INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-163386-03, CC:PSI:B01

District Director

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

X =

Y =

Z =

$A =

$B =

$C =

$D =

$E =

$F =

$G =

A% =

ISSUE:

Can a gross income allocation to X be a significant item of partnership income or gain which has substantial economic effect for purposes of § 1.752-3(a)(3) allowing X to be allocated 100 percent of the excess nonrecourse liabilities?

CONCLUSION:

The allocation to X of 100 percent of the third tier allocations of excess nonrecourse liabilities under § 1.752-3(a)(3) is inappropriate. The regulations under § 1.752-3(a)(3) contemplate that the parties will allocate the excess nonrecourse liabilities in a manner that is consistent with the way they share a significant item of partnership income or gain which has substantial economic effect. The regulation looks to how the partners share a class of partnership income or gain rather than a gross income allocation within a class of income.

FACTS:

Based on the submissions and representations made within, the relevant facts are as follows. X was in the process of acquiring an interest in another company. In order to obtain cash for the acquisition, X decided to restructure and leverage its Z assets. To accomplish the desired result, X organized Y, a limited liability company classified as a partnership for federal tax purposes, with other parties and conveyed to Y its Z assets with a fair market value of $A. Y subsequently borrowed $D against the assets that were contributed by X and other members of Y. Y then simultaneously made a distribution to X totaling $B and issued a Senior Preferred Interest worth $E and Junior Preferred and Junior Common Interests worth approximately $F, while also assuming debt and issuing preferred and common interests to the other members. X owns 100 percent of the Senior Preferred Interest, which has an A% preferred return payable from gross income. Pursuant to the Partnership Agreement, X is allocated 100 percent of the gross income every quarter up to the amount of the preference on the Senior Preferred Interest. The Amended and Restated Limited Liability Company Agreement allocates $B of the nonrecourse liabilities to X and the remaining $G is allocated to another member of Y. The Partnership Agreement specifically provided that X's profits interest is to be determined with reference to the allocations under the Senior Preferred Interest for purposes of determining X's share of excess nonrecourse liabilities.

LAW AND ANALYSIS:

Section 1.707-5(b)(1) provides that if a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under § 1.163-8T to a transfer of money or other consideration within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner's allocable share of the partnership liability. To determine a partner's allocable share of partnership liability for purposes of § 1.707-5(b)(1), the following formula is used:

$$\text{Partner's Share of Liability} \times \frac{\text{Portion of Liability Allocable to the Money or Other Property Transferred to the Partner}}{\text{Total Amount of the Liability}}$$

To calculate the amount that is excluded from § 707 disguised sale amounts under this set of facts, the taxpayer's share of liability is determined with reference to § 1.707-5(a)(2)(ii) since this a nonrecourse liability. The regulations require the application of the same percentage used to determine the partner's share of excess nonrecourse liability under § 1.752-3(a)(3) ("third tier allocation regulations") to be used as the partner's share of liability in the § 1.707-5(b) calculation.

Thus, in order to determine whether or not the "partner's share of liability" number used in the § 1.707-5 calculation is correct, it is necessary to determine if the allocation percentage is correct under § 1.752-3(a)(3). Section 1.752-3(a)(3) provides for the allocation of excess nonrecourse liabilities, or the so called "third tier allocations." The regulation sanctions four methods for the allocation of excess nonrecourse liabilities. First, the regulation provides that a partner's share of the excess nonrecourse liabilities, defined as those not allocated under paragraphs (a)(1) and (a)(2) of this section, of the partnership as determined in accordance with the partner's share of partnership profits. In order to determine the partner's share of partnerships profits, all facts and circumstances relating to the economic arrangement of the partners are taken into account. The regulation goes on to provide a second approved method for the allocation of excess nonrecourse liabilities. The second sanctioned method provides that the partnership agreement may specify the partner's interest in the partnership profits for purposes of allocating the excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations of some other significant item of partnership income or gain that has substantial economic effect under § 704(b).[1] It is this second method that is at the center of the taxpayer's argument.

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[1] Though not implicated under the facts of this case, the regulations also provide for two other methods of allocating excess nonrecourse liabilities, bringing the total to four sanctioned methods. The regulations sanction the allocation of excess nonrecourse liabilities among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. Finally, the regulations also provide that the excess nonrecourse liabilities may first be allocated to a partner up to the amount of built-in gain that is allocable to the partner on § 704(c) property

X's position is that the allocation should be respected for purposes of § 1.752-3(a)(3) and § 1. 707-5(b)(1). The Taxpayer argues that the allocation of 100 percent of the gross income up to the amount of the Senior Preferred Return is a significant item of partnership income or gain.[2] X relies on the allocation rules located in § 1.752-3(a)(3)[3] to claim that its share of nonrecourse liability exceeds the amount of money transferred to, and thus any proceeds received by X in the distribution are excluded from consideration as proceeds of a disguised sale under § 1.707-5. The Taxpayer contends that the purpose of the second sanctioned method of allocating excess nonrecourse liabilities was to provide taxpayers a degree of certainty with regard to the amount of allocations as opposed to the uncertainty that is imbedded in the first method of third tier allocation (allocated according to the partner's share of partnership profits). The taxpayer contends that because the regulations require that the government take into account all relevant facts and circumstances when determining a partner's share of the partnership profits, a taxpayer can never know with certainty what the correct percentage is for the allocation because they can never with certainty know their share of the partnership profits.

However, we believe that the regulations reference to "a significant item of partnership income or gain" refers to a significant class of partnership income or gain. The point of the third-tier allocation is to match the excess nonrecourse deductions up with the manner in which the partners share a significant economic item of partnership income or gain. To simply consider a single gross income allocation in isolation does not encompass this sharing concept. While it is true that the Taxpayer in this case is getting 100 percent of a specific gross income allocation, the allocation does not truly reflect overall the economic relationship between the parties with respect to that item of partnership income. Thus, it cannot be what was intended by the third-tier allocation permitted in the regulation.

In other words, we do not agree that the regulation's reference to a "significant item of partnership income or gain" refers to a traunch of bottom-line gross or net income; rather, it refers to partnership income of a certain character or type, such as gain from the sale of property or tax-exempt income. This is evidenced by the use of the phrase "items of income" in the § 704(b) regulations. For example, § 1.704-1(b)(2)(vii) provides that § 704(b) and § 1.704-1(b) apply to "allocations of income, gain, loss, deduction, and credit, allocations of specific items of income, gain,

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or property for which reverse § 704(c) allocations are applicable where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the gain described in § 1.752-3(a)(2).

[2] It should be noted that the preferred return of gross income could be characterized as a guaranteed payment. See Rev. Rul. 81-300, 1981-2 C.B. 143. However, that is not the issue before us under consideration and we will confine ourselves to the question posed by the Field.

[3] Specifically, the second allocation method sanctioned by § 1.752-3(a)(3) providing that the excess nonrecourse allocations will be respected if they are allocated in a manner that is consistent with the manner in which another item of significant partnership income or gain, which has substantial economic effect, is allocated among the partners.

loss, deduction, and credit, and allocations of partnership net or ‘bottom line’ taxable income and loss. An allocation to a partner of a share of partnership net or “bottom line” taxable income or loss shall be treated as an allocation to such partner of the same share of each item of income, gain, loss, and deduction that is taken into account in computing such net or ‘bottom line’ taxable income or loss.”

As can be seen, the § 704(b) regulation distinguishes between allocations of “items of income” and allocations of partnership net or “bottom-line” income. More significantly, the § 704(b) regulation provides that an allocation of a <u>share</u> of partnership net income is treated as an allocation of <u>the same share</u> of each item of income. Under this regulation, an allocation of a 50 percent share or traunch of partnership gross or net income is not treated as the allocation of 100 percent of a single item of income; it is treated as an allocation of a 50 percent share of <u>each</u> item of income. Given the interdependence between the § 752 regulations and the § 704(b) regulations, we believe that it is appropriate to interpret “item of income” for purposes of the § 752 regulations consistently with its interpretation for purposes of the § 704(b) regulations.

Thus, the more appropriate view of what constitutes a “significant item of partnership income or gain that has substantial economic effect” is to examine the manner in which the partners share items of economic significance and determine if the allocation is consistent with the manner in which the partners share the item. For example, suppose a 50/50 partnership agrees to allocate the first $100x of gross income, an item of income or gain, to Partner 1 and the remaining gross income to Partner 2. Assume further that the partnership agreement provides that for purposes of § 1.752-3(a)(3) third-tier allocations, the allocations will be made in accordance with the manner in which the partners share the first $100x of gross income. Applying the Taxpayer’s argument, this allocation would entitle Partner 1 to 100% of the third-tier allocations (assuming that the § 704(b) requirement is satisfied). However, assuming that total amount of gross income that the partnership was expected to make in that same year is $500x, Partner 1 is only being allocated one-fifth of the total gross income that the partnership earns. Given this, it is not appropriate for Partner 1 to be allocated 100% of the third-tier allocations since it does not truly reflect the underlying economic relations of the partners. Therefore, it is consistent with the purpose of the third-tier allocation regulations for Partner 1 to be allocated 20% of the excess nonrecourse allocations if gross income is the item taxpayer chooses to follow.

Therefore, the Taxpayer’s argument fails to persuade us that the Taxpayer is entitled to 100 percent of the third-tier allocations under § 1.752-3(a)(3). To meet the requirements of the second method of allocating excess nonrecourse allocations sanctioned under § 1.752-3(a)(3), the allocation ratio must reflect how the partners are sharing a significant item of partnership income or gain which has substantial economic effect.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.