Towards an Understanding of the Principles and Application of the Temporary Regulations Under Internal Revenue Code Section 752

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TOWARDS AN UNDERSTANDING OF THE PRINCIPLES AND APPLICATION OF THE TEMPORARY REGULATIONS UNDER INTERNAL REVENUE CODE SECTION 752

by

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INTRODUCTION

Generally

This paper explores the methodology by which the Service² has implemented the Congressional directive³ to allocate basis under I.R.C. §752⁴ in accordance with economic realities. I.R.C. §752 contains rules for adjustment to a partner’s basis in her partnership interest to reflect her share of the partnership’s liabilities. The temporary regulations contain an elaborate set of rules for determining whether any partner bears the economic risk of loss with respect to a partnership liability, and for allocation of partnership liabilities among the partners in a manner consistent with the economic risk of loss analysis.

The Function of Basis

Subchapter K⁵ utilizes a partner’s basis in her partnership interest in a variety of ways. A partner’s distributive share of partnership loss is allowed only to the extent of her basis in her partnership interest.⁷ When a partnership makes a midstream distribution of property (other than money), the partner’s basis in the property is the partnership’s basis immediately before the distribution, but not in excess of the partner’s basis in her partnership interest.⁸ When a partnership distributes money to a partner, gain is not recognized by the partner, except to the extent that the money distributed exceeds the partner’s basis in her partnership interest.⁹

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² Internal Revenue Service of the United States Department of the Treasury.
⁴ All references are to the Internal Revenue Code of 1986, as amended.
⁵ For purposes of this article, the term "her" shall mean her or his and the term "she" shall mean she or he.
⁶ I.R.C. §§701 to 761.
⁷ I.R.C. §704(d).
⁹ I.R.C. §731(a)(1).
Additionally, rules appearing in other parts of the Code\textsuperscript{10} utilize a partner's basis in her partnership interest, as determined under Subchapter K.\textsuperscript{11} For example, upon a sale of a partnership interest by a partner, realized gain or loss is computed by comparing the amount realized on the sale to the partner's basis in the partnership.\textsuperscript{12}

**Principles of I.R.C. § 752**

For basis purposes, an increase in a partner's share of the liabilities of the partnership is treated as a contribution of money by the partner to the partnership.\textsuperscript{13} Similarly, an increase in the partner's individual liabilities by reason of the assumption by such partner of partnership liabilities is also treated as a contribution of money by the partner to the partnership.\textsuperscript{14}

To illustrate this rule, consider the following example: Alice and Betty are 50\% partners in a general partnership, Manufacturing Associates. The partnership agreement provides that the partners will share equally in each item of partnership income, gain, loss, deduction or credit. Manufacturing Associates enters a loan contract with a bank to obtain $1,000, to be used to purchase a machine. Both Alice and Betty increase their bases in their partnership interests by 50\% of Manufacturing Associates' liability, or $500.

The regulations under I.R.C. § 752 require netting of increases and decreases to basis arising under I.R.C. § 752(a) and(b) when they result from a single transaction.\textsuperscript{15} Only the resulting net increase or decrease is treated as a contribution or distribution of money for purposes of I.R.C. § 752.\textsuperscript{16} A partner decreases (but not below zero) her basis in her partnership interest by the amount of money distributed (or deemed distributed) to her by the partnership.\textsuperscript{17} When the amount of money distributed to a partner exceeds her basis in her partnership interest, gain is recognized to the extent of the excess.\textsuperscript{18} For this purpose, a decrease in a partner's share of partnership liabilities is treated as a distribution of money by the partnership to the partner.\textsuperscript{19} A decrease in a partner's share of individual liabilities by reason of assumption by the partnership of such individual liabilities is also treated as a distribution of money by the partnership to the partner.\textsuperscript{20}

\textsuperscript{10} Internal Revenue Code of 1986, as amended.
\textsuperscript{11} I.R.C. §§701 to 761.
\textsuperscript{12} I.R.C. §1001(a).
\textsuperscript{13} I.R.C. §752(a).
\textsuperscript{14} Id.
\textsuperscript{15} Temp. Reg. §1.752-1T(j)(3).
\textsuperscript{16} Id.
\textsuperscript{17} I.R.C. §731(a)(1).
\textsuperscript{18} Id.
\textsuperscript{19} I.R.C. §752(b).
\textsuperscript{20} Id.
To illustrate this rule, consider the following example: In year 1, Bakery, Ltd., a partnership, borrows $1,000 from a bank which it uses to purchase a machine. Bakery, Ltd. has two equal partners, Carol and Debby. The partnership agreement provides that Carol and Debby will share equally in each item of Bakery, Ltd.'s income, gain, loss, deduction, or credit. In year 2, Bakery, Ltd. sells the machine for $200 cash and $1,000 relief from debt to an unrelated buyer. Carol and Debby each decrease their bases in their partnership interests by $500 following the unrelated buyer's assumption of Bakery, Ltd.'s liability.  

Under commercial practices, the debtor commonly has personal liability for the debt, i.e., she bears the risk that the property securing a liability will depreciate in value, requiring the debtor to satisfy any deficiency from her other assets. Such debt is known as "recourse." However, some loan contracts place this risk entirely upon the creditor, so that transfer of title to the encumbered property to the creditor will completely extinguish the debt, regardless of any deficiency which exists after the fair market value of the encumbered property is applied against the outstanding balance of the liability. Such debt is referred to as "nonrecourse" debt. Under I.R.C. §752, for basis purposes, a "nonrecourse" liability secured by the property is treated as a liability of the owner of the property only to the extent of the fair market value of the property. 

THE PRINCIPLES OF THE TEMPORARY REGULATIONS
UNDER I.R.C. §752 AND THEIR APPLICATION

Generally

In accordance with Congressional intent, as expressed in 1984, the regulations seek to distinguish between recourse and nonrecourse partnership liabilities. To the extent that the partners have an economic risk of loss (hereinafter "EROL") for a liability, that liability (or portion thereof) is treated as recourse. Recourse liabilities are "shared" by the partners according to their respective EROL. To the extent that no partner has the EROL with respect to a liability, that liability is non-recourse. Subject to various conditions, nonrecourse partnership liabilities are generally allocated to the partners in accordance with their profit sharing ratio (as specified in the Partnership Agreement). In determining the EROL, the regulations adopt an "atomic bomb" approach; i.e., who, if anyone, would be required to satisfy a liability if all partnership assets (including cash but excluding assets which secure non-recourse debt) become worthless and all partnership liabilities become immediately due and payable. The complexity of the regulations is due, in part, to their

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21 The transaction has yielded a $200 gain. I.R.C. §1001(a). The effect of this gain will be to increase each partner's basis in her partnership interest by $100. I.R.C. §705(a)(1)(A). Thus, the final determination of basis (generally made at the year's end) is the result of the net effect of various partnership items.

22 I.R.C. §752(c).

23 Supra, n. 3.

24 For a glossary of terms, please see page 52.
extensive use of defined terms and the numerous hypotheticals to be applied to determine EROL.

**Determination of Liability Status**

A debt may be enforceable under state law and yet fail to qualify as a liability for purposes of I.R.C. §752. As a result, the initial determination to be made under the regulations is whether the debt under consideration rises to the status of a liability.

The regulations provide three grounds on which a debt may be held to be a liability. A debt is a liability, on the first ground, where the debtor’s incurrence of the debt creates or increases her basis in any property she owns, including cash. The following example illustrates this rule: Ellen enters a loan contract with a bank to borrow $1,000 for the purchase of a machine. Ellen’s debt of $1,000 to the bank is recognized as a liability because it is attributable to Ellen’s $1,000 basis in her loan proceeds.

A debt is recognized as a liability, on the second ground, where incurring the debt gives rise to a deduction taken into account in computing the taxable income of the debtor. For example: Francesca, a businesswoman using the accrual method of accounting, accrues a debt of $1,000 for payroll expense. Francesca’s debt of $1,000 is recognized as a liability because it is attributable to her $1,000 deduction under I.R.C. §162(a)(1) for salary expense.

A debt may be recognized as a liability, on the third ground, where the debtor incurs the debt to meet an expenditure which is neither deductible nor properly chargeable to capital account. Suppose, for example, that Sales, Ltd., a partnership that uses the accrual method of accounting, incurs $1,000 foreign tax expense. Partnerships are not permitted to deduct foreign tax expense in computing their taxable income. The expense is not properly chargeable to capital account. Sales, Ltd.’s debt is recognized as a liability because it is neither deductible nor chargeable to capital account.

Under the regulations, several criteria must be satisfied before a debt of a partner assumed by the partnership will be recognized as a partnership liability. First, the debt must have been cognizable as a liability in the hands of the original debtor, on one of the three grounds discussed above.

The rules pertaining to “assumed” liabilities distinguish between liabilities for which the debtor has personal liability and liabilities for which the debtor has no

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25 Temp. Reg. §1.752-1T(g)(1).
26 Temp. Reg. §1.752-1T(g)(2).
27 Temp. Reg. §1.752-1T(g)(3).
29 Temp. Reg. §1.752-1T(f)(1).

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personal liability. If the original debtor has personal liability, the regulations require
that the substituted debtor also have personal liability. 30 If the original debtor has
personal liability, the regulations further distinguish between debt which is assumed
by a partner, and debt which is assumed by a partnership. If a partner assumes a debt
of a partnership, the creditor on the debt must be aware of the assumption, and be able
to directly enforce the partner’s obligation with respect to the debt. 31 The regulations
further require that, immediately after the assumption, no other partner (or related
person) would be found to bear the EROL with respect to this debt if it were treated
as a partnership liability. 32 Note that these rules do not apply to a partnership’s as-
sumption of a partner’s debt. 33

A debt for which the debtor has no personal liability is assumed when the
debtor transfers the property which is subject to the liability. The regulations provide
that the substituted debtor is considered to have assumed the liability to the extent
that the liability does not exceed the fair market value of the property on the date of
assumption. 34 If a recognized liability is the subject of an effective assumption, the
liability will thereafter be treated as a liability of the partnership, or the partner, as
the case may be. 35

General Principles Governing Determination of Partner’s Share of Partnership
Liabilities

The applicable rules to be used in determining a partner’s share of partnership
liabilities differ significantly, depending upon whether the liability under considera-
tion is determined to be recourse, or nonrecourse, within the meaning of the
regulations. 36 A recourse liability of a partnership is a liability for which (and to the
extent that) any partner bears the EROL. A partner’s share of any recourse liability
of the partnership equals the portion of the EROL for such liability that is borne by
such partner. 37

A nonrecourse liability of a partnership is a liability for which (and to the
extent that) no partner bears the EROL. Generally, partners share nonrecourse
liabilities in the same manner as they share partnership profits. However, other
factors discussed, supra, Part III A and B, also figure predominately in the
apportionment of nonrecourse liabilities. 38 The regulations anticipate that some
partnership liabilities will be part recourse and part nonrecourse. In this instance, the

32 Id.
33 Id.
34 Temp. Reg. §1.752-2T(a).
36 Temp. Reg. §1.752-1T(a)(last sentence).
37 Temp. Reg. §1.752-1T(a)(1)(i).
38 Temp. Reg. §1.752-1T(a)(2)(i).
regulations treat the recourse and nonrecourse portions as separate liabilities.$^{39}$

**Related Persons**

Each of the determinations with respect to a partner which is required to be made must also be made with respect to a person related to a partner.$^{40}$ Under the regulations, a person is related to a partner if she stands in a relationship described by the regulations.$^{41}$ These relationships are of two general types: family relationships, and business relationships between two legal persons (or between a legal person and a natural person).$^{42}$ Additionally, the nonbusiness relationships between a grantor, fiduciary, and beneficiary of a trust (or different trusts, with the same grantor) are described relationships.$^{43}$

The degree of ownership required by the regulations to render a person (legal or natural) related to a legal person is 80% or more of the value.$^{44}$ However, “ownership,” for this purpose, is determined by aggregating the percent of actual ownership and the percent of constructive ownership.$^{45}$

The regulations anticipate that a single nonpartner may be related to more than one partner.$^{46}$ Where a natural person is related to two or more partners, any EROL borne by that nonpartner will be divided equally between the related partners, absent facts and circumstances showing the partners would share the EROL in a different manner.$^{47}$ Generally, where a legal person is related to two or more partners, any EROL borne by that legal person is allocated to the partner with the greatest percentage related ownership.$^{48}$ The regulations provide detailed rules to determine the results of more complex interrelationships.$^{49}$

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$^{39}$ Temp. Reg. §1.752-1T(j)(2).

$^{40}$ See, e.g., Temp. Reg. §1.752-1T(a)(1)(ii) (recourse liability status may arise on grounds that the EROL is borne by a person related to a partner).

$^{41}$ Temp. Reg. §1.752-1T(h).

$^{42}$ Temp. Reg. §1.752-1T(h)(1) (cross-referencing I.R.C. §267(b) and I.R.C. §707(b)(1)).

$^{43}$ Temp. Reg. §1.752-1T(h)(1) (cross-referencing I.R.C. §267(b); see I.R.C. §267(b)(4), (5), (6), (7), & (8)).

$^{44}$ Temp. Reg. §1.752-1T(h)(2)(i).

$^{45}$ Temp. Reg. §1.752-1T(h)(1) (cross-referencing I.R.C. §267(b) and I.R.C. §707(b)(1), both modified by I.R.C. §267(c). See I.R.C. §267(c) and I.R.C. §707(b)(3).

$^{46}$ Temp. Reg. §1.752-1T(h)(3).

$^{47}$ Temp. Reg. §1.752-1T(h)(3)(i)(B) (last sentence).


$^{49}$ The regulations define related person at Temp. Reg. §1.752-1T(h). As a threshold, a person is related to a partner if she and the partner stand in a relationship described by I.R.C. §267(b) or I.R.C. §707(b)(1). Temp. Reg. §1.752-1T(h)(1). I.R.C. §267(b), for this purpose, is not modified by §267(e). However, siblings are excluded from the definition of family members. Temp. Reg. §1.752.1T(h)(2)(ii). Furthermore, the regulations substitute “80% or more” for “more than 50%” each time it appears in the relevant sections. Temp. Reg. §1.752-1T(h)(2)(i). Consistent with this modification, the regulations delete the cross-reference to I.R.C. §267(f)(1)(A). Temp. Reg. §1.752-1T(h)(2)(iii).

I.R.C. §267(b) enumerates 12 relationships. Incorporating the modifications discussed above, these relationships are as follows:
**Economic Risk of Loss**

The regulations provide four grounds upon which to base a determination that a partner has EROL with regard to a partnership liability. Only the first of these grounds will be discussed here; the discussion of the remaining three grounds will appear *supra*, at Part II K.


2) A corporation and its 80% or more shareholder.

3) Two corporate members of the same controlled group. A controlled group is, generally, two or more corporations having 80% or more identity of ownership. I.R.C. §267(f)(1).

4) A grantor and a fiduciary of a trust.

5) Two fiduciaries of different trusts, having the same grantor.

6) A beneficiary and a fiduciary of a trust.

7) A beneficiary and a fiduciary of different trusts, having the same grantor.

8) A fiduciary of a trust and a corporation whose stock is 80% or more owned by either the trust or the trust’s grantor.

9) A tax-exempt organization and (family members of) the person who controls the organization.

10) A corporation and a partnership with 80% or more identity of ownership.

11) Two Subchapter S corporations with 80% or more identity of ownership.

12) A Subchapter S corporation and a Subchapter C corporation with 80% or more identity of ownership.

Note: although ownership, for this purpose, may be constructive, the 80% or more test is not met unless the requisite ownership is in a single person. Percentage ownership is measured against stock value.

I.R.C. §707(b)(1) enumerates two relationships. These relationships are as follows:

1) A partnership and a person owning 80% or more of the profits or capital interest in such partnership.

2) Two partnerships in which the same person owns 80% or more of the profits or capital interests.

Note: I.R.C. §707(b)(3) states that, for this purpose, ownership may be constructive. Constructive ownership of a profits or capital interest in a partnership is determined by analogy to the rules for constructive ownership of stock, appearing in I.R.C. §267(c) (not including I.R.C. §267(c)(3)). See I.R.C. §707(b)(3).

Briefly stated, the rules of constructive ownership appearing in I.R.C. §267(c) are as follows:

1) Stock (or a partnership interest) owned by a legal person is constructively, proportionately owned by the relevant individuals.

2) Stock (or a partnership interest) owned by an individual is constructively owned by her family members.
The first ground for determining that a partner has EROL with regard to a partnership liability is that she has an obligation to make either a net contribution, or a net payment to a creditor or other person, with regard to the liability, in the event

3) Stock owned by an individual is constructively owned by her partner.

4) The constructive ownership of a family member or a partner cannot be used to make another individual a constructive owner.

Example: A partnership, Hairdo Associates, has a $1,000 debt which has tentatively been determined to be a non-recourse liability under Temp. Reg. §1.752-1T(d)(3)(i)(A); Temp. Reg. §1.752-1T(d)(3)(i)(B); Temp. Reg. §1.752-1T(d)(3)(iv); and Temp. Reg. §1.752-1T(d)(3)(v)(A). Anna, the mother of Hairdo Associates’ partner, Belinda, is the creditor of Hairdo Associates’ $1,000 debt. Therefore, the entire $1,000 debt is a recourse liability of the partnership, for which only Belinda bears the EROL. See Temp. Reg. 1.752-1T(d)(3)(i)(B).

For purposes of determining the EROL borne by each partner for partnership liabilities, if related persons (actually or constructively) own an interest in the same partnership, they shall not be treated as related persons. Temp. Reg. §1.752 2D1T(h)(4).

Example: A partnership, Wash, Ltd., has $1,000 debt which has tentatively been determined to be a nonrecourse liability under Temp. Reg. §1.752-1T(d)(3)(i)(A). The creditor of Wash, Ltd.’s $1,000 debt is Wash, Ltd.’s partner, Hilary. Hilary is the mother of Wash, Ltd.’s partner, Brie. Hilary’s relationship to Brie is disregarded for this purpose. See Temp. Reg. §1.752-1T(h)(4). Therefore, the entire $1,000 debt is a recourse liability of the partnership, for which only Hilary bears the EROL. See Temp. Reg. §1.752-1T(d)(3)(i)(B).

The regulations provide rules for prioritizing relationships between a person and more than one partner. These rules require determination of the percentage of related ownership between the related person and each related partner. Temp. Reg. §1.752 2D1T(h)(3).

Natural persons have 100% related ownership with respect to one another. As a consequence, where the same person is a family member of more than one partner, any EROL borne by that person is divided equally between the related partners, unless the facts and circumstances show that the partners would share the EROL in a different manner. Temp. Reg. §1.752-1T(h)(3)(ii)(B) (last sentence).

Example: A partnership, Taxes, Ltd., has a $1,000 debt which has tentatively been determined to be nonrecourse under Temp. Reg. §1.752-1T(d)(3)(i)(A); Temp. Reg. §1.752 2D1T(d)(3)(i)(B); Temp. Reg. §1.752-1T(d)(3)(iv); and Temp. Reg. §1.752-1T(d)(3)(v)(A). The creditor of Taxes, Ltd.’s $1,000 debt is Daphne. Daphne is the mother of both Taxes, Ltd.’s partners, Debby and Dana, but is not herself a partner. There are no facts or circumstances to show that Debby and Dana would share the EROL with regard to the debt in any manner other than equally. Therefore, the entire $1,000 debt is a recourse liability of Taxes, Ltd., the EROL for which is borne $500 each by Debby and Dana, under Temp. Reg. §1.752-1T(d)(3)(i)(B).

The EROL borne by legal persons who are not partners, but who are related to partners, is deemed to be borne by the partner with the greatest percentage related ownership. The EROL borne by individuals who are not partners, but who are related to partners who are legal persons, is also borne by the partner with the greatest percentage related ownership. Temp. Reg. §1.752 2D1T(h)(3)(i). If a person is related to a partner on the basis of more than one of the relationships enumerated in Temp. Reg. §1.752-1T(h)(1) (as modified by Temp. Reg. §1.752-1T(H)(2)) the relationship yielding the highest percentage related ownership controls. Temp. Reg. §1.752-1T(h)(3)(ii) (flush language, first sentence).

Example: A partnership, Pickles, Ltd., has a $1,000 debt which has tentatively been determined to be nonrecourse under Temp. Reg. §1.752-1T(d)(3)(i)(A); Temp. Reg. §1.752 2D1T(d)(3)(i)(B); Temp. Reg. §1.752-1T(d)(3)(iv); and Temp. Reg. §1.752-1T(d)(3)(v)(A). The creditor of Pickles, Ltd.’s $1,000 debt is a trust for the equal benefit of Pickles, Ltd.’s partner, Zelda, and another
of a constructive liquidation. A constructive liquidation is a series of hypothetical events, results of which are used to determine which of the partners, if any, would ultimately be liable to satisfy partnership liabilities if all assets of the partnership (including cash but excluding certain pledged property) became worthless and all liabilities of the partnership became due and owing.

Constructive Liquidation

1. First Event: Determination of the Nature and Value of

unrelated person. The grantor of this trust is Pickles, Ltd.'s other partner, Gayle. Gayle’s percentage related ownership of the trust is 100%. Zelda's percentage related ownership of the trust is 50%. Therefore, under Temp. Reg. §1.752-1T(d)(3)(i)(B), the entire $1,000 debt is a recourse liability of the partnership, for which only Gayle bears the EROL. See Temp. Reg. §1.752-1T(h)(3).

The regulations provide rules for determining the greatest percentage ownership where two legal persons hold ownership interests in one another. The regulations require a determination of the percentage related ownership of both the related persons, and of the partner, and treat the greater of the two percentages as the "percentage related ownership" of the partner. Temp. Reg. §1.752-1T(h)(3)(ii)(A)&(B).

Example: A partnership, Cable, Ltd., has a $1,000 debt which has tentatively been determined to be nonrecourse under Temp. Reg. §1.752-1T(d)(3)(i)(A); Temp. Reg. §1.752-2D1T(d)(3)(i)(B); Temp. Reg. §1.752-1T(d)(3)(iv); and Temp. Reg. §1.752-1T(d)(3)(v)(A). The creditor of Cable, Ltd.'s $1,000 debt is a corporation, the stock of which is wholly owned by Cable, Ltd.'s partner, a trust. The corporation's percentage of related ownership of the trust is zero. The trust's percentage related ownership of the corporation is 100%. Therefore, the trust's percentage related ownership is 100%. Nina's percentage related ownership is 50%. See Temp. Reg. §1.752-2D1T(h). Therefore, under Temp. Reg. §1.752-1T(d)(3)(i)(B), the entire $1,000 debt is a recourse liability of the partnership, for which only the trust bears the EROL. See Temp. Reg. §1.752-1T(h)(3)(ii)(A)&(B).

The regulations provide that, as a general rule, EROL in a person related to two or more partners is allocated to the partner with the greatest percentage related ownership. Temp. Reg. §1.752-1T(h)(3)(ii)(A)&(B). This is an all-or-nothing rule, without provision for rebuttal on a facts and circumstances showing. However, if two or more partners are determined to have the same percentage related ownership, and no partner has a greater percentage related ownership, then the EROL in the related person is allocated equally between the partners. Temp. Reg. §1.752-1T(h)(3)(i) (flush language). In this case, division will not be equal if there are facts and circumstances showing that the partners would divide the EROL in a different manner. See Id.

Example: A partnership, Rocks, Ltd., has a $1,000 debt which has tentatively been determined to be nonrecourse, under Temp. Reg. §1.752-1T(d)(3)(i)(A); Temp. Reg. §1.752-2D1T(d)(3)(i)(B); Temp. Reg. §1.752-1T(d)(3)(iv); and Temp. Reg. §1.752-1T(d)(3)(v)(A). The creditor of this debt is a trust for the equal benefit of Rocks, Ltd.'s partner, Marilyn, and Rocks, Ltd.'s partner Rhaine. There are no facts or circumstances to show that the beneficiaries would divide a loss to the trust other than equally. The percentage related ownership in both Marilyn and Rhaine is 50%. See Temp. Reg. §1.752-1T(h). Therefore, under Temp. Reg. §1.752-1T(d)(3)(i)(B), the entire $1,000 debt is a recourse liability of the partnership, for which both Marilyn and Rhaine bear $500 of the EROL. See Temp. Reg. §1.752-1T(h)(3)(i) (flush language).

Note that the regulations provide that, on certain facts, an entity may be disregarded and its owners treated as the lender. Temp. Reg. §1.752-1T(h)(5).

50 Temp. Reg. §1.752-1T(d)(3)(i)(A); see, e.g., Temp. Reg. §1.752-1T(k) example (3)(iii).
Partnership Assets

In the first event of a constructive liquidation, all partnership assets, other than pledged property, become worthless. The regulations define partnership assets for this purpose as all property and money belonging to the partnership, other than a partner's obligation to make a contribution, or her obligation to make a payment to a creditor or other person. The terms "obligation to make a contribution" and "obligation to make a payment to a creditor or other person" are defined terms, whose meanings are extensively discussed, supra, Part II G and H.

The regulations define "pledged property." Such property arises when a partner contributes (or otherwise furnishes) money or other property to a partnership, and the partnership uses the contribution solely to secure payment of a partnership liability. Consistent with the related party rules, the regulations can reasonably be interpreted to mean that a contribution by a related person is within the meaning of a partner's "otherwise furnishing" property to the partnership. "Property," for this purpose, does not include a promissory note of which a partner is the maker, unless it is readily tradable on an established securities market. A presumption of secured use arises if substantially all the items of income, gain, loss, deduction or credit attributable to the property are allocated to the contributing partner, in contrast to the contributing partner's lesser share of other significant items of partnership income, gain, loss, deduction or credit. Pledged property also arises where contributed money or property is used by the partnership to acquire property that is used solely to secure payment of a partnership liability.

The regulations treat pledged property as an obligation of the contributing partner to make a payment to a creditor or other person. An "obligation to make a payment to a creditor or other person" is a defined term, whose meaning is extensively discussed, supra, Part II H. However, by way of illustration consider the following example: Hilary and Brie form a partnership, Pets, Ltd., each contributing $15,000 cash. Pets, Ltd. enters a loan contract with a bank to borrow $70,000. In

59 See, e.g., Temp. Reg. §1.752-1T(d)(3)(ii)(E)(1)(ii)(B)(2)(i) (time of satisfaction rules contemplate, inter alia, the obligation of a related person to make a payment to creditor or other person). Qualified pledged property is treated as an obligation to make a payment to a creditor or other person; Temp. Reg. §1.752-1T(d)(3)(ii)(A)(2)(ii) (flush language).
connection with the loan contract, Hilary contributes $45,000 to Pets, Ltd. Pets, Ltd. places the $45,000 in an escrow account to partially secure payment of the $70,000 liability to the bank. The partnership agreement provides that the partners will share all items of partnership income and loss equally, except that all interest income generated by the escrow account will be allocated entirely to Hilary. The escrowed funds are pledged property.

2. Second Event

In the second event of a constructive liquidation, all partnership liabilities become due and owing, as a result of the partnership’s failure to make payments.

3. Third Event: Determining the Results of Taxable Transfers

In the third event of a constructive liquidation, the partnership engages in a series of taxable transactions. In the first of these transactions, the partnership transfers any pledged property it holds to the relevant creditor, in full or partial satisfaction of the secured liability.

Pledged property is treated by the regulations as an obligation to make a payment to a creditor or other person. The amount of an obligation to make a payment to a creditor or other person which is limited to the value of property (as is the case with pledged property) is determined by reference to the fair market value of the relevant property. The regulations provide rules for determining the fair market value of pledged property, and thus, the amount of the obligation to make a payment to a creditor or other person. These rules are discussed, supra, Part II J. Generally, if the property has a readily ascertainable market value, or if the value of the property increases or decreases over time on its own terms, then the fair market value of the property is determined on the date the obligation is determined, i.e., the date of constructive liquidation. If the property is not described in the preceding sentence, then its fair market value is determined upon the latest of three events: incurrence of the liability, assumption of the liability, or the most recent valuation of the property made in connection with the liability. Subject to the operation of other recognition rules, the determined fair market value is deemed to be the amount of liability discharged as a result of the taxable exchange of the pledged property with the creditor. These and other recognition rules are discussed supra, Part II J.

\[\text{See, e.g., Temp. Reg. §1.752-1T(k) example (12).}\]
\[\text{Temp. Reg. §1.752-1T(d)(3)(iii)(A)(2).}\]
\[\text{Temp. Reg. §1.752-1T(d)(3)(ii)(F)(1).}\]
\[\text{Temp. Reg. §1.752-1T(d)(3)(ii)(F)(1)(i).}\]
\[\text{Temp. Reg. §1.752-1T(d)(3)(ii)(F)(1)(i).}\]
\[\text{Temp. Reg. §1.752-1T(d)(3)(ii)(F)(1).}\]
The purpose of a constructive liquidation analysis is to determine whether any partner has EROL with regard to a partnership liability.\textsuperscript{72} EROL may arise, \textit{inter alia}, where a partner has an obligation to restore a deficit in her capital account.\textsuperscript{73} In view of this, where book value\textsuperscript{74} differs from tax basis,\textsuperscript{75} the book value of property must be used in computing the adjustment required to be made to the capital account of a partner.\textsuperscript{76}

The term "book value" refers to the fair market value of property on the date of its acquisition by the partnership (or its fair market value as of the date certain optional evaluations of partnership assets are made),\textsuperscript{77} as recorded in accordance with the generally accepted accounting principles with respect to such assets for accounting purposes.\textsuperscript{78} The term "capital account" refers to a financial account of the partner's interest in the partnership, from acquisition to liquidation. The regulations under I.R.C. §752 refer, in places, to the rules of capital accounting which appear in the regulations under I.R.C. §704(b).\textsuperscript{79}

To briefly illustrate this concept, suppose that Jane and Shirley form a partnership. Jane contributes a machine with a fair market value of $1,000 and a basis in her hands of $500. Shirley contributes a patent right with a fair market value of $1,000 and a basis in her hands of zero. At formation, Jane's basis in her partnership interest is $500, and Shirley's is zero; however, both women have positive capital account balances of $1,000. Because the partnership posted the machine and the patent right on its books at their fair market values, these assets are said to have an initial $1,000 "book value." Assuming no amortization is permitted, if the partnership sells the patent right, the partnership recognizes $1,000 income for tax purposes, but zero income for accounting purposes. This result obtains because the partnership posted the asset on its books at its full fair market value at contribution. The rules of Subchapter K would force the partnership to allocate the entire $1,000 tax income to Shirley;\textsuperscript{80} thus, Shirley would increase her basis in her partnership interest to $1,000. However, since there was no accounting income, no adjustment to the capital accounts of either partner would be permitted.

Suppose further that the partnership agreement requires both partners to restore any deficits in their capital accounts upon liquidation, and further provides that

\textsuperscript{72} Temp. Reg. §1.752-1T(d)(3)(i)(A).
\textsuperscript{74} Treas. Reg. §1.704-1(b)(2)(iv)(b).
\textsuperscript{75} I.R.C. §1011.
\textsuperscript{76} See Treas. Reg. §1.704-1(b)(4)(i). For purposes of applying Temp. Reg. §1.752-1T(d)(3)(iii)(A)(3), book value, rather than tax basis, must be used in computing the gain or loss to be allocated to a partner's capital account because, where property has a book value different from its adjusted income tax basis, capital accounts are maintained by reference to such book values -- not income tax basis.
\textsuperscript{77} Treas. Reg. §1.704-1(b)(2)(iv)(f).
\textsuperscript{78} Treas. Reg. §1.704-1(b)(2)(iv)(g).
\textsuperscript{79} See, e.g., Temp. Reg. §1.752-1T(k), example (5)(i).
\textsuperscript{80} I.R.C. §704(c).
losses are to be divided equally between the partners. If the partnership incurs a $5,000 loss, and the partners decide to liquidate, the capital account balances of both partners would be adjusted to reflect their share of the loss. Both accounts would have deficit balances of $1,500 (beginning balance of $1,000, less share of loss, $2,500, for an ending deficit balance of $1,500). Therefore, because of these deficits, both partners would have an obligation under the partnership agreement to make further contributions of $1,500.81

The second transaction deemed to occur in the second event of a constructive liquidation is that the partnership transfers all its remaining assets in a taxable exchange, for no consideration other than relief from any liability for which the creditor’s right to repayment is limited to one or more assets of the partnership.82 In determining the amount of debt relief realized on this transfer, the reduction in the outstanding balance of a liability which results from the transfer of pledged property is to be considered.83

4. Third Event: Identifying the Liabilities for which a Creditor’s Right to Repayment is Limited to One or More Assets of the Partnership

A liability for which the creditor’s right to repayment is limited to one or more assets of the partnership (hereinafter “CRLTD”)84 is defined by the regulations as a partnership liability to the extent (but only to the extent) that the outstanding balance of such liability exceeds the aggregate amount that the partners would be obligated to contribute to the partnership to discharge the liability if the events of a modified constructive liquidation were to occur, and the partners did not perform any obligations to make a payment to a creditor.85

Although not expressly stated by the regulations, in order to identify a CRLTD liability it is necessary to first identify a loan contract under which the creditor is

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81 Example: Alexandra and Liz form a partnership, Shipping, Ltd. Alexandra contributes $10,000 cash and stock with a fair market value of $10,000. Alexandra’s basis in the stock is $7,000. Liz contributes $20,000 cash. At formation, Liz has a $20,000 basis in her partnership interest, and a $20,000 positive capital account balance. See I.R.C. §722; Treas. Reg. §1.704(b)(2)(iv)(b)(1). Alexandra has a $17,000 basis in her partnership interest, and a $20,000 capital account balance. See I.R.C. §722; Treas. Reg. §1.704-1(b)(2)(iv)(b)(2). Shipping, Ltd. has posted the stock to its books at its fair market value of $10,000; therefore, it is said that the stock has a $10,000 “book value.” Shipping, Ltd. enters a loan contract to borrow $10,000. In connection with the loan contract, Shipping, Ltd. places the stock in an escrow account to secure the payment of the $10,000 debt. The stock is pledged property within the meaning of Temp. Reg. §1.752-1T(d)(3)(ii)(A)(2)(ii). In the second event of a constructive liquidation, the pledged property (still valued at $10,000) would be transferred to the creditor. The $10,000 debt would be fully satisfied. For accounting purposes, no gain or loss would be realized with regard to the stock, because $10,000 consideration (debt relief) was received for $10,000 partnership asset (stock).


84 For a glossary of terms, see page 52.

required to forgive any deficiency upon transfer of title to the creditor of a partnership asset serving as sole security for payment of the liability, or pursuant to which no deficiency judgment can be obtained if the fair market value of the assets securing such debt is less than the outstanding loan balance. If such a loan contract is identified, the analysis described below must be performed. Only these loan contracts (loans which the parties have denominated "nonrecourse") are subject to CRLTD analysis. The first step in this analysis is to determine the outstanding balance of the liability. Note that, for purposes of determining the effects of a constructive liquidation, the outstanding balance of a CRLTD liability is reduced by the value of any pledged property treated as transferred to the creditor of the CRLTD liability. However, for purposes of identifying a CRLTD liability, no such reduction is performed.

The second step in the analysis used to determine a CRLTD liability is to perform a modified constructive liquidation. The regulations state that all partnership assets, including pledged property, are treated as worthless.

The third step in the analysis here is to determine the aggregate amount of the partners' "obligations to make a contribution," assuming that no partner performs an "obligation to make a payment to a creditor or other person" following the events of a modified constructive liquidation where such failure would increase the amount the partners would be obligated to contribute (e.g., to reimburse another partner). Both obligations are defined terms under their regulations, and are extensively discussed supra, Parts II G and H.

To illustrate these rules, consider the following example: A partnership, Books, Ltd., has two liabilities: an $800,000 debt, denominated "nonrecourse" by the parties, and a $60,000 debt, denominated "recourse" by the parties. The $800,000 debt is secured by a building owned by the partnership, and by a $100,000 promissory note, whose maker is Books, Ltd.'s partner, Karen. In a modified constructive liquidation, Books, Ltd.'s sole asset is its building, which is treated as worthless. This asset is transferred to the creditor of the only liability of Books, Ltd.
denominated "nonrecourse" by the parties, the $800,000 debt. The outstanding balance of this liability is determined to be $800,000. The promissory note represents the only obligation of a partner to make a contribution. The obligation is recognized to the extent of its face amount, $100,000. The $800,000 debt is a CRLTD liability to the extent of $700,000.95

Note again that, for purposes of performing the third step of a constructive liquidation, the amount of debt relief received by the partnership due to the presence of CRLTD liability is reduced by the value of pledged property transferred to the creditor of the CRLTD.96 Imagine a partnership, Bricks, Ltd., has two assets: cash of $10,000 and a machine with a book value of $100,000. Bricks, Ltd.'s partners, Hilary and Alexandra, have agreed to share equally in each item of partnership income, gain, loss, deduction, and credit. Bricks, Ltd.'s machine is subject to a liability of $100,000. This liability is CRLTD. Bricks, Ltd.'s cash is pledged property, utilized by Bricks, Ltd. to partially secure payment of its $100,000 liability. In the second event of a constructive liquidation, the cash is treated as transferred to the creditor, reducing the liability to $90,000. The machine is then treated as transferred to the creditor, extinguishing the liability. For accounting purposes, Bricks, Ltd. realizes a $10,000 loss on this transfer (amount realized $90,000 debt relief; book value $100,000; accounting loss $10,000). Bricks, Ltd. would allocate this loss equally to the capital accounts of Hilary and Alexandra.

5. Fourth Step: Allocation and Liquidation

In the fourth step of a constructive liquidation, a determination (for book purposes) is made of the partnership's items of income, gain, loss, deduction or credit.97 These items are then allocated to the partners' capital accounts in the manner dictated by the partnership agreement, as if the partnership's taxable year ended on the date of the constructive liquidation. The partnership then liquidates the partners' interests in the partnership.98

To illustrate this rule, consider the following example: Madeline and Barb form a general partnership, Wines Associates, with cash contributions of $20,000 each. At formation, both Madeline and Barb have positive capital account balances of $20,000. The partnership agreement provides that the partners will share all partnership profits and losses equally. The partnership agreement also provides that capital accounts will be properly maintained; liquidating distributions will be made in accordance with the partners' positive capital account balances; and that a partner with a deficit balance in her capital account following liquidation will be required to restore that deficit. Wines Associates enters a loan contract, denominated

97 See n.70, infra.
“recourse” by the parties, to borrow $60,000. As intended, Wines Associates uses its loan proceeds and contributed cash to purchase a machine for $100,000. In a constructive liquidation, Wines Associates would recognize a $100,000 loss on the exchange of its machine for no consideration. Under the partnership agreement, Wines Associates would allocate this loss equally to Madeline and Barb. Both Madeline and Barb would have deficit balances in their capital accounts of $30,000.99

6. Fourth Step: Identification of Certain Obligations to Make a Net Contribution and Obligations to Make a Net Payment to a Creditor or Other Person

In the fourth step of a constructive liquidation, the partnership liquidates the partners’ interests in the partnership. Performing this step permits identification of certain obligations to make a net contribution and obligations to make a net payment to a creditor. The identifiable obligations are “obligations to make a contribution” arising under a provision of the partnership agreement, requiring the partners to restore a deficit in their capital account at liquidation, and “rights of reimbursement” arising from a provision in the partnership agreement, entitling a partner to a distribution from the partnership of her positive capital account balance following liquidation. The meaning of these defined terms is discussed, supra, Part II G and I. Note that all other obligations are identifiable at the close of the third step of the constructive liquidation analysis.101

Example: Alice and Betty form a partnership, Pkg., Ltd. Betty contributes $10,000 cash. Alice contributes a machine with a fair market value of $30,000, subject to a liability of $20,000. The parties to the loan contract have denominated the debt as “nonrecourse.” Alice’s basis in the machine is $10,000. The $20,000 debt is recognized as a liability of Pkg., Ltd. At formation, both Alice and Betty have positive capital account balances of $10,000. The partnership agreement provides that the partners will share all partnership profits and losses equally. The agreement further provides that capital accounts will be properly maintained; that liquidating distributions will be made in accordance with the partners’ positive capital account balances; and that any partner with a deficit capital account balance following liquidation will be required to restore that deficit.

In a constructive liquidation, Pkg., Ltd. will transfer its machine to its creditor for no consideration, other than $20,000 relief from debt. For accounting purposes, Pkg., Ltd. will recognize a $10,000 loss ($30,000 book value less $20,000 debt relief). Note that for tax purposes, Pkg., Ltd. will recognize a $10,000 gain ($20,000 debt relief less $10,000 basis) but that the tax gain does not affect the partners’ capital accounts. Under the partnership agreement, Pkg., Ltd. will allocate its $10,000 loss equally between Alice and Betty, reducing their capital account balances to a positive balance of $5,000 each.

Note: Under rules to be discussed below, the entire $20,000 liability is a nonrecourse liability of the partnership, which the partners share equally.

Note further: Since in a constructive liquidation all partnership assets generally are deemed to become worthless, the $10,000 cash contributed by Betty also generates a $10,000 loss for capital accounting purposes; the capital accounts of both partners will stand at zero after this adjustment.100

Example: Cindy and Mabel form a limited partnership, Box, Ltd., with cash contributions of $20,000 each. Cindy is the general partner, and Mabel is the limited partner. The partnership agreement provides that Cindy and Mabel will share partnership profits and losses equally but the partners have no duty to restore deficits in their capital accounts following liquidation. Box, Ltd. enters a loan contract, denominated “recourse” by

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99 Example: Alice and Betty form a partnership, Pkg., Ltd. Betty contributes $10,000 cash. Alice contributes a machine with a fair market value of $30,000, subject to a liability of $20,000. The parties to the loan contract have denominated the debt as "nonrecourse." Alice's basis in the machine is $10,000. The $20,000 debt is recognized as a liability of Pkg., Ltd. At formation, both Alice and Betty have positive capital account balances of $10,000. The partnership agreement provides that the partners will share all partnership profits and losses equally. The agreement further provides that capital accounts will be properly maintained; that liquidating distributions will be made in accordance with the partners' positive capital account balances; and that any partner with a deficit capital account balance following liquidation will be required to restore that deficit.


101 Example: Cindy and Mabel form a limited partnership, Box, Ltd., with cash contributions of $20,000 each. Cindy is the general partner, and Mabel is the limited partner. The partnership agreement provides that Cindy and Mabel will share partnership profits and losses equally but the partners have no duty to restore deficits in their capital accounts following liquidation. Box, Ltd. enters a loan contract, denominated "recourse" by
Obligations to Make a Net Contribution

1. Generally

An obligation to make a net contribution (hereinafter "OMNC")\textsuperscript{102} is the aggregate amount of a partner's obligation to make a contribution (hereinafter "OMC")\textsuperscript{103} determined as a result of a constructive analysis, reduced by the aggregate amount of reimbursements that the partner (or related person) would be entitled to receive with respect to such contributions.\textsuperscript{104} "Reimbursement," a defined term, is discussed, \textit{supra,} Part II I.

The regulations provide rules for determining the extent, if any, to which an obligation will be recognized for purposes of I.R.C. §752.\textsuperscript{105} These rules will be discussed, \textit{supra,} Part II J. However, note that any OMNC which is tentatively determined to exist may be reduced or disregarded under these rules.

An OMC may arise on one of three grounds. The first ground is the contribution by the partner of a promissory note of which she (or a related person)\textsuperscript{106} is the maker, which is not readily tradable on an established securities market. Subject to the obligation recognition rules, discussed \textit{supra,} Part II J, the amount of an OMC arising on this ground is the outstanding balance of the promissory note.\textsuperscript{107}

The second ground on which an OMC may arise is by operation of state law.

the parties, with a bank to borrow $60,000. Box, Ltd. uses the loan proceeds and its contributed cash to purchase a machine for $100,000. In connection with the loan contract, Mabel enters a guarantee agreement with the bank. Under the guarantee agreement, Mabel is secondarily liable, after Box, Ltd., for repayment of the loan. However, pursuant to Mabel's right of subrogation, Mabel would be entitled to be reimbursed by Box, Ltd. for any payment Mabel made under the guarantee agreement.

In a constructive liquidation, Mabel would be secondarily obligated to make a payment to the creditor of $60,000. However, Mabel would be entitled to be reimbursed for this payment. Cindy, as the general partner, would be primarily obligated under state law to contribute $60,000 to Box, Ltd. to permit Box, Ltd. to satisfy Box, Ltd.'s obligation to its creditor. Accordingly, Mabel has no obligation to make a net payment to a creditor. Cindy has an obligation to make a net contribution of $60,000. The liability is a recourse liability of the partnership, for which only Cindy bears the EROL. \textit{See, e.g.,} Temp. Reg. §1.752 2D IT(k) example (4)(i)&(ii).

Note: If the partners had a duty to restore any deficit in their capital accounts following liquidation, both partners would have an obligation to make a net contribution of $30,000 each; the liability would be a recourse liability, which the partners would share equally. Temp. Reg. §1.752-1T(k) example (5)(i) and (ii).

\textsuperscript{102} For a glossary of terms, please see page 52.

\textsuperscript{103} Id.

\textsuperscript{104} Temp. Reg. §1.752-1T(d)(3)(ii)(B)(3).


\textsuperscript{106} Temp. Reg. §1.752-1T(d)(3)(ii)(B)(2)(iiii) (flush language). Note that the promissory note of a related person is treated as an OMC of the related person only where it was \textit{contributed} to the partnership after December 29, 1988. The date the note was executed is immaterial for purposes of this rule.

or by an agreement (other than a promissory note, discussed above). Under the Uniform Partnership Act (hereinafter "UPA"), a general partner has personal liability for the debts of the partnership. Under the Revised Uniform Limited Partnership Act (hereinafter "RULPA") a limited partnership must have at least one general partner who has personal liability for the recourse debts of the partnership. In a constructive liquidation, a general partner may be determined to have an OMC as a result of the operation of these state laws.

To illustrate the operation of these laws, consider the following example: Rebecca and Sarah form a general partnership, Widgets Associates, each contributing $10,000 cash. The partnership agreement provides that Rebecca and Sarah share partnership profits and losses equally. However, the partnership agreement does not contain provisions requiring that capital accounts be maintained, or that liquidating distributions be made in accordance with the positive capital account balances of the partners, or that the partners are required to restore deficits in their capital accounts following liquidation. Widgets Associates enters a loan contract, denominated "recourse" by the parties, to borrow $80,000. Widgets Associates uses its loan proceeds and contributed cash to purchase a machine for $100,000.

In a constructive liquidation, Widgets Associates' $80,000 liability is due and owing, but Widgets Associates is unable to pay. Under the UPA, both Rebecca and Sarah, as general partners, are liable for Widgets Associates' debts. Accordingly, both Rebecca and Sarah have an OMC of $40,000 each. State law does not give either partner a right of contribution against the other for payment of the liability; therefore, both Rebecca and Sarah have a $40,000 OMC. The liability is a recourse liability of the partnership, for which Rebecca and Sarah share the EROL equally.

Under the RULPA, limited partners have no personal liability for partnership debts beyond the amount they have contributed, or agreed to contribute in the future, to the partnership. In a constructive liquidation, a limited partner may have an OMC as a result of a provision in the partnership agreement requiring her to restore a deficit balance in her capital account, because such a provision is an agreement to contribute in the future (contingent upon there being a deficit balance). However, the regulations (by implication in the examples) provide that where a partner has an obligation arising under both state law and the partnership agreement, the obligation is deemed to arise under the partnership agreement. Consequently, a deficit restoration obligation in a general partner has priority over her state law obligation to the partnership's creditors. This result is obtained because the performance of the obligation arising under the partnership agreement extinguished the liability, leaving nothing upon which state law could operate.

109 UPA §15.
110 RULPA §403.
111 RULPA §§303(a), 502.
112 See, e.g., Temp. Reg. §1.752-1T(k) example (5)(i)&(ii).
Consider the following example: Peggy and Sue form a limited partnership, Bldg., Ltd., each contributing $20,000 cash. Peggy is the general partner, and Sue is the limited partner. The partnership agreement provides that Peggy and Sue will share partnership profits and losses equally; that capital accounts will be properly maintained; that liquidating distributions will be made in accordance with the partners' positive capital account balances; and that any partner with a deficit balance in her capital account following liquidation must restore that deficit. Both Peggy and Sue have initial positive capital account balances of $20,000. Bldg., Ltd. enters a loan contract, denominated 'recourse' by the parties, to borrow $60,000. Bldg., Ltd. uses its loan proceeds and its contributed cash to purchase a machine for $100,000.

In a constructive liquidation, Bldg., Ltd. would recognize a $100,000 loss on the exchange of its machine for no consideration. Under the partnership agreement, Bldg., Ltd. would allocate this loss equally between the partners. In the absence of a deficit restoration agreement, Peggy, as the general partner, would have an OMC of $60,000 by operation of state law. Under the partnership agreement, both Peggy and Sue would be required to restore their deficit balances. Both Peggy and Sue would have deficit capital account balances of $30,000. The partners' obligations to restore deficit balances would be recognized as an OMC to the extent of $30,000 each. Neither partner has a state law right of contribution against the other. Accordingly, both Peggy and Sue have an OMNC of $30,000. The liability is a recourse liability of the partnership, for which the partners bear the EROL equally.

The third ground on which an OMC may arise is where, by agreement or by operation of state law, a partner is obligated to reimburse another partner for her contribution to the partnership.113 "Reimbursement," a defined term, is discussed supra, Part III. However, consider the following example: Sherry and Theresa form a limited partnership, Auto, Ltd., each contributing $10,000 cash. Sherry is the general partner, and Theresa is the limited partner. The partnership agreement provides that the partners will share partnership profits and losses equally; however, the agreement does not provide that the partners have a deficit restoration obligation. Auto, Ltd. enters a loan contract, denominated 'recourse' by the parties, to borrow $80,000. Auto, Ltd. uses its loan proceeds and contributed cash to purchase a machine for $100,000. Sherry and Theresa enter an indemnification agreement, whereby Theresa agrees to reimburse Sherry for 50% of any payment Sherry is required to make to the bank as the general partner of Auto, Ltd.

In a constructive liquidation, Auto, Ltd.'s $80,000 liability would be due and owing, but Auto, Ltd. would be unable to pay. Sherry, as Auto, Ltd.'s general partner, would have an OMC of $80,000 with respect to this liability. However, under the indemnification agreement, Sherry would have a right to be reimbursed by Theresa for 50% of any payment made by Sherry as Auto, Ltd.'s general partner.

113 Temp. Reg. §1.752-1T(d)(3)(ii)(B)(2)(iii); see, e.g., Temp. Reg. §1.752-1T(k) example (14)(i)&(ii).
Accordingly, Sherry has an OMNC of $40,000. Theresa has an OMNC of $40,000. The entire $80,000 debt is a recourse liability of the partnership, for which the partners share the EROL equally.

2. Allocation of an OMNC

Allocation is required to determine a partner’s OMNC with respect to a partnership liability, unless only one partner has an OMNC and there is only one partnership liability. The initial step in this allocation is to determine the outstanding partnership indebtedness with respect to each liability. The regulations define outstanding partnership indebtedness, for this purpose, as the face amount of the liability, reduced as described. The first reduction is the portion of the liability which has been determined to be CRLTD. The second reduction is the excess of any OPC which arises as a result of pledged property, over any rights of reimbursement that the partner would be entitled to receive with respect to those OPC’s. The regulations state that, for this purpose, a pledged amount is not taken into account to the extent it secures a CRLTD.

The second step in this allocation is to determine the sum of the OMNC’s to which all partners would be subject, in the event of a constructive liquidation. The third step in this allocation is to form a fraction, the numerator of which is the outstanding partnership indebtedness, and the denominator of which is the sum of the partner’s OMNC’s. A partner’s OMNC, when multiplied by this fraction, yields her OMNC allocable to a particular partnership liability.

This rule may be illustrated by the following example: A partnership, Service, Ltd. has two liabilities: one for $800,000, and one for $60,000. It has been determined that $700,000 of the $800,000 liability is CRLTD. It has also been determined that $100,000 of an OMC arising from a promissory note exists with respect to the $800,000 liability. Therefore, the amount of outstanding partnership indebtedness with respect to the $800,000 liability, for purposes of allocating the partners’ OMNC’s, is $100,000, i.e., the $800,000 face amount of the liability, less the CRLTD of $700,000. (In this instance, the $100,000 of pledged property was disregarded because it secures the payment of a portion of the $700,000 CRLTD.) The outstanding partnership indebtedness with respect to the $60,000 liability is $60,000. The sum of all partners’ OMNC’s has been determined to be $160,000. General partner’s OMNC is $20,000. General partner’s OMNC allocable to the

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$800,000 liability is $12,500 ($20,000 x 100,000/160 000 = $12,500). General partner's OMNC allocable to the $60,000 liability is $7,500 ($20,000 x 60,000/160,000 = $7,500).

Obligation to Make a Payment to a Creditor or Other Person

An obligation to make a net payment to a creditor or other person (hereinafter "ONPC")122 is the excess of the aggregate of a partner's obligations to make a payment to a creditor or other person (hereinafter "OPC")123 over the amount of any reimbursements that the partner (or a related person) would be entitled to receive with respect to such payments.124 The regulations provide rules for determining the extent, if any, to which an OPC will be recognized for purposes of I.R.C. §752.125 These rules will be discussed supra, Part II J. However, note that any ONPC which is tentatively determined to exist may be reduced or disregarded under these rules.

An OPC may arise on one of three grounds. The first ground is an obligation to make a payment to a creditor or other person, in full or partial satisfaction of a partnership liability, which arises under an agreement or by operation of state law.126 Consider the following example: Eliza and Fern form a limited partnership, Salvage, Ltd. Eliza, the general partner, and Fern, the limited partner, contribute $20,000 and $80,000 cash, respectively. Fern has no further obligation to contribute under the partnership agreement. Salvage, Ltd. enters a loan contract, denominated "re-course" by the parties, to borrow $150,000 from a bank. Salvage, Ltd. uses its loan proceeds and contributed cash to purchase a machine for $250,000. In connection with the loan contract, Eliza enters an indemnification agreement with the bank. Under the indemnification agreement Eliza is jointly and severally liable with Salvage, Ltd. for repayment of the loan; i.e., the bank is entitled to seek payment from Eliza before exhausting its legal remedies against the partnership. The indemnification agreement is enforceable under state law. In a constructive liquidation, Salvage, Ltd.'s $150,000 liability is due and owing, but Salvage, Ltd. is unable to pay. Eliza has an OPC of $150,000 under the indemnification agreement. Eliza has no right to reimbursement with respect to payment of this OPC. Accordingly, Eliza has an ONPC of $150,000. The liability is a recourse liability of the partnership, for which only Eliza bears the EROL. Note that, in the absence of an indemnification agreement, Eliza, as the general partner of Salvage, Ltd., would have an OMNC of $150,000 arising under state law.

The second ground on which an OPC may arise is an obligation to make a payment to certain payees, with respect to any payment made by another partner to a creditor or other person, in full or partial satisfaction of the liability, arising by

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122 For a glossary of terms, please see page 52.
123 Id.
126 Temp. Reg. §1.752-1T(d)(3)(ii)(A)(2)(i)(A); see e.g., Temp. Reg. §1.752-1T(k) example (10)(i)&(ii).
agreement or by operation of law. These payees are a partner, a person related to a partner, or the partnership. The regulations state that an obligation of a partner which constitutes an OMC is not treated as an OPC. The following example illustrates this rule: Cari and Shane form a limited partnership, Repairs, Ltd., with cash contributions of $10,000 each. Shane, the limited partner, has no further obligation to contribute under the partnership agreement. Repairs, Ltd. enters a loan contract, denominated "nonrecourse" by the parties, to borrow $80,000 from a bank. Repairs, Ltd. uses its loan proceeds and its contributed cash to purchase a machine for $100,000. In connection with the loan contract, Cari enters a guarantee agreement with the bank, under which Cari agrees to be jointly and severally liable for repayment of the liability; i.e., the creditor may seek payment from Cari without first exhausting its legal remedies against the partnership. In connection with the guarantee agreement, Cari and Shane enter an indemnification agreement, under which Shane agrees to indemnify Cari for 50% of any payment Cari is required to make under the guarantee agreement.

In a constructive liquidation, Repairs, Ltd.'s duty to pay the loan is extinguished upon Repairs, Ltd.'s transfer of title to the machine to the creditor. However, under the guarantee agreement, the creditor is entitled to sue Cari for any deficiency; Cari, therefore, has an OPC of $80,000. Under the indemnification agreement, Cari is entitled to seek reimbursement from Shane for 50% of Cari's payment, or $40,000. Cari, therefore, has an ONPC of $40,000 (OPC of $80,000, less right of reimbursement of $40,000). Shane also has an ONPC of $40,000. Accordingly, the liability is a recourse liability of the partnership for Temp. Reg. §1.752 purposes, for which Cari and Shane share the EROL equally.

The third ground on which an OPC may arise is an obligation to make a payment to a creditor or other person resulting from the contribution to the partnership of property used solely to secure payment of the liability (i.e., pledged property). For example, if Nancy contributes stock to her partnership, and (1) the partnership places the stock in escrow to secure payment of a partnership liability and (2) Nancy is allocated all the dividend income generated by the stock (in contrast to her 50% share of any other item of partnership income, gain, loss, deduction or credit), then (3) subject to the operation of the recognition rules, Nancy has an OPC equal in amount to the fair market value of the stock, because the stock is pledged property.

Reimbursements

A right of reimbursement arises when a partner (or a related person) has an OPC or OMC, and with respect to this obligation, another partner, a person related

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128 Id.; see, e.g., Temp. Reg. §1.752-1T(k) example (14)(i)&(ii).
to another partner, or the partnership, is obligated to make a payment to the subject partner (or a related person).\textsuperscript{131} The reimbursing obligation may be disregarded or reduced under rules for the recognition of an obligation, to be discussed \textit{supra}, Part II J.\textsuperscript{132} Reimbursing obligations of partnerships are recognized to the extent that they would be recognized, if they were obligations of a partner.\textsuperscript{133}

As an example, suppose Yolanda and Bertha form a partnership, Nails, Ltd., each contributing $20,000 cash. In addition, Bertha contributes her promissory note for $60,000. The note is due immediately upon liquidation, and is not readily tradable on an established securities market. The partnership agreement provides that loss will be allocated 90% to Yolanda, and 10% to Bertha. The agreement further provides that Yolanda and Bertha will share partnership profits equally; that capital accounts will be properly maintained; that liquidating distributions will be made in accordance with the partners’ positive capital account balances; and that partners are required to restore deficits in their capital accounts following liquidation. Both Yolanda and Bertha have positive capital account balances of $20,000 at formation.\textsuperscript{134} Nails, Ltd. enters a loan contract, denominated “recourse” by the parties, to borrow $60,000 from a bank. Nails, Ltd. uses its loan proceeds and contributed cash to purchase a machine for $100,000.

In a constructive liquidation, Nails, Ltd. will recognize a $100,000 accounting loss on the exchange of its machine for no consideration. Under the partnership agreement, Nails, Ltd. will allocate this loss 90% to Yolanda and 10% to Bertha. Following this allocation, Yolanda will have a deficit balance in her capital account of $70,000 ($20,000 at formation, less $90,000 loss). Under the partnership agreement, Yolanda has an OMC of $70,000. Since the terms of Bertha’s promissory note require her to satisfy it at liquidation, Bertha has an OMC of $60,000. Satisfaction of the note will result in a positive balance of $70,000 in Bertha’s capital account ($20,000 at formation, less $10,000 loss, plus $60,000 contribution). Nails’ Ltd. has $130,000, which it uses to satisfy its creditor ($60,000) and to fund the liquidating distribution ($70,000) to which Bertha is entitled under the partnership agreement. Accordingly, $60,000 of Yolanda’s $70,000 OMC is allocable to Nails, Ltd.’s liability, and $10,000 is allocable to Bertha’s right to a liquidating distribution. The liability is a recourse liability of the partnership, for which only Yolanda bears the EROL.

\textit{Rules for the Recognition of an Obligation}

The regulations provide four groups of rules which determine the extent, if

\textsuperscript{131} Temp. Reg. §1.752-1T(d)(3)(ii)(C)(1).
\textsuperscript{132} Temp. Reg. §1.752-1T(d)(3)(ii)(D),(E),&(F).
\textsuperscript{133} Temp. Reg. §1.752-1T(d)(3)(ii)(C)(2).
\textsuperscript{134} The rules of capital accounting promulgated under I.R.C. §704(b) do not permit a credit entry with respect to the contribution of a promissory note of this description. Treas. Reg. §1.704-1(b)(2)(iv)(d)(2). A credit entry is proper at the time of satisfaction of the note. \textit{Id}.
any, to which an obligation (an OPC or an OMC) will be recognized. A recognized obligation is treated as performed at the time of constructive liquidation, for purposes of I.R.C. §752. To the extent an obligation is not recognized, it is disregarded for purposes of I.R.C. §752.

The first group of recognition rules states that if the aggregate EROL determined to be borne by all partners with respect to a partnership liability exceeds the amount of that liability, then the EROL for each partner shall be reduced by an allocable share of the excess. A partner’s allocable share of the excess, for this purpose, is determined by multiplying the amount of the liability by a fraction, the numerator of which is the partner’s EROL with respect to that liability, and the denominator of which is the aggregate of all partners’ EROL with respect to that liability.

By way of illustration, consider the following example: A partnership, Study, Ltd. has a $210,000 liability. In a constructive liquidation, Study, Ltd.’s partner, Susan, has an OMC of $210,000 with respect to this liability, due to Susan’s status as Study, Ltd.’s sole general partner. Study, Ltd.’s limited partner, Brenda, has an OPC of $210,000 with respect to this liability, under an indemnification agreement between Brenda and the creditor. Brenda has no right of reimbursement against Study, Ltd. or Susan for any payment made under the indemnification agreement. Accordingly, the obligation of each partner is reduced to $105,000 ($210,000 x 210,000/420,000 = $105,000). The liability is a recourse liability of the partnership, for which the partners bear the EROL equally.

With respect to this rule, the regulations make the following observation: “In such a case, the facts must be closely scrutinized to determine whether the failure to resolve the manner in which the partners will share the [EROL] attributable to a partnership liability is part of a plan to circumvent or avoid the obligation of a partner ... with respect to that liability.” A finding of a plan to circumvent or avoid the performance of an obligation is grounds for disregarding the obligation, for purposes of I.R.C. §752.

The second group of recognition rules describes the general characteristics necessary to a recognized obligation. The obligation must be legally enforceable. The facts and circumstances must support the conclusion that an obligation would arise if the deemed events of a constructive liquidation actually occurred.

136 Id.
138 Id.; see, e.g., Temp. Reg. §1.752-1T(k) example (9)(iv).
139 Temp. Reg. §1.752-1T(k) example (9)(iv) (fifth and sixth sentences).
The existence and amount of the obligation must be susceptible of a reasonably certain determination. The facts and circumstances must support the conclusion that there is no plan to circumvent or avoid the performance of an obligation.

The third group of recognition rules limit the extent to which an obligation will be recognized, if it is not required to be satisfied within the requisite time period. An OPC is required to be satisfied within a reasonable time after the partnership liability becomes due and owing. The regulations do not provide guidance as to the meaning of "reasonable" for this purpose. However, by analogy to the rules with regard to an OMC, a 90-day period is presumably reasonable. An OMC is required to be satisfied by the later of the end of the partnership taxable year in which the partner's interest is liquidated, or 90 days after the date of such liquidation. Since a partnership is deemed to close its taxable year on the date of constructive liquidation, for purposes of the constructive liquidation analysis, the 90-day period will control. A reasonable interpretation of the intent of the regulations is that an OMC instrument may be drafted so that the partner will never be obligated to satisfy it in less than 90 days. However, in a constructive liquidation, one of the deemed events which occurs is that the partnership year ends. In light of this, an OMC instrument drafted for a calendar year partnership which read "payable on the later of December 31st of the year of liquidation or 90 days after liquidation" would not satisfy the rules under discussion, because, in a short partnership year, the OMC might not be payable by the later of the short taxable year or 90 days after liquidation, i.e., the tax year of liquidation might not include the month of December. Although a "fixed date or 90 days" term is arguably within the contemplation of the regulations, a "described date of 90 days" term is certain to comply, and therefore provides

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145 Temp. Reg. §1.752-1T(d)(3)(ii)(D)(3). Example: AAA, Inc. and Bertha form a limited partnership, X-ray, Ltd., with cash contributions of $100,000 each. X-ray, Ltd. enters a loan contract, denominated "recourse" by the parties, to borrow $150,000. X-ray, Ltd. uses its loan proceeds and contributed cash to purchase a machine for $250,000. In connection with the loan contract, Bertha, the limited partner, enters an indemnification agreement, under which Bertha agrees to be secondarily liable on the loan contract, in the event X-ray, Ltd. defaults. In a constructive liquidation, X-ray, Ltd.'s $150,000 liability is due and owing, but X-ray, Ltd. is unable to pay. Under state law, AAA, Inc., as the general partner of X-ray, Ltd., is obligated to contribute $150,000 to X-ray, Ltd. to fund repayment of X-ray, Ltd.'s liability. Bertha's obligation under the indemnification agreement does not arise until the creditor has exhausted its remedies against X-ray, Ltd. Under the general rules of I.R.C. 752, AAA, Inc. would be determined to have an OMNC of $150,000. However, AAA, Inc. is a corporation formed to acquire and hold an interest in X-ray, Ltd., and AAA, Inc. has no assets other than its interest in X-ray, Ltd. These facts and circumstances, together with Bertha's indemnification agreement, indicate a plan to circumvent or avoid performance of AAA, Inc.'s obligation. Therefore, AAA, Inc.'s OMNC is disregarded. Accordingly, in a constructive liquidation, Bertha would have an ONPC of $150,000 under the indemnification agreement. The liability is a recourse liability of the partnership, for which only Bertha bears the EROL. See, e.g., Temp. Reg. §1.752-1T(k) example (1)(i) and (ii).
149 Id.
151 Id.
greater assurance of result to the taxpayer.

An OPC or an OMC which is not required to be performed within the requisite time period is recognized only to the extent of its value.\(^{152}\) "Value," for this purpose, is determined in effect by discounting the amount of the OPC or OMC by the applicable interest rate.\(^{153}\) If the obligation bears interest from the liquidation date until the date the obligation is satisfied, and the interest rate stated in the terms of the obligation equals or exceeds the applicable Federal rate,\(^{154}\) then value equals the outstanding principal balance stated in the terms of the obligation.\(^{155}\) If the terms of the obligation do not satisfy the requirements of the preceding sentence, then the value of the obligation is its imputed principal amount.\(^{156}\) For this purpose, the "imputed principal amount" of an obligation is determined by computing the value of the remaining payments to be made under the debt instrument by the applicable federal rate, given as consideration for the sale of property occurring at the time of constructive liquidation.\(^{157}\) An explanation of the rules of I.R.C. §1274 is outside the scope of this article; however, note that the section recharacterizes a portion of the principal as interest, in order to increase the interest payable on the obligation to an amount statutorily defined as adequate.

The following example may help to illustrate this rule: In a constructive liquidation, a limited partner, Ginny, has been tentatively determined to have an OMNC of $35,000. The partnership agreement provides that Heather, the general partner, will perform any OMC she may have within 90 days of the date of liquidation. However, the partnership agreement further provides that Ginny is not required to perform any obligation she may have until two years after the date of liquidation. Heather’s OMNC does not bear interest. Heather’s OMNC will be recognized only to the extent of its value. The imputed principal amount of Heather’s OMNC, under I.R.C. §1274(b) (as modified) is $28,795. Heather’s recognized OMNC of $28,795 is treated as if performed at the time of constructive liquidation. The amount of the liability is $70,000. Accordingly, Ginny, as the sole general partner, has an OMNC of $41,205 (liability of $70,000, less Heather’s OMNC of $28,795). The liability is a recourse liability of the partnership, for which Ginny bears $41,205 of the EROL, and Heather bears $28,795 of the EROL.

The fourth group of recognition rules state that, if an obligation is limited to the value of property, then the amount of the obligation equals the fair market value of the property, determined as required.\(^{158}\) Such an obligation arises on the

\(^{154}\) Within the meaning of I.R.C. §1274(d).
\(^{156}\) Supra, n. 152.
\(^{157}\) Temp. Reg. §1.752-1T(d)(3)(ii)(E)(2)(ii)(B) (last sentence); see, e.g., Temp. Reg. §1.752-1T(k) example (15)(i), (ii), (iii), (iv) & (v).
contribution of pledged property.\textsuperscript{159} Such an obligation could also arise where a contract term describes the amount of an obligation by reference to the fluctuation in value of property, i.e., "indexing." If the property is of a type that has a readily ascertainable market value, or that increases or decreases in value by its own terms, then the value of the property (and therefore, the amount of the obligation) is determined on the date that the amount of the obligation is determined (i.e., the date of constructive liquidation).\textsuperscript{160} The regulations give marketable securities as an example of a type of property with a readily ascertainable market value, and an amortizable debt instrument as an example of a type of property which increases or decreases in value by its own terms.\textsuperscript{161}

If the property does not increase or decrease by its own terms, nor have a readily ascertainable market value, then the value of the property (and the amount of the obligation) are determined on the basis of an appraisal performed on the latest of the date the liability was incurred, the date the liability was assumed, or the property was reappraised in connection with the loan contract.\textsuperscript{162} The regulations give real property as an example of this type.\textsuperscript{163}

\textbf{Three Additional Grounds Upon Which Economic Risk of Loss May Arise}

If it is tentatively determined that a partnership liability is nonrecourse because the first ground upon which EROL may be present is not present, the regulations provide that EROL may be present on one of the three additional grounds. Note that these grounds are derivate, i.e., EROL will not be present on the second ground unless it is not present on the first ground, etc.\textsuperscript{164} A partner has EROL, on the second ground, to the extent that the partner (or a person related to that partner) is the creditor of the liability.\textsuperscript{165} The meaning of related person is discussed, infra, Part II D.

Example: A partnership, Copy, Ltd., has a debt of $1,000 which has been tentatively determined to be nonrecourse. The creditor of this debt is Copy, Ltd.'s 50% partner, Jennifer. The de minimis rule, discussed below, does not apply, because Jennifer has a 50% interest in each item of Copy, Ltd.'s income, gain, loss, deduction or credit. Therefore, for basis purposes, the $1,000 debt is treated as a recourse liability of Copy, Ltd., with respect to which Jennifer bears the EROL.

EROL will not be present on this second ground, however, if the liability is

\textsuperscript{161} Id.
\textsuperscript{165} Temp. Reg. §1.752-1T(d)(3)(i)(B); see e.g., Temp. Reg. §1.752-1T(k) example (18)(ii).
qualified nonrecourse financing, and the partner’s interest in each item of partnership income, gain, loss, deduction or credit does not exceed 10%. "Qualified nonrecourse financing" is a defined term, under I.R.C. §465. Generally, qualified nonrecourse financing is a liability acquired in connection with real property, borrowed from certain lenders, for which no person has personal liability, and which is not convertible. For purposes of Temp. Reg. §1.752-1T(d)(3)(vii), the determination is made without reference to the nature of the activity with respect to which the borrowing occurred.

If EROL is not present on either the first or second ground discussed above, then EROL may arise on the third ground. Here, a partner has EROL because she enters an arrangement tantamount to a guarantee. A partner has entered such an arrangement when she (or a person related to her) assumes a contractual duty to facilitate the partnership’s acquisition of the liability, the contractual duty eliminates substantially all the EROL in the creditor, and a principal purpose of the arrangement was to preserve the nonrecourse character of the liability for purposes of I.R.C. §752. Note that the arrangement must eliminate substantially all the EROL in the creditor before it will be treated as an arrangement tantamount to a guarantee. The regulations provide little guidance as to the test of substantiality to be applied here. In the example given to illustrate this point, the regulations utilize an arrangement which eliminates all the EROL in the creditor. It seems reasonable to conclude that something less than 100% is contemplated by the regulations’ use of the term “substantial”; the Service should provide guidance on this point.

The following example may help illustrate this rule: A partnership, Designs, Ltd., has debt of $1,000 which has tentatively been determined to be nonrecourse. Designs, Ltd. used the loan proceeds to acquire a machine. To induce the creditor to make the loan, Designs, Ltd.’s partner, Myra, enters a lease agreement with Designs, Ltd., under which Myra is unconditionally required to make lease payments to Designs, Ltd. sufficient to satisfy Designs, Ltd.’s duty to repay the creditor. One of the principal purposes of the arrangement was to reserve the nonrecourse character of the debt under I.R.C. §752, so that both Designs, Ltd.’s partners, Myra and Linda, could increase their bases in their partnership interests. Therefore, the $1,000 is a recourse liability of the partnership, for which only Myra bears the EROL.

If it is determined that EROL is not present on the first, second, or third

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166 Within the meaning of I.R.C. §465(b)(6).
168 I.R.C. §465(b)(6).
171 Temp. Reg. §1.752-1T(d)(3)(iv); see, e.g., Temp. Reg. §1.752-1T(k) example (20).
172 Id.
173 Temp. Reg. §1.752-1T(k) example (20).
174 Supra, n. 2.
ground discussed above, then EROL may arise on the fourth ground. Here, a partner has EROL when she (or a person related to her) is secondarily liable (after the partnership) to pay in excess of 20% of the total interest which will accrue on the liability during its term.\textsuperscript{175} If the liability has an indefinite term, total interest is determined based upon the expected term of the liability.\textsuperscript{176} The regulations provide no guidance as to how to determine the "expected term of a liability." Such factors as the useful life of an encumbered asset, or the past dealings of the parties, should be persuasive if a facts and circumstances analysis is to be undertaken.

If EROL is determined to be present on the fourth ground, discussed above, the guarantor-partner's EROL is equal to the present value of the guaranteed interest payments.\textsuperscript{177} "Present value," for this purpose, is determined annually by discounting the total remaining interest payments, which have not economically accrued, subject to the guarantee by the applicable interest rate.\textsuperscript{178} If the liability is within the contemplation of either I.R.C. §483 or I.R.C. §1274, the "applicable interest rate" is the applicable federal rate, compounded semiannually.\textsuperscript{179} "Applicable federal rate" is a statutorily defined term.\textsuperscript{180} Generally, a liability is within the contemplation of either I.R.C. §483 or I.R.C. §1274 because the interest stated in the loan contract is inadequate when compared to the applicable federal rate. If the liability is outside these two sections, the applicable interest rate is the interest rate stated in the loan contract.\textsuperscript{181}

If it is tentatively determined that EROL is present on the fourth ground, it must be further determined that, under all the facts and circumstances, it is reasonable to expect that the guarantor-partner would be required to perform if the partnership failed to pay.\textsuperscript{182} Where the guarantor-partner's duty is subject to a condition precedent that the creditor foreclose on the encumbered property, and interest accrues ratably over time, the regulations provide that it is not reasonable to expect that the guarantor-partner would be required to perform.\textsuperscript{183}

This rule may be illustrated by the following example: Anna and Gloria form a general partnership, Radio Associates, each contributing $500,000. The partnership agreement allocates all items of partnership income, gain, loss, deduction or credit equally between the partners. Radio Associates enters a loan contract to borrow $4,000,000. Interest accrues under the contract at the rate of 15% annually.

\textsuperscript{175} Temp. Reg. §1.752-1T(d)(3)(v)(A) (first sentence); see, e.g., Temp. Reg. §1.752-1T(k) example 21(ii).
\textsuperscript{176} Temp. Reg. §1.752-1T(d)(3)(v) (first sentence, third parenthetical).
\textsuperscript{177} Temp. Reg. §1.752-1T(d)(3)(v)(A) (first sentence).
\textsuperscript{178} Temp. Reg. §1.752-1T(d)(3)(v)(B). Note that in the preamble to T.D. 8274 filed November 21, 1989, the Service clarified that any economically accrued but unpaid interest remaining at the close of a partnership taxable year is to be regarded and analyzed as a separate partnership liability.
\textsuperscript{180} I.R.C. §1274(d).
\textsuperscript{182} Temp. Reg. §1.752-1T(d)(3)(v)(A) (third sentence).
\textsuperscript{183} Temp. Reg. §1.752-1T(d)(3)(v)(A) (fourth sentence).
and is payable each December 31st. Principal is payable in a lump sum in 14 years. Anna guarantees the payment of all interest due under the loan contract in the event of default by Radio Associates. The $4,000,000 debt is tentatively determined to be a nonrecourse liability of the partnership. However, Anna has EROL with regard to the debt because of her guarantee of the interest payments. At the time Radio Associates obtains the loan, the present value of the total interest payments due is $3,508,422. Therefore, $3,508,422 of the debt is a recourse liability of the partnership, for which only Anna bears the EROL. The remaining $491,578 of debt is a nonrecourse liability of the partnership, which Anna and Gloria will share equally.

**Distinguishing Between Recourse and Nonrecourse Liabilities of a Partnership**

A partnership liability is a recourse liability to the extent that any partner bears the EROL with respect to that liability. EROL can arise on one of four grounds. A partner has EROL with respect to a liability when she would be required to make an OMNC or an ONPC in the event of a constructive liquidation. If EROL does not arise on the first ground, a partner has EROL with respect to a liability if she (or a person related to her) is the creditor of that liability. If EROL does not arise on either the first or second ground, a partner has EROL when she enters an arrangement tantamount to a guarantee. If EROL does not arise on the first, second, or third ground, a partner has EROL when she guarantees in excess of 20% of the total interest which will accrue on the debt. The application of these rules has been discussed, *infra*, Part II K. A partner’s share of recourse liability equals the portion of the liability for which the partner bears the EROL.

A partnership liability is nonrecourse to the extent (but only to the extent) that no partner bears the EROL for that liability. Generally, partners share nonrecourse liabilities in the same manner that they share partnership profits. However, the regulatory scheme requires that nonrecourse liabilities be allocated first to reflect the partner’s share of partnership minimum gain, and then to reflect I.R.C. §704(c) minimum gain. “Partner’s share of partnership minimum gain,” and “I.R.C. §704(c) minimum gain,” are defined terms, whose meanings are discussed, *supra*, Part III A and B.

The regulations anticipate that some partnership liabilities will be part recourse and part nonrecourse. The regulations provide that such a liability is bifurcated for purposes of I.R.C. §752.

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184 Temp. Reg. §1.752-1T(a)(1)(i).
189 Temp. Reg. §1.752-1T(d)(1).
190 Temp. Reg. §1.752-1T(e)(2).
191 Temp. Reg. §1.752-1T(j)(2).
DETERMINING A PARTNER’S SHARE OF NONRECOURSE LIABILITY

Partner’s Share of Partnership Minimum Gain

A partner’s share of nonrecourse liability is the sum of three amounts.\footnote{Temp. Reg. \S 1.752-1T(e)(1).} The first of these amounts is the partner’s share of partnership minimum gain. Partnership minimum gain is the amount of gain,\footnote{This term is defined at Temp. Reg. \S 1.704-1T(b)(4) (iv)(f), modified for this purpose by Temp. Reg. \S 1.752-1T(e)(3)(i).} if any, that would be realized by the partnership if it disposed, in a taxable transaction, of the partnership property subject to the nonrecourse liability in full satisfaction thereof, and for no other consideration.\footnote{Temp. Reg. \S 1.704-1T(b)(4) (iv)(C).} A nonrecourse liability is a liability for which no partner bears the EROL.\footnote{Temp. Reg. \S 1.704-1T(b)(4)(iv)(k)(3).} As is the case with the constructive liquidation analysis, where book value differs from tax basis, the determination must be made as to book value (and accounting income or loss).\footnote{See, e.g., Temp. Reg. \S 1.704-1T(b)(4)(iv)(f) (flush language, second sentence); Temp. Reg. \S 1.704-1T(b)(5) example (22)(ii).}

This rule is illustrated by the following example: Movies, Ltd., a partnership, has a machine encumbered by a $10,000 nonrecourse liability. The machine has a book value of $3,000. If Movies, Ltd. transferred its machine to its creditor for no consideration other than relief from debt, Movies, Ltd. would recognize a $7,000 accounting gain. Therefore, Movies, Ltd. has $7,000 minimum gain with respect to its $10,000 nonrecourse liability.

A partner’s share of partnership minimum gain is the excess of one determined amount over another determined amount.\footnote{Temp. Reg. \S 1.704-1T(b)(4)(iv)(f)(1).} The first of these determined amounts is the sum of nonrecourse deductions allocated to that partner, up to that time, and the aggregate of distributions, up to that time, of the proceeds of a nonrecourse liability allocable to an increase in partnership minimum gain.\footnote{Temp. Reg. \S 1.704-1T(b)(4)(iv)(b) (first sentence).} A nonrecourse deduction is an allowable deduction of the partnership which has been so labeled because part of the annual increase in partnership minimum gain has been allocated to it.\footnote{Temp. Reg. \S 1.704-1T(b)(4)(iv)(b) (fifth sentence).}

Inasmuch as nonrecourse deductions is a label which attaches to otherwise allowable deductions, where no allowable deductions are present, there will be no nonrecourse deductions.\footnote{Temp. Reg. \S 1.704-1T(b)(4)(iv)(f).} Similarly, where there have been no actual distributions, there will be no distributions of proceeds of a nonrecourse liability allocable to an
increase in partnership minimum gain.\textsuperscript{201} Stated differently, these determinations do not involve the use of any deemed or constructive events.

The second determined amount is the sum of the partner’s share of net decreases in partnership minimum gain, up to that time, and the partner’s share of decreases in partnership minimum gain resulting from re-evaluations of partnership property.\textsuperscript{202} A partner’s share of net decreases in partnership minimum gain, for a partnership taxable year, equals an amount that bears the same relation to the net decrease in partnership minimum gain during such year as such partner’s share of partnership minimum gain at the end of the immediately preceding partnership taxable year bears to the amount of partnership minimum gain at the end of such preceding taxable year.\textsuperscript{203}

A partner’s share of any decrease in partnership minimum gain resulting from a re-evaluation of partnership property equals the amount of the increase in such partner’s capital account attributable to such re-evaluation to the extent of the reduction in partnership minimum gain caused by such re-evaluation.\textsuperscript{204}

When property encumbered by a nonrecourse liability is present at formation of the partnership, there will not yet be any allowable deductions, nor will there likely be any distributions of proceeds of a nonrecourse liability. Therefore, although there may be an increase in partnership minimum gain, the partner’s share of partnership minimum gain at formation (but not necessarily at the end of the first year) will likely be zero.

\textit{I.R.C. §704(c) Minimum Gain}

A partner’s share of I.R.C. §704(c) minimum gain is the partner’s share of taxable gain, if any, which the partnership would realize if it disposed of its property subject to a nonrecourse liability, in a taxable transaction, for no consideration other than relief from debt, to the extent such gain does not exceed the difference between the net book value of the asset and its tax basis at the time of sale.\textsuperscript{205} I.R.C. §704(c) requires a partnership to allocate to the contributing partner the built-in gain or loss in contributed property when realized by the partnership.\textsuperscript{206} I.R.C. §704(c) minimum gain arises when a partner contributes appreciated property to a partnership, and such property is or becomes subject to a nonrecourse liability. Note that, in contrast to the rules under a constructive liquidation, the determination of I.R.C. §704(c) minimum gain is made solely by reference to tax basis and taxable income and

\begin{itemize}
\item \textsuperscript{201} Temp. Reg. §1.704-1T(b)(4)(iv)(g).
\item \textsuperscript{202} Temp. Reg. §1.704-1T(b)(4)(iv)(f)(2).
\item \textsuperscript{203} Temp. Reg. §1.704-1T(b)(4)(iv)(f) (flush language, first sentence).
\item \textsuperscript{204} Temp. Reg. §1.704-1T(b)(4)(iv)(f) (flush language, second sentence).
\item \textsuperscript{205} Temp. Reg. §1.752-1T(e)(1)(ii).
\item \textsuperscript{206} Temp. Reg. §1.704-1T(c)(2)(i).
\end{itemize}
loss.207

Consider the following example: Katherine and Elizabeth form a partnership, Legal, Ltd. Katherine contributes $50,000 in cash. Elizabeth contributes non-depreciable property, subject to a liability of $50,000, with a fair market value of $100,000. Elizabeth’s basis in the property is $25,000. If Legal, Ltd. transferred the property to the creditor for no consideration other than relief from debt, Legal, Ltd. would recognize a $25,000 tax gain.208 The tax gain results from excess amount realized ($50,000 debt relief) over basis ($25,000). Accordingly, Elizabeth’s share of I.R.C. §704(c) minimum gain with respect to the $50,000 nonrecourse liability is $25,000.

A single partnership liability may be determined to be part recourse and part nonrecourse.209 In this instance, the regulations state that the amount of taxable gain which would be realized by the partnership is computed by taking into account only a portion of the basis of property subject to a liability which is part recourse and part nonrecourse.210 The portion of the basis allocable to the nonrecourse liability is determined under the principles developed by the Service211 for the allocation of deductions attributable to nonrecourse liabilities.212 Under these principles, the basis of property subject to two or more liabilities of equal priority are allocated among such liabilities in proportion to their respective outstanding balances.213 However, the basis of property subject to two or more liabilities of unequal priority is allocated to the inferior liability only to the extent that the basis exceeds the outstanding balance of the superior liability.214

This rule may be illuminated by the following example: Lynn and Carol form a partnership, Management, Ltd. Lynn contributes $200,000 cash. Carol contributes a machine, subject to an $800,000 liability, with a fair market value of $1,000,000. Carol’s basis in the machine is $200,000. As a result of a constructive liquidation analysis, it is determined that the $800,000 liability is a partnership liability, which is recourse to the extent of $300,000 and is nonrecourse to the extent of $500,000. It is also determined that the recourse and nonrecourse portions of the liability are of equal priority. In determining the partner’s share of the nonrecourse portion of the liability, it is determined that each partner’s share of partnership minimum gain is zero. Management, Ltd.’s tax basis of $200,000 allocable to the nonrecourse liability is $125,000 ($200,000 x 500,000/800,000 = $125,000). On an exchange of

207 See Temp. §Reg. 1.752-1T(k) example (23)(i)&(ii).
208 Note that Legal, Ltd. would recognize a $50,000 accounting loss (book value $100,000, less debt relief $50,000).
209 Temp. Reg. §1.752-1T(j)(2).
210 Temp. Reg. §1.752-1T(e)(1)(iii) (flush language).
211 Supra, n. 2.
212 Id.
its machine for no consideration other than relief from $500,000 debt, Management, Ltd. would realize $375,000 of gain (amount realized $500,000 less allocable basis $125,000). This is the I.R.C. §704(c) initial minimum gain to be used in determining Carol’s share of the nonrecourse liability as of partnership formation.

Excess Nonrecourse Liability

Nonrecourse liability in excess of both a partner’s share of partnership minimum gain and her I.R.C. §704(c) minimum gain is referred to as excess nonrecourse liability. \(^{215}\) A partner’s share of excess nonrecourse liabilities is determined by multiplying the partner’s interest in partnership profits by the excess nonrecourse liabilities. \(^{216}\)

A partner’s interest in partnership profits is generally determined by a facts and circumstances analysis of the economic arrangement of the partners. \(^{217}\) However, the partnership agreement may contain a provision specifically denoting the partner’s interest in partnership profits for this purpose. \(^{218}\) Such a provision will be respected if it allocates the partners’ interest in partnership profits in a manner reasonably consistent with allocations of some significant item of partnership income or gain, which is itself supported by substantial economic effect, within the meaning of I.R.C. §704(b). \(^{219}\)

**ANALYSIS**

The regulations logically imply (rather than expressly state) some of the rules to be applied, creating unnecessary confusion which the Service should eliminate by further announcement at the earliest opportunity. One such rule is that there is no reason to fully perform the complex constructive liquidation analysis unless the partners have a contractual obligation, under the partnership agreement, to restore deficits in their capital accounts. The regulations seem to recognize this in the examples. \(^{220}\) Elimination of the fourth step simplifies the analysis considerably; the rule should have been expressed in the text of the regulation, without requiring implication from the examples.

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\(^{215}\) Temp. Reg. §1.752-1T(e)(1)(iii).


\(^{217}\) Temp. Reg. §1.752-1T(e)(3)(ii)(C).


\(^{220}\) Compare, Temp. Reg. §1.752-1T(k) example (4) with -1T(k) example (5); although the regulation states that a constructive liquidation analysis has been performed in example (4), the fourth step has not been performed, i.e., allocating items of partnership income, gain, loss, deduction or credit to the partners according to the partnership agreement, and liquidating the partner’s interests in the partnership. See Temp. Reg. §1.752-1T(d)(3)(iii)(A)(4). Note that the regulation refers to examples (3), (5), (12), (13), (16), (17), and (18) to illustrate the constructive liquidation analysis. See Temp. Reg. §1.752 2D1T(d)(3)(iii)(A) (first sentence, flush language).
A further criticism arises with respect to an implication to be found in an example. In discussing the determination that tentative EROL exceeds the outstanding balance of the liability, the regulation states: "In such a case, the facts must be closely scrutinized to determine whether the failure to resolve the manner in which the partners will share the risk of loss attributable to a partnership liability is part of a plan to circumvent or avoid the obligation of any partner to make a net payment to a creditor or other person or a net contribution to the partnership with respect to the liability." This statement implies that an inquiry into the existence of bad intent is indicated in every case where the partners have failed to settle which of them bears the ultimate EROL with respect to a liability. However, such a failure can arise when the partners fail to adequately identify their rights under state law to indemnification, subrogation, etc. The complexity of these state law rights is such that the necessity of such an inquiry in every case seems unwarranted.

Additionally, the regulations use the phrase "a plan to circumvent or avoid [an] obligation" to describe an obligation which will not be recognized. In illustration of such a plan, the example describes an OMNC in a corporate general partner, formed to acquire and hold the partnership interest, and lacking any other assets. There is a qualitative difference between a showing that, as a matter of state law, a corporate general partner will never be able to perform its OMNC, and a showing that the partners have inadvertently rendered themselves jointly and severally liable to the creditor. In the absence of a showing that, by some intentional act, the partners have rendered their obligation illusory, any inquiry which is conducted should not conclude that bad intent is present, and no OMNC or OPNC should be disregarded.

The rule that EROL may arise as a result of a partner’s entering an arrangement tantamount to a guarantee requires clarification. The text of the regulations, and the example given in illustration of the rule do not provide guidance as to how "substantiality" is to be tested, i.e., how may it be determined that the creditor has retained sufficient EROL to preclude application of the rule? Given that a finding of bad intent is a prerequisite of the application of this rule, it is reasonable to conclude that the Service intends this rule to be applied on a "facts and circumstances" basis. Such an application would undercut the certainty of effect which is provided by the regulations generally, and fails to provide taxpayers with sufficient warning as to the tax consequences of their actions. The Service should issue an announcement clarifying the operation of this prophylactic rule.

\footnotesize
221 See Temp. Reg. §1.752-1T(k) example (9)(iv).
222 Id.
224 Temp. Reg. §1.752-1T(k) example (11).
225 Temp. Reg. §1.752-1T(k) example (20).
226 Supra, n. 2.
CONCLUSION

Generally, the Service\textsuperscript{229} has done an excellent job of implementing Congress' mandate\textsuperscript{230} that a method of allocating basis under I.R.C. §752 be developed which reflects economic reality. The approach adopted asks who, among the partners and persons related to partners, is to bear the economic risk of loss in the event that partnership assets lose their value and partnership liabilities come due. This analysis permits the determination of which partner or related person is ultimately responsible for any loss based upon a survey of the rights of partners and related persons under state law, contractual obligations, and enforceable agreements.

Only to the extent that no partner or related person bears any economic risk of loss can it be said that a liability is nonrecourse, i.e., that only the creditor bears the economic risk of loss. Nonrecourse liabilities can be shared among the partners in a manner controlled, in part, by the partnership agreement; recourse liabilities must be allocated to the partner who bears the economic risk of loss in proportion to her burden.

\textsuperscript{229} Id.

\textsuperscript{230} Supra, n. 3.