PROPOSED PARTNERSHIP REGULATIONS WILL AFFECT PARTNERSHIP DEAL ECONOMICS

Authors
Robert G. Rinninsland
Kenneth Lobo
Cheryl Magat

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INTRODUCTION

In 2014-8 I.R.B., the I.R.S. proposed amendments to regulations issued under Code §707 relating to disguised sales of property to or by a partnership and under Code §752 regarding the treatment of partnership liabilities. The proposed regulations address certain deficiencies and technical ambiguities in the existing regulations and certain issues in determining partners' shares of liabilities under Code §752. The proposals are designed to limit taxpayers' ability to structure a sale of a partnership interest as a contribution of property by one partner and the receipt of a distribution by a second partner in a way that is not taxable in the year of the transaction. For a foreign investor, the proposed regulation regarding the interplay of partnership liabilities and investor basis in the partnership add another unwelcome level of complexity that must be accounted for in tax planning for an investment. The reason is that a partner's ability to deduct losses of a partnership or L.L.C. is capped at the basis maintained in the partnership interest held. Partners have basis for liabilities of the partnership. The issue is the allocation of losses among the partners or members. The proposed regulations limit ways to increase basis through planning mechanisms that have been accepted for a long period of time.

PARTNERSHIP BASICS AND RELATED ISSUES

Background

A partnership is said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses.[27]

Whether through special entity classification elections or by virtue of the business deal at hand, the use of the partnership tax structure has historically provided taxpayers with significant U.S. tax benefits. The "pass-through" tax aspects of a partnership arrangement result in the flow-through of income, deductions and credits to the owners. In each case, the item retains its character as determined at

[27] *Commissioner v. Tower*, 326 U.S. 280 (1946).

the level of the partnership. There is no taxation at the partnership level. Consequently, there is only one layer of taxation which is assessed at the individual level. This is in contrast to a corporate entity that pays tax at the corporate level before distributing dividends to shareholders. The dividends paid to individuals and corporate investors are generally taxed a second time, albeit at a lower rate.

Additionally, partnerships offer structural flexibility allowing the partnership agreement to allocate voting and income rights in just about any manner desired, provided that (i) the gains, loses, deductions or credits are allocated to partners based on the partnership agreement and (ii) the allocation has "substantial economic effect." Thus, use of a partnership provides a wide degree of latitude for taxpayers in determining both who is taxed and how that tax will be shared. This freedom of allocation is limited by one important rule. The allocation must be made without the sole intent to reduce the individual partner's tax liabilities and must affect each partner's capital account, so that if a partner is allocated losses, its capital account must be reduced and the reduction affects capital gains allocation at the conclusion of the partnership.

"When a taxpayer contributes property to a partnership in exchange for an interest in that partnership, no gain or loss is recognized by either the partnership or its partners."

Contributions and Basis

When a taxpayer contributes property to a partnership in exchange for an interest in that partnership, no gain or loss is recognized by either the partnership or its partners.[28] This nonrecognition rule applies to both new and existing partnerships. The partnership interest must be received in exchange for "property," which is generally defined as cash, inventory, accounts receivable, patents, instalment obligations, and intangibles, such as goodwill.

Disregarding debt obligations within the partnership, the partner's outside basis in the partnership interest received in connection with the contribution of property is equal to the sum of the money and the adjusted basis of property contributed to the partnership.[29] The partnership's inside basis in the property received is equal to the basis of the contributing partner in the property (*i.e.*, the partnership has a transferred basis in the property received).[30] Any inherent gain or loss is preserved and recognized on disposition of the contributed property or disposition of the partnership interest. In addition, the contributing partner alone bears the consequence of built-in income, gain, deduction loss and credit inherent in the contributed property so that such gain is specially allocated to the contributing partner at such time when it is realized by the partnership.[31] Gain that inures after the contribution is allocated separately in the manner provided by the partnership agreement.

Gain (but not loss) may be recognized, if the contributing partner receives property other than a partnership interest (*i.e.*, boot) but only if the amount of the boot exceeds the total basis in the partnership interest.[32] Liabilities transferred with the contributed property may be boot, but only to the extent that liabilities are

[28] Treas. Reg. §1.721-1(a).
[29] Code §722.
[30] Code §723.
[31] Code §704(c).
[32] Code §752(c); Treas. Reg. §1.752-1(e).

shifted to other partners. Initially, and generally thereafter, the aggregate of the partners' outside bases should equal the partnership's inside basis in its assets.

Each partner's equity in the partnership is reflected in a capital account. Capital accounts reflect the fair market value of assets at the time of contribution and distribution. The capital accounts thus accurately show the partners' economic interests in the partnership and track the "business deal."

The partners' capital accounts can be increased or decreased with no immediate tax consequences. A revaluation of a capital account may be referred to as a "book-up" or "book-down." For example, the partners generally wish to restate their book capital accounts upon the admission of a new partner. For business purposes, this permits the partners to document their ownership in the appreciation of partnership assets that accrued prior to the new partner's admission. For tax purposes, this would permit gain or loss inherent in the property at that point to be taxed to the partner whose business deal is affected by movements in value, thus upholding the assignment of income doctrine.

The partners' book capital accounts, based on generally accepted accounting principles, will reflect book income and deductions and are used primarily for financial reporting purposes. This would be particularly relevant to publicly traded partnerships. The partners' tax capital reflects tax accounting adjustments.

As the foregoing indicates, a partner's capital account is not equal to the outside basis of the partnership interest. Once a partnership begins operations, the outside tax basis computed in the manner discussed above is increased by the distributable share of (i) taxable income, (ii) tax exempt income, and (iii) the excess of the deductions for depletion over the basis of the property subject to depletion[33] The tax basis is decreased by the partner's share of (i) distributions of cash and property, (ii) tax losses, (iii) nondeductible partnership expenditures which cannot be capitalized, and (iii) depletion.[34]

Outside tax basis rules thus function to ensure that, over the partnership's life, the partner does not withdraw more than the net investment in the partnership without a tax impact by providing that a distribution to a partner in excess of outside basis results in a gain.

Partnership Liabilities

An increase in a partner's share of partnership liabilities is considered a contribution of money, which increases the partner's outside basis in the partnership interest.[35] A decrease in a partner's share of partnership liabilities is considered to be a distribution of money[36] to the partner, which decreases the partner's outside basis (but not below zero).[37] If a decrease in the partner's share of partnership liabilities exceeds the partner's outside basis, the partner recognizes the excess as capital

[33] Code §705(a)(1).
[34] Code §§705(a)(2) and 733.
[35] Code §752(a).
[36] Code §752(b).
[37] Code §§705(a) and 733.

gain from the sale or exchange of the partnership interest.[38] This typically occurs in real estate partnerships where depreciation deductions often out-pace amortization of debt principal, resulting in more debt than basis at a given time. An example is real property acquired for a note that calls for interest payments only for a period of time followed by a balloon payment of principal at certain intervals.

A partnership liability is classified as "recourse" only to the extent that a partner bears the economic risk of loss for the liability.[39] A partner's share of the recourse liabilities of a partnership equals the portion of the liability for which the partner bears the economic risk of loss.[40] In simple terms, this means the lender can look to the partner for repayment if the partnership defaults. A liability is "nonrecourse" to the extent that no partner bears the economic risk of loss for the liability.[41] The partners generally share nonrecourse liabilities in proportion to their share of partnership profits.[42] This reflects the fact that only profits can be used to repay the debt, ignoring a repayment funded through a refinancing with other lenders.

"A threshold question is whether a partnership liability actually exists"

When a partner contributes property subject to a liability to a partnership, two transactions are deemed to occur: First, the transfer partner is treated as having received a cash distribution equal to the entire liability assumed by the partnership.[43] Secondly, that partner is treated as having made a cash contribution equal to the transferor's share of the liabilities attached to the transferred property.[44] These events are treated as having occurred simultaneously, resulting in a net deemed distribution or a net deemed contribution of money. Careful tax planning is required to ensure that a partner contributing debt-encumbered property will not realize gain from a sale of a partnership interest. The tax result arising from a transfer of property that is subject to recourse debt against the transferor may differ if the property is subject to nonrecourse debt.

A threshold question is whether a partnership liability actually exists. The Treasury Regulations[45] state that an obligation is a liability only if, when, and to the extent that incurring the obligation: (i) creates or increases the basis of any of the obligor's assets (including cash), (ii) gives rise to an immediate deduction to the obligor, or (iii) gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital. This definition is consistent with Rev. Rul. 88-77, which addressed the definition of partnership liabilities in the context of a cash basis partnership, and Rev. Rul. 95-26, in which a short sale of securities created a partnership liability because it created an obligation for the seller to return the borrowed securities. Thus, the cash received in the short sale resulted in a basis increase to partnership assets.

An obligation is any fixed or contingent obligation to make payment without considering whether the obligation is otherwise taken into account for purposes of

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[38] Code §§731(a)(1), 741.
[39] Treas. Reg. §1.752-1(a)(1).
[40] Treas. Reg. §1.752-2(a).
[41] Treas. Reg. §1.752-1(a)(2).
[42] Treas. Reg. §1.752-3(a).
[43] Treas. Reg. §1.752-1(c).
[44] Treas. Reg. §1.752-1(b).
[45] Treas. Reg. §1.752-1(a)(4)(i). .

“A debt that is created for the sole purpose of generating tax savings is not genuine and must be disregarded for tax purposes. A business motive for incurring a partnership liability must exist.”

the Internal Revenue Code. Examples of obligations for this purpose include debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps.[46]

A debt that is created for the sole purpose of generating tax savings is not genuine and must be disregarded for tax purposes. A business motive for incurring a partnership liability must exist. Similarly, a *bona fide* debt cannot be ignored.

The rules are structured to keep a close correlation between inside and outside basis. If deductions are funded by partnership debt, the outside tax basis is increased to allow the partners the benefit of the deduction. To this end, there is coordination between the rules which govern how partnership liabilities are shared and the rules governing partnership allocations.

<u>Taxable Disguised Sales</u>

The tax-free treatment and adjustments to the outside tax are subject to the so-called “disguised sale” rules. These rules are designed to prevent partners from re-characterizing a sale or exchange of property as a contribution to the partnership followed by a distribution by the partnership. The two-step transaction that is the target of the rules inappropriately allows a partner to avoid or defer tax on the distribution.

A disguised sale occurs when a transfer of property is made from a partner to a partnership and is then followed by a transfer of money or other consideration from the partnership to another partner, if the transfer would not have been made but for the near simultaneous transfer.[47] Although one of the most common scenarios is a property contribution by a partner to a partnership with a distribution of cash from the partnership to the contributing partner (*i.e.*, a disguised sale by the partner to the partnership), a disguised sale can take other forms such as:

- A cash contribution by a partner to a partnership with a property distribution from the partnership to the contributing partner (*i.e.*, a disguised sale by the partnership to the partner); and

- A property contribution by one partner and a cash contribution by another partner with a cash distribution from the partnership to the partner contributing property and a property distribution to the partner contributing cash (*i.e.*, a disguised sale between the partners).

There are several exceptions to the disguised sale rule, most notably the “pre-formation capital exception” and the “debt-financed exception.”

The pre-formation capital exception generally excludes transfers to reimburse a partner for certain capital expenditures and costs incurred provided that: (i) the

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[46] Treas. Reg. §1.752-1(a)(4)(ii).

[47] See the preamble to the proposed disguised sales regulations under Code §707 in Notice of Proposed Rulemaking for REG-119305.

capital expenditures are incurred within two years preceding the contribution of the property and (ii) the capital expenditures do not exceed 20% of the fair market value of the contributed property. The 20% limit does not apply if the fair market value of the property does not exceed 120% of the tax basis of the property.

Under the debt-financed distribution exception to disguised sale treatment, a distribution of money to a partner generally is not treated as consideration to the extent the distribution is traceable to a partnership liability (incurred within 90 days of the distribution) and the amount of the distribution does not exceed the partner's allocable share of the liability incurred to fund the distribution. An anticipated reduction in a partner's share of liability will be taken into account in determining the partner's share of liability for purposes of the disguised sale rule. However, "qualified liabilities" are excluded from disguised sale treatment.

"A leveraged partnership structure allows a seller to transfer most of the economic interest in a business in exchange for cash without triggering current taxes"

PARTNERSHIP PLANNING

The above rules regarding partnership basis, assumptions of liabilities and avoidance of the disguised sales rules are key to leveraged partnerships in capital intensive industries such as oil, gas, and real estate. They also affect hedge funds that acquire businesses in highly leveraged transactions.

A leveraged partnership structure allows a seller to transfer most of the economic interest in a business in exchange for cash without triggering current taxes. The partnership is formed with a purchaser of assets who would act as a strategic business partner or a financing entity and to whom essentially all of the economics (*i.e.*, up to 90%) and effective control of a business would be allocated. The seller of the partnership assets would receive cash proceeds through a leveraged distribution by the partnership. The seller's guarantee of the debt of the partnership in an amount equal to the cash distributed to the seller establishes the seller's basis in the partnership, so that cash proceeds received reduce partnership basis, but the reduction is offset by the increase resulting from the guarantee. Alternatively, the purchaser can provide the financing (so long as the seller guarantees its repayment) or the purchaser can be a co-guarantor, so long as the seller indemnifies the purchaser for any costs it bears as guarantor. Under these arrangements, the seller's gain from the distribution is deferred until such time as (i) the seller exits the partnership, (ii) the assets of the partnership contributed by the seller are sold, (iii) the debt is repaid, or (iv) the guarantee no longer exists.

A bottom guarantee structure can reduce the seller's credit exposure. Here the partnership borrows an amount greater than needed to fund the distribution, thereby creating excess cash for deployment in the business. The seller guarantees all remaining amounts in excess of the first losses on the entire borrowing. The partnership borrows more than, say 90%, of the value of the business so that the seller will still be able to guarantee debt equal to the cash it receives, while not bearing the "first losses" on this debt. The excess cash can be utilized for normal working capital needs of the business or to fund acquisitions or capital expenditures.

The I.R.S. has taken issue with leveraged arrangements under current rules where the seller guarantees arguably were not commercial liabilities of the seller.

In Chief Counsel's Advice ("C.C.A.") 201324013, the taxpayer was an S-corporation that would have incurred significant double tax if it had sold certain property prior to the 10-year anniversary of its conversion to S-corporation status. (For 2009 through 2013, the period was materially shortened to as little as five years. That provision has not yet been extended to 2014, but may be covered by possible legislation to extend expiring tax rules.) To defer the taxable sale date, the taxpayer ("X corp") indirectly contributed the property to a leveraged partnership with the buyer, an indirect subsidiary of Y corp. The buyer contributed both cash and receivables from Y corp. The partnership then borrowed significant cash from a bank and distributed it to X corp. The bank debt was guaranteed by buyer. The partnership agreement also contained put/call provisions to facilitate an exit starting one day after the 10-year period was reached.

The commercial issue faced by X corp was the fact that the buyer guaranteed the borrowing and the bank relied on the guarantee when extending the credit. X corp issued its indemnity to the buyer for a portion of the obligation under the guarantee and argued that its outside basis was increased by the amount of the indemnity. Nonetheless, the C.C.A. concluded that X corp's indemnity should be ignored. It categorized the indemnity as nothing more than optics designed to reduce tax, finding that:

- The indemnity lacked important features typical of an indemnity in a commercially-driven transaction. A typical indemnity expressly includes features such as net worth maintenance requirements, an arms-length fee, an obligation to provide annual financial statements, and evidence that the parties engaged in genuine negotiations over the indemnity.
- The indemnity is specious because there is no practical or commercial risk of it being enforced.
- The buyer merely used the partnership as a conduit to borrow cash in order to accommodate the seller's tax structure.

Consequently, the transaction was taxable as a disguised sale. Alternatively, the C.C.A. concluded that the partnership could be ignored under the partnership anti-abuse regulations. The C.C.A. also noted that the transaction could be considered a straight sale transaction under general common law substance over form principles.

THE PROPOSED REGULATIONS: KEY PROVISIONS

The proposed regulations address (i) the disguised sale rules[48] and (ii) allocation of liabilities to partners' tax basis in the partnership[49] within the context of addressing I.R.S. concerns regarding highly leveraged partnerships, as illustrated by C.C.A. 201324013.

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48 Treas. Reg. §§1.707-3, -4, and -5.
49 Treas. Reg. §1.752-2.

Disguised Sales

The proposed regulations clarify three ambiguities relating to the preformation capital expenditure exception to the disguised sale rules:

- The fair market value limitation test of Treas. Reg. §1.707-4(d)(1)(ii)(B) is applied on a property-by-property basis and not on an aggregate basis.

- The term "capital expenditures" of Treas. Reg. §1.707-4(d)(3) is defined to include capital expenditures that the taxpayer previously elected to deduct but to exclude deductible expenses the taxpayer elected to capitalize.

- The exception under Treas. Reg. §1.707–5(a) would not apply to the reimbursement by the partnership to the extent a partner funds a capital expenditure through borrowing and economic responsibility for the borrowing is shifted to another partner upon the assumption of that liability by the partnership.

The existing regulations provide several exceptions to disguised sale treatment. One such exception generally provides that a distribution of money to a partner is not taken into account to the extent the distribution is traceable to a partnership borrowing and the amount of the distribution does not exceed the partner's allocable share of the liability incurred to fund the distribution. This is known as the "debt-financed distribution exception." The I.R.S. expressed the view that uncertainty exists as to whether the amount of money transferred to a partner that is traceable to a partnership liability is reduced by any portion of such amount that is also excluded from disguised sale treatment under one or more other exceptions. For example, what happens if the transfer of money is also properly treated as a reasonable guaranteed payment? Does the debt-financed distribution exception apply? The answer is yes. The proposed regulations apply the debt-financed distribution exception before other exceptions from disguised sale treatment. This is designed to prevent the application of other exceptions from minimizing the application of the debt-financed distribution exception. If there is any amount not excluded after taking the debt financed distribution exception, the amount is to be tested under a different exception.

Under the existing regulations, a partner's share of a liability assumed, or taken subject to, by a partnership is determined by taking into account certain subsequent reductions in the partner's share of the liability. Specifically, a subsequent reduction in a partner's share of a liability is taken into account if:

- At the time that the partnership incurs, assumes, or takes property subject to the liability, it is anticipated that the partner's share of the liability will be subsequently reduced; and

- The reduction is part of a plan that has as one of its principal purposes minimizing the extent to which the distribution or assumption of, or taking property subject to, the liability is treated as part of a sale (the "anticipated reduction rule").

The I.R.S. recognized that uncertainty exists as to the circumstances in which a reduction is anticipatory because it is generally anticipated that all liabilities will be repaid. Consistent with the overall approach of the existing regulations, the proposed regulations adopt the view that a reduction that is subject to the

entrepreneurial risks of partnership operations (*i.e.*, that will be paid if the business succeeds) is not an anticipated reduction. However, if the a partner's share of the liability is reduced within two years of the partnership incurring, assuming, or taking project subject to the liability due to a decrease in the partner's or related person's net value, then the reduction is presumed to be anticipated. [50] The presumption may be rebutted if the facts and circumstances establish that the liability was not incurred in anticipation of the transfer, [51] and the treatment of the liability as a qualified liability under the new definition is disclosed to the I.R.S.[52]

The existing regulations provide only a limited tiered-partnership rule for cases in which a partnership succeeds to a liability of another partnership. Under those rules, if a lower-tier partnership succeeds to a liability of an upper-tier partnership, the liability in the lower-tier partnership retains the same characterization as either a qualified or a nonqualified liability that it had as a liability of the upper-tier partnership. A similar rule applies to a transfer from a lower-tier partnership to an upper-tier partnership. The proposed regulations add additional rules regarding tiered partnerships. First, the proposed regulations clarify that the debt-financed distribution exception applies in a tiered partnership setting. Second, the proposed regulations provide rules regarding the characterization of liabilities attributable to a contributed partnership interest. A partner that contributes an interest in a partnership to an upper-tier partnership must take into account its share of liabilities from the lower-tier partnership.

The lower-tier partnership is treated as an aggregate[53] for purposes of determining whether the upper-tier partnership's share of the liabilities of that lower-tier partnership is qualified liabilities. Thus, these proposed regulations provide that a contributing partner's share of liabilities from a lower-tier partnership are treated as qualified liabilities to the extent the liability would be a qualified liability had the liability been assumed, or taken subject to, by the upper-tier partnership in connection with a transfer of all of the lower-tier partnership's property to the upper-tier partnership by the lower-tier partnership.

Recourse Liabilities

As discussed above, the existing regulations[54] provide that a partner's share of a recourse partnership liability equals the portion of the liability, if any, for which the partner or related person bears the economic risk of loss. A partner generally bears the economic risk of loss for a partnership liability to the extent the partner, or a related person, would be obligated to make a payment if the partnership's assets were worthless and the liability became due and payable. Current partnership regulations assume that all partners and related persons will satisfy their payment

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[50] Prop. Treas. Reg. §1.707-5(a)(3)(ii).
[51] Treas. Reg. §1.707-5(a)(7)(i).
[52] Disclosure is required under Treas. Treas. Reg. §1.707-8.
[53] When a partnership is treated as an aggregate, all partners are considered as owning a share of all assets of the partnership; the partnership is not an entity separate and apart from its assets.
[54] Treas. Reg. §1.752–2.

obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.[55]

"The I.R.S. is concerned that some partners or related persons have entered into payment obligations that are not commercially reasonable exclusively to achieve an allocation of a partnership liability to such partner."

The I.R.S. is concerned that some partners or related persons have entered into payment obligations that are not commercially reasonable exclusively to achieve an allocation of a partnership liability to such partner. Consequently, the proposed regulations adopt a rule that obligations will not be recognized for basis enhancement purposes unless the following requirements are met:

- The obligor must maintain a commercially reasonable net worth throughout the term of the payment obligation, or otherwise be subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration;
- The obligor must be required to periodically provide commercially reasonable documentation regarding the obligor's financial condition;
- The term of the obligation must not end prior to the term of the partnership liability;
- The payment obligation must not require that the primary obligor, or any other obligor with respect to the partnership liability, directly or indirectly holds money other liquid assets in an amount that exceeds its reasonable needs;
- The obligor must receive arm's length consideration for assuming the payment obligation; and
- For a guarantee or similar arrangement, the obligor must be liable up to the full amount of such obligor's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. No bottom-dollar or partial-dollar guarantees are recognized.

The I.R.S. is also concerned that some partners or related persons might attempt to use certain structures or arrangements to circumvent the rules included in the proposed regulations with respect to bottom-dollar guarantees. For example, a financial intermediary might artificially convert a single mortgage loan into senior and junior tranches using a wrap-around mortgage or other device with a principal purpose of creating tranches for partners to guarantee that result in exposure tantamount to a bottom-dollar guarantee. Accordingly, the proposed regulations revise the anti-abuse rule[56] to address the use of intermediaries, tiered-partnerships, or similar arrangements to avoid the bottom-dollar guarantee rules.

The satisfaction presumption does not apply to the payment obligations of disregarded entities. Instead, the payment obligation of a disregarded entity for which a partner is treated as bearing the economic risk of loss is taken into account only to the extent of the net value of the disregarded entity. In addition, the I.R.S. believes there are other circumstances under which this satisfaction presumption is

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[55] Treas. Reg. §1.752(b)(6).
[56] Treas. Reg. §1.752–2(j).

not appropriate. The proposed regulations expand the net value requirement to any partners and related persons that enter into an obligation with respect to a partnership liability, other than a partner who is an individual or decedent's estate.

As a result, to the extent that an obligation is taken into account under the six requirements, the allocation of a partnership liability, on the account of the obligation entered into by such a partner or related person, will be limited to the obligor's net value. The net value of the partner for these purposes consists of:

- The fair market value of all assets owned by the partners that may be subject to creditors' claims under local law (excluding the partner's interest in the partnership for which the net value is being determined and the net fair market value of any property pledged to secure a liability of the partnership); less
- All of the obligations of the partner that do not constitute payment obligations under the existing liability rules.

An obligor subject to this net value requirement must provide information to the partnership as to the obligor's net value that is appropriately allocable to the partnership's liabilities on a periodic basis.

Finally, in determining the amount of any obligation of a partner to make a payment to a creditor or a contribution to the partnership with respect to a partnership liability, the proposed regulations[57] expand the scope of the rule that reduces the partner's payment obligation by the amount of any reimbursement from others. The current regulations provide that the basis reduction rule applies when the partner would be entitled to receive from another partner, a person related to another partner, or the partnership. Under the proposed regulations, the basis reduction rule applies if there is a right to reimbursement from any person.

Non-Recourse Liabilities

Existing regulations[58] address the methods under which a partner's share of a nonrecourse liability of a partnership. Under one method, a partner's share of excess nonrecourse liabilities is determined in accordance with the partner's share of partnership profits. Alternatively, excess nonrecourse liabilities may be allocated among the partners in the manner that deductions attributable to those liabilities are reasonably expected to be allocated. They may also be allocated in a manner that is reasonably consistent with allocations that have substantial economic effect on some other significant partnership item attributable to the property securing the nonrecourse liability.

The I.R.S. believes that the allocation of excess nonrecourse liabilities in accordance with the latter two methods does not properly reflect a partner's share of partnership profits that are generally used to repay such liabilities because the allocation of the significant item may not necessarily reflect the overall economic

[57] Proposed Treas. Reg. §1.752–2(b)(1).
[58] Treas. Reg. §1.752–3.

arrangement of the partners. Consequently, the two methods are eliminated under the proposed regulations.

Moreover, in determining a partner's interest in partnership profits, the proposed regulations look to the relative "liquidation value percentages" of the partners. For purposes of the proposed rule, the liquidation value of a partner's interest in a partnership is the amount of cash the partner would receive with respect to the interest if, immediately after formation of the partnership or the occurrence of a capital book-up event, the partnership:

- Sold all of its assets for cash equal to the fair market value of such property;
- Satisfied all of its liabilities;
- Paid an unrelated third party to assume all of its liabilities in a fully taxable transaction; and
- Liquidated.

Thus, a partner's liquidation value percentage would be equal to the partner's capital account balance maintained for tax purposes subject to recalibration upon occurrence of events that would provide for a book-up of the capital accounts. This balance is compared with all other balances to determine the percentage. Built-in gains and capital account book-ups or book-downs are taken into account.

CONCLUSION

Commentators have generally viewed the clarifications of ambiguities in the existing regulations as constructive. As to partners' shares of liabilities, however, there is great concern that the proposed regulations fundamentally change the economics of partnership transactions by altering the way economic risk of loss is determined. By limiting economic loss to "commercial" guarantees (those meeting the six requirements set forth in the proposed regulations) and ignoring "bottom-dollar" guarantees, the proposed regulations significantly impact the ability of taxpayers to (i) make tax deferred contributions of leverage property to partnerships, (ii) receive tax deferred distributions of cash from partnerships, and (iii) maintain sufficient allocations of liabilities to avoid recapture of "negative capital accounts" associated with partnership interests.

The current regulations address issues arising from allocations of non-recourse debt that provide unwarranted tax benefits from a basis bump-up. Specific aspects of the business deal, economic substance requirements for allocations, and rules that mandate the restoration of negative capital accounts or face other curative allocations of partnership level tax attributes likely address most concerns addressed in the proposed regulations.

Where a foreign person operates in the U.S. through a partnership or L.L.C., the general partners or managers have an obligation to withhold U.S. income tax on the

distributive share of effectively connected income allocated to the foreign partner.[59] The fact that no distribution is made to the foreign partner is not material in reducing the imposition of the withholding tax obligation.

"Liabilities that might have increased an investor's capacity to absorb and deduct partnership losses – through an increase in basis – may turn out to be ephemeral."

The proposed regulations may exacerbate cash-flow issues where phantom income issues arise. It is anticipated that not all commercial risk legitimately assumed by an investor in a partnership transaction will meet the strict economic risk standards imposed by the proposed regulations. For the foreign investor in a leveraged investment, such as real estate, the proposed regulations add another unwelcome level of complexity onto an already complex area of the tax law that is not well understood outside the U.S. Liabilities that might have increased an investor's capacity to absorb and deduct partnership losses – through an increase in basis – may turn out to be ephemeral.

[59] I.R.C. §1446. .