

AUGUST 2011 CPA NEWSLETTER

IRC 752 - ALLOCATION OF DEBT AMONG PARTNERS - THE FUNDAMENTALS

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This month's newsletter focuses on an oldie but goodie: IRC 752—Allocation of debt among partners—the fundamentals. For various reasons, we have been called up on to consult with accounts on the allocation of liabilities among partners—remember those boxes you have to check on the K-1's? Almost invariably the liability allocations are wrong. It is not surprising since the rules are arcane and generally unknown to all but a select few.

The primary area that we are seeing this come up recently is in debt cancellation cases. In order to figure out how the CODI is allocated, you have to know how the debt was allocated initially—make sense? So we all happily look at the K-1's right? But this is where the garbage in, garbage out rule comes into play—most often these allocations are wrong or outdated. The allocation of debt issue is a year-by-year analysis as the debts can change and the financial arrangement among the partners can change. Partnerships may convert to LLCs or vice versa. So you can't just look at last year and apply it to this year. Additionally, novel questions can arise such as how do you allocate debt when you have a 1% LLC as a general partner in a limited partnership and all the owners own the same percentages in each entity but there are no personal guaranties?

Never fear, WKBKY has designed a simple outline that our attorneys use when they teach partnership taxation which we thought we would deliver to your doorstep. You will find it below. Hand it out to your coworkers. If you would like us to meet with your staff and coworkers and go over it, let us know and we will have one or our tax attorneys either meet with you in person or do a phone call gratis. It will make all our jobs easier later if we are called in to help with an audit or litigation.

OUTLINE - IRC SECTION 752

I. REASONS TO DETERMINE A PARTNER'S SHARE OF LIABILITIES

Assuming there has not been a transfer of the partnership interest, a partner's outside basis in his partnership interest generally consists of the sum of his (i) capital account (based on cost, not value); and (ii) share of partnership liabilities. The Section 752 regulations provide a set of rules for determining a partner's "share" of partnership liabilities. There are three basic reasons why it is important to determine a partner's share of liabilities.

1. Loss Limitations. Under Section 704(d), a partner may deduct partnership losses allocated to him under Section 704(b) only to the extent of his adjusted basis in his partnership interest.

2. Amount Realized. If a partnership interest is sold or exchanged, any resulting reduction in the transferor partner's share of partnership liabilities is included in the amount realized.

3. Partnership Distributions. A partner's outside basis will determine the amount of gain resulting from a distribution of cash to the partner from a partnership and will limit the amount of substituted basis a partner may have in property distributed from a partnership.

II. GENERAL EXPLANATION OF RECOURSE VS. NONRECOURSE UNDER STATE LAW

A. General Explanation. In order to understand the tax rules under Section 752, a basic understanding of the definition of **recourse** versus **nonrecourse** debt under State law is required. **Recourse** debt is debt which does not restrict the creditor's ability to collect on the debt to the collateral securing the debt. **Nonrecourse** debt is debt which restricts the ability of the creditor to collect against property secured by that debt. Generally speaking, all debt is recourse. This is true whether it is secured by real property, personal property or unsecured.

B. Types of Nonrecourse Debt. Debt can be made nonrecourse by specific contractual language contained in the debt instrument. There are also certain statutes which make debt nonrecourse even absent specific contractual language. Some examples of these statutory restrictions are contained in the "anti-deficiency laws" of California. While a comprehensive discussion of the "anti-deficiency laws" is beyond the scope of this course, suffice it to say that Civil Code of Procedure Section 580 restricts a creditor's ability to collect on debt secured by real property in two common situations:

1. Debt is used to acquire the property and the property consists of four residential units or under, one of which is occupied by the debtor;
2. Vendor-financed purchase money debt where the seller sells real property and receives as partial consideration a note secured by the real property.

There are numerous exceptions to the above rules.

III. THE 1991 FINAL REGULATIONS - GENERAL RULES

A. Tax Definitions of Recourse vs. Nonrecourse

1. "Recourse Liability". Regulations Section 1.752-1(a)(1) provides that a partnership liability is treated as a recourse liability to the extent that any **partner** or **related person** bears the economic risk of loss for the liability. A "related person" means a person having a relationship to a partner described in Regulations Section 1.752-4(b). While the definition of **related person** will not be summarized in this discussion, you should review the definition contained in the Regulations.

2. "Nonrecourse Liability". Regulations Section 1.752-1(a)(2) provides that a partnership liability is treated as "nonrecourse" to the extent that no partner or related person bears the economic risk of loss for the liability.

IV. 1991 REGULATIONS - DETERMINING PARTNER'S SHARE OF RECOURSE LIABILITIES

A. The Concepts of Economic Risk of Loss and Constructive Liquidation. The 1991 Regulations define a partnership liability as "recourse" to the extent that any partner or related person bears the economic risk of loss for the liability.

A PARTNER BEARS THE ECONOMIC RISK OF LOSS FOR A PARTNERSHIP LIABILITY TO THE EXTENT THAT, IF THE PARTNER-SHIP CONSTRUCTIVELY LIQUIDATED, THE PARTNER OR RELATED PERSON WOULD BE OBLIGATED TO MAKE A PAYMENT TO ANY PERSON (OR A CONTRIBUTION TO THE PARTNERSHIP) DUE TO THE FACT THAT THE 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.

Thus, there are two steps in determining a partner's share of recourse debt: first, the partnership must be constructively liquidated; and second, it must be determined which partners have an obligation to pay the partnership debts.

B. Constructive Liquidation. The following circumstances constitute a constructive liquidation for purposes of the Section 752 regulations:

1. All of the partnership's liabilities become payable in full;
2. With the exception of property contributed to secure a partnership liability, all of the partnership's assets, including cash, have a value of zero;
3. The partnership disposes of all of its property 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);
4. All items of income, gain, loss or deduction are allocated among the partners; and
5. The partnership liquidates.

Example #1

Determining When a Partner Bears the Economic Risk of Loss. A and B form a general partnership with each

contributing \$100 in cash. The partnership purchases an office building on leased land for \$1,000 from an unrelated seller, paying \$200 in cash and executing a note to the seller for the balance of \$800. The note is a general obligation of the partnership, i.e., no partner has been relieved from personal liability. The partnership agreement provides that all items are allocated equally except that losses from depreciation or the sale of real property are specially allocated 90% to A and 10% to B and that capital accounts will be maintained in accordance with the regulations under Section 704(b), including a deficit capital account restoration obligation on liquidation. In a constructive liquidation, the \$800 liability becomes due and payable. All of the partnership's assets, including the building, are deemed to be worthless. The building is deemed sold for a value of zero. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

	A	B
Initial Contribution	\$100	\$100
Loss on Hypothetical Sale	(900)	(100)
	(\$800)	\$-0-

Other than the partners' obligation to fund negative capital accounts on liquidation, there are no other contractual or statutory payment obligations existing between the partners, the partnership and the lender. Therefore, \$800 of the partnership liability is classified as a recourse liability because one or more partners bears the economic risk of loss for nonpayment. B has no share of the \$800 liability since the constructive liquidation produces no payment obligation for B. A's share of the partnership liability is \$800 because A would have an obligation in that amount to make a contribution to the partnership.

6. For purposes of this constructive liquidation, if a creditor's right to repayment is limited solely to one or more assets of the 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 in only those assets. To the extent that Section 704(c) or Regulations Section 1.704-1(b)(4)(i) applies to an asset, gain or loss recognized is equal to the difference between the amount of the liability extinguished by the deemed disposition and the book value of the asset.

7. In addition, upon a constructive liquidation, a partnership recognizes a loss equal to the tax basis of all of the partnership's assets not subject to a creditor's right to repayment. To the extent that such assets are subject to Section 704(c) or Regulations Section 1.704-1(b)(4)(i), the partnership recognizes a loss on their deemed disposition equal to the remaining book value of the assets.

C. Obligations to Make a Payment or a Contribution.

1. General Rule. A partner does not bear the economic risk of loss with respect to a partnership liability unless the partner or a related person would be obligated, upon a constructive liquidation, to make a payment to any person, or a contribution to the partnership.

2. Facts and Circumstances. The question of whether a partner or related person is obligated to make a payment to any person (or a contribution to the partnership) is generally a facts and

circumstances inquiry. For purposes of this inquiry, all of the following statutory and contractual obligations are taken into account:

- a. Contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements and other obligations running directly to creditors or to other partners, or to the partnership;
- b. 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 the partnership; and
- c. Payment obligations imposed by state law, including the governing state partnership statute.

Example #2

Recourse Liability; Deficit Restoration Obligation. C and D each contribute \$500 in cash to the capital of a new general partnership, CD. CD purchases property from an unrelated seller for \$1,000 in cash and a \$9,000 mortgage note. The note is a general obligation of the partnership, i.e., no partner has been relieved from personal liability. The partnership agreement provides that profits and losses are to be divided 40% to C and 60% to D. Upon winding up of the partnership C and D are required to make up any deficit in their capital accounts. In a constructive liquidation, all partnership assets are deemed to become worthless and all partnership liabilities become due and payable in full. The partnership is deemed to dispose of all its assets in a fully taxable transaction for no consideration. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

	C	D
Initial Contribution	\$500	\$500
Loss on Hypothetical Sale	(4,000)	(6,000)
	(\$3,500)	(\$5,500)

C's capital account reflects a deficit that C would have to make up \$3,500 and D's capital accounts reflects a deficit that D could have to make up \$5,500. Therefore, the \$9,000 mortgage note is a recourse liability because one or more partners bears the economic risk of loss for the liability. C's share of the recourse liability is \$3,500 and D's share is \$5,500.

V. PARTNER'S SHARE OF NONRECOURSE LIABILITIES

A. In General. A partner's share of partnership nonrecourse liabilities includes the following three tiers:

1. The partner's share of partnership "minimum gain" determined in accordance with the

rules of Section 704(b)(Tier-1);

2. The amount of any taxable gain that would be allocated to the partner under Section 704(c) if the partnership disposed of all partnership property subject to one or more nonrecourse partnership liabilities in a taxable transaction in full satisfaction of the liabilities and for no other consideration (Tier-2:

704(c) Minimum Gain; and

3. The partner's share of excess nonrecourse liabilities (defined as nonrecourse liabilities not allocated under (a) or (b) above) (Tier-3).

B. Tier-1.

1. Coordinating Share of Nonrecourse Liabilities with Share of Minimum Gain. Partnership minimum gain is defined as the gain that a partnership would realize if it disposed of all partnership property subject to nonrecourse liabilities in full satisfaction of the liabilities, and for no other consideration. Minimum gain is a complicated concept which we will study more when we review IRC §704. At this point, I want to give you a layman's explanation: the concept is that if a partner takes advantage of a deduction, such as depreciation, which is based on a nonrecourse debt, that partner must pay back that deduction when the property is sold.

Example #3

Partnership AB is a two-person equal partnership composed of A and B. AB buys property by paying \$20,000 as a down payment and \$80,000 as a nonrecourse note. The entire property is depreciable on a straight-line basis over 10 years with no residual value. In the first and second year, there would be no "minimum gain" since no gain would be realized if the property were disposed of solely in consideration of the relief of the nonrecourse debt of \$80,000. On the first day of year four (and ratably during year three), there would be minimum gain, because the basis of the property would be \$70,000 and a disposition of the property for the relief of the \$80,000 nonrecourse debt would produce \$10,000 of "minimum gain." In tax parlance, there has been an "increase" in "minimum gain" of \$10,000 from the beginning year three to the beginning of year four. Similarly, there has been \$10,000 of "partnership nonrecourse deductions" for this period and "A" and "B" each have \$5,000 of "partner nonrecourse deductions" for this period. Under Tier-1, both A and B would be allocated \$5,000 of nonrecourse debt.

2. Tier-2: §704(c) Minimum Gain. A partner's share of partnership nonrecourse liabilities includes the amount of any taxable gain that would be allocated to the partner under Section 704(c) if the partnership disposed of all partnership property subject to one or more nonrecourse liabilities in a taxable transaction in full satisfaction of the liabilities and for no other consideration.

Example #4

C and D form an equal partnership CD. C transfers Blackacre with a basis of \$50,000 and a value of \$100,000.

D transfers \$100,000 in cash. CD takes out a nonrecourse loan secured by Blackacre in the amount of \$80,000. There is a total of \$50,000 of built-in gain in the property contributed by C. C's Tier-2 allocation of the nonrecourse loan would be \$30,000 ($\$80,000 - \$50,000 = \$30,000$) because under §704(c), the \$30,000 of §704(c) built-in gain in Blackacre will be allocated to C when Blackacre is sold solely in satisfaction of the nonrecourse debt of \$80,000. There, C's share of §704(c) minimum gain is \$30,000.

C. Tier-3. For Tier-3 allocations, the Regulations provide three principal alternative methods for determining a partner's share of excess nonrecourse liabilities. Excess nonrecourse liabilities are determined by subtracting the Tier 1 and Tier 2 allocated nonrecourse liabilities from the total nonrecourse liability. A partnership need not allocate excess nonrecourse liabilities under the same method each year.

1. Profits. Under the first method, the partnership may allocate such excess liabilities in accordance with the partner's share of partnership profits. Generally, a partner's share of partnership profits is determined by reference to all the facts and circumstances relating to the economic arrangement between the partners. The partnership agreement may specifically provide for the partners' interests in profits for purposes of allocating excess nonrecourse liabilities. However, such provisions will be respected only if the profits interests specified are reasonably consistent with allocations of some other significant item of partnership income or gain.

2. Related Deductions. Under the second alternative, a partnership may allocate excess nonrecourse liabilities in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated.

3. Section 704(c) Gain. The third alternative allows a partnership to allocate an excess nonrecourse liability to partners based on their share of "excess Section 704(c) gain" inherent in the property. The "excess Section 704(c) gain" is the excess of the amount of Section 704(c) built-in-gain attributable to an item of property over the amount of Section 704(c) minimum gain on that property.

Example #5

Assume the same facts as in Example 4 above. The excess nonrecourse liabilities would be \$50,000.

Total Nonrecourse Liability = \$80,000

Tier 1 Allocation = \$0

Tier 2 Allocation = <\$30,000>

Excess Nonrecourse Liability = \$50,000

Since this is an equal partnership, the \$50,000 of excess nonrecourse liability would be allocated equally between C and D under option 1 or 2. C would be allocated \$25,000 of nonrecourse liabilities and D would be allocated \$25,000 of nonrecourse liabilities.