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Allocating Partnership Liabilities

J. MARTIN BURKE & MICHAEL K. FRIEL *

Introduction

In the Tax Reform Act of 1984, Congress directed the Treasury to revise and update its regulations under section 752,[1] and to base those revisions "largely on the manner in which the partners . . . share the economic risk of loss with respect to partnership debt." [2] It is the thesis of this article that the congressional directive—and the interest of simplicity, certainty, and coherence in the rules governing partnerships and tax shelter investments—would be best served by permitting partners to allocate partnership debt among themselves in whatever manner they choose. This freedom should be permitted for both recourse and nonrecourse liabilities, and for both general and limited partnerships. Further, having once allocated a liability, partners should be free to reallocate it in a different way for a subsequent year, again in whatever way they choose. The principal concern of the Service in this should simply be that it be notified of the allocations; to this end, it is appropriate to require that the allocation of liabilities be stated on each partnership return.

To the objection that the allocation must have substance, or must reflect the manner in which the liability will be borne, the answer is that these concerns are the province of other provisions—most importantly, sections 465, 704(b), and 704(d). It is unnecessary and unwise to ask section 752 to duplicate what other provisions are better suited to accomplish. Section 752 is properly mechanical and ministerial in operation; it should depart from that pattern as little as possible.

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[1] Pub. L. No. 98-369, § 79, 98 Stat. 494, 597 (1984). The statutory provision, which was not made part of the Code, directs that § 752 be applied without regard to the decision of the Claims Court in Raphan v. United States, 3 Cl. Ct. 457 (1984), *aff'd in part, rev'd in part,* 759 F.2d 879 (Fed. Cir. 1985) (discussed in the text accompanying notes 26 and 27), and provides that in amending the regulations to reflect this directive, the Treasury shall provide for the treatment of "guarantees, assumptions, indemnity agreements, and similar arrangements."

[2] H.R. REP. No. 861, 98th Cong., 2d Sess. 869 (1984), *reprinted in* 1984-3 (vol. 2) C.B. 123. It was recognized that this directive could not be applied to "bona fide nonrecourse debt." *Id.* No "major changes" in the regulations affect-

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An Overview of the Present Rules

Section 752 provides rules for the treatment of liabilities in the partnership context. At first glance, they seemed straightforward. In their application to modern partnerships, however, the rules are neither simple nor clear. And yet, they play a central role in the taxation of partners.

Section 752 treats increases or decreases in a partner's share of partnership liabilities as money contributions by or distributions to the partner. Generally, a partner's contribution of money is added to the basis for his interest in the partnership (his outside basis), and a distribution of money to him is nontaxable, but reduces his outside basis. As a result, the principal effect of section 752 is to increase and decrease the outside bases of the partners.

The outside bases of partners are significant in determining the tax consequences of distributions to partners and sales and exchanges of partnership interests. Perhaps most important of all, however, section 704(d) limits a partner's deduction for partnership losses to the amount of his outside basis.[3] Outside basis thus determines whether a partner can deduct his share of a partnership loss when the partnership sustains it, or must, instead, defer the deduction until he acquires additional basis to absorb the suspended loss. The potential for partnership liabilities to create outside basis, and thereby increase partners' deductions for partnership losses, accounts for much of the popularity of partnerships in tax shelters. It distinguishes partnerships from both C and S corporations, where inside liabilities do not affect outside basis.[4] A limited part-

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ing nonrecourse debt are expected, except that the new regulations might "attempt to provide more certainty than presently exists." *Id.*

[3] Section 704(d) provides:

> A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

[4] Given the aggregate theory of partnerships, a partner can be viewed as owning an undivided interest in each asset of the partnership and—depending on the nature of the liability, the partner's status, and the partnership agreement—as owing a share of each liability of the partnership. A corporate stockholder, in contrast, is not viewed as having a specific interest in any asset or liability of the corporation. Thus, stock basis, unlike a partner's basis for his interest, does not include a share of corporate liabilities. Under § 358, a shareholder's basis for newly issued stock equals (1) the sum of the cash and the adjusted basis of the property that the shareholder contributed, (2) less any liability of the shareholder which the corporation either assumed or took property subject to, (3) increased by gain to the shareholder on the exchange in which the stock was issued to him. When stock is sold by a shareholder, the buyer takes a cost basis under § 1012, unaffected by corporate liabilities.

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nership can often be used to combine liability limitations for the principal investors with essentially unlimited pass through of losses in a way that cannot be accomplished with any other form of organization.

Section 752(a) provides that an increase in a partner's share of partnership liabilities, or an increase in a partner's individual liabilities resulting from his assumption of partnership liabilities, will be considered as a contribution of money by the partner to the partnership. Under section 722, a partner's outside basis is increased by any money he contributes to the partnership. Assume *X* and *Y* form a general partnership in which they will share profits and losses equally. They each contribute $100,000 to the partnership. The partnership uses the $200,000 contributed as part payment on the purchase price of property costing $500,000. The partnership borrows the other $300,000 on a recourse basis. *X* and *Y* are deemed to have made contributions to the partnership of $250,000 each, consisting of $100,000 actually contributed and $150,000 deemed contributed under sections 752(a) and 722. Each partner has an outside basis of $250,000.

Conversely, section 752(b) provides that a decrease in a partner's share of partnership liabilities, or a decrease in his individual liabilities resulting from a partnership's assumption of the partner's liabilities, will be considered as a distribution of money to the partner. Under sections 731(a)(1) and 733, a money distribution to a partner reduces his outside basis, and generally is taxable only if it exceeds that basis.[5] Assume *X* and *Y* form a general partnership in which they will share profits and losses equally. *X* contributes property (fair market value of $140,000 and adjusted basis of $100,000) which is encumbered by a $40,000 indebtedness. The partnership assumes this liability. *Y* contributes $100,000 cash. Under section 721, *X* recognizes no gain on his transfer of the property to the partnership. He is, however, treated as having a net reduction in liabilities of $20,000,[6] which in turn results

In this regard, a shareholder in an S corporation is not treated differently from a shareholder in a C corporation. While a shareholder in an S corporation can deduct a proportionate share of an operating loss of the corporation, § 1366(d) limits these losses to "the sum of (A) the adjusted basis of the shareholder's stock in the S corporation . . . , and (B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder." Because neither of these basis figures is inflated by corporate liabilities, the § 1366(d) limitation is much more of a threat than the corresponding rule for partnerships.

[5] Section 1.752-1(c) of the regulations provides an example of a deemed money distribution under § 752(b) producing a realized capital gain under § 731(a).

[6] Reg. § 1.752-1(b). The transfer to the partnership decreases his individual liabilities by $40,000, but he acquires a $20,000 share of the partnership's liability of $40,000.

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in a deemed distribution to *X* under section 752(b) of $20,000. *X*'s outside basis in his partnership interest is $80,000: the $100,000 basis of the transferred property [7] reduced by the $20,000 deemed distribution.[8]

In both examples, *X* and *Y* were assumed to share liabilities equally. Determining a partner's share of liabilities is seldom so simple. Unfortunately, the statute gives no guidance regarding the determination of a "partner's share of the liabilities of the partnership." The regulations provide assistance that is critical, yet fairly limited. Section 1.752–1(e) of the regulations [9] addresses the matter as follows: First, recourse liabilities—that is, liabilities for which one or more of the partners have personal liability—are shared by the partners in the same proportions as they share losses under the partnership agreement. A limited partner,

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[7] I.R.C. § 722.

[8] Under the rule described in the preceding paragraph in text, *Y*'s basis for his partnership interest is $120,000, the sum of his actual contribution of $100,000 and his $20,000 share of the liability assumed by the partnership.

The regulations offer some modest examples of the mechanics of computing increases and decreases in a partner's liabilities. They also usefully indicate that the simultaneous increase and decrease in a partner's liabilities that occur on the contribution or distribution of encumbered property should be treated as a net increase or net decrease, as the case may be, rather than as a separate increase and a separate decrease, the deemed order of which could have significant and arbitrary tax consequences. Reg. § 1.752–1(a), (b).

[9] In full, § 1.752–1(e) provides:

> A partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement. In the case of a limited partnership, a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement. However, where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under § 752(c) in the same proportion as they share the profits. The provisions of this paragraph may be illustrated by the following example:
>
> > Example. G is a general partner and L is a limited partner in partnership GL. Each makes equal contributions of $20,000 cash to the partnership upon its formation. Under the terms of the partnership agreement they are to share profits equally but L's liabilities are limited to the extent of his contribution. Subsequently, the partnership pays $10,000 for real property which is subject to a mortgage of $5,000. Neither the partnership nor any of the partners assume any liability on the mortgage. The basis of such property to the partnership is $15,000. The basis of G and L for their partnership interests is increased by $2,500 each, since each partner's share of the partnership liability (the $5,000 mortgage) has increased by that amount. However, if the partnership had assumed the mortgage so that G had become personally liable thereunder, G's basis for his interest would have been increased by $5,000 and L's basis would remain unchanged.

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however, does not share in a recourse liability unless the partnership agreement requires him to make one or more additional contributions to the partnership. In such a case, his share is restricted to the sum of the additional contributions that may be demanded of him. Second, nonrecourse liabilities—that is, liabilities for which none of the partners has any personal liability—are shared by all partners in the proportions in which they share partnership profits.[10]

Rationale Underlying the Present Rules

The general rules of section 1.752–1(e) appear simple and indicate the Treasury's effort to allocate liabilities in a manner reflecting economic substance. Allocation of recourse liabilities in proportion to the partners' loss sharing ratios can be explained this way: When a partnership sustains losses exceeding the aggregate of the partners' contributions and the accumulated income of the partnership, the excess is a loss of funds owed to creditors. Thus, a recourse liability can appropriately be allocated to those partners, whether general or limited, who, either by state law or the partnership agreement, can be called upon to pay partnership creditors. The increase in basis resulting from this allocation assures that the partners bearing the risk of loss on recourse liabilities will have basis sufficient to permit the deduction of losses attributable to this debt.

A simple example demonstrates the theory. *X* and *Y* form a limited partnership. *X*, the general partner, contributes $100. *Y*, the limited partner, contributes $1,000, and is not obligated to contribute further to the partnership. The partnership borrows $900 on a recourse basis to purchase a piece of equipment. The partnership agreement allocates losses first to *Y* (the limited partner) up to the amount of his contribution, and provides that losses beyond this amount are allocable to *X*.[11] The partnership generates no income, but sustains losses of $1,500, all of which are deductible by the partnership. Under the partnership agreement, *Y* deducts the first $1,000 of losses and *X* deducts the remaining $500. Because the first $1,100 of loss exhausts the partners'

[10] If the partners agreed that all losses were to be allocated to *Y*, losses in excess of $1,000 would nevertheless be allocated to *X*, rather than to *Y*. Section 704(a) and (b) provides that while partners are generally free to allocate partnership income, deductions, losses, and credits in whatever way they choose, an agreed upon allocation is denied tax effect if it lacks "substantial economic effect." Because *Y* cannot suffer an economic loss in excess of his $1,000 contribution and because partnership losses in excess of $1,000 fall economically on *X*, an allocation of more than $1,000 of loss to *Y* has no economic effect and would be disregarded. *See* Reg. §§ 1.704–1(b)(1)(i), 1.704–1(b)(2)(ii)(a), 1.704–1(b)(3).

[11] The present regulations are silent with respect to whether nonrecourse debts in a general partnership will be allocated on the basis of profit ratios or loss ratios.

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contributions, the last $400 of loss is a loss of borrowed money. *X*, the general partner, would bear this loss from his personal assets if the partnership were to dissolve at this point. Since *X* will bear any loss in excess of the partners' aggregate contributions, it is appropriate that *X* be allocated the entire $900 of recourse indebtedness. This allocation would give *X* an outside basis of $1,000, enabling him to deduct the loss allocated to him.

Nonrecourse liabilities, by contrast, cannot appropriately be allocated among partners in the proportions in which they share losses. When a partnership loses money it has borrowed without recourse, the lender, not the partners, bears the economics loss. Section 752, however, draws no distinction between recourse and nonrecourse liabilities, and thus causes the outside bases of the partners to be increased for nonrecourse as well as recourse liabilities. In doing this, section 752 incorporates the principle of *Crane v. Commissioner* [12]—generally equating nonrecourse liability with recourse liability for basis purposes—and places a partner in a position comparable to that of an individual owner of encumbered property.

The application of the *Crane* doctrine in the partnership context is complicated by the necessity of allocating nonrecourse liabilities among the partners. The regulations require that a nonrecourse liability be allocated according to the profit sharing ratio, recognizing that if the nonrecourse indebtedness is to be paid at all, it will be paid from partnership profits and capital, not from personal assets of partners. Because the sharing of profits is central to the existence of a partnership and because all partners' expectations of profits are frustrated when there is a loss associated with a nonrecourse liability, such a loss is borne economically by the partners (to the extent it is borne by the partners at all) in proportion to their shares of profits. Therefore, the nonrecourse allocation rules are arguably justifiable.

The rules of section 1.752–1(e) of the regulations thus seek to reflect economic substance by allocating liablities to the partners bearing the losses associated with the liabilities. The premises underlying the rules, however, are not necessarily borne out in reality.

First, the recourse liability allocation rules assume that the partnership may default on its obligations, thus exposing personal assets of partners to creditors' claims. Several factors, however, make the possibility of enforcement of personal liability small in most cases. Creditors usually try to protect themselves by demanding adequate security. Assume a limited partnership borrows money from the *Z Lending Bank*. The partnership gives a recourse note to *Z*. *Z* also receives a first mortgage

[12] 331 U.S. 1 (1947).

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on partnership property. If the value of the security significantly exceeds the indebtedness and there is only a remote possibility that the security will ever substantially decrease in value, as is often the case, the possibility of enforcement of personal liability is minimal. This possibility is also remote if the partnership is sufficiently profitable so that the loan is almost certain to be repaid from partnership profits. The costs to the lender of enforcing personal liability, furthermore, may be so large as to discourage it from seeking personal payment from the partners even if the security and partnership profits both prove insufficient to satisfy the debt.

Nevertheless, section 1.752–1(e) allocates the entire liability among the partners who could be called upon to pay if the partnership defaulted—the general partners and those limited partners, if any, who are obligated to make further contributions to the partnership. If there is little possibility of any partner being required to pay from personal assets, all partners, including limited partners with no obligation to contribute further to the partnership, will effectively contribute to the retirement of the debt because partnership earnings will be the primary source for repayment of the debt. In these cases, allocation of the liability only to the partners who could be required to make personal payment does not reflect economic substance. The regulations' distinction between recourse and nonrecourse indebtedness is artificial and distorts computation of a partner's outside basis.

A second, and perhaps more fundamental, difficulty with the liability sharing rules is that they fail to account for the differences between economic losses and tax losses. Were only economic losses deductible, the recourse sharing rules would be justifiable, and the nonrecourse rules would necessarily be arbitrary since the lender, and not the partners, would bear the risk of loss. Losses deductible for tax purposes, however, may not represent actual economic losses. Indeed, taxpayers sometimes report losses for tax purposes when they have economic profits. For example, during a tax year, a partnership may make an economic profit but, because of substantial depreciation deductions or depletion allowances, show a loss for tax purposes. Tax shelters—frequently organized as limited partnerships—exploit discrepancies between tax losses and economic losses.

Since lenders generally try to minimize the possibilities of default, the liability sharing rules are significant primarily as a means of allowing partners to deduct artificial tax losses incurred where the potential for economic loss is remote. Thus, while the liability allocation rules—specifically, the recourse liability sharing rules—may in principle seek to reflect economic substance, that end is frustrated by the nature of the federal tax system and by the practical realities of financing.

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Problems in Application

In addition to the questionable economic basis of the liability allocation rules, application of the rules has presented significant difficulties for the courts and the Treasury, often producing results at odds with economic substance.

Guarantee and Indemnification Arrangements

Rigid application of the regulation's distinction between recourse and nonrecourse liabilities has led to allocations that can fairly be characterized as arbitrary. This has been particularly true in cases involving indemnification arrangements and guarantees. Revenue Ruling 69–223,[13] *Raphan v. United States,*[14] and a recent technical advice memorandum [15] illustrate the difficulties the courts and the Service have had in applying the regulation in this context. These authorities suggest the necessity of significant revision of section 1.752–1(e)—as directed by the Congress in the Tax Reform Act of 1984—if any semblance of economic substance is to be preserved in liability allocations.

In Revenue Ruling 69–223, the Service considered whether an indemnification agreement entitled a limited partner to a share of a recourse liability of the partnership. The limited partner had agreed to indemnify a general partner if the general partner "should be required to pay more than his pro rata share of partnership liabilities." [16] The partnership agreement said that the indemnification arrangement was "not intended for the benefit of third party creditors," [17] and that the limited partner was not liable for losses in excess of his initial capital contribution. The certificate of limited partnership provided that the limited partner was not required to make any contribution beyond his initial contribution.

The Service held that none of the partnership's recourse liability could be allocated to the limited partner. It noted that under the regulations, a limited partner shares in a recourse liability only if the limited partner is required to make an additional contribution to the partnership.[18] The indemnification agreement failed to qualify the limited partner for a share of the liability because it was made between the general and limited partners "in their individual capacities." [19] The limited partner had no

[13] 1969–1 C.B. 184.

[14] 3 Cl. Ct. 457 (1984), *aff'd in part, rev'd in part,* 759 F.2d 879 (Fed. Cir. 1985).

[15] TAM 8504005 (Sept. 28, 1984).

[16] 1969–1 C.B. 184.

[17] *Id.*

[18] *Id.* at 185.

[19] *Id.*

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further obligation "to the partnership."[20] Therefore, the limited partner's share of the liability was held to be zero. The general partner was allocated the entire liability.

In a 1984 technical advice memorandum,[21] the Service applied the regulations in an equally rigid manner, holding that limited partners who guaranteed 80% of a recourse loan were not entitled to add any portion of the liability to the bases of their partnership interests. Under the terms of the guarantee, the creditor was not required to foreclose first upon the partnership property securing the indebtedness, but could proceed directly against the guarantors. The limited partnership agreement, however, stated that the limited partners' liability was limited to their contributions, and that creditors could not look to the "separate assets of any limited partner for satisfaction of a partnership debt."[22] Neither the partnership agreement nor the certificate of limited partnership "require[d] any additional contributions or guarantees from any of the limited partners."[23] Other evidence, however, established that before becoming partners, the limited partners understood that they would be required to guarantee the partnership liability. At least one potential investor chose not to invest because he did not want to undertake the liability associated with guaranteeing the partnership debt.

The Service, nonetheless, rejected the argument that the guarantees should be treated as part of the partnership agreement. Because neither the partnership agreement nor the certificate of partnership required additional contributions by the limited partners, the Service concluded that "the guaranty agreements executed by the partners were made outside the partnership agreement."[24] Accordingly, the limited partners were found not to be obligated for additional contributions, and thus were allocated none of the liability.[25]

Revenue Ruling 69–223 and the technical advice memorandum reflect a slavish adherence to formality, and fail to reflect the spirit of economic substance underlying the regulations. In both situations, the Service, in allocating recourse liabilities just to general partners, failed

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[20] *Id.* See Pritchett v. Commissioner, 85 T.C. 580 (1985) and Abramson v. Commissioner, 86 T.C. No. 23 (Mar. 12, 1986).

[21] TAM 8504005 (Sept. 28, 1984).

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] The Service relied on two Tax Court memorandum decisions, Brown v. Commissioner, 40 T.C.M. (CCH) 725 (1980), and Block v. Commissioner, 41 T.C.M. (CCH) 546 (1980), as authority for its conclusion. These cases held that the guaranteeing of a partnership liability, outside the partnership agreement, does not transform the debt into part of the "total contribution which [the limited partner] is obligated to make under the limited partnership agreement." Reg. § 1.752–1(e).

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to recognize that limited partners had also exposed their personal assets to liability. In the technical advice memorandum, the creditor, in the event of default, could have proceeded immediately against the assets of the limited partners who guaranteed the loan. In Revenue Ruling 69-223, the limited partner's liability to the recourse lender was less direct. Nevertheless, if there were a loss attributable to the indebtedness, the limited partner's personal assets would, albeit indirectly, be relied upon to satisfy at least part of the loss. Certainly, if the possibility that one will be called upon to pay a liability is the justification for allocation of liability under the rule for recourse debt, the limited partners in Revenue Ruling 69-223 and the technical advice memorandum were entitled to a share of the liability. The refusal to give the limited partners any basis increase because the partnership agreement did not require the limited partners to make additional contributions suggests confusion as to the purpose of the liability sharing rules, and provides a trap for the unwary.

The Service's position in the ruling and the memorandum is especially curious in light of the government's argument in *Raphan v. United States.*[26] *Raphan* addressed a related issue: Did a general partner's guarantee of an otherwise nonrecourse loan create a personal liability that would preclude limited partners from sharing in the liability? The government argued that because guarantee of the loan by the general partners created personal liability, the liability sharing rule for nonrecourse debt was inapplicable.

The Claims Court rejected the argument, reasoning that in guaranteeing the loan, the general partners had acted in a nonpartner capacity. If forced to pay the lender, the guaranteeing partners would be subrogated to the rights and remedies of the lender, including the right to foreclose on the collateral. If there were a foreclosure by the guaranteeing general partners, the interest of every partner would be diminished. The courts concluded that the guaranteeing partners should only be viewed as creditors of the partnership. "The guaranteeing of a partnership debt does not make the guaranteeing partner 'personally liable' under Treas. Reg. § 1.752-1(e) and does not preclude the remaining partners from sharing in the step up in basis on account of such debt." [27]

Both Congress and the Federal Circuit recognized the merit of the Service's position in *Raphan.* Congress prospectively overruled *Raphan,*[28] and the Federal Circuit reversed the Claims Court.[29] Con-

[26] 3 Cl. Ct. 457 (1984), *aff'd in part, rev'd in part,* 759 F.2d 879 (Fed. Cir. 1985).

[27] *Id.* at 466.

[28] Pub. L. No. 98-369, § 79, 98 Stat. 494, 597 (1984). The legislative overturning of *Raphan* was effective as of March 1, 1984. H.R. REP. No. 861, 98th

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gress and the Federal Circuit recognized that guarantees are of considerable importance if one is anxious to assure that liabilities are allocated to partners who will bear a loss, if any, attributable to recourse liabilities.[30]

If the general partner's guarantee should have been considered a significant factor in the allocation of the "nonrecourse liability" in *Raphan*, however, should not this same treatment have been given the indemnification agreement in Revenue Ruling 69-223 and the limited partners' guarantees in the technical advice memorandum? The provision that legislatively overturns *Raphan*—section 79 of the Tax Reform Act of 1984—directs the Treasury to provide by regulation for "the treatment of guarantees, assumptions, indemnity agreements, and similar arrangements." The legislative history of the provision states that the regulations "will be based largely on the manner in which the partners, and persons related to the partners, share the economic risk of loss with respect to partnership debt (other than bona fide nonrecourse debt)."[31]

Cong., 2d Sess. 869 (1984), *reprinted in* 1984-3 (vol. 2) C.B. 123. No "inference . . . regarding the validity of the *Raphan* decision for transactions prior to March 1, 1984" was intended. *Id.*

[29] 759 F.2d 879 (Fed. Cir. 1985). According to the Federal Circuit, the general partners had not acted at arm's length in guaranteeing the loan, but, rather, had acted as partners. That the guarantee was not mentioned in the partnership agreement was not determinative. From an economic substance standpoint, the position of the Federal Circuit and the congressional position in the 1984 Tax Reform Act are correct. Having guaranteed the nonrecourse liability, the general partners subjected their personal assets to the claims of the creditor. If a loss attributable to the liability were sustained, the general partners would bear that loss. The liability should therefore be allocated only to the general partners and not shared among all the partners.

[30] If, in *Raphan*, the guarantee had been made by the limited partner, the limited partner would bear the economic risk of loss and should therefore be allocated the entire liability. Congress presumably would recognize that as the appropriate result. The Staff of the Joint Committee in its explanation of § 79 of the Tax Reform Act of 1984 said: "When a limited partner guarantees a liability, the regulations will not shift the basis attributable to that liability away from the limited partner as a result of the guarantee." STAFF OF JOINT COMM. ON TAX'N, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1984, 251 (Comm. Print 1984). See Abramson v. Commissioner, 85 T.C. No. 23 (Mar. 12, 1986) (limited partner's pro rata guarantee of a partnership's nonrecourse obligation entitled the limited partner to include a pro rata portion of the obligation in his partnership basis).

A related issue is what result obtains if the nonrecourse debt is guaranteed by a person who is not a partner. Does it matter whether, and in what way, the guarantor is related to one of the partners? From an economic substance standpoint, it might sometimes be appropriate to consider the relationship between the guarantor and a partner because, through the related party's guarantee, the partner might effectively subject his own assets to claims of the creditor.

[31] H.R. REP. No. 861, 98th Cong., 2d Sess. 869 (1984), *reprinted in* 1984-3 (vol. 2) C.B. 123.

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Specifically, it is suggested: "When a limited partner guarantees a [nonrecourse] liability, the regulations will not shift the basis attributable to that liability away from the limited partner as a result of the guarantee."[32]

The congressional intention with respect to other situations, including those of Revenue Ruling 69–223 and the technical advice memorandum, is not clearly expressed. Logically, a limited partner's agreement to indemnify a general partner on recourse debt or a limited partner's guarantee of a recourse debt should be effective to shift basis to that partner. More generally, the legislative directive will require a rethinking of the approaches taken in the revenue ruling and the technical advice memorandum.

Economic Substance and the Contingent Obligation of Limited Partners

Limited Partners Obligated for Additional Contributions

The revenue ruling and the technical advice memorandum discussed above held that limited partners were not entitled to share in recourse liabilities because the partnership agreements failed to require additional contributions from them. Even where additional contributions are required from limited partners, however, the Service has sometimes denied them the right to share in the allocation of these liabilities.

In a 1983 technical advice memorandum,[33] the limited partnership agreement provided that the limited partners could pay for their interests in the partnership in several ways, including a "Letter of Credit method" whereby the limited partner would immediately pay 20% of the subscription price in cash, give a recourse note due within a year for an additional 20% of the subscription price, and execute and deliver a transferable "Letter of Credit" for the balance of the subscription price.[34] The letters of credit were to be the primary security for a "Loan" which the partnership was to obtain from a bank (the "Lending Bank"), and had to be issued by banks acceptable to both the general partners and the Lending Bank. A limited partner electing the letter of credit method was also required to sign an "Assumption Agreement" "by which the limited partner [would] assume and promise to pay his proportionate share of principal, interest and other charges, if any, due under the Loan."[35] The partnership pledged the assumption agreements and letters of credit as security for the loan.

[32] STAFF OF JOINT COMM. ON TAX'N, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1984, 251 (Comm. Print 1984).

[33] TAM 8404012 (Oct. 13, 1983).

[34] *Id.*

[35] *Id.*

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One of the issues considered by the Service in the technical advice memorandum was whether a portion of the liability for repayment of the loan was allocable to a limited partner who signed the letter of credit and assumption agreement. Although it recognized the obligation of the limited partner to make further contributions to the limited partnership under the letter of credit and assumption agreement, the Service concluded that a section 752 allocation of liability to the limited partner would not be appropriate. According to the Service, the limited partner's obligation to make additional contributions was too contingent to justify a basis increase.[36] Because the principal of the loan was not due for four years and no interest payment was due for one year, "the obligation to make any additional contributions to the partnership was indefinite and contingent. . . . [T]he partnership could have generated sufficient income to pay the Loan either through income from operations or sale of assets prior to the due date of the Loan."[37] The Service further concluded that the liability could not be treated as a nonrecourse debt in which limited partners were entitled to share because their obligation to contribute took the liability out of the nonrecourse category. While it is not entirely clear from the memorandum, the liability was apparently allocated only to the general partners.

In a 1984 technical advice memorandum,[38] issued just a few months after the memorandum discussed in the two preceding paragraphs, the Service reached a similar conclusion. The partnership agreement in the 1984 memorandum provided that those lending money to the partnership could collect a certain amount from the limited partners if the partnership failed to repay the loan. The Service concluded that this provision did not allow any portion of the partnership's recourse liabilities to be allocated to limited partners. According to the Service, the "obligation [of the limited partners] to contribute must be fixed and absolute in both time and amount under the partnership agreement."[39] The Service held that the limited partners' obligation to contribute was contingent because they would only have to make additional contributions "if the additional amounts [were] necessary to pay any of the partnership's loan obligations."[40]

The conclusions of the Service in these memoranda undermine further the economic foundation of the regulations. That the profits of the partnership might have been sufficient to service the debt hardly seems an appropriate basis for finding that the liability undertaken by the limited partners was too contingent to justify a basis increase. If the

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[36] *Id.*
[37] *Id.*
[38] TAM 8421004 (Jan. 25, 1984).
[39] *Id.*
[40] *Id.*

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possibility of adequate profits renders a limited partner's obligation to make further contributions too contingent to justify a basis increase, the regulations are wrong in allowing general partners to increase their bases for recourse obligations. In many, if not most, cases, recourse loans are adequately secured. Given the underlying security and the cash flow of the partnership business, the likelihood of a general partner ever paying a recourse obligation of his partnership from personal assets is small. It is doubtful, indeed, that the limited partners' liability in these two technical advice memoranda was any more contingent than that of a general partner in a typical recourse liability context.

The unreasonableness of the holdings in the memoranda is further shown by the fact that they apparently allowed the general partners to include the entire amount of the liabilities in their bases. The liabilities were not contingent; the creditors had a right to be paid. Thus, the only question was to whom the liabilities would be allocated for purposes of section 752. The holdings that no portion of the liabilities was allocable to limited partners necessarily caused the liabilities to be allocated entirely to the general partners. To allocate them entirely to the general partners, when limited partners would be called on to pay if any partnership liability were enforced, is unreasonable and entirely inconsistent with any notion of economic substance.[41]

Other Characterization Problems

The problems encountered by the courts and the Service regarding guarantees, indemnification arrangements, and contingencies are only a few of the problems created by section 1.751–1(e) of the regulations. Other significant questions must also be addressed. The legislative history of section 79 of the Tax Reform Act of 1984, for example, indicates that the regulations to be promulgated on partnership liabilities

[41] Literal application of the recourse liability sharing rules can produce a similarly unjustified result where limited partners are allowed to pay for their interests in installments. Assume a limited partnership authorizes payment of the subscription price for limited partnership interests to be made in installments. Some of the limited partners pay in full for their interests in the partnership, while others take advantage of the installment arrangement. Assume the partnership borrows on a recourse basis. Section 1.752–1(e) of the regulations would allocate the liability among the general partners and those limited partners who are obligated to make additional contributions to the partnership. Under the partnership agreement and local law, however, the limited partners would most likely be required to complete their contributions before liability for unpaid partnership debt would finally fall on the general partners. If this is so, the economic burden of the first dollars of partnership debt is borne by the limited partners who are obligated for additional contributions, and economic substance can only be accurately reflected by allocating liabilities to limited partners exclusively, up to the amounts due from them.

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should deal with nonrecourse loans made by limited partners.[42] The Service has recently dealt by ruling with the treatment of partnership liabilities that are recourse in part, and nonrecourse in part.[43] We do not comprehensively catalogue these issues; they are mentioned only to suggest that the unanswered questions under the present regulations are legion.[44]

Problems Associated With Status of Partners, General or Limited

In addition to requiring characterization of a liability as recourse or nonrecourse, the regulation rules necessitate that every partnership and every partner be characterized as general or limited.

While determination of whether a partner is general or limited is typically straightforward, serious problems can arise. For example, the issue appears to refer to local law. Under the Uniform Limited Partnership Act in force in most states, a limited partner becomes a general partner if he engages in excessive management activities;[45] the boundary lines here are uncertain, and may be established only well after the fact. Do basis shifts thereby result? Also, it is not uncommon for a partner to be both a general partner and a limited partner in the same partnership. Is the limited partner status to be ignored for basis purposes with respect to recourse liabilities? Does the partner have a single basis in

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[42] The Staff of the Joint Committee on Taxation states in its explanation of the 1984 Act: "[T]he basis attributable to a nonrecourse loan made to the partnership by a partner would be treated in the same manner as basis attributable to a bone [sic] fide third party nonrecourse loan which that partner guaranteed." STAFF OF JOINT COMM. ON TAX'N, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1984, 251 (Comm. Print 1984). Elsewhere, the staff explanation says that a limited partner guarantee of nonrecourse debt should not have the effect of shifting basis attributable to the debt away from the partner. *Id.* The intention apparently is that when a limited partner makes a nonrecourse loan, the partnership liability on the loan should be allocated among the partners, including the lending partner, by the rule applied to nonrecourse debt owed to third parties, and the fact that the lender is a limited partner should not affect the allocation. There surely are numerous other issues relating to loans made by partners that could be addressed by the new regulations.

[43] The Service has ruled that two separate liabilities are created for purposes of § 752, one recourse and one nonrecourse. Rev. Rul. 84-118, 1984-2 C.B. 120, *amended by* Ann. 85-19, 1985-5 I.R.B. 31 (Feb. 4, 1985). The Tax Court had previously indicated that such a liability should be treated as a recourse liability for basis sharing purposes. Long v. Commissioner, 77 T.C. 1045 (1981).

[44] For an excellent discussion of a broader range of § 752 problems than those summarized herein, as well as a discussion of the discontinuities among §§ 752, 704(b), and 465, see Rosen & Kalish, *The Risky Basis for Partnership Allocations*, 38 TAX LAW. 119 (1984).

[45] UNIF. LTD. PARTNERSHIP ACT, 6 U.L.A. 582 (West).

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the partnership, as the Service has ruled,[46] or does each interest have its own basis?

Again, it is possible to answer each of these questions by assessing the liability, if any, a partner has with respect to each indebtedness. To the extent personal assets of a partner may be looked to in satisfying partnership debt, a share of the liability should be allocated to the partner under section 752 in computing the partner's outside basis. The focus on whether a partner is general or limited may be misplaced.

Measurement Problems

These problems may be the least complex of the issues raised by section 1.752–1(e) of the regulations. The regulation allocates liabilities among partners according to profit and loss ratios. Because complex sharing and allocation arrangements are typical of present day partnerships, the determination of profit and loss sharing ratios is often extremely difficult, if not impossible. Understandably, section 1.752–1(e) provides no guidance in ascertaining the ratios. Indeed, contemporary partnership arrangements are so complex that any standard, short of something so broad as to be of little value, would be deficient.

Assume a general partnership consisting of *X*, *Y*, and *Z*. The partners specially allocate all depreciation deductions to *X* for the first ten years. Otherwise, all partnership items are shared equally. Assume the special allocation to *X* has substantial economic effect under section 704(b). It would not be accurate to say that the partners share profits and losses equally. Because partner *X* initially has a greater share of partnership deductions, it would not be correct to allocate only one third of partnership liabilities to *X*. To pass muster under section 704(b), the allocation of the depreciation to *X* must be reflected by charges against his capital account, and the partnership agreement must obligate *X* to make up any deficit in his capital account that might exist when the partnership liquidates.[47] The allocation thus exposes *X* to the risk of economic loss beyond the risk borne by the other partners, and an allocation of liabilities reflective of economic substance must give more of the liabilities to *X*. But, how much more?

If one could quantify the impact of the depreciation allocation on the

[46] Rev. Rul. 84–53, 1984–1 C.B. 159.

[47] The Treasury has recently issued final regulations stating that an allocation of gross income, loss, or deduction has economic effect under § 704(b) only if (1) each item allocated to a partner is reflected in his capital account, (2) capital accounts are followed in distributing partnership assets on liquidation, and (3) a partner whose capital account is in deficit when liquidation occurs must make a contribution to the partnership sufficient to make up the deficit. Reg. § 1.704–1(b)(2)(ii)(b).

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current year's loss sharing arrangement, the current year's loss sharing arrangement could be controlling for the section 752 allocation made for the year. This approach would entail shifts in the allocation from year to year. Alternatively, an allocation might be computed at the outset that would take account of both the special allocation in the first ten years and the shift of the depreciation deductions in the eleventh year. Which approach is correct? Does either approach lead out of the unmanageable computational conundrum? The regulations, case law, and administrative rulings shed no light on this dilemma.

The example is relatively simple. Many partnership arrangements involve numerous special item allocations, as well as complex bottom line allocations. Provisions that flip allocations from limited partners to general partners at particular times are common. If accurate measurement of the partnership's loss sharing ratio is difficult in this simple example, how much more difficult is the measurement task when multiple allocations and flips are present? Any effort to distill from these arrangements a single profit or loss ratio necessarily involves a high degree of arbitrariness and guesswork.

Congress apparently recognized the difficult measurement problems presented by the present regulation. The legislative history of the 1984 congressional directive indicates that the Treasury need not make "major changes" in the manner in which the partners share nonrecourse liabilities, but then states that the Treasury "may attempt to provide more certainty than presently exists." [48] Measuring loss ratios for purposes of sharing of recourse liabilities is no less complicated than measuring profit ratios for purposes of sharing nonrecourse liabilities. Ultimately, the Treasury may find a way to simplify determination of the profit and loss sharing ratios, but one's confidence in the economic soundness of the determination will likely be far from absolute.

ALI and New York State Bar Association Proposals

ALI Proposal

Considering the importance of the section 752 allocation rules, it is not surprising that Congress and practitioners alike have been concerned with the uncertainties and inconsistencies of section 1.752–1(e) of the regulations. Indicative of the significance of the problem is the attention paid to partnership liabilities by the American Law Institute in its subchapter K project.[49] After providing examples of the many prob-

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[48] H.R. Rep. No. 861, 98th Cong., 2d Sess. 869 (1984), *reprinted in* 1984–3 (vol. 2) C.B. 123.

[49] ALI, Federal Income Tax Project, Proposals on the Taxation of Partners (1984).

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lems created by the present liability allocation rules, the ALI proposes that the present rules be retained, but with certain significant modifications.

The most important of the recommended changes relates to the sharing of nonrecourse liabilities. The ALI suggests several alternatives that could replace the regulation rule for these liabilities. Among the possibilities are:

(1) An "arbitrary rule, e.g., that current profits interests at any given point in time control the allocation of nonrecourse debt." The argument for this rule is "that no particular rule will uniformly reach a correct result and it is best to have a clear bright line." [50]

(2) "Nonrecourse debt could be allocated based on a detailed facts-and-circumstances analysis, to try to determine for a given partnership the appropriate allocation of debt for each particular year. Such an analysis could take into account relative obligations to make contributions, current and residual distribution provisions, and profit-and-loss allocations." [51]

The ALI recommends neither of these alternatives. Indeed, they can be viewed as nothing more than possible interpretations of the present rule. The measurement problems previously discussed are present in both.

While the first alternative limits the measurement problem by focusing solely on the profit sharing ratios for the current year, quantifying even these ratios would not always be simple. As the ALI recognizes, "there may be different profit interests at different levels of income, and there may be no profits at all in the particular year for which liabilities are being allocated." [52] The ALI calls this first alternative "arbitrary." [53] The second alternative simply summarizes the variables that must be considered in determining profit sharing ratios once the focus is broadened beyond the current year. The very vagueness of this alternative is indicative of the difficulties of measurement created by the current standard.

In lieu of the present standard, the ALI suggests the following rule:

> Nonrecourse liabilities shall be allocated among partners as the partners determine in the partnership agreement if the allocation bears a reasonable relationship to the partner's interests in the partnership apart from such allocation. In the absence of such an allocation, such liabilities shall be allocated at any time in accordance with the current profit-sharing ratios for operating income of the partnership then in effect.[54]

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[50] *Id.* at 269–70.
[51] *Id.* at 270.
[52] *Id.* at 271.
[53] *Id.* at 269.
[54] *Id.* at 278.

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The ALI justifies this standard on three grounds. First, the standard provides "relative certainty and simplicity." [55] Second, if strict rules for allocating gross income and deductions are provided under section 704(b),[56] "there seem to be no important policies served by a strict rule for allocating liabilities among partners in computing their basis for their partnership interests." [57] Third, "while practitioners often plan around the present uncertainties, many unnecessary uncertainties remain that have simply not surfaced because of low audit coverage of the issue." [58]

The ALI standard, while at first glance quite flexible, exhibits a tentativeness that makes it as uncertain and difficult of application as the present rule. The ALI proposal permits the partners to allocate nonrecourse liabilities only in ways that bear "reasonable relationship[s] to the partners' interests in the partnership." [59] The official comments on the proposed standard say that the "reasonable relationship" requirement refers to a partner's economic interest.[60] Is not the economic interest of a partner essentially the basis for the present sharing rules? In determining a partner's economic interest will not one be required to quantify the impact of various special allocations? If so, the ALI standard is simply the current standard in disguise.

While the ALI points to proposed rules under section 704(b) as negating the need for stringent allocation rules under section 752, it declines to follow through on the implications of that observation. The ALI comments:

> [A]n amendment to the partnership agreement to modify a previously agreed to allocation of nonrecourse debt will only be recognized as bearing a reasonable relationship to the partners' interests if such change bears a reasonable relationship to other changed terms in the partnership agreement. This restriction is designed to avoid partners shifting the allocation of the debt from year to year, depending solely upon the best tax results to them for that year.[61]

Section 704(b), strictly applied, together with the deduction limiting rules of section 704(d) and section 465, greatly limit, if not eliminate, the abuse potential which concerns the ALI.

More disappointing than the ALI's very cautious proposal concern-

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[55] *Id.* at 270.

[56] The ALI suggests rules for allocating gross income and deductions similar to those in the § 704(b) regulations. *Compare id.* at 251–52, *with* Reg. § 1.704–1(b)(2)(i).

[57] *Id.* at 270.

[58] *Id.*

[59] *Id.* at 278.

[60] *Id.* at 279.

[61] *Id.* at 280.

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ing nonrecourse indebtedness is its failure to address the serious measurement problems it recognizes in the current rules for allocating recourse liabilities. The proposed standard for the allocation of nonrecourse indebtedness, as limited as it is, is not recommended for recourse indebtedness. Rather, the ALI embraces the present rule for recourse liabilities, thus accepting the basic premise of the present regulation that it is appropriate to distinguish between recourse and nonrecourse debt in allocating basis among partners. In supporting the continuation of this distinction, the drafters of the ALI study reasoned:

> Recourse liabilities may well have to be funded by the partners, and the allocation rules for losses should, in general, allocate losses to partners who may ultimately have to fund the recourse debt. Also, as discussed above, since contingent liabilities for recourse debt can be manipulated for tax purposes, it seems unwise to expand the possible allocation to limited partners of basis for a recourse debt beyond the present rule.[62]

The ALI proposal thus continues the present state of uncertainty, doing so out of a concern for economic substance. The ALI itself, however, recognizes that the present allocation rules do not always assure that the partner who may actually bear loss associated with recourse liability will necessarily be allocated the liability. In light of its own proposals for strict allocation rules under section 704(b), together with the failure of the present standard to assure economic substance, the ALI's proposal seems quite modest, and does not satisfactorily address the serious application problems associated with section 752.

The ALI proposal does, however, address two problems associated with section 1.752–1(e) of the regulations. First, the ALI proposes that "if a limited partner has personal liability for a partnership debt, either by agreement with the lender or by having agreed to indemnify another partner against liability, or otherwise, he shall be allocated a share of such debt as if he were a general partner." [63] If the current standards for the allocation of liabilities are to be retained, this proposal moves in the right direction. In contrast to current law, it recognizes that while a partner may be labeled a limited partner and indeed, for all other purposes, is a limited partner, his agreement to take on personal responsibility for a particular partnership debt thrusts the risk of loss on him to that extent, and should justify a liability allocation to him; the general partner, by contrast, should, to the same extent, be relegated to the status of a limited partner for this purpose.

Second, this same recharacterization of one's status as a general or a limited partner is mirrored in a related proposal:

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[62] *Id.* at 271.
[63] *Id.* at 278.

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> Any debt of a general partnership for which some but not all of the partners are personally liable shall be allocated among the partners as it would be in a limited partnership in which the personally-liable partners were the general partners and the other partners were the limited partners.[64]

This rule, like that discussed in the previous parargaph, addresses in part both the characterization and the economic substance problems associated with the current regulation.

The ALI proposal also fills a gap in the present regulation by providing that "nonrecourse debt in a general partnership shall be allocated according to the same rules that apply to nonrecourse debt in a limited partnership." [65] Again, this rule is needed if the current regulation is to be retained.

In sum, while recognizing the problems created as a result of the liability allocation rules of section 752, the ALI fails to propose adequate solutions to these problems, particularly the difficult measurement problems. The proposal maintains the need to distinguish between recourse and nonrecourse debt, and between limited and general partners. It maintains the need to determine profit and loss sharing ratios. Even the ALI proposal with respect to nonrecourse debt, improvement though it is, remains unsatisfactory: It is limited in its application solely to nonrecourse debt, and it is restricted to "reasonable" allocations. This latter restriction could well generate difficulties of its own as practitioners and the Service struggle to define the boundaries of reasonableness in innumerable partnership configurations.

New York State Bar Proposal

On May 7, 1985, the New York State Bar Association Section of Taxation submitted a report to the Treasury and the Service containing the section's recommendations for regulations to be issued pursuant to the 1984 congressional directive.[66] The report makes recommendations with respect to allocation under section 752 of both recourse and nonrecourse debt.

It recommends that as a general rule, recourse liability:

> should be allocated to the partner who is liable for the debt, giving effect to the agreements with the lenders and among the partners and to state law. If the partnership agreement does not specify how partners share liability for partnership debts, such obligations should be allocated among those

[64] *Id.*

[65] *Id.*

[66] New York State Bar Association Tax Section, *Report on Proposed Regulations Pursuant to Sections 704(c), 707(a)(2) and 752* (1985), *reprinted in* 85 Tax Notes Today 102–57 (May 22, 1985) [hereinafter cited as New York State Bar Report].

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partners against whom the lender has recourse in accordance with their respective shares of losses.[67]

The report gives several examples of the application of this proposed standard, including one similar to the indemnification agreement in Revenue Ruling 69-223. The report, like the ALI proposal, concludes that the limited partner agreeing to indemnify a general partner should be allocated a share of the liability.

The report adopts the rule of the present regulations that a limited partner can share in recourse indebtedness only if the partner is required to make an additional contribution to the partnership. It provides, however, that "a limited partner who assumes a partnership liability should be able to include the amount of the assumed liability in his basis." [68] A debt should be considered to be assumed for this purpose, the report says, if a limited partner "through a pledge of property, direct assumption of liability, or otherwise, shoulders the ultimate risk." [69] The report acknowledges that this standard is inconsistent with the position expressed in a 1983 technical advice memorandum.[70] Given the facts of that memorandum, the report "would allow the inclusion of the amount of the letter of credit in the limited partner's basis." [71]

The report expresses general agreement with the present rule that nonrecourse debt is to be allocated in the same proportions that the partners share in profits, but urges that the revised regulations "address those situations in which partners share profits not in accordance with one overall set of percentages but in a variety of different ways." [72] "In particular," the report says, "if an allocation of profits will be respected under section 704, such allocation should be given effect under section 752." [73] If one cannot determine from the partnership agreement what the partners' respective shares of profits are, nonrecourse liabilities should be allocated "in accordance with the partners' respective interests in the partnership, determined on the basis of all the facts and circumstances. Such a determination should consider different allocations of profits and the effect such allocations may have on the repayment of partnership debts." [74]

Finally, the report urges that the regulations under sections 704 and 752 be coordinated:

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[67] *Id.* at 69.
[68] *Id.* at 72.
[69] *Id.*
[70] TAM 840412 (Oct. 13, 1983). *See supra* notes 33-37 and accompanying text.
[71] New York State Bar Report, *supra* note 66, at 73.
[72] *Id.*
[73] *Id.* at 74.
[74] *Id.*

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> If a partner's deductions are deemed to be in accordance with his interest in the partnership under the proposed Regulations under section 704, the Committee believes that it is illogical that the partner may not use deductions because the basis for his partnership interest has not been increased to permit such losses to be taken under section 704(d). Instead, the Committee believes that the suggested rules, which would allocate basis attributable to debt in accordance with economic benefit or risk, are consistent with the approach under section 704 and should yield results which are not inconsistent.[75]

While modest in scope, these proposals address many of the economic substance problems previously discussed. The proposals are broader than those of the ALI, but suffer from some of the same shortcomings. They retain the distinction between recourse and nonrecourse indebtedness. More importantly, they do not address the significant measurement problems associated with the use of profit and loss ratios in allocating liabilities. The proposals recommend that special allocations be considered in determining profit and loss ratios, and yet provide no guidance on how to determine the profit or loss ratio when a special allocation is present. Further, the report suggests that if the partnership agreement is unclear as to what the profit ratio is, nonrecourse liabilities should be allocated in proportion to the partners' interests in the partnership, a standard that surely would be difficult to apply.

Perhaps the most significant proposal made by the report is that the regulations under sections 704(b) and 752 be coordinated. As is discussed below, section 704(b) provides a significant roadblock to allocations lacking economic substance. Since liability allocations under section 752 are significant primarily in their effects on partners' ability to deduct losses allocated to them, there is no reason why a loss allocation that passes muster under section 704(b) should be blocked by section 752.

In sum, the New York State Bar report suggests some relief from the problems associated with the present regulations under section 752; the relief, however, like that in the ALI proposal, is inadequate.

Proposal: Flexible Allocation Standard

The difficulties inherent in any scheme that limits partners in the allocation of partnership liabilities are probably insurmountable. The only workable alternative to the present regulations is to permit partners to allocate all liabilities, recourse and nonrecourse, among themselves as they choose, and to permit reallocations on an annual basis.

This suggested standard might seem to be no standard at all, an

[75] *Id.* at 76.

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alternative that would encourage tax avoidance. The only function of section 752, however, is to incorporate certain fundamental tax principles into the partnership context—that is, to give partners basis for liability taken on through the partnership format and to treat liability reductions through a partnership as either reductions of the partners' bases or as gain to be recognized by the partners. The proposed flexible allocation standard would be consistent with this conception of the purpose of section 752. It would limit the total of the outside basis created by inside debt to the sum of partnership liabilities, and would require that any reduction of partnership liability be treated as a distribution to some partner or partners. The basis generating and destroying function of section 752 does not require a policing of the allocation of basis increases and decreases among partners.

The present regulations, and the alternatives suggested by the ALI and the New York State Bar, arrogate to section 752 an additional function: to allocate debt among partners in a way assuring that no partner has a basis for his interest that is greater than the losses he could be called on to bear economically. But, it is the function of section 704(b)—which invalidates any allocation of partnership income, gain, deduction, or loss that lacks substantial economic effect—to deny tax effect to loss allocations that do not square with allocations of economic risk.[76] Section 704(b) performs this task much more effectively and efficiently than allocation regulations under section 752 ever could.

A brief primer on section 704(b) and the regulations promulgated under that provision is needed to develop a fuller understanding of this last point.

Regulations Under Section 704(b)

The present version of section 704(b) was enacted in 1976. Proposed regulations under the provision were issued in 1983;[77] final regulations were not adopted until December 1985.[78]

A governing principle of the regulations is that capital accounts must be maintained and followed.[79] In general, an allocation is valid only if it is reflected as an appropriate increase or decrease in a partner's capital

[76] Also, a loss allocation that is valid under § 704(b) may be made nondeductible, at least temporarily, by the at risk rules of § 465, which limit loss deductions from most investments other than real estate to the amounts taxpayers have at risk in the investments. If allocation rules under § 752 are calculated to closely match each partner's outside basis with the amount of his exposure to economic loss, § 752 also functions as an at risk limitation, and invades the province of § 465 as well as that of § 704(b).

[77] Prop. Reg. § 1.704–1, 1983–1 C.B. 930.

[78] Reg. § 1.704–1, (T.D. 8065 (Dec. 24, 1985)).

[79] *See* Reg. § 1.704–1(b)(2)(ii)(b).

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account and only if, on liquidation, each partner is entitled to a distribution of the amount shown in his capital account. Therefore, a tax allocation of a dollar of income, gain, deduction, or loss to a partner is valid only if it increases or decreases the partner's potential entitlement on liquidation by a dollar. If, for example, depreciation deductions are specially allocated to one partner, section 704(b) invalidates this allocation unless that partner's capital account is reduced by the depreciation allocated to him. As a result, if the depreciation becomes an economic loss, this partner will bear it. Likewise, if a bottom line loss is allocated to one partner, section 704(b) gives effect to the allocation only if this partner bears the loss economically.

An allocation that creates or increases a deficit in the capital account of a partner is valid under the regulations only if any partner with "a deficit balance in his capital account following the liquidation of his interest in the partnership . . . is unconditionally obligated to restore the amount of such deficit balance to the partnership, which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances." [80] If, for example, a special allocation of depreciation to a partner increases a deficit in the partner's capital account, the allocation is valid only if it exposes the partner to the possibility of having to make up this allocation with a cash contribution on liquidation.

In addition to the requirement to follow the capital accounts, the regulations, consistent with the mandate of section 704(b), require that "the economic effect of [an] allocation must be substantial." [81] The regulations further provide that, in general: "The economic effect of an allocation . . . is substantial if there is a reasonable possibility that the allocation . . . will affect substantially the dollar amounts to be received by the partners from the partnership independent of the tax consequences." [82]

Example 7(ii) of the regulations demonstrates the operation of the substantiality requirement. In the example, a two person partnership has invested equal dollar amounts in tax-exempt bonds and corporate stock. One partner is allocated 90% of the first $10,000 of dividend income from the corporate stock and the other partner, who is expected to be in a higher marginal tax bracket, is allocated 90% of the first $10,000 of interest income from the tax-exempt bonds. The allocation is only for the first year of the partnership. All other income of the

[80] Reg. § 1.704-1(b)(2)(ii)(b)(3).
[81] Reg. § 1.704-1(b)(2)(i).
[82] Reg. § 1704-1(b)(2)(iii)(a).

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partnership for the year will be allocated equally between the partners. If at the time the agreement was made "[t]here is a strong likelihood . . . that in the first taxable year of the partnership the partnership will earn more than $10,000 of tax-exempt interest and more than $10,000 of taxable dividends," the allocation is not valid because the "economic effect is not substantial." [83] There is, rather, "a strong likelihood . . . that at the end of the [one] year period to which such allocations relate, the net increases and decreases to the [partners'] capital accounts will be the same with such allocations as they would have been in the absence of such allocations, and that the total taxes of [the partners] will be reduced as a result of such allocations." [84]

The basic point of the regulations is that tax allocations must be matched with economic consequences. Generally, a tax item (that is, an item of gross income, deduction, or loss) is mirrored, at least potentially, by an economic consequence. A tax loss, for example, is a deduction for an economic loss that either has occurred or could occur in the future. If the loss is incurred by a partnership, the regulations require that the tax deduction be allocated to the partner or partners who bear the economic loss or the risk of economic loss.

This matching of tax and economic consequences is not possible when a deduction or loss is attributable to nonrecourse debt. The proposed regulations provided that a deduction or loss is attributable to nonrecourse debt to the extent of any resulting excess of the debt over the adjusted basis of the property that secures it.[85] Such a loss is borne economically by the nonrecourse lender, but is deductible by the owner of the property that secures the debt. If the property is owned by a partnership, the loss must be allocated among the partners, even though none of the partners bears the economic burden of the loss.

The statutory mandate that no allocation of partnership income, gain, deduction, or credit be given effect unless it has substantial economic effect thus cannot be fully effectuated for losses attributable to nonrecourse debt. The proposed regulations, in their most controversial provisions, generally allowed these losses to be allocated in whatever way the partners choose. The principal limitation on this freedom is that subsequent tax items must be allocated consistently. The final regulations, reflecting the controversy, did not adopt the provisions of the proposed regulations, or any provisions, regarding allocations attributable to nonrecourse debt. The issue thus remains unsettled.

A loss attributable to nonrecourse debt is nearly always matched

[83] Reg. § 1.704–1(b)(5) Ex. 7(ii).
[84] Reg. § 1.704–1(b)(5) Ex. 7(i).
[85] Prop. Reg. § 1.704–1(b)(4)(iv).

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some time in the future by a recognition of an identical amount of income or gain. Assume a partnership purchases a building for $1,000, paying $900 of the price with money borrowed on a nonrecourse basis. Depreciation deductions of $300 are taken, which reduce the adjusted basis of the property to $700. The partnership breaks even in cash flow, and tax losses thus equal the depreciation of $300. If the indebtedness has remained at $900, $200 of the $300 loss is attributable to the nonrecourse debt. It is unlikely that the partnership's investment can be wound up without the recognition of $200 of income or gain to parallel the $200 loss attributable to nonrecourse debt. If the partnership allows the lender to foreclose on the property, for example, the excess of the liability ($900) over the adjusted basis ($700) is gain to the partnership on the foreclosure.[86] If the debt is paid from rents generated by the property, $200 of the $900 will have to be paid from after-tax dollars because only $700 of depreciation remains. Generally, any transaction that eliminates or narrows the gap between the principal amount of the debt and the adjusted basis of the property generates income or gain in like amount.

Very generally, the proposed regulations would require that this income or gain be allocated in the same way as the earlier losses attributable to nonrecourse debt. More specifically, losses attributable to nonrecourse debt would be charged against the capital accounts of the partners to whom the losses were allocated, under the rules described earlier. In addition, any partner with a capital account deficit resulting from an allocation of loss attributable to nonrecourse indebtedness would be allocated income or gain from that property to the extent of the difference between the outstanding principal balance of the nonrecourse indebtedness and the adjusted basis of the property securing that indebtedness.[87]

Relationship of Section 752 to Section 704(b)

Because section 704(b) and the regulations thereunder assure, to the extent possible, that a partner who is allocated the tax deduction for a partnership loss will also bear the economic burdens of the loss, there is no need for a completely separate standard under section 752 to accomplish the same result. Indeed, as indicated by the present state of affairs, separate standards only engender confusion, create serious inconsistency, and fail to reflect economic substance. Just as section 704(b) permits partners to allocate tax items in any manner the partners choose so long as the allocations have substantial economic effect, so, too, section 752

[86] Commissioner v. Tufts, 461 U.S. 300 (1983).
[87] Prop. Reg. § 1.704-1(b)(4)(iv).

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should give partners broad authority to allocate liabilities. It is certainly anomalous that section 752, in conjunction with section 704(d), can deny a partner the immediate benefit of a deduction when it has been determined under section 704(b) that the allocation of the deduction to the partner has substantial economic effect.

Assume *X* and *Y* form a general partnership, each partner contributing $100. The partnership purchases depreciable property for $1,000, paying $800 of the purchase price with a nonrecourse borrowing. The partnership agreement provides for equal sharing of profits and losses, except that a special allocation of all depreciation is made to *X*. Allocations are appropriately reflected in capital accounts. The partnership agreement requires that capital account deficits be made up on liquidation, and allocates to *X* income and gain as required by the rules of the proposed regulations on losses attributable to nonrecourse debt. *X*'s basis for his partnership interest is apparently $500, the sum of his cash contribution and one half of the indebtedness. Once *X* has been allocated $500 of depreciation and loss, *X*'s basis will be zero, and section 704(d) will bar him from further deductions. This will be so even though the allocation of depreciation to *X* satisfies section 704(b). Since the proposed section 704(b) rules on nonrecourse indebtedness treat a partner in the same way as an individual taxpayer, there is no reason why the partners should not have as much freedom in allocating liabilities as they do in allocating depreciation and losses. Given this freedom, *X* could be allocated the entire debt, giving him a $900 basis that would support most of the depreciation deductions.

Y, the other partner, is not harmed by this allocation of the liability to *X*. While it would leave *Y*'s basis at $100, the amount of his contribution, *Y* is not allocated income, gain, or loss associated with the nonrecourse indebtedness. *Y* thus does not bear the burden imposed on taxpayers who benefit from deductions associated with nonrecourse indebtedness.

Given the existence of a partnership liability, indicating that for tax purposes an investment has been made by the partnership, the flexible allocation standard essentially proposes that it is for the partners to decide among themselves who has made the investment, bears its burden, and receives its benefit. The policy goal of restricting trafficking in losses is adequately served by section 704(b), and would not be undermined by the flexible allocation standard.

Application of Flexible Allocation Standard

The following hypotheticals demonstrate the application of the suggested flexible allocation standard in a variety of situations:

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Hypothetical 1

G is the general partner and *L* is the limited partner of the *GL* limited partnership. As a result of partnership operations and distributions, *G* and *L* each have capital accounts of zero and zero bases for their partnership interests. The partnership borrows $200 on a recourse note, and uses the borrowing to construct a building. *G*, the general partner, is personally liable on the debt. *L* has no personal liability. The loan, however, is secured by the building, which has a value greater than the principal amount of the loan, and it is expected that the cash flow from the building will be sufficient to service the loan. The partnership agreement entitles *L* to all depreciation deductions. The agreement also requires that capital accounts be followed on liquidation, and requires *L* to restore any deficit in his capital account that exists when the partnership liquidates. Partner *G*, however, bears the risk of any decline in the building value in excess of allowable depreciation deductions.

Under section 1.752–1(e) of the regulations, none of the $200 liability is allocated to *L* because the liability is recourse and *L* has no obligation to contribute further to the partnership.[88] *L*'s basis, therefore, remains zero. The allocation of the depreciation deductions to *L* is valid under section 704(b), but, because *L* has a zero basis, section 704(d) prevents *L* from taking the deductions currently. The deductions will be held in abeyance until *L* has a basis in his partnership interest. That the debt is adequately secured by the building and that the cash flow of the partnership will be used to service the debt does not change the result.

The proposed flexible allocation standard would permit results more consistent with the agreement of the partners. Even though the liability is recourse and *L* has no fixed obligation to contribute further, *L* could be allocated the entire liability, giving him a basis of $200. With this basis, *L* could immediately use the depreciation deductions.

The deductions would put *L*'s capital account into deficit. The partnership agreement would make *L* liable to *G* to restore the capital account to zero in the event of liquidation. In effect, *L* would agree to indemnify *G*, to the extent of *L*'s capital account deficit, for amounts that *G* might be required to pay on the recourse indebtedness. If, for exam-

[88] The partnership agreement obligates *L* to contribute to the partnership in the event of liquidation to make up any deficit then existing in *L*'s capital account. Arguably, this is an obligation to contribute that entitles *L* to share in recourse debt under the present regulations. The Service, however, would doubtlessly regard this obligation as too contingent to justify any such participation. See TAM 8404012 and TAM 8421004, discussed in the text accompanying notes 33–40. *See also* Pritchett v. Commissioner, 85 T.C. 580 (1985).

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ple, the indebtedness were foreclosed, and *G* had to satisfy a deficiency judgment, *L*'s obligation to restore the deficit in his capital account would make *G* whole, except to the extent the deficiency exceeded the deficit. Thus, *L* is indirectly liable on the recourse liability to the extent of the deficit, even though *L* is not personally liable to creditors. *G*'s liability may be more apparent than real.[89] The basis increase associated with the recourse liability is appropriately *L*'s and not *G*'s.

Assume that after *L* deducts $100 of depreciation on the building, the partnership sells the property for its book value of $100, and liquidates. Assume $200 remains owing on the loan. *L*'s capital account is $100 in deficit, and, under the partnership agreement, *L* must contribute this amount to the partnership. This $100 and the $100 proceeds of the sale would be paid to the creditor. After restoring the $100, *L*'s capital account, like *G*'s, would be zero. Neither partner would receive anything in the liquidation. *L*, having benefited from the depreciation deductions, would also have borne the economic burden of the depreciation.

This hypothetical demonstrates several important aspects of the flexible allocation standard. First, the standard enables *L* to use deductions which, under section 704(b), are validly allocated to him. Under the existing regulations, the allocation of the deductions, although proper under section 704(b), is rendered useless by sections 752 and 704(d).

Second, the flexible allocation standard produces results reflective of economic substance because *L* bears the economic burden associated with the deductions allocated to him. When the tax depreciation is matched by economic depreciation, *L* suffers a dollar of economic loss for every dollar of deduction allocated to him. Even though *G* is personally responsible for the loan, the allocation of the liability to *L* is economically sound, given *L*'s obligation to restore deficits in *L*'s capital account. Section 704(b), as interpreted by the regulations, assures that when a partnership has a loss attributable to a recourse borrowing, the partner to whom the loss is allocated bears, at least indirectly, the economic burden of the debt. Any allocation of liabilities that parallels the partner's allocations under section 704(b) thus necessarily has economic substance.

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[89] *G*'s liability, of course, is not always illusory. If the building burned down uninsured the day after purchase, *L* would have no depreciation deductions, no capital account deficit, and the loss would be borne by *G*. Indeed, if for whatever reason the building declined in value in excess of allowable depreciation deductions, *G* bears a real risk of loss. Nonetheless, the possibility that *G* might, in some circumstances, bear the loss should not obscure the genuine liability *L* takes on as depreciation deductions are passed through to *L* and his capital account becomes negative.

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Hypothetical 2

G and *L* form a limited partnership, each contributing $100. The partnership purchases a building for $400, borrowing $200 of the purchase price without recourse and giving a mortgage on the building as security. Income, gains, deductions, and losses will be shared equally, except that the first $300 of depreciation will be allocated to *L* and the balance of the depreciation will be allocated to *G*. Gain on a disposition of the building will be allocated first to each partner in amounts equal to the depreciation previously allocated to him. The partnership agreement also requires each partner to make up any deficit in his capital account on liquidation, except to the extent the deficit results from allocations of depreciation deductions attributable to nonrecourse debt.

Assume the flexible allocation standard is in effect, and the partners agree to allocate the liability to *L*. As a result, *L*'s basis is $300, while *G*'s basis is $100. *L*'s capital account is $100. Assume *L* takes $300 in depreciation deductions. If the principal amount of the debt remains at $200, the last $100 of these deductions is attributable to nonrecourse debt, under the definition of the proposed regulations, because it causes the adjusted basis of the property to fall $100 below the amount of the debt. *L*'s basis is reduced to zero and his capital account to a negative $200. The remaining $100 of depreciation deductions (all attributable to nonrecourse debt) would be allocated to *G* under the agreement.

But, assume the partnership sells the property for $200, and liquidates before any depreciation is allocated to *G*. Gain on the sale is $100. All of the gain is attributable to the nonrecourse debt. Because $100 of *L*'s capital account deficit was caused by the allocation to him of depreciation attributable to nonrecourse debt, the proposed regulations provide that the gain, all being attributable to nonrecourse debt, must be allocated to *L*.[90] This raises *L*'s basis to $100 and his capital account to negative $100. Because this $100 of deficit is not attributable to nonrecourse debt, the partnership agreement requires that *L* make it up with a $100 contribution to the partnership. This contribution raises *L*'s basis to $200 and his capital account to zero. When the $200 debt is paid, the payment is treated as a distribution of $200 to *L*, reducing *L*'s basis from $200 to zero. After payment of the debt, the partnership has $100 of cash, which is distributable to *G* in payment of the balance in his capital account. The distribution reduces *G*'s basis to zero. Neither *G* nor *L* recognizes gain or loss on liquidation.

In sum, *L* contributes $100 at the outset, takes depreciation deductions of $300, reports $100 of gain, and contributes an additional $100 to make up his capital account deficit on liquidation. The $300 of de-

[90] *See* Prop. Reg. § 1.704-1(b)(4)(iv).

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preciation deductions consist of $100 attributable to his own contribution, $100 attributable to *G*'s contribution,[91] and $100 attributable to nonrecourse liability. The allocation of the first $200 of these deductions is matched by an economic loss of $200, consisting of the $100 contributed on the organization of the partnership and $100 contributed to make up the capital account deficit on liquidation. The last $100 of the depreciation allocation is matched by an allocation of $100 of gain. The flexible allocation standard, when limited by the rules under section 704(b), produces results which are economically sound and are consistent with general tax principles.[92]

The present regulations would presumably require that some of the nonrecourse debt, perhaps one half of it, be allocated to *G*. This would have the effect of limiting *L*'s beginning basis to something less than $300, and would thus effectively deny him the benefit of some of the depreciation allocated to him. The provisions of the partnership agreement required to give validity to the allocation under section 704(b), however, expose *L* to either a risk of economic loss or the certainty of a future allocation of income or gain each time depreciation is allocated to him. These provisions give economic substance to the arrangement. The additional restraints imposed under the present regulations by sections 752 and 704(b) are arbitrary, and make the law less reflective of economic substance, not more. No revision of the section 752 regulations, short of an adoption of the flexible allocation standard, would alleviate this arbitrariness.

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[91] This is so because (1) the first $200 of depreciation is attributable to the partnership's equity in the property and hence to the partner's $200 of contributions, (2) *L* is allocated all of the first $200 of depreciation, and (3) *L* is thus allocated the depreciation attributable to the contributions of both himself and *G*.

[92] The flexible allocation standard, however, would not guarantee that allocations valid under § 704(b) would never be frustrated by § 704(d). If *L* were allocated all $400 of the depreciation on the property, the allocation of the last $100 could be valid under § 704(b), but would be blocked, at least temporarily, by section 704(d), even under the flexible allocation standard. Under this standard, *L*'s basis cannot exceed $300, the sum of his $100 contribution and the liability of $200. The regulations under § 704(b) effectively allow the benefit of *G*'s contribution to be assigned to *L* for purposes of allocations of deductions and losses. *See supra* note 91. No existing provision, however, allows one partner's contribution to be assigned to another partner for basis purposes.

If *L* is obligated to restore a deficit in his capital account, there is no conceptual reason to preclude the partners from giving *L* rather than *G* basis for *G*'s contribution. Indeed, *G*'s contribution could be restructured either as a loan to *L*, who thereupon contributes the money to the partnership, or as a loan to the partnership with the resulting partnership liability allocated entirely to *L* under the flexible standard. In either case, *L* would achieve sufficient basis for § 704(d) purposes. However, while it may be conceptually appealing to permit one partner to loan his basis due to contribution to another partner, such a proposal is beyond the scope of § 752 and of this article.

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Reallocations

The flexible allocation standard, in addition to giving complete freedom in the initial allocation of liabilities among the partners, would also freely allow reallocations of liabilities in subsequent years. It would therefore enable partners to direct basis increases and decreases from time to time where they would do the most good. This subsequent shifting may seem more problematical than the initial allocations of liability demonstrated in Hypotheticals 1 and 2. Consider the following hypothetical:

Hypothetical 3

GL is a limited partnership in which *G* is the general partner and *L* is the limited partner. The partnership agreement allocates all losses to *L* for five years, and provides for equal sharing of subsequent profits and losses. The agreement contains all the provisions necessary to make these allocations valid under section 704(b). Pursuant to the flexible allocation standard, the partners allocate a $500 recourse liability to *L*. Partnership losses are incurred during the first five years that reduce *L*'s basis for his partnership interest to zero, and leaves him with a deficit of $250 in his capital account. None of the $500 liability has been repaid.

The flexible allocation standard would allow the partners to reallocate the liability. If they agreed to reallocate the liability to *G*, for example, *G*'s basis would be increased by $500. The objection might be made that the reallocation would allow *G* to deduct an additional $500 of loss; that is, it would allow the liability to be used a second time in supplying basis to support loss deductions. The $500 liability would support $1,000 of loss. Once *G* deducted the additional $500 of loss, furthermore, the liability could be reallocated to *L*, giving him $500 of basis and allowing him to deduct another $500 of loss. By a series of well timed reallocations, the $500 liability could be passed back and forth between the partners to become the foundation of loss deductions of infinite magnitude.

The objection, however, is premised on an accounting impossibility. Partnership losses, net of partnership profits, can never exceed the sum of the partners' contributions and partnership liabilities. Once net losses equal the sum of the contributions and liabilities, there can be no more losses until the contributions or liabilities are increased. Thus, a reallocation of a liability that has been used as the basis for a loss deduction would only create useless basis.

To illustrate, suppose *G* and *L* each contribute $50 to the *GL* partnership when it is organized. The partnership buys depreciable property for $600, paying the price with the money contributed by the partners

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and $500 borrowed on a recourse basis. During the first five years, when losses are only allocable to *L*, the partnership has losses of $550. If the liability is initially allocated to *L* under the flexible allocation standard, the losses equal *L*'s beginning basis, and are fully deductible.

Assume the liability is reallocated to *G* for the sixth and subsequent years. The reallocation raises *G*'s basis to $550, and would seem to set the stage for deductions by *G* of up to $550 of subsequent losses. If the partnership acquires no liabilities beyond the $500 borrowed to purchase the property, however, subsequent losses cannot exceed $50. Assume, first, that the partnership breaks even in cash flow, and that partnership losses consist of depreciation. Only $600 of depreciation is allowable over the life of the property. *L* took $550 of this depreciation, and only $50 remains for *G*. Assume, second, that the partnership has cash flow losses, and that the tax losses include both depreciation and cash flow losses. The losses subsequent to the fifth year are not limited to $50 in this case, but each dollar of cash flow loss must be financed either by contributions from the partners or by partnership debt. A partnership cannot lose money that it neither has nor owes. The losses subsequent to the fifth year, therefore, cannot exceed the sum of $50 and the new liabilities incurred. The losses could be made fully deductible to *G* by allocating the new liabilities to him; the reallocation of the original $500 liability is not necessary or even helpful.

Assume *G* arranges to sell his interest for $250 at the beginning of the sixth year. The basis of his interest is $50, the amount of his contribution. His gain on the sale is $200. But, suppose $200 of the partnership liability is reallocated to *G* just before the sale. Would the reallocation give *G* basis sufficient to wipe out the gain? No, because a partner's share of partnership liabilities is included in the amount realized on the sale of his partnership interest.[93] After the reallocation, *G*'s amount realized is $450 (the sum of the selling price of $250 and the liability share of $200), and the gain remains at $200.

Thus, a reallocation of a liability already used by a partner as the basis for a loss deduction creates no opportunity for manipulation whether the partner to whom the liability is reallocated is contemplating an allocation of partnership loss or a disposition of his interest.

Further, such a reallocation entails a real cost to the partner from whom it is allocated. When the $500 liability is reallocated from *L* to *G*, section 752(b) treats *L* as having received a distribution of $500 cash. *L*'s basis at the time of the deemed distribution is zero. Under section 731(a)(1), any excess of a money distribution over the basis of the distributee's interest is recognized as gain. Therefore, *L* recognizes gain of $500.

[93] I.R.C. § 752(c).

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Liability reallocations, if allowed as proposed under the flexible allocation standard, thus could not be used as tools of manipulation. Rather, reallocations would be useful only as mid-course corrections. If an allocation of liability were made to allow a particular partner to absorb anticipated losses or deductions, but the losses or deductions proved to be less than expected, for example, a reallocation could be made so that liability would not be stranded in the basis of a partner who could never use it. To deny the right to reallocate would simply be to provide a bonus for partners whose prognostications of the future come closest to realization. No rational tax policy requires such a bonus.

If the flexible allocation standard were adopted to only apply to initial allocations, and there was no right to reallocate, furthermore, the prohibition on reallocations would be difficult to enforce. A shifting of the allocation could often be achieved by the simple expedient of refinancing the liability, if necessary with a different creditor.

In sum, even in the context of reallocations, the flexible standard produces economically sound results. The standard is simple, and negates the inconsistences between the operation of sections 752 and 704(b). Most importantly, it resolves the many problems associated with the current regulations. The flexible allocation standard offers the opportunity to avoid the tax consequences of present law that serve no sound tax policy; the ability to make reallocations as events unfold should also serve to offset to a considerable degree the untoward tax consequences that an initial allocation may threaten.

Failure to Allocate

Adoption of the flexible allocation standard would necessitate a rule for situations where the partners either neglect to determine the allocation of a liability, or are unable to reach agreement on an allocation. There are several potential solutions to the allocation issue in the absence of partnership agreement. One approach would be to apply the existing regulations.

Alternatively, the regulations could be amended to provide—as the regulations under section 704(b) do with respect to special allocations that lack substantial economic effect—that the allocation be made in accordance with the partners' interests in the partnership, with a rebuttable presumption that those interests are equal. Any arbitrariness and uncertainty such a rule would entail, although undesirable, could be defended on the grounds that it is within the partners' power to avoid such a result.

As yet another alternative, the regulations could say that in the absence of agreement under the flexible allocation standard, the bar of section 704(d) should be minimized by allocating liabilities at year's

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end to those partners with negative capital account balances. Any excess liabilities could then be allocated among all the partners in accordance with their loss sharing ratios, which reflects the approach of the existing regulations. Such a position would serve to minimize harm to partners who do not reach agreement, while preserving the flexible standard for those partnerships that do reach agreement.

Conclusion

The Tax Reform Act of 1984 requires that the Treasury "prescribe regulations relating to liabilities, including the treatment of guarantees, assumptions, indemnity agreements, and similar arrangements." [94] The conference report states that the revision "should be based largely on the manner in which the partners share the economic risk of loss with respect to partnership debt, other than bona fide nonrecourse debt. With respect to nonrecourse debt, the conferees do not expect that the regulations will make major changes to the manner in which the partners' shares are determined, but may attempt to provide more certainty than presently exists." [95]

The flexible allocation standard proposed here obviously was not contemplated by the conferees. The conference report, on the contrary, refers to the distinctions of the present regulations between recourse and nonrecourse debt and between general and limited partners. Nonetheless, there is no conflict between the statutory mandate for new section 752 regulations, and the flexible allocation standard.

Indeed, in substance, there is essential harmony between the two. The principal message of the conference report is that allocations of partnership liabilities, in order to be respected for tax purposes, should reflect the partner's economic risk of loss. The flexible allocation standard appropriately leaves to section 704(b) the determination of whether tax allocations are sufficiently imbued with economic risk. Permitting the flexible standard to determine basis does not impinge on the requirement that tax losses or deductions have economic substance. The emphasis the present regulations place on the distinctions between recourse and nonrecourse debt, and general and limited partners, is not required by statute. The need to revise those regulations creates an opportunity to achieve simplicity and certainty under section 752, fully consistent with the directive to ground those regulations in the stuff of economic substance.

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[94] Pub. L. No. 98-369, § 79(b), 98 Stat. 494, 597 (1984).

[95] H.R. REP. No. 861, 98th Cong., 2d Sess. 869 (1984), *reprinted in* 1984-3 C.B. (vol. 2) 123.

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