

**COMMENTS CONCERNING THE CHARACTERIZATION OF A PARTNERSHIP
LIABILITY UNDER SECTION 752 WHERE A DISREGARDED ENTITY IS A
GENERAL PARTNER**

The following comments represent the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the Section of Taxation of the American Bar Association.

These comments were prepared by individual members of the Committee on Partnerships and LLCs of the ABA Section of Taxation. The principal draftsman of these comments is Martin Pollack, with substantial contributions by John Maxfield, Todd Molz, Stephen Owen, and Thomas Yearout. Helpful comments were received from Terrence Cuff. The comments were reviewed by Bill Wilkins of the Section's Committee on Government Submissions and by Jerald August the council director of the Committee on Partnerships and LLCs .

Although members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

We are submitting these comments in the present "question and answer" format in order to expedite our submission at the request of the government which is committed to providing guidance on this subject in a short time frame.

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Date: April 5, 2004

EXECUTIVE SUMMARY

These comments illustrate an important application of the liability characterization rules under the existing Treasury Regulations promulgated under Section 752 of the Code. The Section 752 regulations characterize partnership liabilities as either "recourse" or "nonrecourse" for purposes of determining which partners will include such liabilities in the basis of their partnership interests. The particular application of these rules to which the comments are addressed concerns the common situation in which a partnership liability is "recourse" to a partnership's general partner, but the general partner is a limited liability company that is disregarded as a separate entity under the Treasury Regulations promulgated under Section 7701 of the Code (a "Disregarded Entity"). The comments adopt the view that, in general, the determination of the extent to which a partnership's liability is characterized as "recourse" is to be made by reference to the level of economic risk of loss in respect of the liability to which those persons who are properly treated as "partners" for federal income tax purposes are subject. Because a Disregarded Entity is not such a person, the comments take the position that where the economic risk of loss to which the owner of the Disregarded Entity is subject differs from the economic risk of loss to which the Disregarded Entity is subject, the former generally should be controlling. Nevertheless, the comments recognize that there will be circumstances in which an exception should be made to this general principle and the comments suggest a methodology that could be used to define and administer such an exception.

BACKGROUND

The Service is committed to providing guidance regarding the characterization of a partnership liability under section 752 where a disregarded entity is a general partner. The following examples and analysis illustrate the governing principles upon which we believe this guidance should be based.

EXAMPLES AND ANALYSIS

I. Background Example.

A. Initial Facts. Corporation A ("A") and Corporation L ("L") form a limited partnership (the "Partnership"). A is the general partner and L is the limited partner of the Partnership. A has assets with a fair market value of \$600 in addition to its interest in the Partnership, and has no liabilities, other than in its capacity as general partner of the Partnership. L has no obligation to restore any deficit in its capital account. The Partnership borrows \$1,000 from an unrelated lender ("Lender"), executing a note for \$1,000 (the "Liability"). The Liability is a general obligation of the Partnership for which A is personally liable as general partner. L has no obligations with respect to the Liability and there are no arrangements that contravene the anti-abuse rules of Treas. Reg. § 1.752-2(j).

B. Analysis. A, as the sole general partner, bears the economic risk of loss for the entire Liability. Treas. Reg. § 1.752-2(b)(1). Thus, for purposes of Section 752, the entire Liability is classified as a “recourse” liability and allocated to A. This is true notwithstanding the fact that A’s assets other than its interest in the Partnership have a value less than the amount of the Liability, by virtue of Treas. Reg. § 1.752-2(c)(6) (which provides that “[f]or purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.”). The rule of Treas. Reg. § 1.752-2(c)(6) is hereinafter referred to as the “Presumption Of Solvency.”

II. Example 1: Disregarded Entity Owning No Other Assets Is GP.

A. Facts. The facts are the same as above, except that

1. A owns 100% of the equity of Disregard, a limited liability company which is treated as a disregarded entity under the Section 7701 regulations;

2. Disregard (rather than A) is the general partner of the Partnership (and thus Disregard, not A, is personally liable for the Liability) from and after the time that Partnership incurs the Liability; and

3. Disregard owns no assets other than its interest in the Partnership and has no liabilities, other than in its capacity as general partner of the Partnership.

B. Analysis. Disregard, a disregarded entity, should not be treated as a “partner” of the Partnership for federal income tax purposes (even though Disregard is the general partner under local law) because Disregard should be disregarded as an entity separate from A. For federal income tax purposes, since A is treated as owning the assets of Disregard, A should be treated as the owner of the general partner interest in the Partnership. For purpose of allocating the Liability under Section 752, the correct question is whether the Liability is a recourse liability of A for purposes of the Section 752 regulations. To answer this question, a determination must be made as to whether A (or a related person) has the economic risk of loss for the Liability.

1. Disregard is a limited liability company that owns no assets other than its interest in the Partnership. As a result, A has no economic risk of loss for the Liability because, if all of the assets of the Partnership were to become worthless,

(a) none of A’s directly owned assets would have to be paid to Lender; and

(b) Disregard owns no assets (other than its interest in the Partnership) that would have to be paid to Lender.

2. While Disregard bears the economic risk of loss for the Liability, Disregard’s status as a disregarded entity whose assets are owned by A implies that Disregard is

not a “person” for federal income tax purposes. Accordingly, Disregard is not a “related person” to A.

3. Thus, because no partner of the Partnership (and no related person) bears any portion of the economic risk of loss for the Liability, the entire \$1,000 should be classified under Section 752 as a “nonrecourse” liability that is allocated in accordance with Treas. Reg. § 1.752-3.

4. If the Presumption of Solvency were applicable to Disregard, the result would be different. However, the Presumption of Solvency would not appear to be applicable to Disregard for two reasons: First, this presumption applies only to partners and related persons and, for the reasons discussed above, Disregard is neither. Second, on the facts of this Example, where Disregard owns no assets other than its interest in the Partnership, the facts and circumstances strongly suggest a plan to circumvent or avoid the obligation that the Presumption of Solvency normally assumes will be performed. Such a plan is subject to the anti-abuse rule of Treas. Reg. § 1.752-2(j) which prevents the Presumption of Solvency from applying even if it otherwise were technically applicable. *See* Treas. Reg. § 1.752-2(j)(1) (“An obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person for purposes of this section if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Circumstances with respect to which a payment obligation may be disregarded include, but are not limited to, the situations described in paragraphs (j)(2) and (j)(3) of this section.”).

III. Example 2: Disregarded Entity Owning Other Assets (Consisting Solely of Cash) Is GP.

A. Facts. A’s assets and liabilities and the other facts are the same as in Example 1, except that Disregard also owns \$600 in cash (uninvested) at the time that Partnership incurs the Liability and at all times thereafter. Disregard has no liabilities other than its liability as general partner of the Partnership.

B. Analysis.

1. A bears the economic risk of loss for \$600 of the Liability. Treas. Reg. § 1.752-2(b)(1). The \$600 represents the amount of A’s assets (which include Disregard’s assets because Disregard’s assets are treated as owned by A for federal income tax purposes) at risk for the Liability if all of the Partnership’s assets were to become worthless. The economic risk of loss for the remaining \$400 is not borne by any partner (or related person) of the Partnership. Accordingly, for purposes of Section 752, the Liability should be bifurcated with \$600 classified as a “recourse” liability and \$400 classified as a “nonrecourse” liability. *See* Treas. Reg. 1.752-1(i) (bifurcating partnership’s liability which is part recourse and part non-recourse).

2. The question can be asked as to whether if A has the unfettered ability to withdraw the \$600 from Disregard at any time, the anti-abuse rule of Treas. Reg. § 1.752-2(j)

might be applicable to disregard Disregard's potential \$600 payment obligation. See Treas. Reg. § 1.752-2(j) (the "Anti-Abuse Rule"). Under the Anti-Abuse Rule, "[a]n obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation." Treas. Reg. § 1.752-2(j)(3). In the absence of other facts that evidence a plan to circumvent or avoid the \$600 economic risk of loss with respect to the Liability, the Anti-Abuse Rule should not apply on the facts of this Example.

IV. Example 2A: Disregarded Entity Owning Other Assets Is GP - Effect Of Change In Value.

A. Facts. The facts are the same as in Example 2, except that after the Liability is incurred, Disregard invests its \$600 in assets that appreciate (or depreciate) in value.

B. Analysis.

1. As an economic matter, Disregard's assets have an economic equivalent effect on A's economic risk of loss as would a pledge of Disregard's assets to Lender. This equivalence might suggest that the theory of the pledge rule of Treas. Reg. § 1.752-2(h) (the "Pledge Rule") should be applied to determine A's economic risk of loss. Under the Pledge Rule, economic risk of loss is determined by reference to the value of the collateral when the liability is incurred and changes in the value of the collateral are ignored. If the logic of the Pledge Rule were applied to this Example, A would be treated as bearing the economic risk of loss for the Liability to the extent of the fair market value of Disregard's assets (other than the Partnership interest) at the time that the Liability is incurred, and the Liability would be treated for purposes of Section 752 as a "recourse" liability to that extent, regardless of subsequent increases or decreases in the value of such assets.

2. While borrowing the methodology of the Pledge Rule is tempting, two elements of that Rule cause us to forego the temptation. First, the Pledge Rule is flawed insofar as it appears to focus on the gross fair market value of collateral without regard for the fact that the net fair market value of the collateral may be considerably lower by reason of superior liens. Second, the operation of the Pledge Rule belies economic reality to achieve administrative convenience by ignoring changes in the value of collateral. While we appreciate the importance of administrative convenience, ignoring changes in value for the purpose of determining a partner's economic risk of loss appears counter-intuitive and inconsistent with economic reality. Accordingly, we believe these flaws of the Pledge Rule should not be extended to this context and would encourage Treasury to reconsider these aspects of the Pledge Rule.

3. In view of the competing considerations, we believe that Treasury should adopt a new rule to govern this Example that is better reflective of the true economic burden of the debt. This new rule would initially determine the economic risk of loss based upon the net fair market value of Disregard's net assets at the time the Liability is incurred and immediately after the contribution of non-*de minimis* additional assets to Disregard. Asset sales by Disregard would cause a revaluation of the sold assets. For the effect of distributions by Disregard see examples 2B and 2C below. (It may be appropriate for there to be revaluations on

certain other occasions as well.) In addition, the Partnership would be given the ability to make a one-time irrevocable election (in the taxable year in which the Liability is incurred) to have economic risk of loss determined with regard to changes in the value of Disregard's assets as of the last day of each taxable year that the Liability is outstanding. The Anti-Abuse Rule would serve as a backstop to prevent partners from achieving abusive results with this election. This rule is conceived to strike a balance between the benefit of reflecting the true economic burden of the debt and the administrative cost of continuous revaluations.

V. Example 2B: Disregarded Entity Owning Other Assets Is GP - Effect Of Distribution of Assets, No Obligation to Recontribute Assets.

A. Facts. The facts are the same as in Example 2, except that during the taxable year following the taxable year in which the Liability was incurred, Disregard distributes \$300 of its cash to A. A has no obligation to return the \$300 to Disregard under the operating agreement of Disregard or under applicable law.

B. Analysis. Following the distribution, A should be treated as bearing the economic risk of loss in respect of the Liability only to the extent of the remaining \$300 of Disregard's cash. For purposes of Section 752, therefore, from and after the distribution the Liability should be bifurcated with \$300 classified as a "recourse" liability and \$700 classified as a "nonrecourse" liability.

VI. Example 2C: Disregarded Entity Owning Other Assets Is GP - Effect Of Distribution of Assets, Requirement to Recontribute Assets

A. Facts. The facts are the same as in Example 2B except that, under applicable law, A may be obligated to recontribute to Disregard the withdrawn cash for a period of time (the "Clawback Period") following the distribution (e.g., if the state limited liability company statute treated the distribution as a wrongful return of part of A's capital contribution because Disregard's liabilities exceed the fair market value of Disregard's assets).

B. Analysis.

1. If, under applicable law, the circumstances are such that A's obligation to return the distribution would be reasonably certain if the partnership were to effect the constructive liquidation described in Treas. Reg. § 1.752-2(b)(1), then (i) until the end of the Clawback Period the analysis is the same as in Example 2, and (ii) after the end of the Clawback Period the analysis is the same as in Example 2B.

2. However, if, under applicable law, the facts and circumstances are such that A's obligation to return the distribution to Disregard (under the circumstances described above) would not be reasonably certain, then A's clawback obligation is a contingent obligation and Treas. Reg. § 1.752-2(b)(4) should apply to disregard the clawback obligation until it is determinable with reasonable certainty ("If a payment obligation would arise at a future time

after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs.”).

VII. Example 2D: Taxpayer Transfers Substantially All of Its Assets And Liabilities To Disregarded Entity That Is GP

A. Facts. The facts are the same as in Example 1 except that A has transferred substantially all of its assets and liabilities to Disregard.

B. Analysis. Unless Disregard is afforded the benefit of the Presumption of Solvency, the Liability would be bifurcated with \$600 treated as a “recourse” liability and \$400 treated as a “non-recourse” liability. This result is dramatically different from the result in Part I above in that the formation of Disregard has, in effect, enabled A to “turn off” the Presumption of Solvency. This fact situation provides the strongest case for Treasury to modify the Presumption of Solvency to make it applicable to a disregarded entity in appropriate circumstances. What the “appropriate circumstances” are is difficult to define in the abstract and is likely to require a case by case determination. One way to achieve this result would be for the Presumption of Solvency to be modified so that it is clearly applicable to disregarded entities subject to the application of the Anti-Abuse Rule which would “turn off” the Presumption in circumstances where, as in Part II.B.4 above, Disregard's level of assets and other activities is too insignificant to support the Presumption.

VIII. Example 3. Disregarded Entity Is GP – Owner of Disregarded Entity Has DRO.

A. Facts. The facts are the same as in Example 1, except that A has a \$600 deficit restoration obligation (“DRO”) under the operating agreement of Disregard (and A has agreed with Lender that it will not modify the DRO provisions of Disregard’s operating agreement without Lender’s consent).

B. Analysis. Applying Treas. Reg. § 1.752-2(b), A bears \$600 of the economic risk of loss in respect of the Liability by reason of its DRO under the Disregard operating agreement. For purposes of Section 752, the Liability should be bifurcated with \$600 classified as a “recourse” liability and \$400 as a “nonrecourse” liability.