Section 752.—Treatment of Certain Liabilities

26 CFR 1.752–3: Partner's share of nonrecourse liabilities.

T.D. 8906

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Allocation of Partnership Debt

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the allocation of nonrecourse liabilities by a partnership. The final regulations revise tier three of the three-tiered allocation structure contained in the current nonrecourse liability regulations, and also provide guidance regarding the allocation of a single nonrecourse liability secured by multiple properties.

DATES: *Effective Date*: These regulations are effective October 31, 2000.

Applicability Date: For dates of applicability of these regulations, see §1.752–5(a).

FOR FURTHER INFORMATION CONTACT: Dan Carmody, (202) 622-3070 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Introduction

This document revises §1.752–3 of the Income Tax Regulations (26 CFR part 1) relating to the allocation by a partnership of nonrecourse liabilities.

Background

On January 13, 2000, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG–103831–99, 2000–5 I.R.B. 452 [65 F.R. 2084]) to provide guidance relating to the allocation of nonrecourse liabilities by a partnership. The IRS and Treasury received public comments concerning the proposed regulations, and a public hearing was held on May 3, 2000. After consideration of the comments received, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Revisions and Summary of Comments

1. *In General*

Treasury regulation §1.752–3 currently provides a three-tiered system for allocating nonrecourse liabilities. The three-tiered system applies sequentially. Under the first tier, a partner is allocated an amount of the liability equal to that partner's share of partnership minimum gain under section 704(b). See §1.704–2(g)(1). Under the second tier, to the extent the entire liability has not been allocated under the first tier, a partner will be allocated an amount of liability equal to the gain that partner would be allocated under section 704(c) if the partnership disposed of all partnership property subject to one or more nonrecourse liabilities in full satisfaction of the liabilities (section 704(c) minimum gain). Under the third tier, a partner is allocated any excess nonrecourse liabilities (i.e., nonrecourse liabilities in excess of the portion allocable in the first and second tiers) under one of several methods (i.e., partner's share of profits or certain reasonably expected deductions) that the partnership may choose.

The proposed regulations modified the third tier to allow an additional method under which a partnership may allocate an excess nonrecourse liability based on the excess section 704(c) gain (i.e., the excess of the amount of section 704(c) built-in gain attributable to an item of property over the amount of section 704(c) minimum gain on that property) attributable to the properties that are subject to the liability. In addition, for purposes of determining section 704(c) minimum gain under the second tier, the proposed regulations provided that if a partnership holds multiple properties subject to a single liability, the liability may be allocated among the properties based on any reasonable method. A method is not reasonable under the proposed regulations if it allocates to any property an amount that exceeds the fair market value of the property.

2. *Allocation of Debt in Accordance With Reverse Section 704(c) Gain*

One commentator noted that the additional method provided in the proposed regulations under the third tier covers only built-in gain on section 704(c) property, which includes built-in gain (i.e., book value minus adjusted basis) attributable to contributed property, but not built-in gain attributable to property subject to a revaluation (pursuant to §1.704–1(b)(2)(iv)(*f*)) (i.e., reverse section 704(c) gain). The commentator noted that this distinction is not made in allocating nonrecourse liabilities in accordance with section 704(c) minimum gain under the second tier and questioned the policy reason for excluding the reverse section 704(c) gain in applying the third tier. In response to this comment, the final regulations provide that an excess nonrecourse liability may be allocated under the third tier in accordance with excess section 704(c) gain as well as excess reverse section 704(c) gain (i.e., the excess of the amount of reverse section 704(c) gain attributable to an item of property over the section 704(c) minimum gain on that property) with respect to property that is subject to such liability.

3. *Interplay With the Disguised Sales Rules*

One commentator noted that the proposed amendments to §1.752–3 would impact the disguised sales rules relating to transfers of encumbered property. The disguised sale rules treat a contribution of property encumbered by a "non-qualified" liability (generally, a liability incurred within two years of the contribution to the partnership that is incurred in anticipation of such contribution) as a disguised sale to the extent that the amount of the liability exceeds the contributing partner's share of the liability immediately after the contribution. Section 1.707–5(a)(2)(ii) provides that a partner's share of a nonrecourse liability, for purposes of the disguised sale rules, is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under §1.752–3(a)(3).

Because the proposed amendments to §1.752–3(a)(3) would allow excess nonrecourse liabilities to be allocated according to an amount, rather than a percentage, the potential for ambiguity exists. The commentator suggested that the disguised sale rules should be modified to define a partner's share of a nonrecourse liability by cross-reference to §1.752–3(a), rather than limiting the definition to the third tier. The commentator noted that maintaining separate definitions for the same term was burdensome and confusing for practitioners, and noted that the disguised sale rules provide consistency between sections 707(a) and 752 with respect to the definition of a partner's share of a recourse liability by reference to §1.752–2 without limitation.

The preamble to §1.707–5 explains that the cross-reference defining a partner's share of nonrecourse liabilities is limited to the third tier of §1.752–3(a) because the adoption of the full three-tier approach in the disguised sale context would provide an inverse relationship between the gain inherent in the contributed property and the extent to which a disguised sale of the property results from the encumbrance. See preamble (57 F.R. 44974). The contributing partner's share of the liability under §1.752–3(a) generally will increase as the amount of built-in gain on the property increases, which in turn would reduce the extent to which the contribution would be treated as a disguised sale.

The same problem would exist if the proposed modifications to the third tier were taken into account for purposes of §1.707–5(a)(2)(ii). To the extent that excess section 704(c) gain exists with respect to a property, the partnership could

allocate excess nonrecourse liabilities to the contributing partner. The greater the built-in gain with respect to a property, the less likely it would be that a disguised sale would result from the contribution. In order to avoid this inappropriate result, the final regulations clarify that the modifications made to the third tier do not apply for purposes of §1.707–5(a)(2)(ii). Thus, for purposes of the disguised sale rules, the partner's share of nonrecourse liabilities continues to be determined under the third tier by reference to the partner's share of profits or certain reasonably expected deductions.

4. *Treatment of "Extra" Excess Section 704(c) Gain*

Rev. Rul. 95–41 (1995–1 C.B. 132) holds that if a partnership determines the partners' interests in partnership profits based on all of the facts and circumstances relating to the economic arrangement of the partners, excess section 704(c) gain is one factor, but not the only factor, to be considered under §1.752–3(a)(3). The preamble to the proposed regulations provides that this holding will remain relevant where a partnership does not allocate nonrecourse debt under the third tier based on the excess section 704(c) gain attributable to the property that is subject to the debt. The preamble also provides that once a partnership has allocated nonrecourse indebtedness pursuant to the rule in the proposed regulations based upon excess section 704(c) gain, that excess section 704(c) gain cannot again be considered in determining a partner's interest in partnership profits.

One commentator asked, in situations where the amount of a liability allocated to a partner under the third tier pursuant to the rule contained in the proposed regulations is less than the partner's share of excess 704(c) gain, whether the remaining excess 704(c) gain should be taken into account for purposes of determining a partner's interest in partnership profits under the third tier with regard to other liabilities.

The statement contained in the preamble regarding the impact of the proposed regulations on Rev. Rul. 95–41 reflects a concern on the part of IRS and Treasury that taxpayers might count the same excess section 704(c) gain in applying the rule in the proposed regulations and then again in determining a partner's interest in partnership profits under the third tier. To the extent that a portion of excess section 704(c) gain remains after a liability has been fully allocated, there is no double-counting, and the remaining portion of the gain should be taken into account as one factor to be considered in determining a partner's interest in partnership profits under §1.752–3(a)(3) and Rev. Rul. 95–41.

5. *Applicability of §1.752–3(b) to Third-Tier Allocations*

The proposed regulations provide rules regarding the allocation of a single liability among multiple properties. The proposed regulations generally provide that if a partnership has multiple properties subject to a single liability, for purposes of determining the amount of section 704(c) minimum gain in applying the second tier, the partnership may allocate to each property an amount of the liability that, when combined with any other liabilities allocated to the property, do not exceed the property's fair market value. The portion of the liability allocated to each property will be treated as a separate loan in determining the section 704(c) minimum gain attributable to the property.

One commentator asked that the rule for allocating a single liability among multiple properties under the second tier also apply to third tier allocations. For purposes of the second tier, where nonrecourse debt is cross-collateralized, it is necessary to determine how much of the nonrecourse debt is attributable to each partnership property, since debt is allocated among the partners under that tier based upon the amount by which the debt attributable to each specific property exceeds the tax basis of such property. (See §1.704–3(a)(2), which provides that, except in limited circumstances, section 704(c) applies on a property-by-property basis.) Under the proposed modification to the third tier, any remaining nonrecourse liability of the partnership could be allocated to a partner up to the excess section 704(c) gain allocable to the partner on property subject to that liability. There is no need to bifurcate cross-collateralized debt under this tier, since excess section 704(c) gain is not limited by the amount of debt attributable to specific partnership property. So long as a partner's share of excess section 704(c) gain is attributable to property that is "subject to" the debt being allocated, the debt may be allocated in accordance with that partner's share of such excess section 704(c) gain. Multiple properties may be "subject to" the same indebtedness. Bifurcating the debt among multiple properties so that each property is treated as subject to only a portion of the debt actually would limit taxpayers' flexibility and narrow the scope of the proposed change to the third tier. Accordingly, the commentator's recommendation is not adopted. However, the final regulations add an example which clarifies the operation of this rule.

6. *Retroactive Effective Date*

One commentator suggested that the regulations should apply on a retroactive basis. This suggestion has not been adopted. However, the final regulations respond to this recommendation by providing an optional effective date for those taxpayers who wish to apply the rules currently to liabilities incurred prior to the issuance of these regulations.

7. *Additional Comments Requested*

The preamble to the proposed regulations requested comments regarding the allocation of a single liability among multiple partnerships. Although no formal comments were submitted on this issue, several commentators have indicated that additional guidance regarding appropriate methods of allocating such liabilities would be helpful. The IRS and Treasury again request comments regarding this issue.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Christopher T. Kelley, Office of Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.752–3 is amended as follows:

1. Paragraph (a)(3) is amended by adding three sentences immediately before the last sentence in the paragraph.

2. Paragraph (b) is redesignated as paragraph (c).

3. New paragraph (b) is added.

4. Newly designated paragraph (c) is amended by revising the introductory text and adding a new *Example 3*.

The revisions and addition read as follows:

§1.752–3 Partner's share of nonrecourse liabilities.

(a) * * *

(3) * * * Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property (as defined under §1.704–3(a)(3)(ii)) or property for which reverse section 704(c) allocations are applicable (as described in §1.704–3(a)(6)(i)) where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the gain described in paragraph (a)(2) of this section with respect to such property. This additional method does not apply for purposes of §1.707–5(a)(2)(ii). To the extent that a partnership uses this additional method and the entire amount of the excess nonrecourse liability is not allocated to the contributing partner, the partnership must allocate the remaining amount of the excess nonrecourse liability under one of the other methods in this paragraph (a)(3).

* * *

(b) *Allocation of a single nonrecourse liability among multiple properties*—(1) *In general*. For purposes of determining the amount of taxable gain under paragraph (a)(2) of this section, if a partnership holds multiple properties subject to a single nonrecourse liability, the partnership may allocate the liability among the multiple properties under any reasonable method. A method is not reasonable if it allocates to any item of property an amount of the liability that, when combined with any other liabilities allocated to the property, is in excess of the fair market value of the property at the time the liability is incurred. The portion of the nonrecourse liability allocated to each item of partnership property is then treated as a separate loan under paragraph (a)(2) of this section. In general, a partnership may not change the method of allocating a single nonrecourse liability under this paragraph (b) while any portion of the liability is outstanding. However, if one or more of the multiple properties subject to the liability is no longer subject to the liability, the portion of the liability allocated to that property must be reallocated among the properties still subject to the liability so that the amount of the liability allocated to any property does not exceed the fair market value of such property at the time of reallocation.

(2) *Reductions in principal*. For purposes of this paragraph (b), when the outstanding principal of a partnership liability is reduced, the reduction of outstanding principal is allocated among the multiple properties in the same proportion that the partnership liability originally was allocated to the properties under paragraph (b)(1) of this section.

(c) *Examples*. The following examples illustrate the principles of this section:

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Example 3. Allocation of liability among multiple properties. (i) A and B are equal partners in a partnership (PRS). A contributes $70 of cash in exchange for a 50-percent interest in PRS. B contributes two items of property, X and Y, in exchange for a 50-percent interest in PRS. Property X has a fair market value (and book value) of $70 and an adjusted basis of $40, and is subject to a nonrecourse liability of $50. Property Y has a fair market value (and book value) of $120, an adjusted basis of $40, and is subject to a nonrecourse liability of $70. Immediately after the initial contributions, PRS refinances the two separate liabilities with a single $120 nonrecourse liability. All of the built-in gain attributable to Property X ($30) and Property Y ($80) is section 704(c) gain allocable to B.

(ii) The amount of the nonrecourse liability ($120) is less than the total book value of all of the properties that are subject to such liability ($70 + $120 = $190), so there is no partnership minimum gain. §1.704–2(d). Accordingly, no portion of the liability is allocated pursuant to paragraph (a)(1) of this section.

(iii) Pursuant to paragraph (b)(1) of this section, PRS decides to allocate the nonrecourse liability evenly between the Properties X and Y. Accordingly, each of Properties X and Y are treated as being subject to a separate $60 nonrecourse liability for purposes of applying paragraph (a)(2) of this section. Under paragraph (a)(2) of this section, B will be allocated $20 of the liability for each of Properties X and Y (in each case, $60 liability minus $40 adjusted basis). As a result, a portion of the liability is allocated pursuant to paragraph (a)(2) of this section as follows:

Partner	*Property*	*Tier 1*	*Tier 2*
A	X	$0	$0
	Y	$0	$0
B	X	$0	$20
	Y	$0	$20

(iv) PRS has $80 of excess nonrecourse liability that it may allocate in any manner consistent with paragraph (a)(3) of this section. PRS determines to allocate the $80 of excess nonrecourse liabilities to the partners up to their share of the remaining section 704(c) gain on the properties, with any remaining amount of liabilities being allocated equally to A and B consistent with their equal interests in partnership profits. B has $70 of remaining section 704(c) gain ($10 on Property X and $60 on Property Y), and thus will be allocated $70 of the liability in accordance with this gain. The remaining $10 is divided equally between A and B. Accordingly, the overall allocation of the $120 nonrecourse liability is as follows:

Partner	*Tier 1*	*Tier 2*	*Tier 3*	*Total*
A	$0	$0	$5	$5
B	$0	$40	$75	$115

Par. 3. In §1.752–5, paragraph (a) is amended by adding three sentences after the first sentence:

Section 1.752–5 Effective dates and transition rules.

(a) *In general.* * * * However, §1.752–3(a)(3) fifth, sixth, and seventh sentences, (b), and (c) *Example 3*, do not apply to any liability incurred or assumed by a partnership prior to October 31, 2000. Nevertheless, §1.752–3(a)(3) fifth, sixth, and seventh sentences, (b), and (c) *Example 3*, may be relied upon for any liability incurred or assumed by a partnership prior to October 31, 2000 for taxable years ending on or after October 31, 2000. * * *

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David A. Mader,
Acting Deputy Commissioner of Internal Revenue.

Approved October 11, 2000.

Jonathan Talisman,
Acting Assistant Secretary of the Treasury.

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