5000 BASIS & LIABILITIES

5010 BASIS

A partnership has an adjusted basis in its assets. This basis is sometimes referred to as "inside basis." The amount of its adjusted basis in its assets is significant in a variety of situations, including in the computation of the amount of gain or loss realized by the partnership upon the sale of an asset.

A partner's basis in a partnership interest is commonly referred to as a partner's "outside basis". This is one of the most important concepts in partnership taxation. The determination of outside basis is significant in the determination of the following:

- the tax consequences of distributions from the partnership,
- the gain or loss reportable on a disposition or liquidation of a partnership interest,
- the deductibility of losses passed through from the partnership to the partners,
- the basis of property distributed to a partner.

Generally, the aggregate of the partners' adjusted basis in their partnership interest (outside basis) equals the aggregate of the adjusted basis of partnership assets (inside basis). There are, however, events that may cause a difference between inside and outside basis. These events include:

- Sale or exchange of a partnership interest or inheritance of a partnership interest,

- Distribution which requires partner to recognize a gain or loss,
- Decrease in basis of a distributed partnership asset on a current distribution or increase/decrease in basis of a distributed partnership asset on a liquidating distribution.

A partner is only required to compute his basis in his partnership interest if the computation is necessary in the determination of his tax liability. [Treas. Reg. § 1.705-1(a)(1)] Ordinarily, basis computations are necessary in the following circumstances:

- to determine the deductibility of the partner's share of a loss from a partnership;
- upon liquidation or disposition of a partner's interest, in order to determine the amount of gain or loss;
- upon the distribution of cash or property to a partner, in order to ascertain the basis of the property received or the taxability of the cash distribution.

The basis of a partner's interest is initially determined under IRC § 722 or 742 ("initial basis") and then adjusted each year for the partner's distributive share of partnership items, additional contributions, and distributions ("determination of basis of partner's interest"). [IRC § 705].

5020 CALIFORNIA CONFORMITY TO BASIS, LIABILITIES AND AT RISK

In general, California Revenue and Taxation Code § 17851 conforms to Subchapter K. California also conforms to IRC § 465 with California Revenue and Taxation Code § 17551. If there are areas of non-conformity, they will be discussed in each particular section of this manual.

5030 INITIAL BASIS

A partner's initial basis for his partnership interest is determined pursuant to IRC § 722 if the interest acquired is a result of a contribution to the partnership, or pursuant to IRC §742 if the interest is acquired other than by contribution. IRC § 722 provides that the initial basis of an interest acquired by contribution is the sum of:

- the amount of money and,
- contributor's adjusted basis in any property contributed at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time. (See PTM 5100)

Note: For purposes of IRC § 722 contribution of money includes a partner's assumption and share of partnership liabilities, which is treated as a cash contribution under IRC § 752(a). [Treas. Reg. § 1.722-1] (See PTM 5400)

IRC § 742 provides that if a partnership interest is acquired by means other than contribution (i.e. purchase, gift, or inheritance), the initial basis is determined by referencing to IRC § 1011 and following. (See PTM 5130)

5040 ADJUSTMENTS TO BASIS-INCREASES

A partner's initial basis for his partnership interest is increased by his distributive share of the following:

- partnership taxable income as determined under IRC § 703(a) [IRC § 705(a)(1)(A)],
- tax-exempt income of the partnership [IRC § 705(a)(1)(B)],
- excess of partnership deduction for depletion over the basis of the property subject to depletion [IRC § 705(a)(1)(C)],
- capital contributions made by a partner at any time during the year [Treas. Reg. § 1.705-1(a)(2)] (the partners basis will be increased by the money contributed or the adjusted basis of the property contributed), and
- any increase in a partner's share of the partnership liabilities, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities [IRC § 752(a)] (See PTM 5400)

When an increase to basis adjustment is made, the starting point is zero even though previous decreases would otherwise have produced a distribution in excess of basis. [*Falkoff, Milton, (1974)* 62 TC 200]

Example:

A owned an interest in LP Partnership. A's adjusted basis in LP was $100 on January 1, 2018. During 2018, the partnership operated at a loss and A's share of the loss was $50 and there was a $150 distribution of cash to A. Since the cash distribution ($150) exceeded A's basis ($100) by $50, A reported a $50 capital gain. A's basis after the cash distribution was $0. A's share of the partnership loss of $50 was suspended under IRC § 704(d) due to insufficient basis. In 2019, A contributed cash of $50. After the contribution, A's basis increased to $50. The suspended losses would then be allowed to be deducted.

- Discharge of partnership liabilities results in partnership taxable income which increases the adjusted basis of a partner's interest in the partnership. [IRC §

705(a)(1)(A)] A basis increase applies even if the partner excludes the cancellation of debt income in accordance with IRC § 108(a)(1).

- A partner's adjusted basis in a partnership interest **should not** be increased by his distributive share of partnership tax deferred income. Income that is tax deferred should not result in a basis increase since such an adjustment allows the income to escape taxation rather than merely deferring it to some point in the future.

5050 ADJUSTMENTS TO BASIS-DECREASES

Generally, a partner's basis for his partnership interest is decreased (not below zero) by his distributive share of the following:

- the amount of any cash distributed to him as provided in IRC § 733 [IRC § 705(a)(2)];
- the basis to him of any property distributed to him by the partnership as provided in IRC § 733 [IRC § 705(a)(2)];
- his distributive share of partnership losses [IRC § 705(a)(2)(A)];
- expenditures of the partnership not deductible in computing taxable income of the partnership and not properly chargeable to the capital account [IRC § 705(a)(2)(B)];
- the amount of his depletion deductions for oil and gas property as provided under IRC § 613A(c)(7)(D) [IRC § 705(a)(3)] and
- reduction of partner's share of liabilities. [IRC § 752(b)]

The adjustments to basis are made before calculating the loss limitation. [Revenue Ruling 66-94, 1966-1 CB 166]

5060 ORDERING AND TIMING OF ADJUSTMENTS

The order in which the various basis adjustments are made can be important in applying the loss limitation rules and the current distribution rules. In general, basis is computed at the end of the partnership tax year. However, if a partner transfers, withdraws or liquidates his interest in the partnership, his basis is adjusted as of the date of transfer, withdrawal, even though his distributive share of income or loss has not yet been determined.

- Income or loss is taken into account at the end of the partnership year ordinarily. [IRC §706(a) and Treas. Reg. § 1.705-1(a)(1)]
- Contributions increase a partner's basis at the time of contribution. [IRC § 722]

- Distributions ordinarily decrease basis at the time the distribution is made. Basis immediately before a partnership distribution is the relevant basis for determining gain or loss on the distribution. [IRC § 705 and Treas. Reg. § 1.705-1(a)(1)]
- Advances or draws of money or property against a partner's distributive share of income are treated as current distributions made on the last day of the partnership tax year. [Treas. Reg. § 1.731-1(a)(1)(ii)]
- Deemed distributions resulting from the decrease in a partner's share of partnership liabilities is treated as if it is made on the last day of the partnership tax year to the extent of the partner's distributive share of income for the partnership taxable year. The amount treated as an advance or drawing of money is taken into account at the end of the partnership tax year. [Revenue Ruling 94-4. 1994-1 CB 195]

Example:
On January 1, 2018, A's basis in his partnership interest is $100 which includes his share of partnership liabilities in the amount of $50. In 2018, the partnership operates at a loss and A's share is $100. This loss decreases A's basis to $0. In 2019, the partnership pays its liability in full. A's share of the partnership liability is reduced to zero and this reduction is treated as a distribution from the partnership on the last day of the partnership's tax year. In this case, A would have a gain in the amount of $50. If the partnership generates income from operations during 2019 and A's share is more than $50, he may not have to recognize a capital gain from the distribution.

Assume on June 30, 2019, the partnership pays its liability in full and in addition, the partnership generates income and A's share of the income is $40. The decrease in A's share of the partnership liability of $50 is deemed a cash distribution to A under IRC § 752(b). To the extent of A's distributive share of income, which is $40, it is treated as a current distribution made on December 31, 2019. The remaining $10 is treated as a cash distribution made on June 30, 2019. Since A's basis immediately before the $10 cash distribution is $0, A must recognize capital gain of $10 under IRC § 731. The cash distribution of $40 on December 31, 2019 is not taxable to A because A's share of the partnership income increases A's basis from $0 to $40, which gives A sufficient basis to take the distribution tax-free.

5100 CONTRIBUTIONS OF PROPERTY

PTM 5110 Contributions in General

5110 Contributions in General

The basis of an interest in a partnership acquired by a contribution of property to the partnership is:

- the contributing partner's adjusted basis of such property at the time of contribution
- increased by any gain recognized under IRC § 721(b) at such time [IRC § 722]

Example:
On January 1, 2018, C and L form an equal partnership. C contributes $40,000 in cash and L contributes unencumbered property with a fair market value of $40,000 and an adjusted basis of $20,000. C's initial basis in her partnership interest is $40,000 (the amount of cash contributed) and L's initial basis in his partnership interest is $20,000 (his adjusted basis in the contributed property)

5120 Contribution of Encumbered Property

If a partner contributes encumbered property to a partnership, the partnership is treated as having assumed the liabilities, to the extent that the liabilities do not exceed the fair market value of the property at the time of contribution. [Treas. Reg. § 1.752-1(e)]

A contribution of encumbered property results in both a decrease and an increase in the contributing partner's share of liabilities:

- Under § 752(b), the partnership's assumption of the contributing partner's liabilities that the contributed property is subject to is treated as a deemed cash distribution from the partnership to the contributing partner.

- Simultaneously, the increase in the contributing partner's share of partnership liabilities as a result of the assumption of the encumbrance by the partnership is treated as a deemed cash contribution from the partner to the partnership under § 752(a).

- The deemed cash distribution and contribution discussed above are netted and only the net change is taken into account in determining the partner's outside basis. [Treas. Reg. § 1.752-1(f)]

***Example 1**:*

A acquired a 20-percent interest in a partnership by contributing property. At the time of A's contribution, the property had a fair market value of $10,000, an adjusted basis to A of $4,000, and was subject to a mortgage of $2,000. Payment of the mortgage was assumed by the partnership. The basis of A's interest in the partnership is $2,400, computed as follows:

Adjusted basis to A of property contributed	*$4,000*
Less portion of mortgage assumed by other partners which must be treated as a distribution (80 percent of $2,000)	*1,600*
Basis of A's interest	*$2,400*

See Treas. Reg. § 1.722-1 Example (1)

The contributing partner may be required to recognize taxable gain on the contribution if the deemed cash distribution exceeds the contributing partner's basis in his partnership interest. [IRC § 731(a)(1); § 741] (See PTM 4100)

Gain recognized upon a contribution of encumbered property does not result in an increase in the contributing partner's basis in the partnership, since the gain results only from a deemed cash distribution to the partner in excess of his basis in the partnership. [Revenue Ruling 84-15, 1984-1 CB 158]

Observation:
A typical contribution of encumbered property results in a decrease in the contributing partner's initial basis equal to the liability allocated to all other partners.

5130 Other Acquisitions of Partnership Interests

Generally, the basis of a partnership interest acquired by purchase is its cost.

If a partner pays cash for his interest, his initial basis in his interest is the amount of cash paid.

PTM 5131 Acquisition of Partnership Interest from a Decedent
PTM 5132 Acquisition of Partnership Interest by Gift
PTM 5133 Other Acquisition Issues

5131 Acquisition of Partnership Interest from a Decedent

The initial basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of death.

In a community property state (like California), an interest in a partnership is considered owned by both husband and wife. [Revenue Ruling 79-124, 1979-1 CB 224] For Federal purposes, if a spouse, who is the partner in the partnership, dies, the surviving spouse's basis in the entire inherited partnership interest will be the fair market value of the interest at the date of death as provided by IRC § 1014(a). The result is a stepped up basis in the entire partnership interest. The result may be different for California purposes depending on the date of death. The surviving spouse may not have a stepped up (or stepped down) basis regarding his or her own one-half interest in the partnership.

The successor's basis is increased by its allocable share of liabilities and decreased by items constituting income in respect of a decedent. [Treas. Reg. § 1.742-11; IRC § 1014(a)]

5132 Acquisition of Partnership Interest by Gift

Generally, a partnership interest acquired by gift is the donor's adjusted basis in the interest prior to the transfer.

For purposes of determining loss realized at the disposition of the interest, the donee's basis is limited to the fair market value of the interest at the time of the gift. [IRC § 1015(a)]

5133 Other Acquisition Issues

A lender who took a partnership interest in exchange for canceling the unpaid balance of the indebtedness, had a basis in the partnership equal to fair market value of the partnership interest. The value of the basis is based on the facts that the transaction was at arm's-length and that the partnership had been enjoying profits at the time, was held to be equal to the amount of the unpaid debt. [*Sargent, Estill*, (1970) TC Memo 1970-214] However, where the lender could not establish a fair market value for the partnership interest because of the financial condition of the partnership, his basis was held to be zero. [*Shaheen, George*, (1982) TC Memo 1982-445]

5200 DISTRIBUTIONS

5210 Distributions of Cash

- As a general rule, neither the partnership nor the partner recognizes gain or loss on a distribution of money or property in a current or liquidating distribution. (See PTM 6100 and PTM 6200 series)

- Cash distributions reduce a partner's basis by the amount of the distribution (**not below zero**). Non-taxable cash distributions are limited to a partner's basis in his partnership interest. If the distribution exceeds a partner's interest, a gain or loss must be recognized.

Example:
On January 1, 2018, C's adjusted basis in his partnership interest is $25,000. During the course of the year, the partnership makes a cash distribution to C in the amount of $40,000. Since the distribution exceeds C's basis, the difference between his adjusted basis and the distribution is a capital gain. In this case, the capital gain is equal to $15,000 ($25,000 adjusted basis less $40,000 cash distribution) and his adjusted basis in his partnership interest is $0. If the distribution had been only $20,000, C would recognized no gain and his adjusted basis in his partnership interest would be decreased to $5,000 ($25,000 adjusted basis less $20,000 cash distribution)

5220 Distributions of Property: Non-Liquidating

- In a non-liquidating distribution, the partner's adjusted basis is decreased by the amount of money distributed and by the partner's adjusted basis in property distributed to him. [IRC § 733]

- Generally, a partner's basis in property distributed by a partnership is equal to the partnership's adjusted basis in the property immediately preceding the distribution. [IRC § 732(a)(1); Treas. Reg. § 1.732-1(a)]

- A partner's basis in distributed property is limited to the partner's adjusted basis in his partnership interest immediately preceding the distribution (decreased by any money distributed in the same transaction). [IRC § 732(a)(2); Treas. Reg. § 1.732-1(a)]

Example:
On January 1, 2018, partner A has a $20,000 adjusted basis in his partnership interest. During the year, the partnership distributes in a non-liquidating distribution, $10,000 cash and property with a fair market value of $15,000 and an adjusted basis to the partnership of $12,000. A's basis in his partnership interest is first reduced to $10,000 ($20,000 adjusted basis less $10,000 distribution). A's adjusted basis in the distributed property is limited to $10,000 that is his adjusted basis in his partnership interest immediately before the property distribution. The $10,000 distribution of property further reduces his adjusted basis in his partnership interest to $0 ($10,000 adjusted basis after cash distribution less $10,000 property distribution).

5230 Distributions of Property: Liquidating

- Generally, no gain or loss is recognized by either the partnership or the partner on a liquidating property distribution.

- A partner's adjusted basis in his partnership interest is decreased to $0 when property is distributed.

- If a partnership distributes property (other than money) to a partner in liquidation of a partner's entire interest in the partnership, the partner's basis in the distributed property (other than money) is equal to the partner's adjusted basis in his partnership interest reduced by the amount of any money distributed to him in the same transaction immediately preceding the distribution . [IRC § 732(b); Treas. Reg. § 1.732-1(b)]

- Since a liquidating distribution is a distribution in complete liquidation of a partner's interest; there is no need to determine the distributed partner's adjusted basis in his partnership interest after the distribution.

Example:
On January 1, 2018, Partner B has a $20,000 adjusted basis in her partnership interest. During 2018, the partnership distributes to B in liquidation of her entire partnership interest, $5,000 cash and a building with a fair market value of $75,000 and an adjusted basis of $40,000. B's distribution of cash first reduces her basis to $15,000 ($20,000 adjusted basis less $5,000 cash distribution). B's basis in the building is $15,000 which is the adjusted basis of her partnership interest after the cash distribution. There is no gain or loss reported on this transaction.

5240 Alternative Computation of Basis

- Under certain circumstances, the adjusted basis of a partner's interest in a partnership may be determined by reference to his proportionate share of the adjusted basis partnership property upon a termination of the partnership. [IRC § 705(b)]

- The alternate rule may be used for determining a partner's basis if the partner cannot practicably apply the general rules of IRC § 705. [Treas. Reg. § 1.705-1(b)]

- When the indirect method of basis calculation is used, the partnership assets should first be reduced by total partnership liabilities and each partner's basis must be determined under the indirect determination rule. Liabilities must then be reallocated among the partners using the liability allocation rules. [Treas. Reg. § 1.705-1(b) Example 3]

- If the alternative rule is used, a partner's adjusted basis may need to be adjusted to reflect discrepancies between the partner's share of the adjusted basis of partnership property and the partner's adjusted basis in the interest. [Treas. Reg. § 1.705-1(b)] These discrepancies may result from property contributions or distributions, or transfers of partnership interests.

Example:
A, B and C are equal partners in a partnership. On January 1, 2018, the partnerships assets consist of a building with an adjusted basis of $50,000 and $10,000 in cash. The total basis of partnership property is $60,000. Each partner's share of the adjusted basis of the partnership's property is $20,000 ($60,000 x 1/3). If the alternative rule is used, each partner's basis in his partnership interest is $20,000.

5300 BASIS VS. CAPITAL ACCOUNT

PTM 5310 General
PTM 5320 At Risk Limitations-General
PTM 5330 Qualified Nonrecourse Financing
PTM 5340 At Risk Recapture

5310 General

- Capital accounts are intended to keep track of partners' contributions, distributions and allocations. The capital account is separate and distinct from his adjusted basis in his partnership interest. [Treas. Reg. § 1.705-1(a)(1)]

- Capital accounts are kept using "book" accounting whereas basis is kept using "tax" accounting.

- A partner's capital account does not reflect the partner's share of partnership liabilities.

- Upon occurrence of certain events (contributions, distributions), partnership property is accounted for at fair market value for book purposes (in the partner's capital account) regardless of whether fair market value differs from basis.

- Capital accounts can be negative whereas basis can **never** fall below zero.

Example:
B contributes unencumbered property to a partnership. His partnership interest is increased by his adjusted basis (under IRC § 722) in the contributed property, but his capital account is increased by the fair market value of the contributed property.

5320 At Risk Limitations-General

Under IRC § 465, a partner may deduct losses from business and investment activities only to the extent of the aggregate amount that the partner is at risk. The at risk rules are designed to prevent the deduction of "artificial losses" when the taxpayer is protected from suffering an actual out of pocket loss.

The amount at risk for an activity includes:

- the amount of money and the adjusted basis of other property contributed to the partnership with respect to the activity. [IRC § 465(b)(1)(A)]

- amounts borrowed with respect to the activity. [IRC § 465(b)(1)(B)] This includes borrowed amounts which the partner is personally liable [IRC § 465 (b)(2)(A)] or must have pledged his own property (other than that used by the partnership) as security for the repayment of the borrowed amounts. [IRC § 465(b)(2)(B)]

- "Qualified nonrecourse financing". Generally qualified nonrecourse financing is included as an "amount at risk" if it meets all of the tests below. (see PTM 5330) [IRC § 465(b)(6)]

If a partner cannot deduct partnership losses because of the at risk limitations, the losses can be carried forward indefinitely. The losses become deductible when the partner has a sufficient amount at risk to deduct the losses.

In general, a taxpayer is not at risk for the amount of any nonrecourse loan.[17]

A taxpayer is not considered at risk with respect to amounts borrowed in connection with certain activities if funds are borrowed from a person who has an interest in such activity other than a creditor interest. [IRC § 465(b)(3)]

The at risk rules apply to any interest acquired after 1986 in a partnership, an S corporation, or any other pass through entity holding real property, regardless of when the entity placed the real property in service. [1986 TRA Section 503(c)(2)]

5330 Qualified Nonrecourse Financing

- The funds are borrowed with respect to the activity of holding **real property**. [IRC § 465(b)(6)(B)(i)]

- The funds are borrowed from a "**qualified person**" [IRC § 465(b)(6)(B)(ii)]. This includes any person actively engaged and regularly engaged in the business of lending money who is **not:** a person from whom the property was acquired or a person who receives a fee with respect to the investment in the property.

- No person is personally liable for repayment of the funds [IRC § 465(b)(6)(B)(iii)]. The debt can be bifurcated and considered part qualified and part nonqualified nonrecourse financing.

- For a partnership, **qualified nonrecourse financing** is to be allocated among the partners in accordance with the rules for determining the partners' respective share of liabilities of the partnership. [IRC § 465(b)(6)(C)] The § 752 regulations provide the necessary rules.

- The fact that the loan is secured by real property **does not** automatically mean that it is used with respect to the activity of holding real property:

Example:
Individual A owns and actively manages an equipment rental business. In order to have a place to store and service equipment, she purchases a commercial garage. She uses funds obtained by a nonrecourse loan from a state government agency,

[17] Section 465(b)(2). E.g., Santulli v. Comr., T.C. Memo 1995-458 (taxpayer not at risk on nonrecourse debt because lender could only look at collateral security interest on encumbered property to recover any loss and net assets of initial or subsequent purchasers). In addition, a taxpayer may not be at risk for the amount of any convertible recourse loan that is nearly certain to convert to a nonrecourse loan. See Segal v. Comr., 41 F.3d 1144 (7th Cir. 1994)

secured by the garage. The loan is with respect to the activity of equipment rental, rather than with respect to the activity of holding real property, and the loan therefore cannot be "qualified nonrecourse financing." (If the equipment rental business and the garage can be treated as separate "activities" the result would be different)

5340 At Risk Recaptures

If a partner's amount at risk falls below zero (i.e. as a result of a cash distribution), the partner must recognize gain in an amount equal to his negative amount at risk. [IRC § 465(e)(1)(A)]

The "recaptured" amount under IRC § 465(e)(1)(A) is treated as a deduction which is allowed in subsequent years to the extent that the partner's amount at risk rises above zero. [IRC § 465(e)(1)(B)]

Example:

In Year 1, A's amount at risk in an activity is $100 and sustains a taxable loss of $100. The loss reduces A's amount at risk to $0. In Year 2, A receives $50 cash distribution from the activity, (or if a $50 recourse loan is converted to nonrecourse). Assume no income or loss from the activity in Year 2, A's amount at risk is reduced to negative $50 because of the cash distribution. Under § 465(e), A has recapture of losses income of $50 which must be included in his gross income for Year 2. As a result of the recapture, A's amount at risk is restored back to zero. If A's amount at risk rises to $50 in Year 3, A can deduct the $50 loss carried over from Year 2.

5400 PARTNERSHIP LIABILITIES

One of the most distinctive features of partnership taxation is the treatment of partnership liabilities. In general, when a partner’s share of partnership liabilities increases or when he personally assumes partnership liabilities, he is treated as making a constructive cash contribution to the partnership. Conversely, when a partner’s share of partnership liabilities decreases or when his personal liabilities are assumed by the partnership, he is treated as receiving a constructive cash distribution from the partnership. Therefore, the determination of a partner’s “share” of partnership liabilities, or a relief thereof, is of vital importance in determining his adjusted basis in the partnership interest. This section discusses:

- Types of Partnership Liabilities,
- Allocation Rules,
- Sharing of Recourse Liabilities, and
- Sharing of Nonrecourse Liabilities.

5410 General Rules

- Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption of partnership liabilities by such partner, is treated as a cash contribution by the partner to the partnership. [IRC § 752(a)]

- Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of an assumption of the individual liabilities by the partnership, is treated as a cash distribution by the partnership to the partner. [IRC § 752(b)]

5420 When to Determine Partner's Share of Liabilities

A partner's share of partnership liabilities is required to be determined whenever it is necessary to determine the tax liability of the partner or any other person. [Treas. Reg. § 1.752-4(d)]

A partner's share of partnership liabilities may change constantly due to numerous transactions occurring at the partnership level.

The following transactions may cause a shifting in the sharing of partnership liabilities:

- An entry of a new partner into the partnership,
- Retirement of an existing partner,
- A shift in the allocation of profits or losses, (See PTM 1000)
- Repayment of partnership liabilities,
- Recharacterization of a partnership debt from recourse to nonrecourse or vice versa,
- A partner's status changes from general to limited or vice versa,
- Changes in a partner's obligation to contribute to the partnership, (See PTM 5530)
- Contributions or distributions of encumbered property, (see PTM 5120 and PTM 5220, PTM 5230), and
- A partner becomes "affiliated" with a lender. ***n**:*

For audit purposes, all partnership transactions should be analyzed for potential changes in the partners' share of partnership liabilities and their impact on the partners' adjusted basis in the partnership interests. Many partnership transactions that have nothing to do with partnership liabilities may cause a shift in the sharing of partnership liabilities.

5430 Types of Partnership Liabilities Affecting Basis

PTM 5431	What Constitutes Partnership Liabilities
PTM 5432	Cash Basis Partnerships
PTM 5433	Completed-Contract Method
PTM 5434	Contingent Liabilities
PTM 5435	Option Payments
PTM 5436	Short Sales of Security
PTM 5437	Sham Transactions

5431 What Constitutes Partnership Liabilities

Treas. Reg. § 1.752-1, effective on May 26, 2005 and applicable to liabilities assumed on or after June 24, 2003, except as otherwise noted, defines partnership liabilities by reference to the term "obligation".

Treas. Reg. § 1.752-1(a)(4) defines the types of obligations that constitute partnership liabilities for basis purposes.

There are, essentially, two categories of “liabilities” for purposes of § 752 and the regulations thereunder. In the first category are obligations that are considered liabilities for purposes of § 752 and Reg. § 1.752-1 (referred to as “Reg. §1.752-1 liabilities” or “-1 liabilities”). In the second category are obligations that are considered liabilities for purposes of Reg. § 1.752-7 (referred to as “Reg. § 1.752-7 liabilities” or “-7 liabilities”).

For purposes of § 1.752-1(a)(4) and §1.752-7, an "obligation" means any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code. Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps. [Treas. Reg. § 1.752-1(a)(4)(ii)]

Treas. Reg. § 1.752-1 liabilities:

Under Treas. Reg. § 1.752-1(a)(4)(i) in general, an obligation is a liability for purposes of section 752 and the regulations thereunder (§ 1.752-1 liability), only if, when, and to the extent that incurring the obligation—

(A) Creates or increases the basis of any of the obligor's assets (including cash);
(B) Gives rise to an immediate deduction to the obligor; or
(C) Gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital (i.e. § 705(a)(2)(B) expenditures).

This definition applies to liabilities assumed on or after June 24, 2003 (even though § 1.752-1 generally applies to liabilities assumed on or after December 28, 1991).

Treas. Reg. § 1.752-7 liabilities:

Definition: In general. A §1.752-7 liability is an obligation described in §1.752-1(a)(4)(ii) to the extent that either—

(A) The obligation is not described in § 1.752-1(a)(4)(i); or
(B) The amount of the obligation (under paragraph (b)(3)(ii) of this section) exceeds the amount taken into account under §1.752-1(a)(4)(i). [Treas. Reg. § 1.752-7(b)(3)(i)]

Amount and share of § 1.752-7 liability: The amount of a § 1.752-7 liability (or, for purposes of paragraph (b)(3)(i) of this section, the amount of an obligation) is the amount of cash that a willing assignor would pay to a willing assignee to assume the § 1.752-7 liability in an arm's-length transaction. A partner's share of a partnership's § 1.752-7 liability is the amount of deduction that would be allocated to the partner with respect to the § 1.752-7 liability if the partnership disposed of all of its assets, satisfied all of its liabilities (other than § 1.752-7 liabilities), and paid an unrelated person to assume all of its § 1.752-7 liabilities in a fully taxable arm's-length transaction (assuming such payment would give rise to an immediate deduction to the partnership). [Treas. Reg. § 1.752-7(b)(3)(ii)]

Treas. Reg. § 1.752-7 is effective for liability transfers occurring on or after June 24, 2003, or for any transfer after October 18, 1999 and before June 24, 2003 if an election is made. § 1.752-7(k)(2).

Example:
In 2018, A, B, and C form partnership PRS. A contributes $10,000,000 in exchange for a 25% interest in PRS and PRS's assumption of a debt obligation. The debt obligation was issued for cash and the issue price was equal to the stated redemption price at maturity ($5,000,000). The debt obligation bears interest, payable quarterly, at a fixed rate of interest, which was a market rate of interest when the debt obligation was issued. At the time of the assumption, all accrued interest has been paid. Prior to the partnership assuming the obligation, interest rates decrease, resulting in the debt obligation bearing an above-market interest rate. Assume that, as a result of the decline in interest rates, A would have had to pay a willing assignee $6,000,000 to assume the debt obligation. The assumption of the debt obligation by PRS from A is treated as an assumption of a § 1.752-1(a)(4)(i) liability in the amount of $5,000,000 (the portion of the total amount of the debt obligation that has created basis in A's assets, that is, the $5,000,000 that was issued in exchange for the debt obligation) and an assumption of a § 1.752-7 liability in the amount of $1,000,000 (the difference between the total obligation, $6,000,000, and the § 1.752-1(a)(4)(i) liability, $5,000,000). [Treas. Reg. § 1.752-7(b)(3)(iii)]

***Observation**: § 1.752-7 liabilities are often contingent and include environmental obligations, tort obligations, contract obligations, pension obligations, and various obligations that may arise under derivative financial instruments such as options, forward contracts, futures contracts, and swaps.*

The purpose of IRC § 752 is to maintain a basis relationship (an equality) between the partnership's aggregate basis in its assets (inside basis) and the partners' total basis in their partnership interests (outside basis). Therefore, when a partnership purchases a property and incurs an obligation to the seller as part of the purchasing price, the obligation is part of the partnership's basis in the property and treated as a partnership liability that increases the partners' basis in their partnership interests.

In the same manner, if the partnership borrows money to finance its operations (e.g., paying deductible expenses) or to purchase other assets, the loans are also treated as partnership liabilities.

***Example**:*
A and B are equal partners in partnership AB. A and B each contributes $500 cash to the partnership. The partnership purchases a real property from an unrelated party, paying $1,000 cash and signing a promissory note for $9,000. The partnership's basis in the property is $10,000 which includes $1,000 cash payment and $9,000 obligation. The obligation is also treated as a partnership liability which increases A's and B's basis in their partnership interests by $9,000. Thus, A's and B's aggregate basis in their partnership interests equal the partnership's basis in the property, which is $10,000.

There are certain obligations that give rise to an expenditure but are neither deductible in computing the partnership income nor chargeable to the partners' capital accounts (e.g., premium payment for a general partner's life insurance). These obligations are treated as partnership liabilities since they reduce the partnership's assets (inside basis).

5432 Cash Basis Partnerships

If the partnership uses cash accounting method, accrued but unpaid expenses and accounts payable are not "liabilities of a partnership" or "partnership liabilities" within the meaning of section 752 of the Code for purposes of computing the adjusted basis of a partner's interest in a cash basis partnership. [Revenue Ruling 88-77, 1988-2 CB 129]

5433 Completed-Contract Method

Progress payments received by a partnership using the completed-contract method of reporting construction income do not create partnership liabilities since the partnership has fully earned the payments and is under no obligation to return them or perform additional services to retain them. These payments are characterized as "unrealized receivables" and will increase a partner's basis in the partnership only when they are recognized by the partnership for tax purposes. [Revenue Ruling 73-301, 1973-2 CB 215]

5434 Contingent Liabilities

- A payment obligation (See PTM 5531) is disregarded if, taking into account all the facts and circumstances, the obligation is subject to contingencies that make it unlikely that the obligation will ever be discharged. If a payment obligation would arise at a future time after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs. [Treas. Reg. § 1.752-2(b)(4)]

- Contingent liabilities and claims are not treated as partnership liabilities for the purposes of IRC § 752 because they do not create basis. [*Albany Car Wheel Co., Inc.*, 333 F.2D 653]

- Contingent or contested liabilities will become partnership liabilities when they become fixed or liquidated. [*Marshall Long*, 71 TC 1 (1978)] "It is settled by many decisions that a taxpayer may not accrue an expense the amount of which is unsettled or the liability of which is contingent…" [*Security Flour Mills Co. v. Comr.*,321 US 281, 284 (1944)]

- To determine whether or not a liability is contingent, both cash basis and accrual basis partnerships have to use the "all events" test. [*Joseph W. LaRue*, 90 TC 465, (1988)] This test requires that (1) all events must have occurred to fix the fact of the liability and (2) the amount of the liability must be determinable with reasonable accuracy. [IRC § 461(h)(4)]

5435 Option Payments

Prior to promulgation of Treasury Regulation section 1.752-1(a)(4) – Liability Defined, payment received under an option agreement are not liabilities under section 752 because a partnership's obligation under the option does not become fixed until the option is exercised. [*George Helmer*, 34 TCM 727 (1975)] Treas. Reg. section 1.752-1(a)(4) applies prospectively to liabilities that are incurred or assumed by the partnership on or after June 24, 2003.

***Example**:*
A and B are equal partners in partnership AB which owns a piece of land with an adjusted basis of $40,000 and a market value of $1,000,000. A's and B's basis in their partnership interests are $20,000, respectively. During the year, the partnership signs an option agreement with C that grants C an option to buy the land anytime within the next two years at the current market value. C agrees to pay the partnership $100,000 as consideration for the option to purchase the land. The agreement provides that if C exercises the option within the next two years, the payment will be applied to reduce the purchase price. However, if C does not exercise the option, the payment will not be refunded. Immediately after receiving the payment, the partnership distributes the entire cash proceeds to its two partners. What are the tax consequences of the transactions?

First, the payment of $100,000 is not considered a partnership liability because the partnership is not required to return the payment. Therefore, A's and B's basis in their partnership interests are not increased by the payment. Second, the distribution of the payment to the partners exceeds their adjusted basis in the partnership by $60,000, which represents the gain they have to recognize.

***Observation**: a similar tax consequence may often result from cash distributions attributable to progress payments under the complete contract method [Rev. Rul. 81-241] or cash proceeds from property sale under § 1033 [Rev. Rul. 81-242]. In these cases, the receipt of cash increases the partnership's assets (inside basis) without a correlative increase in the partners' outside basis since the option payments, progress payments, and deferred gain are not "partnership liabilities" for purposes of § 752. As a result, the cash distributions may be taxable if they exceed the partner's outside basis.*

5436 Short Sales of Securities

A short sale of securities occurs when an investor sells securities and delivers the securities in the future. The short sale is "closed" when the seller meets his obligation to deliver the securities.

***Example**:*
On April 1, 2018, Richie sold short 100 shares of TA&A stock for $100 per share. He did not own these shares at the time of the sale but expected that TA&A stock would decline in value by the time he closed the sale. On April 4, 2018, TA&A stock declined to $85 per share. Richie purchased 100 shares and delivered them to his broker to close the short sale. Richie recognized a gain of $1,500.

When a partnership makes a short sale of securities, its obligation to deliver the borrowed securities to the broker to close out the short sale is treated as a partnership liability because it increases the partnership's basis in the short sale (which is a partnership asset). [Revenue Ruling 95-26, 1995-1 C.B. 131; also see *Salina Partnership LP v. Commissioner*, T.C. Memo 2000-352]

5437 Sham Transactions

Case law has shown that in some situations, a partnership may incur a large amount of nonrecourse debt secured by a property whose value, determined at the time the liability is incurred, is materially less than the debt amount. The debt may be treated as a sham obligation since repayment of the debt may be deemed to be contingent (or even optional) on the future appreciation of the asset.[*Est. of Charles T. Franklin*, 64 TC 752 (1975), aff'd, 544 F2d 1045 (9th Cir. 1976)] The debt may not be treated as a genuine obligation and therefore not a partnership liability for the purposes of § 752. [*Commissioner v. Turf,* 43-1 USTC 9328]. However, if the value of the collateral fluctuates or materially decreases after the liability is incurred, the liability may still be respected until some other event occurs that justifies a reassessment of the obligation.

5440 Loans by Partners or Related Persons

In general, a partner who engages in a transaction with a partnership, other than in his capacity as a partner, shall be treated as if he were not a member of the partnership with respect to such transaction. Such transactions include loans of money or property by the partner to the partnership. [Treas. Reg. § 1.707-1(a)] Thus, loans by partners to the partnership are treated as liabilities of the partnership for the purposes of § 752.

Recourse loans from partners to partnerships are treated as partnership liabilities and allocated to the partners based on their share of the "economic risk of loss" as provided under § 752. (See PTM 5510)

Nonrecourse loans from a partner or a related person (See PTM 5540) are also recognized as partnership liabilities but are allocated entirely to the lending partner or the partner related to the lender. (See PTM 5491)

5450 Partner Loans Characterized as Capital Contributions

Loans from a partner to a partnership may be recharacterized as capital contributions if the facts and circumstances show that the substance of the transaction is actually a capital contribution. In all cases, the substance of the transaction will govern rather than its form [Treas. Reg. § 1.707-1(a)] This

recharacterization is commonly referred to as the "Thin Partnership" doctrine that parallels the "Thin Incorporation" doctrine of corporate tax law.

The Thin Partnership doctrine was first applied in *Joseph W. Hambuechen*, 43 TC 90 (1964). In this case, the taxpayer made substantial advances to a financially faltering partnership under an agreement providing that the advances were to be placed in a special account on the partnership books, not bearing interest, unsecured and subordinated. The taxpayer claimed a business bad debt deduction when the special account was liquidated. The Service denied the deduction on the theory that no debt existed. The Tax Court agreed with the Service that the loan was actually a capital contribution because:

- Under the same circumstances, no creditor would have made a similar unsecured, subordinate loan to the partnership,
- The advances were unsecured, subordinated to other claims of past, present, and future creditors, and did not bear interest or have a fixed maturity date, and
- There was no reasonable expectation of repayment regardless of the success of the partnership.

It should be noted that taxpayers may attempt to use the Thin Partnership doctrine to their advantage by arguing that advances made to partnerships and treated as loans should be recast as capital contributions. In *Curtis W. Kingbay*, 46 TC 147 (1966), the Tax Court rejected the taxpayer's argument based on the facts that regular repayments of the debt were made by the partnership, notes were given, the debt was not subordinated, and the partnership's capitalization was normal with regard to its business. In *Donna Woolley,* 61 TCM 131 (1991), the taxpayer attempted to recharacterize a loan as a capital contribution to increase his basis in the partnership interest. The Tax Court distinguished *Hambuechen,* on the grounds that in the case before it, the taxpayer's advances were evidenced by the interest bearing notes, and the taxpayer may have had recourse to the assets of the partnership or other partners. Therefore, the advances were properly characterized as debt, not equity. The taxpayer structured the transactions as loans and should not obtain a more favorable result by resorting to the substance over form theory.

***Observation**:*
The significance of the Thin Partnership doctrine has been reduced by the enactment of the at risk limitations under § 465, the passive loss rules under § 469, and the 1991 regulations under § 752. (See PTM 5491)

5460 Assumption of Liabilities

- A partner's assumption of partnership liabilities or a partnership's assumption of a partner's personal liabilities is treated as a cash contribution to or cash distribution from the partnership. (See PTM 5410)

- In general, a person is considered to assume a liability only to the extent that he is personally obligated to pay the liability. If a partner or a related person assumes a partnership liability, the creditor must know of the assumption and can directly enforce the partner or the related person to satisfy the liability. In addition, no other partners or a related person of the other partners bears the economic risk of loss with respect to the liability immediately after the assumption. [Treas. Reg. § 1.752-1(d)]

- **Exception**: With regard to the contribution or distribution of encumbered property, the transferee is treated as having assumed the liability, to the extent that the amount of liability does not exceed the fair market value of the property at the time of the contribution or distribution. [Treas. Reg. § 1.752-1(e)] (**There is no requirement that the creditor must know of the assumption of the liability**.)

***Example**:*
A contributes property with an adjusted basis of $5,000 to a general partnership in exchange for an interest in the partnership. At the time of contribution, the property is subject to recourse debt of $1,000 and has a fair market value in excess of $1,000. The partnership does not have any other outstanding liabilities. After the contribution, A remains personally liable to the creditor and none of the other partners bears any of the economic risk of loss for the liability under state law or otherwise. Under the rule stated above, the partnership is treated as having assumed the $1,000 liability. Therefore, A's individual liability decreases by $1,000. At the same time, however, the entire $1,000 partnership liability is allocated to A because he bears the economic risk of loss. Accordingly, A's initial basis in the partnership interest is $5,000. See Treas. Reg. § 1.752-1(g) Example (1).

***Observation**:*
In the above example, the encumbered liability is "automatically" assumed by the partnership when the property is contributed to the partnership, regardless of whether or not the creditor is aware of the transfer. After the liability becomes the partnership liability, it is allocated entirely to A because A is still personally liable to the creditor and therefore bears the economic risk of loss.

5470 Netting Increases and Decreases in Liabilities

- If, as a result of a single transaction, a partner incurs both an increase and a decrease in the partner's share of partnership liabilities, only the net increase or

the net decrease is treated as a contribution or distribution, respectively, of money to or from the partnership. [Treas. Reg. § 1.752-1(f)]

- Usually, the netting happens when there is a contribution or distribution of property subject to a liability or the termination of a partnership under § 708(b).

***Example**:*
In the above example, A contributed a property subject to $1,000 in liability to a partnership in exchange for a partnership interest. Because the partnership is treated as assuming the encumbered liability, A's personal liability is reduced by $1,000. However, as a partner in the partnership, A is allocated the entire $1,000 liability because he bears the economic risk of loss. The decrease and increase in liability are netted because they are from a single transaction.

5480 Determining Partner's Share of Partnership Liabilities

The Internal Revenue Code provides the tax consequences of the partners' share of partnership liabilities; however, the rules for determining the partners' share of partnership liabilities are left to the Treasury Regulations. There are three sets of Regulations: the 1956 Regulations, the 1988 Regulations, and the 1991 Regulations.

PTM 5481 The 1956 Regulations
PTM 5482 The 1988 Regulations, the 1991 Regulations, and Subsequent Development
PTM 5483 Effective Dates and Transition Rules
PTM 5484 The Grandfather Rule
PTM 5485 Election to apply 1991 Regulations
PTM 5486 Technical Termination
PTM 5487 Material Modification

5481 The 1956 Regulations

This set of Regulations, promulgated in 1956 and commonly referred to as the Old Regulations, provides that *recourse* liabilities are to be shared by the general partners (see PTM 3000) in accordance with their loss sharing ratios. *Nonrecourse* liabilities are shared among both general and limited partners in accordance with their profit sharing ratios. Furthermore, a limited partner's share of partnership recourse liabilities cannot exceed the difference between his actual contribution to the partnership and the total contribution he is obligated to make under the limited partnership agreement.

The above sharing rules are based on the principle that since general partners are responsible for payment of recourse liabilities if the liabilities are not satisfied by the partnership, they are allocated partnership recourse liabilities proportionately to their loss sharing ratio. With regard to nonrecourse liabilities, for which no partner has any personal liability, the only way to repay these nonrecourse liabilities is through partnership profits or assets. Therefore, the nonrecourse liabilities are shared by all general and limited partners based on their profit sharing ratios.

While the above sharing principles are theoretically sound, the Old Regulations are too general, ambiguous, and caused confusion not only among taxpayers, but for the government as well.

5482 The 1988 and the 1991 Regulations and Subsequent Development

On December 29, 1988, the IRS issued a new set of temporary and proposed regulations, commonly referred to as the 1988 Temporary Regulations. These regulations are regarded as lengthy and overly complicated. On December 28, 1991, the IRS issued a new simplified set of regulations which is referred to as the 1991 Final Regulations. Together, the Temporary and the Final Regulations are referred to as the 1991 Regulations.

The **principal difference** between the Old and the New Regulations is the concept of “economic risk of loss” (See PTM 5510), which is used as a basis to distinguish between recourse and nonrecourse liabilities and to determine the partners’ share of recourse liabilities.

Rules were added to the § 752 regulations in 2005 to address assumption by partnerships of "Reg. § 1.752-7 liabilities" (i.e. partner obligations other than "liabilities" under § 752 and the 1991 Regulations) and the effect on the basis of the partner from whom a partnership assumes a "Reg. § 1.752-7 liability."

In 2013, proposed regulations were issued that would provide guidance with respect to (1) how a partnership should allocate a partnership recourse liability when multiple partners have overlapping economic risk of loss with respect to that liability; (2) how the related party rules should be applied when (a) a partner is a constructive owner of stock; or (b) a person is a lender or has a payment obligation for a partnership liability and is related to more than one partner; and (3) how the related partner exception should be applied.[18]

[18] Prop. Reg. § 1.752-2, § 1.752-4, REG-136984-12, 78 Fed. Reg. 76,092 (Dec. 16, 2013), which would generally apply to any liability incurred or assumed by a partnership on or after the date the final regulations are published in the Federal Register, other than liabilities incurred or assumed by a partnership pursuant to a written binding contract in effect prior to that date.

In 2014, the IRS issued proposed regulations under Reg. §1.752-2 and Reg. §1.752-3 containing rules regarding how partnership recourse and nonrecourse liabilities should be shared. In 2016, the IRS (1) withdrew the proposed regulations under Reg. § 1.752-2 and proposed new regulations under that section regarding a partner's share of recourse liabilities [see PTM 5500]; and (2) issued temporary regulations under Reg. § 1.752-2 to address when certain payment obligations are recognized for purposes of determining whether a liability is a recourse liability under § 752 [see PTM 5534].

5483 Effective Dates and Transition Rules

Before attempting to allocate partnership liabilities, the applicable provisions must be determined. The three sets of Regulations - Old, Temporary, and Final - are effective based on the date that *the applicable liabilities (on a liability-by-liability basis) are incurred or assumed by the partnership*, not the date the partnership is formed. A liability is treated as incurred or assumed on the date a written, binding contract becomes effective. [Treas. Reg. § 1.752-5(a)]

5484 The Grandfather Rule

In general, the Old Regulations apply to liabilities incurred before January 30, 1989. The Temporary Regulations apply to liabilities incurred on or after January 30, 1989 but before December 28, 1991. The Final Regulations apply to liabilities incurred on or after December 28, 1991 [Treas. Reg. § 1.752-5(a)]

5485 Election to apply 1991 Regulations

A partnership may elect to apply the 1991 Final Regulations to all of its liabilities, including those liabilities to which these provisions would not otherwise apply, by attaching a written statement to the partnership tax return filed for the first taxable year of the partnership ending on or after December 28, 1991. The written statement must include the name, address, and taxpayer identification number of the partnership making the statement and contain a declaration that an election is being made under Reg. § 1.752-5(b). [Treas. Reg. § 1.752-5(b)(2)]

- **If no election** is made by the partnership, the determination of the applicable set of rules is on a liability-by-liability basis, as discussed above.

5486 Technical Termination

A partnership may terminate if within a 12-month period, there is a sale or exchanges of 50 percent or more of the total interest in the partnership capital or profit. This is commonly referred to as a Technical Termination under §

708(b)(1)(B). When a partnership terminates under § 708(b)(1)(B), the liabilities that were incurred or assumed prior to the termination are **not** treated as incurred or assumed on the date of the termination. [Treas. Reg. § 1.752-5(c)] In other words, a technical termination does not cause all partnership liabilities to be treated as incurred or assumed on the termination date.

5487 Material Modification

If a liability that is not subject to the 1991 Regulations is "materially modified," the liability becomes subject to the regulations in effect when the modification occurs. A partner's or a related person's guarantee of a grandfathered liability is not considered a material modification. [T.D. 8380, 1992-1 C.B. 205]

5490 Recourse versus Nonrecourse Liabilities

One of the most important steps in determining a partner's share of partnership liabilities is to determine if a liability is recourse or nonrecourse.

Definition of Recourse Liabilities

Under the Final Regulations, a partnership liability is a **recourse** liability to the extent that any partner or related person (See PTM 5540) bears the economic risk of loss set forth under § 1.752-2. [Treas. Reg. § 1.752-1(a)(1)] (See PTM 5510)

Definition of Nonrecourse Liabilities

Under the Final Regulations, a partnership liability is a **nonrecourse** liability to the extent that no partner or related person bears the economic risk of loss for that liability set forth under § 1.752-2. [Treas. Reg. § 1.752-1(a)(2)]

Observation:
For a true nonrecourse liability, only the lender bears the economic risk of loss if the partnership defaults on the loan. Real estate loans, for instance, are one of the most common types of nonrecourse loans. Typically, the real property is pledged as security for the debt and in the event of default, the lender's only recourse is to foreclose on the property.

5491 Nonrecourse Loans by Partners

- If a partner or related person makes a nonrecourse loan to the partnership, the nonrecourse loan will be characterized as recourse loan if the economic risk of loss for the liability is not borne by another partner. [Treas. Reg. § 1.752-2(c)(1)] The reason is because the lender-partner is deemed to bear the economic risk of loss if the partnership defaults on the loan.

- See exceptions to this rule under De Minimis rule (See PTM 5492), Wrapped Indebtedness (See PTM 5495), and Bifurcated Debt (See PTM 5494).

Observation:
Nonrecourse loans made by a partner or his related person to the partnership is referred to as "Partner Nonrecourse Debt" under Regs. § 1.704-2(b)(4). (See PTM 1000 *Capital Accounts- Allocation of Partnership Income and Loss) For allocation purposes, a debt treated as a partner nonrecourse debt has to be allocated to the lender partner since he bears the economic risk of loss. Thus, other partners may not include any portion of this loan in their basis.*

***Example**:*
A and B are equal partners in partnership AB. A and B each contributes $500 cash to the partnership in 2018. The partnership purchases a rental property for $100,000 from C, an S corporation to which B is 100 percent shareholder. The partnership paid C $1,000 in cash and signs a promissory note for $99,000. The note is secured by the property. Neither A nor B are personally liable for the note. Though the note is nonrecourse, it is treated as recourse because it is made by a related person to B. B is considered to bear the entire economic risk of loss with regard to the note. As a result, the note is allocated 100 percent to B to give him a basis of $99,500 in the partnership interest. A's basis in his partnership interest is $500.

5492 De Minimis Exceptions

Under the general rules, nonrecourse debts made or guaranteed by a partner (See PTM 5491) are treated as recourse and allocated to the lender or guarantor partner. [Treas. Reg. § 1.752-2(b)(1) & (c)(1)] However, there are two exceptions to the general rules:

- Partner as lender (See PTM 5493)
- Partner as guarantor (see PTM 5494)

5493 Partner as Lender

The general rule under § 1.752-2(c)(1) **does not** apply if the partner as a lender meets both of the following requirements:

- the lender partner or his related person whose interest in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, and
- the loan made to the partnership constitutes a "qualified nonrecourse financing" within the meaning of § 465(b)(6) (determined without regard to the type of activity financed) [Treas. Reg. § 1.752-2(d)(1)] (See PTM 5330)

For the purposes of computing the 10 percent interest in the partnership, both direct and indirect ownership of partnership through one or more partnerships, including the interest of any related person, are taken into consideration. [Id]

5494 Partner as Guarantor

The general rule under § 1.752-2(b)(1) **does not** apply if the partner as a guarantor meets both of the following requirements:

- The partner meets the 10 percent ownership stated in PTM 5493, and
- Guarantees a loan that would otherwise constitute a qualified nonrecourse financing within the meaning of § 465(b)(6) if the guarantor had made the loan to the partnership. [Treas. Reg. § 1.752-2(d)(2)]

***Observation**:*
*To be a qualified nonrecourse loan under § 465 (*See PTM 5330*), the loan has to be from a qualified lending institution or if from a related person, it has to be commercially reasonable. Thus, the de minimis exception covers essentially loans from banks or other lending institutions. This makes sense since the bottom line of the de minimis exceptions is to allow all partners to continue sharing in the qualified nonrecourse liabilities rather than reallocating the liabilities to the lender partner provided (1) the lender partner is in the business of lending money and (2) the lender partner's relationship to the partnership is primarily that of a lender as evidenced by the fact that the lender partner holds only a small equity interest (10 percent or less) in the partnership.*

5495 Wrapped Debt

If a partnership liability is owed to a partner or related person and that liability includes (i.e., is "wrapped" around) a nonrecourse liability encumbering partnership property that is owed to another person, the partnership liability will be treated as two separate liabilities.

The portion corresponding to the wrapped debt is treated as a liability owed to another person. [Treas. Reg. § 1.752-2(c)(2)]

***Example**:*
*Tom holds 25 percent interest in Tommy partnership. The partnership purchases a property from Tom for $100,000, paying $10,000 in cash and signs a promissory note for the balance of $90,000. The note is secured by the property and none of the other partners are personally liable for the note. At the time of the purchase, the property has an encumbered liability of $70,000. The liability is a nonrecourse debt owed to the Bank of Sacramento and incurred when Tom purchased the property. The debt is secured by a mortgage on the property. Tom continues to make payments on the $70,000 mortgage to the bank after the property is sold to the partnership. For the purposes of § 752, the partnership note of $90,000 is treated as a wrapped debt that includes the $70,000 owed to the Bank of Sacramento. The liability is a recourse liability to the extent of $20,000 because Tom is the creditor with respect to the note and Tom bears the economic risk of loss for $20,000. The remaining $70,000 is treated as a partnership nonrecourse liability that is owed to the Bank. [Treas. Reg. § 1.752-2(f), Ex. (6)]****

Note: Assume in the above example, the property becomes worthless and the partnership defaults on the $90,000 loan, which causes Tom to default on the $70,000 loan to the bank. Since none of the partners are personally liable for the $90,000 loan, nor is Tom personally liable for the $70,000 loan, the bank bears the economic risk of loss for $70,000 and Tom's net economic risk of loss is only $20,000. Therefore, the above treatment appears reasonable from an economic standpoint.

5500 SHARING OF RECOURSE LIABILITIES

Under the New Regulations, a partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person **bears the economic risk of loss**. (See PTM 5510) [Treas. Reg. § 1.752-2(a)]

Thus, the **economic risk of loss** concept is used not only to distinguish recourse from nonrecourse liabilities, but also to determine the partners' share of such recourse liabilities.

***Observation**:*
Under the 1956 Regulations, the sharing of recourse liabilities is based on the partners' ratios for sharing losses. Though this allocation method is theoretically sound, the Regulations promulgated thereunder are criticized as too ambiguous and not useful in resolving even the simple liability-sharing questions, particularly in the context of modern complex partnerships. [See McKee, Ibid., ¶ 8.2] Under the New

Regulations (1988 and 1991), the sharing of recourse liabilities is based on the "economic risk of loss" concept that is derived from the same principle of loss sharing. However, the New Regulations attempt to take into account various potential economic or financial arrangements between the partnership and its creditors as well as among the partners. This is part of the reason the New Regulations are lengthy and complicated.

5510 Determining a Partner's Economic Risk of Loss

Under the New Regulations, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person will be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or a person related to another partner. [Treas. Reg. § 1.752-2(b)]

Thus, the economic risk of loss test consists of two steps: a **hypothetical constructive liquidation** of the partnership (See PTM 5520) and the **determination of each partner's obligations** (See PTM 5530) to make payments or to contribute to the partnership as a result of the constructive liquidation.

5520 Constructive Liquidation

The first step in the determination of a partner's economic risk of loss is a hypothetical liquidation of the partnership in which all of the following events are deemed to occur simultaneously:

- All of the partnership's liabilities become payable in full;

- All of the partnership's assets, including cash, have a value of zero, except the property contributed to the partnership to secure a partnership liability under § 1.752-2(h)(2));
- All of the partnership's property is disposed of in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership);
- All items of income, gain, loss, or deductions are allocated among the partners in accordance with the partnership agreement;
- The partnership liquidates. [Treas. Reg. § 1.752-2(b)]

The net effect of the constructive liquidation is to create a hypothetical situation in which all of the partnership's assets are deemed worthless or lost. As a result, the constructive losses are allocated among the partners, which cause their capital accounts to be negative. Each partner's negative capital account will be a measure of the net amount (obligation) he has to pay to satisfy partnership creditors or the partners with positive capital accounts. This net amount represents each partner's "economic risk of loss" regarding partnership liabilities. The share of partnership recourse liabilities among the partners is based on this economic risk of loss.

Constructive Liquidation-Computation of Gain or Loss

For purposes of the constructive liquidation, gain or loss on the deemed disposition of the partnership's assets is computed in accordance with the following:

- If the creditor's right to repayment of a partnership liability is limited solely to one or more assets of a partnership, gain or loss is recognized in an amount equal to the difference between the amount of the liability that is extinguished by the deemed disposition and the tax basis (or book value to the extent § 704(c) or § 1.704-1(b)(4)(i) applies) in those assets. [Treas. Reg. § 1.752-2(b)(2)(i)]

- A loss is recognized equal to the remaining tax basis (or book value to the extent § 704(c) or § 1.704-1(b)(4)(i) applies) of all the partnership's assets not taken into account in paragraph Reg. § 1.752-2(b)(2)(i). [Treas. Reg. § 1.752-2(b)(2)(ii)]

***Example 1**:*
Tom and Jerry form a general partnership with each contributing $100 in cash.

The partnership purchases a building from an unrelated party for $1,000, paying $200 in cash and signs a note to the seller for the balance of $800. The note is a general obligation of the partnership, i.e., both Tom and Jerry are personally liable for repayment on the note. The partnership agreement provides that all items are

allocated equally, except tax losses, which are specially allocated 90% to Tom and 10% to Jerry, and that the partners' capital accounts are maintained in accordance with § 704(b) regulations, including the obligation to restore the deficit capital account on liquidation. Tom and Jerry's share of the $800 recourse liability is determined as follows:

In a constructive liquidation, the $800 liability becomes due and payable immediately. All of the partnership's assets (which is the building) are deemed to be worthless. The building is deemed to be sold for a zero value, which causes a loss of $1,000 (partnership's cost basis in the building is $1,000.) The loss is allocated to Tom and Jerry. Their capital accounts are adjusted to reflect the hypothetical disposition, as follows:

	Tom	*Jerry*
Initial Contribution	*$100*	*$100*
Loss on Disposition	*(900)*	*(100)*
Ending Capital account	*($800)*	*$0*

There are no other contractual obligations between the partners except the obligation to satisfy the creditor of the partnership ($800). The $800 liability, therefore, is classified as a recourse liability and is allocated entirely to Tom since he would have an obligation to make a contribution in that amount to the partnership to satisfy the recourse loan. See Treas. Reg. § 1.752-2(f), Ex. (1).

Example 2:
Assume the same facts as the above example except that the partnership agreement provides that all items of income or loss are allocated 60% to Tom and 40% to Jerry. Under the same constructive liquidation test, the partnership has $1,000 loss on the hypothetical disposition of the building. The partners' capital accounts are adjusted to reflect the loss, as follows:

	Tom	*Jerry*
Initial Contribution	*$100*	*$100*
Loss on Disposition	*(600)*	*(400)*
Ending Capital account	*($500)*	*($300)*

Tom and Jerry's capital accounts reflect the deficits of $500 and $300, respectively, that they have to restore. Therefore, the $800 note is a recourse liability because one or more partners bear the economic risk of loss for the liability. Also, Tom's and Jerry's shares of the recourse liability are $500 and $300, respectively. See Treas. Reg. § 1.752-2(f), Ex. (2).

Note: In the above two examples, the computation of the loss on the deemed disposition is based on the partnership's tax basis in the building. The creditor's right to repayment is not limited solely to the building of the partnership because the note is a general obligation of the partnership (partners are personally liable for repayment, as stated in the Examples.)

5530 Obligations to Make Payment or Contribution

As discussed in PTM 5510, under the New Regulations, a partner bears the economic risk of loss with respect to a partnership liability to the extent that, upon the partnership's constructive liquidation, the partner is obligated to make a payment to any person, or a contribution to the partnership.

PTM 5531 Contingent Obligations
PTM 5532 Reimbursement Rights
PTM 5533 Deemed Satisfaction of Obligation
PTM 5534 Bottom Dollar Guarantees
PTM 5535 Other Obligations

5531 Contingent Obligations

If a payment obligation is subject to contingencies that, based on all facts and circumstances, make it unlikely that the obligation will ever be discharged, the obligation is disregarded.

If a payment obligation would arise at a future time after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs. [Treas. Reg. § 1.752-2(b)(4)]

***Example**:*
Paul and Paula form a general partnership with cash contributions of $5,000 each. The partnership purchases a rental property paying $10,000 in cash and signs a note for $90,000. The note is nonrecourse, secured by the rental property. The loan document provides that the partnership will be liable for the outstanding balance of the loan on a recourse basis to the extent of any decrease in value of the rental property resulting from the partnership's failure to maintain the property. There are no facts that establish with certainty the existence of any liability on the part of the partnership or its partners for damages caused by the partnership's failure to properly maintain the rental property. Therefore, no partner bears the economic risk of loss, and the liability constitutes a nonrecourse liability. [Treas. Reg. § 1.752-2(f), Ex. (8)]

5532 Reimbursement Rights

If a partner or related person is entitled to reimbursement from another partner (or a related person of the other partner), their payment obligation is reduced by the amount of reimbursement. [Treas. Reg. § 1.752-2(b)(5)]

Example:
Tom and Mary form a general partnership. Mary is the general partner and Tom is the limited partner. Tom guarantees a portion of the partnership liability which is a general obligation of the partnership, i.e. no partner has been relieved from personal liability. If under state law, Tom is subrogated to the rights of the lender, Tom would have the right to recover the amount he paid to the recourse lender from Mary, the general partner. Therefore, Mary, rather than Tom, bears the economic risk of loss from the partnership liability. [Treas. Reg. § 1.752-2(f), Ex. (4)]

If the presumption is that the general partner will satisfy their deficit capital account restoration obligations and thereby prevent any guarantees of a partnership liability from being called, then the guarantee is generally offset by that presumption, regardless of a right of subrogation. *[Treas. Reg. § 1.752-2(f), Ex. (3)]*

5533 Deemed Satisfaction of Obligation

For purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. [Treas. Reg. § 1.752-2(b)(6)] (See PTM 5630)

5534 Bottom Dollar Guarantees

Temp. Treas. Reg. § 1.752-2T(b)(3), which is effective for liabilities incurred or assumed on or after 10/05/2016, added an obligation situation that would impact a partner's economic risk of loss with respect to a partnership liability. The rules under the temporary regulations will, unless final regulations are issued, expire on 10/04/2019. California has not conformed to Temp. Treas. Reg. § 1.752-2T.

Under the temporary regulations, a partner's or related person's bottom dollar payment obligation will not be recognized for purposes in evaluating the partner's economic risk of loss. Prior to the issuance of the Temporary Regulations, bottom

dollar payment obligations were used to minimize a partner's actual economic exposure, while increasing the economic risk of loss the partner was treated as bearing. [Temp. Treas. Reg. § 1.752-2T(b)(3)(ii)(A)]

A bottom dollar payment obligation is a payment obligation that is the same as or similar to the following payment obligation or arrangements:

(a) with respect to a guarantee or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.

(b) with respect to an indemnity or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation, if, and to the extent that, any amount of the payment obligation of the indemnitee or benefited party's payment obligation that is recognized under this section.

(c) an arrangement with respect to a partnership liability that uses tiered partnerships, intermediaries, senior, and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liability were incurred pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements, and with a principal purpose of avoiding having at least one of such liabilities or payment obligations with respect to such liabilities being treated as a bottom dollar payment obligation described in items (a) or (b) of this list. [Temp. Treas. Reg. § 1.752-2T(b)(3)(ii)(C)(3)]

Generally speaking, in a bottom-dollar payment obligation, the obligor partner is only obligated to pay part of the debt if the creditor collects less than a guaranteed minimum amount. In other words, as long as the creditor receives an amount of principal that equals to or exceeds the partner's guarantee, the partner is not responsible for any portion of the partnership's debt, even if the partnership defaults.

A bottom dollar payment obligation will be recognized where the partner's or related person's payment obligation (initial payment obligation) would be recognized, except that an indemnity, reimbursement agreement, or similar arrangement turns the initial payment obligation into a bottom dollar payment obligation. In such a case, the obligation is recognized if the partners or related is liable for at least 90% of the partner's or related person's initial payment obligation. [Temp. Treas. Reg. § 1.752-2T(b)(3)(ii)(B)]

Example 1 – Guarantee of first and last dollars:

A, B, and C are equal partners in ABC partnership. ABC borrows $1,000 from Bank. A guarantees payment of up to $300 of the ABC liability if any amount of the full $1,000 liability is not recovered by Bank. B guarantees payment of up to $200, but only if the Bank otherwise recovers less than $200. Both A and B waive their rights of contribution against each other.

Because A is obligated to pay up to $300 if, and to the extent that, any amount of the $1,000 partnership liability is not recovered by Bank, A's guarantee is not a bottom dollar payment obligation and is recognized under the above rules, giving A a $300 economic risk of loss. Because B is obligated to pay up to $200 only if and to the extent that the Bank otherwise recovers less than $200 of the $1,000 partnership liability, B's guarantee is a bottom dollar payment obligation that is not recognized, with the result that B bears no economic risk of loss. Note that if the lender recovers only $300 from ABC while the other $700 is not paid, A is obligated to pay lender the $300 he guaranteed, but B has no obligation to pay lender any of the remaining unpaid debt. In sum, $300 of ABC's liability is allocated to A under § 1.752-2(a), and the remaining $700 liability is allocated to A, B, and C under § 1.752-3. See Temp. Treas. Reg. § 1.752-2T(f), Ex. (10).

Example 2 – Indemnification of guarantees:

Same facts as Example (1), except that, in addition, C agrees to indemnify A up to $100 that A pays with respect to its guarantee and agrees to indemnify B fully with respect to its guarantee.

Whether C's indemnity is recognized is determined without regard to whether C's indemnity itself causes A's guarantee not to be recognized. Because A's obligation would be recognized but for the effect of C's indemnity and C is obligated to pay A up to the full amount of C's indemnity if A pays any amount on its guarantee of ABC's liability, C's indemnity of A's guarantee is not a bottom dollar payment obligation and is, therefore, recognized, giving C a $100 economic risk of loss. Because C's indemnity is recognized, A is liable for $200 only to the extent any amount beyond $100 of the partnership liability is not satisfied. Thus, A's guarantee is a bottom dollar payment obligation that is not recognized, with the result that A bears no economic risk of loss with respect to the liability. Because B's obligation is not recognized under the above rules independent of C's indemnity of B's guarantee, C's indemnity is not recognized, with the result that C bears no economic risk of loss for its indemnity of B's guarantee. In sum, $100 of ABC's liability is allocated to C under § 1.752-2(a), and the remaining $900 liability is allocated to A, B, and C under § 1.752-3. See Temp. Treas. Reg. § 1.752-2T(f), Ex. (11)

Exceptions:

A payment obligation is not a bottom dollar payment obligation (1) where a partner's payment obligation covers any shortfall, but is subject to a maximum dollar value (i.e. a "top dollar" obligation) and (2) where a partner's payment obligation is limited to a fixed percentage of the partnership's liability to which such obligation related (i.e. the "vertical slice" exception). [Temp. Treas. Reg. § 1.752-2T(b)(3)(iii)(C)(2)]

A partnership is obligated to disclose the existence of any bottom dollar obligation with respect to a partnership liability for the taxable year in which the bottom dollar obligation is undertaken. [Temp. Treas. Reg. § 1.752-2T(b)(3)(ii)(D)]

5535 Other Obligations

The determination of the extent to which a partner or a related person has an obligation to make a payment is based on the facts and circumstances at the time of the determination. All statutory and contractual obligations relating to the partnership liability are taken into account for the purposes of the determination, including: [Treas. Reg. § 1.752-2(b)(3) and Temp. Treas. Reg. § 1.752-2T(b)(3)] The temporary regulations which is effective for liabilities incurred or assumed on or after 10/05/2016 will expire on 10/04/2019. California has not conformed to Temp. Treas. Reg. § 1.752-2T.

- Contractual obligations outside the partnership agreement such as guarantees, indemnification, reimbursement agreement, and other obligations running directly to creditors, to other partners, or to the partnership.

- Obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of a partnership.

- Payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law including the governing state partnership statute.

Any obligations that are not described above are **not** recognized as valid obligations for the purpose of § 752. [Treas. Reg. § 1.752-2(b)(3)]

5540 Related Person

Under the 1991 Regulations, a person is related to a partner if the person and the partner bear a relationship to each other that is specified in § 267(b) or § 707(b)(1), modified as follows:

- All references to "more than 50 percent" are replaced by "80 percent or more";
- Brothers and sisters are not included in a person's family; and
- Disregard §§ 267(e)(1) and 267(f)(1)(A). [Treas. Reg. § 1.752-4(b)(1)]

Related Person Under Modified § 267(b)

Based on the provisions under § 752, the modified version of § 267(b) regarding a related person is as follows:

- Members of a family (including a spouse, ancestors, and lineal descendants; brothers and sisters are not included);
- An individual and a corporation if the individual owns, directly or indirectly, more than 80 percent of the value of the outstanding stock of the corporation;
- Two corporations which are member of the same controlled group as defined under § 1563(a) without regard to §267(f)(1)(A).
- A grantor and a fiduciary of any trust;
- A fiduciary of a trust and a fiduciary of another trust, if both trusts have the same grantor;
- A fiduciary of a trust and a beneficiary of such trust;
- A fiduciary of a trust and a beneficiary of another trust if both trusts have the same grantor
- A fiduciary of a trust and a corporation if the trust or its grantor owns more than 80 percent of the value of the outstanding stock of the corporation;
- A person and an organization to which § 501 applies if the organization is controlled directly or indirectly by such person or, if the person is an individual, by members of the individual's family;
- A corporation and a partnership if the same person owns more than 80 percent in the value of the outstanding stock of the corporation, and more than 80 percent of the capital interest, or the profits interest, in the partnership;
- An S corporation and another S corporation if the same person owns more than 80 percent the outstanding stock of each corporation;
- An S corporation and a C corporation, if the same person owns more than 80 percent the outstanding stock of each corporation.

PTM 5541 Person Related to More Than One Partner
PTM 5542 Entities Structured to Avoid Related Person Status

5541 Person Related to More Than One Partner

In applying the rules discussed in PTM 5540, if a person is related to more than one partner, he should be treated as related only to the partner with whom there is the highest percentage of ownership. If two or more partners have the same percentage of related ownership, the liability is allocated equally among the partners having equal percentage of related ownership. [Treas. Reg. § 1.752-4(b)(2)(i)]

For purposes of determining the percentage of related ownership between a person and a partner, natural persons who are related by virtue of being members of the same family are treated as having a percentage relationship of 100 percent with respect to each other. [Treas. Reg. § 1.752-4(b)(2)(ii)]

Related partner exception: persons owning interests directly or indirectly in the same partnership are not treated as related persons for purposes of determining the economic risk of loss born by each of them. However, this exception does not apply when determining a partner's interest under the de minimis rule. (See PTM 5492)

***Example**:*
F and S are father and son who each owns 8 percent interest in a partnership. For purposes of determining the economic risk of loss, each of them has to compute their own economic risk of loss to determine their share of partnership recourse liabilities without taking into account their father-son relationship. However, as stated above, this exception does not apply in determining if a lender owns 10 percent or less interest in a partnership under the de minimis rule. Therefore, if the father makes a nonrecourse loan to the partnership, both his own interest in the partnership and his son' interest in the partnership are taken into account, which in this case, exceeds the 10 percent threshold. Therefore, the nonrecourse loan is treated as a recourse loan and allocated to the lender partner.

5542 Entities Structured to Avoid Related Person Status

If:

- A partnership liability is owed to or guaranteed by another entity that is a partnership, an S corporation, a C corporation, or a trust,
- A partner or related person owned (directly or indirectly) 20% or more ownership interest in the other entity; and
- A principal purpose of having the other entity act as a lender or guarantor of the liability was to avoid the determination that the partner who owns the interest bears the economic risk of loss for federal income tax purposes,

then the partner is treated as holding the other entity's interest as a creditor or guarantor to the extent of the partner or related person's ownership interest in the entity. [Treas. Reg. § 1.752-4(b)(2)(iv)]

***Example**:*
Al, Burt, and Carol are equal partners in general partnership ABC. Each contributes $10,000 to the partnership. The partnership wants to buy a property for $100,000. Al and Burt want to loan money to ABC and have the loan treated as nonrecourse for purposes of § 752. Al and Burt form a new partnership AB and each contributes $35,000. Al and Burt are equal partners in partnership AB. Partnership AB loans partnership ABC $70,000 on a nonrecourse basis, secured by the property partnership ABC is going to purchase with the loan. Under these facts and circumstances, Al and Burt bears the economic risk of loss with respect to the partnership ABC's $70,000 loan equally, based on their equal loss-sharing ratios in partnership AB. Carol's basis in partnership ABC does not include any portion of the $70,000 loan. [Treas. Reg. § 1.752-4(b)(2)(iv)(C)]

5550 Partner Guarantees Interest on Loan

A lender may require one or more partners to guarantee the interest payments on a nonrecourse loan made to the partnership. In such situation, the loan is treated as partially recourse and partially nonrecourse as provided below:

General Rule

If one or more partners or related person have guaranteed the payment of more than 25 percent of the total interest that will accrue on a partnership nonrecourse liability over its remaining term, and it is reasonable to expect that the guarantor will be required to pay substantially all of the guaranteed future interest if the partnership fails to do so, then the partnership liability is treated as two separate partnership liabilities. The partner or related person that provides the guarantee is treated as bearing the economic risk of loss for the liability to the extent of the present value of future interest payments. The remainder of the stated principal amount of the partnership liability constitutes a nonrecourse liability. [Treas. Reg. § 1.752-2(e)(1); § 1.752-1(i)]

In applying this rule, it is reasonable to expect that

- the guarantor will be required to pay substantially all of the future interest if the partnership defaults on payment, and
- the lender can enforce the interest guaranty without foreclosing on the property and thereby extinguishing the underlying debt.

This rule, once applicable, will remain in effect even after the point at which the amount of guaranteed interest is reduced to less than 25 percent of the total interest that will accrue on the property. [Treas. Reg. § 1.752-2(e)(1)]

***Example 1**:*
Ron is a partner in RL partnership. On January 1, 2018, the partnership obtains a $2,000,000 nonrecourse loan secured by an office building owned by the partnership. According to the loan agreement, neither the partnership nor any partner has any personal liability for repayment of the principal amount. The loan has an annual interest rate of 15%, payable on the last day of each year. The principal is payable in a lump sum on December 31, 2032. Ron guarantees payment of 50 percent of each interest payment required by the loan. The guarantee can be enforced without first foreclosing on the property. When the partnership obtains the loan, the present value (discounted at 15%, compounded annually) of the future interest payments is $1,754,211 and of the future principal payment is $245,789. Since a partner guarantees 50 percent of the future payments, which is $877,106 ($1,754,211 x .5), this amount is treated as a recourse liability because Ron, the guaranteeing partner, bears the economic risk of loss. The remainder of the principal, $1,122,894, ($2,000,000 - 877,106) is treated as a partnership nonrecourse liability. [Treas. Reg. § 1.752-2(f), Ex. (7)]

It should be noted that in applying this provision, the original principal amount of the partnership loan ($2,000,000) is bifurcated into two separate portions. The portion that relates to the present value of the guaranteed interest payments ($877,106) is treated as recourse and allocated to the guaranteeing partner. The remainder of the loan ($1,122,894) is treated as nonrecourse and allocated to all partners in accordance with the nonrecourse rules.

***Example 2**:*
Same as the above example, except that two years after providing the guarantee that he would pay 50 percent of total future interest payments in case of default by the partnership, Ron negotiates with the lender and is allowed to reduce the guaranteed amount to 20 percent of the total future interest. Does this change affect the original bifurcation of the liability? The answer is no. Once the interest guarantee rule applies, which results in the bifurcation of the partnership liability into recourse and nonrecourse, the bifurcation will remain in effect until all the guaranteed interest is paid even if the guaranteed interest amount is changed to less than 25 percent of the total interest that will accrue on the liability.

Computation of Present Value

The present value of the guaranteed future interest payments is computed using the discount rate equal to:

- The interest rate stated in the loan document, or

- The applicable federal rate if the interest rate is imputed under either § 483 or § 1274, compounded semiannually. [Treas. Reg. § 1.752-2(e)(2)]

The computation takes into account any payment of interest that the partner or related person may be required to make only to the extent that the interest will accrue economically (determined in accordance with section 446 and the regulations thereunder) *after* the date of the interest guarantee. [Treas. Reg. § 1.752-2(e)(2)]

If the loan document contains variable rates based on current values of an objective interest index, the present value is computed on the assumption that the interest determined under the objective interest index on the date of the computation will remain constant over the term of the loan. [Treas. Reg. § 1.752-2(e)(2)]

The term "objective interest index" has the meaning given under § 1275 and the regulations thereunder. Examples of an objective interest index include the prime rate of designated financial institution, LIBOR (London Interbank Offered Rate), and the applicable federal rate under § 1274(d). [Treas. Reg. § 1.752-2(e)(2)]

Safe Harbor

The interest guarantee rule does not apply to a partnership nonrecourse loan if the guarantee of interest by the partner or related person is for a period not in excess of the lesser of five years or one-third of the term of the liability. [Treas. Reg. § 1.752-2(e)(3)]

De Minimis Exception

The interest guarantee rule also does not apply if:

- The partner or related person who provides the guarantee owns 10 percent (or less) interest in each item of partnership income, gain, loss, deduction, or credit for every taxable year the partner is a partner in the partnership; and
- The loan constitutes a qualified nonrecourse loan under § 465(b)(6) (regardless of the type of activity financed). [Treas. Reg. § 1.752-2(e)(4)]

Note: For purposes of the above 10 percent rule, the allocation of the guaranteed interest which is paid by the guaranteeing partner does not count.

5600 PARTNER PLEDGING PROPERTY AS SECURITY FOR PARTNERSHIP LOAN

It is not unusual for a lender to require one or more partners of the borrowing partnership to pledge their own property as security for a loan. In such situation, the determination of the economic risk of loss is discussed below.

Direct Pledge

If a partner or a related person pledges his separate property (other than a direct or an indirect interest in the partnership) as security for the partnership liability, he is considered to bear the economic risk of loss for the partnership liability to the extent of the value of the pledged property. [Treas. Reg. § 1.752-2(h)(1)]

Indirect Pledge

If a partner contributes property to the partnership *solely* for the purpose of securing a partnership liability, he is considered to bear the economic risk of loss to the extent of the value of the contributed property. A property is not considered as contributed solely for the purpose of securing a partnership property unless substantially all of the items of income, gain, loss, and deduction attributable to the contributed property are allocated to the contributing partner and this allocation is generally greater than the partner's share of other significant items of partnership income, gain, loss, or deduction. [Treas. Reg. § 1.752-2(h)(2)]

Valuation

For purposes of determining the economic risk of loss, the value of the directly or indirectly pledged property is based on its fair market value determined at the time of the pledge or contribution. [Treas. Reg. § 1.752-2(h)(3)]

Partner's Promissory Note

If a partner contributes his promissory note to the partnership as a security for a partnership liability, the promissory note is not taken into account unless it is readily tradable on an established market. [Treas. Reg. § 1.752-2(h)(4)]

PTM 5610 Valuation of Payment or Contribution Obligations–General Rule
PTM 5611 Valuation of an Obligation
PTM 5612 Satisfaction of Obligation with Partner's Promissory Note
PTM 5620 Recourse Liabilities in Tiered Partnerships
PTM 5621 Recourse Liabilities in Disregarded Entities
PTM 5630 Anti-Abuse Rules

5610 Valuation of Payment or Contribution Obligations–General Rule

The time-value of money has to be taken into account in determining the value of an obligation to pay or to contribute to the partnership.

The extent to which a partner or related person bears the economic risk of loss is determined by taking into account any delay in time when a payment or contribution obligation is to be satisfied. Note that the delayed performance does not result in the obligation being completely ignored, but only causes it to be valued at less than its face value.

If a payment obligation is not required to be satisfied within a reasonable time, or if the obligation to make a contribution to the partnership is not required to be satisfied before the later of:

- the end of the year in which the partner's interest is liquidated, or
- 90 days after the liquidation,

then the obligation is recognized only to the extent of the value of the obligation. [Treas. Reg. § 1.752-2(g)(1)]

Example:
Peter, a limited partner, guarantees the partnership's nonrecourse partnership liability. The guarantee cannot be exercised until seven years after the creditor has exhausted its remedies against the partnership. Due to this delay, the guarantor-limited partner is treated as bearing the economic risk of loss with respect to the liability only to the extent of the amount of the liability discounted for a seven year performance delay.

PTM 5611 Valuation of an Obligation
PTM 5612 Satisfaction of Obligation with Partner's Promissory Note

5611 Valuation of An Obligation

If a payment or contribution obligation is not required to be satisfied within the time period specified under the general rule (See PTM 5610), the value of such obligation equals the entire principal balance only if the obligation bears interest equal to or greater than the applicable federal rate under § 1274(d) at the time of valuation, commencing on:

- in the case of a payment obligation, the date the partnership liability to a creditor becomes due and payable, or
- in the case of a contribution obligation, the date of the liquidation of the partner's interest in the partnership. [Treas. Reg. § 1.752-2(g)(2)]

In other words, if an obligation is not satisfied within the required time period, it has to bear interest in order for it to be taken at its face value. If the obligation does not bear interest at a rate at least equal to the applicable federal rate at the time of valuation, the obligation is discounted to the present value of all payments due from the partner or related person, using the imputed principal amount computed under § 1274(b). [Treas. Reg. § 1.752-2(g)(2)(ii)]

Note: Under § 1274(b), the imputed principal amount of any debt instrument equals the sum of the present value of all payments due under such instrument discounted at the applicable federal rate.

For purposes of determining the present value, the partnership is deemed to have constructively liquidated as of the date on which the payment obligation is valued. [Treas. Reg. § 1.752-2(g)(2)(ii)]

***Example**:*
John, the general partner, and Janet, the limited partner, each contributes $10,000 to J&J partnership. The partnership purchases a building for $90,000 from an unrelated seller, paying $20,000 in cash and signing a $70,000 recourse note. The partnership agreement provides that profits and losses are to be divided equally. Both John and Janet are required to make up any deficit in their capital accounts. However, while John is required to restore his deficit capital account within 90 days after the date of the liquidation of the partnership, Janet does not have to restore her capital account until two years after the liquidation date. In addition, Janet's deficit amount does not bear interest during that two year period. The determination of John's and Janet's economic risk of loss is based on the constructive liquidation as follows:

	John	*Janet*
Initial Contribution	*$10,000*	*$10,000*
Loss on hypothetical sale	*(45,000)*	*(45,000)*
Ending Capital account	*($35,000)*	*($35,000)*

John and Janet's capital accounts each reflects a deficit of $35,000 which they have to restore. John has to make up his deficit capital account within 90 days from the liquidation date; therefore the obligation is taken at its face value, which is $35,000.

With regard to Janet, she is not obligated to make up the negative capital account until two years after the liquidation. In addition, her obligation bears no interest. Therefore, the fair market value of her obligation is deemed to equal the imputed principal amount under § 1274(b). Assuming the federal rate with respect to Janet's obligation is 10% compounded semiannually, the fair market value of $35,000 discounted at 10% equals $28,795. This is the value of Janet's obligation to restore her capital account. Accordingly, Janet bears the economic risk of loss to the extent of the value of her contribution. With regard to John, since he is the sole general partner, he would be obligated by operation of law to contribute an additional $6,205 (35,000 - 28,795) to make up for Janet.
Therefore, John bears the economic risk of loss for $41,205 (35,000 + 6,205). As a result, the $90,000 recourse liability is allocated to John and Janet in the amounts of $41,205 and $28,795, respectively. [Treas. Reg. § 1.752-2(g)(4) Ex]

Note: The above example is modified after an example provided in the regulations. It not only illustrates the computation of the present value of the obligation to restore the deficit capital account, but also shows that a recourse liability is allocated to partners who bear economic risk of loss associated with the liability. In addition, in the above example, if Janet is not required to restore her capital account, she does not bear the economic risk of loss of anything beyond her initial contribution. As a result, the entire $90,000 recourse loan is to be allocated to John, the general partner.

5612 Satisfaction of Obligation with Partner's Promissory Note

An obligation is not satisfied by transferring to the obligee a promissory note by a partner or related person unless the note is readily tradable on an established securities market. [Treas. Reg. § 1.752-2(g)(3)]

5620 Recourse Liabilities in Tiered Partnerships

If a partnership (the upper-tier partnership) owns (directly or indirectly through one or more partnerships) an interest in another partnership (the lower-tier partnership), then the upper-tier partnership's liability includes a share of the lower-tier partnership's liability (other than any lower-tier partnership liability owed to the upper-tier partnership). [Treas. Reg. § 1.752-4(a)]

The liabilities of the lower-tier partnership are allocated to the upper-tier partnership in an amount equal to the sum of the following:

- The amount of the economic risk of loss that the upper-tier partnership bears with regard to the liabilities; and

- Any other amount of liabilities with respect to which partners of the upper-tier partnership bear the economic risk of loss. [Treas. Reg. § 1.752-2(i)]

***Example**:*
A and B form AB partnership. AB partnership owns 20 percent interest in CD partnership. CD partnership has a $100,000 recourse liability and a $250,000 nonrecourse liability. A pledges his own home as security for the nonrecourse loan. At the time of the pledge, the fair market value of his home is $120,000. Applying the economic risk of loss rules, the recourse liabilities of CD (the lower-tier) which are allocated to AB (the upper-tier) include 20 percent of the $100,000 recourse liability and $120,000 that represent the economic risk of loss A has to bear.

For purposes of § 752, the amount of indebtedness is to be taken into account only once even though a partner (in addition to his indebtedness as a partner) may be liable for the debt in a capacity other than a partner. [Treas. Reg. § 1.752-4(c)]

5621 Recourse Liability in Disregarded Entities

The disregarded entity rules [Treas. Reg. § 1.752-2(k)] apply to liabilities incurred or assumed by a partnership on or after October 11, 2006, other than liabilities incurred or assumed pursuant to a binding written contract in effect prior to that date [Treas. Reg. § 1.752-2(l)]. If a **disregarded entity** (qualified real estate investment trust (REIT) subsidiaries, qualified Subchapter S Subsidiaries, and single-owners entities that are disregarded under the check-a-box rules) **is a partner** in a partnership, any payment obligations undertaken by the disregarded entity generally are treated by the regulations as a presumption of deemed satisfaction of obligation undertaken by the partner. [Treas. Reg. § 1.752-2(b)(6]

However, the owner of a disregarded entity under statutory local law generally has no obligation to satisfy the payment obligation of its disregarded entity. Therefore, obligations undertaken as a partner, generally create no real economic risk of loss for the disregarded entity or its owner unless the disregarded entity has assets in addition to its partnership interest.

Aside from the anti-abuse rules discussed below, according to the 2006 Regulations, if a partner owns a partnership interest through a disregarded entity, the partner is treated as bearing the economic risk of loss for a partnership liability only to the extent of the "net value" of the disregarded entity's assets as of the "allocation date" unless the owner of the disregarded entity is required to satisfy the payment obligation. [Treas. Reg. § 1.752-2(k)(1)]

Net Value

For purposes of determining the net value of the disregarded entity, the value is equal to [Treas. Reg. § 1.752-2(k)(2)]:

- The fair market value of all assets owned by the entity that may be subject to creditor's claims under local law, including the entity's enforceable rights to contributions from its owner and the fair market value of an interest in any other partnership (excluding the entity's interest in the partnership for which net value is being determined and the fair market value of property pledged to secure a partnership liability under § 1.752-2(h)(1)), less

- All obligations of the entity that do not constitute obligations for which the entity is treated as bearing economic risk of loss.

Example:
In 2018, Nathan forms a wholly owned limited liability company, N LLC, with a contribution of $100,000. N LLC is a disregarded entity and Nathan has no liability for the LLC's debt. N LLC has no enforceable rights to contribution from Nathan. N LLC contributes $100,000 to AB LP (a limited partnership) in exchange for general partnership interest. A and B each also contribute $100,000 in exchange for a limited partnership interest in AB LP. The partnership agreement provides that only N LLC is required make up any deficit in its capital account. In 2019, AB LP borrows $300,000 from the bank and purchase non-depreciable property for $600,000. The $300,000 debt is secured by the property and is also a general obligation of AB LP. AB LP determines its partners' shares of the $300,000 debt at the end of its tax year. Thus, as of December 31, 2019, N LLC holds no asset other than its interest in AB LP. Because N LLC is a disregarded entity, Nathan is treated as the partner in AB LP for tax purposes. Only N LLC has an obligation to make a payment on account of the $300,000 debt if the partnership were to constructively liquidate. Therefore, Nathan is treated as bearing the economic risk of loss for AB LP's $300,000 debt, but only to the extent of N LLC's net value. Because that net value is $0 (N LLC's only asset is its interest in the partnership) on Dec. 31, 2019, Nathan is not treated as bearing the economic risk of loss for any portion of the partnership's $300,000 debt. As a result, the partnership's $300,000 debt is treated as nonrecourse debt, and is allocated as required by Treas. Reg. §1.752-3. [Treas. Reg. § 1.752-2(k)(6) Ex. (1)]

Timing of Net Value Determination

The initial determination of the net value of a disregarded entity is made on the allocation date, which is the earlier of,

(1) the first day during such year on which it is necessary to determine the basis of the disregarded entity's share of partnership liabilities or
(2) the end of the partnership's tax year in which the requirement to determine the net value of a disregarded entity arises. [Treas. Reg. § 1.752-2(k)(2)(iv)]

After the net value of a disregarded entity is initially determined, it is not later re-determined unless a valuation event occurs during the partnership taxable year. [Treas. Reg. § 1.752-2(k)(2)(ii)(B)] (See Treas. Reg. § 1.752-2(k)(2)(iii) for the valuation events)

Multiple Liabilities

If one or more disregarded entities have obligations that may be taken into account with respect to one or more partnership liabilities, the partnership must allocate the net value of each disregarded entity among partnership liabilities in a reasonable and consistent manner, taking into account the relative priorities of those liabilities. [Treas. Reg. § 1.752-2(k)(3)]

5630 Anti-abuse Rules

The general anti-abuse rule is provided in the 1991 Regulations to allow the government to disregard the form of a financing arrangement designed to allocate partnership liabilities to the partners that do not bear the economic risk of loss.

An obligation of a partner or related person to make payment may be disregarded or treated as an obligation of another person if the facts and circumstances indicate that the principal purpose of the arrangement between the parties is to eliminate the economic risk of loss of a partner with regard to an obligation or create the appearance of a partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. These circumstances include, but not limited to, the following situations: [Treas. Reg. § 1.752-2(j)(1)]

Arrangement Tantamount To A Guarantee

Regardless of the form of a contractual obligation, a partner is considered to bear the economic risk of loss with respect to a partnership liability, or a portion thereof, to the extent that:

1) The partner or related person undertakes one or more contractual obligations so that the partnership may obtain a loan;

2) The contractual obligation of the partner or related person eliminates substantially all the risk to the lender if the partnership does not satisfy its obligation under the loan; and

3) One of the principal purposes of using the contractual obligation is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests.

Additional Information: Temp. Treas. Reg. § 1.752-2T(j)(2), which is effective for liabilities incurred or assumed on or after October 5, 2016, added another situation that would be subject to the anti-abuse rules. Under the temporary regulations, a partner is treated as bearing the economic risk of loss with respect to a partnership liability to the extent that another partner, or a person related to another partner, enters into a payment obligation with a principal purpose of causing the partner's payment obligation described in 1) and 2) to be disregarded as a bottom dollar payment obligation. The rules under the temporary regulations will, unless final regulations are issued, expire on 10/04/2019. California has not conformed to Temp. Treas. Reg. § 1.752-2T.

For purposes of an arrangement tantamount to a guarantee, partners are considered to bear the economic risk of loss for the liability in accordance with their relative economic burdens for the liability under the contractual obligation. Thus, a lease between a partner and a partnership that is not on commercially reasonable terms could be tantamount to a guarantee by the partner of a partnership liability. [Treas. Reg. § 1.752-2(j)(2); Temp. Treas. Reg. § 1.752-2T(j)(2)(ii)]

Example:
K partnership is formed by K and L for the purposes of buying and leasing computer equipment. K invested in this partnership, in part, to obtain tax benefits arising from partnership losses. The partnership borrows money on a nonrecourse basis to acquire a computer that is subject to an existing two-year lease. In order to induce the creditor to make the loan, L agrees to lease the computer from the partnership under a master lease arrangement that requires L to maintain the computer and to continue making lease payment even if the computer is damaged or destroyed. The rental payments under the master lease are sufficient to fully amortize all amounts due under the loan and the master lease agreement is pledged to the lender.

K will have sufficient basis in its partnership interest to take full advantage of its share of the partnership losses only if the loan is treated as a nonrecourse liability

(which would be shared among partners in accordance with their partnership profits interests). Under the anti-abuse rule, however, the master lease may be treated as tantamount to a guarantee by L, the partner who, because of the master lease, may be treated as having the economic risk of loss for the entire liability.

PLAN TO CIRCUMVENT OR AVOID THE OBLIGATION

If the facts and circumstances indicate a plan to circumvent or avoid the obligation, a partner's obligation to make a payment may not be recognized. [Treas. Reg. § 1.752-2(j)(3)]

***Example**:*
A and B form a general partnership. A, a corporation, contributes $50,000 and B contributes $450,000. A is obligated to restore any deficit in its partnership capital account. The partnership agreement provides that losses will be allocated 10% to A and 90% to B until B's capital account is reduced to zero, after which, all losses will be allocated to A. The partnership purchases a depreciable property for $5,000,000 paying $500,000 cash and borrowing $4,500,000 from a bank. The loan is a recourse liability since B guarantees payment of the $4,500,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership. A is a subsidiary of another corporation, formed for the purposes of investing in the business activity with capital limited of $50,000. The agreement to allocate all losses to A after B's capital account is reduced to zero is to allow A to enjoy the tax loss generated by the property at the same time limiting its monetary exposure for such losses. These facts, when considered with B's guarantee of the loan, indicates a plan to circumvent or avoid A's obligation to contribute to the partnership. Even though the partnership agreement provides that A has to restore its deficit capital account, this obligation to contribute must be ignored. The entire $4,500,000 recourse liability has to be allocated to B who bears the economic risk of loss. [Treas. Reg. § 1.752-2(j)(4)]

5700 PARTNER'S SHARE OF NONRECOURSE LIABILITY

For purposes of § 752, a nonrecourse liability is a partnership liability for which no partner or related person bears the economic risk of loss (See PTM 5492). Therefore, the allocation of a true nonrecourse liability cannot be determined based on the partners' economic risk of loss. Instead, partnership nonrecourse liabilities are allocated among the partners in the following order: [Treas. Reg. § 1.752-3(a)]

- The partner's share of partnership minimum gain determined in accordance with the rules of § 704(b) and the regulations thereunder (See PTM 5710)
- The amount of any taxable gain that would be allocated to the partner under § 704(c) (or in the same manner as § 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the partnership liabilities and for no other consideration (See PTM 5720); and
- The partner's share of excess nonrecourse liabilities (those not allocated under the above two rules, i.e., § 704(b) and § 704(c).) The allocation of the excess nonrecourse liabilities is in accordance with the partner's share of partnership profits or another method elected by the partnership provided this method meets the requirements under § 704(b) regulations.

The above three tiers apply to partnership nonrecourse liabilities on a liability-by-liability basis. (See PTM 3071 for discussion of situations when a property is subject to more than one liability)

PTM 5710	Partnership Minimum Gain Under § 704(b)
PTM 5720	Partnership Minimum Gain Under § 704(c)
PTM 5730	Nonrecourse Liabilities in Tiered Partnerships

5710 Partnership Minimum Gain Under § 704(b)

- The amount of partnership minimum gain is the gain that a partnership would realize if it disposed of the property subject to that liability for no consideration other than in full satisfaction of the liability. [Treas. Reg. § 1.704-2(d)(1)]

- In general, the minimum gain amount is determined by subtracting the partnership's adjusted basis in the property from the balance of the encumbering liability. If the partnership's adjusted basis is more than the amount of the encumbering liability, there is no minimum gain and this rule does not apply.

- If partnership property is reflected on a partnership's books at a value that differs from its adjusted tax basis, the determination of PMG is based on the book value. [Treas. Reg. § 1.704-2(d)(3)]

***Example**:*
*GP (general partner) and LP (limited partner) formed a partnership in 2018. GP contributed $10,000 and LP contributed $90,000. The partnership agreement provides that losses would be allocated 10% to GP and 90% to LP (assume the allocation has substantial economic effect (*see PTM 1100*)). Partnership AB bought a depreciable property in 2018 for $1,000,000, paying $50,000 in cash and the balance is financed through a nonrecourse loan. As of December 31, 2019, the partnership's adjusted basis in the property is $800,000 (due to depreciation of $200,000) and the balance on the loan is $950,000. Assuming the partnership disposed of the building for no other consideration except to satisfy the nonrecourse loan, the partnership would realize $150,000 in minimum gain. Under the "minimum gain chargeback" rule*[19]*, this gain would normally be allocated ("charged back") to the partners who took the (depreciation) deductions that created the minimum gain. Therefore, an amount of nonrecourse liability equal to the minimum gain of $150,000 is allocated to GP and LP in accordance with their share of depreciation deduction on the property, which is 10% and 90%, respectively. [Treas. Reg. § 1.704-2(m), Ex. (1)] The remaining $800,000 of the nonrecourse liability will be allocated according to the partners' profit ratio. (There is no § 704(c) built-in gain to be allocated in this case (See* PTM 5720*)*

Note: The regulations under § 704(b) are discussed in PTM 1000 through PTM 1495.

5720 Partnership Minimum Gain Under § 704(c)

A partner's share of nonrecourse liabilities includes the amount of any taxable gain that would be allocated to the partner under § 704(c) or in the same manner as § 704(c) if partnership property is revalued.

IRC § 704(c) provides that income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution. [IRC § 704(c)(1)]

If a partner contributes a property to a partnership, and at the time of contribution, the fair market value of the contributed property exceeds the partner's adjusted

[19] Treas. Regs. § 1.704-2(e)(3); 1.704-2(f)

basis in the property, the excess amount is referred to as § 704(c) gain, or the built-in gain. It is a gain that the contributing partner would have recognized had he sold the property at its fair market value. The regulations under § 752 ensure that the contributing partner's share of the nonrecourse liability encumbering the property he contributes should include this built-in gain to prevent recognition of gain on the contribution of the property.

Note: In Rev. Rul. 95-41, 1995-1 C.B. 132, the IRS issued guidance on the effect of § 704(c) on the allocation of nonrecourse liabilities under Reg. § 1.752-3(a).

Example:
Assume the facts are the same as the above example, except that on December 31, 2019, a new limited partner is admitted into the partnership for a 50% limited interest in the partnership. The new partner contributes $50,000 in cash to the partnership. The partnership uses the cash as its working capital. The partners' interests in the partnership capital, profits, and losses are as follows: GP: 10%; Old LP (LP 1): 40%; and New LP (LP 2): 50%. Since a new partner is admitted, the partnership's property is revalued, which shows it has a market value of $1,000,000. The allocation of the $950,000 outstanding nonrecourse liability among the three partners is as follows:

Determining the amount of PMG
Under the general rule discussed in PTM 5700*, the first tier is the allocation of the minimum gain under §704(b), which reflects the excess of the outstanding liability over the partnership's adjusted basis in the property. The partnership tax basis in the property is $800,000. However, due to the revaluation, the book value of the property is "booked up" to $1,000,000, which reflects its market value. As discussed above (see* PTM 5710*), when a property's book basis is different from its tax basis, the book basis is to be used for the purpose of computing the partnership minimum gain. In the instant case, since the book basis ($1,000,000) exceeds the outstanding loan ($950,000), there is no partnership minimum gain.*

Determining the amount of § 704(c) minimum gain
Under the rule discussed in PTM 5700*, the second tier of allocation includes the gain determined under § 704(c) or in the same manner as § 704(c) in connection with a revaluation of partnership property, which applies in this case due to the admission of a new partner. In general, the § 704(c) minimum gain reflects the built-in gain the contributing partner should recognize if the partnership disposes of the property in full satisfaction of the encumbering liability. Therefore, the difference between the liability ($950,000) and the tax basis of the property ($800,000) which is $150,000 will be allocated to GP and LP 1 (which reflects the gain associates with their holding of the property during the years before LP 2 is admitted.) However, it should be*

noted that if the property is hypothetically sold for the balance of the liability, which is $950,000, it would generate a book loss of $50,000 (because the property's book value is $1,000,000). Depending on the methods the partnership adopts under § 704(c) rules, the partnership may allocate $150,000 minimum gain to GP and LP 1 under the traditional method or traditional method with curative allocation or allocate $200,000 ($150,000 minimum gain plus $50,000 remedial allocation) under the remedial method, $20,000 to GP and $180,000 to LP 1. [Revenue Ruling 95-41, 1995-23 IRB 5]

The excess nonrecourse liability

Assuming the partnership adopts the remedial method and allocates $200,000 in § 704(c) gain to GP and LP 1 (according to their previous ratio 10/90), the excess nonrecourse liability of $750,000 ($950,000 - 200,000) is allocated to GP, LP 1, and LP 2 according to their profit ratio or a different method they agree upon provided this method meets the requirements under § 704(b) regulations.

5730 Nonrecourse Liabilities in Tiered Partnerships

An upper-tier partnership's share of the liabilities of the lower-tier partnership is treated as a liability of the upper-tier partnership for purposes applying § 752 (and the regulations thereunder) to the partners of the upper-tier partnership. The liability of the lower-tier partnership that is owed to the upper-tier partnership is not counted under this "flow-through" method.

***Example**:*

Al contributes $10,000 in cash to AA partnership for a 10% interest in the partnership. Partnership AA invests $50,000 for 50% interest in Realty partnership. Realty partnership purchases an apartment building, incurring a nonrecourse loan of $900,000.

Partnership AA's share of partnership Realty's liability is 50% of the $900,000 nonrecourse loan, which is $450,000. Therefore, partnership AA's basis in Realty is $500,000 (consisting of its cash investment of $50,000 and $450,000 in its share of Realty liability). Al's basis in partnership AA is $55,000 (consisting of $10,000 in cash contribution and $45,000, his 10% share of AA's liability). [Revenue Ruling 77-309, 1977-2 CB 216]

5800 BASIS & LIABILITIES: POTENTIAL AUDIT ISSUES & TECHNIQUES

PTM 5810 In General PTM
5820 Basis
PTM 5830 At Risk Issues
PTM 5840 Audit Issues–Involving Partnership Liabilities

PTM 5850 Audit Issues–Is the Liability A Partnership Liability?
PTM 5860 Audit Issues–Is the Liability Recourse or Nonrecourse?
PTM 5870 Audit Issues–Determining Partner's Share of Partnership Liability
PTM 5880 Audit Issues–Valuation of an Obligation

5810 In General

GATHERING THE FACTS IS THE MOST IMPORTANT STEP IN THE AUDIT PROCESS.

5820 Basis

Generally, auditors will need to know a partner's basis in their partnership interest, **especially** in the following situations:

- The partnership reports a loss on the Schedule K that flows through to partners.

  The issue is whether the partner has sufficient basis in his partnership interest to deduct the losses. A computation of basis should be made to determine the deductibility of the loss. If the partner does not have sufficient basis in their partnership interest, losses may be disallowed in the current year and suspended until the partner has enough basis to deduct the losses.

- The partnership distributes property or cash in a non-liquidating or liquidating distribution.

  The issue is whether the distribution is taxable (See PTM 6000). A computation of the partner's basis in the partnership should be made to determine the taxability of the distribution. If a distribution is in excess of a partner's adjusted basis in his partnership interest, the distribution may be taxable.

  Although a distribution of property generally is not taxable, the basis of the distributed property may be adjusted under § 732. When the distributed property is subsequently sold, auditors need to verify the basis used in computing the gain or loss on the sale.

- The partnership is relieved of liabilities or has a decrease in liabilities. This would appear as other income on the Schedule K or on the Schedule L (balance sheet) as a decrease in liabilities.

The issue is whether the decrease in liabilities creates a deemed distribution. If the audit determines that a deemed distribution occurred, taxable income must be reported. (See PTM 6000)

- There was a sale of partnership interest. The issue is whether the leaving partner reported the correct gain. The amount realized from sale of partnership interest include cash or other property received plus relief of partner's share of partnership liabilities, if any. When the partnership interest is disposed of, the partner's tax basis in the partnership needs to be verified.

A schedule of basis should be requested from the **partner** since the partnership is not required to calculate basis for each partner. Once this is provided, a cursory check should be made by comparing amounts on the schedule of basis with the actual return and prior year Schedule K-1s.

If the partner does not provide a schedule of basis, the auditor has two options. The first option is to obtain Schedule K-1's from inception (if available) and calculate the partner's basis using the Schedule K-1's and canceled checks to verify contributions. The second option is to use the alternate method discussed at PTM 5240.

5830 At Risk Issues

Auditors should compute a partner's amount at risk if a loss has been reported on the **partner's** return. The audit issues and techniques are as follows:

For Real Estate Partnerships:

- If a liability (other than qualified nonrecourse) is included in the at risk calculation, the auditor should verify that the **partner** is personally liable.

  The issue is whether the partner is actually liable for the debt. If the partner is not liable, it cannot be included in the amount at risk computation. If the partner does not have enough at risk, losses may be suspended until the partner does have enough at risk. Normally, the loan document or amendment to the loan document will substantiate that fact.

- If a nonrecourse note is included in the at risk computation, verification should be made that the nonrecourse financing is **qualified**.

  The issue is whether the nonrecourse financing meets the criteria stated in PTM 5330. If the financing does not meet the criteria, it is not allowed to be included

in the at risk computation. If the partner does not have enough at risk, losses may be suspended until the partner has enough at risk to deduct the losses. To determine if a note meets the criteria, the auditor should examine the loan documents. The loan documents will disclose who the lender is and the fact that it is actually a nonrecourse note. Most loan documents will state the purpose of the loan (e.g. construction or real estate).

For Non-Real Estate Partnerships:

- If a liability is included in the amount at risk, the auditor should verify that the **partner** is personally liable.

  The issue is whether the partner is actually liable for the debt. If the partner is not liable, it cannot be included in the amount at risk computation. Normally, the loan document or amendment to the loan document will state whether an individual partner has guaranteed the note.

A partner may be subject to gain recognition if his amount at risk falls below zero (i.e. due to a cash distribution). Any recaptured loss amount is deductible in subsequent years when the partner's at risk amount rises above zero. (PTM 5340)

5840 Audit Issues Involving Partnership Liabilities

Determining a partner's share of partnership liabilities, or a relief thereof, is an important part of the determination of a partner's basis in his partnership interest. (See PTM 5820) In some situations, the determination of a partner's share of partnership liabilities may be complicated. Though the regulations promulgated under § 752 are lengthy and complex, the auditor needs to understand them thoroughly to determine if the partnership's allocation of its liabilities is in compliance with the law. This section provides some guidelines on the areas the auditor may want to examine and certain audit techniques.

In general, an examination of a partner's share of partnership liabilities should include the following:

- Determining if the liability is a partnership liability.
- Determining if the liability is a recourse or nonrecourse liability.
- Examining the allocation of the liability to partners.
- Examining the valuation of the partner's obligation to contribute or to make a payment.

Though there is no requirement that all of the above areas have to be thoroughly examined in each case, the auditor should be able to make a determination based

on the provided documents. If the auditor decides to pursue an area further, he may want to consider the following factors before and during the audit:

- Materiality: An examination of § 752 issues may be time consuming due to the potential amount of documents to be reviewed. The auditor needs to determine in advance the materiality of the issue and the estimated time to resolve the issue.

- Audit Scope: An examination of a partner's share or relief of partnership liabilities may be complicated in some situations. The auditor needs to exercise judgment to limit or expand the scope of his examination based on the facts and circumstances. For instance, if a partner transfers a portion of his partnership interest to another partner, the issue may be limited to the tax effects of the relief of liability on the transferring partner. However, if the transferring partner claims that he remains liable for the liability associated with the transferred interest, the auditor may have to expand the examination to determine if the partner's claim is valid. In other words, the auditor needs to constantly evaluate the scope of his examination based on the facts and circumstances of the case.

5850 Audit Issues–Is the Liability A Partnership Liability?

In order for a liability to be allocated to the partners, it has to be a partnership liability for purposes of § 752 (see PTM 5431)

In most situations, there is compliance in this area. Generally, the auditor may be able to determine if a liability is a § 752 liability based on a review of the loan document. However, there are several issues identified in this area.

Accounts Payable

Facts: The taxpayer computes his insolvency for purposes of § 108. He includes his proportionate share of partnership's accounts payable. The accounts payable relates to partnership's purchase of its inventory. The partnership is on a cash accounting method.

Issue: If a partnership uses a cash accounting method, its account payable may not be considered a § 752 liability and the partners cannot increase their partnership's basis by their share of the account payable. (See PTM 5432).

Techniques: The auditor needs to verify the partnership's accounting method as reported on Form 565, line G (or line E for 2008 and after). If there is a change in the partnership's accounting method during the year, the auditor needs to examine the tax consequences of the change as well as its impact on the partnership's

account payable. [See, e.g., §§ 481(a), 446 and the regulations thereunder.] Also, request the taxpayer's explanation of the inclusion of such amount in his basis.

Contingent Liabilities

Issue: There are a number of cases where the taxpayers include their share of certain partnership liabilities which appear to be contingent liabilities for purposes of §752, particularly when the partners compute their insolvency under § 108. Whether a liability is contingent depends on the facts and circumstances. (See PTM 5434) It should also be noted that a liability required to be reported for financial purposes does not necessarily constitute a liability for tax purposes or § 752 purposes.

Techniques: The auditor needs to request all documents related to the said liabilities and determine whether they meet the requirements of § 752 (see PTM 5431) or if they meet the "all event" test (see PTM 5434).

Note: There are no cases or IRS guidance regarding the inclusion of contingent liabilities in the insolvency computation.[20] For instance, when a limited partner guarantees a partnership liability and the partnership as well as other partners are insolvent, should the limited partner be allowed to include the liability in his insolvency computation?

Loans by Partners

Issue: If a partner or his related person makes a nonrecourse loan to the partnership, the loan is characterized as a recourse loan and allocated to the lending partner (see 5440). (There are exceptions.) A loan from a partner may also arise out of the sale of property by a partner to the partnership.

Techniques: Based on the loan documents, the auditor should be able to determine whether or not the loan is a nonrecourse loan from a partner. Check if the exception rules apply. Also, the auditor should analyze the tax effects of the liability reallocation on all partners, such as limiting losses or recognizing gain from a distribution exceeding basis.

Loans or Capital Contributions

Issue: As discussed in PTM 5450, a partner's loan may be recharacterized as a capital contribution or vice versa, based on the facts and circumstances of each particular case. In some situations, a partner may want to recharacterize a capital

[20] See, e.g., R. Zebulon Law, Esq., Insolvency: *Excluding Debt Relief Income Under IRC Section 108(a)(1)(B*

contribution as a loan to obtain the benefit of deducting a bad debt when the partnership is not capable of repaying its debt. If the loan is in essence a capital contribution, the partner's bad debt deduction may be disallowed and the loss from a capital contribution may not be recognized until the partnership liquidates. In other situations, a partner may want to characterize a loan as a capital contribution to obtain additional basis in his partnership interest.

Techniques: Again, whether an advance of money is a loan or a capital contribution depends largely on the facts and circumstances. The auditor needs to obtain all related documents and make a determination accordingly. Please note that the government may be allowed to recharacterize a partnership transaction based on its substance while the taxpayers are generally bound by the form of the transaction they selected though they might have intended differently.

Partner's Assumption of Partnership Liabilities

Issue: A partner's assumption of partnership liabilities may occur in a number of situations, e.g., when a property encumbered with liability is distributed to a partner. Also, when a partner's status changes from being a general partner to a limited partner, he may or may not remain liable for certain partnership liabilities that he previously assumed as a general partner.

Techniques: The purpose of the examination is to determine if the partner's assumption is valid. The auditor needs to consider a number of factors such as the partner's status, the type of partnership liabilities, the financial agreements and arrangements among the lender, the partnership, and all partners, etc. The auditor should also be aware of certain limitations regarding the amount assumed and the conditions for the assumption (see PTM 5460). In addition, the auditor may want to know what happened to the liability after it was assumed by the partner, e.g., if the partner made any payments on interest and principal of the loan, etc.

Netting of Increases and Decreases in Liabilities

Issue: In general, all increases and decreases in a partner's share of partnership liabilities are netted if they are from a single transaction. (See PTM 5470) The issue is to determine which increase or decrease is associated with a transaction. Also, the issue may be to determine what constitutes a "single transaction" for netting purposes.

Example: Corporation A is an equal partner in partnership AB. The partnership owns a building that is rented by A. For various tax planning purposes (which are irrelevant in this example) the following "transactions" occur at the same time:

- The partnership refinances its old mortgage on the building with a new mortgage;
- The partnership distributes both the building and the new mortgage to B, the other corporate partner; A receives nothing but the right to lease the building;
- B sells the building to the bank (mortgage holder) in cancellation of the outstanding mortgage;
- The bank leases the building to A subject to certain requirements so that for income tax purposes, A is treated as owner of the property and enjoys all the tax benefits associated with such ownership (e.g., deduction for depreciation, interest expenses, etc.)

There is no issue with the leasing arrangement in this case. However, the main issue is at the time of the partnership liquidation, A has a very large negative capital account that is not restored when the partnership liquidates. Since both the building and the mortgage are distributed to B, A's share of the partnership liability is decrease which constitutes a deemed cash distribution to A. Therefore, the negative capital account represents the potential gain A has to recognize. However, A argues that it has no gain on the partnership liquidation because the relief of liability from the liquidation is netted with the liability A assumes when it leases the building from the bank. The basis for netting the decrease and increase in liabilities, according to A, is because the partnership liquidation and the lease of the building are merely "steps" in a single transaction aiming at transferring the building and the mortgage to A.

As it could be seen, the issue with this case is what constitutes a "single transaction": whether the liquidation of the partnership, the sale of the building, and the subsequent lease can be treated as steps in a single transaction or separate and distinct transactions with their own tax consequences. Though A's arguments may be challenged under the "step transaction" theory, this case is an illustration of a potential issue with the netting rule.

Techniques: In cases similar to the above, the auditor needs to develop all the facts and circumstances and make a determination based on case law precedence.

5860 Audit Issues–Is the Liability Recourse or Nonrecourse?

After determining if a liability is a partnership liability for § 752 purposes, the auditor needs to verify if the partnership's liabilities are correctly characterized as recourse or nonrecourse.

- A partnership liability is a recourse liability if any partner (or a related person) bears the economic risk of loss for the liability. (See PTM 5490) An economic risk of loss is determined using the constructive liquidation test. (See PTM 5510)

In essence, this test determines the amount a partner has to contribute to the partnership to satisfy the partnership creditors if all of the partnership assets become worthless.

- A nonrecourse liability is a liability for which no partner (or a related person) bear the economic risk of loss (see PTM 5492).

Therefore, "economic risk of loss" is used to characterize a partnership liability as a recourse or nonrecourse liability.

In most situations, the auditor should first determine whether a loan is recourse or nonrecourse based on the terms of the agreements between the lender and borrower. For instance, in a nonrecourse loan agreement, the lender's recourse is usually limited to taking the collateral by power of sale under the deed of trust and no deficiency judgment can be obtained even if the value of the collateral is less than the amount of the liability. On the other hand, if a lender may obtain a deficiency from the debtor and the general partners, the liability is recourse.

In addition, a loan may also be recourse or nonrecourse based on the lender's rights under state law. For instance, a loan incurred in connection with the purchase of a personal residence in California is nonrecourse by virtue of California law. [Cal. Code Civ. Proc. § 580b]

The problem with distinguishing recourse from nonrecourse is when the loan agreement is silent with regard to borrower's "personal liability". In this situation, the auditor should look at the type of loans. For instance, if the loan is a personal loan, not secured by any property, the loan should be treated as recourse since the lender has no other recourse except to look at the borrower as a source of repayment. If the loan is secured by a property and there is no expressed provisions regarding personal liability, the loan is generally nonrecourse since the lender's only recourse is to foreclose on the securing property. Please note that even in a nonrecourse loan, a borrower may be liable for certain items such as intentional misrepresentation and fraud, environmental indemnity, waste, etc.

The auditor should then determine whether any partner or related person bears economic risk of loss with respect to the partnership liability by considering various contractual obligations and economic arrangements between the partners and between the lender and the partners, such as partnership agreement, side agreements, indemnifications, guarantees, pledges, as well as obligations imposed by state and local law.

Techniques: The auditor should consider the purposes of all loans, the partnership business, and the underlying operation of state law. In addition, it is helpful if the auditor has copies of all loan agreements, side agreements, and modifications.

5870 Audit Issues–Determining Partner's Share of Partnership Liability

Applicable Regulations

The sharing of recourse and nonrecourse liabilities is provided in three different sets of regulations with different effective dates (see PTM 5480). The application of these regulations to a liability is based on the date the liability is incurred, unless the partnership makes an election to apply differently. Though the underlying sharing principle is the same in all three sets of regulations, the New Regulations provide more clarification and restrictions on the allocation of partnership liabilities.

In reviewing a partnership liability, the auditor may want to verify if the allocation of such liability is in compliance with the applicable regulations.

Sharing of Recourse Liabilities

To determine a partner's share of recourse liability, the auditor should perform the following tasks:

- *Determining a partner's economic risk of loss*: A partner's share of partnership recourse liabilities under the regulations is based on his economic risk of loss. The determination of a partner's economic risk of loss is made under a hypothetical liquidation in which the partnership's assets were disposed of for no value and the resulting loss is allocated to the partners according to their loss sharing ratio. This allocated loss causes the partners' capital account to be negative. Each partner's negative capital account represents the amount he has to contribute to the partnership or to the creditor to satisfy the liability, which is also referred to as his "economic risk of loss". As a result, the partner is allocated all or a portion of the partnership recourse liabilities equivalent to this economic risk of loss amount, provided the obligations determined under this hypothetical liquidation meet the requirements discussed below. (See Examples in PTM 5520)

- *Valuation of the Obligations*: The hypothetical liquidation helps determine each partner's obligation to contribute or to make payment. To what extent these obligations are recognized depends on the facts and circumstances at the time of the determination. The 1991 Regulations provide various rules regarding the valuation of an obligation to make payment or contribution (see PTM 5530, PTM 5610). For instance, contractual obligations outside the

partnership agreement such as guarantees, reimbursement agreement, etc. entered into by the partners, creditors, or the partnership are recognized. Contingent obligations are not recognized. (See PTM 5531) Also, if an obligation is not satisfied within the time period specified in the law (see PTM 5610), the value of such obligation is computed based on its present value rather than its face value (see PTM 5611).

The auditor needs to verify if the obligations are in compliance with the rules provided in the regulations. Any allocations that are different from the amounts determined in the above process should be revised.

Note: In general, for purposes of determining the partner's economic risk of loss and his obligations, it is assumed that the partner is capable of satisfying these obligations, regardless of his financial situation, unless the facts and circumstances indicate a plan to circumvent or avoid the obligations (see PTM 5533)

Sharing of Nonrecourse Liabilities

In general, a partner's share of nonrecourse liabilities is based on three tiers (see PTM 5700): PMG, § 704(c) minimum gain, and the excess nonrecourse gain. Due to the complexity involving § 704(b) and (c) regulations, the potential issues involving nonrecourse liabilities are discussed in PTM 2000 through PTM 3500.

Techniques

When to audit? The most commonly asked question is in what situation should an auditor need to verify the allocation of partnership liabilities? The general answer is whenever there is a need to determine a partner's basis in the partnership. The need to determine a partner's basis may arise when a partner is allocated partnership losses, distributed partnership property, or when there is a change in the ownership of partnership interest (through a sale, gift, retirement, admission of new partners, etc.)

As mentioned earlier, the determination to examine the liability allocation should be based on materiality and the time it takes to complete the examination.

Entity vs Investor Level: The need to examine the sharing of partnership liabilities may arise due to various reasons, e.g., an admission of a new partner into the partnership, a special allocation of certain partnership items of income or losses to certain partners, etc. Currently, there is no guideline on whether the auditor should conduct the examination at the partnership or the partner level. It is up to the auditor's judgment to determine the scope and the extent of his examination based on the facts and circumstance of each case. For instance, if the schedule K-1

shows a limited partner being allocated a partnership recourse liability, the auditor may start his examination at such partner's level and request supporting evidence. However, if as a result of his examination, it is determined that the liability may have to be reallocated to other partners, the auditor may contact the partnership for additional information.

Note: Under the TEFRA rules, the amount, character and changes in partnership liabilities are treated as "partnership items" and should be determined at the partnership level. [See § 6231 and the regulations thereunder]

What documents to request? As a general rule, the auditor should have the following documents available for review:

- Partnership agreements and all amendments.
- All loan agreements, including all side agreements between the creditor and the partners.
- All agreements between the partners outside the partnership agreement.
- A schedule computed by the partnership showing how the partnership liabilities are allocated among the partners. Also, request the partnership to provide detailed explanation of its allocation and the authority supporting its allocation.

What to look for:

First, the allocation of partnership liabilities on the schedule computed by the partnership should match the amounts reported on the schedule K-1 issued to each partner.

Second, the auditor should verify the partnership's computation of its partners' economic risk of loss under the hypothetical liquidation. This verification should include a review of the partnership's total assets as reported on the Schedule L (Form 565), the balance of the liabilities immediately prior to the event that triggers the needs to examine the liability allocation, and the loss sharing ratios as stated in the partnership agreement.

Third, once the auditor is satisfied with the computation of the partners' economic risk of loss, he needs to evaluate the obligations to contribute or to make payment by verifying if the partners are required to timely restore their negative capital accounts as provided in the partnership agreement, or if there are any side agreements among the partners regarding reimbursement, indemnification, etc.

5880 Audit Issues–Valuation of an Obligation

The constructive liquidation test is to determine a partner's obligation to contribute to the partnership or to make a payment to any person (another partner or the creditors of the partnership). Whether or not an obligation is respected depends on facts and circumstances at the time of the determination. The § 752 regulations are specific about what obligations are recognized for purposes of § 752 (see PTM 5530). The auditor needs to be aware of these requirements and determine if the obligations meet these requirements.

The Anti-abuse Rules: The law provides that any obligations determined above may be disregarded if the facts and circumstances indicate a plan to eliminate certain partner's economic risk of loss or create the appearance of an economic risk of loss for certain partner (see PTM 5630). The auditor needs to evaluate all of the partnership's arrangements and contractual obligations as a whole and determine the substance of these arrangements.