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# EXCULPATORY LIABILITIES AND PARTNERSHIP NONRECOURSE ALLOCATIONS

Karen C. Burke\*

## I. INTRODUCTION

The rise of limited liability companies (LLCs) classified as partnerships for federal income tax purposes challenges traditional assumptions concerning the treatment of recourse and nonrecourse liabilities under Subchapter K.<sup>1</sup> The complex rules of sections 704(b) and 752 give little attention to liabilities that are recourse to the entity under section 1001 but for which no member bears the economic risk of loss under section 752.<sup>2</sup> In comparison to traditional general or limited partnerships, however, LLCs are much more likely to incur such “exculpatory” liabilities because of the limited liability shield under state law.<sup>3</sup> Under the existing regulations for section 704(b) and 752 (the “section 704(b)/752 regulations”), the classification of liabilities as either recourse or nonrecourse is essential for purposes of allocating basis and deductions attributable to such liabilities.<sup>4</sup> Although exculpatory liabilities are functionally quite similar to traditional nonrecourse liabilities secured by all of an LLC’s assets, literal application of the section 704(b)/752 regulations with respect to such liabilities is fraught with difficulties.<sup>5</sup>

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<sup>1</sup>The reference to LLCs also includes limited liability partnerships (LLPs) and similar business entities that, under state law, shield individual members from personal liability for entity-level debts. The explosive growth in the number of LLCs is largely attributable to the liberalization of the entity classification rules in 1996. See Reg. § 301.7701-3 (elective classification of eligible entities).

<sup>2</sup>See Clayton S. Reynolds, *Treatment of Recourse Liabilities in the Context of a Limited Liability Company*, 74 TAXES 397, 397 (1996). The preamble to the final section 704(b) regulations, promulgated in 1991, recognizes that a partnership may have a liability “that is not secured by any specific property and that is recourse to the partnership as an entity, but explicitly not recourse to any partner (exculpatory liability).” T.D. 8385, 1992-1 C.B. 199. See also T.D. 8380, 1992-1 C.B. 218. For a contemporary view by one of the principal authors of the nonrecourse regulations, see Susan Pace Hamill, *Final Regulations Concerning Liabilities Join Substantial Economic Effect Rules*, 9 J. PARTNERSHIP TAX’N 99 (1992).

<sup>3</sup>An exculpatory liability may arise in a general or limited partnership if the recourse lender has exculpated all of the general partners from personal liability. See William B. Brannan, *The Subchapter K Act of 1997*, 75 TAX NOTES (TA) 121, 125 (Apr. 7 1997). The difference is that in an LLC any general unsecured liability is an exculpatory liability, since all of the members are statutorily protected from personal liability. See *id.*; see, e.g., Limited Liability Company Act, Del. Code Ann. tit. 6, § 18-303 (2003).

<sup>4</sup>See Reg. §§ 1.752-1(a)(1), -1(a)(2), 1.704-2(b)(3) (defining recourse liability, defining nonrecourse liability, and cross-referencing the § 752 definition of nonrecourse liability, respectively); see also Reg. §§ 1.704-1, -2 (recourse deductions and nonrecourse deductions).

<sup>5</sup>See Reynolds, *supra* note 2; see also Bryan P. Collins, Glenn E. Dance & Monte A. Jackel, *Allocating Debt-Financed Losses of an LLC under Section 704(b)*, 2 J. LTD. LIAB. CO. 135 (1995); Kenneth Heller & James Boyd, *Partnership Liabilities: IRS Interpretation Helpful But Further Guidance Needed*, 13 J. PARTNERSHIP TAX’N 243 (1996); Christine Rucinski Strong & Susan Pace Hamill, *Allocations Attributable to Partner Nonrecourse Liabilities: Issues Revealed by LLCs and LLPs*, 51 ALA. L. REV. 603 (2000).

Under these regulations, the allocation of tax items attributable to nonrecourse liabilities is extraordinarily permissive: since no partner bears the economic risk of loss attributable to such liabilities, the corresponding deductions may be allocated in virtually any manner the parties desire.<sup>6</sup> Upon disposition of the underlying property, however, the partners who received such deductions must be allocated offsetting gain and income to restore any capital account deficits, thereby vindicating the earlier loss allocations.<sup>7</sup> The underlying premise of the nonrecourse allocation rules is that it is possible to identify the partnership's nonrecourse liabilities and track the deductions generated by such liabilities for purposes of allocating the corresponding basis and losses.<sup>8</sup> Because of their hybrid nature as recourse liabilities for purposes of section 1001 and nonrecourse liabilities for purposes of section 752, exculpatory liabilities challenge the basic premises of this somewhat oversimplified description of the nonrecourse allocation rules. Indeed, as two recent articles demonstrate, the uncertainty and lack of consensus concerning the treatment of exculpatory liabilities within the framework of the section 704(b)/752 regulations is quite remarkable.<sup>9</sup>

This article seeks to disentangle the treatment of exculpatory liabilities under the nonrecourse allocation rules and suggests several needed reforms. Part II concludes that an exculpatory liability should be treated similarly to a traditional nonrecourse liability for purposes of determining economic risk of loss upon a constructive liquidation. Part III argues that the mechanical provisions of the nonrecourse allocation rules can be properly applied to exculpatory liabilities once it is clearly understood that the nonrecourse standard of sections 704(b) and 752 diverges fundamentally from the nonrecourse standard of section 1001. Part IV discusses related problems that arise because exculpatory liabilities are secured not by particular assets but rather by all of an LLC's assets. Finally, Part V suggests that the section 704(b) regulations should be amended to harmonize the treatment of guaranteed recourse liabilities of an LLC (or recourse loans from an LLC member) and functionally similar guaranteed nonrecourse liabilities of an LLC (or nonrecourse loans from an LLC member).

While clarifying these issues is necessary to provide certainty in the tax treatment of exculpatory liabilities, this article also suggests the need to rethink the

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<sup>6</sup>See, e.g., George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations*, 51 SMU L. REV. 125, 150-52 (1997); Brannan, *supra* note 3, at 122-24.

<sup>7</sup>See Reg. § 1.704-2(f) (minimum gain chargeback).

<sup>8</sup>See *infra* notes 50-53 and accompanying text.

<sup>9</sup>See Terence Floyd Cuff, *Indebtedness of a Disregarded Entity*, 81 TAXES 303, 303 (2003) ("Partners and tax practitioners throw around terms like recourse debt and nonrecourse debt with reckless abandon. We may imagine that we understand [their meaning but] terms such as nonrecourse debt are not so clearly defined [or] well understood."); Bethany Atkins Rice, *Does Regulation Section 1.704-2 Permit Special Allocations of Nonrecourse Deductions Attributable to Exculpatory Liabilities?*, 56 TAX LAW. 155, 170-71 (2002) (arguing that "[a]lthough special allocations of nonrecourse deductions attributable to exculpatory liabilities are warranted based on well-settled tax policy, under current law exculpatory liabilities not allocated to specific properties do not justify special allocations of nonrecourse deductions").

nonrecourse definition under sections 704(b), 752, and 1001. Upon a disposition of property encumbered by liabilities in excess of fair market value, the section 1001 regulations draw a distinction between recourse and nonrecourse liabilities; the latter generate section 1001 gain through relief from the underlying liability, while the former generate a combination of section 1001 gain (or loss) and ordinary income from discharge of indebtedness.<sup>10</sup> Although the conceptual model underlying the section 704(b)/752 regulations is derived from section 1001 and *Tufts v. Commissioner*,<sup>11</sup> the drafters failed to clearly articulate and rationalize the manner in which the nonrecourse allocation rules deviate from the section 1001 standard.<sup>12</sup> Consequently, uncertainty persists concerning the precise boundaries between the nonrecourse definitions of sections 704(b), 752, and 1001. Ultimately, such uncertainty can be dispelled only if the section 704(b)/752 regulations construct a theory of nonrecourse allocations that is explicitly independent of the section 1001 standard.<sup>13</sup>

## II. APPLYING ECONOMIC RISK OF LOSS TO DETERMINE PARTNERSHIP NONRECOURSE LIABILITIES

### A. Overview

Broadly speaking, the section 704(b) regulations divide partnership allocations between recourse and nonrecourse deductions. Nonrecourse deductions, defined as deductions attributable to nonrecourse liabilities, cannot have economic effect because the creditor alone bears the economic burden attributable to such liabilities.<sup>14</sup> While nonrecourse deductions generally fall under the nonrecourse safe harbor provisions of the section 704(b) regulations,<sup>15</sup> all other deductions are generally governed by the substantial economic effect (SEE) test.<sup>16</sup> Similarly, the section 752 regulations bifurcate partnership liabilities between recourse and nonrecourse.<sup>17</sup> The overarching goal of the section 752 regulations is to assign liabilities to those partners who will ultimately receive the

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<sup>10</sup>See *infra* notes 30-32 and accompanying text.

<sup>11</sup>*Tufts v. Commissioner*, 461 U.S. 300 (1983).

<sup>12</sup>For example, the section 704(b) and section 752 regulations employ the term nonrecourse liabilities in a highly specialized and sometimes artificial manner; by constructing a definition of nonrecourse liabilities and nonrecourse deductions independent of the section 1001 standard, the drafters presumably intended to ensure that a disposition of encumbered property would always trigger minimum gain equal to the excess of any section 752 nonrecourse liability over the basis of such property, regardless of the characterization of the debt for purposes of section 1001. See *infra* notes 80-90 and accompanying text.

<sup>13</sup>See Cuff, *supra* note 9, at 363.

<sup>14</sup>Reg. § 1.704-2(b)(1). The reference to nonrecourse deductions does not include deductions attributable to section 1001 nonrecourse liabilities for which a partner bears the economic risk of loss, e.g., as a guarantor or creditor; such deductions must generally be allocated to the partner who bears the economic risk of loss. See Reg. § 1.704-2(b)(4), -2(i) (partner nonrecourse deductions); see also *infra* notes 129-38 and accompanying text.

<sup>15</sup>See Reg. § 1.704-2(e).

<sup>16</sup>See Reg. § 1.704-1(b)(2).

<sup>17</sup>See Reg. § 1.752-1(a)(1), -1(a)(2).

corresponding deductions.<sup>18</sup> Since liabilities follow losses, each partner should have sufficient outside basis to utilize her share of partnership deductions. Although the section 704(b)/752 regulations set forth rules for partnership allocations that are often excruciatingly detailed, the treatment of exculpatory liabilities of an LLC remains puzzling.

Commentators have argued that literal application of the section 704(b)/752 regulations to exculpatory liabilities of an LLC gives rise to strange and unexpected results.<sup>19</sup> Since the regulations were largely completed prior to the advent of LLCs, it is hardly surprising that the drafters failed to appreciate fully the importance of the limited liability shield for such entities.<sup>20</sup> If an LLC classified as a partnership incurs a traditional nonrecourse liability secured by specific assets, the liability and corresponding deductions are generally allocated under the nonrecourse portion of the section 704(b)/752 regulations in the same manner as if the nonrecourse liability were incurred by a general or limited partnership.<sup>21</sup> The limited liability shield is irrelevant because the contractual agreement between the entity and the lender suffices to eliminate any personal liability for the LLC members. Thus, the allocation of traditional nonrecourse liabilities generally does not depend on whether the business is formally organized as a general partnership, limited partnership, or LLC.

The situation is different, however, if an LLC classified as a partnership incurs a general, unsecured liability or a liability secured by all of its assets for which none of the members is personally liable. In the case of a general partnership, the recourse nature of the liability to the entity flows through to the general partners who have a state law obligation to repay the debt if the partnership's assets are insufficient.<sup>22</sup> In the case of an LLC, however, a liability that is recourse to the entity may be functionally nonrecourse to the members as a result of the limited liability shield.<sup>23</sup> Such an exculpatory liability should be treated as nonrecourse under the section 752 regulations, since no partner bears the economic risk of loss for the liability.<sup>24</sup> Regulation section 1.704-2(b)(3), which cross-references the definition of nonrecourse liabilities under the section 752 regulations, treats an exculpatory liability as nonrecourse for purposes of the section 704(b) regulations.<sup>25</sup> Nonrecourse classification of an exculpatory liabil-

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<sup>18</sup>A partner's share of recourse liabilities is based on the obligation to repay the creditor, as determined under a constructive liquidation. Reg. § 1.752-2(b). A partner's share of nonrecourse liabilities equals the sum of the partner's share of partnership minimum gain, section 704(c) minimum gain, and excess nonrecourse liabilities that have not yet generated nonrecourse deductions. Reg. § 1.752-3(a).

<sup>19</sup>See Reynolds, *supra* note 2, at 397 (results are obviously incorrect); see also Cuff, *supra* note 9, at 303-04 (sections 704(b), 752, and 1001 regulations are "badly drafted, incomplete, ambiguous, and sometimes internally inconsistent").

<sup>20</sup>See Strong & Hamill, *supra* note 5, at 668; Reynolds, *supra* note 2, at 397.

<sup>21</sup>See Strong & Hamill, *supra* note 5, at 658.

<sup>22</sup>See *id.* at 659.

<sup>23</sup>This is particularly true for a single purpose entity when the lender requires a blanket security interest. See Cuff, *supra* note 9, at 339.

<sup>24</sup>See Reg. § 1.752-1(a)(2).

<sup>25</sup>See Reg. § 1.704-2(b)(3); see also T.D. 8385, 1992-1 C.B. 199.

ity under the section 704(b)/752 regulations has important repercussions: allocation of liabilities and losses should generally be governed by the nonrecourse rules, consistent with the notion that no member bears the economic risk of loss.

Notwithstanding the nonrecourse characterization under the section 704(b)/752 regulations, most commentators agree that an exculpatory liability should be treated as recourse for purposes of section 1001.<sup>26</sup> In general, the section 1001 regulations distinguish between recourse and nonrecourse liabilities based on whether the debtor is personally liable for repayment of the obligation (an unlimited or personal liability) or the creditor's remedy is instead limited to one or more assets of the debtor (a limited liability).<sup>27</sup> Whether a liability is treated as recourse or nonrecourse for purposes of section 1001 apparently depends on the form of the debt rather than the character of the borrower.<sup>28</sup> Because the section 1001 regulations disregard the practical consequences at the member level, an LLC's exculpatory liabilities should retain their character as section 1001 recourse liabilities.<sup>29</sup>

Under section 1001, the classification of a liability as recourse or nonrecourse affects the tax consequences upon a disposition of encumbered property. While a disposition of property subject to a nonrecourse debt in excess of fair market value triggers *Tufts* gain,<sup>30</sup> a similar disposition involving recourse debt triggers a combination of gain (or loss) and potential income from cancellation of debt (COD).<sup>31</sup> In both situations, the borrower must take into account the entire liability for tax purposes; thus, the combined amount (but not the character) of the section 1001 gain (or loss) and COD income will be the same. The notion of *Tufts* gain upon a disposition of property subject to a nonrecourse liability provides the conceptual framework underlying the treatment of nonrecourse liabilities under the section 704(b)/752 regulations. Thus, it may seem odd that a liability may be recourse for purposes of section 1001 but nevertheless nonrecourse for purposes of sections 704(b) and 752.<sup>32</sup>

<sup>26</sup>See Reynolds, *supra* note 2, at 401 (noting schizophrenic treatment of exculpatory liabilities as recourse for purposes of section 1001 but nonrecourse for purposes of sections 704(b) and 752); see also Cuff, *supra* note 9, at 342 (if a recourse loan to a corporation is treated as an unlimited liability under section 1001, "[i]t is not readily apparent why there should be a different answer" in the partnership context); Rice, *supra* note 9, at 161 n.32 (since section 1001 applies to a partnership as an entity, an exculpatory liability should be treated as recourse for purposes of section 1001).

<sup>27</sup>The section 1001 regulations do not provide a comprehensive definition of the terms recourse and nonrecourse. See Reg. § 1.1001-2(a), -2(c).

<sup>28</sup>See Reynolds, *supra* note 2, at 399. Indeed, the examples set forth in Regulation section 1.1001-2(c) do not generally distinguish between corporate and individual taxpayers. See *id.* at 399 n.9.

<sup>29</sup>Strong & Hamill, *supra* note 5, at 667 (noting that section 1001 distinction is based on the "superficial form of the debt to the borrower-entity, rather than the real substantive consequences of that debt" to the members).

<sup>30</sup>See Reg. §§ 1.1001-2(a)(1), -2(a)(4)(i), -2(c), Ex. (7); see also *Tufts v. Commissioner*, 461 U.S. 300, 317 (1983).

<sup>31</sup>See Reg. § 1.1001-2(a)(2), -2(a)(4)(ii), -2(b), -2(c), Ex. (8). If debt is reduced or forgiven without a sale or exchange of the encumbered property, the taxpayer recognizes COD income rather than gain, regardless of whether the debt is recourse or nonrecourse. See Rev. Rul. 1991-31, 1991-1 C.B. 19.

<sup>32</sup>Conversely, a section 1001 nonrecourse liability may be recourse under the section 752 regulations if a partner guarantees the debt, thereby shifting the economic risk of loss from the creditor to the guarantor. See *infra* notes 129-33 and accompanying text.

### B. *Constructive Liquidation, Economic Risk of Loss, and Limited Liabilities*

Despite the conceptual link between the section 704(b)/752 regulations and *Tufts* gain, significant differences exist between the partnership nonrecourse definition and the section 1001 standard. The section 752 regulations employ the fiction of a constructive liquidation to identify whether liabilities are recourse or nonrecourse and to determine which partner, if any, bears the economic risk of loss for the partnership's recourse liabilities.<sup>33</sup> Under the constructive liquidation, the partnership's assets (including cash) are deemed to be worthless and the partnership is deemed to dispose of its assets in a fully taxable exchange for no consideration other than relief from limited liabilities. For this purpose, a limited liability is defined as any liability "for which the creditor's right to repayment is limited solely to one or more assets of the partnership."<sup>34</sup> Pursuant to the constructive liquidation, the partnership is deemed to recognize gain or loss equal to the difference between the amount of any limited liability and the tax basis (or book value, if different) of assets encumbered by such liability.<sup>35</sup>

Limited liabilities clearly include true nonrecourse liabilities (*i.e.*, section 1001 nonrecourse liabilities) which would be extinguished by the deemed transfer of the partnership's assets.<sup>36</sup> The term limited liability is also presumably intended to encompass certain liabilities classified as recourse for purposes of section 1001 but as nonrecourse for purposes of sections 704(b) and 752. From an entity perspective, an exculpatory liability might appear to be an unlimited liability, since all of the entity's assets can potentially be reached by the creditor.<sup>37</sup> As a result of the limited liability shield, however, the creditor's rights are statutorily limited to the entity's assets, without recourse to the assets of the individual members.<sup>38</sup> Thus, an exculpatory liability should generally be treated as a limited liability for purposes of the constructive liquidation under section 752.<sup>39</sup>

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<sup>33</sup>See Reg. § 1.752-2(b)(1).

<sup>34</sup>See *id.*; see also Reg. § 1.752-2(b)(2).

<sup>35</sup>See Reg. § 1.752-2(b)(1)(iii).

<sup>36</sup>See Reg. § 1.1001-2(a)(1), -2(a)(4)(i).

<sup>37</sup>See Reynolds, *supra* note 2, at 399.

<sup>38</sup>Based on this reasoning, the prior version of the section 752 regulations concluded that all liabilities of an LLC or similar entity should generally be treated as limited liabilities for purposes of a constructive liquidation. See Temp. Reg. § 1.752-1T(d)(3)(ii)(B)(4)(ii), 1989-1 C.B. 180, 188 ("For example, if an entity that is treated as a partnership for federal income tax purposes is organized and operated under a local law which provides that none of the members of that entity is liable for its debts and other obligations, then all the liabilities of that entity will generally constitute liabilities for which the creditor's right to repayment is limited to one or more assets of the partnership because the members of that entity are not required to make contributions to the entity to discharge its liabilities."). The more concise final regulations, issued in 1991, omit this language. See Brannan, *supra* note 3, at 137 n.85 (noting "concerns of commentators that the 1988 temporary regulations were too long and complicated").

<sup>39</sup>See Reynolds, *supra* note 2, at 400 (treating recourse liabilities of an LLC as unlimited liabilities would "produce peculiar results under a constructive liquidation analysis"); see also Rice, *supra* note 9, at 162 (apparently treating an exculpatory liability as a limited liability for purposes of the constructive liquidation).

The following example illustrates the consequences of classifying an exculpatory liability as a limited liability. Assume that *A* and *B* each contribute \$20 to an LLC classified as a partnership, and the LLC incurs a general unsecured liability of \$60. The LLC purchases nondepreciable property worth \$100, its sole asset. Upon a constructive liquidation, the LLC would be treated as transferring the property for no consideration other than relief of the limited liability of \$60, triggering a loss of \$40 (\$100 basis less \$60 amount realized). Assuming that the loss of \$40 is allocated equally to *A* and *B*, each member's capital account would be reduced to zero (\$20 less \$20 share of loss). Treating an exculpatory liability as a limited liability necessarily means that any loss realized in the constructive liquidation is limited to the excess of the tax basis (or book value, if different) of the property over the exculpatory liability.<sup>40</sup> Thus, no member will wind up with a capital account deficit in excess of that member's obligation to contribute funds upon a constructive liquidation.

### C. *Alternative Approach: Unlimited Liability and COD*

An alternative approach would be to treat an exculpatory liability as an unlimited liability for purposes of the constructive liquidation. The excess of an exculpatory liability over the basis of the encumbered property would trigger potential COD income (rather than section 1001 gain), eliminating any deficit in the partners' capital accounts.<sup>41</sup> In the above example, if the \$60 unsecured liability were treated as an unlimited liability, the LLC would recognize a loss of \$100 on the constructive liquidation, since the liability would not be treated as an amount realized. If the loss were allocated equally to *A* and *B*, each partner would be left with a negative capital account of \$30, even though neither has any obligation to repay the liability. Treatment of an exculpatory liability as an unlimited liability seems obviously wrong, since it would suggest that *A* and *B* bear the economic risk of loss even though they are, in fact, protected against such risk as a result of the limited liability shield.<sup>42</sup> By integrating the COD concept and the constructive liquidation, however, it might appear possible to reach a defensible result.<sup>43</sup> Under this approach, *A* and *B* would be allocated

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<sup>40</sup>The portion of the liability which does not give rise to a loss on the constructive liquidation (\$60) equals the amount of nonrecourse deductions that have not yet been allocated. See Reg. § 1.704-2(c), -2(d). It also represents the amount of *Tufts* gain that would be triggered upon a constructive liquidation if the liability were nonrecourse and the basis (and fair market value) of the encumbered property were reduced to zero. See Rice, *supra* note 9, at 162 n.41.

<sup>41</sup>See Rice, *supra* note 9, at 170-71 (recommending that Regulation sections 1.704-2 and 1.752-2 be amended to expressly incorporate COD in calculating minimum gain and to treat an exculpatory liability as an unlimited liability for purposes of the constructive liquidation).

<sup>42</sup>If the liability were treated as recourse for purposes of section 752, then the corresponding allocations of income and loss would be governed by the recourse portions of the section 704(b) regulations. The difficulty would be, of course, that any loss allocation under the section 704(b) safe harbor would be impermissible unless the LLC's members are obligated to restore capital account deficits. See Reynolds, *supra* note 2, at 400 n.15.

<sup>43</sup>Compare Rice, *supra* note 9, at 168-71 (advocating COD approach) with Reynolds, *supra* note 2, at 400-01 (rejecting COD approach).



offsetting COD income (\$30 each) sufficient to eliminate the deficit in each partner's capital account. Since *A* and *B* have no obligation to repay any portion of the liability, the LLC should arguably be treated as recognizing COD income under section 1001 if the fair market value of the property is insufficient to satisfy the liability.<sup>44</sup>

The COD approach should be rejected because it is inconsistent with the purpose of the constructive liquidation and the nonrecourse treatment of exculpatory liabilities under the section 704(b)/752 regulations. The constructive liquidation is intended to segregate those liabilities for which the partners bear the economic risk of loss (section 752 recourse liabilities) and those for which no partner bears the economic risk of loss (section 752 nonrecourse liabilities). If a liability does not give rise to an aggregate deficit in the partners' capital accounts upon a constructive liquidation (*i.e.*, because the liability is treated as a limited liability), the absence of economic risk of loss signifies generally that the section 704(b) and 752 nonrecourse rules will govern allocation of the liability and corresponding deductions. Conversely, if a liability gives rise to an aggregate deficit in the partners' capital accounts upon a constructive liquidation (*i.e.*, because the liability is treated as an unlimited liability), the presence of economic risk of loss signifies that the recourse rules will govern allocation of the liability and corresponding deductions. Such a deficit means that the partners in the aggregate would be called upon to contribute an amount equal to such deficit to repay any positive capital account balances and section 752 recourse liabilities.

For purposes of the economic risk of loss analysis, an exculpatory liability should clearly be treated as a limited liability, since the creditor's remedies are limited solely to one or more assets of the entity. If such a liability were instead treated as an unlimited liability, the constructive liquidation would give rise to a capital account deficit that would be eliminated by an equal and offsetting allocation of COD income.<sup>45</sup> The COD allocation would apparently play a role similar to minimum gain upon disposition of property subject to traditional nonrecourse liabilities.<sup>46</sup> Any capital account deficit attributable to the exculpatory liability would be meaningless, however, because there would always be an equal and offsetting allocation of income or gain.<sup>47</sup> Thus, the proper approach is

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<sup>44</sup>See Reynolds, *supra* note 2, at 400.

<sup>45</sup>See Rice, *supra* note 9, at 166-68.

<sup>46</sup>If an exculpatory liability is treated as a limited liability, the constructive liquidation can never give rise to COD income because the amount realized equals the amount of the exculpatory liability, *i.e.*, the fair market value of the encumbered property is deemed to be at least equal to the amount of the section 752 nonrecourse liability. Of course, COD income may arise upon an actual disposition if the fair market value of the encumbered property is less than the amount of any exculpatory liabilities; COD income is likely to be deferred, however, to the extent that the creditor can reach other retained assets. See *infra* notes 85-95 and accompanying text.

<sup>47</sup>It is not clear whether a special allocation of COD income would have substantial economic effect, since it arguably does not affect the dollar amounts to be received by the partners. In Revenue Ruling 1992-97, 1992-2 C.B. 124, the Service determined the validity of special allocations of COD income attributable to recourse debt. In the first situation, the special allocation lacked economic effect because the partners' obligation to restore deficits depended solely on the amount of the

to treat an exculpatory liability as a limited liability for purposes of the constructive liquidation, thereby ensuring that only those liabilities for which a partner bears the economic risk of loss will give rise to a capital account deficit.<sup>48</sup>

In conclusion, the COD approach would obfuscate rather than clarify the intended operation of the section 704(b)/752 regulations. Under the existing scheme, if an exculpatory liability is viewed as a limited liability, all of the partners are entitled to a share of the basis and corresponding deductions under the nonrecourse rules. In other words, exculpatory liabilities generally receive treatment on par with traditional nonrecourse liabilities. While it is true that the members are not deemed to bear the economic risk of loss for the limited liability, it does not follow that they will be deprived of "sufficient basis . . . to take advantage of special allocations of nonrecourse deductions."<sup>49</sup> Instead, such treatment merely ensures that the basis and deductions attributable to such liabilities will be governed by the section 704(b) and 752 nonrecourse rules.

### III. EXCULPATORY LIABILITIES, MINIMUM GAIN, AND NONRECOURSE DEDUCTIONS: BEYOND *TUFTS* PRINCIPLES

#### A. Overview

The nonrecourse allocation rules of section 704(b) require a mechanism for measuring and tracking nonrecourse deductions. Under the nonrecourse debt safe harbor, the concept of partnership minimum gain (PMG) plays four essential roles. First, a partner's share of PMG (*i.e.*, her share of *Tufts* gain upon a disposition of property subject to a nonrecourse liability in excess of basis) supports allocation to her of the corresponding nonrecourse deductions; indeed, PMG measures the amount of nonrecourse deductions arising in any particular year.<sup>50</sup> Second, a partner's share of PMG is treated as a deemed deficit restoration obligation (DRO);<sup>51</sup> the deemed DRO prevents a partner's capital account

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canceled debt; in the second situation, the special allocation was upheld because the partners had an unlimited obligation to restore deficits, so that an allocation of COD income disproportionate to the prior deductions would affect the amounts each partner received upon liquidation of the partnership. *See id.*; *see also* Rev. Rul. 1999-43, 1999-2 C.B. 506 (COD income attributable to reduction in the amount of nonrecourse debt that had not yet generated nonrecourse deductions; special allocation of COD income to insolvent partner, coupled with a corresponding downward revaluation of the partners' capital accounts, lacked substantiality under the overall economic effect test and shifting allocations test); *see generally* Edward J. Buchholz, *Substantiality under Section 704(b)—Some Forgotten Issues and Some Ancient Concepts Revisited*, 10 VA. TAX REV. 165, 244-52 (1999).

<sup>48</sup>The COD approach may be even less satisfactory if a member bears the economic risk of loss as a result of an exculpatory loan to an LLC, since it may suggest that no member (rather than the lender partner) bears the economic risk of loss. *See Reynolds, supra* note 2, at 400-01.

<sup>49</sup>*See Rice, supra* note 9, at 162-63. This conclusion apparently rests on the dubious proposition that, under section 704(b) principles, exculpatory liabilities must be allocated under the recourse portion of the section 752 regulations; *see infra* notes 65-71 and accompanying text. *See also Rice, supra* note 9, at 163 ("[I]f the Treasury considers exculpatory liabilities as nonrecourse to the partners (or members), then why wouldn't it allow them sufficient bases to make use of special allocations, as it does with other nonrecourse liabilities?").

<sup>50</sup>*See* Reg. § 1.704-2(b)(2), -2(c).

<sup>51</sup>*See* Reg. §§ 1.704-1(b)(2)(ii)(d), -2(g)(1).

from becoming impermissibly negative. Third, a partner's share of PMG measures the amount of nonrecourse liabilities included in her outside basis.<sup>52</sup> Finally, under the minimum gain chargeback (MGC) provision, a partner's share of PMG will be charged back at the latest upon disposition of property securing nonrecourse liabilities, thereby vindicating the earlier allocation of nonrecourse deductions.<sup>53</sup>

The concept of PMG is essential to maintaining parity between the treatment of exculpatory liabilities and traditional nonrecourse liabilities. Unless exculpatory liabilities give rise to PMG, they cannot generate nonrecourse deductions. While the Preamble to the final section 704(b) regulations suggests that exculpatory liabilities create PMG, it warns that calculating such minimum gain may pose special difficulties because such liabilities are not "secured by specific property" and hence the bases of properties that can be reached by the lender may "fluctuate greatly."<sup>54</sup> The concept of PMG presupposes that property is "subject to" a nonrecourse liability, and that such liability "encumbers" the property.<sup>55</sup> The meaning of "subject to" and "encumbers" in the context of exculpatory liabilities is unclear.<sup>56</sup> One interpretation is that these requirements should be satisfied under a "floating lien" approach: exculpatory liabilities would be treated as secured by all of an LLC's assets that could be reached by the recourse lender.<sup>57</sup>

Treating assets burdened by exculpatory liabilities as subject-to assets paves the way to applying the nonrecourse allocation rules to such liabilities, although technical problems remain.<sup>58</sup> Thus, PMG would arise to the extent that exculpatory liabilities exceed the aggregate basis of the LLC's underlying property.<sup>59</sup> A net increase in PMG for a particular year would give rise to a corresponding amount of nonrecourse deductions with respect to the exculpatory liability. Because the section 704(b) nonrecourse regulations fail to "prescribe precise rules" for allocating income and loss attributable to exculpatory liabilities, taxpayers must allocate such items "in a manner that reasonably reflects the principles of section 704(b)."<sup>60</sup> Given the differences between traditional nonrecourse liabilities and exculpatory liabilities, however, determining how to apply section 704(b) principles has led to much uncertainty in the absence of more specific guidance.

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<sup>52</sup>See Reg. § 1.752-3(a).

<sup>53</sup>See Reg. § 1.704-2(f).

<sup>54</sup>See T.D. 8385, 1992-1 C.B. 199.

<sup>55</sup>See Reg. § 1.704-2(d) ("subject to" liability), -2(b)(2) (liability that "encumbers" property); see also Cuff, *supra* note 9, at 351.

<sup>56</sup>See Cuff, *supra* note 9, at 353 (noting that the language of the Preamble "may be carefully avoiding the use of the term 'encumber'").

<sup>57</sup>See Brannan, *supra* note 3, at 125; Yin, *supra* note 6, at 153.

<sup>58</sup>For example, a disposition of property would permit deferral of a MGC to the extent that the entity is not released from the underlying liability. See Collins, *supra* note 5, at 137 (suggesting that this technical problem might call into question the presence of minimum gain); see also *infra* notes 124-28 and accompanying text.

<sup>59</sup>If an LLC has "other debt secured by particular assets, exculpatory liabilities should be treated as subordinate to such other" debt for purposes of allocating basis (and hence calculating PMG) with respect to particular liabilities. See Brannan, *supra* note 3, at 125.

<sup>60</sup>See T.D. 8385, 1992-1 C.B. 199.

B. *Do Exculpatory Liabilities Generate Minimum Gain and Nonrecourse Deductions?*

The Preamble to the final section 704(b) regulations has sparked considerable controversy concerning the allocation of deductions attributable to exculpatory liabilities. One commentator has described the Preamble as “perplexing—no less perplexing than the regulations themselves.”<sup>61</sup> The reference in the Preamble to section 704(b) principles is arguably inconsistent with the notion that exculpatory liabilities generate nonrecourse deductions.<sup>62</sup> Another commentator has questioned whether it is “practically feasible” to measure PMG in connection with exculpatory liabilities.<sup>63</sup> If no nonrecourse deductions are generated, or the associated PMG is not susceptible of measurement, then exculpatory liabilities would apparently give rise to losses that could not be passed through to the LLC members;<sup>64</sup> alternatively, LLC members would lack sufficient outside basis to utilize their share of losses attributable to exculpatory liabilities.<sup>65</sup> Such interpretive problems illustrate the perils of inordinately complex and necessarily incomplete regulatory guidance. Before concluding that the drafters of the section 704(b)/752 regulations have created such an unworkable scheme, however, it is useful to scrutinize more closely the underpinnings of such claims.

Taking the Treasury to task for “mudd[ying] the waters,”<sup>66</sup> one commentator concludes that exculpatory liabilities must be allocated under the section 752 rules governing *recourse* (rather than *nonrecourse*) liabilities because “under the principles of section 704(b) . . . an exculpatory liability is treated as a recourse liability.”<sup>67</sup> This comment is baffling, since the Preamble expressly states that an exculpatory liability is a nonrecourse liability under the definition of the section 752 regulations, as cross-referenced by Regulation section 1.704-2(b)(3).<sup>68</sup> Moreover, the Preamble should clearly be accorded less weight than the regulations in interpreting the operation of sections 704(b) and 752.<sup>69</sup> Nor do section 704(b) principles apply exclusively to recourse allocations, as this interpretation might seem to suggest. The basic principles set forth in Regulation section 1.704-1(b)(1)(i) clarify that an allocation that lacks economic effect may nevertheless satisfy section 704(b) principles if it is deemed to be in accordance with the

<sup>61</sup>See Cuff, *supra* note 9, at 354.

<sup>62</sup>See *id.*

<sup>63</sup>Rice, *supra* note 9, at 160.

<sup>64</sup>If exculpatory liabilities do not generate PMG, then deductions attributable to such liabilities would not give rise to a deemed DRO under the capital account exception for nonrecourse deductions. See Reg. §§ 1.704-1(b)(2)(ii)(d), -2(g)(1).

<sup>65</sup>See Rice, *supra* note 9, at 162-63 (concluding that “only a portion [of an exculpatory] liability will be allocated among the members. Without sufficient basis, no member can take advantage of special allocations of nonrecourse deductions.”).

<sup>66</sup>*Id.* at 162.

<sup>67</sup>*Id.* at 164; see also *id.* at 163 (“Without further explanation, the application of Regulation section 1.752-2 to exculpatory liabilities remains puzzling.”)

<sup>68</sup>See T.D. 8385, 1992-1 C.B. 199.

<sup>69</sup>See Cuff, *supra* note 9, at 354 (suggesting that, notwithstanding the Preamble, a court might conclude that exculpatory liabilities are nonrecourse for purposes of section 1001).

partners' interests in the partnership under the special rules pertaining to partnership revaluations and allocation of nonrecourse deductions.<sup>70</sup> Thus, it seems counterintuitive and strained to interpret the Treasury's reference to section 704(b) principles as a backhanded attempt to deny nonrecourse treatment for exculpatory liabilities.<sup>71</sup>

Moreover, the failure of the section 704(b) regulations to provide precise rules for allocating income and loss attributable to exculpatory liabilities should not be taken as "evidence that exculpatory liabilities do not produce nonrecourse deductions."<sup>72</sup> In effect, the Preamble directs that exculpatory liabilities be allocated in a reasonable manner that takes into account "practical concerns" as well as the need to ensure proper allocation of income and losses attributable to such liabilities.<sup>73</sup> The Preamble clearly contemplates that exculpatory liabilities give rise to minimum gain, even though it does not expressly refer to such liabilities as generating nonrecourse deductions. Since the definition of nonrecourse deductions depends on the net increase in minimum gain for a particular year, however, it would seem to follow that liabilities which generate PMG must also necessarily generate nonrecourse deductions. The practical difficulty of measuring such deductions and the relative novelty of LLCs are the most likely reasons for the Treasury's failure to prescribe precise allocation rules.<sup>74</sup>

A related argument is that calculating PMG with respect to exculpatory liabilities "is an administrative nightmare because the fair market value of assets will constantly fluctuate."<sup>75</sup> According to this argument, the minimum gain realized on a hypothetical disposition of property encumbered by exculpatory liabilities must be computed by reference to the fair market value of the underlying property, rather than the amount of nonrecourse liabilities as contemplated by the section 704(b) regulations.<sup>76</sup> The underlying theory of the nonrecourse rules is that the fair market value of encumbered property is irrelevant because PMG fluctuates only with the difference between the amount of nonrecourse liabilities and the basis of property encumbered by such liabilities. This relationship is readily satisfied in the case of traditional nonrecourse liabilities because *Tufts* gain is always equal to the excess of the amount of section 1001 nonrecourse liabilities over the basis of the property secured by such liabilities. In the case of exculpatory liabilities, however, *Tufts* principles do not apply because such liabilities are classified as recourse for purposes of section 1001. Because the amount of section 1001 gain therefore fluctuates according to the fair market value of the encumbered property, PMG is arguably not susceptible of measure-

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<sup>70</sup>See Reg. §§ 1.704-1(b)(1)(i), -1(b)(4), 1.704-2.

<sup>71</sup>*Cf. Rice, supra* note 9, at 164 (conceding that recourse treatment "not only flies in the face of the Treasury's declaration that an exculpatory liability is a nonrecourse liability, but also could create a limitation" on allocating such a liability for basis purposes).

<sup>72</sup>Cuff, *supra* note 9, at 354.

<sup>73</sup>See T.D. 8385, 1992-1 C.B. 199.

<sup>74</sup>See *supra* note 20 and accompanying text.

<sup>75</sup>Rice, *supra* note 9, at 161.

<sup>76</sup>See Reynolds, *supra* note 2, at 401.

ment.<sup>77</sup> Alternatively, it might be necessary to reassess the fair market value of the encumbered property annually to determine any net increase (or decrease) in PMG.<sup>78</sup>

If the underlying premise of this argument—namely, that minimum gain for purposes of the section 704(b) regulations is coextensive with *Tufts* gain under section 1001—were true, exculpatory liabilities would indeed fall outside the nonrecourse rules. The purported difficulty arises, however, only if one mistakenly assumes that PMG is identical to *Tufts* gain.<sup>79</sup> Notwithstanding contrary suggestions,<sup>80</sup> the section 704(b) regulations do not define PMG by reference to the section 1001 standard. Rather than incorporate the section 1001 standard in the definition of PMG, Regulation section 1.704-2(d) relies on the definition of nonrecourse liabilities under the section 752 regulations to determine PMG.<sup>81</sup> The nonrecourse allocation rules literally ignore section 1001 and instead treat exculpatory liabilities as generating PMG in a manner similar to traditional nonrecourse liabilities.<sup>82</sup> If the fair market value of encumbered property is less than the amount of an exculpatory liability, the combination of section 1001 gain (or loss) and COD income will match the amount of *Tufts* gain. Once COD is taken into account, there will always be sufficient gain and income to satisfy the MGC requirement. However serious the practical problems of measuring PMG may be, the argument that PMG is unascertainable because it depends on the fair market value of encumbered property is fundamentally flawed. It fails to perceive the divergence between the section 1001 standard and the definition of nonrecourse liabilities under the section 704(b)/752 regulations.

### C. Integrating Nonrecourse Deductions, Economic Risk of Loss, and COD

The nonrecourse allocation rules do not limit nonrecourse deductions to those liabilities classified as nonrecourse for purposes of section 1001. Had the drafters intended this result, the definition of nonrecourse deductions and PMG could

<sup>77</sup>See *id.* at 401 (“Not surprisingly, such a computation leads to untenable results.”).

<sup>78</sup>See Cuff, *supra* note 9, at 352 (“Must the partnership regularly reassess the fair market value of property at the end of each year in order to assess minimum gain properly?”).

<sup>79</sup>Such an interpretation is contrary to the literal language of the regulations. See Reg. § 1.704-2(d) (PMG defined); see also Cuff, *supra* note 9, at 353 (“The definition of nonrecourse deductions should have referred to Code Sec. 1001 if the regulations had intended to incorporate Code Sec. 1001.”)

<sup>80</sup>See Reynolds, *supra* note 2, at 401 (“The regulations under Section 704 define minimum gain . . . by reference to concepts under section 1001.”); Rice, *supra* note 9, at 160 (“In determining the amount of partnership minimum gain, . . . Regulation section 1.704-2(d) refers to the computation of gain as required under Regulation section 1.1001-2 when liabilities are discharged as a result of a disposition of property.”).

<sup>81</sup>Under Regulation section 1.704-2(d), partnership minimum gain is determined by “computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability” and then aggregating the minimum gain separately determined for each property. See also Reg. § 1.704-2(b)(3) (cross-referencing section 752 definition of nonrecourse liability).

<sup>82</sup>See Cuff, *supra* note 9, at 353 (“A literal interpretation of the language of the definition of nonrecourse deductions would ignore Code Sec. 1001.”); see also *id.* at 350 (noting that the section 752 nonrecourse standard may diverge significantly from the section 1001 standard).

simply have referred to section 1001 nonrecourse liabilities rather than section 752 nonrecourse liabilities.<sup>83</sup> The reference to section 752 nonrecourse liabilities is presumably intended to indicate that PMG is generated by any liability for which no partner bears the economic risk of loss.<sup>84</sup> Thus, nonrecourse liabilities are generally those liabilities for which no partner is personally liable, regardless of whether such liabilities are classified as recourse or nonrecourse for purposes of section 1001. Since no partner is obligated to repay such liabilities, it is necessary to trigger minimum gain on disposition of the encumbered property to ensure that no partner will wind up with an impermissible capital account deficit.

One difficulty with this interpretation is the language of Regulation section 1.704-2(b)(2) indicating that a disposition of property encumbered by nonrecourse liabilities in excess of basis will trigger “gain that at least equals such excess (partnership minimum gain).”<sup>85</sup> Because of the historical link between PMG and *Tufts* gain, it may be tempting to interpret the reference to “gain” as meaning section 1001 gain. Since only section 1001 nonrecourse liabilities are certain to generate sufficient section 1001 gain, however, such an interpretation would constrict the class of nonrecourse deductions to section 1001 nonrecourse liabilities.<sup>86</sup> Another possibility is that the reference to “gain” is simply evidence of sloppiness or oversight by the drafters who may have ignored the fair market value limitation on gain recognized on a disposition of property encumbered by section 1001 recourse liabilities.<sup>87</sup> If the fair market value of the encumbered property is insufficient, the excess of section 1001 recourse liabilities over fair market value will generate potential COD income.

While the drafting may be inartful, it seems more logical to interpret “gain” in Regulation section 1.704-2(b)(2) as shorthand for PMG, consistent with the clarifying parenthetical reference to PMG. This interpretation avoids the structural inconsistencies that would arise from limiting nonrecourse deductions to section 1001 nonrecourse liabilities. Since PMG is defined as the excess of section 752 nonrecourse liabilities over the tax basis (or book value, if different) of encumbered property, the amount of PMG will always be sufficient to charge back prior nonrecourse deductions.<sup>88</sup> Thus, the minimum gain reservoir would consist of a combination of section 1001 gain and potential COD income.<sup>89</sup>

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<sup>83</sup>See *supra* note 79 and accompanying text.

<sup>84</sup>See Cuff, *supra* note 9, at 351 n.221.

<sup>85</sup>See Reg. § 1.704-2(b)(2).

<sup>86</sup>See Cuff, *supra* note 9, at 352-53.

<sup>87</sup>See *id.* at 352 (“The regulation seems oblivious to the fair market value limitation on amount realized when the liability constitutes a recourse liability under Code Sec. 1001.”).

<sup>88</sup>See Reg. § 1.704-2(d).

<sup>89</sup>*Cf.* Cuff, *supra* note 9, at 352 (“The underlying theoretical construct of nonrecourse deductions relates to a build up in the reservoir of minimum gain that will be recognized under Code Sec. 1001 on a foreclosure of the property. . . .”). Literally, it is not true even of nonrecourse liabilities that there will always be sufficient section 1001 gain to charge back prior nonrecourse deductions, since a debt reduction (without a sale or exchange) results in COD income rather than gain. See Rev. Rul. 1991-31, 1991-1 C.B. 19. The net decrease in PMG may trigger a chargeback of COD income to the

Ignoring the character of the gain makes sense if PMG is essentially viewed as a measuring rod for determining the amount of nonrecourse deductions that must be restored. If the character (as well as the amount) of the chargeback is considered relevant, it would be possible to link PMG and COD directly by requiring that COD income be charged back to the partner who had previously received the corresponding nonrecourse deductions.<sup>90</sup>

To illustrate the PMG concept in the case of exculpatory liabilities, assume that an LLC incurs a general unsecured liability of \$150 to purchase a depreciable asset worth \$150, the LLC's sole asset. When the asset has an adjusted basis of \$25 and a fair market value of \$100, the LLC surrenders the asset to the lender who agrees not to pursue the deficiency of \$50. At the time of disposition, the LLC has \$125 of PMG (\$150 section 752 nonrecourse liability less \$25 basis).<sup>91</sup> The LLC recognizes \$75 of gain under section 1001 (\$100 amount realized less \$25 basis) and \$50 of COD income (\$150 liability less \$100 fair market value). The COD is not treated as an amount realized for purposes of section 1001 because the liability is recourse at the entity level.<sup>92</sup> The total section 1001 gain and COD income equals the total gain (\$125) that would be recognized if the liability were nonrecourse for purposes of section 1001.

Because there is a net decrease in PMG of \$125, each LLC member must be allocated items of income and gain equal to such member's share of the net decrease in PMG.<sup>93</sup> Under Regulation section 1.704-2(f)(6), an MGC consists first of gain from disposition of assets subject to one or more nonrecourse liabilities and then, if necessary, of a ratable share of other income and gain for the year.<sup>94</sup> If the LLC's only items for the year are section 1001 gain and COD income on the disposition, each member must therefore be allocated a ratable share of these items to match that member's share of the net decrease in PMG. Under this view, it is not necessary to amend the section 704(b) regulations to integrate the concept of COD, since COD income would be treated no differently from other income for purposes of satisfying the MGC to the extent that section 1001 gain on disposition is insufficient.<sup>95</sup> To eliminate potential confu-

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partners in proportion to their shares of prior nonrecourse deductions. See Reg. § 1.704-2(f)(1), -2(f)(6); see also Buchholz, *supra* note 47, at 249 (noting that "allocation of any COD in excess of the minimum gain chargeback is not governed by any particular provision and is, therefore, subject to the same substantiality" requirements as in the case of recourse debt).

<sup>90</sup>See *infra* notes 93-95 and accompanying text.

<sup>91</sup>See Reg. § 1.704-2(d) (excess of section 752 nonrecourse liability over basis of encumbered property).

<sup>92</sup>See Reg. § 1.1001-2(a)(2).

<sup>93</sup>See Reg. § 1.704-2(f)(1), -2(g)(2).

<sup>94</sup>See Reg. § 1.704-2(f)(6).

<sup>95</sup>*Cf.* Rice, *supra* note 9, at 168-71 (arguing that COD concept should be integrated into the section 704(b) regulations in a manner similar to *Tufts* gain). While the section 1001 rationale for distinguishing between COD and *Tufts* gain is murky, the section 704(b) regulations apparently treat an allocation of COD income as potentially possessing economic effect. See *supra* note 47. Without an adequate theory to explain why section 1001 results in *Tufts* gain in some situations and COD in other situations, it seems appropriate to treat COD in the same manner as other income for purposes of the section 704(b) regulations.



sion, it might be helpful if the regulations clarified that PMG may consist of a combination of section 1001 gain and potential COD income. Such clarification would help to eliminate any lingering doubts concerning the relationship between the section 704(b) minimum gain concept and *Tufts* gain under section 1001.

#### IV. OTHER UNRESOLVED ISSUES: PREVENTING EXCULPATORY LIABILITIES FROM UNDERMINING THE NONRECOURSE ALLOCATION RULES

Even if exculpatory liabilities generate minimum gain and nonrecourse deductions, policing allocations attributable to exculpatory liabilities may nevertheless pose significant practical problems. One concern is that such allocations may fail to pass muster under the consistency requirement of the nonrecourse safe harbor.<sup>96</sup> Another concern relates to permissible methods of allocating exculpatory liabilities among multiple assets, which may affect both the timing of nonrecourse deductions and the identity of the partner to whom such deductions are allocated.<sup>97</sup> Finally, the MGC requirement may be frustrated if a chargeback may be postponed indefinitely upon disposition of specific assets which generated nonrecourse deductions.<sup>98</sup>

##### A. Consistency Requirement

Even if exculpatory liabilities are indeed governed by the nonrecourse rules, they may nevertheless fall outside the safe harbor provisions of section 704(b). Of the four prongs of the nonrecourse safe harbor under the section 704(b) regulations, the most problematic with respect to exculpatory liabilities is the second prong, often referred to as the consistency requirement.<sup>99</sup> The consistency requirement is intended to restrain the ability to allocate nonrecourse items too freely. This requirement mandates that nonrecourse deductions be allocated “in a manner that is reasonable consistent” with other allocations of recourse deductions which have substantial economic effect and are “attributable to the property securing” the nonrecourse liability.<sup>100</sup> Thus, the consistency requirement can be satisfied only if exculpatory liabilities are treated as secured by property that could be reached by the recourse lender.<sup>101</sup>

Under a floating lien approach, the consistency requirement would be essentially meaningless with respect to an LLC’s exculpatory liabilities. To satisfy the second prong of the safe harbor requirement, nonrecourse deductions attribut-

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<sup>96</sup>See Reg. § 1.704-2(e).

<sup>97</sup>See Collins, *supra* note 5, at 137-39; Reynolds, *supra* note 2, at 402-03.

<sup>98</sup>See Yin, *supra* note 6, at 154 n.126; Reynolds, *supra* note 2, at 402.

<sup>99</sup>See Reg. § 1.704-2(e)(2).

<sup>100</sup>*Id.*

<sup>101</sup>*Cf.* Cuff, *supra* note 9, at 354 (consistency requirement “should not have been limited to secured liabilities if exculpatory liabilities produced nonrecourse deductions”).

able to exculpatory liabilities would need merely to be reasonably consistent with an allocation of any significant item having substantial economic effect. Since an exculpatory liability may burden all of an LLC's assets, the consistency requirement would no longer be tied to particular assets. Such an interpretation of the consistency requirement would sanction "virtually any allocation arrangement desired by the parties."<sup>102</sup> The practical elimination of any constraints under the safe harbor's second prong would mean that exculpatory liabilities would receive even more favorable treatment than traditional nonrecourse liabilities.

The potential of the floating lien approach to undermine the consistency requirement should not be lightly dismissed. The consistency requirement was added largely to address dissatisfaction with an earlier version of the section 704(b) regulations that relied exclusively on the MGC to vindicate traditional nonrecourse deductions.<sup>103</sup> The consistency requirement itself is quite lenient, however, and imposes few limitations on nonrecourse allocations generally.<sup>104</sup> If the safe harbor provisions are unavailable, allocations attributable to exculpatory liabilities would need to pass muster under the partners' overall sharing arrangement.<sup>105</sup> Denying safe harbor treatment may appear overly harsh, since exculpatory liabilities are functionally equivalent to nonrecourse liabilities. Perhaps a better approach would be to impose more meaningful constraints on all nonrecourse deductions.<sup>106</sup>

#### B. *Floating Lien Versus Specific Allocation Method*

The nonrecourse safe harbor rules generally assume that nonrecourse financing will be secured by specific property. If property is subject to multiple liabilities, Regulation section 1.704-2(d)(2) allocates the basis of the property among the liabilities for purposes of computing minimum gain with respect to a particular nonrecourse liability.<sup>107</sup> Basis is allocated first to the liability of the highest priority to the extent of its outstanding balance and then to each remaining liability in descending order of priority to the extent of its outstanding balance.<sup>108</sup> These allocation rules are intended to assign basis according to the creditors' relative priorities, reflecting the manner in which sale proceeds would be used to pay off creditors if each property were sold for an amount equal to its adjusted basis.<sup>109</sup> By assigning basis last to the most "junior" nonrecourse debt, the allo-

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<sup>102</sup>See Yin, *supra* note 6, at 153.

<sup>103</sup>See *id.* at 150-51; Brannan, *supra* note 3, at 123 n.10.

<sup>104</sup>Brannan, *supra* note 3, at 123 ("The current system imposes no meaningful limitation on the ability of partnerships to make tax-motivated allocations of tax items attributable to third-party nonrecourse debt."); Yin, *supra* note 6, at 150-52.

<sup>105</sup>See Reg. §§ 1.704-1(b)(3), -2(b)(1).

<sup>106</sup>See Yin, *supra* note 6, at 154-55 (proposing that regulations replace the consistency requirement with a "few selective safe harbors" defining the partners' overall economic interest).

<sup>107</sup>See Reg. § 1.704-2(d)(2)(i).

<sup>108</sup>See Reg. § 1.704-2(d)(2)(ii).

<sup>109</sup>See Collins, *supra* note 5, at 137.

cation rules accelerate PMG and nonrecourse deductions attributable to such debt.<sup>110</sup> Under the floating lien approach, no nonrecourse deductions attributable to exculpatory liabilities would arguably be generated until the amount of such liabilities exceeds the allocable basis of all of the LLC's property, including cash.<sup>111</sup>

If an LLC has multiple liabilities, determination of nonrecourse deductions depends on the manner in which such liabilities are allocated among the LLC's assets. For example, assume that an LLC's assets consist solely of \$5 cash and an asset with a basis of \$50 and a fair market value of \$200. The asset (but not the cash) secures a third-party nonrecourse liability of \$40 and a nonrecourse loan of \$20 from an LLC member. In addition, the LLC has a general unsecured liability of \$30 which is subordinate to the other two liabilities. Under the stacking rules of Regulation section 1.704-2(d), basis should be allocated first to the two nonexculpatory liabilities based on their relative priorities. If the third-party nonrecourse loan is superior to the member loan, the basis allocable to the former is \$40 and the basis allocable to the latter is \$10 (\$50 less \$40 basis allocated to third-party nonrecourse loan). The basis allocable to the exculpatory liability is limited to \$5 (the amount of the LLC's cash), since the \$50 basis of the asset is allocated entirely to the other two liabilities of higher priority. Thus, the LLC has no PMG attributable to the third-party nonrecourse liability (\$40 liability-less \$40 basis) and PMG of \$25 attributable to the exculpatory liability (\$30 liability less \$5 allocable basis).<sup>112</sup>

In determining nonrecourse deductions, it is not clear whether a floating lien approach is the only permissible allocation method or whether an LLC may specifically allocate exculpatory liabilities to particular assets.<sup>113</sup> In at least one situation, the section 752 regulations permit allocation of nonrecourse liabilities based on the respective fair market value of the encumbered properties.<sup>114</sup> Specifically, Regulation section 1.752-3(b)(1) permits a single nonrecourse liability secured by multiple section 704(c) assets to be allocated among such assets in a reasonable manner.<sup>115</sup> Each portion of the nonrecourse liability so allocated is

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<sup>110</sup>See Reg. § 1.704-2(m), Ex. 1(v) and (vii).

<sup>111</sup>For example, the allocable basis may exceed the amount of exculpatory liabilities because of significant retained cash flow; in this situation, "minimum gain will not increase, thus preventing the nonrecourse allocation rules from applying." Strong & Hamill, *supra* note 5, at 662.

<sup>112</sup>There is also \$10 of minimum gain (\$20 partner nonrecourse debt less \$10 allocable basis) attributable to the member loan; the corresponding deductions must be allocated solely to the lender who bears the economic risk of loss. See *infra* notes 129-37 and accompanying text.

<sup>113</sup>Consistent with the Preamble, the issue is whether the specific allocation method should be deemed to be a reasonable method of allocating items attributable to exculpatory liabilities. See T.D. 8385, 1992-1 C.B. 199; cf. Rice, *supra* note 9, 166 (arguing that "current law discriminates against special allocations of exculpatory liabilities used to purchase new properties"); see also *id.* at 163-64 (discussing the same argument).

<sup>114</sup>See Reg. § 1.752-3(b); see also Rev. Rul. 1995-41, 1995-1 C.B. 132 (coordinating sections 704(c) and 752); Heller & Boyd, *supra* note 5, at 259 (discussing other reasonable methods of allocating nonrecourse liabilities for purposes of section 752).

<sup>115</sup>See Reg. § 1.752-3(b)(1).

treated as a separate liability for purposes of determining the second-tier allocation of nonrecourse liabilities secured by section 704(c) property.<sup>116</sup> An allocation based on the relative fair market value of each asset is considered reasonable if it does not exceed the fair market value of the asset (net of other liabilities allocated to such asset) when the liability is incurred.<sup>117</sup> While any portion of the nonrecourse liability remains outstanding, a partnership generally may not change the method of allocation. If one or more of the secured assets ceases to be subject to the nonrecourse liability, the previously allocated portion of the liability is reallocated to other property.<sup>118</sup>

For example, assume that *A* and *B* are equal members of an LLC, which owns a single asset (*x*) with a book value and tax basis of \$10. In exchange for a 50% interest, *C* contributes an asset (*y*), which has a tax basis of \$30 and a fair market value of \$100. Upon admission of *C*, the LLC agrees to book up asset *x* to \$100, its fair market value.<sup>119</sup> Immediately after *C*'s admission, the LLC incurs a \$50 liability which is a general unsecured liability. Pursuant to Regulation section 1.752-3(b), the LLC may allocate the \$50 exculpatory liability evenly between assets *x* and *y*, since they are both of equal value.<sup>120</sup> Accordingly, under the second-tier allocation of liabilities, the LLC has \$15 of section 704(c) minimum gain with respect to asset *x* (\$25 allocable portion of liability less \$10 tax basis) and none with respect to asset *y* (\$30 tax basis less \$25 allocable portion of liability).<sup>121</sup>

By analogy to the principles of Regulation section 1.752-3(b), it may be argued that LLCs should be free to allocate exculpatory liabilities among multiple assets based on relative fair market value to determine PMG. For purposes of tracking nonrecourse deductions, this approach would enhance the resemblance between exculpatory liabilities and traditional nonrecourse liabilities, since the allocable portion of the liability would be treated as a separate liability.<sup>122</sup> Thus, PMG would no longer depend on the aggregate basis of the LLC's assets allocable to exculpatory liabilities but rather on the difference between the allocable portion of the liability and the basis of particular assets deemed to secure

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<sup>116</sup>Under the second-tier allocation, a partner's share of nonrecourse liabilities equals the amount of section 704(c) gain allocable to such partner if the partnership disposed of the encumbered property for no consideration other than relief of nonrecourse liabilities. See Reg. § 1.752-3(a)(2).

<sup>117</sup>See Reg. § 1.752-3(b)(1).

<sup>118</sup>See *id.* Any reduction in the outstanding principal amount must be allocated among the multiple assets in the same proportion as the liability was originally allocated. See Reg. § 1.752-3(b)(2).

<sup>119</sup>See Reg. § 1.704-1(b)(2)(iv)(f), -1(b)(2)(iv)(g).

<sup>120</sup>See Reg. § 1.752-3(b)(1).

<sup>121</sup>See Reg. § 1.752-3(a)(2). The partnership has no PMG because the book value of *x* and *y* exceeds the amount of exculpatory liabilities allocated to each property. See Reg. § 1.704-2(b)(2), -2(d)(3). If partnership property is revalued, the partners' capital accounts are subsequently adjusted for their share of book items; section 704(c) principles must be applied in determining the partners' share of tax items. See Reg. §§ 1.704-1(b)(2)(iv)(f)(1)-(4), 1.704-3(a)(6).

<sup>122</sup>See Rice, *supra* note 9, at 163 (noting that calculation of PMG would then be feasible because "each portion of the liability would become the same as a traditional nonrecourse liability").

the liability. Because the specific allocation approach would not affect the recourse creditor's right to proceed against all of the LLC's assets, however, a disposition of the assigned security would not necessarily trigger a MGC.<sup>123</sup> Thus, important differences would persist under the MGC rules between exculpatory and traditional nonrecourse liabilities.

### C. Deferral of Gain Chargeback

In the case of traditional nonrecourse liabilities, there is generally a one-to-one correspondence between nonrecourse deductions and the MGC triggered upon disposition of the encumbered asset. Since the amount realized on disposition includes the underlying nonrecourse liability, a gain chargeback generally cannot be deferred beyond the time of disposition.<sup>124</sup> An MGC is appropriate because the creditor's claim is extinguished as a result of the transfer. Upon a disposition of property subject to a recourse liability, however, the liability is included in amount realized only if the transferee agrees to pay the liability.<sup>125</sup> Thus, the timing of a gain chargeback upon disposition of assets encumbered by exculpatory liabilities may be significantly deferred.<sup>126</sup>

Although surrender of a single asset may eliminate minimum gain attributable to the particular asset, no MGC would be triggered under the floating lien approach unless there is a net decrease in overall minimum gain. The section 704(b) regulations clearly contemplate this result when a single traditional nonrecourse liability encumbers multiple assets, only one of which is disposed of.<sup>127</sup> Similarly, under the special section 752 rule for liabilities secured by multiple section 704(c) assets, a disposition of one of the encumbered assets triggers a reallocation of the liability to other retained assets.<sup>128</sup> Thus, the specific allocation approach would also permit significant deferral of a gain chargeback upon disposition of an asset that generated nonrecourse deductions, as long as the LLC has other assets to which the liability may be reallocated. Of course, it may be argued that such deferral merely mimics the economic rights of the creditor, who may still reach the proceeds from other encumbered assets to satisfy the section 1001 recourse liability. Under this view, a gain chargeback may be deferred theoretically until an LLC disposes of all of its assets and the section 1001 recourse liability is discharged. By undermining the operation of the gain chargeback rules, exculpatory liabilities may threaten to create a significant breach in the nonrecourse allocation rules.

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<sup>123</sup>See *infra* notes 125-26 and accompanying text.

<sup>124</sup>See Reg. § 1.1001-2(a)(1), -2(a)(4)(i).

<sup>125</sup>See Reg. § 1.1001-2(a)(4)(ii).

<sup>126</sup>See Reynolds, *supra* note 2, at 402; Yin, *supra* note 6, at 154 n.126.

<sup>127</sup>See Reg. § 1.704-2(m), Ex. 2 (netting increases and decreases in PMG upon a disposition of one of three assets encumbered by a single nonrecourse liability).

<sup>128</sup>See Reg. § 1.752-3(b)(1).

## V. EXCULPATORY LIABILITIES AND PARTNER NONRECOURSE DEBT

### A. Section 1001 Nonrecourse Liabilities and Section 752 Recourse Liabilities

In addition to the rules for recourse and nonrecourse liabilities, the section 704(b) regulations establish a third set of rules—the partner nonrecourse debt (PNRD) rules—governing allocations attributable to section 1001 nonrecourse liabilities to the extent a partner bears the economic risk of loss, *e.g.*, as a guarantor or creditor.<sup>129</sup> PNRD is treated as recourse for purposes of section 752 but quasi-nonrecourse for purposes of section 704(b).<sup>130</sup> Rather than subjecting PNRD to the SEE test, the section 704(b) regulations create a parallel system of so-called partner nonrecourse deductions (*i.e.*, deductions attributable to PNRD) similar to the rules governing nonrecourse deductions.<sup>131</sup> The PNRD rules determine the amount of partner nonrecourse deductions, allocate such deductions to the partner who bears the economic risk of loss, and require a gain chargeback on disposition.<sup>132</sup>

Regulation section 1.704-2(b)(4) defines the term PNRD (or “partner nonrecourse liability”) as any liability to the extent that the liability is nonrecourse for purposes of section 1001 and a partner (or related party) bears the economic risk of loss attributable to such liability.<sup>133</sup> The reference to partnership liabilities that are nonrecourse within the meaning of section 1001 is subject to different interpretations. Under one view, the reference to section 1001 in this portion of the regulations may be attributable merely to poor drafting, and no special significance should be accorded to the drafters’ failure to reference section 1001 in other portions of the section 704(b)/752 regulations dealing with nonrecourse liabilities.<sup>134</sup> The alternative view is that the use of the section 1001 standard in the PNRD rules evinces the drafters’ awareness of the divergence between the

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<sup>129</sup>See Reg. § 1.704-2(b)(4), -2(i).

<sup>130</sup>Under the section 752 regulations, a partner can bear the economic risk of loss for section 1001 recourse liabilities as well as section 1001 nonrecourse liabilities for which the partner is the guarantor or lender. Reg. §§ 1.752-1(a)(1), -2(b)(1); Reg. § 1.752-2(c)(1) (lender), -2(f), Ex. 5 (guarantor). By contrast, under the section 704(b) regulations, liabilities treated as recourse for purposes of section 752 are governed by two different regimes: the SEE rules (section 1001 recourse liabilities) and the PNRD rules (section 1001 nonrecourse liabilities for which a partner bears the economic risk of loss). Reg. §§ 1.704-2(b)(4), 1.704-1(b)(4); *see also* Strong & Hamill, *supra* note 5, at 667 (“This duplicate coverage adds an enormous amount of complexity to an area that already enjoys the reputation as one of the most difficult in the income tax arena . . .”).

<sup>131</sup>See Reg. § 1.704-2(i).

<sup>132</sup>See *id.*

<sup>133</sup>See Reg. § 1.704-2(b)(4) (PNRD is any “partnership liability to the extent the liability is nonrecourse for purposes of § 1.1001-2 and a partner or related party (within the meaning of § 1.752-4(b)) bears the economic risk of loss”).

<sup>134</sup>See Cuff, *supra* note 9, at 359 (“Was this a subtle distinction thoughtfully constructed by the drafters, or was it merely sloppy nonparallelism reflecting the work of different drafters . . .?”); *id.* (“The difference in language merely may reflect the difference in drafters and lack of precision in drafting.”).

standards under sections 704(b) and 752, on the one hand, and section 1001, on the other hand.<sup>135</sup>

Without the PNRD rules, it would be difficult or impossible to measure partner nonrecourse deductions, since the section 1001 nonrecourse classification of such liabilities means that any corresponding capital account deficit would be meaningless. Upon a constructive liquidation, *Tufts* gain would always be sufficient to eliminate any capital account deficit attributable to partner nonrecourse deductions. Hence, the drafters apparently considered the PNRD rules essential as a “measurement mechanism” for partner nonrecourse deductions.<sup>136</sup> Such deductions closely resemble recourse deductions, since the guarantor (or lender) generally bears the economic risk of loss and must be allocated the corresponding deductions. Nevertheless, the mechanism for allocating partner nonrecourse deductions follows closely the rules for partnership nonrecourse deductions.<sup>137</sup>

### B. *The Problem of Illusory DROs: Circumventing Economic Risk of Loss*

The PNRD rules deal with liabilities that are nonrecourse liabilities under section 1001 but are recourse liabilities under section 752.<sup>138</sup> In one sense, PNRD thus represents the mirror image of exculpatory liabilities which are recourse liabilities under section 1001 but are nonrecourse liabilities under section 752. For purposes of determining economic risk of loss under section 752, a guarantor’s contractual obligation to pay the creditor is treated as a payment obligation.<sup>139</sup> Depending on the parties’ business arrangement, however, the guarantor may or may not receive a capital account credit as a result of payment under the guarantee. Without such a capital account credit, the guarantor has no ability “to enforce a [DRO] agreed to by another” party.<sup>140</sup> The PNRD rules serve to ensure that such an “illusory” DRO cannot be used to support allocation of deductions to a non-guarantor partner.<sup>141</sup>

<sup>135</sup>See *id.* Compare Reg. § 1.704-2(b)(2) (definition of PMG) with Reg. § 1.704-2(b)(4) (definition of PNRD).

<sup>136</sup>Strong & Hamill, *supra* note 5, at 650-51, 669.

<sup>137</sup>Notwithstanding important technical differences, the SEE rules and the PNRD rules generally reach the same end result: liabilities and losses must be allocated to the partner who bears the economic risk of loss.

<sup>138</sup>The section 752 regulations characterize as recourse a liability that is described as PNRD under the section 704(b) regulations. See Reg. §§ 1.752-1(a)(1), -2(c)(1); see also Brannan, *supra* note 3, at 122 n.8 (arguing that the Treasury should harmonize usage by “adopting the more descriptive section 704(b) terminology in the section 752 context”).

<sup>139</sup>See Reg. § 1.752-2(b)(3)(i). Since the capital account maintenance rules do not require that payment of a guarantee be reflected as a capital account credit, the parties’ contractual agreement controls. See Hamill, *supra* note 2, at 121 n.94.

<sup>140</sup>Strong & Hamill, *supra* note 5, at 652.

<sup>141</sup>See *id.* at 650 (noting that PNRD rules “prevent partners from receiving loss allocations . . . supported by illusory rather than real deficit restoration obligations”); see also *id.* at 671 (noting that the safe harbor under the economic effect test “arguably treats all obligations to restore as valid to support a deficit capital account, even if the obligation is illusory due to the presence of minimum gain”).

For example, assume that a partnership incurs a section 1001 nonrecourse liability of \$50, which it uses to purchase depreciable property worth \$50. The liability is guaranteed by partner A, converting the indebtedness to a section 752 recourse liability because A now bears the economic risk of loss; the corresponding deductions are allocated to partner B, however, who agrees to repay a deficit of \$50. When the property has an adjusted basis and fair market value of zero, the lender forecloses on the property and A pays the creditor \$50 under the guarantee. A is not entitled to a capital account credit upon payment to the creditor. B's DRO should not suffice to shift the \$50 of deductions away from A because the obligation is illusory with respect to the guaranteed nonrecourse liability.<sup>142</sup> The result would be the same if A instead made a nonrecourse loan of \$50 to the partnership and was not entitled to any capital account credit: since A would bear the economic risk of loss for the liability, B's DRO would be meaningless.<sup>143</sup>

To detect illusory DROs, the section 704(b) regulations generally treat PNRD as a limited liability for purposes of the constructive liquidation.<sup>144</sup> Because the partnership is deemed to realize an amount equal to the PNRD, the constructive liquidation triggers gain to the extent that the liability exceeds the basis of the encumbered property, thereby eliminating any illusory DRO. Thus, the regulations respect only those payment and contribution obligations that arise independently of a capital account deficit attributable to PNRD.<sup>145</sup> If such an independent obligation exists (e.g., because the guarantor receives a capital account credit upon payment of the guarantee), then the PNRD is treated as an unlimited liability for purposes of the constructive liquidation.<sup>146</sup> Because the creditor's remedy is no longer limited solely to the partnership's assets, the corresponding deficit is not eliminated upon a constructive liquidation and the non-guarantor partner's DRO is not illusory. Accordingly, the economic risk of loss is shifted to the non-guarantor partner to whom the corresponding basis and deductions may be validly allocated.<sup>147</sup>

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<sup>142</sup>See Reg. § 1.704-2(i)(1) (requiring that partner nonrecourse deductions be allocated to the partner who bears the economic risk of loss).

<sup>143</sup>It might be argued that guaranteed nonrecourse liabilities should be distinguished from partner nonrecourse loans based on the section 1001 treatment; to the extent that the guarantee is available to satisfy the liability, the partnership will presumably not recognize gain under section 1001. Thus, guaranteed nonrecourse liabilities (as opposed to partner nonrecourse loans) might more appropriately have been handled under the section 704(b) recourse rules. Cf. T.D. 8385, 1992-1 C.B. 199 (stating that such a distinction "may not always be appropriate" and concluding that "in many instances . . . guaranteed nonrecourse debt is more appropriately treated under the partner nonrecourse debt rules"); see also Cuff, *supra* note 9, at 359 (questioning whether a partnership liability can be nonrecourse under section 1001 if a partner (or related party) bears the economic risk of loss).

<sup>144</sup>See Strong & Hamill, *supra* note 5, at 652.

<sup>145</sup>See Hamill, *supra* note 2, at 120-21; see also Strong & Hamill, *supra* note 5, at 664 n.237.

<sup>146</sup>See Hamill, *supra* note 2, at 120-21; see also Strong & Hamill, *supra* note 5, at 652-53.

<sup>147</sup>See Reg. § 1.704-2(i)(1) (bifurcating PNRD into two or more separate liabilities if more than one partner bears the economic risk of loss).



In the example above, assume that A is entitled to a capital account credit upon payment of the \$50 guarantee, so that the guaranteed nonrecourse liability is treated as an unlimited liability. Upon a constructive liquidation, the partnership would realize a loss of \$50 (zero amount realized less \$50 basis), giving rise to a deficit of \$50 in B's capital account. The deficit is not illusory since B would be obligated to contribute \$50 to satisfy A's capital account credit. Thus, B may be validly allocated the deductions and basis attributable to the PNRD. Presumably, the regulations could have achieved a similar result by testing allocations attributable to the guaranteed nonrecourse liability under the SEE rules, since B bears the economic risk of loss for the liability. Given the different ways in which guarantees may be structured, however, the Treasury evidently considered that the PNRD rules were more appropriate.<sup>148</sup>

### C. Partner Nonrecourse Deductions and Exculpatory Liabilities

What is striking is that the PNRD rules are inapplicable to guaranteed exculpatory liabilities (or recourse loans from an LLC member).<sup>149</sup> In the case of a section 1001 nonrecourse liability for which an LLC member bears the economic risk of loss as the guarantor or lender, the PNRD rules operate as intended because the entity has no personal liability. If the LLC's liability is an exculpatory liability, the liability is recourse to the entity but nonrecourse to all of the members. Therefore, if a member guarantees such an exculpatory liability, the economic risk of loss is shifted from the creditor to the guarantor. Since the liability is treated as recourse for purposes of section 1001, however, the PNRD rules are inapplicable by definition.<sup>150</sup> If the PNRD rules do not apply to such a liability, it is not clear whether any other portion of the section 704(b) regulations provides guidance.<sup>151</sup>

As a result of this "technical glitch,"<sup>152</sup> exculpatory liabilities for which an LLC member bears the economic risk of loss (as a guarantor or lender) apparently do not generate partner nonrecourse deductions. Accordingly, a capital account deficit arising from an allocation of losses attributable to such liabilities will not automatically give rise to a deemed DRO.<sup>153</sup> If the PNRD rules are inapplicable, the only alternative apparently would be to treat allocations attributable to such liabilities as subject to the SEE rules, including the tests for transitory and shifting allocations.<sup>154</sup> The section 704(b) regulations fail to pro-

<sup>148</sup>See T.D. 8385, 1992-1 C.B. 199.

<sup>149</sup>See, e.g., Reynolds, *supra* note 2, at 402; Collins, *supra* note 5, at 136.

<sup>150</sup>See Reg. § 1.704-2(b)(4); see also Strong & Hamill, *supra* note 5, at 645 (stating that "[o]nly liabilities where state law treats the partnership as the borrower as having no personal liability can meet the definition of partner nonrecourse debt").

<sup>151</sup>See Collins, *supra* note 5, at 136 (noting that "[n]o other part of the section 704(b) Regulations provides relevant guidance").

<sup>152</sup>See *id.*

<sup>153</sup>See Reg. §§ 1.704-1(b)(2)(ii)(d), -2(i)(5). But a guaranteed recourse liability of an LLC may furnish a limited DRO based on the guarantor's unconditional obligation to pay the liability. See Reg. § 1.704-1(b)(2)(ii)(c).

<sup>154</sup>See Strong & Hamill, *supra* note 5, at 662.

vide any rationale for limiting PNRD deductions to section 1001 nonrecourse liabilities, thereby excluding exculpatory liabilities for which an LLC member bears the economic risk of loss as a guarantor or lender.<sup>155</sup> The resulting patchwork of regulations is thus both extraordinarily complex and ultimately unsatisfactory: guaranteed nonrecourse liabilities of an LLC are governed by the PNRD rules, while guaranteed recourse liabilities of an LLC are apparently governed by the recourse allocation rules.<sup>156</sup> Given the substantive similarity between these types of liabilities, such a distinction seems difficult to defend or rationalize.

One practical solution would be to treat section 1001 recourse liabilities of an LLC initially as section 1001 nonrecourse liabilities for the limited purpose of applying sections 704(b) and 752.<sup>157</sup> Such treatment would effectively expand the concept of PNRD to include exculpatory liabilities guaranteed by an LLC member (or recourse loans from an LLC member). Rather than relying on the status of the liability to the entity as borrower, the definition of PNRD would look through the entity to the members' lack of personal liability in their capacity as members.<sup>158</sup> To the extent that the economic risk of loss is borne by a member (or related party) in the capacity of a guarantor or lender, the PNRD rules would thus apply to all liabilities that would otherwise be treated as nonrecourse under section 752, regardless of the section 1001 classification of such debt. This modification of the PNRD category to include guaranteed exculpatory liabilities (or recourse loans from an LLC member) would remedy the technical glitch under the current regulations, thereby preventing potential misallocation of income and losses attributable to such liabilities.

One potential drawback is that this approach would expand the PNRD rules significantly, thereby further increasing the complexity of the section 704(b) regulations. Such an expansion seems unavoidable, however, if one accepts the premise that the PNRD rules are essential to measure partner nonrecourse deductions and safeguard against illusory DROs.<sup>159</sup> As a practical business matter,

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<sup>155</sup>In the case of exculpatory liabilities, the drafters may have considered application of the PNRD rules superfluous because all of the entity's assets could be reached by the lender. *See id.* (explaining that "the mechanics of the partner nonrecourse debt rules are not needed to properly measure the amount of real loss potential that exists for allocation purposes"). But this statement seems to overlook the role of the PNRD rules in safeguarding against illusory DROs. *See infra* note 159 and accompanying text.

<sup>156</sup>*See* Strong & Hamill, *supra* note 5, at 663.

<sup>157</sup>*See* Reynolds, *supra* note 2, at 402, 399 n.14 (arguing that sections 752 and 1001 need not be interpreted consistently); *see also* Yin, *supra* note 6, at 157.

<sup>158</sup>*See* Strong & Hamill, *supra* note 5, at 665.

<sup>159</sup>*See id.* ("If these illusory deficit restoration obligations can support distributive shares of losses under the economic effect safe harbor, LLCs and LLPs incurring recourse debt expose a major hole in the partner nonrecourse debt rules."); *id.* at 664 n.237 (illustrating illusory DRO when payment of a liability is limited to an LLC's assets). If guaranteed recourse liabilities of an LLC were subject to the PNRD debt rules, the gain chargeback requirement would eliminate the problem of a "disappearing" limited DRO. *See* Michael A. Oberst, *The Disappearing Limited Deficit Restoration Obligation*, 56 TAX LAW. 485, 501-09 (2003).

LLC members may often be required to guarantee exculpatory liabilities or may provide recourse loans. To eliminate anomalies under the PNRD rules, the Treasury should harmonize the treatment of section 1001 nonrecourse liabilities and exculpatory liabilities to the extent that a member bears the economic risk of loss as a guarantor or lender.

## VI. CONCLUSION

It has been suggested elsewhere that little (if anything) can be confidently asserted concerning the nature of nonrecourse liabilities and nonrecourse deductions for purposes of sections 704(b) and 752.<sup>160</sup> This article has suggested that such pessimism may be overstated, but caution is clearly necessary. Although the section 704(b)/752 regulations build upon section 1001 principles and particularly the concept of *Tufts* gain, they depart significantly from the section 1001 standard. The regulations attempt to define nonrecourse liabilities and nonrecourse deductions based on the concept of economic risk of loss. While this concept is itself tenuously linked to economic reality,<sup>161</sup> it serves to insulate the nonrecourse allocation rules from the relatively amorphous and arbitrary distinctions inherent in the section 1001 standard. Thus, the status of a liability as recourse or nonrecourse for purposes of the section 704(b)/752 regulations does not depend on the section 1001 character of the debt to the entity as borrower, but rather on the economic consequences to the entity's members.

Within the artificial construct of the section 704(b)/752 regulations, exculpatory liabilities should generally be treated as nonrecourse liabilities which generate nonrecourse deductions in a manner similar to traditional nonrecourse liabilities. The section 1001 classification of such liabilities should be irrelevant because, under the economic risk of loss analysis, exculpatory liabilities are nonrecourse with respect to the entity's members. Indeed, a prior version of the regulations explicitly stated that liabilities of an LLC would generally be treated as liabilities for which a creditor's right to repayment is limited to one or more assets of the entity, *i.e.*, limited liabilities.<sup>162</sup> Under the current regulations, exculpatory liabilities should also be treated as limited liabilities based on the consequences of a constructive liquidation.<sup>163</sup> The concept of limited liabilities

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<sup>160</sup>See Cuff, *supra* note 9, at 362 ("This article has failed to identify clearly nonrecourse debt [and] nonrecourse deductions. . . . This article has not been a particularly great success in many respects. We probably thought we knew more at the beginning of this article than we think we know at the end."). Despite this modest conclusion, the quoted article is enormously helpful in framing the questions posed by exculpatory liabilities and suggesting possible answers.

<sup>161</sup>See generally Stephen G. Utz, *Partnership Taxation in Transition: Of Form, Substance, and Economic Risk*, 43 *TAX LAW.* 693, 714 (1990) (describing the regulatory emphasis on economic risk as "quite disingenuous").

<sup>162</sup>See *supra* note 38 and accompanying text.

<sup>163</sup>While limited liabilities most obviously include traditional nonrecourse liabilities and exculpatory liabilities (section 752 nonrecourse liabilities), they may also include guaranteed section 1001 nonrecourse liabilities for which no partner is entitled to a capital account credit (section 752 recourse liabilities). Thus, limited liabilities do not fit precisely within the definition of "nonrecourse liabilities" for purposes of either section 752 or section 1001.

adds yet another layer of potential confusion, however, since the term has no precise meaning outside the partnership allocation regulations.<sup>164</sup>

While the section 704(b)/752 regulations move toward implementing a construct of nonrecourse liabilities and nonrecourse deductions that is independent of the section 1001 standard, the drafters did not fully articulate this goal. Thus, the existing regulations have given rise to a surprising degree of uncertainty concerning application of the core principles of the nonrecourse allocation rules to exculpatory liabilities. Given the historical role of *Tufts* principles in the evolution of the section 704(b) regulations, it may seem anomalous to treat exculpatory liabilities in excess of the fair market value of encumbered assets as giving rise to minimum gain. But this apparent anomaly is troubling only if the concept of minimum gain is perceived as essentially identical to *Tufts* gain and hence derivative of the section 1001 standard. If minimum gain is understood simply as a mechanism for determining the amount of gain and income to be charged back to restore prior nonrecourse deductions, however, this departure from the *Tufts* concept seems far less radical than might initially appear. Thus, it should be possible to satisfy a gain chargeback attributable to exculpatory liabilities by a combination of section 1001 gain and COD income.

Indeed, it is useful to consider whether the clarity of the nonrecourse allocation rules could be improved by more explicitly acknowledging and rationalizing the divergence between the section 704(b) and 752 nonrecourse standard and the section 1001 standard.<sup>165</sup> The accretion of section 1001 principles may owe more to adherence to judicial precedent than to any well-considered tax policy.<sup>166</sup> Rather than awaiting reform of section 1001 and its implementing regulations, it may be worthwhile to concentrate on perfecting the section 704(b)/752 regulations by exploring more thoroughly the ramifications of defining nonrecourse liabilities and nonrecourse deductions independently of section 1001.<sup>167</sup> Since

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<sup>164</sup>The distinguishing hallmark of a limited liability is apparently that no member is required to make contributions to the entity to fund the liability. Even after careful study of the regulations, however, the concept of a limited liability is hardly pellucid. For example, the regulations do not make explicit the notion that a guaranteed nonrecourse liability may be either a limited or unlimited liability, depending upon whether the guarantor is entitled to a capital account credit. See *supra* notes 139-47 and accompanying text. For a criticism that the current regulations fail to define even more fundamental terms such as "liability," see Brannan, *supra* note 3, at 137. For a recent proposal to define liabilities for purposes of section 752, see T.D. 9062, 2003-28 I.R.B. 46.

<sup>165</sup>See Cuff, *supra* note 9, at 363 ("It would be possible to construct a theory of nonrecourse deductions under Code Sec. 704 that is not dependent on Code Sec. 1001 nonrecourse debt. . . . Such a theory based on whether some partner has liability might well be workable, but it requires rewriting the nonrecourse deduction regulations a bit.")

<sup>166</sup>For example, it is not entirely clear why a reduction in the amount of section 1001 nonrecourse debt (without a sale or exchange) should generate COD while a disposition of property encumbered by the same debt generates section 1001 gain. See *supra* note 31. Presumably, such a discrepancy provides an opportunity for taxpayers to engage in tax arbitrage with respect to section 1001 nonrecourse debt. Without a coherent explanation of such disjunctions, it seems perilous to rest the sections 704(b) and 752 distinctions on the shifting foundation of section 1001.

<sup>167</sup>As this article suggests, the section 1001 nonrecourse standard is inadequate for purposes of defining PNRD because it excludes exculpatory liabilities for which a member bears the economic risk of loss as a guarantor or lender. See *supra* notes 149-59 and accompanying text.

the section 704(b)/752 regulations apply only to partnerships, it is not apparent that these definitions need to be congruent with the section 1001 standard to the extent that the latter is insufficiently nuanced to reflect economic reality.<sup>168</sup> Unfortunately, penetrating the multiple layers of fictions under the existing section 704(b)/752 regulations may require more effort than can reasonably be expected of most LLC advisors, regardless of the soundness of the overall conceptual framework.<sup>169</sup>

While exculpatory liabilities could safely be ignored when the nonrecourse allocation rules were initially drafted, they have assumed increasing significance because of the rise of LLCs. Once the threshold definitional issues have been resolved, there remain quite daunting practical problems in implementing the nonrecourse allocation rules with respect to exculpatory liabilities. Especially in light of the revised section 752 rules for nonrecourse liabilities secured by section 704(c) built-in gain property, the Treasury needs to provide more explicit guidance concerning reasonable methods of allocating exculpatory liabilities among multiple assets. Perhaps even more importantly, the Treasury should clarify the application of the consistency requirement and the gain chargeback rules when exculpatory liabilities encumber multiple assets. Ultimately, the risk is that exculpatory liabilities may further undermine the existing restraints on allocation of nonrecourse deductions, which are already widely perceived as inadequate.

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<sup>168</sup>In the case of exculpatory liabilities, an alternative approach might be to treat such liabilities as nonrecourse for purposes of sections 704(b), 752, and 1001. Revising the section 1001 standard is problematic, however, because it would create a new disparity based on the nature of the excused borrower, *i.e.*, as a corporation or pass-through entity.

<sup>169</sup>For a skeptical assessment concerning the ability of practitioners to understand and apply the increasingly sophisticated regulations under Subchapter K, see Lawrence Lokken, *As The World of Partnership Taxation Turns*, 56 SMU L. REV. 365, 368-69 (2003) (expressing doubt whether the "intellectual revolution" in partnership tax will "become a revolution in the practical reality of partnership taxation"). For a more optimistic view, see generally Mark P. Gergen, *The End of the Revolution in Partnership Tax?*, 56 SMU L. REV. 343 (2003).