease in minimum gain so that refinancings in which the amount of total nonrecourse debt remains the same do not trigger a minimum gain chargeback. Reg. \( 1.704-2(m) \), Ex. 2. Exceptions are provided, however:

1. If the net decrease in partnership minimum gain is caused by a guarantee, refinancing or other change in the debt instrument causing it to become partially or wholly recourse debt or partner nonrecourse debt and the partner bears the economic risk of loss (under Reg. \( 1.752-2 \)) for the changed liability. Reg. \( 1.704-2(f)(2) \);

2. To the extent the partner actually contributes capital to the partnership that is used to repay the nonrecourse debt or is used to increase the basis of property subject to the nonrecourse liability and the partner's share of the net decrease in partnership minimum gain results from the repayment or the increase in the property's basis. Reg. \( 1.704-2(f)(3) \); Reg. \( 1.704-2(m) \), Ex. 1(iv).

3. If the minimum gain chargeback would cause a distortion in the economic arrangement among the partners, it is not expected that the partnership will have other income to correct the distortion and a waiver by the Commissioner of the minimum gain chargeback is obtained. The following facts must be demonstrated for a waiver request to be considered:

   i. The partners have made capital contributions or received net income allocations that have restored the previous nonrecourse deductions and distributions attributable to the proceeds of a nonrecourse liability; and
(ii) The minimum chargeback requirement would distort the partners' economic arrangement as reflected in the partnership agreement and as evidenced over the term of the partnership by the partnership's allocations and distributions and the partners' contributions.

Reg. '1 704-2(f)(4).

It appears that if a partner does not have a deficit in his capital account at the time minimum gain is recognized, it is unnecessary to require a minimum gain chargeback, provided a waiver is obtained from the Internal Revenue Service. See Reg. '1 704-2(f)(7), Ex. 1.

(4) The Commissioner may provide additional exceptions by ruling. Reg. '1 704-2(f)(5).

(5) The reason for the change in the Final Regulations was to prevent distortions from the economic business arrangement the parties undertook.

2. A "nonrecourse" liability is one with respect to which none of the partners bears the economic risk of loss. Consequently, a purported nonrecourse loan made by a partner to a partnership, or a nonrecourse loan guaranteed by a partner, is not a nonrecourse loan for this purpose and allocations of losses and deductions attributable thereto will be made in accordance with the partners' interests in the partnership. Reg. '1 704-2(b)(3); Orig. Reg. '1 704-1(b)(4)(iv)(g); Temp. Reg. '1 704-1T(b)(4)(iv)(h)(1). The regulations allocate the entire loss attributable thereto to the creditor partner. Reg. '1 704-2(m) Ex. 1(viii); Orig. Reg. '1 704-1(b)(5) Ex. 20 (vii); Temp. Reg. '1 704-1T(b)(4)(iv)(h)(2).

Also, Orig. Reg. '1 704-1(b)(l)(iii) indicates the Service will look at debt/equity characterization issues with respect to third party purported nonrecourse debts and could characterize them as equity. However, the de minimis '752 exception, i.e., 10% interest or less of Reg. '1 752-2(d), is incorporated.

3. (a) (i) The Temporary and Final Regulations provide that if a partner bears the economic risk of loss of a partnership nonrecourse debt, it is recharacterized as a "partner nonrecourse debt" and any nonrecourse deductions attributable to that debt must be allocated to the partner who bears its economic risk of loss, or among all partners who bear the economic risk of loss in the ratio in which they bear that risk of loss. Reg. '1 704-2(b)(4), 704-2(i); Temp. Reg. '1 704-1T(b)(4)(iv)(h)(2). This effectuates a special allocation of the deduction to the lender so that the other partners may have taxable income without any cash flow.
(ii) Note that the Temporary Regulations define "partner nonrecourse debt" as any nonrecourse debt for purposes of '752 for which a partner bears the economic risk of loss, thus including unsecured advances by a partner with respect to which no partner is personally liable. Reg. '1.704-2(b)(4) defines this term by reference to the definition of nonrecourse debt used in Reg. '1001-2, i.e., apparently limiting partner nonrecourse debt only to secured debts.

(b) For this purpose a more-than 10% partner is deemed to bear the economic risk of loss if the nonrecourse loan is made by a person related to that partner under the rules applicable for purposes of determining basis in partnership interests under Section 752. Reg. '1.752-4(b); Temp. Reg. '1.752-1T(h) (Sections 267(b) and 707(b)(1), with modifications, related to over 10% partners); Temp. Reg. '1.704-1T(b)(4)(iv)(k)(1); Reg. '1.704-2(b)(4). The Temporary '752 and Final '752 regulations grandfathered pre-January 30, 1989 related party loans and guarantees and do not require a shift from unaffiliated partners to related ones, although nonrecourse deductions funded by such loans for 1989 and thereafter will not be allowed to the unaffiliated persons. Temp. Reg. '1.752-4T(a), 1.752-4T(d); Reg. '1.752-5; See also, Levine, Loffman and Presant, A Practical Guide to the New Section 752 Regulations, Part II, 70 Journal of Taxation 260 (May, 1989). These debts will be treated for '704(b) purposes as partnership non-recourse debts if incurred or assumed by the partnership prior to January 30, 1989 or pursuant to a contract which was binding prior to January 30, 1989. Temp. Reg. '1.704-1T(b)(4)(iv)(m)(2). Also, partnership nonrecourse debts which were treated as such under the prior '752 regulations before the effective date of the Tax Reform Act of 1984 (March 1, 1984) and which had been incurred or assumed by the partnership prior to March 1, 1984, will continue to be treated as partnership nonrecourse debt for '704 purposes, but without permitting increases in the amount thereof after December 31, 1986 to be taken into account. Temp. Reg. '1.704-1T(b)(4)(iv)(m)(3).

(c) If there is a decrease in the minimum gain attributable to partner nonrecourse debt, a minimum gain chargeback must be provided in the partnership agreement, i.e.:

(1) Under the Temporary Regulations, all partners with a share of that minimum gain attributable to the partner nonrecourse debt at the beginning of the year must be allocated items of partnership income and gain thereafter in proportion to, and the extent of, an amount equal to the greater of:

(i) The portion of such partner's share of the net decrease in the minimum gain attributable to such partner nonrecourse debt that is allocable to the disposition of partnership property subject to the debt; or
(ii) The deficit balance of such partner's capital account at the end of such year (determined before allocations of income, gains, deductions and losses for such year but net of his deficit restoration obligation, his remaining share of partnership minimum gain, share of minimum gain attributable to partner nonrecourse debt and the adjustments in Reg. ' 1.704-1(b)(2)(ii)(d)(4), (5) and (6)). Temp. Reg. ' 1.704-1(b)(4)(iv)(h)(4).

(2) Under the Final Regulations:

(i) Any partner with a share of that partner nonrecourse debt minimum gain as of the beginning of the year must be allocated items of income and gain for the year (and, if necessary, for succeeding years) equal to that partner's share of the net decrease in partner nonrecourse debt minimum gain (determined in the same manner as a partner's share of decreases in partnership minimum gain is determined).

(ii) If, however, the reduction is caused by a conversion of the debt into partnership nonrecourse debt the lender partner's decrease in partner minimum gain is added to the partner's share of partnership minimum gain. This defers the chargeback until the debt is discharged or the property is sold. Reg. ' 1.704-2(i)(4).

(d) A partner's share of minimum gain attributable to partner nonrecourse debt at the end of any year and his share of net increases in minimum gain are determined under rules identical to the determination of the shares of partnership minimum gain. Temp. Reg. ' 1.704-1T(b)(4)(iv)(h)(5) and (6); Reg. ' 1.704-2(i)(5).

(e) Rules consistent with those pertaining to the distribution of partnership nonrecourse debt proceeds apply also to distributions of the proceeds of partner nonrecourse debts. Reg. ' 1.704-2(i)(6).

4. In computing the amount of minimum gain, if a property is subject to more than one liability of equal priority, the book value is allocated among all liabilities in proportion to their outstanding balances. If it is subjected to two or more liabilities of unequal priority, book value is allocated among the liabilities in the order of their priority up to the balance of each. Orig. Reg. ' 1.704-1(b)(4)(iv)(c); Temp. Reg. ' 1.704-1T(b)(4)(iv)(c); Reg. ' 1.704-2(d)(2).

5. (a) Under the Original Regulations, a partner's "share of minimum gain" at the end of each year is defined as the aggregate "nonrecourse deductions" allocated to that partner up to that time less his share of decreases in minimum gain allocated to him up to that time, under the final regulations. Orig. Reg. ' 1.704-1(b)(4)(iv)(f).
(b) (1) The Temporary and Final Regulations define "partnership minimum gain" to be equivalent to the excess of the nonrecourse liabilities encumbering a partnership asset over the adjusted tax basis of the asset (or book value if different from adjusted basis). This definition is much better in that it permits minimum gain to be created or increased as a result of a refinancing. Temp. Reg. 1.704-1T(b)(4)(iv)(a)(2); 1.704-1T(b)(4)(iv)(f); Reg. 1.704-2(d)(3), 1.704-2(h); see, Reg. 1.704-2(m), Ex. 1(vi).

(2) The precise definition of a partner's "share of minimum gain" which appears in the Final Regulations is an amount which equals:

(i) The sum of nonrecourse deductions allocated to that partner (and to that partner's predecessors in interest) up to that time and the distributions made to that partner (and to that partner's predecessors in interest) up to that time of proceeds of a nonrecourse liability allocable to an increase in partnership minimum gain; minus

(ii) The sum of that partner's (and that partner's predecessors' in interests) aggregate share of the net decreases in partnership minimum gain plus their aggregate share of decreases resulting from revaluations of partnership property subject to one or more partnership nonrecourse liabilities. Reg. 1.704-2(g)(1).

(3) However,

(i) The capital account maintenance requirements and requirement that assets be distributed at liquidation in accordance with positive capital accounts of Reg. 1.704-1(b)(2)(ii)(b)(1) and (2) must be satisfied throughout the partnership's term, and

(ii) All other material allocations and capital account adjustments under the partnership agreement must be recognized under Reg. 1.704-1(b) and 1.704-1T (without regard to whether allocations of adjusted tax basis and amount realized under Section 613A(c)(7)(D) are recognized). Temp. Reg. 1.704-1T(b)(4)(iv)(g)(1); Reg. 1.704-2(e).

(4) Although the usual rule is that a distribution of loan proceeds will be treated as a distribution which is allocable to an increase in partnership minimum gain to the extent of the net increase therein, the Final and Temporary Regulations permit a partnership to treat such a distribution as not being allocable to an increase in partnership minimum gain provided the distribution does not cause or increase the deficit balance in the distributee's capital account above his deficit restoration obligation and deemed deficit restoration obligation (without regard to the effect thereon of the distribution itself) as of the
end of the partnership taxable year in which the distribution occurs. Reg. 1.704-2(h)(3); Temp. Reg. 1.704-1T(b)(4)(iv)(g)(1). Apparently no formal election need be filed for a partnership to opt for this different treatment. The effect of this election, as indicated below, would be to enable the distributee and non-distributee partners to utilize the increase in minimum gain against partnership deductions.

(c) (1) The Final and Temporary Regulations provide that a net increase in minimum gain is allocated to a nonrecourse liability to the extent of the increase in minimum gain which arose as a result of incurring the liability. If the net increase for a partnership year is allocated to more than one nonrecourse liability and the sum of the amounts so allocated exceeds the total amount of such net increase,

(i) Under the Temporary Regulations the amount of the net increase in minimum gain allocated to each such liability equals the amount determined by multiplying the net increase by a fraction the numerator of which is the amount of net increase which would be allocated to the liability over the sum of the net increases which would be allocated to all such liabilities. Temp. Reg. 1.704-1T(b)(4)(iv)(g)(2);

(ii) Under the Final Regulations, the net increase is allocated among the liabilities on a pro rata basis based on the outstanding balance of each liability. Reg. 1.704-2(h)(1).

(2) If the aggregate increases in the minimum gain for all nonrecourse liabilities exceed the sum of distributions and losses for the year,

(i) The excess ("excess allocable amount") is carried over to the next succeeding year and is absorbed to the extent of the sum of distributions and losses for that year in generating a net increase in total partnership minimum gain, and

(ii) If there is not a 100% absorption in the next year, the absorption is prorated among all nonrecourse liabilities in proportion to the amount each liability contributed to the increase in minimum gain. Reg. 1.704-2(h)(4); Temp. Reg. 1.704-1T(b)(4)(iv)(g)(3).

(d) The determination of to whom excess financing proceeds are distributed can be done under any reasonable method. The regulations state that the interest allocation rules of Reg. 1.163-8T (tracing the loan proceeds) is a reasonable method. Reg. 1.704-2(h)(2); Temp. Reg. 1.704-1T(b)(4)(iv)(g)(4). This method determines to which partner the minimum gain generated by the excess financing must be allocated.
6. (a) In the case of tiered partnerships, the Final and Temporary Regulations provide that an upper tier partnership's increase or decrease in its share of a lower tier partnership's minimum gain is an increase or decrease, respectively, in the minimum gain of the upper tier partnership. Reg. ' 1.704-2(k)(1) and (2); Temp. Reg. ' 1.704-1T(b)(4)(iv)(j).

(b) Also, proceeds of nonrecourse debts of the lower tier partnership distributed to the upper tier partnership are treated as proceeds of a nonrecourse liability of the upper tier partnership. Reg. ' 1.704-2(k)(3).

(c) All nonrecourse deductions of the lower tier partnership allocated to the upper tier partnership are treated as depreciation or cost recovery deductions with respect to property owned by the upper tier partnership subject to a nonrecourse liability.

7. (a) A special rule has been added by the Final Regulations to reflect a revaluation of partnership property subject to a nonrecourse debt occasioned by the admission of a new partner, contribution of property by an existing partner, withdrawal of an old partner or as of calendar year 1987. (Reg. ' 1.704-1(b)(2)(iv)(d), (f) and (r)). Reg. ' 1.704-2(d)(4), 1.704-2(m) Ex. 3(iii).

(b) If the capital accounts are so increased or decreased:

(i) The net decrease or increase in partnership minimum gain using the current year's book values and the prior year's partnership minimum gain amount is first determined.

(ii) Any decrease attributable solely to the revaluation is added back so that the revaluation will not trigger a minimum gain chargeback.

Restated book values thereafter are used to determine net increases and decreases in minimum gain. However, the revaluation is based on the fair market value of the partnership's assets which, as to property subject to nonrecourse debt, is not less than the nonrecourse mortgage balance. Reg. ' 1.704-1(b)(2)(iv)(f)(1); I.R.C. ' 7701(g). Consequently, all revaluations eliminate all minimum gain, but because of the above special rule no minimum gain chargeback is triggered.

D. Example.

To illustrate, assume that on January 15, 1992 G and L form a limited partnership (L being the limited partner) with G contributing $10,000 cash and L contributing $90,000 cash for interests in operating profits, losses and cash flow of 10% and 90% throughout the partnership's term, respectively, and in gains on sale of 10% and 90%, respectively, until L's positive capital account balance equals $90,000 less
refinancing cash flow distributed to L during the partnership’s term, and thereafter gains would be allocated 50%-50%.

The agreement provides that capital accounts will be maintained and liquidating distributions will be made in accordance with positive capital account balances pursuant to Reg. 1.704-1(b)(2)(ii)(b)(1) and (2), that G is required to eliminate the deficit in his capital account within 90 days after the final liquidating distribution as to his interest but L is not so required (nor is he required to make any other capital contributions) and the agreement contains a qualified income offset.

The agreement also provides that if there is a net decrease in either G's or L's share of partnership "minimum gain", he will be allocated items of gross income and gain on sale equal to his share of the reduction in minimum gain. The agreement provides further that L will not be distributed any cash if the effect thereof is to cause the deficit in his capital account to exceed his share of minimum gain nor will L be allocated any losses if the effect thereof is to cause his deficit capital account balance to exceed his share of minimum gain.

The Partnership enters into a 99 year ground lease of vacant property at a rent of $10,000 per year (with rent commencing on completion of improvements) and constructs an office building on it at a cost of $500,000, $450,000 of which is financed with a nonrecourse loan from a qualified lender, interest-only at 10% per annum for the first 5 years with principal amortized in equal, annual principal payments over 15 years ($30,000/year) plus 10% per annum interest on the unpaid principal balance. The building is completed on January 1, 1993 and no income or loss is sustained for 1992.

The operating results for the first five years are as follows:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent</td>
<td>$20,000</td>
<td>$25,000</td>
<td>$30,000</td>
<td>$40,000</td>
<td>$45,000</td>
</tr>
<tr>
<td>Operating Expense</td>
<td>10,000</td>
<td>15,000</td>
<td>20,000</td>
<td>25,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Interest</td>
<td>45,000</td>
<td>45,000</td>
<td>45,000</td>
<td>45,000</td>
<td>45,000</td>
</tr>
<tr>
<td>Depreciation (S/L)</td>
<td>15,873</td>
<td>15,873</td>
<td>15,873</td>
<td>15,873</td>
<td>15,873</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>$70,873</td>
<td>$75,873</td>
<td>$80,873</td>
<td>$85,873</td>
<td>$90,873</td>
</tr>
</tbody>
</table>
Cash flow deficits are covered by recourse loans from the General Partner repayable commencing in the 6th year with interest of 10% per annum. Under Sections 267(a)(1) and (e)(1)(B)(i), however, the interest thereon is not deductible until paid, absent the possible application of Section 7872(b). See, Prop. Reg. '1.7872-4(f). No cash distributions are made to G or L during the first 5 years.

(a) Does this partnership satisfy the requirements of Reg. '1.704-2(e)?

(1) Paragraphs (1) and (4) appear to be satisfied since capital accounts will be maintained and liquidating distributions will be made in accordance with them and there is a qualified income offset.

(2) Paragraph (2) seems to be satisfied since the allocation of deductions and gain on disposition attributable to nonrecourse debt is the same as the general profit-loss sharing allocation.

(3) Paragraph (3) ("minimum gain chargeback") is satisfied by allocating all items of gross income and gain to L and G equal to their shares of any reduction in minimum gain.

(b) The capital accounts would apparently be maintained as follows:

<table>
<thead>
<tr>
<th>Capital Accounts</th>
<th>G</th>
<th>L</th>
</tr>
</thead>
<tbody>
<tr>
<td>Formation</td>
<td>$ 10,000</td>
<td>$ 90,000</td>
</tr>
<tr>
<td>1992</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>1993</td>
<td>(5,087)</td>
<td>(45,786)</td>
</tr>
<tr>
<td>Balance</td>
<td>$ 4,913</td>
<td>$ 44,214</td>
</tr>
</tbody>
</table>

1994 - Ordinarily L would be allocated a loss of $45,786 but such an allocation would create a $1,572 deficit in his capital account. Because there is no minimum gain at the end of 1994, e.g.:
$500,000
2 yrs. depreciation       (31,746)
Adjusted Basis           $468,254

compared to nonrecourse debt of
$450,000, the allocation would be

(6,659)  (44,214)
(1,746)    $   -0-

1995 - Ordinarily L would be allocated a loss of $45,786 but such an allocation could not cause a deficit in L's capital account in excess of his share of minimum gain:

Nonrecourse debt           $450,000
Adjusted Basis            $452,381¹
Minimum Gain              -0-      (50,873)   -0-
                          (52,619)  $   -0-

1996 - Ordinarily L would be allocated $41,286 of loss, but such an allocation could not cause his deficit capital account balance to exceed his share of minimum gain:

¹$500,000 - (3 x $15,873) = $452,381
<table>
<thead>
<tr>
<th></th>
<th>$G$</th>
<th>$L$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonrecourse debt</td>
<td>$450,000</td>
<td></td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>$436,508&lt;sup&gt;2&lt;/sup&gt;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$13,492</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$\times 90%</td>
<td></td>
</tr>
<tr>
<td>L's Share of Minimum Gain</td>
<td>$12,143</td>
<td>(33,730)</td>
</tr>
<tr>
<td></td>
<td>$(86,349$</td>
<td>$(12,143$</td>
</tr>
</tbody>
</table>

**1997** - Ordinarily L would be allocated $41,286 of loss but such an allocation could not cause the deficit in his capital account to exceed his share of minimum gain:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonrecourse debt</td>
<td>$450,000</td>
<td></td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>$(420,635$</td>
<td>$29,365</td>
</tr>
<tr>
<td></td>
<td>$\times 90%</td>
<td>$26,428</td>
</tr>
</tbody>
</table>

Less L's Deficit at 12/31/96

<table>
<thead>
<tr>
<th></th>
<th>$G$</th>
<th>$L$</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/96</td>
<td>(12,143)</td>
<td>$(31,588$</td>
</tr>
</tbody>
</table>

<sup>2</sup>$500,000 - (4 x $15,873) = $436,508
(c)(i) If before the end of 1997 the partnership had refinanced its nonrecourse mortgage with a new nonrecourse mortgage having a principal balance of $550,000 and it retained the excess $100,000 refinancing proceeds for working capital needs, the increase in minimum gain attributable to the refinancing and operations would be $115,873 ($550,000 - $420,635 = $129,365 - $13,492 = $115,873). Reg. 1.704-2(d)(3), 1.704-2(h). However, because no part of excess refinancing proceeds were distributed to the partners in 1997, that increase is treated as nonrecourse deductions which can then be taken into account in 1997 up to the partnership's 1997 loss of $45,873, i.e., the entire 1997 loss would be deemed attributable to nonrecourse deductions, and the allocations of the 1997 loss would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>G</th>
<th>L</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonrecourse debt</td>
<td>$550,000</td>
<td>($86,349)</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>($420,635)</td>
<td>($12,143)</td>
</tr>
<tr>
<td>Minimum Gain 12/31/96</td>
<td>$129,365</td>
<td>(13,492)</td>
</tr>
<tr>
<td>Increase</td>
<td>$115,873</td>
<td></td>
</tr>
<tr>
<td>Limited to L's Share of 1997 Loss</td>
<td>$ 45,873</td>
<td></td>
</tr>
<tr>
<td>1997 Loss x 90%</td>
<td>( 4,587)</td>
<td>( 41,286)</td>
</tr>
<tr>
<td></td>
<td>$(90,936)</td>
<td>$(53,429)</td>
</tr>
</tbody>
</table>

The theory is that of the extra $100,000 of nonrecourse debt proceeds, $30,000 [$45,873 - ($29,365 - $13,492 = $15,873)] was used to fund the partnership's 1997 loss. The balance of the loss was attributable to depreciation in the amount of $15,873.

The "excess allocable amount" of minimum gain increase not taken into account in 1997 and carried over to 1998 would be $70,000, the excess of the total increases in minimum gain for 1997 over the amount taken into account for 1997 ($115,873 - $45,873 = $70,000).

(ii) If the $100,000 of excess financing proceeds had been distributed in 1997 entirely to G, the extra $30,000 of operating losses (apart from depreciation) would generally not be treated as nonrecourse deductions since conceptually they would have been deemed funded with the
recourse debt from G to the partnership. Thus, L would not have borne this loss. However, as noted above, the partnership could elect not to treat this distribution as attributable to nonrecourse debt so as to permit L the same level of deductions he would have had if the loan proceeds were not distributed.

(iii) If the excess financing proceeds had been distributed $10,000 to G and $90,000 to L, the increase in minimum gain of $115,872 would have been fully taken into account in 1997, unless the partnership elected not to treat the $10,000 distributed to G as allocable to nonrecourse debt. However, because L’s capital account, immediately after the distribution but before his allocation of the 1997 loss, would be ($102,143) and his share of total minimum gain at that point would be $116,428 [$90% x $129,365], his share of 1997 loss would nevertheless be limited to only ($14,285) as was the case absent a refinancing. The election not to treat the $10,000 distributed to G as derived from nonrecourse refinancing would apparently permit L an additional $9,000 of loss (90% x $10,000 undistributed loan proceeds).

(iv) Consequently, an excess refinancing of nonrecourse debt helps limited partners if the proceeds thereof are not distributed.

(d) (1) If the income and operating expense figures for 1998 were identical to those for 1997, as shown in Paragraph (b) above, but at the beginning of 1998 principal of $30,000 is paid on the nonrecourse mortgage, the taxable income of the partnership would be computed as follows:

- Rent $ 45,000
- Operating Expense $ 30,000
- Interest $420,000 x 10% = 42,000
- Depreciation 15,873

(87,873)

$(42,873)

However, there would be a reduction in G's and L's shares of minimum gain as of December 31, 1998:

Total Minimum Gain 12/31/97 $ 29,365
At 12/31/98 Debt $420,000
Adjusted Basis (404,762) (15,238)

Reduction in Total Minimum Gain $14,127

The allocations for 1998 should be:

G L

Capital Account
Balances Forward

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>G</td>
<td>$(117,937)</td>
<td>$(26,428)</td>
</tr>
<tr>
<td>L</td>
<td>$(116,524)</td>
<td>$(13,714)</td>
</tr>
</tbody>
</table>

Allocation of Gross Income

Equal to Shares of

<table>
<thead>
<tr>
<th>Reduction in Minimum Gain</th>
<th>1,413</th>
<th>12,714</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance of Loss</td>
<td>$(57,000)</td>
<td>-0-</td>
</tr>
<tr>
<td></td>
<td>$(173,524)</td>
<td>$(13,714)</td>
</tr>
</tbody>
</table>

(2) If in (d)(1) above the $30,000 of principal reduction came from a capital contribution from G, pursuant to the exception set forth in Reg. 1.704-2(f)(3), 1.704-2(m) Ex. 1(iv), the allocations for 1998 would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>G</th>
<th>L</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Account Balances</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward</td>
<td>$(117,937)</td>
<td>$(26,428)</td>
</tr>
<tr>
<td>Capital Contribution</td>
<td>30,000</td>
<td>-0-</td>
</tr>
<tr>
<td>Allocation of Gross Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equal to Reduction in Minimum Gain - None to G</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Because of Use of his Funds to Repay Debt</td>
<td>N/A</td>
<td>$12,714</td>
</tr>
<tr>
<td>Funds to Repay Debt</td>
<td>$87,937</td>
<td>(13,714)</td>
</tr>
<tr>
<td>Balance of Loss</td>
<td>$(55,587)</td>
<td>-0-</td>
</tr>
<tr>
<td></td>
<td>$(143,587)</td>
<td>$(13,714)</td>
</tr>
</tbody>
</table>

The total net loss allocated to G in (d)(1) and (d)(2) is the same because the partnership had sufficient gross income to cover the full reduction in minimum gain.

(e) Assume the above agreement had been modified at inception so that there were no limitations in the agreement on cash distributions or loss allocations to L, even if they caused a deficit in his capital account to exceed his share of minimum gain. You are asked to prepare the partnership's 1994, 1995, 1996 and 1997 returns. Assuming the fair market value of the property at December 31, 1994, 1995, 1996 and 1997 were as follows:

<table>
<thead>
<tr>
<th>Date: December 31st</th>
<th>Fair Market Values</th>
</tr>
</thead>
</table>
(1) Could you ethically prepare those returns allocating to L the full amount of losses he would be allocated under the partnership agreement? What if fair market values equaled adjusted basis?

(2) If so, what type of disclosure on the return should you provide?

In Young v. Commissioner, T.C. Memo. 1987-397, 54 T.C.M. (CCH) 119 (1987), aff'd, 923 F.2d 719 (9th Cir. 1991), the Tax Court and Ninth Circuit refused to apply a book up of capital accounts because no authority for that was cited. However, the pre-1976 Act regulations in defining "substantial economic effect" provided:

"[W]hether the allocation has substantial economic effect, that is, whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences." Reg. ' 1.704-1(b)(2) (1964). (Emphasis Added.)

However, the court in this case determined that liquidating distributions were not to be made in accordance with positive capital account balances so even if the capital accounts could be marked to fair market value, the allocations would still have lacked economic effect.

(f) If the partnership agreement contained a special allocation of depreciation 1% to G and 99% to L with first gains on sale (up to the aggregate amount of depreciation deducted by the partnership) allocated 1% to G and 99% to L, with the next amount of gains until L's positive capital account balance equals $90,000 (less refinancing cash flow distributed to L during the partnership's term) allocated 10% to G and 90% to L and with remaining gains allocated 50% to G and 50% to L, is the consistency requirement of Reg. ' 1.704-2(e)(2) satisfied?

Here 10% of the building cost ($50,000) was funded with the capital contributions of the partners. Although depreciation is a "significant item" with respect to the property securing nonrecourse liabilities, is 10% of total depreciation (attributable to the partners' equity interests in the building) significant? Note that Orig. Reg. ' 1.704-1(b)(5) Ex. 20(ii) indicates that a 20% equity and recourse investment would be significant. Temp Reg. ' 1.704-1(b)(5) Ex. 20 (iii) and Reg. ' 1.704-2(m). Ex. 1(iii) provides that a 99% share of nonrecourse deductions is not reasonably consistent with a 90% interest in other items of income gain, loss and deduction.
VII. Allocating Nonrecourse Liabilities

A. Allocation Rules.

Reg. \textsuperscript{1} 1.752-3 which governs the allocation of nonrecourse liabilities utilizes the section 704 concepts of "minimum gain" and "built-in gain." A partner's share of nonrecourse liabilities equals the sum of:

1. The partner's share of minimum gain determined in accordance with the rule of section 704(b) and its regulations. Minimum gain is the excess of nonrecourse liability secured by any property over the property's adjusted basis. The "partnership minimum gain" for a nonrecourse liability is the gain the partnership would realize if the property was sold for an amount equal to the liability. Reg. \textsuperscript{1} 1.704-2(d). If the partnership has more than one nonrecourse liability, partnership minimum gain is the sum of the minimum gain computed for all nonrecourse liabilities;

2. The amount of any taxable gain that would be allocated to the partner under section 704(c) if the partnership disposed of all partnership property (in a taxable transaction) subject to nonrecourse liabilities, in full satisfaction of the liabilities and for no other consideration; and

3. The partner's share of the excess nonrecourse liabilities (those not allocated above) in accordance with the partner's share of partnership profits.

Accordingly, each partner's share of nonrecourse liabilities is the sum of (1) his or her share of minimum gain, (2) his or her section 704(c) taxable gain, and (3) his or her share of the partnership's excess nonrecourse liabilities.

On January 13, 2000, the Treasury Department issued proposed regulations revising the allocation of nonrecourse liabilities under the three tier system. Prop. Reg. \textsuperscript{1} 1.752-3. The proposed regulations do not alter the allocation of nonrecourse liabilities under tier-1 or tier-2. However, under tier-3, the proposed regulations provide that, to the extent allocable to property subject to the nonrecourse liability, the partnership may first allocate the excess nonrecourse liabilities to any partner to the extent that the partner has section 704(c) built-in gain in excess of the section 704(c) taxable gain allocated to that partner under tier-2. Any remaining excess nonrecourse liabilities would then be allocated to each partner in accordance with the partner's share of partnership profits.

B. Allocations of Debt When There is Contributed Property.

Section 704(c)(1)(A) provides that income, gain, loss, and deduction with respect to property contributed to a partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution. Under the implementing regulations, a partnership, subject to general anti-abuse rules,
has an option of three methods to accomplish the section 704(c) requirement -- the traditional method, the traditional method with curative allocation, and the remedial method.

In Revenue Ruling 95-41, 1995-23 IRB. 5, the Service provided guidance concerning the allocation of nonrecourse liabilities when property subject to a liability is contributed to a partnership. The Ruling points out that generally there will be no tier-1 allocation on formation because the partnership has no minimum gain. As to tier-2 -- section 704(c) minimum gain - the amount allocated will depend upon the section 704(c) method utilized by the partnership. If the remedial method is elected, the contributing partner is allocated nonrecourse liabilities in tier-2 equal to the fair market value of the contributed property in excess of its tax basis. In contrast, if the traditional or the traditional with curative allocation are elected, the amount allocated to the contributing partner under tier-2 is merely the excess of the non-recourse liability over tax basis.

As to tier-3, the Ruling states that the partners’ agreement to share the profits of the partnership is one fact to be considered in making the determination. Another fact to be considered is a partner’s share of section 704(c) built-in gain to the extent that the gain was not taken into account in making an allocation of liabilities under tier-2. However, the Ruling makes clear that the amount of section 704(c) built-in gain is not determinative for purposes of allocation of tier-3 liabilities.

For more information, please call:

M. Celeste Pickron  
Sutherland Asbill & Brennan LLP  
999 Peachtree Street, NE  
Atlanta, GA  30309  
Phone: 404.853.8222  
mcpickron@sablaw.com