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ALLOCATIONS ATTRIBUTABLE TO PARTNER NONRECOURSE LIABILITIES: ISSUES REVEALED BY LLCS AND LLPS*

*Christine Rucinski Strong***
*Susan Pace Hamill****

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* This Article, the fourth in the series, concludes the series of articles published in the *Alabama Law Review* exploring legal issues and practical problems raised by limited liability companies and limited liability partnerships, two relatively new business organizations offered in Alabama as well as nationwide. *See* Mitchel Hampton Boles & Susan Pace Hamill, *Agency Powers and Fiduciary Duties Under the Alabama Limited Liability Act: Suggestions for Future Reform*, 48 ALA. L. REV. 143 (1996); Laurel Wheeling Farrar & Susan Pace Hamill, *Dissociation From Alabama Limited Liability Companies in the Post Check-the-Box Era*, 49 ALA. L. REV. 909 (1998); and Fallany O. Stover & Susan Pace Hamill, *The LLC Versus LLP Conundrum: Advice For Businesses Contemplating the Choice*, 50 ALA. L. REV. 813 (1999). Professor Hamill thanks each of her four student co-authors for their hard work and dedication. These students labored their entire third year conducting exhaustive research, producing endless drafts and re-writes and finally tolerated long and grueling writing sessions with me to bring independent study papers up to publishable quality. Professor Hamill also greatly appreciates the students who served on the *Alabama Law Review*, especially Shane Black, Jim Hughey, Pam Payne and Lisa Moss (serving as Editors-in-Chief during the four academic years of the series), for their hard work and support of this series.

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*** Associate Professor of Law, The University of Alabama. Professor Hamill thanks Dean Kenneth Randall and her faculty colleagues for all of their support and gratefully acknowledges the University of Alabama Law School Foundation, the Edward Brett Randolph Fund and the William H. Sadler Fund. Professor Hamill recognizes the students who completed the fall 1999 course, Limited Liability Companies and Other Closely Held Businesses, for all their hard work towards understanding the unique allocation issues posed by LLCs and LLPs, especially within the context of the partner nonrecourse debt allocation rules. *See infra* notes 202, 212-14, and 239-41 and accompanying text for suggestions made by Thad Davis, Eric Johnson, Lisa Moss and Robert Plott in well written exam answers on how the § 704(b) regulations might be improved to address these issues.

I. INTRODUCTION

Mirroring the trend nationwide, the popularity of limited liability companies ("LLC"s) and limited liability partnerships ("LLP"s) has grown rapidly in Alabama since the Alabama legislature enacted its first LLC statute in 1993[1] and its first LLP statute in 1996.[2] LLCs and LLPs offer all members and partners the same limited liability protection enjoyed by shareholders of corporations.[3] Although LLCs, LLPs and corporations, especially closely held corporations, often bear a strong resemblance to one another under state law, the federal income tax system taxes these business organizations in radically different ways based on whether the participants have filed articles of

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1. ALA. CODE §§ 10-12-1 to -61 (1993), *amended by* Pub. L. No. 97-920, 1997 Ala. Acts 312, 1st Sp. Sess., No. 97-920, H. 3. The Alabama LLC Act became effective on October 1, 1993, and its amendments became effective on January 1, 1998. ALA. CODE §§ 10-8A-101 to -1109 (1996); *see also* Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1461, 1463-69, nn.23, 36, 43, 59, 72, 73, 74, & 75 (1998) (documenting the movement of LLC statutes across the states and the inside story behind the rise of the LLC).

2. In 1996, the state legislature repealed the "Alabama Partnership Act" (modeled on the Uniform Partnership Act ("UPA") promulgated in 1914) and adopted the Alabama Uniform Partnership Act ("RUPA"). RUPA supplements Alabama's partnership law with provisions providing for a LLP. RUPA became effective January 1, 1997. *See also* Stover & Hamill, *supra* note *, at 816 n.11 (documenting the movement of LLP statutes across the states starting with Texas in 1991).

3. ALA. CODE § 10-12-20(a) (1999).

> Except as otherwise provided in this chapter, a member of a limited liability company is not liable under a judgment, decree, or order of a court, or in any other manner, for a debt, obligation, or liability of the limited liability company, whether arising in contract, tort, or otherwise, or for the acts or omissions of any other member, manager, agent, or employee of the limited liability company.

Id.; ALA. CODE § 10-8A-306(c) (1999).

> Except as provided in subsection (d) of this section and subsection (a) of Section 10-8A-1010, a partner in a registered limited liability partnership is not personally liable or accountable, directly or indirectly (including by way of indemnification, contribution, assessment or otherwise), for debts, obligations and liabilities of, or chargeable to, the registered limited liability partnership or another partner or partners, whether arising in tort, contract or otherwise, solely by reason of being such a partner or acting (or omitting to act) in such capacity, which such debts, obligations and liabilities occur, are incurred or are assumed while the partnership is a registered limited liability partnership.

Id. § 10-8A-306(c).

incorporation under state law. Regardless of the entity's business characteristics, the Internal Revenue Code taxes all state law corporations as corporations per se, which results in either a two-tier tax under subchapter C or one level of taxation under the restrictions imposed by subchapter S.[4] On the other hand, the Code automatically taxes LLCs and LLPs as partnerships due to their unincorporated status under state law.[5] The mem-

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4. *See* I.R.C. § 7701(a)(2), (3) (1994) (referring to the state law designations in the definitions of corporation and partnership, with a requirement that a partnership be engaged in business activity and the possibility of a partnership being treated as an association taxable as a corporation); Gen. Couns. Mem. 37,127 (May 18, 1977), Gen. Couns. Mem. 37,953 (May 14, 1979) (citing Dartmouth College v. Woodward, 17 U.S. 518 (1819) and Priv. Ltr. Rul. 79-21-084 (Feb. 27, 1979) (the definition of corporation in § 7701(a)(3) requires that all business organizations organized as corporations under state law be taxed as corporations for federal income tax purposes)). *See also* Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393 (1996) (discussing the advantages enjoyed by LLCs under the partnership tax regime as compared to the taxation of C and S corporations and examining the important question whether LLCs (and due to same limited liability protection offered with partnership tax status, LLPs) indirectly threaten the two-tier tax imposed on C corporations; the article concludes that while LLCs will not materially undermine corporate tax revenues, their widespread growth illustrates the inconsistent and unfair system of taxing business organizations faced by small businesses and further exposes the complexities of the corporate integration issue in the context of larger businesses).

5. Section 7701 of the Code defines all unincorporated business organizations as partnerships unless they are otherwise deemed associations or meet the definition of a publicly traded partnership under § 7704. I.R.C. §§ 7701(a)(2), 7704 (Law. Co-op. 1999). The current partnership classification regulations, often referred to as the check-the-box regulations, tax all domestic unincorporated business organizations as partnerships unless the participants affirmatively elect association status. *See* Treas. Reg. § 301.7701-1 to -4 (as amended in 1997). The 1960 partnership classification regulations preceding the check-the-box regulations required all business entities possessing three out of four corporate characteristics (limited liability, continuity of life, centralized management and free transferability of interests) to be taxed as a corporation. Unincorporated business entities that lacked at least two of these characteristics would receive pass-through treatment under the partnership tax provisions. Treas. Reg. § 301.7701-2 (as amended in 1993 and repealed in 1996). The default provisions of the Alabama LLC Act, passed in 1993, ensured that Alabama LLCs complied with the 1960 classification regulations. *See* Rev. Rul. 94-6, 1994-1 C.B. 314 (holding that Alabama's LLC statutory default provisions confer partnership treatment); *see also* Hamill, *Origins*, *supra* note 1, at 1504-08 (discussing the historical trail of partnership classification regulations from 1913 until the Service promulgated the 1960 regulations); Susan Pace Hamill, *The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case for Eliminating the Partnership Classification Regulations*, 73 WASH. U.L.Q. 565, 573-77, 581-98 (1995) (discussing the development of the 1960 regulations leading up to the check-the-box regulations).

For Alabama state income tax purposes, LLCs follow the partnership classifi-

bers or partners may affirmatively elect for the LLC or LLP to be taxed as a corporation.[6]

The partnership tax provisions found in Subchapter K of the Internal Revenue Code treat LLCs and LLPs as well as all other unincorporated business organizations, referred to generically as partnerships, as conduits with no income tax consequences. The members of a LLC and the partners of a LLP, as well as all other owners of unincorporated business organizations, referred to generically as the partners, individually report their distributive shares of the partnership's items of taxable income, gain, loss, deduction and credit, and these items retain the same character to the partners as determined at the partnership level.[7] The Code affords important opportunities to partnerships that it denies to S corporations. These include great contractual flexibility to allocate the distributive shares in any manner provided for in the partnership agreement and the ability to receive distributive shares of partnership losses supported by shares of the partnership's liabilities.[8]

In the earliest years, the partnership tax provisions, which in their skeletal form date back to the first modern income tax of 1913, implicitly assumed that the partners' distributive shares of income and loss would follow their economic rights and obligations, thus fostering flexible economic arrangements.[9] By the late 1960s, however, the tendency to use the partnership form in order to deflect distributive shares of losses and income to partners without any corresponding economic consequences began to proliferate rapidly out of control.[10] The Service's promulgation

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cation provided by federal law:

> For purposes of the taxing statutes in Title 40, Code of Alabama 1975, all LLCs which, pursuant to Act 97-920, includes both single member and multiple member LLCs, organized on or after January 1, 1997, will be classified as they are classified for federal income tax purposes under the Internal Revenue Service's "check-the-box" regulations.

ALA. REV. PROC. 98-001 (1997).

6. Treas. Reg. § 301.7701-3 (as amended 1998).

7. I.R.C. §§ 701-702 (1994).

8. *Id.* §§ 704(b), 752 (1994).

9. *See infra* notes 17-24 and accompanying text (exploring the historical story behind the partnership tax rules leading up to the 1954 Code).

10. *See* Hamill, *Partnership Classification*, *supra* note 5, at 574-75 (discussing the use of tax shelters organized as limited partnerships proliferating out of control and the failure of the partnership classification regulations then in effect to curb

of an elaborate set of regulations, known as the § 704(b) regulations, represents one of many responses aimed at stopping allocations of distributive shares carrying no economic consequences.[11] Although the Service now possesses new weapons, the passive activity loss provisions enacted as part of the Tax Reform Act of 1986 being the most important,[12] to deny partners the

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this spread); Hamill, *Origins*, *supra* note 1, at 1512-17 (tracing the birth of tax shelter investments conducted in limited partnerships to the rise of independent oil producers using limited partnerships, which for complex reasons related to the development of the oil industry started to materially grow in the late 1960s); Hamill, *Corporate Integration*, *supra* note 4, at 426-27 (discussing the use of limited partnerships and documenting the global net deficit shown by the aggregate of all limited partnerships nationwide through the 1980s which shows that limited partnerships primarily produced distributive shares of tax losses).

By 1986 the tax shelter problem had become so widespread that Congress was forced to respond with the passive activity loss rules. *See infra* note 12. The staff of the Joint Committee on Taxation explained that Congress created those rules because the extensive tax shelter

> activity contributed to public concerns that the tax system was unfair, and to the belief that tax is paid only by the naive and the unsophisticated. This, in turn, not only undermined compliance, but encouraged further expansion of the tax shelter market, in many cases diverting investment capital from productive activities to those principally or exclusively serving tax avoidance goals.

STAFF OF THE JOINT COMM. ON TAX'N, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 210 (Joint Comm. Print 1987) [hereinafter 1986 BLUEBOOK].

11. *See infra* notes 50-64 and accompanying text (detailing the historical trail of the § 704(b) regulations promulgated after the statutory amendment of § 704(b) in 1976 and during the first waive of the tax shelter movement).

12. The passive activity loss provisions enacted as part of the Tax Reform Act of 1986 are the most important of the anti-abuse provisions aimed at stopping tax shelters. Essentially, the passive activity loss rules of § 469 force taxpayers to net passive activity losses and credits against passive activity income. *See* I.R.C. § 469 (Law. Co-op. 1999). If the result is a net passive activity loss, the loss is suspended and carried forward to the next year. *See id.* The staff of the Joint Committee on Taxation explained that when the losses from passive activities exceed the income from passive activities, the "losses . . . generally cannot be applied to shelter other income, such as compensation for services or portfolio income (including interest, dividends, royalties, annuities, and gains from the sale of property held for investment)." 1986 BLUEBOOK, *supra* note 10, at 215; *see also* 1 WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 10.08 (3d ed. 1997) (discussing the interaction of the passive activity loss rules with the partnership regulations). The rules prevent the tax shelter abuses of the 1970s and 1980s where paper losses—losses supported by partnership liabilities carrying little or no practical economic risk of the partners' being required to make contributions to cover payment of the liability—from passive activities were used to offset large amounts of other income. See *supra* note 10 for an explanation of Congress' concerns with tax shelters.

ability to avoid taxes inappropriately through partnership distributive shares,[13] all unincorporated business organizations taxed as partnerships still must comply with the § 704(b) regulations in order to ensure that the partners' allocations of the distributive shares will be respected.[14] As a result, general practitioners advising LLCs and LLPs must have a working knowledge of the § 704(b) regulations in order to adequately serve their clients, even if the participants are not engaging in any sophisticated tax planning.

This Article attempts to bring the mysterious web of complexity surrounding the § 704(b) regulations, and the closely related rules for sharing liabilities in the § 752 regulations, closer to the average professional assisting LLCs and LLPs and explores issues that arise under the § 704(b) regulations due to the limited liability protection offered to all members of LLCs and partners of LLPs.[15] To understand the broader framework from which these regulations arose, Part II presents a historical

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13. The most recent curb within the partnership tax regulations is the anti-abuse rule of § 1.701-2. Treas. Reg. § 1.701-2 (as amended in 1995). Outside of the partnership rules, the Service can invoke the protections of the at-risk rules of § 465 and the passive activity loss rules of § 469. *See* I.R.C. §§ 465 (1994), 469 (Law. Co-op. 1999). For a more detailed discussion of these rules and their application to the allocations of distributive shares, see 1 WILLIAM S. MCKEE ET AL., *supra* note 12, ¶¶ 10.04-10.08.

14. While the regulations were drafted for the purpose of preventing tax abuse, they must be complied with even if the entity is not engaged in tax arbitrage. *See* Treas. Reg. § 1.704-1(b)(1)(i) (as amended in 1997).

15. In many ways this Article represents a continuation of an earlier article, published in the summer of 1992 a few months after the Service finalized the portion of the § 704(b) regulations addressing allocations attributable to nonrecourse liabilities and the § 752 regulations. Although the 1992 article explores the interplay between the § 704(b) and the § 752 regulations and highlights issues within the nonrecourse allocation rules, it does not focus on the unique issues raised by LLCs and LLPs. *See* Susan Pace Hamill, *Final Regulations Concerning Liabilities Join Substantial Economic Effect Rules*, 9 J. PARTNERSHIP TAX'N 99 (1992). The 1992 article does discuss the allocation rules and the rules for increasing outside basis for shares of partnership liabilities in the context of book/tax disparities. A book/tax disparity exists if one or more partnership properties is reflected on the partnerships's books at a value that differs from the adjusted basis for tax purposes. A book/tax disparity is typically created by contributions of property to the partnership or when existing partnership property has been properly revalued. This Article does not attempt to discuss the allocation rules and the rules for increasing outside basis for shares of partnership liabilities in the context of book/tax disparities. See *id.* at 126-29; I.R.C. § 704(c); Treas. Reg. §§ 1.704-1(b)(2)(iv)(f), (g) and 1.704-3 for the allocation rules dealing with book/tax disparities.

overview of partnership tax law, emphasizing the statutory and regulatory evolution of § 704(b) and § 752. Part III explains the mechanical rules of the § 704(b) regulations governing the partners' distributive shares of taxable income and loss.

Part III first focuses on distributive shares that carry a real possibility that the partners will enjoy economic benefits or suffer economic burdens, known as allocations with substantial economic effect, and then examines distributive shares, known as nonrecourse deductions and minimum gain, that carry no possibility of economic burdens or benefits. Part III also illustrates how the § 752 regulations apportion the increase to each partner's basis in the partnership interest, known as outside basis, in a manner reflecting the partners' distributive shares of losses meeting the safe harbors provided by the substantial economic effect and nonrecourse allocation portions of the § 704(b) regulations. Finally, Part III outlines the mechanical details of and the need for a third set of rules governing allocations attributable to partner nonrecourse liabilities. These rules, which parallel the nonrecourse allocation rules, apply if the partnership as the borrower incurs nonrecourse debt under state law under circumstances where a partner nevertheless bears the economic risk of loss for the liability.[16] This third regime governing distributive shares of losses and income attributable to partner nonrecourse debt, while adding enormous complexity to the § 704(b) regulations, ensures that the partners allocate the proper amount of losses to the appropriate partner.

Part IV discusses how the three separate sets of rules for allocating distributive shares of partnership income and losses apply based on whether the participants choose to operate as a general partnership, a limited partnership, a LLC or a LLP. If the distributive shares of income result from the unincorporated business organization earning true economic profit or if the dis-

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16. The most common examples of partner nonrecourse debt include a partner making a nonrecourse loan to the partnership and a partner guaranteeing a partnership nonrecourse liability. *See infra* note 191 and Hamill, *Final Regulations*, *supra* note 15, at 119. In each of these examples, the partnership as the borrower faces no personal liability for payment of the debt (i.e., the creditor may only proceed against those partnership assets contractually identified as collateral). However, the fact of the partner making the loan or executing an independent guarantee causes the partner to bear personal liability even though the partnership does not bear personal liability. *See infra* notes 187-92 and accompanying text.

tributive shares of losses or income fall under the rules for allocations attributable to nonrecourse or partner nonrecourse debt, the allocation rules apply in the same manner regardless of the business organization chosen because the existence of limited liability protection does not affect the analysis. However, if the presence or absence of limited liability protection affects the potential economic burdens of some or all of the participants, the type of business organization chosen materially affects the analysis of the distributive shares. If the business organization incurs recourse liabilities, meaning under state law the entity as the borrower incurs personal liability, state law automatically holds the general partners, of general and limited partnerships, personally liable while the limited liability provided by LLCs and LLPs protects all their members and partners from bearing personal liability for these liabilities in the event the LLC or LLP fails to pay. The automatic personal liability borne by general partners activates the substantial economic effect rules for distributive shares of losses and income attributable to recourse debt incurred by general or limited partnerships while the state law limited liability protection offered by LLCs and LLPs causes the nonrecourse debt allocation rules to apply even if LLCs or LLPs incur recourse liabilities.

Finally, Part IV explores the unique nuances that materialize when LLCs and LLPs incur recourse liabilities and raises the fundamental question whether the § 704(b) regulations can be altered in a manner that fosters proper allocations of distributive shares without the rules for allocations attributable to partner nonrecourse liabilities. The limited liability protection provided to all members of LLCs and all partners of LLPs leads to different portions of the § 704(b) regulations applying in circumstances with a strong substantive resemblance. Because of the limited liability protection provided by LLCs and LLPs, the members' or partners' economic risk of loss must come externally from affirmative contractual agreements regardless of whether the LLC or LLP as the borrower incurs recourse or nonrecourse debt. If a member or partner bears the economic risk of loss for the LLC's or LLP's recourse liabilities, the substantial economic effect rules apply. However, if a member or partner bears the economic risk of loss for the LLC's or LLP's nonrecourse liabilities, the partner nonrecourse debt rules apply.

Moreover, when LLCs and LLPs incur recourse liabilities, the substantial economic effect rules create an opportunity for the members or partners to allocate distributive shares of losses away from the members or partners who actually bear the economic burden by relying on an obligation to restore a deficit capital account that in fact will never materialize and therefore is illusory. Part IV concludes by exploring the possibility of making amendments to the § 704(b) regulations that eliminate the need to include the partner nonrecourse debt rules.

II. THE HISTORY BEHIND THE PARTNERSHIP TAX ALLOCATION RULES

A. Federal Income Tax Law Applicable to Partnerships From 1913 Through the 1954 Code

The federal income tax law never imposed an entity level tax on partnerships. The first corporate income tax, the Tariff Act of 1909,[17] only covered corporations, joint stock companies, associations, and insurance companies.[18] The first modern income tax, enacted shortly after Congress ratified the Sixteenth Amendment in 1913,[19] imposed the tax on both individuals and corporations but included language exempting partnerships.[20]

17. Tariff Act of 1909, ch. 6, § 38, 36 Stat. 11.

18. *Id.* The first corporate income tax provided as follows:

> That every corporation, joint stock company or association, organized for profit and having a capital stock represented by shares, and every insurance company, now or hereafter organized under the laws of the United States or of any State or Territory of the United State or under the Acts of Congress applicable to Alaska or the District of Columbia or now or hereafter organized under the laws of any foreign country and engaged in business in any State or Territory of the United States or in Alaska or in the District of Columbia, shall be subject to pay annually a special excise tax with respect to the carrying on or doing business by such corporation, joint stock company or association, or insurance company, equivalent to one per centum upon the entire net income over and above five thousand dollars received by it from all sources during such [taxable] year. . . .

Id.

19. U.S. CONST. amend. XVI (creating broad Congressional powers to tax).

20. Tariff Act of 1913, ch. 16, § II(G)(a), 38 Stat. 114.

[T]he normal tax hereinbefore imposed upon individuals likewise shall be levied, assessed, and paid annually upon the entire net income arising or accru-

The first Internal Revenue Code, enacted in 1939, contained only eight provisions specifically addressing the federal income tax consequences of partnerships and their partners.[21] These early provisions confirmed the partnership entity as exempt from tax. They stated that the partners bear the partnership's federal income tax in their individual capacities[22] and therefore must include their "distributive shares" of the partnership's net short-term and long-term capital gains or losses and ordinary net income or loss.[23] In so stating, these early provisions in the 1939 Code set up the aggregate theory of partnership tax law with the income and losses for tax purposes passing through the partnership directly to the individual partners.

Because most unincorporated business organizations taxed under the partnership provisions were probably organized as simple general partnerships under state law and the widespread market for tax shelter investments had not yet developed,[24] the 1939 Code probably sufficiently explained how to determine the federal income tax consequences of the individual partners from owning an interest in a partnership. Consequently, the Treasury likely found it unnecessary to clarify the statutory provisions or promulgate detailed regulations in order to prevent allocations of the partnership's income and losses in a manner carrying no

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> ing from all sources during the preceding calendar year to every corporation, joint-stock company or association, and every insurance company, organized in the United States, no matter how created or organized, *not including partnerships* . . . .

Id. (emphasis added).

21. I.R.C. §§ 181-188 (1952).

22. *Id.* § 181 ("Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.").

23. *Id.* § 182.

> In computing the net income of each partner, he shall include, whether or not distribution is made to him—
>
> (a) As a part of his short-term capital gains or losses, his distributive share of the net short-term capital gain or loss of the partnership.
>
> (b) As a part of his long-term capital gains or losses, his distributive share of the net long-term capital gain or loss of the partnership.
>
> (c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b).

Id.

24. *See* Hamill, *Origins*, *supra* note 1, at 1504-08, 1514-16 (examining early partnership classification regulations that made it more difficult for limited partnerships to be taxed as partnerships).

economic consequences. When partners allocated their distributive shares of the partnership's items of taxable income and loss, presumably these tax allocations followed the partners' economic interests in the partnership. However, as the popularity of partnerships increased over time, taxpayers became dissatisfied with the increasing uncertainty resulting from the 1939 Code's sparse provisions.[25] Questions about whether the aggregate theory of partnership tax law applied to partnership liabilities which would require corresponding increases to the partners' bases and whether the Service possessed any power to challenge the partners' distributive shares of partnership income and loss numbered among the many unanswered issues posed by the 1939 Code.

The federal income tax law as applied to partnerships and partners remained unchanged until Congress enacted Subchapter K as part of the 1954 overhaul of the Internal Revenue Code.[26] In enacting Subchapter K, Congress acknowledged that the 1939 Code's provisions addressing partnerships left many issues open.[27] Among the many issues addressed, the 1954 Code's provisions of the newly enacted Subchapter K made important additions concerning both the treatment of partnership liabilities and the determination of the partners' distributive shares of the partnership's income and losses. Unlike the 1939 Code, which failed to address the treatment of partnership liabilities thus providing no authority for increasing the partners'

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25. Jacob Rabkin & Mark H. Johnson, *The Partnership Under the Federal Tax Laws*, 55 HARV. L. REV. 909 (1942) (revealing the numerous uncertainties that surrounded the 1939 tax law governing partnerships).

26. Internal Revenue Service Code of 1956, §§ 701-771, 68A Stat. 1, 239-54 (1954). Section 771 provided that Subchapter K applies to partnerships with a taxable year beginning after December 31, 1954.

27. *See* H.R. REP. NO. 83-1337, at 65 (1954); S. REP. NO. 83-1622, at 89 (1954). Congress described the problem as follows:

> The existing tax treatment of partners and partnerships is among the most confused in the entire income tax field. The present statutory provisions are wholly inadequate. The published regulations, rulings, and court decisions are incomplete and frequently contradictory. As a result partners today cannot form, operate, or dissolve a partnership with any assurance as to tax consequences. . . . Because of the vital need for clarification, your committee has undertaken the first comprehensive statutory treatment of partners and partnerships in the history of the income tax laws.

H.R. REP. NO. 83-1337, at 65; S. REP. NO. 83-1622, at 89.

outside bases, the newly enacted § 752 in the 1954 Code continues the aggregate theory of taxing partnerships and partners by clearly stating that partners receive an increase to their individual outside bases for their shares of partnership liabilities.[28]

Also, while the 1939 Code described the partners' "distributive shares" as a flow-through of a portion of the partnership's income and loss, the statutory language did not contemplate the Service reallocating invalid distributive shares.[29] For the first time the 1954 Code statutorily recognized that the distributive shares of partnership income and loss contractually agreed upon by the partners could be invalid and therefore not respected for tax purposes. The language of the newly codified § 704(b) of the 1954 Code clearly permitted the Service to challenge and reallocate distributive shares where "the principal purpose . . . is the avoidance or evasion of any tax. . . ."[30]

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28. I.R.C. § 752 (1994). Although the Code treats a partner's share of partnership liabilities as a deemed contribution of money, thus increasing outside basis, the statute failed to indicate how the individual partners share partnership liabilities. *See infra* notes 66-73.

29. I.R.C. § 182 (1952).

> In computing the net income of each partner, he shall include, whether or not distribution is made to him—
>
> (a) As part of his short-term capital gains or losses, his distributive share of the net short-term capital gain or loss of the partnership.
>
> (b) As a part of his long-term capital gains or losses, his distributive share of the net long-term capital gain or loss of the partnership.
>
> (c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b).

Id.

30. Internal Revenue Code of 1954, § 704(b)(2), ch. 736, 68A Stat. 1, 239 (1954).

> DISTRIBUTIVE SHARE DETERMINED BY INCOME OR LOSS RATIO.—
>
> A partner's distributive share of any item of income, gain, loss, deduction, or credit shall be determined in accordance with his distributive share of taxable income or loss of the partnership, as described in section 702(a)(9), for the taxable year, if—
>
> (1) the partnership agreement does not provide as to the partner's distributive share of such item, or
>
> (2) the principal purpose of any provision in the partnership agreement with respect to the partner's distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle.

Id. § 704(b).

B. Historical Trail of Authorities Addressing Distributive Shares of Partnership Taxable Income and Loss Under § 704(b)

Despite the material improvements offered by the statutory language of the 1954 Code's version of § 704(b) governing distributive shares, two major issues continued to persist. Although the former language of § 704(b) clearly empowered the Service to reallocate items of partnership income or loss that must be separately stated (for example capital gains and losses) if the partners' allocations met the tax avoidance standard, the provision failed to address whether the Service could reallocate a partnership's net ordinary taxable income or loss, known as bottom-line taxable income or loss.[31] By only covering distributive shares of the partnership's separately stated items, the 1954 version of § 704(b) left a material loophole which allowed allocations of partnership bottom-line ordinary income and loss to vary from the economic benefits and burdens associated with the distributive shares.[32] Moreover, the regulations promulgated a

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31. I.R.C. § 704(b) (1970). Section 702 requires a number of income and loss distributive shares to be separately stated due to the tax consequences at the partner level varying from the treatment of ordinary income and ordinary loss (e.g., capital gains and losses, charitable contributions, certain dividends, foreign taxes, tax-exempt bond interest).

32. The 1954 version of § 704(b) provided that, unless otherwise provided by the partnership agreement or for the principal purpose of the "avoidance or evasion of any tax," a partner's distributive share was to be allocated in accordance with his distributive share of partnership income or loss as provided in § 702(a)(9). *Id.* Under § 702(a)(9), each partner was allocated his distributive share of the partnership's "bottom-line" taxable income or loss, excluding items that were to be reported separately. Items that were to be reported separately included the following: (1) gains and losses from sales or exchanges of capital assets held for not more than six months, (2) gains and losses from sales or exchanges of capital assets held for not more than six months, (3) gains and losses from sales or exchanges of property described in § 1231, (4) charitable contributions, (5) dividends with respect to which there is provided an exclusion under § 116 or a deduction under part VIII of subchapter B, (6) taxes described in § 901, paid or accrued to foreign countries and possessions of the United States, (7) partially tax-exempt interest on obligations of the United States or on obligations of instrumentalities of the United States as described in § 35 or §. 242, and (8) other items of income, gain, loss, deduction or credit provided by the regulations. *Id.* § 702(a)(9).

Despite the statutory language that contemplated special allocations of bottom line profit or loss being above challenge by the Service, some commentators disagreed with this conclusion stating that "substance prevails over form. . . . It is the author's conclusion that while § 704(b) does not apply specifically to the allocation of

few years after Congress enacted the 1954 Code's version of § 704(b) also failed to require the partners' distributive shares of bottom-line taxable income and loss to reflect their economic rights to the partnership's assets or exposure to the partnership's economic losses.[33]

In addition, the "avoidance or evasion of any tax" language established a very vague standard defining when a partnership's separately stated allocations could be reallocated by the Service.[34] However, the regulations promulgated under the 1954 version of § 704(b) somewhat clarified the vague "avoidance or evasion of any tax" language by detailing a list of relevant factors to consider in deciding whether the principal purpose of an allocation was for the avoidance of tax. These factors were: (1) whether the partnership or a partner individually had a business purpose for the allocation; (2) whether the allocation had "substantial economic effect"[35]; (3) whether related items of in-

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bottom line profit or loss, nevertheless there must be business and economic reality to any special allocation of § 702(a)(9) [bottom line] income." 1 ARTHUR B. WILLIS ET AL., PARTNERSHIP TAXATION § 25.11, at 317-18 (2d ed. 1976); *see also* 1 WILLIAM S. MCKEE ET AL., *supra* note 12, ¶ 10.01[2], at 10-6 (1st ed. 1977) (discussing how bottom line losses were arguably subject to reallocation by the Service under § 704(b)). *But see* Holladay v. Commissioner, 72 T.C. 571, 586-87 (1979) (finding the Commissioner's concession that § 704(b)(2)'s tax avoidance test for allocations is inapplicable to allocations of bottom line income or loss in § 702(a)(9)); Boynton v. Commissioner, 72 T.C. 1147, 1174 (1977) ("The Commissioner has conceded that as a matter of statutory construction § 704(b)(2) is inapplicable to this case which involves an attempted allocation of overall or 'bottom line' losses described in § 702(a)(9) rather than an allocation of any of the 'items' described in § 702(a)(1)-702(a)(8)."); Kresser v. Commissioner, 54 T.C. 1621, 1631 n.5 (1970) (deciding the issue of whether to reallocate a partnership's bottom line taxable income that lacked economic substance, but because the allocations failed to pass the economic substance test, the court did not have to decide whether § 704(b)(2) applied only to the items listed in § 702(a)(1) through (8) and not to bottom line income or loss in § 702(a)(9)).

33. Treas. Reg. § 1.704-1(b)(1) (1957).

> If the partnership agreement makes no specific provision for the manner of sharing one or more items or classes of items, a partner's distributive share of such items shall be determined in accordance with the provisions of the partnership agreement for the division of the general profits or losses (that is, the taxable income or loss of the partnership described in section 702(a)(9)).

Id.

34. THOMAS CRICHTON, IV ET AL., PARTNERSHIP—TAXABLE INCOME; ALLOCATION OF DISTRIBUTIVE SHARES; CAPITAL ACCOUNTS A-48 (Tax Management Portfolios No. 712, 3d ed. 1993).

35. The regulations defined "substantial economic effect" as "whether the alloca-

come, gain, loss, deduction, or credit from the same source were subject to the same allocation; (4) whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated; (5) what was the duration of the allocation; and (6) what were the overall tax consequences of the allocation.[36] Despite this extensive list of considerations, the courts' interpretations of the "avoidance or evasion of any tax" standard focused on whether the allocation had "substantial economic effect."[37]

Orrisch v. Commissioner, an early case, addressed whether special allocations met the "avoidance or evasion of any tax" standard while relying primarily on the "substantial economic effect" concept.[38] In *Orrisch*, the partners agreed to share partnership gains and losses equally, while specially allocating all the depreciation deductions to one partner. The partner receiving all the depreciation deductions had substantial income from other sources while the other partner did not.[39] Consequently the special allocation substantially reduced the first partner's tax liability without increasing the second partner's tax liability. The Service challenged the special allocation of the depreciation deductions under § 704(b) as designed primarily for tax avoidance purposes.[40] Despite the court's acknowledgment of the regulations' list of factors, the court appeared to place the greatest weight on the "substantial economic effect" test and its reliance on maintaining capital accounts.[41] In order for the spe-

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tion may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences." Treas. Reg. § 1.704-1 (as amended by T.D. 6175, 1956-1 C.B. 211, 220).

36. *Id.* § 1.704-1(b)(2).

37. *Holladay*, 72 T.C. 571, 587-88 (1979); *Boynton*, 72 T.C. 1147, 1159-61 (1979); Harris v. Commissioner, 61 T.C. 770, 786 (1974); Orrisch v. Commissioner, 55 T.C. 395, 403 (1970). The concept of "substantial economic effect" was first introduced in the Senate Committee on Finance Report on the 1954 Code. S. REP. NO. 83-1622, at 379 (1954). In explaining when the tax avoidance limitation of § 704(b) would be used to disregard a partnership allocation, the Senate report explained that where "a provision in a partnership agreement for a special allocation of certain items has *substantial economic effect* and is not merely a device for reducing the taxes of certain partners without actually affecting their shares of partnership income, then such a provision will be recognized for tax purposes." *Id.* (emphasis added).

38. 55 T.C. 395 (1970).

39. *Orrisch*, 55 T.C. at 396-97.

40. *Id.* at 395.

41. *Id.* at 400-04.

cial allocation to have "substantial economic effect," the court stated that the partner receiving the special allocation must decrease his capital account accordingly, causing him to either receive a smaller share of the assets on liquidation or bear a larger share of any payments to the partnership's creditors if partnership assets are insufficient to satisfy all claims.[42] The court held that the partners' agreement failed to economically reduce the recipient partner's capital account for the special allocation of depreciation and, in the event of liquidation, the partners intended an equal division of the partnership's assets or liabilities if contributions were necessary to pay creditors.[43] Thus the court held that the special allocation of depreciation met the tax avoidance standard under § 704(b) and the regulations justifying the Service's reallocation of fifty percent of the depreciation deductions to the other partner.[44]

The next major change of partnership tax law addressing allocations of distributive shares occurred in 1976, when the Tax Reform Act of 1976[45] solved both of the problems with the 1954 version of § 704(b). First, the 1976 version of § 704(b) empowered the Service to reallocate a partner's distributive share of all partnership items, both separately stated and bottom-line.[46] Second, the statutory language of § 704(b) abandoned the "avoidance or evasion of any tax" language and adopted the "substantial economic effect" language.[47] Despite the formal codification of the "substantial economic effect" standard, the legislative history states that the change was intended to be entirely consistent with prior law,[48] which leaves *Orrisch* and similar cases

42. *Id.* at 403-04.

43. *Id.* at 403-04.

44. *Orrisch*, 55 T.C. at 404.

45. The Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976).

46. *Id.* § 704(b), at 1548 (currently codified at I.R.C. § 704(b) (1994)); *see also* S. REP. NO. 94-938, at 99 (1976) ("The committee believes that an overall allocation of the taxable income or loss for a taxable year (described under section 702(a)(9)) should be subject to disallowance in the same manner as allocations of an item of income or loss.").

47. I.R.C. § 704(b).

48. S. REP. NO. 94-938, at 99-100 (1976). The Joint Committee Explanation of the change provides:

> The Act provides that an allocation of overall income or loss . . . , or of any item of income, gain, loss, deduction, or credit . . . , shall be controlled by the partnership agreement if the partner receiving the allocation can demonstrate

that were decided under the 1954 version of § 704(b) intact as good law. Section 704(b), as amended in 1976, serves as the governing provision today.[49]

Starting in 1983 with a set of proposed regulations, the Service began providing guidelines and examples interpreting the statutory language of § 704(b) as amended in 1976.[50] In 1985, the Service issued the final § 704(b) regulations, which continue to operate as the governing provision for all distributive shares of partnership income and losses that carry the potential for economic benefits or burdens.[51] The 1985 regulations state that the allocations of partnership income and losses in the partnership agreement will be respected if: (1) taking into consideration all the facts and circumstances, the allocations are in accordance with the partners' interests in the partnership;[52] (2) the allocations have substantial economic effect; or (3) the allocations are deemed to be in accordance with the partners' interests in the partnership.[53] In turn, the substantial economic effect standard introduces a two-part mechanical test for ensuring that the tax allocations match the economic benefits and burdens.[54] If the partners' allocations do not satisfy one of these three tests, the Service possesses the power to reallocate the tax allocations in accordance with the partners' true economic inter-

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> that it has "substantial economic effect," i.e., whether the allocation may actually affect the dollar amount of the partner's share of the total partnership income or loss, independent of tax consequences.

STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 95 (Joint Comm. Print 1976).

49. I.R.C. § 704(b) (1994). Section 704(b), as amended in 1976, applies to partnership taxable years beginning after December 31, 1975. Pub. L. No. 94-455, § 213(f)(1).

50. Prop. Treas. Reg. § 1.704-1(b), 48 Fed. Reg. 9871 (1983).

51. Treas. Reg. § 1.704-1(b) (as amended by T.D. 8065, 1986-1 C.B. 254). The final regulations differed significantly from the proposed regulations. In the 1985 final regulations, the Treasury expressly reserved for a later time the promulgation of regulations relating to allocations attributable to nonrecourse liabilities.

52. *Id.* § 1.704-1(b). Factors to be considered included (1) the partners' relative contributions to the partnership, (2) the partners' interests in economic profits and losses (if different from taxable income or loss), (3) the partners' interests in cash flow and other nonliquidating distributions, and (4) the partners' rights to distributions of capital upon liquidation. *Id.* § 1.704-1(b)(3)(ii).

53. *See id.* § 1.704-1(b)(4) (rules for allocations reflecting certain revaluations of property) and § 1.704-2 (rules for allocations attributable to nonrecourse liabilities).

54. *Id.* § 1.704-1(b)(2). For a detailed discussion of the mechanical safe harbor establishing substantial economic effect, see *supra* Part III.A.

ests in the partnership.[55]

In addition to addressing allocations of income and losses carrying the potential of economic benefits and burdens, the set of proposed regulations issued in 1983 contained the basic concepts dealing with allocations attributable to nonrecourse liabilities which cannot carry any potential of economic benefits or burdens. Although the mechanical rules contained only sparse details, the 1983 proposed regulations recognized that losses attributable to nonrecourse liabilities, known as nonrecourse deductions, and the income restoring those deductions, known as minimum gain, could not have substantial economic effect. The 1983 proposed regulations first articulated the standard of measuring the existence of nonrecourse deductions and minimum gain at the partnership level by comparing the face amount of the nonrecourse liability and the basis of any property securing that liability.[56] Although the 1985 final regulations covering allocations with substantial economic effect or otherwise consistent with the partners' interests in the partnership did not address allocations attributable to nonrecourse liabilities, a year later in 1986 the Treasury promulgated final regulations providing guidelines for allocating distributive shares of nonrecourse deductions.[57] The fundamental guidelines contained in the 1986 final regulations, including the mechanical calculation of nonrecourse deductions being tied to minimum gain increases, first appeared in the 1983 proposed regulations.[58]

The 1986 regulations, however, contained some major problems that needed to be addressed with additional regulatory amendments. The 1986 regulations failed to impose a minimum gain chargeback requirement to offset the nonrecourse deductions and did not address allocations attributable to partner nonrecourse debt, which refers to liabilities that are nonrecourse under state law to the partnership as the borrower where a partner nevertheless bears the economic risk of loss.[59] On De-

55. Treas. Reg. § 1.704-1(b)(1) (as amended by T.D. 8065, 1986-1 C.B. 254). The facts and circumstances test deems allocations in accordance with the partners' interests in the partnership by taking into consideration factors that affect the partners' economic arrangement.

56. Prop. Treas. Reg. § 1.704-1(b)(4)(iv), 48 Fed. Reg. 9871 (1983).

57. T.D. 8099, 1986-2 C.B. 84.

58. *Id.* at 86-87.

59. *Id.* at 87. Under the 1986 final regulations, allocations attributable to non-

cember 30, 1988, the Treasury issued temporary regulations that identified and corrected problems with the 1986 regulatory treatment of allocations attributable to nonrecourse liabilities.[60] In addition to providing a elaborate set of mechanical rules measuring the existence of nonrecourse deductions and minimum gain, the 1988 Temporary Regulations required the partnership agreement to contain a minimum gain chargeback provision as a condition to meeting the safe harbor for allocating nonrecourse deductions. The 1988 Temporary Regulations also created a parallel regime mirroring the nonrecourse allocation rules covering allocations attributable to partner nonrecourse liabilities.[61] In 1991, the Treasury issued § 1.704-2, the final portion of the § 704(b) regulations which continue to serve as the governing authority for allocations attributable to nonrecourse and partner nonrecourse liabilities.[62] These regulations vastly simplify the language of the 1988 Temporary Regulations and eliminate the "complexity of the two-prong calculation"[63] by

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recourse liabilities could meet the safe harbor without a minimum gain chargeback provision if the partnership agreement satisfied Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3), which required capital account maintenance, liquidation according to positive capital accounts, and an unlimited obligation to restore any deficit capital account. *Id.* As a practical matter, very few partnerships meet this standard because state law does not automatically provide an unlimited obligation to restore a deficit capital account to pay off nonrecourse debt, and no partner would agree as a business matter to give up the protection from personal liability granted by the nonrecourse aspect of debt to avoid a minimum gain chargeback.

60. T.D. 8237, 1989-1 C.B. 180 (amended by T.D. 8274, 1989-2 C.B. 101).

61. *Id.* at 203. Another example of an important change made by the 1988 Temporary Regulations involved the treatment of distributions to a partner attributable to proceeds of a nonrecourse liability. Under the 1986 final regulations, distributions of proceeds of a nonrecourse liability could result in a deficit capital account in excess of a partner's deficit restoration obligation because a share of minimum gain did not follow the distribution; however, under the 1988 Temporary Regulations distributions of proceeds of a nonrecourse liability carried with them the minimum gain chargeback requirement through a share of minimum gain. *Id.* at 183.

62. T.D. 8385, 1992-1 C.B. 199. Note that final regulations under I.R.C. § 752 were issued contemporaneously with the final § 704(b) regulations. Treas. Reg. § 1.752-1 to -4 (as amended by T.D. 8380, 1992-1 C.B. 218).

63. T.D. 8385, 1992-1 C.B. 199, 202 (noting that the two-prong approach was "heavily criticized in the comments"). Under the temporary regulations, the minimum gain chargeback was the greater of: (1) the partner's share of the net decrease in partnership minimum gain attributable to a disposition of partnership property subject to nonrecourse liabilities or (2) the partner's deficit capital account balance. T.D. 8237, 1989-1 C.B. 180, 203-04. Problems with this minimum gain chargeback computation arose when the debt was converted, refinanced or otherwise modified, result-

basing the minimum gain chargeback exclusively on the partners' shares of the partnership's net decrease in minimum gain while providing exceptions to the minimum gain chargeback requirement.[64]

C. *Historical Trail of Authorities Addressing the Partners' Shares of Partnership Liabilities Under § 752*

The current statutory language of § 752, which provides the authority for increasing the partners' outside bases to reflect shares of the partnership's liabilities, reads identically to the language that first appeared in the 1954 Code.[65] According to

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ing in inappropriate chargebacks under the second prong. Also, the calculations created economic distortions when partners restored their nonrecourse allocations through income allocations or capital contributions before there was a net decrease in minimum gain in the partnership.

64. T.D. 8385, 1992-1 C.B. 199, 202. A partner's share of the partnership's net decrease in minimum gain is computed by his percentage share of the partnership's total minimum gain. The regulations set forth detailed effective dates and transitional rules that apply to the different sets of regulations. The effective dates for the regulations governing nonrecourse deductions are generally as follows: (1) the 1991 regulations apply to partnership taxable years beginning after December 27, 1991, *id.* at 209-210; (2) the 1988 temporary regulations apply to partnership taxable years beginning after December 29, 1988 and before December 28, 1991, *id.*; and (3) the 1986 regulations apply to taxable years after December 31, 1975 and before December 29, 1988. T.D. 8099, 1986-2 C.B. 84, 84-85. The regulations set forth detailed and complex transition rules.

65. I.R.C. § 752 (1954). Section 752 introduced in 1954 is identical to the current § 752. Section 752 provides:

Treatment of certain liabilities.

(a) Increase in partner's liabilities.

Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

(b) Decrease in partner's liabilities.

Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

(c) Liability to which property is subject.

For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.

(d) Sale or exchange of an interest.

In the case of a sale or exchange of an interest in a partnership, liabili-

one commentator, the liability sharing rules introduced in 1954 were "welcomed by Federal income tax practitioners . . . [because] for the first time the troublesome subject of how to deal with the liabilities of a partnership in direct relation to its partners were [sic] defined and made workable."[66] Under § 752 a partner has a share of partnership liabilities either by assuming a partnership liability or by the partnership itself incurring liabilities. In both cases, the partner's outside basis includes the partner's share of the liabilities. Section 752 increases the partner's outside basis by treating the amount of the partner's share of liabilities as a contribution of money by the partner to the partnership. On the other hand, when the partner's share of partnership liabilities decreases, either when the partnership assumes the partner's personal liabilities or the liabilities of the partnership itself are decreased (for example as the partnership pays down the principal of a loan), § 752 reduces the partner's outside basis by treating the amount of the decrease as a distribution by the partnership to the partner. The statutory language of § 752 provides no guidance addressing how the partners determine their individual shares of the partnership's liabilities.[67] Because § 704(d) suspends all losses once the partner's outside basis reaches zero,[68] a partner's share of partnership liabilities often plays a critical role in determining whether the partner has sufficient outside basis to absorb the distributive share of losses.

In 1956, the Treasury issued the first set of regulations

> ties shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

Id.

66. 1 J.M. BARRETT & ERWIN SEAGO, PARTNERS & PARTNERSHIPS LAW & TAX'N § 5 (1st ed. 1956).

67. *See* I.R.C. § 752(a)-(b) (1994).

68. *Id.* § 704(d).

> A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

Id. A partner would need to calculate outside basis under other circumstances as well, for example in contemplation of a sale of the partnership interest to a third party buyer.

under § 752 that provide guidance for determining the partners' shares of partnership liabilities.[69] These short and concise early regulations did not differentiate between "recourse" and "nonrecourse" liabilities, but rather classified liabilities based on whether a partner had "any personal liability with respect to a partnership liability" and provided only few examples.[70] Essentially, under these regulations, recourse liabilities were allocated among the partners in accordance with the ratio by which they agreed to share losses, and nonrecourse liabilities were allocated in accordance with the ratio by which they agreed to share profits.[71]

The guidance provided by the 1956 regulations ultimately proved to be inadequate as commercial loan arrangements became more sophisticated. As part of the Tax Reform Act of 1984, Congress issued a directive to the Treasury to promulgate additional regulations under § 752 to "be based largely on the manner in which the partners, and persons related to the partners, share the economic risk of loss with respect to partnership debt (other than bona fide nonrecourse debt . . .)."[72] In 1988, the Treasury issued temporary regulations that set forth in greater detail how to determine a partner's share of partnership liabilities and defined all liabilities as either recourse, meaning at least one partner bore the risk of loss if the partnership failed to pay the liability, or nonrecourse, meaning no partner bore the economic risk of loss.[73] To determine whether partnership liabilities are recourse or nonrecourse the temporary regulations set up an elaborate process, known as constructive liquidation. In addition to separating recourse and nonrecourse debt, the process also identified which partners bore the risk of loss for shares of recourse debt.[74] The 1988 Temporary Regulations

69. T.D. 6175, 1956-1 C.B. 211, 298.

70. *Id.* at 1956-1 C.B. 211, 300.

71. For a thorough discussion of the early regulations, see 1 WILLIAM S. MCKEE ET AL., *supra* note 12, ¶ 8.02[1], at 8-6 to -8 (2d ed. 1990).

72. H.R. REP. NO. 98-861, at 869 (1984); *see also* STAFF OF THE JOINT COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 250-52 (Joint Comm. Print 1984).

73. T.D. 8237, 1989-1 C.B. 180, 184-85 (as amended by T.D. 8274, 1989-2 C.B. 101).

74. *Id.* The 1988 temporary regulations also amended § 1.704-1 to directly coordinate the allocation rules under § 704(b) and liability sharing rules under § 752 in

were highly criticized,[75] and the Treasury responded by adopting final regulations, published on December 23, 1991,[76] which greatly simplified the language of the temporary regulations. The 1991 final § 752 regulations, which currently remain in effect, have been praised as a "more concise version" of the 1988 Temporary Regulations.[77]

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the case of allocations attributable to nonrecourse debt. The relationship between § 704(b)'s allocation rules and § 752's liability sharing rules was acknowledged in the preamble to § 752's temporary regulations issued in 1988:

> The economic risk of loss analysis employed in the temporary regulations generally corresponds to, and further develops, the economic risk of loss analysis employed in the regulations under section 704(b). The coordination of these two sections reflects the fact that one of the principal purposes for including partnership liabilities in the bases of the partners' interests in the partnership is to support the deductions that will be claimed by the partners for the items attributable to those liabilities.
>
> . . . [T]he coordination of the economic risk of loss analysis employed in sections 704(b) and 752 generally requires that the basis for a partnership liability be allocated to the partner that will be allocated the deductions attributable of [sic] that liability.

T.D. 8237, 1989-1 C.B. 180, 182. The final §§ 752 and 704(b) regulations, issued in conjunction with one another, ensure that allocations of partnership nonrecourse liabilities under § 704(b) are consistent with § 752's liability sharing rules. Partners who are entitled to allocations attributable to nonrecourse liabilities under § 704(b) will receive the necessary outside basis increase for a share of the partnership's nonrecourse liabilities that will support the nonrecourse deductions. I.R.C. § 705(a)(1) (1994); Treas. Reg. § 1.752-3 (1991); *id.* § 1.752-1(c).

75. *E.g.*, Howard E. Abrams, *Long-Awaited Regulations Under Section 752 Provide Wrong Answers*, 44 TAX L. REV. 627 (1989); William P. Bowers & Michael K. Stone, *The Section 752 Regulations: A Critical Analysis*, 68 TAXES 99, 123 (1990); Mark P. Gergen, *Disproportionate Loss Allocations*, 48 TAX NOTES 1051, 1054-55 (1990).

76. T.D. 8380, 1992-1 C.B. 218. The final § 752 regulations apply to liabilities incurred or assumed by a partnership after December 27, 1991.

77. LISA MARIE STARCZEWSKI, PARTNERSHIPS—ALLOCATIONS OF LIABILITIES; BASIC RULES A-17 (Tax Management Portfolios No. 714, 3d. ed. 1995) (praising the final regulations as a "much more concise version" of the 1988 regulations); 1 ARTHUR B. WILLIS ET AL., *supra* note 32, § 6.01[1], at 6-5, -6 (6th ed. 1997).

III. DETAILED DISCUSSION OF THE REGULATIONS GOVERNING ALLOCATIONS OF DISTRIBUTIVE SHARES UNDER § 704(b) AND SHARES OF PARTNERSHIP LIABILITIES UNDER § 752

A. *The Rules For Achieving Substantial Economic Effect and for Sharing Liabilities Based on Economic Risk of Loss*

The § 704(b) regulations use detailed rules to ensure that allocations are "consistent with the underlying economic arrangement of the partners."[78] Distributive shares of taxable income carry corresponding rights to shares of the assets of the partnership while distributive shares of taxable loss carry a corresponding share of any economic burden associated with that loss.[79] If a partnership agreement complies with the regulatory rules for establishing substantial economic effect, generally the Service cannot challenge the partnership's tax allocations.[80] The "substantial economic effect" safe harbor entails a two-part analysis at the end of the partnership's taxable year: (1) "the allocation must have economic effect," and (2) "the economic effect of the allocation must be substantial."[81]

The standard for establishing "economic effect" comprises a mechanical web of rules providing a safe harbor that, if met, conclusively treats the distributive shares of income and losses for income tax purposes as corresponding to the partners' shares of the partnership's economic benefits and burdens.[82] The economic effect safe harbor can be broken down into three components that must not only appear in the partnership agreement, but in fact, must reflect the partners' true economic arrange-

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78. Treas. Reg. § 1.704-1(b)(2)(ii) (as amended in 1985).

79. The regulations explain this concept as follows: "[i]n the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden." *Id.* § 1.704-1(b)(2)(ii)(a).

80. *Id.* § 1.704-1(b). *But see supra* note 13 (discussing other provisions that allow the Service to challenge the validity of a distributive share or suspend the deductibility of losses until some point in the future).

81. Treas. Reg. § 1.704-1(b)(2)(i).

82. *Id.* § 1.704-1(b)(2)(ii).

ment.[83] The three conditions for meeting the economic effect safe harbor are as follows: (1) the partnership must maintain capital accounts in accordance with § 1.704-1(b)(2)(iv); (2) the partnership must liquidate in accordance with the partners' positive capital accounts; and (3) all partners showing deficits in their individual capital accounts must have unconditional obligations to restore the deficit (within ninety days of the liquidation of the partnership or the partner's interest) for the benefit of partners with positive capital account balances or the partnership's creditors.[84] The partners may also satisfy the third requirement addressing deficit capital accounts by meeting the alternate test for economic effect, if one or more partners does not have an unconditional obligation to restore a deficit capital account regardless of the amount.[85]

The requirement that the partners maintain capital accounts represents the cornerstone of the economic effect safe harbor. Proper positive and negative adjustments to the individual capital accounts, combined with the corresponding consequences affecting the partners' business arrangements for sharing the partnership's net worth or obligations to make payments or contributions on the partnership's behalf, cause the tax distributive shares to conform to the economic arrangement among the partners. A positive capital account generally reflects a partner's share of the partnership's economic net worth, while a

83. *Id.*

84. *Id.* § 1.704-1(b)(2)(ii)(b). Treasury Regulation § 1.704-1(b)(2)(ii)(*i*) provides another means by which a partnership's allocations can be deemed to have "economic effect"—the "economic effect equivalence" test. The economic effect equivalence test provides that tax allocations that do not satisfy the "economic effect" safe harbor will nevertheless be respected if, at the end of the partnership's taxable year, a liquidation of the partnership would produce the same economic results as would result if the partners met the economic effect safe harbor. *Id.* Thus, under the economic effect equivalence test, if at the end of the partnership taxable year the partnership's allocations are equivalent to the partners' economic rights, the Service will deem the allocations to have "economic effect" despite the fact that the allocations fail to comply with the regulatory requirements. The "economic effect equivalence" language in the regulations serves as a backstop to protect unsophisticated business participants, who may not even have a written partnership agreement, from having their allocations successfully challenged when, in fact, the partners' tax distributive shares are following the business arrangement. Treas. Reg. § 1.704-1(b)(2)(ii)(*i*).

85. *See infra* notes 102-12 and accompanying text discussing the details of the alternate test.

negative capital account broadly represents what the partner owes the partnership.[86]

Although mechanically the capital account maintenance portion of the economic effect safe harbor seems enormously complex, most of the actual adjustments required by the rules boil down to a few basic business concepts. The capital account maintenance rules require an increase for money as well as the fair market value of property (net of liabilities) contributed to the partnership.[87] Moreover, all allocations of partnership income and gain (including income and gain exempt from tax) also must come with a corresponding increase to the partners' individual capital accounts.[88] The capital account maintenance rules require a decrease for money as well as the fair market value of property (net of liabilities) distributed to the partner.[89] Moreover, all allocations of partnership losses and deductions (including those expenditures that cannot be deducted or added to the basis of the property) must come with a corresponding decrease to the partners' individual capital accounts.[90] By requiring the capital account increases and decreases to reflect contributions, distributions and distributive shares of income and losses, these rules set up a system that requires the partners' distributive shares of the partnership's items of income or loss for tax purposes to correspond to how the partners share economic resources.

The requirement that partners liquidate in accordance with their positive capital account balances ensures that at some point (liquidation representing the last possible moment) the partners actually receive their respective shares of the partnership's wealth. If the partners have been following the capital account maintenance rules, their positive capital accounts, representing their shares of the partnership's net worth, will reflect their contributions, distributions and past distributive shares of partnership income and loss.[91] The regulations define liquidation as occurring on the earlier of the partnership's

86. *See* Treas. Reg. § 1.704-1(b)(2)(iv).
87. *See id.*
88. *See id.*
89. *See id.*
90. *See id.*
91. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2) (as amended in 1997).

liquidation or the liquidation of a partner's individual interest in the partnership.[92] To comply with this portion of the economic effect safe harbor, a partner must have the right to receive the entire balance of the positive capital account at liquidation.[93] The adjustments required by capital account maintenance throughout the life of the partnership and the final determination of the partners' economic rights at liquidation allow operating distributions to be made in any ratio that suits the business needs of the partners.

The third portion of the economic effect safe harbor focuses on the requirements if one or more partners receive a distributive share of losses that causes or increases a deficit capital account.[94] Unless the distributive share of losses causing or creating a deficit capital account has been properly labeled a nonrecourse deduction, the partner must be obligated to make a contribution, known as a "deficit restoration obligation," to restore the deficit.[95] The regulations require such contributions to be made no later than ninety days after the liquidation of the partnership or the partner's interest.[96] If a deficit capital account results from a loss allocation properly labeled a nonrecourse deduction, the regulations do not require a deficit restoration obligation because those losses will be offset with later income allocations carrying no rights to the partnership's economic net worth.[97] The deficit restoration obligation can either be unlimited or limited.[98] A limited deficit restoration obligation requires a partner to restore a deficit up to a defined amount,[99] while an unlimited deficit restoration obligation requires a partner to un-

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92. *Id.* § 1.704-1(b)(2)(ii)(g); *id.* § 1.761-1(d).

93. *See id.* § 1.704-1(b)(2)(ii)(b).

94. *Id.* § 1.704-1(b)(2)(ii)(b)(3).

95. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3).

96. *Id.*

97. *See generally id.* § 1.704-2 (as amended in 1991).

98. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3). A partner should never agree to an unlimited deficit restoration obligation; rather, the partnership should comply with the alternate test. *See infra* text accompanying notes 103-12.

99. In the event of a limited deficit restoration obligation, an allocation can have partial economic effect, in which case the Service will respect the allocation to the extent that it has partial economic effect, and the balance will be reallocated in accordance with the partners' interests in the partnership. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(c)(1) (as amended in 1997).

conditionally restore a deficit regardless of the amount.[100] The legal obligation that creates a partner's deficit restoration obligation can arise under state law, the partnership agreement, or a side agreement.[101]

The alternate test applies anytime a partnership agreement or state law fails to impose unlimited deficit restoration obligations on all partners to cover any current or potential future partnership losses. Only general partnerships, due to the joint and several personal liability borne by all partners, impose, as a matter of state law, unlimited deficit restoration obligations on all partners.[102] Consequently, many unincorporated business organizations taxed as partnerships (which includes LLCs and LLPs as well as limited partnerships) must comply with the alternate test in order to meet the economic effect safe harbor.[103] The alternate test requires that all deficit capital accounts either created by or increased due to a distributive share of losses not properly labeled as nonrecourse deductions be covered dollar for dollar by a limited obligation to restore the deficit.[104] The alternate test has two additional requirements designed to ensure that the limited obligation to restore in fact covers the entire deficit capital account.[105] First, the capital account must be adjusted hypothetically for certain expected debits, for example, an expected distribution that will not be matched with an income allocation.[106] This hypothetical downward adjustment to the capital account is made solely to measure how large the limited deficit restoration obligation must be when testing the economic effect of the distributive shares of actual tax losses that year.[107] This hypothetical adjustment en-

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100. Treas. Reg. § 1.704-1(b)(2)(ii)(c)(2).

101. *Id.* § 1.704-1(b)(2)(ii)(c).

102. *See infra* notes 223-27 and accompanying text (discussing loss allocations in the context of general partnerships).

103. *See infra* notes 228-30 and accompanying text (discussing loss allocations in the context of limited partnerships and the need for all limited partnerships to meet the alternate test; because LLCs and LLPs offer limited liability protection to all members and partners, state law imposes no unlimited deficit restoration obligation on members of LLCs or partners of LLPs rendering it essential for all LLCs and LLPs to meet the alternate test for economic effect). *See id.*

104. Treas. Reg. § 1.704-1(b)(2)(ii)(d) (as amended in 1997).

105. *Id.*

106. *Id.*

107. *Id.*

sures that the limited deficit restoration obligation that supports a current distributive share of taxable loss will be large enough to cover both the actual loss and the expected debit to the capital account in the future.[108]

The partnership agreement must also include a "qualified income offset" provision.[109] A qualified income offset will be triggered in the event of certain *unexpected* debits to a partner's capital account, for example, a distribution without a matching income allocation, creating a deficit capital account balance without a corresponding obligation to restore the deficit.[110] If a distribution or other event activates the qualified income offset provision, the partner whose capital account unexpectedly has dropped below any corresponding limited deficit restoration obligation must receive an allocation of income or gain "in an amount and manner sufficient to eliminate such deficit balance as quickly as possible."[111] Allocations of income and gain pursuant to a qualified income offset must consist of a pro rata share of each item of partnership income and gain for the taxable year.[112]

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108. *Id.* For example, assume that a $100 loss allocated by a limited partnership to a limited partner brings her capital account balance from $100 to zero, but she expects to receive a $50 distribution at a future time that will have no matching income allocation. Further assume that the partners expect the limited partnership to incur a $50 recourse loan and distribute the proceeds to the limited partner. Because the distribution comes from recourse debt proceeds, there will be no matching income allocation or share of minimum gain, and the general partner will bear the economic risk of loss for the debt. The alternate test requires that her capital account be reduced not by just the $100 current distributive share of taxable loss but also by the $50 expected distribution. Consequently in order for the distributive share of the $100 loss to meet the alternate test, the limited partner must agree to a deficit restoration obligation of at least $50.

109. Treas. Reg. § 1.704-1(b)(2)(ii)(d).

110. *Id.*

111. *Id.*

112. *Id.* In the example discussed in note 108, the limited partner (if she was not required to agree to a $50 deficit restoration obligation initially because she did not expect to receive the distribution in the earlier year) would be required to receive a $50 income allocation under the qualified income offset in the year the distribution of recourse debt proceeds brought her capital account to a deficit below any limited obligation to restore. The qualified income offset should never be confused with an obligation to restore a deficit capital account. The qualified income offset, if triggered, will require the partner to report a distributive share of partnership income without any corresponding right to receive a share of the partnership's wealth. Because the qualified income offset uses income allocations to eliminate deficit capi-

In addition to complying with the allocation rules under § 704(b), partners receiving distributive shares of losses must have sufficient outside basis to absorb the loss in order to avoid the loss being suspended.[113] Under § 752, partners receive an increase to their individual outside basis for shares of the partnership's liabilities.[114] The regulations classify all partnership liabilities as either recourse or nonrecourse. If any partner or related person[115] bears the economic risk of loss associated with the liability, the § 752 regulations deem that liability recourse.[116] Conversely, if no partner or related person bears the economic risk of loss associated with the liability, then the § 752 regulations deem that liability nonrecourse.[117] The partners' shares of partnership recourse liabilities and the economic effect safe harbor are integrally related. If a partner satisfies the economic effect safe harbor by agreeing to an obligation to restore a deficit capital account or a payment obligation or is legally required under state law to make payments or contributions on behalf of the partnership, that partner will also bear the risk of loss for the corresponding share of the partnership's recourse liability. Consequently, very few distributive shares of losses that in fact meet the economic effect safe harbor will be suspended due to insufficient outside basis to absorb the loss.[118]

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tal accounts that should be, but are not, covered by an obligation to restore, this mechanism of the economic effect safe harbor conceptually resembles the minimum gain chargeback which restores previous nonrecourse deductions with income allocations that do not carry a share of the partnership's wealth. *See infra* notes 170-79 and accompanying text.

113. I.R.C. § 704(d) (1994).

114. Treas. Reg. § 1.752 (as amended in 1991).

115. "Related person" is defined in Treas. Reg. § 1.752-4(b), -1(a)(3).

116. *Id.* § 1.752-1(a)(1).

117. *Id.*

118. *See* Hamill, *Final Regulations*, *supra* note 15, at 107-09. *But see infra* notes 203-09, 237, 238 (discussing the potential that a partner's illusory deficit restoration obligation can support a distributive share of losses under the economic effect safe harbor even though the § 752 constructive liquidation process will not increase the partner's outside basis, because the deficit restoration obligation will never materialize, so the partner bears no economic risk of loss). In rare circumstances, especially in partnerships with no liabilities, a distributive share of losses can meet the economic effect safe harbor and still be suspended under § 704(d). For example, if a partner receives a distributive share of losses that in fact corresponds to another partner's capital, an obligation to restore a capital account will cause the allocation to have economic effect, but will not support an outside basis increase until the partner makes an actual contribution, therefore causing the loss to be suspended.

To determine whether a partner (or related person) bears the economic risk of loss, the § 752 regulations engage in an entirely hypothetical constructive liquidation of the partnership.[119] The constructive liquidation treats the partnership's assets (including cash) as having a value of zero.[120] The partnership's liabilities become payable in full,[121] and the regulations deem the partnership property as disposed of in a taxable transaction.[122] Liabilities where payment is not limited to one or more assets of the partnership (meaning the creditor or a partner by virtue of possessing a positive capital account can proceed against one or more partners) produce a taxable loss equal to the basis of any property acquired with the debt proceeds or any available cash from the debt proceeds.[123] Finally, the regulations hypothetically allocate the items of gain or loss to the partners and liquidate the partnership.[124] If, as a result of the constructive liquidation, a partner (or related person) would be required to make a payment or contribution to satisfy the liability, the § 752 regulations deem that partner to bear the economic risk of loss and receive the corresponding increase to outside basis.[125] For purposes of determining whether a partner or related person bears the economic risk of loss for partnership liabilities, the § 752 regulations consider obligations imposed by contract (such as guarantees or indemnifications), the partnership agreement, or state law (which will include obligations to restore a deficit capital account resulting from the hypothetical loss allocations generated by the constructive liquidation).[126] As previously mentioned, a partner's share of the partnership's recourse liabilities as determined by the construc-

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119. Treas. Reg. § 1.752-2(b)(1)(v).

120. *Id.* § 1.752-2(b)(1)(ii).

121. *Id.* § 1.752-2(b)(1)(i) (1991).

122. *Id.* § 1.752-2(b)(1)(iii).

123. *Id.* § 1.752-2(b)(1)(iv). If payment on the liability is limited to the partnership's assets (e.g., nonrecourse liabilities under § 1.1001-2 incurred by general partnerships, limited partnerships, LLCs or LLPs as well as recourse liabilities under § 1.1001-2 incurred by LLCs and LLPs), the constructive liquidation process triggers gain to the extent the face of the liability exceeds the basis of the property securing the liability.

124. Treas. Reg. § 1.752-2(b)(1).

125. *Id.*

126. *Id.* § 1.752-2(b)(3).

tive liquidation process of the § 752 regulations also supplies the necessary obligation to restore a deficit capital account in order to satisfy the economic effect safe harbor.[127]

The second half of the regulations' test for determining whether an allocation will be respected requires that the allocation be "substantial."[128] Unlike the economic effect safe harbor which focuses on each individual partner enjoying the economic benefits and bearing the economic burdens from the distributive shares of partnership income and loss, the substantiality rules use present value concepts and focus on the after-tax economic consequences from the special allocations and the after-tax economic consequences to the partners as a group. The rules are designed to prevent the partners, as a group, from reducing their overall tax liability with special allocations of partnership income and loss that, in fact, carry little economic risk of altering the partners' intended economic arrangement. For allocations to be substantial, the regulations require special allocations to come with a reasonable possibility of affecting the dollar amounts received by the partners. Unlike the mechanical "economic effect" rules, which, if followed, provide an absolute safe harbor insulating the allocations from attack by the Service, the substantiality rules are more subjective and only provide taxpayers with guidelines, leaving the Service with the ultimate discretion to challenge the allocations.[129]

Allocations deemed "insubstantial" are those that, despite meeting the economic effect safe harbor, effectively reduce the participant's overall tax liability with little if any economic risk to the partners. The regulations paint two broad scenarios illustrating examples of insubstantial allocations: (1) transitory allo-

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127. *Id.* § 1.752-2(b)(3)(ii)-(iii), -2(f), Example 1 (as amended in 1991); *id.* § 1.704-1(b)(2)(ii)(c) (as amended in 1997).

128. Treas. Reg. § 1.704-1(b)(2)(iii)(a). The general rules for testing allocations for substantiality require that the after-tax economic consequences of at least one partner be enhanced (in present value terms) as a result of the special allocation and a strong likelihood exist that the after-tax economic consequences of no partner (in present value terms) be substantially diminished as a result of the special allocation.

129. *See id.* The general rules testing allocations for substantiality under § 1.704-1(b)(2)(iii)(a) provide the Service with enormous discretion to challenge allocations. The language specifically states that even allocations which avoid being treated as insubstantial under the transitory allocations or character shifting rules can still be treated as insubstantial under the general language. *Id.*

cations,[130] and (2) character shifting allocations.[131] Transitory allocations occur when a partner receives a loss allocation which is later offset by an income allocation, thereby allowing the partner to take advantage of the time value of the money resulting from the ability to save taxes from the use of early tax losses at the price of more taxes from an income allocation in the future restoring the earlier loss.[132] To avoid the Service reallocating both the original and offsetting allocations, the partners must show that at the time they agreed to both allocations, a substantial risk existed that the offsetting allocation would never materialize, thus rendering permanent the capital account adjustment from the original allocation.[133]

If little or no risk exists concerning the availability of future income to offset the earlier special allocations of losses, the Service can potentially invoke the transitory allocation rules and reallocate the special allocations of losses and the offsetting income.[134] However, even if little or no risk exists concerning the availability of income to offset an earlier loss, the regulations provide two situations in which allocations will be deemed "substantial" despite their transitory nature.[135] If the source of the later offsetting income allocation comes from the disposition of the property that generated the original loss allocation, the regulations conclusively assume that the income will never be generated because of the regulations' presumption that the value of all property equals and, therefore will never exceed, the basis in the property.[136] Moreover, if the partnership agreement requires the partner to wait until the sixth year to offset the earli-

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130. *Id.* § 1.704-1(b)(2)(iii)(c).

131. *Id.* § 1.704-1(b)(2)(iii)(b) (as amended in 1997).

132. Transitory allocations can also result when special allocations of income in earlier years are later offset by loss allocations. Treas. Reg. § 1.704-1(b)(2)(iii)(b).

133. *Id.* § 1.704-1(b)(2)(iii)(c).

134. *See id.* The same analysis applies if the original allocation of income is largely offset with a later loss allocation. The transitory allocation rules require the partners as a group to save taxes as a result of the original and offsetting allocations. *Id.* Consequently, if all the partners have an equal ability to take advantage of the time value of money consideration and save taxes from an earlier distributive share of losses that is offset by a later distributive share of income, the special allocations cannot be deemed insubstantial because a reallocation among the partners will not produce more tax liability when viewing the partners as a group.

135. *Id.* § 1.704-1(b)(2)(iii)(c).

136. Treas. Reg. § 1.704-1(b)(2)(iii)(c)(2).

er special allocation, the regulations presume that a sufficient level of risk exists to render both allocations substantial.[137]

Character shifting, on the other hand, occurs when the partners take advantage of the unavoidable fact that taxable income and losses of different characters can result in varying tax treatment among the partners depending on their individual tax situations.[138] For example, capital gains historically have been taxed at lower rates than ordinary income while tax-exempt bond interest comes with no tax burden at all. Losses that represent above-the-line business expenses have a greater potential to reduce tax liability than capital losses.[139] Special allocations can be reallocated on substantiality grounds if the partners use the character distinctions and agree to special allocations that reduce the partners' total tax liability, while having little or no affect on their economic consequences.[140] For example, if the partners agree to allocate all the ordinary income to the partners with expiring net operating losses and all the capital gain to the partners in the highest income tax bracket, and the economic performance of both sources of income is steady and predictable, the Service can reallocate both special allocations.[141]

B. The Rules Applicable to Allocations and Outside Bases Adjustments Attributable to Nonrecourse Liabilities

The fundamental principles of the federal income tax system treat proceeds derived from nonrecourse borrowings the same as proceeds derived from recourse borrowings and proceeds gener-

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137. *Id.* § 1.704-1(b)(2)(iii)(c)(2).

138. *Id.* § 1.704-1(b)(2)(iii)(b).

139. *See* I.R.C. § 1(h) (complex formula establishing maximum capital gains rate at a figure less than top income tax rate of 39.6% for individuals); *id.* § 103 (exempting from tax interest on state or local bonds); *id.* § 162 (allowing a deduction for all ordinary and necessary business expenses); *id.* § 1211 (establishing limitations on the deductibility of capital losses).

140. Treas. Reg. § 1.704-1(b)(2).

141. The character shifting rules require the partners as a group to save taxes as a result of the shifting character allocations. Consequently, if, for example, the partners agree to special allocations that shift tax items with different characters amongst themselves but as a group do not save taxes, the special allocations cannot be deemed insubstantial because a reallocation among the partners will not produce more tax liability when viewing the partners as a group. *Id.* § 1.704-1(b)(2)(iii).

ated from after-tax dollars. On the theory that the borrower's desire to keep the property that often secures nonrecourse debt will motivate the borrower to pay off nonrecourse liabilities, despite the absence of personal liability, proceeds from nonrecourse borrowings can generate current deductions or provide basis in property eligible for depreciation deductions. If the taxpayer fails to pay off the nonrecourse loan, the requirement that the entire unpaid balance be included in the amount realized ensures that any previous deductions supported by nonrecourse debt are restored with taxable income carrying no possibility of economic wealth, sometimes referred to as phantom income or minimum gain.[142]

A partnership financed with capital from nonrecourse liabilities can generate depreciation and other deductions through the use of those proceeds that must be allocated to the individual partners. Allocations of losses and deductions attributable to nonrecourse debt incurred by the partnership[143] cannot have "economic effect" because such losses never carry an economic burden in that only the nonrecourse lender, rather than any of the partners, will suffer an economic loss if the partnership fails to pay back the liability. Moreover, the taxable income offsetting previous nonrecourse deductions can never carry a corresponding economic benefit.[144] The § 704(b) regulations define a nonrecourse liability as a debt for which no partner or related person bears the economic risk of loss under the hypothetical constructive liquidation of the § 752 regulations.[145] State law deems liabilities nonrecourse when some, or all, of the borrower's assets are beyond the lender's reach in the event of default.[146] In a general or limited partnership, because the

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142. *See infra* notes 144 and 150.

143. The most common example of an allocation attributable to nonrecourse liabilities is depreciation deductions on property subject to nonrecourse liabilities.

144. Under the concepts of the *Crane v. Commissioner* and *Tufts v. Commissioner* cases, allocations of income offsetting nonrecourse deductions are either "phantom gain" or in fact produce real economic proceeds that actually pay off the nonrecourse liability and therefore still cannot benefit any partner. *See* Crane v. Commissioner, 331 U.S. 1 (1947); Commissioner v. Tufts, 461 U.S. 300 (1983). For a detailed explanation of the *Crane* and *Tufts* cases, see MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAX ¶¶ 13.01, 13.04 (8th ed. 1999).

145. Treas. Reg. § 1.704-2(b)(3) (1991). *See supra* text accompanying notes 122-24.

146. *See* Treas. Reg. § 1.1001-2 (1980).

partnership as borrower bears no personal liability for state law nonrecourse debt, no partner will bear personal liability if the partnership fails to pay off the nonrecourse liability.[147] Since the lender, rather than the partners or related persons, bears the potential economic burden that corresponds to these allocations, the allocations cannot have "substantial economic effect."[148] However, despite the lack of any economic burden, the partners often enjoy great flexibility to allocate losses and deductions attributable to nonrecourse debt in a number of different ratios, so long as they comply with the § 704(b) regulations' safe harbor that deems such allocations in accordance with the partners' interests in the partnership.[149]

The nonrecourse debt rules employ the concept of "minimum gain"[150] and the presumption that the value of partnership property equals its adjusted tax basis in order to measure the existence of nonrecourse deductions at the partnership level and determine the appropriate time to restore the previous nonrecourse deductions with income allocations.[151] Minimum gain exists to the extent the face amount of a nonrecourse liability exceeds the adjusted basis of property securing the debt.[152]

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147. *See infra* note 189 (discussing the different tax consequences to the borrower based on whether the liability is recourse or nonrecourse); note 217 (discussing treatment of recourse and nonrecourse liabilities incurred by general or limited partnerships); and text at p. 657 (discussing the tax consequences of general and limited partnerships incurring nonrecourse debt as defined by § 1.1001-2).

148. Treas. Reg. § 1.704-2(b)(1).

149. *Id.* § 1.704-2(e)(2). *See also infra* notes 168 and 169 (discussing permissible ratios for allocating nonrecourse deductions under the reasonable consistency requirement).

150. The concept of "minimum gain" can be traced to the case of *Commissioner v. Tufts*, 461 U.S. 300 (1983). At issue in *Tufts* was whether the amount realized from the disposition of property subject to a nonrecourse liability includes such liability. *Tufts*, 461 U.S. at 301. The Tax Court held that the nonrecourse liability must be included in calculating the amount realized on the property's disposition even if the amount of the mortgage exceeds the property's fair market value. *Id.* at 317. Without such a rule, partners who receive deductions attributable to property subject to nonrecourse liabilities would be able to escape the tax burden associated with the later disposition of the property. *See id.* Thus, when property's adjusted basis falls below the face amount of a nonrecourse debt, minimum gain is created. *See id.*

151. Treas. Reg. § 1.704-2(b)(2) (1991).

152. *See id.* The value-equals-basis presumption conclusively assumes that the fair market value of the partnership's property, regardless of evidence to the contrary, equals its adjusted tax basis. Consequently, the property's basis represents the maximum amount the partnership could receive from creditors if the property were

Minimum gain grows wider as the difference between the property's basis and the unpaid amount of the liability increases.[153] This event often occurs when property subject to a nonrecourse liability depreciates at a rate faster than the partnership pays down the principal or when a partnership uses property to secure a nonrecourse debt that exceeds the basis of such property. The ironclad "value equals basis" presumption of the regulations assumes that the property's basis represents the maximum amount the lender could receive in a foreclosure sale, even if solid evidence indicates that the property in fact has more value.[154] Minimum gain shrinks as the difference between the property's basis and the liability decreases, which often occurs when the partnership repays a nonrecourse debt or when a partnership disposes of property secured by a nonrecourse debt.[155]

The regulations calculate the partnership's minimum gain on a net basis.[156] If a partnership incurs more than one nonrecourse liability, the regulations first calculate the increase or decrease in minimum gain on each liability and then net the figures together to compute an overall minimum gain increase or decrease for the partnership's taxable year.[157] As a result of comparing the overall minimum gain for the current partnership taxable year with the overall minimum gain for the immediately preceding partnership taxable year, a partnership will either show a net increase, a net decrease or no change in the overall minimum gain.[158] To the extent of the partnership's net increase in minimum gain, existing partnership losses and deductions must be identified and labeled "nonrecourse deductions."[159] The regulations first treat depreciation or cost recovery deductions of property subject to nonrecourse debt as nonre-

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sold or otherwise transferred. *See id.* However, if the basis of property secured by a nonrecourse liability equals or exceeds the amount of the nonrecourse debt, no minimum gain exists because the value-equals-basis rule assumes that nonrecourse liability has adequate security. *See id.*

153. *Id.*

154. Treas. Reg. § 1.704-2(d).

155. *Id.* § 1.704-2(b)(2).

156. *Id.* § 1.704-2(d)(1).

157. *Id.*

158. *Id.*

159. Treas. Reg. § 1.704-2(c) (1991).

course deductions, and if such amount is insufficient to cover the net increase in minimum gain, then a pro rata share of the partnership's other losses and deductions are treated as nonrecourse deductions.[160]

The § 704(b) regulations' safe harbor for allocating distributive shares of nonrecourse deductions requires the following: (1) the partnership agreement must comply with all requirements of the "economic effect" safe harbor[161] (either with an unlimited deficit restoration obligation[162] or via the alternate test with a qualified income offset provision as well as a limited deficit restoration obligation covering past loss allocations carrying economic burdens[163]); (2) in the first taxable year in which there are nonrecourse deductions through the remainder of the partnership's term, the partnership agreement must provide for allocations of nonrecourse deductions in a manner that is "reasonably consistent" with other allocations that have substantial economic effect of some other "significant" partnership item attributable to the property securing the nonrecourse debt[164]; (3) in the first taxable year in which there are nonrecourse deductions or distributions of nonrecourse debt proceeds,[165] the partnership agreement must include a "minimum gain chargeback" requirement;[166] and (4) all other material allocations

160. *Id.* § 1.704-2(j)(1)(ii). If the amount of the nonrecourse losses and deductions exceeds the partnership's losses and deductions, the excess partnership minimum gain is carried over to the following partnership taxable year. *Id.* § 1.704-2(j)(1)(iii).

161. *See id.* § 1.704-1(b)(2) (as amended in 1985).

162. *See supra* text accompanying note 100.

163. *See supra* text accompanying notes 109-12.

164. Treas. Reg. § 1.704-2(e)(2).

165. Distributions of nonrecourse debt proceeds result when proceeds from a nonrecourse borrowing cause an increase in partnership miniumum gain and are distributed rather than being invested in partnership assets or used to meet partnership expenditures. *Id.* § 1.704-2(c) and § 1.704-2(h).

166. *Id.* § 1.704-2(e)(3) and § 1.704-2(f). The minimum gain chargeback requirement is subject to three exceptions. *Id.* § 1.704-2(f)(2)-(4). First, if a conversion, refinancing or other change to a nonrecourse debt causes the liability to become partially or wholly a recourse or a partner nonrecourse debt, a partner whose share of the net decrease in minimum gain resulted from the conversion will not face the minimum gain chargeback to the extent that the partner bears the economic risk of loss for the newly converted liability. *See id.* § 1.704-2(f)(2). Second, if a partner contributes capital to the partnership to repay the nonrecourse liability or increase the basis of the property subject to the nonrecourse liability, the contributing partner will not face the minimum gain chargeback to the extent his share of the net decrease in the partnership minimum gain resulted from his capital contribution.

and capital account adjustments must be respected by the Service under § 1.704-1(b).[167]

The "reasonably consistent" requirement governs the ratio in which partners are entitled to allocate the distributive shares of nonrecourse deductions. Distributive shares of nonrecourse deductions satisfy the "reasonably consistent" requirement if the partners' ratio for sharing nonrecourse deductions corresponds to other "significant" allocations that have substantial economic effect.[168] While the regulations do not explicitly provide the permissible allocation ratios, the regulatory examples indicate that if the partner's shares of profit and loss differ, either the profit or loss ratio or any ratio in between will satisfy the "reasonably consistent" requirement.[169]

The "minimum gain chargeback" requirement ensures that partners who receive the benefit of earlier nonrecourse deduc-

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Treas. Reg. § 1.704-2(f)(3). Third, the Commissioner has the power to waive the minimum gain chargeback requirement if a partner restored prior nonrecourse deductions with capital contributions or net income allocations before the partnership had a net decrease in minimum gain; the minimum gain chargeback would distort the partner's economic relationship; and finally the partnership will probably not have sufficient income to correct the economic distortion. *See id.* § 1.704-2(f)(4).

167. *Id.* § 1.704-2(e)(4).

168. *Id.* § 1.704-2(e)(2).

169. *Id.* § 1.704-2(m), Examples 1 (i)-(iii). The examples involve two partners contributing 10% and 90%, respectively, of the partnership's equity. The partnership obtains a nonrecourse loan constituting 80% of the money needed to purchase the partnership's only asset; that is, 20% of the value of the partnership's assets is represented by amounts that could result in real economic losses to the partners. The two partners share all losses 10%-90%, in accordance with their capital contribution ratios, and all profits, after losses have been charged back, are split evenly. The example states that nonrecourse deductions can be shared among the partners 10%-90%, 50%-50%, 25%-75%, or in any other ratio between the loss and profit ratios. The example also indicates that allocations outside the parameters of the loss and profit ratios (i.e., a 1%-99% ratio for sharing the nonrecourse deductions) will not satisfy the reasonable consistency requirement. *See* Treas. Reg. § 1.704-2(m), Examples 1 (i)-(iii). The regulations clearly require the profit and loss ratios that establish the boundaries of permissible nonrecourse deduction ratios to be significant items. At some point, the percentage of the partnership's capital financed with equity or recourse liabilities becomes so small that the potential for real economic losses becomes meaningless. The examples involve property that is financed with 20% equity capital and 80% nonrecourse debt, which suggests that 20% equity capital is "significant"; however, it is unclear how much less equity capital would render the loss ratio insignificant. *See id.* If the loss ratio cannot serve as a permissible boundary establishing the shares of nonrecourse deductions, the partners must use the profit ratio.

tions bear the tax burden of such deductions. This chargeback is accomplished by allocating income or gain allocations that come with no corresponding economic rights to the partnership's cash or other assets to the partners who received past distributive shares of nonrecourse deductions or distributions of proceeds attributable to nonrecourse liabilities. The regulations trigger the minimum gain chargeback requirement when the partnership experiences a net decrease in partnership minimum gain during the year.[170] The regulations use the partner's percentage share of the partnership's total minimum gain (which reflects that partner's past allocations of nonrecourse deductions and distributions of nonrecourse debt proceeds) to measure the partner's share of the net decrease in partnership minimum gain.[171] Thus, in the event of a net decrease in partnership minimum gain, each partner who received previous allocations of nonrecourse deductions or distributions of nonrecourse debt proceeds must be allocated income and gain in an amount equal to his share of the net decrease in partnership minimum gain.[172]

The most common events that cause partnership minimum gain to decrease include dispositions of partnership property subject to nonrecourse debt and payments on the principal of nonrecourse liabilities. For example, if during the current year, a partnership made a $150 principal payment on a $1000 nonrecourse liability secured by property with $800 adjusted basis,[173] the net decrease in partnership minimum gain for the current year would be $150.[174] If the partnership had two partners each with a fifty percent share of the partnership's total $200 minimum gain, their shares of the net decrease would be

170. *Id.* § 1.704-2(f) and § 1.704-2(d) (1991). Minimum gain decreases when the spread between the face amount of all nonrecourse debts and the basis of all property subject to the debts shrinks. *See supra* text accompanying notes 149-54.

171. Treas. Reg. § 1.704-2(g)(1).

172. *Id.* § 1.704-2(f) and § 1.704-2(g)(2).

173. This assumes that the partnership has no other assets secured by nonrecourse liabilities, and the asset's basis did not change.

174. The partnership's minimum gain on the last day of the preceding year was $200 (the difference between the $1000 liability and the asset's $800 basis). At the end of the current year, the partnership's minimum gain was $50 (the difference between the $850 liability after the principal payment and the asset's $800 basis), resulting in a $150 net decrease.

$75 each.[175] At the end of the current taxable year, the partnership's total minimum gain would be $50, and each partner's share (and future minimum gain chargeback potential) would be $25.

Under the minimum gain chargeback requirement, existing partnership income and gain must be allocated to the partners to the extent of their share of the net decrease in partnership minimum gain during the year.[176] The minimum gain chargeback first consists of gains realized from the disposition of partnership property subject to nonrecourse liabilities.[177] If such gains are insufficient, the regulations use a pro rata share of the partnership's other items of income and gain to satisfy the minimum gain chargeback.[178] If the minimum gain chargeback exceeds the partnership's income and gains for the taxable year, the excess carries over to succeeding years until the partnership has sufficient income to satisfy the chargeback.[179]

Partners who receive distributive shares of partnership losses properly labeled as nonrecourse deductions must have sufficient outside basis to absorb the loss in order to avoid having § 704(d) suspend the loss. The regulations under § 752 direct that partners receiving distributive shares of nonrecourse deductions under the safe harbor receive corresponding increases to their outside bases for shares of partnership nonrecourse liabilities. The priority rules for increasing outside bases for shares of the partnership's nonrecourse liabilities have three levels. First, the partnership liabilities are allocated to the partners to reflect their shares of partnership minimum gain under § 1.704-2.[180] Second, nonrecourse liabilities are allocated to reflect the taxable gain that would be allocated to the partners under § 704(c) or § 1.704-1(b)(4)(i) if the partnership disposed of all its property subject to nonrecourse liabilities for no consideration other than relief of those liabilities.[181] Finally, any remaining nonrecourse liabilities are then allocated in accordance with the partners'

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175. Each has a 50% share of the $150 net decrease ($75 each).
176. Treas. Reg. §1.704-2(f)(1) (1991).
177. *Id.* § 1.704-2(f)(6), (j)(2).
178. *Id.*
179. *Id.* § 1.704-2(f)(6) and § 1.704-2(j)(2)(iii).
180. *Id.* § 1.752-3(a)(1).
181. Treas. Reg. § 1.752-3(a)(2) (1991). *See supra* note 15.

shares of the partnership's profits or in the manner the partners reasonably expect to allocate future nonrecourse deductions.[182] The partners' profit-sharing arrangement, specified in the partnership agreement, will be respected so long as it is consistent with other significant allocations that have substantial economic effect.[183]

C. Separate Safe Harbor for Allocations Attributable to Partner Nonrecourse Liabilities

The § 704(b) regulations contain a third set of rules governing allocations attributable to partner nonrecourse liabilities. These provisions, often referred to as the partner nonrecourse debt rules, set up a safe harbor governing allocations of losses and deductions attributable to nonrecourse liabilities where, despite the nonrecourse status of the debt to the partnership as the borrower, a partner or related person[184] bears the economic risk of loss under the § 752 regulations. The partner nonrecourse debt rules do not treat a partner's economic risk of loss, with respect to a partnership nonrecourse liability, as an obligation to restore a deficit capital account under the economic effect safe harbor. Rather, the partner nonrecourse debt rules set up a parallel regime similar to the safe harbor applicable to allocations attributable to nonrecourse liabilities in order to ensure that the appropriate amount of losses attributable to the partner nonrecourse debt are allocated to the partner who bears the economic risk of loss.[185] First, the safe harbor identifies nonrecourse liabilities where a partner nevertheless bears the economic risk of loss; then the rules require minimum gain calculations, with respect to that individual debt. The minimum gain calculations focus on the particular partner nonrecourse liability and measure the extent the partner nonrecourse deductions must be segregated and allocated to the partner bearing the corresponding risk of loss.[186]

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182. *Id.* § 1.752-3(a)(3).

183. *Id.*

184. "Related person" is defined in Treas. Reg. § 1.752-4(b), -2(b)(4) (1991).

185. *Id.* § 1.704-2(i) (1991).

186. *Id. See also infra* text accompanying notes 205-07 (illustrating how the partner nonrecourse debt rules prevent the partners from allocating losses inappropriate-

The regulations classify a debt as a partner nonrecourse liability to the extent it meets the definition of nonrecourse under § 1.1001-2 and a partner (or related person) bears the economic risk of loss under the § 752 regulations.[187] The regulations under § 1.1001-2 differentiate between recourse and nonrecourse liabilities based on the lender's rights against the borrower upon default. If the lender can pursue only certain assets of the borrower, or stated another way, the lender cannot pursue all the borrower's assets, the liability meets the definition of nonrecourse as contemplated by § 1.1001-2.[188] If all the borrower's assets can be pursued by the lender to pay the debt, thereby rendering the borrower personally liable, the debt meets the definition of recourse under state law as contemplated by § 1.1001-2.[189] Only liabilities where state law treats the partnership as the borrower as having no personal liability can meet the definition of partner nonrecourse debt.

The second half of the partner nonrecourse debt definition looks to the § 752 regulations to determine if a partner bears the economic risk of loss for the liability despite the liability's nonrecourse status to the partnership as the borrower.[190] The most common examples of partner nonrecourse debt include a partner making a nonrecourse loan to the partnership and a partner

ly to partners who bear no economic burden because their deficit restoration obligations will never materialize and are therefore illusory).

187. Treas. Reg. § 1.704-2(b)(4).

188. *Id.* § 1.1001-2 (1980).

189. *Id.* Under § 1.1001-2, with dispositions of property subject to a nonrecourse liability, the transferor's amount realized includes the unpaid portion of the nonrecourse liability regardless of the property's fair market value. *Id.* § 1.1001-2(a)(4)(i), -2(b); *see also* Commissioner v. Tufts, 461 U.S. 300 (1983) (entire unpaid balance of a nonrecourse liability must be included in the amount realized when the property subject to the debt is disposed of, even if the unpaid nonrecourse mortgage exceeds the property's fair market value; under the facts a general partnership incurred a nonrecourse liability and disposed of the underlying property after the property's value had fallen below the face of the debt). However if the property disposed of is subject to a recourse liability, the amount realized on the disposition of the property includes the liability only to the extent another person agrees to pay the liability. Treas. Reg. § 1.1001-2(a)(4)(ii). If the property subject to a recourse liability is disposed of and only part of the recourse liability is paid off (i.e., the property's value falls below the face of the recourse liability, and the lender does not proceed against the borrower's personal assets because the borrower has no assets), then the unpaid portion of the recourse liability is treated as cancellation of indebtedness income. *See id.* § 1.1001-2(a)(2).

190. *Id.* §§ 1.704-2(b)(4), 1.752-2 (1991).

guaranteeing a nonrecourse loan made to the partnership by a third party.[191] The § 752 regulations contain a special rule outside the constructive liquidation process that deems partner nonrecourse lenders as bearing the economic risk of loss for the loan while the hypothetical constructive liquidation process recognizes guarantees of the partnership's third party nonrecourse debt as payment obligations.[192]

The mechanics of the partner nonrecourse debt rules strongly resemble the rules for allocations attributable to nonrecourse liabilities, except that the regulations calculate the minimum gain increases and decreases individually with respect to each partnership nonrecourse liability where a partner bears the economic risk of loss.[193] The minimum gain calculations, with respect to each partner nonrecourse liability, ensure that the partner who bears the economic risk of loss not only receives the outside basis increase for the liability but also the distributive shares of partnership losses and income attributable to the liability. Similar to the rules governing allocations attributable to nonrecourse liabilities, if the individual partner nonrecourse liability shows a net increase in minimum gain (because, for example, depreciation on property securing the liability falls below the face of the liability), the partner who bears the economic risk of loss must be allocated partner nonrecourse deductions in an amount equal to the net increase minimum gain.[194] The partner nonrecourse deductions must first come from depreciation or cost recovery deductions on property subject to the partner nonrecourse debt, and if such amount fails to cover the minimum gain increase, a pro rata share of the partnership's other losses and deductions. If the amount of partner nonrecourse deductions exceeds the partnership's losses and deductions for the taxable year, the excess carries over to succeeding

191. *See id.* § 1.704-2, 56 Fed. Reg. 66,978 (1991) (preamble to the regulations).

192. *See id.* § 1.752-2(c)(1) (noting that a partner making a nonrecourse loan to the partnership is deemed to bear the economic risk of loss unless another partner bears the economic risk of loss); *id.* § 1.752-2(b)(3)(i) (specifically referring to guarantees by partners of partnership liabilities where the rights run directly to the creditor as obligations to be factored into the constructive liquidation process). See *infra* text accompanying notes 210-11 for examples of non-lending partners bearing the economic risk for partner nonrecourse loans.

193. Treas. Reg. § 1.704-2(i).

194. *Id.* § 1.704-2(i)(2).

years until the partnership has sufficient losses and deductions.[195]

Similar to the rules governing allocations attributable to nonrecourse liabilities, the partner nonrecourse debt rules contain a minimum gain chargeback requirement. If the minimum gain on the individual partner nonrecourse debt decreases (because, for example, the partnership disposes of the property subject to the liability or pays off the liability), the partner who received previous allocations of any partner nonrecourse deductions must be allocated income and gain equal to the amount of the net decrease in partner nonrecourse debt minimum gain.[196] The partner nonrecourse debt minimum gain chargeback first consists of gains realized from the disposition of partnership property subject to the particular partner nonrecourse liability. If such gains are insufficient, the regulations use a pro rata share of the partnership's other items of income and gain to satisfy the minimum gain chargeback. If the minimum gain chargeback exceeds the partnership's income and gains for the taxable year, the excess carries over to succeeding years until the partnership has sufficient income.[197]

The existence of a third set of rules that require allocations attributable to partner nonrecourse debt to follow a safe harbor parallel to the nonrecourse allocation rules adds enormous complexity to the § 704(b) regulations. The existence of the partner nonrecourse debt rules essentially divides losses and income that in the ordinary sense carry economic consequences to at least one partner[198] into two allocation regimes, the substantial

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195. *Id.* § 1.704-2(j)(1)(i) & -2(j)(1)(iii) (1991).

196. *Id.* § 1.704-2(i)(4).

197. *Id.* § 1.704-2(j)(2)(ii) and -2(j)(2)(iii).

198. Partners who bear the economic risk of loss for liabilities that are recourse to the partnership (and therefore are treated as having a deficit restoration obligation under the economic effect safe harbor, and if the partnership fails to pay back the recourse debt the obligation to restore can be invoked to satisfy the recourse debt) substantively resemble partners who make nonrecourse loans to the partnership or guarantee the partnership's third party nonrecourse debt. Like the circumstances where a partner bears the economic burden for a share of recourse debt, the taxable losses resulting from depreciation or business expenses generated from partner nonrecourse debt can only be borne by the lender or guarantor. If the partnership fails to earn sufficient funds to pay back the partner nonrecourse liability, the lender will not be paid back, or the guarantor will be forced to pay the liability if the partnership fails to earn sufficient funds to pay off the liability. Moreover, if the

economic effect rules and the partner nonrecourse debt rules, each of which operates from a different conceptual framework. When analyzing distributive shares of partnership losses, the economic effect safe harbor focuses on the proper debit of the partner's capital account and the existence of an appropriate obligation to restore a deficit capital account. Under the economic effect safe harbor, a partner's capital account serves as the sole barometer to account for the partner's share of partnership losses.[199] Because the distributive shares of losses that have economic effect either reduce the partners' shares of the partnership's assets or create a potential obligation to restore a deficit capital account, the partners normally will insist on companion special allocations of income restoring the previous special allocations of losses. The substantiality rules empower the Service to scrutinize and possibly reallocate both sets of special allocations.[200]

The partner nonrecourse debt safe harbor operates under the same principles, based on minimum gain, as the rules governing allocations attributable to nonrecourse liabilities. Since a partner bears the economic risk of loss, the safe harbor focuses on the individual liability to ensure that the proper partner receives the appropriate amount of the distributive shares of losses. The rules first measure the existence of partner nonrecourse deductions by calculating minimum gain increases. Then the rules label existing losses as partner nonrecourse deductions and require that the allocations of the partner nonrecourse deductions be made to the partner who bears the economic risk of loss for the partnership's nonrecourse liability. Finally, the rules require those losses to be restored at the appropriate time through the minimum gain chargeback requirement.[201] The partner nonrecourse debt rules cover existing losses and deduc-

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partnership earns sufficient income to pay back the partner nonrecourse liability, the lender or guarantor benefits economically from the distributive share of income in a similar manner as partners bearing the risk of loss for shares of recourse debt, because in each situation the partners avoid suffering an economic loss by having to make actual payments (or failing to be paid back in the case of the partner nonrecourse lender).

199. Treas. Reg. § 1.704-1(b)(2)(ii)(b) and § 1.704-1(b)(2)(ii)(a) (as amended in 1997).

200. *Id.* § 1.704-1(b)(2)(iii). *See supra* notes 132-37 and accompanying text.

201. Treas. Reg. § 1.704-2(i) (1991).

tions whenever the spread between the basis of property securing the liability and the liability's face amount increases regardless of whether the partners' capital accounts show a deficit. Moreover, the partner nonrecourse debt rules do not require an obligation to restore a deficit capital account because the minimum gain chargeback requirement always restores the partner nonrecourse deductions. Unlike the substantiality rules that scrutinize income allocations offsetting previous special allocations of losses with economic effect, the minimum gain chargeback in the partner nonrecourse debt rules requires the income allocations to restore the previous partner nonrecourse deductions.

The regulations created a separate allocation regime parallel to the nonrecourse allocation rules for partner nonrecourse debt in order to ensure that the partnership allocates the proper amount of losses to the appropriate partner. Under the current structure of the § 704(b) regulations, the partner nonrecourse debt rules measure the amount of losses in the hands of the partnership potentially borne by a partner for genuine nonrecourse debt. The § 704(b) regulations need to contain a mechanism that measures this loss potential because of the difference under state law in the economic consequences at the partnership level from defaulting on recourse and nonrecourse debt. Because state law holds the partnership, as the borrower, personally liable for recourse debt, the potential for real economic loss at the partner level can be measured by the economic effect safe harbor's focus on the capital accounts of the partners. The capital accounts reflect the aggregate of the partnership's assets, all of which are available to the creditor to satisfy the partnership recourse debt.

However, in the case of genuine nonrecourse debt at the partnership level, only the assets identified in the loan agreement as security for the debt are available to the creditor if the partnership defaults. Consequently the potential for real economic loss at the partner level can be measured only by referring to the difference between the basis of these assets and the face amount of the partnership's nonrecourse liability. For example, if a partner makes a nonrecourse loan (or guarantees the partnership's third party nonrecourse debt) to the partnership, secured only by nondepreciable raw land, none of the

partnership's losses can be attributed to that debt as long as the land's basis equals the face of the liability. Consequently, distributive shares of losses to the lending or guaranteeing partner creating a deficit capital account cannot have economic effect without an independent obligation to restore a deficit capital account. In other words, the partner's risk of loss for this nonrecourse liability of the partnership cannot be substituted for an independent deficit restoration obligation, because under the value-equals-basis rule, no loss has occurred to the partnership as the borrower with respect to the nonrecourse debt secured by the nondepreciable raw land. Since the current structure of the economic effect safe harbor contains no mechanism to measure the loss potential from the partnership's nonrecourse debt, the § 704(b) regulations need to include the third allocation regime embodied in the partner nonrecourse debt rules. By measuring the existence of partner nonrecourse deductions through a net increase in minimum gain calculation with respect to the particular liability and the particular assets securing the liability, the mechanics of the partner nonrecourse debt rules properly measure the amount of real economic loss potentially borne by the partner.[202]

The partner nonrecourse debt rules also prevent partners from receiving loss allocations under the economic effect safe harbor supported by illusory rather than real deficit restoration obligations. Under the economic effect safe harbor, partners can receive distributive shares of taxable losses as long as the capital accounts are properly maintained and debited, and the partner covers any deficit capital account resulting from the distributive share with an obligation to restore the deficit at liquidation. Pursuant to the economic effect safe harbor, the obligation to restore a deficit capital account will only materialize if the deficit capital account still remains after all income and gain allocations triggered during the liquidation are accounted for

202. Professor Hamill credits Lisa Moss for identifying and articulating, in a well written exam answer, the need for a mechanism to measure the existence of real losses at the partnership level attributable to the nonrecourse liability in order to allocate the appropriate amount of losses to the partner bearing the economic risk of loss. Ms. Moss also recognized the inability of the current economic effect rules to measure these losses because of the focus on all of the partnership's assets in the aggregate as reflected in the partners' capital accounts in the aggregate.

with capital account increases.[203] However, when defining what constitutes a valid obligation to restore a deficit capital account for purposes of supporting a distributive share of taxable losses in a particular taxable year, the economic effect safe harbor uses examples tautologically by merely referring to promissory notes made by the partner as well as obligations imposed by state or local law without further elaboration or definition. Moreover, the definition of a valid obligation to restore only focuses on the contractual deficit restoration obligations the partner agrees to during the taxable year the deficit restoration obligation exists rather than concentrating on the actual effect of the deficit restoration obligation upon liquidation of the partnership.[204] If a partner agrees to a contractually enforceable deficit restoration obligation in a particular taxable year, that agreement arguably meets the definition of a valid deficit restoration obligation which can support a distributive share of taxable losses even if the deficit restoration obligation will never materialize due to the existence of income and gain that will eliminate the deficit capital account during the partnership's liquidation, rendering the obligation to restore illusory.

Two simple examples best illustrate how the partner nonrecourse debt rules prevent illusory deficit restoration obligations

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203. Treas. Reg. § 1.704-1(b)(2)(iv)(b) (partners' capital accounts must be increased for allocations of income and gain); *id.* § 1.704-1(b)(2)(ii)(b)(2)-(3), -(d)(2)

> (Distributive shares of partnership losses creating a deficit capital account must be covered by either a unlimited or limited obligation to restore the deficit capital account upon liquidation of the partnership; if a partner has a deficit capital account following liquidation of the partnership, *taking into account all capital account adjustments* during such year the liquidation occurs, the partner must make contributions restoring the amount of the deficit).

(emphasis added).

204. *Id.* § 1.704-1(b)(2)(ii)(c)

> (If a partner is not expressly obligated to restore the deficit balance in his capital account, such partner nevertheless will be treated as obligated to restore the deficit balance in his capital account . . . to the extent of (1) The outstanding principal balance of any promissory note (of which such partner is the maker) contributed to the partnership . . . and (2) The amount of any unconditional obligation of such partner (whether imposed by the partnership agreement or by State or local law) to make subsequent contributions to the partnership . . .).

Id. § 1.704-1(b)(2)(ii)(b)(3) (obligation to restore a deficit capital account materializes at liquidation after accounting for all positive or negative adjustments in the year of liquidation).

from supporting allocations of distributive shares of taxable losses. Partners making nonrecourse loans to a partnership will never receive a capital account credit if the loan qualifies as debt rather than equity.[205] Similarly if the business arrangement between the partners fails to treat payment on a guarantee of a partnership nonrecourse liability as a deemed equity contribution, like the partner nonrecourse lender, the guarantor will never receive a capital account credit. Because no capital account credit results from the loan or the payment on the guarantee, the lending or guaranteeing partner has no means to enforce a deficit restoration obligation agreed to by another partner.[206] Because the § 752 regulations treat payment of these liabilities as limited to the partnership's assets, the constructive liquidation process triggers gain to the extent the unpaid portion of the liability exceeds the basis of the partnership's assets subject to the liability. This gain eliminates the illusory deficit restoration obligation agreed to by the nonlending or nonguaranteeing partner, resulting in the outside basis increase being apportioned to the lending or guaranteeing partner.[207]

Because the definition of partner nonrecourse debt directly uses § 752's constructive liquidation process to define which partner must receive the partner nonrecourse deductions, illusory deficit rstoration obligations cannot be used to inappropriately shift distributive shares of losses away from the lending or guaranteeing partner. If the economic effect safe harbor applied to distributive shares of taxable losses that are now covered by the partner nonrecourse debt rules, an illusory deficit restoration obligation could arguably allow a partner, other than the lender or guarantor, to receive the losses on the strength of an illusory deficit restoration obligation.[208] The partner nonre-

205. *See* I.R.C. § 385 (1994).

206. *See, e.g.*, ALA. CODE § 10-8A-807(b) (1999) (providing in the settling of accounts that the partnership is only required to make distributions to the extent a partner has credits in his capital account).

207. *See* Treas. Reg. § 1.752-2(b)(2)(i) (1991) (During constructive liquidation, if payment on the liability is limited solely to one or more assets of the partnership, then gain or loss is triggered equal to the difference between the amount of the liability extinguished and the basis of the property; therefore if the unpaid liability exceeds the basis of the property, then gain will be recognized during the constructive liquidation.); *see also* Hamill, *Final Regulations*, *supra* note 15, at 120-21.

208. Because the constructive liquidation process of the § 752 regulations always

course debt rules ensure that the distributive shares of the partnership's losses end up with the appropriate partner who bears the economic risk of loss, the partner who receives the outside basis increase under the § 752 regulations.[209]

The partner nonrecourse debt rules cover many situations where the threat of illusory deficit restoration obligations supporting distributive shares of taxable losses does not exist. For example, if the partners' business arrangement treats payments on a guarantee of a partnership nonrecourse liability as a deemed equity contribution, the guarantor will receive a capital account credit (upon payment on the guarantee) that provides an effective means to enforce the deficit restoration obligation of another partner. Moreover, in the context of all partner nonrecourse loans and all guarantees made by partners on partnership nonrecourse debt (whether or not payment on the guarantee increases the guarantor's capital account), if another partner agrees to an absolute payment or reimbursement obligation that materializes upon default of the loan, without regard to the existence of a deficit capital account, such obligation will be enforceable by the lending or guaranteeing partner. Because the § 752 regulations treat payment of these liabilities as not limited to the assets of the partnership,[210] the constructive liquidation process triggers a loss equal to the basis of any partnership assets available to satisfy the liability, and the outside basis increase follows how the partners bear the economic risk of loss.

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prevents illusory deficit restoration obligations from resulting in outside basis increases, the § 704(d) suspension rules could also operate as a backstop to prevent distributive shares of losses from being deducted by partners who in fact bear no economic burden for the losses. However, if the partner agreeing to the illusory deficit restoration had sufficient outside basis from other sources and the partner nonrecourse debt rules did not exist, the economic effect safe harbor could be used to gain the timing benefit of allocating currently deductible losses that in substance carry no economic burden. If the partner nonrecourse debt rules did not exist the Service could still try to disallow distributive shares of taxable losses supported by illusory deficit restoration obligations based on general substance over form principles and the broad anti-abuse rule of § 1.701-2. However, the substance over form and anti-abuse arguments would require the Service to find and audit loss allocations supported by illusory deficit restoration obligations. Because the partner nonrecourse debt rules effectively deny taxpayers a reporting position, they do a much better job stopping distributive shares of losses based on illusory deficit restoration obligations.

209. Treas. Reg. § 1.704-2(b)(4), -2(i) (1991).

210. *See* Hamill, *Final Regulations*, *supra* note 15, at 120-21.

Because the liability literally falls within the definition of partner nonrecourse debt—nonrecourse to the partnership under § 1.1001-2 with at least one partner bearing the economic risk of loss—the partner nonrecourse debt rules apply. The risk of loss ratio established by the § 752 regulations creates two or more separate partner nonrecourse liabilities and requires separate minimum gain calculations for each liability.[211]

Including within the partner nonrecourse debt rules situations where the threat of illusory deficit restoration obligations supporting distributive shares of taxable losses does not exist greatly increases the complexity of the partner nonrecourse debt rules by requiring multiple partner nonrecourse debt minimum gain calculations with respect to one liability in the commercial sense. If a non-lending or non-guaranteeing partner truly bears the economic risk of loss for a partnership nonrecourse liability lent or guaranteed by another partner, no abuse potential through the use of illusory deficit restoration obligations exists. Consequently, the substantial economic effect rules could apply to absolute payment obligations and real deficit restoration obligations agreed to by non-lending and non-guaranteeing partners. The definition of partner nonrecourse debt in § 1.704-2(b)(4) could be amended to exclude partner nonrecourse liabilities created by the splitting of a partner nonrecourse loan or guarantee of a partnership nonrecourse debt caused by another partner bearing the risk of loss through a absolute payment obligation or a real deficit restoration obligation.[212] This would leave the portion of the partner nonrecourse liability allocated under the § 752 regulations to the original lender or guarantor within the

211. Treas. Reg. §§ 1.752-2, 1.704-2(b)(4), -2(i) (1991).

212. The language modifying the definition of partner nonrecourse debt in § 1.704-2(b)(4) could be as follows:

> Partner nonrecourse debt does not include debts for which the partner making or guaranteeing the debt to the partnership has a contractual right to be restored (partially or wholly) by a second partner if that payment obligation results in the second partner bearing some or all of the economic risk of loss under § 1.752-2(b) because either the guaranteeing partner receives an increased capital account upon payment of the guarantee, or the subsequent payment obligation by the second partner is not dependent on him or her having a deficit capital account.

Professor Hamill credits Robert Plott for coming up with this language in a well written exam answer.

partner nonrecourse debt rules. The portion of the partner nonrecourse liability split off and allocated to a non-lending or nonguaranteeing partner, which under current rules requires separate minimum gain calculations, would be available to support a deficit capital account under the substantial economic effect rules.

However, amending the definition of partner nonrecourse debt, in order to avoid creating multiple partner nonrecourse liabilities when no possibility exists that an illusory deficit restoration obligation will support a loss, raises at least two problems. First, the amendment will not always clearly identify which portion of the partner nonrecourse liability properly belongs to the original lender or guarantor, for example, in cases involving cross guarantees.[213] Moreover, the proposed amendment contains no mechanism to measure the amount of real losses at the partnership level with respect to the portion of the nonrecourse liability removed from the partner nonrecourse debt rules and sent over to the substantial economic effect rules. Because the portion of the nonrecourse liability moved to the economic effect rules can only produce a real economic loss at the partnership level to the extent that the basis of the contractually identified assets securing the loan exceeds the face amount of the liability, and the economic effect rules use the partners' capital accounts to measure real losses with respect to all partnership assets in the aggregate, the proposed amendment by itself cannot properly measure how much real loss potential exists for allocation purposes.[214]

213. Professor Hamill credits Thad Davis for pointing out the problem of determining which partner is the original guarantor in the context of the proposed amendment to the definition of partner nonrecourse debt in a well written exam answer.

214. Professor Hamill credits Lisa Moss for pointing out the problem of properly measuring how much real loss potential exists for allocation purposes in the context of the proposed amendment to the partner nonrecourse debt rules in a well written exam answer.

IV. The Application of the § 704(b) Regulations to Different Business Organizations and Unique Issues Posed by LLCs and LLPs

A. Allocation Rules in the Context of Different Business Organizations

The type of business organization chosen by the participants under state law sometimes affects the analysis of both the § 704(b) regulations governing distributive shares of partnership income and loss and the § 752 regulations governing outside basis increases for shares of partnership liabilities. The existence or absence of limited liability protection under state law for the partners or members constitutes the most important state law characteristic that can affect the allocation and liability sharing rules. The four most common state law unincorporated business organization choices—the general partnership, limited partnership, limited liability company and limited liability partnership—are often identified by the presence or absence of limited liability protection.[215] Under state law all partners of a general partnership bear personal liability for all recourse debts of the partnership.[216] State law only exposes the general partners of limited partnerships to personal liability for the partnership's recourse debts, while providing limited partners with the same limited liability protection enjoyed by shareholders of corporations.[217] LLCs and LLPs, the newest unincorporated business organizations available, provide all members and partners with the same limited liability protection enjoyed by corporate shareholders.[218]

In many circumstances, the type of business organization chosen by the participants will not affect the analysis of the distributive shares. Regardless of whether the participants choose a general partnership, limited partnership, LLC or LLP, the dis-

215. *See* sources cited at *supra* notes 1-5; *see also supra* note * (citing other three articles of the *Alabama Law Review* series that discuss other distinguishing business characteristics among these four business organization forms).

216. ALA. CODE § 10-8A-306(a) (1999).

217. *Id.* § 10-9B-303, 403.

218. *Id.* §§ 10-12-20(a), 10-8A-306(c).

tributive shares of losses, typically representing the initial start-up costs of the business, attributable to the partners' shares of equity capital[219] will be respected as long as the partners properly debit the capital accounts, liquidate according to positive capital accounts and avoid violating the substantiality rules. Similarly, regardless of whether the participants choose a general partnership, limited partnership, LLC or LLP, distributive shares of income that either restore previous losses attributable to equity capital or represent bona fide profit (income exceeding amounts restoring all initial capital of the partnership) will be respected as long as the partners properly credit the capital accounts, liquidate according to positive capital accounts and avoid violating the substantiality rules.[220] Income allocations restoring previous losses related to equity contributions subject

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219. Regardless of whether the participants operate as a general partnership, limited partnership, LLC or LLP the partners or members normally will agree to a loss sharing ratio that charges their shares of equity capital in a proportional fashion (allowing no losses to create a deficit capital account while other capital accounts are still positive). In the context of general partnerships, if the partners fail to agree to a specific loss ratio, the default ratio for sharing losses follows the partners' profit ratio. The default profit sharing ratio can create a deficit capital account for some partners (especially those contributing services rather than equity capital) while other partners' capital accounts remain positive. For general partnerships, state law automatically requires the partner with a deficit capital account to make contributions to satisfy the other partner's positive capital account. *See* ALA. CODE § 10-8A-401 & cmt. 3 (1999), *discussed in* Stover & Hamill, *supra* note *, at 836 n.100. In the context of LLCs and LLPs if the members or partners fail to agree on a loss sharing ratio, the default provisions ensure that no member or partner receives losses creating a deficit capital account while other members or partners still show a positive capital account. *See* ALA. CODE § 10-12-28 (1999) and RUPA § 401(b), *discussed in* Stover & Hamill, *supra* note *, at 835-38. Consequently, with LLCs and LLPs (as well as limited partners of limited partnerships), the members or partners have to affirmatively agree to an obligation to restore a deficit capital account in order to be forced to make contributions.

Because of the automatic unlimited deficit restoration obligation imposed by state law, general partnerships can meet the economic effect safe harbor without complying with the alternate test. For limited partnerships, LLCs and LLPs, the operating agreement must contain a qualified income offset in order to meet the safe harbor for establishing economic effect under the alternate test even if no deficit capital accounts exist or are contemplated in the future. The qualified income offset serves as a backstop providing mandatory income allocations in the event that future loss allocations bring a partner's capital account below the amount that is covered by a limited obligation to restore a deficit capital account or will be restored by the minimum gain chargeback. *See also supra* notes 94-103 and *infra* notes 223-30.

220. Treas. Reg. § 1.704-1(b)(2)(ii) and Treas. Reg. § 1.704-1(b)(2)(iii) (as amended in 1997).

both the previous losses and offsetting income to scrutiny as possible transitory allocations. These earlier loss allocations also face scrutiny under the portion of the substantiality rules dealing with shifting different characters of income or losses among the partners.[221] Income allocations representing true profit will generally pose no substantiality problems as long as the partners avoid character shifting allocations. As long as each partner's distributive share of the different characters of income follows the overall profit ratio, the allocation should pose no substantiality issues due to shifting allocations.[222]

The rules for allocating distributive shares of losses and income attributable to liabilities meeting the definition of nonrecourse under § 1.1001-2 (the entity as the borrower is not personally liable) apply in the same manner regardless of whether a general partnership, limited partnership, LLC or LLP incurred the liability. The nonrecourse debt allocation rules calculate minimum gain increases and decreases, and the safe harbor for allocating nonrecourse deductions and minimum gain chargebacks remains unaffected by the type of entity chosen. If the debt is truly nonrecourse to the entity, the assets available to satisfy the loan (which provide the backbone of the minimum gain calculations in the regulations governing allocations attributable to nonrecourse liabilities) will be determined by the contractual agreement between the lender and the entity and will not be affected by the presence or absence of limited liability protection to the participants. Moreover, if one or more of the partners or members bear the economic risk of loss for a nonrecourse liability (as defined by § 1.1001-2) of a general partnership, limited partnership, LLC or LLP, the partner nonrecourse debt allocation rules apply in the same manner regardless of the type of entity that incurred the liability. The contractual arrangements, rather than the presence or absence of limited

221. Treas. Reg. § 1.704-1(b)(2)(iii). *See supra* notes 132-37 (discussing transitory allocations) and *supra* notes 138-41 (discussing shifting character allocations). The general rules testing allocations for substantiality can apply and force a reallocation of the distributive shares even if the transitory and character shifting rules do not apply. *See supra* notes 128-29.

222. Treas. Reg. § 1.704-1(b)(2)(iii). *See supra* notes 138-41 (discussing shifting character allocations). The general rules testing allocations for substantiality can apply and force a reallocation of the distributive shares even if the character shifting rules do not apply. *See supra* notes 128-29.

liability protection that surrounds the partner or member making the loan or guaranteeing the entity's third party nonrecourse debt, determine who receives the allocations of losses and minimum gain under the partner nonrecourse debt rules.

If the unincorporated entity incurs liabilities meeting the definition of recourse under § 1.1001-2 (the entity as the borrower is personally liable), then the type of business organization chosen greatly affects how the § 704(b) regulations apply to the distributive shares. The presence or absence of limited liability protection serves as the pivotal characteristic that determines whether the substantial economic effect or the nonrecourse allocation regime applies. Under state law, all partners in general partnerships are personally liable for all debts for which the partnership bears personal liability.[223] In other words, the recourse nature of the liability to the partnership automatically passes through to the partners and renders them automatically personally liable for all recourse debts of the partnership by virtue of their status as general partners. These recourse obligations include not only traditional loans the partnership incurs from banks or other creditors, but also judgment claims of tort claimants.[224] Consequently, state law creates an automatic deficit restoration obligation for all general partners, with no set dollar amount.[225] The partners determine their ultimate contribution rights against each other based on the ratio in which they have agreed to bear losses.[226] If a partner guarantees the partnership's recourse liability, the standard subrogation rights, which allow the guarantor to proceed against the other partners based on the loss sharing ratio, prevent the guarantee from

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223. ALA. CODE § 10-8A-306(a) (1999); *see also id.* § 10-9B-403(a) ("Except as provided in this chapter or in the partnership agreement, a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners.").

224. *Id.* § 10-8A-306(a) ("[A]ll partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law.").

225. Treas. Reg. § 1.704-1(b)(2)(ii)(c) (as amended in 1997).

226. If the partners fail to agree to a ratio for bearing losses incurred by the partnership, the statutory default divides partnership losses in proportion to the partners' shares of profits. ALA. CODE § 10-8A-401(b) ("Each partner is entitled to an equal share of the partnership profits and, subject to the limitations in subsection (a)(2) of this section, is chargeable with a share of the partnership losses in proportion to the partner's share of the profits.").

shifting the economic burden to the guarantor, under both the economic effect safe harbor and the § 752 regulations.[227]

Under state law, only general partners of limited partnerships bear personal liability for all the partnership's recourse debts. Consequently, state law creates an automatic deficit restoration obligation with no set dollar amount only for the general partners of limited partnerships. Because limited partners enjoy the same limited liability protection as shareholders of corporations, limited partners have no automatic deficit restoration obligation imposed upon them as a matter of state law for the limited partnership's recourse liabilities.[228] Unless a limited partner contractually agrees to an obligation to restore a deficit capital account, or to another form of a payment obligation shifting the economic risk of loss for the recourse liability away from the general partner, only the general partner can receive distributive shares of losses attributable to the limited partnership's recourse liabilities. However, as long as the partners comply with the alternate test for economic effect, limited partners can receive distributive shares of losses attributable to the limited partnership's recourse liabilities without agreeing to an unlimited deficit restoration obligation.[229] If a limited part-

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227. *See id.* § 10-8A-401; Treas. Reg. §§ 1.704-1(b)(2)(ii)(c) (as amended in 1997) & 1.752-2 (1991).

228. ALA. CODE §§ 10-8A-306, 10-9B-403 ("Except as provided in this chapter or in the partnership agreement, a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners."). *Id.* § 10-9B-303(a).

> Except as provided in subsection (d), a limited partner is not liable for the obligations of a limited partnership unless he or she is also a general partner or, in addition to the exercise of his or her rights and powers as a limited partner, he or she participates in the control of the business. However, if the limited partner participates in the control of the business, he or she is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's participation in such control, that the limited partner is a general partner.

Id.

229. Normally, a limited partner will only agree to a deficit restoration obligation capped at a specific dollar amount—a limited deficit restoration obligation. A limited partner should never agree to an unlimited deficit restoration obligation. Such an agreement would remove the limited liability shield afforded a limited partner and create the same personal liability exposure of a general partner. Any time a limited partner receives a distributive share of losses, the partnership must comply with the alternate test even if the distributive share does not cause or create a deficit capital account (as would be the case if the limited partner's capital account equals at least

ner guarantees the partnership's recourse liability, the standard subrogation rights, which allow the guarantor to proceed against the general partner based on the general partner's personal liability under state law, prevent the guarantee from shifting the economic burden to the guarantor, under both the economic effect test and the § 752 regulations.[230]

B. Allocation Rules in the Context of LLCs and LLPs Incurring Recourse Liabilities

The limited liability protection accorded all members of LLCs and all partners of LLPs greatly affects how the partnership allocation rules apply when the LLC or the LLP incurs liabilities meeting the definition of recourse under § 1.1001-2. Despite the LLC's or LLP's personal liability as the borrower, by virtue of the limited liability protection provided by state law, no member or partner has personal liability exposure. Because no member or partner can be forced to make payments or contributions, absent an explicit contractual agreement, the § 752 regulations treat liabilities that are recourse to the LLC or LLP as nonrecourse for tax purposes.[231] Therefore, the rules governing allocations attributable to nonrecourse liabilities apply.[232] Practical difficulties can arise in the minimum gain calculations with respect to liabilities which are recourse to the LLC or LLP. When a LLC or LLP borrows on a recourse basis, under state law the creditor has the right to proceed against every asset the entity owns.[233] Because minimum gain calculations focus on the spread between the basis of assets available to satisfy the debt and the face of the debt, minimum gain with respect to

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zero or a positive number). Although the limited partner does not have to agree to a deficit restoration obligation in order to receive the loss (unless the expected debits to the capital account under § 1.704-1(b)(2)(ii)(d)(4)-(6) along with the distributive share of losses create a deficit capital account), the qualified income offset requirement of the alternate test ensures that no unexpected debits to the capital account (as contemplated by § 1.704-1(b)(2)(ii)(d)(4)-(6)) create a deficit capital account in the future that is not covered by a deficit restoration obligation. Treas. Reg. § 1.704-1(b)(2)(ii)(d).

230. *See supra* notes 223-25 and 228.

231. Treas. Reg. § 1.752-2 (1991).

232. *Id.* § 1.704-2(b)(3).

233. *See* ALA. CODE § 10-8A-307(d) (1999).

recourse debts of a LLC or LLP will literally fluctuate with the available cash flow that remains undistributed at the end of the taxable year. If the bases of all available assets exceed the face amount of the recourse liabilities (which can occur if the entity retains a significant amount of its cash flow), minimum gain will not increase, thus preventing the nonrecourse allocation rules from applying.

If a member of a LLC or partner of a LLP guarantees a liability that is recourse to the entity, the guarantee will shift the entire economic risk of loss to the guarantor. Although the LLC or LLP bears personal liability for payment on the debt, the limited liability shield enjoyed by all members or partners prevents that personal liability from passing through; therefore no subrogation rights against other members or partners exist for the guarantor to inherit. However, since the liability is recourse to the LLC or LLP under § 1.1001-2, the partner nonrecourse debt rules do not apply. Because the creditor has rights to proceed against all the assets of the entity, the mechanics of the partner nonrecourse debt rules are not needed to properly measure the amount of real loss potential that exists for allocation purposes with respect to the recourse liability. Under the substantial economic effect rules, the obligation to make payments pursuant to the guarantee will be treated as a limited obligation to restore a deficit capital account capable of supporting distributive shares of losses under the economic effect safe harbor. Income allocations that restore previous loss allocations must clear the substantiality rules, with the transitory allocation rules posing the most obvious hurdle. If members of LLCs or partners of LLPs make recourse loans to the entity, the allocations must be analyzed similarly under the substantial economic effect safe harbor, with the loan essentially being treated as a deemed obligation to restore a deficit capital account.[234]

At least at a practical level, from the perspective of the members of LLCs and the partners of LLPs, recourse versus nonrecourse liabilities to the entity are very similar on a sub-

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234. Because only equity contributions can increase a partner's capital account, the recourse loan made to the LLC or LLP must be analyzed as an obligation to restore a deficit capital account. If at a later time the LLC or LLP fails to pay the liability, the unpaid loan proceeds must be treated as an actual contribution made pursuant to the earlier obligation to restore a deficit capital account.

stantive level. With both types of liabilities, state law protects the members or partners from personal liability exposure. Both types of liabilities also require a member or partner either to provide the funds as the lender or to contractually agree to a payment or deficit restoration obligation in order to bear the economic risk of loss if the entity defaults on the loan.[235] Despite this strong substantive resemblance, if a member or partner makes the loan or contractually agrees to a payment or deficit restoration obligation, the partner nonrecourse debt rules apply to the distributive shares when the liability is nonrecourse to the LLC or LLP, while the substantial economic effect rules apply to the distributive shares when the liability is recourse to the LLC or LLP.

At the broadest level, the partner nonrecourse debt and the substantial economic effect rules often produce the same results—the member or partner who bears the economic risk of loss for the liability receives the corresponding losses and income allocations restoring those losses. Despite their similarities, material differences within the details of the substantial economic effect and the partner nonrecourse debt allocation regimes, especially when focusing on income allocations, can affect the partners or members. The partner nonrecourse debt rules require minimum gain chargeback allocations at the appropriate time determined by the timing of minimum gain decreases. On the other hand, the substantial economic effect rules permit income allocations restoring previous loss allocations, but only if the partners clear the substantiality rules, with the transitory rules being the most obvious hurdle.[236] Arguably, it is

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235. Of course from the entity's perspective, material differences exist between recourse and nonrecourse loans. Recourse lenders have the power to seize all of the entity's assets while nonrecourse lenders may only proceed against the assets identified as securing the loan in the loan agreement. These materially different consequences to the entity arguably spill over indirectly to the owners in that the entity's recourse loans made or guranteed by the member or partner offer more protection (all assets secure the loan) than similar nonrecourse loans (only limited assets secure the loan). Arguably, these differences do not justify the major tax distinctions between the partner nonrecourse debt and the substantial economic effect rules.

236. The mechanical rules for allocating losses under the partner nonrecourse debt and substantial economic effect rules contain major differences that often increase the complexity and confusion in an already difficult area. The partner nonrecourse debt rules segregate the different partner nonrecourse liabilities, conduct minimum gain calculations and label and allocate existing losses to the appropriate

inequitable and inefficient to apply two separate sets of rules, the partner nonrecourse debt and the substantial economic effect rules, based on the status of the debt as nonrecourse versus recourse to the LLC or LLP.

Unfortunately, the tax inefficiency resulting from different rules applying to substantively similar situations is not the only consequence of the substantial economic effect rules operating when LLC members or LLP partners bear the economic risk of loss for the entity's recourse debt. Because the partner nonrecourse debt rules cannot apply when a member or partner makes a recourse loan to a LLC or LLP and when a member or partner guarantees a recourse loan made to a LLC or LLP, the potential exists that illusory deficit restoration obligations can support distributive shares of losses from a LLC or LLP. If partners or members other than the lender or guarantor agree to deficit restoration obligations that are in fact illusory, because the lender or guarantor enjoys no capital account credit for his outlay of funds, arguably the current definition of obligation to restore a deficit capital account in the economic safe harbor treats the illusory obligation as a real obligation.[237] Because the LLC or LLP as the borrower bears personal liability, the partner nonrecourse debt rules do not apply and therefore cannot operate to ensure that the appropriate partner or member

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partner. The economic effect rules focus on the proper debiting of the capital account with a sufficient obligation to restore a deficit capital account if loss distributive shares create a deficit. Although substantively each regime focuses on the losses going to the appropriate partner, the partner nonrecourse debt rules require more complex calculations and impose more record keeping burdens.

237. *See supra* notes 203-09 and accompanying text (explanation of illusory deficit restoration obligations). The constructive liquidation process of the § 752 regulations triggers gain equal to the difference between the face of liabilities where payment is limited to one or more assets of the partnership and the basis of the assets available to satisfy the liabiliiesy. With LLCs and LLPs payment is always initially limited to one or more assets of the partnership (in this case all the assets of the partnership) even though under state law the liability is recourse to the LLC or LLP. If a member or partner makes a recourse loan to the LLC or LLP or guarantees the LLC's or LLP's recourse loan under circumstances where payment on the guarantee results in no capital account credit, payment is still limited to the assets of the LLC or LLP. Therefore a deficit restoration obligation agreed to by another member or partner is illusory because the gain triggered in the constructive liquidation process will eliminate the deficit restoration obligation thus ensuring that the member or partner will never be required to restore the deficit capital account. *See also* Hamill, *Final Regulations*, *supra* note 15, at 120-21.

receives the distributive shares of losses. If these illusory deficit restoration obligations can support distributive shares of losses under the economic effect safe harbor, LLCs and LLPs incurring recourse debt expose a major hole in the partner nonrecourse debt rules.[238]

The Service should amend the current regulations to address the tax inefficiency of two different sets of allocation rules applying to substantively similar situations and the more serious problem of illusory deficit restoration obligations potentially supporting distributive shares of losses when LLCs and LLPs incur recourse debt. To accomplish these twin goals, the definition of partner nonrecourse debt in § 1.704-2(b)(4) could be modified to include recourse liabilities incurred by LLCs, LLPs and any other unincorporated business organizations offering complete limited liability protection to all owners. The modified definition could change the initial trigger defining partner nonrecourse debt from the liability's status to the borrower under § 1.1001-2 to the liability's status with respect to the partners under state law. That would enlarge the definition of partner nonrecourse debt to potentially include liabilities where no partner initially bore the risk of loss due to the state law limited liability protection, despite the recourse nature of the debt to the entity.[239]

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238. The anti-abuse rule represents a separate line of attack for the Service. *See* Treas. Reg. § 1.701-2 (1991). Also § 704(d) will operate to suspend the loss if the member or partner agreeing to the illusory deficit restoration obligation needs a share of the LLC's or LLP's recourse debt in outside basis. *See supra* note 208.

239. The definition of partner nonrecourse debt in § 1.704-2(b)(4) could be modified to read: "Partner nonrecourse debt means any debt incurred by a partnership for which no partner bears the economic risk of loss under state law as a result of being a partner, but for which one or more partners does bear the economic risk of loss under § 1.752-2(b) via a contractual agreement or by being the source of the funds (i.e., is the creditor)." By focusing on the consequences to the partner under state law rather than to the entity, this definition initially renders all liabilities where state law protects the partners from personal liability (either because the liability is truly nonrecourse to the borrower or limited liability protects all partners) as eligible to be covered by the partner nonrecourse debt rules. This definition also carefully avoids including liabilities where state law automatically imposes personal liability on at least one partner (recourse liabilities incurred by general and limited partnerships) where the potential of illusory deficit restoration obligations does not exist. The reference to § 752's constructive liquidation process ensures that in fact a partner bears the economic risk of loss and appropriately identifies which partner receives the partner nonrecourse deductions.

Although enlarging the definition of partner nonrecourse debt to include all recourse liabilities incurred by unincorporated business organizations offering limited liability to all participants would improve the regulations by eliminating the potential of illusory deficit restoration obligations as well as the disparate treatment between recourse and nonrecourse loans in the context of LLCs and LLPs, this proposal could be criticized as an unnecessary extension of the partner nonrecourse debt rules. First, like all portions of the § 704(b) regulations this proposal creates more complexity in the name of stopping tax abuse at the expense of increasing the costs incurred by the average business to comply with the § 704(b) regulations. Moreover, the partner nonrecourse debt rules are not needed to measure how much real loss potential exists for allocation purposes when the entity as the borrower bears personal liability.

C. *A Broader Solution—Does § 704(b) Need the Partner Nonrecourse Debt Rules?*

As previously stated, the § 704(b) regulations created the partner nonrecourse debt allocation rules for two identifiable reasons. First, the partner nonrecourse debt rules ensure that the partnership allocates the proper amount of losses, through the measurement of real loss potential at the partnership level

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The following example illustrates how this definition works. Assume that X and Y form a LLP which purchases a single machine lathe using the proceeds from a $90,000 loan, which is recourse to the LLP, made by a third party lender. X guarantees the entire loan and Y agrees to a $45,000 limited deficit restoration obligation. The third party lender has a right to proceed directly against X in the event the LLP fails to pay back the loan, but X has no right to a capital account credit for any payments made pursuant to the guarantee. Under the proposed definition of partner nonrecourse debt the recourse loan made to the LLP meets the definition of partner nonrecourse debt with X bearing the entire economic risk of loss. The constructive liquidation process of the § 752 regulations disregards Y's deficit restoration obligation as illusory because X has no right to enforce that obligation due to the absence of a capital account credit for payment on the guarantee. Under the current definition of partner nonrecourse debt, the $90,000 recourse loan to the LLP is not covered by the definition. The substantial economic effect rules govern the distributive shares of losses and arguably Y's $45,000 illusory deficit restoration obligation can be used to support a distributive share of losses even though the constructive liquidation process of the § 752 regulations allocates the entire outside basis increase for the $90,000 liability to X. Professor Hamill credits Robert Plott and Thad Davis for providing the statutory language and the example in well written exam answers.

using the minimum gain calculations. Second, by using § 752's constructive liquidation process to define the appropriate partner to receive the losses, the partner nonrecourse debt rules prevent illusory deficit restoration obligations from supporting distributive shares of losses. Of these two goals, the potential of tax abusive allocation schemes through the use of illusory deficit restoration obligations probably poses more danger to the integrity of the tax system than imprecise measurements of losses at the partnership level. Two separate sets of regulatory requirements, the substantial economic effect and the partner nonrecourse debt rules, cover what amounts to, in the broadest sense, distributive shares of losses where partners bear an economic burden and the distributive shares of income restoring those losses. This duplicate coverage adds an enormous amount of complexity to an area that already enjoys the reputation as one of the most difficult in the income tax arena—partnership taxation generally and the § 704(b) allocation rules specifically.

Furthermore, the mechanical details of the partner nonrecourse debt rules do not always produce results consistent with their most important goals. The partner nonrecourse debt rules apply even when illusory deficit restoration obligations pose no threat and result in different rules applying to recourse and nonrecourse liabilities when members of LLCs or partners of LLPs contractually agree to bear the economic risk of loss for the entity's liability. Even more problematically, the partner nonrecourse debt rules leave open opportunity for LLC members and LLP partners to rely on illusory deficit restoration obligations in order to support distributive shares of losses when LLCs and LLPs incur recourse debt.

At the broadest level, the problems with the partner nonrecourse debt rules stem from the substantive difference between the two "triggers" of § 704(b) which are: (1) the state law definitions of recourse and nonrecourse in § 1.1001-2 and (2) the economic risk of loss analysis in § 752. Section 752 relies on the existence of a real economic burden, in substance, to the individual partners. Section 1.1001-2, however, bases its distinctions on the superficial form of the debt to borrower-entity, rather than the real substantive consequences of that debt to the members or partners. These substance and form differences clash when they are combined in the partner nonrecourse debt rules, which

effectively act as a hybrid between the substantial economic effect rules and the rules governing allocations attributable to nonrecourse liabilities. These differences stand out in the context of LLCs and LLPs, where globally little substantive difference exists at the member or partner level between state law defined recourse and nonrecourse debt. Because the bulk of the regulations under both §§ 752 and 704(b) were written before LLCs and LLPs gained national prominence, it is not surprising that the regulations fail to recognize the unique issues raised by these entities.[240]

If it were possible to eliminate the partner nonrecourse debt rules and cover all allocations related to liabilities where a partner bears the economic burden under the substantial economic effect rules, the § 704(b) regulations would become considerably more user friendly. This would simplify the § 704(b) regulations in a manner that follows § 752's regulatory example, which divides all partnership liabilities into two regimes—those liabilities where one or more partners bears the economic risk of loss and those liabilities where no partner bears the economic risk of loss. The best way to accomplish this goal would be to accompany a repeal of the partner nonrecourse debt rules with a change in the language of the substantial economic effect regime. The new language would require all legitimate deficit restoration obligations for economic effect purposes to be tied to the partner bearing the economic risk of loss under the § 752 regulations. In addition to vastly simplifying the § 704(b) regulations, this change would end the use of the partner nonrecourse debt rules when the threat of illusory deficit restoration obligations is not present. The modification would also eliminate the discrepancies caused by disparate treatment between the substantial economic effect and the partner nonrecourse debt rules when LLCs and LLPs incur recourse verus nonrecourse debt. More importantly, this change would prevent tax planners from exploiting the opportunity that arguably allows illusory deficit restoration obligations to support distributive shares of losses

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240. *See supra* notes 50-64 (discussing the historical trail of the § 704(b) regulations after the substantial economic effect standard was codified in 1976) and notes 69-77 (explaining the historical trail of the § 752 regulations). Professor Hamill credits Lisa Moss for articulating the analysis in this paragraph, much of which was taken word-for-word from her well written exam answer.

when LLCs and LLPs incur recourse debt.[241]

However, in order for these amendments to completely replace the partner nonrecourse debt rules, language would need to be added to the economic effect safe harbor to preserve the measurement scheme that now exists through the minimum gain calculations in the partner nonrecourse debt rules. Because the economic effect safe harbor measures the loss potential by referring to the partners' capital accounts with respect to all partnership assets in the aggregate, any elimination of the partner nonrecourse debt rules must be accompanied with a mechanism to measure how much real loss potential exists when partners face an economic burden for partnership liabilities where the assets in the aggregate cannot measure the risk. In other words, the substantial economic effect rules can be enlarged to include distributive shares of losses and income currently handled by the partner nonrecourse debt rules only if the amendment includes a "measurement mechanism" to determine how much real loss potential exists for liabilities that are nonrecourse to the entity.

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241. These changes could be made by (1) amending § 1.704-1(b)(2)(ii)(b)(3) to replace "unconditionally obligated to restore the amount of such deficit to the partnership" with "unconditionally obligated to make payments or contributions to the partnership liabilities, such obligation bearing the economic risk of loss for that liability, whereby such obligation would reduce a deficit balance if the partnership constructively liquidated, as set out under § 1.752-2"; (2) amending § 1.704-1(b)(2)(ii)(c) by adding: "For the purposes of partnership allocations under § 1.704, an obligation to restore a deficit balance must bear the economic risk of loss for that liability if the partnership constructively liquidated, as set out under § 1.752-2, in determining whether such obligation has economic effect"; and (3) amending § 1.704-1(b)(2)(ii)(d)(2) by replacing "is not obligated to restore the deficit balance in his capital account to the partnership or is obligated to restore only a limited dollar amount of such deficit balance" with

> is not obligated to make payments or contributions to the partnership liabilities, such obligation bearing the economic risk of loss for that liability, whereby such obligation would reduce a deficit balance if the partnership constructively liquidated, as set out under § 1.752-2, or is obligated to pay or contribute only a limited dollar amount of such partnership liabilities, whereby such limited obligation would reduce a deficit balance in proportion to the limited dollar amount if the partnership constructively liquidated, as set out under § 1.752-2.

Professor Hamill credits Eric Johnson for providing this statutory language in a well written exam answer.

V. CONCLUSION

The aggregate theory of taxing partnerships as flow-through entities, which dates back to the first modern income tax, created the need to account for the partnership's items of income, gain, loss, deduction and credit in the partners' distributive shares. The vast flexibility enjoyed by partners under state law to craft any economic arrangement for sharing profits and losses that they see fit explains why the partners have unlimited flexibility to share the partnship's items of income and loss for tax purposes in any ratio they choose. The ability of tax planners to use this flexibility to allocate the partnership's tax distributive shares in ways that further no legitimate business purpose other than to save taxes created the need to invent § 704(b) and its regulations. The § 704(b) regulations contain three different sets of allocation regimes that apply to distribute shares of taxable losses and income. The substantial economic effect safe harbor governs all allocations that carry the possibility of actual economic losses or income and essentially requires the tax distributive shares to mirror the partners' business deal. The nonrecourse debt allocation rules recognize that losses and deductions attributable to proceeds from nonrecourse liabilities cannot carry economic burdens or benefits. The separate regime for allocations attributable to nonrecourse liabilities provides a mechanical set of rules that measure the existence and timing of losses and income that carry no economic benefits or burdens and then sets up a safe harbor for allocating their distributive shares. Partners enjoy a great deal of flexibility to allocate losses attributable to nonrecourse debt under ratios designed loosely to mirror allocations of losses and income that do carry economic consequences. The minimum gain chargeback requirement ensures that the appropriate partners who received nonrecourse deductions restore those deductions with phantom gain.

The partner nonrecourse debt allocation rules set up a third parallel regime to operate alongside the nonrecourse debt allocation rules to cover losses and income attributable to nonrecourse liabilities at the partnership level where a partner nevertheless bears the economic risk of loss due to external contractual circumstances. The partner nonrecourse debt rules are needed to ensure that the proper partner receives the appropriate amount

of losses. The current economic effect language does not guarantee that the appropriate partner will receive the distributable share of losses because the safe harbor arguably treats all obligations to restore as valid to support a deficit capital account, even if the obligation is illusory due to the presence of minimum gain. The current economic effect language contains no mechanisms to measure the proper amount of losses at the partnership level when the creditor cannot proceed against all the assets of the partnership. The partner nonrecourse debt rules, by rigidly requiring separate minimum gain calculations for each partnership nonrecourse liability and using the § 752 constructive liquidation process to identify which partner bears the economic risk of loss, properly measure the losses at the partnership level and ensure that the proper partner receives the tax losses, known as partner nonrecourse debt deductions.

In addition to adding enormous complexity to the § 704(b) regulations, the partner nonrecourse debt rules do not work perfectly. Many liabilities (for example, guarantees of partnership nonrecourse liabilities that carry rights to a capital account credit) are covered by the partner nonrecourse debt rules even though no potential exists for another partner to receive losses through an illusory obligation to restore a deficit capital account. Even more disturbing, the definition of partner nonrecourse debt fails to cover liabilities that are recourse to a LLC or LLP, even though the potential for loss allocations supported by illusory deficit restoration obligations exists under the economic effect safe harbor. If a member or partner guarantees a LLC's or LLP's recourse liability under circumstances where no capital account rights exist (or if a member or partner makes a recourse loan to the LLC or LLP), the economic effect safe harbor can literally be invoked to legitimize a deficit restoration obligation of a non-guarantor (or a non-lender), despite the absence of any means to enforce the obligation. If the partner nonrecourse debt rules were amended to cover all liabilities where state law protects the members or partners from bearing personal liability, the non-guarantor (or non-lender) would not only be denied an outside basis increase, but would also not be able to receive losses under the partner nonrecourse debt rules.

To simplify the three regimes that currently govern allocations, while making sure that distributive shares of losses al-

ways carry a potential economic burden if one exists, the Treasury could attempt to eliminate the partner nonrecourse debt rules by revising the definition of obligation to restore under the economic effect safe harbor to provide a direct coordination with the constructive liquidation process of § 752. Linking § 704(b)'s definition of a valid deficit restoration obligation with § 752's constructive liquidation test for economic risk of loss would ensure that only legitimate payment obligations are respected under the economic effect safe harbor and would further ensure that only partners with legitimate payment obligations receive loss allocations. Because illusory deficit restoration obligations would no longer be recognized as valid obligations to restore, there would be no need for the partner nonrecourse debt rules to cover the many situations where illusory deficit restoration obligations can inappropriately shift losses. More importantly, an amendment that directly links the § 752 constructive liquidation process to the definition of obligation to restore under the economic effect safe harbor would render ineffective illusory deficit restoration obligations that now can inappropriately shift losses when LLCs or LLPs incur recourse obligations.

Although revising the definition of obligation to restore to directly refer to § 752's definition of risk of loss could easily be accomplished, the partner nonrecourse debt rules still cannot be eliminated without dealing with the measurement of loss problem. The economic effect safe harbor currently measures the partnership's loss potential by referring to the partners' capital accounts with respect to all the partnership's assets in the aggregate. As long as the partnership's cash and assets consist of equity, and debt for which the partnership bears personal liability, a measurement scheme that aggregates all assets as having the same potential to produce partnership losses properly measures the losses. Losses from liabilities where the partnership bears no personal liability cannot properly be measured at the partnership level without a measurement scheme that examines the individual liability and the basis of any assets serving as collateral. The partner nonrecourse debt rules properly measure the partnership's losses before allocating them to the appropriate partner. Any elimination of the partner nonrecourse debt rule must be accompanied by revisions to the economic effect safe harbor that incorporates this measurement scheme.