ECONOMIC REALITY OR REGULATORY GAME PLAYING?: THE TOO MANY FICTIONS OF THE § 752 LIABILITY ALLOCATION REGULATIONS

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I. INTRODUCTION

Hyperlexis—the incapacitation of our society by the prolifera-

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tion and increasing complexity of laws, regulations, cases, and commentaries[1]—has captured the attention of income tax commentators. The reason is simple. Some tax laws and regulations are so elaborate and technical that only a handful of specialists can apply them, making widespread voluntary compliance impossible.[2] Critics have decried several regulations, including the § 704 partnership special allocation regulations and the § 752 partnership liability allocation regulations, as contributing to our nation's hyperlexis.[3]

In contrast to articles that call merely for less confusing regulations, this Article does more than just condemn the regulations. The Article examines the § 752 partnership liability allocation regulations, identifies the regulations' conceptual and administrative flaws, and then offers a simplified, more understandable approach to the allocation of partnership liabilities.

As background, I began researching the § 752 regulations, first the temporary regulations, and then the final regulations, in anticipation of teaching a Partnership Tax class. My frustration at not grasping the rationale for the regulations' underlying assumptions, and an intuitive but inarticulable feeling that something about the regulations was amiss, pushed me to analyze the regulations' assumptions and fictions. From that analysis came this Article's recommendations.

My polestar was to balance precision with comprehension. Income tax laws and regulations of necessity entail some complexities.[4] As a working premise, the tax laws and regulations should be understandable by those persons required to use them in their reg-

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1 *See* Bayless Manning, *Hyperlexis: Our National Disease*, 71 Nw U. L. REV. 767, 767 (1977).

2 *See generally* Gordon D. Henderson, *Controlling Hyperlexis—The Most Important "Law and . . .,"* 43 TAX LAW. 177 (1989); Bayless Manning, *Hyperlexis and the Law of Conservation of Ambiguity: Thoughts on Section 385*, 36 TAX LAW. 9 (1982) [hereinafter, *Law of Conservation*]; Manning, *supra* note 1, at 773.

3 *See, e.g.*, *Law of Conservation*, *supra* note 2, at 15 (describing the 110 single-spaced pages of proposed § 385 regulations as a "fungus of regulations"); Henderson, *supra* note 2, at 198 (recommending simplification for the complicated §704(b) partnership special allocation regulations and the § 752 partnership liability allocation regulations); Richard M. Lipton, *"We Have Met the Enemy and He Is Us": More Thoughts on Hyperlexis*, 47 TAX LAW. 1, 3-6 (1993) (blaming lengthy § 469, § 338, and § 382 regulations partly on practitioners' demands for guidance); John A. Miller, *Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation*, 68 WASH. L. REV. 1, 17-20 (1993) (detailing the development of regulations defining 'activity' for the § 469 passive activity rules).

4 *See* Boris I. Bittker, *Tax Reform and Tax Simplification*, 29 U. MIAMI L. REV. 1, 2 (1974).

ular activities or should at least be understandable by their tax advisors.[5] The more sophisticated the taxpayers affected, the more tolerable are more complex regulations. The rules of more general application, on the other hand, should be more basic and understandable by the general population.[6] Precision may justify complexity, of course, but not if the costs of complexity exceed the benefits of precision. Given a choice of two solutions having equal precision, the more easily understood alternative is preferred.

The partnership tax rules apply to business persons who are more sophisticated than most taxpayers and who usually engage the services of attorneys, accountants, and other persons trained in tax law. Some complexity, therefore, is acceptable. The complications, however, must be no greater than those that are comprehendible by those legal and tax advisors. The § 752 partnership liability allocation regulations fail miserably against this standard. Professor Howard E. Abrams, for example, in his concluding paragraph criticizing the temporary regulations, wrote:

> Quite simply, the temporary regulations cannot be understood. They cannot be understood by the revenue agents who will be charged with enforcing them, by the citizens who wish to abide by them, or even by the tax experts who will be hired to interpret them.[7]

N. Jerold Cohen, a respected tax practitioner,[8] recently wrote that the complexity of the § 704 and § 752 rules caused him to enlist an expert for assistance in the area.[9]

These are not unusual or surprising responses to the regulations. It is too easy to err when working with the regulations. Not only is understanding the artificiality of the regulations themselves fraught

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5 Martin J. McMahon, Jr., *Reflections on the Regulation Process: 'Do the Regulations Have to be Complex' or 'Is Hyperlexis the Manna of the Tax Bar?'*, 51 TAX NOTES 1441, 1442-43 (1991).

6 Bittker, *supra* note 4, at 5-7.

7 *See, e.g.*, Howard E. Abrams, *Long-Awaited Regulations Under Section 752 Provide Wrong Answers*, 44 TAX L. REV. 627, 640 (1989). The Treasury has shortened and improved the final regulations. The final regulations, however, remain too complex.

8 *Martindale-Hubbell* lists as some of N. Jerold Cohen's accomplishments graduating *magna cum laude* from Harvard Law School where he was Book Review editor for the *Harvard Law Review*; Chief Counsel of the Internal Revenue Service (1979-81); Adjunct Professor at Emory University School of Law; Member, American Law Institute; Fellow, American College of Tax Counsel; and Vice-Chair, ABA Section of Taxation. If Mr. Cohen finds § 752 regulations intimidating, the average tax practitioner, partnership specialist, real estate attorney, or other practitioner understandably could feel uneasiness with the regulations.

9 N. Jerold Cohen, *It Always Looks Better When You Look Back, in Tax Lawyering: A Changing Profession - A Modest Collection of Short Essays*, 46 TAX LAW. 665, 684 (1993).

with error potential, but the regulations demand such concentration that secondary errors easily occur.

While researching this subject, I found errors in several publications. Errors occurred in student, law professor, practicing attorney, and state bar authored articles.[10] For example, one writer allocated a recourse note guaranteed by a limited partner to the limited partner when the regulations definitively allocate the entire liability to the general partner.[11] Another writer tried to use the deficit account restoration provision to allocate a nonrecourse note to one general partner, even though the other general partner guaranteed the nonrecourse note.[12] In another, the writer tried to increase the basis of transferred property when the transferring partner satisfied a partnership liability the partner had agreed to pay. Finally, a state bar section on taxation, in illustrating nonrecourse liability allocation, miscalculated the liability allocation.[13] Significantly, these oversights occurred in examples far simpler than those experienced in everyday business situations.

On its face, § 752 is straightforward. The section merely equates changes in a partner's liabilities or her share of the partnership's liabilities with money being contributed by or distributed to the part-

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10 The author has chosen not to identify individual writers. The author practiced tax work as a CPA for three years before law school and as an attorney for five years after law school, taught taxation for six years in law schools, and spent several months researching § 752. He is getting better at finding errors but would be reluctant to guarantee the accuracy of any complex analysis under the regulations. The errors noted in text are unfortunate, but understandable.

11 Treas. Reg. § 1.752-2(f) ex. 3 & ex. 4 (1991). The author's explanation would be correct if the note was nonrecourse rather than recourse.

12 The writer posited a general partnership incurring a nonrecourse note, but where general partner *Y* guaranteed the debt. Losses were allocated 90% to *X* and only 10% to *Y*, however. The writer erroneously tried to override the nonrecourse note terms by resorting to *X*'s obligation to restore a deficit capital account. Thus, the writer allocated the full nonrecourse note to *X* when the temporary regulations allocated the nonrecourse debt to *Y*, the partner who guaranteed the debt without any right to reimbursement. Temp. Treas. Reg. § 1.752-1T(d)(3)(ii)(B)(4)(ii)(B) (1993); Temp. Treas. Reg. § 1.752-1T(k) ex. 13(iii) (as amended 1989) (repealed 1991); *see also* 1 WILLIAM S. MCKEE, ET AL., FEDERAL TAXATION OF PARTNERSHIP AND PARTNERS 8-41 to 8-44 (2d ed. 1990) (and common sense if common sense is allowed in allocating partnership debt).

13 In its example, the article posited a partnership with a $100,000 nonrecourse liability. First year depreciation of $10,000 was allocated 99% to *A* and 1% to *B*. All other gains and losses were allocated 50-50 except for minimum gain chargebacks. The article correctly noted that the obligation is initially allocated at $50,000 to each partner. But one year later, instead of allocating the liability $54,900 to *A* and $45,100 to *B*, the article allocated $59,900 to *A* and $40,100 to *B*. Without knowing for sure, I am guessing the reason for the error is that the authors of the article were so intent on exploring another aspect of the regulations and its relationship with other sections that they overlooked the workings of § 704.

ner.[14] The tax effects of these changes in liabilities then depend on other sections.[15]

One of these tax effects is to increase a partner's basis in her partnership interest.[16] The general rule for determining basis enacted in 1954, and that still maintains today, emphasizes an individual partner approach, allocating contributions to capital accounts, partnership distributions, profits and losses, and the partner's share of the partnership liabilities.[17]

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14 I.R.C. § 752(a)-(b) (1988).

15 *See* 1 ARTHUR B. WILLIS, ET AL., PARTNERSHIP TAXATION § 61.01 (4th ed. 1990). Section 722 on its face seems to increase a partner's basis for money contributed only when the contribution is to acquire a partnership interest and not for any money transactions subsequent to an acquisition and probably not for a mere borrowing by the partnership that does not affect any partner's interest in the partnership. Moreover, § 705 provides only for a decrease in the partner's basis for distributions, and omits any reference to increases in the partner's basis for contributions. Nonetheless, the legislative history indicates that Congress thought that § 705 authorized the adjustment. S. REP. No. 1622, 83d Cong., 2d Sess. 384 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4623, 5025-26 (the unadjusted basis determined under section 722 and 742 "is to be increased by any further contributions"). It has been commonly accepted that any change in a partner's share of the partnership liabilities increases or decreases the partner's basis in his partnership interest. *See, e.g.*, Jackson v. Commissioner, 42 Tax Ct. Mem. Dec. (CCH) 1413, 1418 (1981) (interpreting I.R.C. § 722 as increasing basis for all contributions, not just when a partner acquires an interest); MCKEE, *supra* note 12, ¶ 6.03; J. Martin Burke & Michael K. Friel, *Allocating Partnership Liabilities*, 41 TAX L. REV. 173, 174 (1986). Although subchapter K could function consistently if interpreted strictly as drafted, it is more likely at this late date that Congress would amend the section to provide for nonacquisition contributions increasing basis. This Article assumes the current interpretation of the effect of the partnership's incurring or retiring debt, as affecting basis, will continue unless Congress specifically legislates to the contrary.

16 Treas. Reg. § 1.722-1 (1960).

17 *See* I.R.C. §§ 705, 722, & 742 (1988). The partner's original basis also is increased by any gain recognized for certain transfers to investment companies. *Id.* § 722; *see also id.* § 721.

Despite today's common acceptance of the importance of a partner's basis, the 1939 Code did not contain a definition for a partner's basis in his partnership interest. In 1954 members of the American Law Institute wrote that a partner's basis was necessary to compute "gain or loss on his retirement from the partnership, on a dissolution of the partnership, or on the sale of his interest in the partnership." J. Paul Jackson et al., *A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners-American Law Institute Draft*, 9 TAX L. REV. 109, 118 (1954). Not until 1950 did the Commissioner acknowledge that a sale of a partnership interest was the sale of the partnership interest as an asset rather than the sale of the partner's pro-rata share of the partnership's underlying assets, Gen. Couns. Mem. 26,379 (1950) (revoking Gen. Couns. Mem. 10,092, XI-1 C.B. 114 (1932)), although courts and commentators had recognized a partnership interest as a capital asset. Even in 1954, however, the ALI members did not recognize any need to know a partner's basis in his partnership interest for loss limitations or for taxation of nonliquidating cash distributions.

The American Law Institute proposed that any new partnership tax provisions in the 1954 Code allocate to each partner as his basis in his partnership interest the partner's share of the partnership's aggregate tax basis. Jackson, *supra*, at 118. The

A major consequence of liabilities increasing the basis of a partner's interest in the partnership is that a partner's basis establishes the maximum amount of losses and deductions a partner may deduct[18] and also the maximum amount of nontaxable cash distributions a partner may receive from the partnership.[19] In fact, a liability's increasing a partner's basis, thereby increasing the amount of tax losses and deductions the partner recognizes from the partnership, served as a foundation stone for most tax shelter investments.[20]

ALI proposal would not have considered or adjusted for any partnership liabilities. Intriguingly, the ALI favored a transference of basis to equalize each partner's basis in the partnership's assets. Thus, where *A* transfers land into the partnership with a basis of $100,000 and *B* transfers land with a basis of $20,000 (assuming both parcels are valued at $100,000 and the partners are equal partners) each partner would have a basis in his partnership interest of $60,000. *See id.* at 127-29. The ABA also proposed a shift or transference of basis on contributed property. *The Internal Revenue Code of 1954: Hearings on H.R. 8300 Before the Senate Comm. on Finance*, 83d Cong., pt. 1, 2d Sess. 463 (1954) (setting forth the ABA's recommendation).

Congress adopted a form of the ALI's proposals on partner's basis as an alternative rule in circumstance where it is impracticable to use the general rule. I.R.C. § 705(b) (1988). Even there, however, Congress rejected the transference or shifting of basis approach. The committee reports stressed that a partner who avails himself of the alternative rule for calculating basis must make adjustments, to yield substantially the same result as the general rule of § 705(a), to reflect any discrepancy in the basis of his partnership interest as a result of contributed property, transfers of partnership interests, or distributions of property in kind to the partners. S. REP. No. 1622, *supra* note 15, at 5026. The regulations for the alternative rule generally track the committee reports. Treas. Reg. § 1.705-1(b) (1957).

18 I.R.C. §704(d) (1988).

19 *Id.* § 731(a).

20 Boris I. Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case*, 33 TAX L. REV. 277, 283 (1978). Increasing basis via debt serves two separate tax functions in tax shelters. First, the partnership incurs debt in the purchase of depreciable or depletable assets such as buildings, equipment, films, or oil leases. The debt forms part of the purchased asset's basis, which is subject to depreciation or depletion, thereby creating deductions for the partnership without cash outlay. Thus, for example, partners can purchase a $1,000,000 building by contributing $100,000 cash and financing the remaining $900,000 by issuing a note. The partnership then depreciates the building based on its one million dollar purchase price (less any amount allocated to the underlying land) and not just the $100,000 cash outlay, and passes the depreciation through to the partners.

Second, and more relevant to this Article, the partners deduct the depreciation even when the cumulative depreciation deductions exceed their cash contributions because each partner's proportionate share of the debt increases his adjusted basis in the partnership. Because losses are allowed as long as the losses do not reduce the partner's adjusted basis to zero, I.R.C. § 704(d) (1988), partners take deductions on their tax returns in excess of their cash outlays.

This result must be contrasted with the same scenario occurring in an S corporation. The S corporation, like the partnership, increases the basis of the purchased asset by the amount of debt financing and thereby increases its depreciation deduction. Unlike the partnership scenario, however, the S corporation shareholder cannot add his proportionate share of the corporation's debts to the basis of his interest in the corporation. Therefore, the S corporation shareholder's losses are limited to

Section 752 comprises four subsections. The first subsection provides that any increase in a partner's share of the partnership's liabilities or, in the more obvious situation, any assumption by a partner of a partnership liability, shall be considered a contribution of money to the partnership.[21] The second subsection treats any decrease in a partner's share of the partnership liabilities or any assumption by the partnership of a partner's individual liabilities as a distribution of money to the partner by the partnership.[22] A third subsection provides that liabilities in the case of a sale or exchange of a partnership interest shall be treated in the same manner as liabilities in connection with the sale or exchange of any other property.[23] Finally, § 752(c) provides that the owner of property subject to a debt shall be considered the person responsible for the liability to the extent of the fair market value of the property.[24]

Believing the rules for sharing partnership liabilities under the § 752 regulations then in effect were outdated and required revision,[25] Congress in 1984 charged the Secretary of the Treasury with the task of prescribing new regulations to allocate liabilities to the respective partners' basis under § 752 of the Internal Revenue Code.[26] Treasury pronouncements and judicial opinions had so distorted the former liability allocation regulations[27] that a fresh start was needed.

The Treasury issued temporary § 752 regulations in December 1988,[28] amended these regulations in November 1989,[29] and issued final regulations in December 1991.[30] Several commentators responded favorably to the temporary regulations as providing more certainty to the debt allocation process than did the old regulations.[31]

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his contributions to the corporation. *See also* William S. McKee et al., *The Tax Reform Act of 1976: Changes Affecting the Taxation of Partnerships and Partners*, 33 TAX L. REV. 485, 492-98 (1978) (discussing at risk limitations as applied to tax shelter activities).

21 I.R.C. § 752(a) (1988).

22 *Id.* § 752(b).

23 *Id.* § 752(d).

24 *Id.* § 752(c).

25 *Id.*

26 Deficit Reduction Act of 1984, Pub. L. 98-369, § 79, 98 Stat. 494, 597 (1984).

27 *See* Brown v. Commissioner, 40 Tax Ct. Mem. Dec. (CCH) 725 (1980); Block v. Commissioner, 41 Tax Ct. Mem. Dec. (CCH) 546, 552 (1980); Raphan v. Commissioner, 3 Cl. Ct. 457, *rev'd on this issue*, 759 F.2d 879 (Fed. Cir. 1985); Rev. Rul. 69-223, 1969-1 C.B. 184; Rev. Rul. 83-151, 1983-2 C.B. 105; Priv. Ltr. Rul. 8404012 (October 13, 1983).

28 T.D. 8237, 1989-1 C.B. 180.

29 T.D. 8274, 1989-2 C.B. 101.

30 T.D. 8380, 1992-1 C.B. 218. The regulations, slightly modified, had been released as Proposed Regulations on July 26, 1991. *Id.*

31 MCKEE, *supra* note 12, ¶ 8.01[1], at 8-3 (new regulations "provide a framework that is both theoretically sound and sufficiently comprehensive to resolve clearly most

Other writers criticized the new temporary regulations.[32] Most commentators, however, both supporters and detractors, lamented the temporary regulations' length and complexity,[33] and the absence of an explicit articulation of the regulations' underlying principles.[34] The Treasury, in response to criticisms that the temporary regulations were too long and complex, shortened the final regulations. Few substantive changes occurred, however, and the temporary regulations may in fact become the unofficial guide in interpreting sophisticated financial arrangements. What the Treasury failed to do in simplifying the final regulations was to eliminate the confusing nature of the analysis.[35]

This Article proposes simpler and, in many cases, more realistic alternatives to the § 752 partnership liabilities allocation regulations. Part II analyzes the underlying premises and fictions of the regulations in allocating recourse liabilities. Part III explains the general contours of two proposed alternatives—Pure Passthrough and Zero Value—emphasizing the effects on recourse liability allocation. The primary points of disagreement concern whether the regulations should allocate partnership liabilities based on the partnership's debt or on the more encompassing partners' obligations; whether the partnership assets should be deemed to have value or be deemed worthless; whether the constructive liquidation process is necessary at all; and whether the deficit account restoration procedure harms or benefits the allocation process. Part IV evaluates the regulations' chief components in search of a simpler, even more economically realistic, approach for allocating nonrecourse liabilities. That part will evaluate guarantees and other outside arrangements, the partnership minimum gain allocations, and the § 704(c) gain allocations.

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of the issues that were left open by the Old Regulations"); Stephen L. Millman, *A Critical Analysis of the New Section 752 Regulations*, 43 TAX LAW. 1, 32 (new regulations "apply a consistent set of principles. The regulations, therefore, reach an appropriate result in the vast majority of instances."); Richard E. Levine et al., *A Practical Guide to the Section 752 Temp. Regs.-Part II*, 70 J. TAX'N 260, 268 (1989) ("The 752 and 704 Regulations provide long-awaited answers to questions that have troubled tax advisors both before and after DRA. There finally is consistency between the basis rules of Section 752 and the tax allocation rules of Section 704(b).").

32 Abrams, *supra* note 7, at 640.

33 MCKEE, *supra* note 12, ¶ 8.01[17].

34 Millman, *supra* note 31, at 32; New York State Bar Assoc. Section on Taxation, Comm. on Partnerships, *Allocation of Debt Regulations*, 45 TAX NOTES 1113, 1114 (1989).

35 The substance of the regulations are explained in the relevant parts of this Article.

II. Reality and Fiction in Allocating Recourse Liabilities

A. *Liabilities, Debts, and Obligations*

This part evaluates the current regulations' allocation of recourse liabilities. First, this part criticizes the terminology and definitional aspects of the regulations. Subparts B and C explore the fictions inherent in the regulations' constructive liquidation procedure and criticizes the misguided deficit account restoration fiction fundamental to the current regulations.

The current regulations develop a methodical approach that can be learned, even if not mastered or understood. Grasping the approach is difficult initially because the regulations develop as a series of definitions, and the regulations do not always make clear which phrases are to be defined in the regulations and which are used in their ordinary sense, or which words have precise meanings within the regulations or which words are interchangeable.[36] For example, debt, obligation, and liability are not interchangeable under the regulations, and a nonrecourse debt easily could be allocated as a recourse liability rather than as a nonrecourse liability. "Debts" include loans, notes, and other partnership payables and is synonymous with the common understanding of debt or liability.

"Liability" has two meanings. First, and not pertinent to the immediate discussion, a liability is a debt that is recognized currently for tax purposes as either a deduction or a capitalizable expenditure at the partnership level, or that is neither deductible nor capitalizable.[37] More germane to the current discussion, the term "liability" preceded by the adjective "recourse" or "nonrecourse"

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36 For example, in its attempt to tie the regulations into the legislative history's emphasis on economic risk of loss, the regulations begin the allocation of recourse liabilities by a general rule that allocates recourse liabilities to the partner who "bears the economic risk of loss." Treas. Reg. § 1.752-2(a) (1991). The regulations' next sentence then defines the extent a partner bears the economic risk of loss by reference to the constructive liquidation rules. Because the economic risk-of-loss concept is used in this context and as a conclusion in the examples, it really does not need to be mentioned in the regulations at all. Its inclusion seems justified only as an attempt to add credence to the constructive liquidation process, which, as discussed later, is mired in so many fictions that economic risk of loss becomes a misnomer.

37 Temp. Treas. Reg. § 1.752-1T(g) (1991) (removed by T.D. 8380, 1992-1 C.B 218). The Temporary Regulations detailed what qualifies as a partnership liability for purposes of § 752, emphasizing that the incurring of liability gives rise to the basis of an asset, a taxable deduction, or a nondeductible, noncapitalizable expenditure. *Id.* § 1.752-1T(g)(1)-(3). A lengthy discussion about what constitutes a partnership liability, initially intended for this Article, has been deleted because the discussion would detract from the main focus of this Article: the unnecessary complexity of the current regulations. Under either approach, what constitutes a partnership liability will remain an issue.

denotes the extent of the partnership's, its partners', or related persons' responsibility for satisfying or not satisfying a debt with nonpartnership assets. It is not the debt itself, but the partnership's, partners', or related persons' responsibility to pay the debt, loan, or payable. Most partnership debts will result in some partnership liabilities.

"Obligation" refers to a partner's or related person's responsibility to make a payment, reduced by the amount of reimbursement for which the partner or related person is entitled from another partner.[38] The sum of the partners' obligations will equal the partnership's recourse liabilities.[39] Partnership liabilities for which no partner or related person has an obligation to make a payment are labelled nonrecourse liabilities.[40] The regulations never explicitly explain these differences in terminology.

As an illustration of the differences, in Example 14 of the Temporary Regulations a two-partner limited partnership secured a nonrecourse loan from a bank, and granted the bank a mortgage on rental property. The general partner guaranteed the note.[41] Although the note was a nonrecourse note, the liability was a recourse liability because the general partner was obligated to pay the bank.[42] Since under the temporary regulations the partner who was "obligated" to make a "net payment" was deemed to bear the "economic risk of loss" for the amount of his obligation to pay,[43] the general partner who guaranteed the note was deemed to bear the economic risk of loss for the full amount of the nonre-

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38 *See, e.g.*, Treas. Reg. § 1.752-2(b)(1) & (b)(5) (1991) (discussing a partner's obligation to make a payment).

39 *Compare id.* § 1.752-1(a)(1) ("A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability under § 1.752-2.") *with id.* § 1.752-2(b)(1) ("[A] partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated the partner . . . would be obligated to make a payment to any person . . . because that liability becomes due and payable and the partner . . . would not be entitled to reimbursement").

40 *Compare id.* § 1.752-1(a)(2) ("A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability under § 1.752-2.") *with id.* § 1.752-2(b)(1) ("[A] partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated the partner . . . would be obligated to make a payment to any person . . . because that liability becomes due and payable and the partner . . . would not be entitled to reimbursement").

41 Temp. Treas. Reg. § 1.752-1T(k) ex. 14 (as amended in 1989) (referencing Temp. Treas. Reg. § 1.752-1T(d)(1) & (2)).

42 *See id.*

43 Temp. Treas. Reg. § 1.752-1T(d)(3)(A)(1) (as amended in 1989). The quoted words have particular meanings in the regulations.

course note. The limited partner was not allocated any part of the nonrecourse note because he had no obligation personally to pay any part of the note.[44] The general partner's guarantee of the entire nonrecourse note transformed what was initially a nonrecourse debt into a recourse liability.[45] The general partner, therefore, was allocated the entire amount of the liability associated with the note.[46]

To continue the illustration, the limited partner in Example 14 entered into an indemnification agreement agreeing to reimburse the general partner for fifty percent of any payment that the general partner was required to make pursuant to the guarantee.[47] The regulations assumed the limited partner would reimburse the general partner after the general partner paid the creditor.[48] Thus, the general and limited partner each would be "obligated" to make a "net payment" of fifty percent of the nonrecourse note amount, so that each would "bear the economic risk" of half of the partnership liability.[49] Accordingly, the nonrecourse note was a recourse liability.[50] Fifty percent of the liability was allocated to each partner.

Precise use of the terms is laudable, especially designating 'obligations' to refer to the partners' legal duty to pay extra money or not to be reimbursed for any payment made. Unfortunately, labelling such as "recourse liabilities" and "nonrecourse liabilities" to contrast with recourse debt and nonrecourse debt is unnecessarily confusing, especially since the regulations do not delineate the distinction with any specificity.[51] If the Treasury retains its current approach to allocating partnership liabilities, the Treasury, in the regulations, should articulate that the nature of the debt instru-

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[44] Temp. Treas. Reg. § 1.752-1T(a)(2)(i) (as amended in 1989) (removed in 1991). *See* Treas. Reg. § 1.752-3(a)(3) (1993).

[45] *See* Temp. Treas. Reg. § 1.752-1T(a)(1)(iii) (as amended 1989) (explaining that "a partner bears the economic risk of loss for a partnership liability to the extent that the partner . . . would bear the economic burden of discharging the obligation represented by that liability if the partnership were unable to do so.").

[46] Temp. Treas. Reg. § 1.752-1T(a)(1)(i) (as amended 1989). The regulations in this situation duplicated the approach and result of Revenue Ruling 83-151. Rev. Rul. 83-151 is discussed *supra*, note 27, and accompanying text.

[47] Temp. Treas. Reg. § 1.752-1T(k) ex. 14 (1991).

[48] *Id.*

[49] *Id.*

[50] *Id.*

[51] The differences between "obligations," "liabilities," and "debt," and the manner in which nonrecourse debt could be a recourse liability, and vice versa, were addressed above. *See supra* notes 36-50 and accompanying text.

ment on its face as recourse or nonrecourse is not conclusive as to how the underlying liability is to be shared for purposes of § 752.

More critically, the regulations should abandon the current emphasis on the vague 'liabilities' concept and reinstate the emphasis on the specific "debt" to be allocated. The Treasury's mistake was basing the allocation of partnership liabilities on its currently formulated liability concept first rather than anchoring its analysis on the partnership debts themselves. The regulations' reliance on recourse liability and nonrecourse liability, for example, portends a separate analysis for recourse liabilities than will be applied for nonrecourse liabilities. Yet that is not the case. Although the regulations purport to allocate recourse liabilities and nonrecourse liabilities in different sections,[52] the determination of a partner's share of a liability can be ascertained only after a review of the partnership's total financial situation, including rights and obligations under the partnership agreement and under state law.[53] The allocation of "nonrecourse liabilities" merely entails the final steps in the liability allocation process that includes allocation of all partnership liabilities rather than an allocation of clearly separate categories of debt.

In summary, relying on the terms "recourse liabilities" and "nonrecourse liabilities" as demarcating independent sections of the regulations misleads readers into thinking they can, and must, determine if they are allocating a recourse or nonrecourse liability so they can apply the proper subsection of the regulations. Furthermore, use of the terms misleads readers into believing they should be able to allocate a recourse or nonrecourse liability independent of the partnership's total financial posture. Finally, the terms mislead readers into thinking that the regulations allocating nonrecourse liabilities are independent of the regulations allocating recourse liabilities. This Article's proposals favor doing exactly what the current regulations misleads readers into believing it is doing: allocating recourse debts and nonrecourse debts independently.[54]

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52 Treas. Reg. § 1.752-2 (1991) (Partner's share of recourse liabilities); *id.* § 1.752-3 (Partner's share of nonrecourse liabilities).

53 *See, e.g.*, *id.* § 1.752-2(b)(3)(ii) & (iii) (requiring consideration of the "obligations to the partnership that are imposed by the partnership agreement" or "imposed by state law, including the governing state partnership statute").

54 The Zero Value alternative emphasizes each debt. See *infra* notes 113-26 and accompanying text for a discussion of the Zero-Value alternative. The Pure Passthrough model does not incorporate a recourse-nonrecourse dichotomy. See *infra* notes 100-12 and accompanying text for a discussion of the Pure Passthrough model.

B. Fictions of Constructive Liquidation

To determine if a liability is recourse or nonrecourse, the regulations suppose a 'constructive liquidation' to determine the extent, if any, that the partners individually would be obligated to make a payment to the partnership, to a creditor, or to another partner to satisfy any partnership liability.[55] The partnership liabilities not allocated to any partner after applying the constructive liquidation procedures are allocated according to the nonrecourse liabilities section,[56] which allocates liabilities for which no partner is liable beyond the assets in the partnership.

To begin the analysis, the regulations assume the partnership "constructively liquidates"[57] at a time when: (1) all of the partnership's assets (other than a narrow category of assets serving only as security for a liability) become worthless,[58] and (2) all of the partnership's liabilities become due and payable.[59] Although sometimes colorfully referred to as the "atom bomb" rule[60] because the analysis assumes all the partnership's assets have been destroyed, the approach does not assume that all assets are destroyed, but rather that most partnership assets have become worthless. Not only are the tangible assets considered worthless; so are intangible assets including all contractual rights such as nonpartner guarantees, leases, and insurance contracts.[61] Moreover, although the regulations do not state so explicitly, a necessary corollary is that only partners (and persons related to the partners) will satisfy their obligations and all other persons except for creditors and the Internal Revenue Service have no assets and will not fulfill any obligation.[62]

Before continuing the explanation of the constructive liquidation process, we should examine the fictions at play so far. First, the regulations assume that the partnership assets are worthless.[63] In most cases partnership assets have value. Rejection of the regula-

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55 *See, e.g.*, Treas. Reg. § 1.752-2(b)(1) & (b)(3) (1991).

56 *Id.* § 1.752-3.

57 *Id.* § 1.752-2(b)(1).

58 *Id.* § 1.752-2(b)(ii).

59 *Id.* § 1.752-2(b)(i).

60 *E.g.*, John Schmalz, *The Effect of Partnership Liabilities on Basis, At-Risk Amounts, and Capital Accounts*, 5 J. PARTNERSHIP TAX'N 291, 304-07 (1989).

61 *See* Temp. Treas. Reg. § 1.752-1T(d)(3)(iii)(B) (as amended 1989).

62 Dare we imagine a world where an atomic bomb destroys all assets except the partners' personal assets not held in the partnership, and kills all people except the partners, their creditors, and the Internal Revenue Service?

63 In contrast, the Pure Passthrough solution assumes, unless clearly indicated otherwise, that the partnership assets have a value equal at least to the partnership

tions' no-value fiction dooms the regulations from the outset.[64] It would seem appropriate for the Treasury to use the asset's purchase price or latest revaluation, if later than the purchase date, as a surrogate asset value, limiting true losses to those not covered by the partnership assets' values.[65]

As the second fiction in the regulations' approach, the partnership is considered to be liquidating and going out of business and in the process not collecting any receivables from customers. The going-concern precept that a business is deemed to be operating and on-going dooms the regulations' approach: the regulations attempt to determine which partners will be legally obligated to contribute funds, but in the almost inconceivable situation where the partnership ceases operations with no assets or hope of obtaining any assets from business operations. This fiction is embraced even though the partnership owing the liabilities is in fact continuing.

The third fiction is that all liabilities come due at once despite the loan terms, a necessary fiction to complement the first two fictions. Fourth, no customer (other than some related persons) owing the partnership money will pay: again a fiction made necessary to complement the first two premises.

On the other hand, the regulations treat all partners as able and willing to satisfy any legal obligation related to the partnership unless the facts and circumstances indicate a plan to circumvent or avoid the obligation to make payment to a creditor.[66] Specifically,

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liabilities being allocated. See *infra* notes 100-12 and accompanying text for discussion of the Pure Passthrough solution.

64 Acceptance of the no-value fiction negates the Pure Passthrough proposal. See *infra* text accompanying notes 100-12 for a discussion of the Pure Passthrough proposal. The Zero Value alternative trepidly accepts the regulations' zero asset value premise. See *infra* text accompanying notes 113-26 for a discussion of the Zero Value alternative.

65 *Cf.* Treas. Reg. § 1.704-1(b)(3)(iii)(b) (1991) (asset deemed sold at book value to determine partner's interest in the partnership for allocation of income and losses). Book value is not the best indicator of value for debt allocation, however, especially after depreciation adjustments.

66 Treas. Reg. § 1.752-2(b)(6) (1991). The examples in the regulations illustrate possible schemes to avoid making a payment to a creditor. In one example, the regulations found such a scheme where a corporation set up a subsidiary solely to acquire and hold its general partner interest in a limited partnership, capitalizing the subsidiary only with the funds needed to acquire the general partner interest. *Id.* § 1.752-2(j)(4). Furthermore, the regulations suggest in an example that a scheme will not be found, but a close scrutiny of the facts and circumstances will be warranted, where a limited partner agrees pursuant to an indemnification agreement to pay a creditor if the partnership defaulted on the note. Under the indemnification agreement the creditor had the option of proceeding against the partnership or the limited partner.

all contractual obligations, including the partnership agreement itself and obligations imposed by state law on partners or related persons[67] to contribute money to the partnership or to pay a creditor or another partner, will be recognized as continuing obligations of value to the partnership.[68]

The fictions here, again of seeming necessity, are that all partners are able to and will honor their legal obligations, and that the partners will contribute no more than they are legally required. In practice, partners in partnerships facing financial distress react in different ways. Often some partners contribute extra funds in an effort to stave off calamity, even when other partners refuse to invest more funds. The contributing partners may receive a proportionate increase in their partnership interests or they may not. Outside investors may provide additional capital in return for an interest in the venture. The partnership may borrow, creating even more debt. Possibly, as the regulations assume, the partnership may continue its structured finances and relationships until its demise. And, of course, the partnership may never face a severe financial crisis. Although the regulations should not attempt to anticipate all possible maneuverings that may occur, the regulations should be mindful that the ultimate financial consequences will differ from that apparent at the annual allocation of liabilities.

Moreover, not all partners do or are able to satisfy all obligations after the liquidation. For example, a corporate general partner may not have enough assets to satisfy the liabilities that the regulations try to allocate to the partner.[69] Likewise, an individual general partner may not be able to satisfy any obligations.[70] Yet the

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The partnership had no right to be reimbursed by the limited partner and the limited partner had no right to be reimbursed by the partnership. Except for the indemnification agreement the limited partner had no obligation to satisfy the liability. Temp. Treas. Reg. § 1.752-1T(k) ex. 9 (1991).

Another example would allow the Treasury to challenge a partner's obligation to restore her deficit account if a second partner's contribution of a promissory note to the partnership constituted a plan to circumvent or avoid the first partner's deficit restoration obligation. Temp. Treas. Reg. § 1.752-1T(k) ex. 7 (1989).

67 The regulations define "related person" in Treas. Reg. § 1.752-4(b) (1991). The remainder of this Article will reference only partners, and will not elaborate as to the effect of the related person rules unless clearly indicated. All discussion should be modified as necessary to account for the related person rules.

68 Treas. Reg. § 1.752-2(b)(3) (1991).

69 The regulations look through the corporate structure if the arrangement constitutes a plan to circumvent or avoid an obligation, Treas. Reg. § 1.752-2(j)(4) (1991), but beyond this minor instance, the regulations respect the corporation as a general partner able to fulfill its financial obligations.

70 For example, many real estate investments are limited partnerships. A few dealers or developers are general partners and the investors are limited partners. The

regulations would allocate all recourse notes to the general partners. In many partnerships, some partners are service partners and others are financial partners. In these partnerships, the financial partner will satisfy any liability in excess of partnership assets; or more precisely, the service partner often will not have the personal resources to bear her share of any partnership liabilities. Administrative sensibilities may conclude that any regulations trying to accommodate these relationships would complicate the regulations beyond the benefits conferred.[71] Nonetheless, the intentional disregard of these situations should not be coupled with an allocation process that purports to allocate liabilities according to risk of loss in a precise manner.

This Article's proposals[72] do not stipulate a constructive liquidation procedure. None is needed. The constructive liquidation process does not identify any debts or otherwise unknown liabilities. Constructive liquidation's primary function is to establish individual liabilities under a partner's obligation to restore a deficit capital account, which, as discussed in the next section, is unnecessary and needlessly complicates liability allocation.

C. *The Partnership Agreement, Outside Agreements, and the Misguided Deficit Account Restoration Fiction*

The next step under a constructive liquidation, after determining that all partnership assets are worthless and that all liabilities are due, is to have a deemed disposition of all assets.[73] The regulations establish the disposition price as zero for recourse liabilities and the amount of the outstanding debt for nonrecourse liabilities. If the creditor must look solely to the assets of the partnership because, for example, the note is nonrecourse and no partner guarantees the note, the partnership is deemed to sell the property securing the note for the amount of the note.[74] If any partner is liable for a note under a contract, the partnership agree-

general partners often are the general partners in multiple real estate syndications in a local area. If the real estate market becomes depressed, the general partners would be hard-pressed to pay the monthly payments, much less the full liabilities of all the partnerships.

71 The regulations arguably allow some allocation of risk for tax purposes by taking into account partnership agreements. *See* Treas. Reg. § 1.752-2(b)(3)(ii) (1991).

72 The proposals are the Pure Passthrough alternative discussed *infra* at notes 100-12 and accompanying text, and the Zero Value alternative is discussed *infra* at notes 113-26 and accompanying text.

73 Treas. Reg. § 1.752-2(b)(1)(iii) (1991).

74 *Id.* § 1.752-2(b)(2).

ment, or state law, the asset is deemed sold for no consideration.[75] If there is a disparity between book basis and tax basis, the book basis is used.[76] All gains and losses are allocated among the partners' capital accounts and the partnership then liquidates.[77] Because most assets are deemed sold for no consideration or for the amount of nonrecourse liabilities, the partnership must be deemed to have no assets with which to pay its debts. The partners, therefore, must use personal assets held outside the partnership[78] to retire the remaining partnership debts.

The regulations derive a partner's obligation to satisfy a partnership liability from three general sources: contractual obligations outside the partnership such as indemnifications, guarantees, reimbursement agreements, and other agreements running directly to creditors, other partners, or to the partnership;[79] obligations "imposed by state law including the governing state partnership statute";[80] and "obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership."[81]

A partner's most pervasive obligation to contribute comes not from an agreement related to any specific debt such as a promissory note, guarantee, or indemnification agreement, but from the obligation of general partners to contribute whenever necessary to satisfy a partnership liability imposed by the partnership agreement

75 *Id.* § 1.752-2(b)(1)(iii).

76 *Id.* § 1.752-2(b)(2); *Id.* § 1.704-1(b)(4)(i) (as amended 1991). Book value is not the same as book value under generally accepted accounting principles, but is fair market value at time of acquisition or revaluation as adjusted thereafter under tax accounting rules.

77 *Id.* § 1.752-2(b)(1)(iv) & (v).

78 Some assets contributed to the partnership solely to be pledged as security for a loan will still be considered to have value, *id.* § 1.752-2(h)(2), and are treated as though still owned by the contributing partner. Most partnerships will have none of these assets.

79 *Id.* § 1.752-2(b)(3)(i).

80 *Id.* § 1.752-2(b)(3)(iii).

81 *Id.* § 1.752-2(b)(3)(ii). This Article's Zero Value proposal accepts these sources except for the obligation to restore a deficit capital account upon liquidation. By refusing to consider the deficit capital account restoration source, the Zero Value proposal eliminates the need for the regulations' constructive liquidation process. *See infra* text beginning at note 113. A possible obstacle confronts the regulations' constructive liquidation approach if the partnership agreement does not provide for deficit capital account restoration and the state partnership law does not require partners to restore any deficit capital accounts. *See, e.g,* Hogan v. Commissioner, 59 Tax Ct. Mem. Dec. (CCH) 870, 873-75 (1990).

or by operation of law.[82] The regulations recognize the obligation of general partners under operation of state law to be personally liable for all debts and obligations that the partnership must satisfy,[83] and treat this obligation to contribute to the partnership under state law as an obligation to contribute for purposes of § 752.[84]

Consequently, it matters little that a partner signs a guarantee or an indemnification agreement, as long as that partner has a right of reimbursement from the partnership and any of the other partners are classified as general partners under a state statute corresponding to the Uniform Partnership Act,[85] the Uniform Limited Partnership Act,[86] or the Revised Uniform Limited Partnership Act.[87] Likewise, it is inconsequential that a partner has not signed a note, guarantee, or indemnification agreement, and has not contributed to the partnership property to be used as security for a liability, as long as the partner is considered a general partner under a state statute corresponding to one of the three uniform partnership acts, and the creditor's (or partner's making a payment to the creditor) right to repayment is not limited to one or more partnership assets.[88] Thus, when the debt is a recourse debt and there is a general partner, most outside agreements will not alter the allocation results.

The outside agreements, on the other hand, greatly influence the allocation of nonrecourse debt by transforming nonrecourse debt into a recourse liability. Several variations of outside arrangements and partnership agreements—a partner being the creditor on a nonrecourse note; a partner's contributing property solely to secure a debt; a partner's contributing a promissory note to the

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82 Treas. Reg. § 1.752-2(b)(3)(ii) & (iii) (1991). A partner's obligation to contribute extra funds to satisfy a third party debt is different from a partner's obligation to contribute extra funds to restore a deficit capital account. *See Hogan*, 59 Tax Ct. Mem. Dec. at 871-76.

83 *See id.* § 1.752-2(b)(3)(iii) (stating that, *inter alia*, state partnership law is used to determine partners' liabilities); *see also* UNIF. PARTNERSHIP ACT § 15 (1969); UNIF. LIMITED PARTNERSHIP ACT § 9 (1969); REV. UNIF. LIMITED PARTNERSHIP ACT § 403 (1993).

84 Treas. Reg. § 1.752-2(b)(3)(iii) (1991).

85 UNIF. PARTNERSHIP ACT § 15 (1969).

86 UNIF. LIMITED PARTNERSHIP ACT § 9 (1969).

87 REV. UNIF. LIMITED PARTNERSHIP ACT § 403 (1993).

88 *See, e.g.*, Treas. Reg. § 1.752-2(f) ex. 3 (1991) (general partner allocated liability even though limited partner guarantees debt; assumption is that general partner will satisfy debt and limited partner will not have to honor guarantee.); *id.* ex. 4 (liability allocated to general partner even where limited partner must honor guarantee since limited partner would be subrogated to rights of creditor and could recover from general partner).

partnership; a partner's entering into arrangements tantamount to a guarantee, as examples—can transmute a nonrecourse debt into a recourse liability.[89] Because the regulations characterize liabilities as recourse or nonrecourse based on the partners' individual obligations to pay, the allocation of recourse liabilities must consider in greater detail the outside agreements in allocating recourse liabilities (as the regulations use the term).

The partnership agreement plays an important role in the liability allocation process. At minimum, the partner's loss sharing ratios come from the partnership agreement. Additionally, although their agreement may not bind creditors, the partners in the partnership agreement can allocate the responsibility among themselves to make additional contributions to the partnership to satisfy debts. For example, the partnership agreement may require limited partners to contribute money in excess of original contributions. The limited partners will be allocated recourse debt as though the limited partners were general partners until the allocated debt equals the amount the partnership obligates the limited partners to contribute.[90] Likewise, the partners can agree among themselves who will satisfy a particular debt either solely from the partner's capital account and profit share or, in case the partnership ever defaults, on the note.

This Article's proposals and the § 752 regulations give effect to the partnership agreement.[91] The regulations and this Article part ways, however, with respect to the desirability of the deficit account restoration requirement. The regulations' examples repeatedly use, approvingly, an allocation in the partnership agreement based on the substantial economic effect provisions under the § 704(b) regulations, including specifically the deficit account restoration obligation.[92] In fact, a principal purpose of the § 752 regulations is

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89 For the regulatory distinctions between debts, liabilities, and obligations, see *supra* text accompanying notes 36-53. The Zero Value approach, *see infra* text accompanying notes 113-26, allocates nonrecourse debts subject to any of these agreements under the section allocating nonrecourse liabilities and not under the section allocating recourse liabilities, as do the regulations. The Pure Passthrough solution does not distinguish recourse from nonrecourse liabilities at all, instead allocating the liabilities according to the partners' relative ownership interests in the securing property. *See infra* text accompanying notes 100-12 and 154-59.

90 Treas. Reg. § 1.752-2(b)(3)(ii) (1992).

91 Treas. Reg. § 1.752-2(b)(3)(ii) (1991).

92 The examples in the temporary regulations use a derivative of the following partnership agreement:

> The partnership agreement provides that the partners will share partnership taxable income and loss equally. The partnership agreement also provides that capital accounts will be determined and maintained

to allocate liabilities to the same partners that are allocated the deductions attributable to those liabilities under § 704.[93]

Whereas the regulations bottom the entire allocation process on the deficit account restoration requirement, this Article's proposals would not consider the deficit account restoration requirement at all, even if it is in the partnership agreement. This Article's proposals exclude the deficit account restoration element for two reasons. First, the process unnecessarily complicates the allocation procedure.[94] Including the deficit account restoration requirement in the allocation procedure causes so much confusion for tax advisors that its inclusion in the allocation process cannot be justified unless including the restoration requirement materially improves precision. The inclusion, however, does not add precision. The many fictions discussed above prevent precision. Moreover, allocations without considering the deficit account restoration adequately allocate partners' liabilities.[95]

Second, the deficit account restoration provision does not function to allocate liabilities according to economic risk of loss. The provision merely compensates for disproportionate capital account balances.[96] As a simple illustration, assume a partnership borrows $10,000 on a recourse note and the partners agree to allo-

> for the partners in accordance with § 1.704-1(b)(2)(iv), distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partner's positive capital account balances (as set forth in § 1.704-1(b)(2)(ii)(b)(2)), and any partner with a deficit balance in the partner's capital account following the liquidation of the partner's interest must restore that deficit to the partnership (as set forth in § 1.704-1(b)(2)(ii)(b)(3)).

Temp. Treas. Reg. § 1.752-1T(k) ex. (8) (as amended 1989). Variations may be found in examples (5), (6), & (7) (all adopting facts of ex. (5)), and examples (10), (12), (13), (15), (22). The final regulations more subtly mention the capital account restoration obligation. *See* Treas. Reg. § 1.752-2(f) ex. 1 & 2 (1991); *see also id.* § 1.752-2(g)(4) (providing more examples); *id.* § 1.752-2(j)(4) (same).

93 Temp. Treas. Reg. § 1.752-1T(a)(1)(iv) (as amended 1989). The deficit account restoration obligation is not needed to carry out this purpose. The proposed allocation serves as well to allocate the debt to the party taking the deductions "attributable to those liabilities" since the proposed process allocates debt based on loss sharing ratios attributable to the debt. This seems to allocate debt and deductions attributable to the debt more precisely than does the burdensome deficit account restoration procedure.

94 *See, e.g., id.* § 1.752-1T(k) ex. 4 to 9 and 12 to 15 (as amended 1989); *see also infra* text accompanying notes 127-49 for more examples.

95 See *infra* text accompanying notes 127-49 for a discussion on the current tax regulations' approach for allocating nonrecourse liabilities.

96 *See also* Abrams, *supra* note 7, at 639 ("This flaw causes allocations under the temporary regulations to turn on all potential obligations to contribute additional funds to the partnership, even those obligations having no relation to partnership indebtedness.")

cate losses 50% to *A* and 50% to *B*. In addition, *A* contributes $10,000 and *B* contributes $20,000 to the partnership. At this point the partnership has $40,000 cash. In a constructive liquidation the partnership recognizes a $40,000 loss, allocated $20,000 to *A* and $20,000 to *B*. *A*'s capital account becomes negative $10,000 and *B*'s capital account falls to zero. If the partnership agreement contains a deficit account restoration requirement, *A* must contribute an additional $10,000 to the partnership. Therefore, under the regulations, the full $10,000 liability is allocated to *A*. In reality, of course, both partners are jointly and severally liable for the note. In fact, existing partnership assets can satisfy the note.

The only reason *A* had a resulting negative basis in her capital account was that she had a disproportionately low initial capital account. If *A* had contributed an extra $10,000 or if *B* had contributed $10,000 less, the debt would have been allocated to the partners according to their loss sharing ratios. Despite the current regulations, disproportionate capital account disparities should not be relevant in allocating liabilities.[97]

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97 The constructive liquidation process and the deficit account restoration factor play havoc with anticipated results. For example, assume that in an equal partnership, each partner contributes $100, and the partnership buys an asset for $200 on a $200 recourse debt. On a deemed disposition, the partnership suffers a $400 loss, allocated $200 to each partner:

	A	*B*
Capital Account Before Constructive Liquidation	$100	$100
Less Loss:	(200)	(200)
Capital Account After Constructive Liquidation	($100)	($100)

Because under the partnership agreement the parties must restore any deficit account, *A* is obligated to contribute $100 and *B* is obligated to contribute $100 to the partnership. There being no other partners, no other agreements respecting the liability, and no other assets, *A* will be allocated $100 of the $200 liability and *B* also will be allocated $100.

Now assume that *B* contributes $200 to the partnership so that *B*'s capital account increases to $300. Her capital account increased by the $200 she contributed. Intuitively, *B*'s basis should increase by $200 but under the regulations her basis will increase by only $100. Upon a constructive liquidation, the partnership will be deemed to have a $600 loss (no consideration received in exchange for cash with a basis of $400 and the property with a basis of $200). Under the partnership agreement, *A* will be allocated 50% of the loss ($300) and *B* will be allocated 50% ($300), which affects each partner's capital account as follows:

	A	*B*
Capital Account Before Constructive Liquidation	$100	$300
Less Loss:	(300)	(300)
Capital Account After Constructive Liquidation	($200)	-0-

Another fiction at this stage could ease the deficit account restoration confusion created by disproportionate account balances. Under this assumption, all partners are deemed to contribute money immediately before the deemed sale to bring all capital accounts in proportion to the partners' relative ownership interests; or, as effectively, the partnership makes distributions to partners immediately before the deemed sale to bring the partners' capital accounts in proportion to the partners' relative ownership interests.[98] The positive effect of this new fiction is to emphasize only the debt obligation in the deficit account restoration process. The fiction also eliminates the need for the deficit restoration process, and allocates recourse liabilities according to the Zero Value procedures developed in the next part of this Article.[99] Preferably, and more straightforward than incorporating another fiction, the regulations should eliminate the deficit account restoration provision.

III. The Proposed Alternatives

A. *Pure Passthrough Alternative*

With one of two fundamental changes, the regulations could be simplified tremendously with little or no loss in precision. The first, and preferable, change is to allocate all liabilities according to the partners' shares of the partnership assets expected to satisfy the debt. This would allow recourse liabilities as well as nonrecourse liabilities to be allocated to limited partners. Allocating recourse as well as nonrecourse liabilities to limited partners eliminates the need for most complications in the regulations and is theoretically superior to denying limited partners an allocation of recourse liabilities.[100] The second change, as an alternative to the first, would allocate partnership liabilities or debt individually rather than the

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Because *A* is obligated to restore $200 he is deemed obligated to contribute $200 to the partnership and will be allocated the full $200 liability under the regulations. Thus, without any action on *A*'s part or the partnership's incurring any additional debt, *A*'s basis in the partnership increases by $100. *B* will be allocated none of the liability. Thus, in this example *A* and *B* each have identical bases in their respective partnership interests. *B*'s basis increased $100 (from $200 to $300) even though she contributed $200. Meanwhile, *A*'s basis also increased $100 even though he contributed no extra funds.

98 Professor Abrams would achieve the same result by calculating any change in obligations to contribute following a constructive liquidation after incurring a debt as compared with a constructive liquidation immediately before incurring the debt. Abrams, *supra* note 7, at 639.

99 *See infra* text accompanying notes 113-22.

100 The regulations are premised on the limited partners' not shouldering any economic risk for recourse liabilities. *See, e.g.*, Treas. Reg. § 1.752-2(f) ex. 4 (1991). The regulations and this Article's proposals adopt different premises.

regulations' current approach of determining each partner's "obligation" for total partnership liabilities. Flowing from this change, the regulations should abandon the constructive liquidation procedure, including the deficit account restoration provision.

The first suggested change, hereinafter termed "Pure Passthrough," would allocate all liabilities according to partners' interests in assets securing the debt, or according to the partners' general interest in partnership assets. Notwithstanding the continued longstanding presumption against allocating recourse liabilities to limited partners, and notwithstanding the committee reports on the 1984 Act, which anticipate a continued policy of excluding limited partners from sharing in recourse liabilities, a rethinking of economic risk results in the conclusion that even limited partners should share in recourse liabilities to the extent of any pledged asset's value, or even to the extent the value of all the partnership's assets exceed the partnership's liabilities.[101]

Under an aggregate theory, each partner, general and limited partner alike, owns a proportionate part of each asset. As long as the partnership might use a portion of a partner's assets to satisfy a liability, satisfaction of the liability by use of the asset diminishes the partner's wealth.[102] Thus, to the extent a limited partner has an interest in partnership property, the limited partner should be allocated her portion of the partnership liabilities, whether it be recourse liabilities or nonrecourse liabilities. Only if the partnership assets' value is less than the liabilities should only the general partners share the liabilities.[103]

The possible objections that come to mind are that the limited partners have made no contributions for the asset value at stake or that the limited partners already have the benefit of contributions

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101 This idea has been whispered, though not advocated vigorously. *See* MCKEE, *supra* note 12, at 8-7 n.12; ARTHUR B. WILLIS ET AL., PARTNERSHIP TAXATION - STUDENT EDITION § 62.07, at 4-88 (1989). Congress would need to modify its charge before the Treasury could implement the Pure Passthrough alternative.

102 Some may argue that using partnership assets to reduce partnership debt does not affect a partner's wealth because the decrease in assets is offset by a decrease in liabilities. That presumes the partner's assets are reducing the partner's share of the partnership's liabilities. Under the current regulations, a limited partner's share of partnership assets, as an example, may be used to satisfy a liability allocated exclusively to general partners.

103 *Cf.* I.R.C. §752(c) (1988) ("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."). Under an aggregate theory of the partnership where the individual partners own the partnership assets and are liable for the partnership debts, the quoted language mandates that the partners be allocated their respective shares of the liability.

reflected in their bases. In an asset purchase solely for recourse obligations, no partner has put up any asset. Granted, if for some reason the partnership assets' value, reduced for selling costs, falls below the note, only the general partners must pay. That reasoning, however, does not justify allocating the complete note to the general partners. For example, assume a partnership buys a $100,000 asset for a $100,000 recourse note. Assume further that the partnership has no other assets or debt and no income or expenses. If the asset's value falls to $90,000, the general partners will be obligated to satisfy the remaining $10,000. This does not justify allocating the full $100,000 to the general partners.[104] The first objection is not valid.

The second objection advanced against allocating recourse liabilities to limited partners seeks to limit the allocations because the partners already have received a basis adjustment for any asset they contributed.[105] This objection also is invalid, which seems obvious on its face, because the main consequence of allocating liabilities to the partners is a basis adjustment over and above that created by partner contributions. Both general and limited partners increased their bases above actual contributions.

The easy case as an illustration is the purchase of the asset for a note. There, no partner has had her basis in the partnership increased because of any "contribution" to the partnership. Yet the partners are still liable for the note (limited partners' liability limited to value of assets in partnership) and are still joint owners of the property that in all likelihood will satisfy the liability in case of default. Before the asset purchase, the partnership's inside basis presumably equalled the partners' cumulative outside basis.[106] If

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104 Certainly, if the partnership pays the $100,000 note from operating profits, the limited partners would share in any proceeds from the sale of the asset, whether it be for more or less than $100,000.

105 *See, e.g.*, ARTHUR B. WILLIS, PARTNERSHIP TAXATION § 22.02, at 249 (2d ed. 1976):

> In a limited partnership, the limited partners are liable for full recourse partnership liabilities only to the extent of their capital contributions. They already have their capital contributions in the bases of their partnership interests under § 722, so they do not increase the adjusted bases of their partnership interests by any shares of full recourse partnership liabilities.

Id.

106 *See generally* HOWARD E. ABRAMS, FEDERAL INCOME TAXATION OF PARTNERSHIPS AND OTHER PASS-THRU ENTITIES 14-19 (1993). The equality can be broken, but not by the transaction used in the text illustration. *Id.* "Inside basis" represents the partnership's basis in its assets. "Outside basis" is the basis of a partner in her partnership interest. The partners' cumulative outside bases normally equals the partnership's inside basis.

the inside basis increases because the partnership purchases an asset, the outside bases must increase also. The Pure Passthrough model would allocate that outside basis increase according to each partner's share in the asset that serves to secure payment of their individual liabilities, usually the purchased asset.

This is not so different a concept from one specifically authorized by the regulations. A limited partner is allowed a share of recourse liabilities to the extent the limited partner is obligated to contribute funds to the partnership.[107] The only difference is that here the asset is already in the partnership. As an example, an equal limited partnership with no assets borrows $1000 on a recourse note. The partnership immediately distributes the money equally to the general and limited partner. According to the partnership agreement, the limited partner must contribute $500 if the money is needed to satisfy partnership debts. The regulations would allocate $500 of the debt to the limited partner. Logically, the allocation should be the same if the partners left the money in the partnership.

As a trickier case, assume a limited partner transfers to a partnership an asset with a $100 basis[108] and a fair market value of $1000, not subject to any debt. The partnership borrows $500 on an unsecured note,[109] the proceeds to be used as operating capital. In allocating the liability, an economic risk of loss should ask which partners will suffer a loss of assets (either assets held in the partnership or nonpartnership assets) to satisfy the note. No partner in the absolute sense has contributed the $500 borrowed, and no partner increases her basis under the contribution rules. Yet, because the limited partner has an interest in all partnership assets, if the partnership used the original $500 to repay the loan, the limited partner's share of the $500 has been used to pay the loan. Thus, rationally, she should be allocated part of the liability.

The logic holds even if the borrowed $500 is spent on operating expenses. The allocated losses reduce the partners' bases, presumably including the limited partner's basis, but the loan still must be satisfied. The partnership looks first to partnership assets so that any partner having an interest in the remaining partnership assets, in our example only the contributed asset remains, bears the

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107 Treas. Reg. § 1.752-2(b)(3)(ii) (1991).

108 The amount of the basis is irrelevant. It could just as easily have been the same as the asset's fair market value.

109 Obviously, having the contributed asset secure the recourse note supports the theory in text more than does the unsecured note example in text.

risk of loss of that asset, and should share the recourse liability. This includes the limited partners.[110]

The pledging is not talismatic. Only when the property serves as a primary source of payment is it significant. Most payments, in default situations, come from the value of the underlying assets. The asset serves to satisfy any liability accruing to its owner. Much has been written on profits and losses, but the true risk of loss is the value of a partner's property she expects to sacrifice to satisfy a liability.[111]

The Pure Passthrough proposal would simplify the allocation process tremendously. All debt would be allocated according to the same rules. There would be no need to distinguish recourse from nonrecourse liabilities. Guarantees and other arrangements would not need be considered unless the partnership liabilities exceeded the value of the partnership assets or some partner took full responsibility for payment of a liability without reimbursement rights against the partnership or the other partners, or the partnership had a specified right of reimbursement from a partner primarily responsible for a debt.[112]

B. Zero Value Alternative

Long-standing practices are not often abandoned readily. Recognizing a probable unwillingness for many to accept the Pure Passthrough alternative, this Article submits a second alternative accepting the questionable practice of looking primarily to the use of nonpartnership assets to satisfy partnership liabilities. Because this option accepts the traditional approach of deeming the partnership assets to be without value, this alternative herein is referred to as "Zero Value." The most positive consequence of this Zero Value approach, besides its more common sense interpretation of liabilities to be allocated, is that it eliminates the unnecessary constructive liquidation analysis that paralyzes the current regulations.

110 This theory would also require rethinking the at-risk rules of I.R.C. § 465 (1988).

111 *Cf. id.* §752(c) ("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.").

112 Fact questions would still occur. A partner who has guaranteed a loan may be deemed primarily liable for a liability where the facts demonstrate that, in substance, the partner has borrowed funds and subsequently advanced them to the partnership. *Cf.* Selfe v. United States, 778 F.2d 769, 774 (11th Cir. 1985) (shareholder guarantor of loan to S Corporation may include debt in basis).

This Zero Value alternative first classifies all partnership debts or liabilities[113] as recourse or nonrecourse determined at the entity level. The Zero Value proposal equates liability with debt and equates recourse notes with recourse liabilities and nonrecourse notes with nonrecourse liabilities as the starting point in the allocation process. The proposal adjusts for guarantees and other agreements emphasizing each individual debt (although most debts would be combined for allocation).

Nonrecourse liabilities would be limited to those in which by the terms of a loan agreement or local law were nonrecourse liabilities. For the most part, nonrecourse liabilities would consist of nonrecourse loans on the face of the document limiting the creditor or anyone standing in the stead of the creditor solely to assets pledged to secure the debt in case of debtor default. It would also include notes recourse on their face but which are considered nonrecourse because the partnership received property subject to the debt and so, as to the partnership under local law, the debt is nonrecourse. All other debts and liabilities including trade debts and recourse loans should be classified as recourse liabilities.

1. Allocating Recourse Liabilities

The Zero Value proposal,[114] in allocating recourse debt, recognizes in the first instance the general partners' liability under state law to satisfy the partnership's liabilities with personal assets if the partnership has insufficient assets to satisfy all debts. Under both the regulations and Zero Value, guarantees and other agreements generally are given no effect.[115] Only if some partner indemnifies the general partners for any debt or guarantees the debt with no recourse against the partners do guarantees or indemnities make a difference in allocating recourse debt. In most cases, the general partners share the liabilities according to their respective loss-sharing ratios. Limited partners are treated as general part-

113 Determining what comprises a partnership liability itself is a task. The task is the same under the regulations' and this Article's approaches. For space considerations, the discussion of partnership liabilities has been omitted. The determination of partnership liabilities merited significant space in the temporary regulations, *see, e.g.*, Temp. Treas. Reg. § 1.752-1T(g) (1989) (defining liability); *id.* § 1.752-1T(k) ex. 2, but receives none in the final regulations.

114 *See supra* Section B (Zero Value Alternative).

115 This is consistent with the current regulations' treatment of pure recourse debt, *see* Treas. Reg. § 1.752-2(f) ex. 2 & 3 (1991), but the regulations litter the analysis with nonrecourse debt treated as recourse liabilities and with capital deficit restoration obligations.

ners to the extent that the limited partners have agreed to contribute extra funds to the partnership.

A section of the regulations should explain how to allocate recourse liabilities and a separate section should allocate nonrecourse liabilities. Anyone wanting to know how to allocate a debt could go straight to the applicable section. Instead of this straightforward, common-sense approach, the current regulations lump recourse debt and nonrecourse debt together and then through a fictitious logic structure reminiscent in spirit to the logic fictions of the Rule Against Perpetuities, seek to determine which partners or related persons have an obligation to make a payment to a creditor, the partnership, or some other partner.[116]

In contrast to the regulations, the Zero Value alternative begins with the proposition that recourse liabilities are allocated to those partners who have personal liability for the debts of the partnership. In both general and limited partnerships, the general partners would be allocated the recourse debt under the general rule. Although arguments can be proffered on whether loss-sharing or profit-sharing ratios should be used, or some other formula,[117] the former regulations[118] and most commentators[119] accept allocating recourse liabilities based on loss-sharing ratios.

Modifications and exceptions to the general allocation rule would be detailed next. The former regulations set out one exception: a limited partner could be treated the same as a general partner to the extent she was obligated to contribute under the limited partnership agreement.[120] In other words, a limited partner who was required to contribute additional capital to the partnership could be allocated shares of recourse liabilities until the amount of the total liabilities allocated to the partner was equivalent to the amount the partner was still required to contribute.

Under either the Pure Passthrough alternative, where even limited partners share recourse liabilities,[121] or the more traditional Zero Value approach, where limited partners share recourse

116 *See* Treas. Reg. § 1.752-2 (1991) (Partner's share of resource liabilities). For a more thorough discussion of the regulations, see *supra* text accompanying notes 36-99.

117 Philip F. Postlewaite & Tammy J. Bialosky, *Liabilities in the Partnership Context—Policy Concerns and the Forthcoming Regulations*, 33 UCLA L. REV. 733, 747-750 (1986); *see also supra* notes 100-12 and accompanying text for a discussion of the Pure Passthrough Model.

118 Treas. Reg. § 1.752-1(e) (1988).

119 *See, e.g.*, Postlewaite & Bialosky, *supra* note 117, at 733.

120 Treas. Reg. § 1.752-1(e) (repealed 1989).

121 *See supra* notes 100-12 and accompanying textual discussion.

liabilities only in limited situations, partner guarantees of recourse liabilities should be given no effect if the guaranteeing partner is subrogated to the rights of the lender. Although challengeable as unrealistically fictitious,[122] this rule is consistent with the current regulations' results.[123] Theoretically, the guaranteeing partner either will not have to pay the debt because the general partners will contribute the additional funds or, if the guaranteeing partner pays the loans, she would be reimbursed for her actual payments.[124] Likewise, consistent with the congressional mandate and the current regulations, a partner who must indemnify the partnership or another partner and who has no right to be reimbursed herself should be allocated that part of any liability up to the amount of the indemnification.

Loss sharing ratios can differ for each debt. The general loss sharing ratio should prevail in most instances; but if the loss or depreciation of an asset acquired through the incurring of the debt is allocated under ratios different than the general loss sharing ratios, the debt should be allocated according to the special loss allocations. Or, alternatively, a partnership may allocate the responsibility for repaying any loans solely to one or more partners and as long as either the partners make those payments or any partnership payments reduce the partners' capital accounts, the liability should be allocated to the responsible partners.[125]

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122 Guarantor partners in many cases are not called upon to honor the guarantee unless the primary debtor, here the partnership, materially defaults. Usually the partnership has ample opportunity to secure contributions from general partners who are able to contribute. If a guarantor must satisfy the partnership's liabilities, there is a good chance she will not be reimbursed by the general partners. *See supra* notes 69-70 and accompanying text.

123 Treas. Reg. §§ 1.752-2(b)(5) & 1.752-2(f) ex. 3 & 4 (1991).

124 *But see supra* note 122.

125 The current regulations exhibit some reservation concerning possible abusive use of debt allocation based on partners' agreeing who should be liable. The difficulty, of course, lies in distinguishing legitimate arrangements from abusive schemes. Setting guidelines is understandably fraught with possible contradictory interpretations. The current regulations, for example, require the partners to take into consideration all contractual arrangements outside the partnership agreement, including reimbursement agreements and indemnifications, and all obligations imposed by the partnership agreement. Treas. Reg. § 1.752-2(b)(3) (1991). This seems to legitimate a partnership agreement or other agreement placing primary responsibility for the loan agreement, or the face value of the note, as between the partners, on one or more but fewer than all partners liable for the debt under state law. *See also id.* § 1.752-2(b)(5). Yet Treasury Regulation § 1.752-1(d) (1991) provides that a person is deemed to assume a liability only if the creditor or lender knows of the assumption and can directly enforce the person's obligation and no other party would bear the economic risk of loss after the assumption, restricting the general rule recognizing all agreements altering debt responsibility.

2. Allocating Recourse Liabilities of Limited Liability Companies

A special subsection under recourse liabilities should recognize that some entities have no partners, members, or investors that are personally liable for partnership recourse liabilities but yet the entities are taxed as partnerships. The most visible such entity today is the limited liability company, a business form insulating all its members from personal liability.[126] Because no member is personally liable solely due to her status as a member of the entity, all recourse liabilities of the organization must be satisfied by the organizations's assets and profits. Although creditors may have more security under this arrangement than with a traditional nonrecourse debt that limits a creditor to pledged assets for security, the absence of any personal liability for any member makes the relationship more akin to a nonrecourse liability and therefore should be evaluated the same as a nonrecourse liability. The special subsection, therefore, should reference the nonrecourse liability section for the rules allocating this type of recourse liability.

IV. Allocating Nonrecourse Liabilities

A. *The Regulations' Approach*

Nonrecourse liabilities[127] consist of nonrecourse loans on the face of the document limiting the creditor or anyone standing in the stead of the creditor solely to assets pledged to secure the debt in case of debtor default. Nonrecourse liabilities also include notes recourse on their face but which are considered nonrecourse because the partnership received property subject to the debt and so, as to the partnership under local law, the debt is nonrecourse. Also, nonrecourse liabilities would include recourse liabilities of entities in which no member has any personal liability, such as limited liability companies. The regulations allocate nonrecourse debt in both the section titled "Partner's share of nonrecourse liabilities"[128] and the section titled "Partner's share of recourse liabilities."[129]

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126 *See* Joseph A. Snoe, *Entity Classification Under the Internal Revenue Code: A Proposal to Replace the Resemblance Model*, 15 J. Corp. L. 647, 707 (1990).

127 Nonrecourse liabilities as used here means nonrecourse liabilities or nonrecourse debt as generally understood, not the specially defined term of the § 752 regulations. *See supra* notes 14-17 and accompanying text.

128 Treas. Reg. § 1.752-3 (1991).

129 *Id.* § 1.752-2. *See id.* §§ 1.752-2(b)(1)(iii) (Obligation to make a payment), 1.752-2(b)(2) (Treatment upon deemed disposition), 1.752-2(d) (De minimis excep-

The regulations favor allocating all debts, if possible, as recourse liabilities, and only if a liability cannot be allocated as a recourse liability is it allocated as a nonrecourse liability.[130] The regulations allocate any nonrecourse debt for which some partner bears responsibility as a recourse liability. This Article's proposals more simply would allocate them as nonrecourse debts. The regulations determine each partner's share of the remaining nonrecourse liabilities according to the sum of (a) "the partner's share of partnership minimum gain";[131] (b) the amount of any taxable gain that would be allocated to the partner under § 704(c) if the partnership in a taxable transaction disposed of all partnership property subject to nonrecourse liabilities solely in full satisfaction of the nonrecourse liabilities and for no other consideration;[132] and (c) the partner's proportionate share of the excess nonrecourse liabilities of the partnership.[133] Nonrecourse liabilities are allocated first according to the partner's share of minimum gain and according to the taxable gain allocated under § 704(c); then the excess nonrecourse liabilities are allocated according to the partners' relative interests in the partnership profits.[134]

1. Section 704(b) Partnership Minimum Gain Allocations

Under § 704(b) a partnership determines partners' distributive shares of income and loss according to the partnership agreement or, if the agreement does not have substantial economic effect, according to the partners' interests in the partnership.[135] The regulations implement § 704(b) in a lengthy and complicated set of rules emphasizing partners' capital accounts in determining economic effect and the substantiality of the economic effect.[136]

The § 704(b) regulations allocate deductions and losses attributable to nonrecourse liabilities according to partners' shares of 'partnership minimum gain' assuming the partnership satisfies a minimum gain chargeback requirement.[137] The maximum

tions), 1.752-2(e) (Special rule for nonrecourse liability with interest guaranteed by a partner), 1.752-2(f) ex. 5.

130 *Id.* § 1.752-1(a)(2).

131 *Id.* § 1.752-3(a)(1).

132 *Id.* § 1.752-3(a)(2).

133 *Id.* § 1.752-3(a)(3). The remaining nonrecourse liabilities are termed excess nonrecourse liabilities. *Id.*

134 Temp. Treas. Reg. § 1.752-3 (1991).

135 I.R.C. § 704(b) (1988).

136 *See* Treas. Reg. § 1.704-1(b) (as amended 1991); Treas. Reg. 1.704-2 (1991) (Allocations attributable to nonrecourse liabilities).

137 *Id.* § 1.704-2 (1991).

amount of nonrecourse liabilities allocable, based on § 704(b) partnership minimum gain, is the excess of the nonrecourse liabilities over the securing property's book basis (not tax basis).[138] The § 752 regulations reduce the amount of nonrecourse liabilities allocated under § 704(b) minimum gain allocations, however, by reducing the amount of the nonrecourse debt in the formula by the amount of any guarantees, indemnifications, or other agreements creating a responsibility in some partner.[139] The main objections to use of § 704(b) partnership minimum gain are that liabilities allocation cannot be determined without trudging through the § 704(b) regulations, and that the § 752 regulations distort liabilities allocations by granting undue influence and precedence to guarantees and other agreements such that the correcting allocations served by § 704(b) often will not come into play. As discussed more fully below, a more straightforward solution would allocate nonrecourse liabilities on profit-sharing or loss-sharing ratios without adjusting for either guarantees or § 704(b).

2. Section 704(c) Allocations

Under § 704(c) a partnership, in allocating income, gain, loss, and deductions, is to consider the variation between the basis of property contributed to the partnership and the property's fair market value at the time of contribution.[140] The partnership must allocate any taxable consequences to reduce the variation between the results for book purposes and for tax purposes. For example, if a partner transfers property to a partnership with a fair market value of $1000 and a basis of $600, the partnership must use the $600 basis for calculating taxable depreciation and taxable gains and losses. For book purposes, however, the regulations require that the partnership use the $1000 basis.[141] Assuming the asset is not depreciable, if the partnership sells the asset for $1100, the partnership must allocate $400 of the $500 gain to the contributing partner for income tax purposes.[142] The remaining $100 gain is allocated according to the partnership agreement for sharing gains.[143] This accords with what would have happened for book purposes.[144] The example in this paragraph illustrates the

[138] *Id.* § 1.704-2(d)(1) & (2).
[139] *Id.* § 1.752-2(b)(3)(i).
[140] I.R.C. § 704(c)(1)(A) (1988 & Supp. IV 1992).
[141] Prop. Treas. Reg. § 1.704-3(a), 57 Fed. Reg. 61,348 (1992).
[142] *See* Prop. Treas. Reg. § 1.704-3(b)(1), 57 Fed. Reg. 61,349 (1992).
[143] *See* Prop. Treas. Reg. § 1.704-3(b)(3) ex. 1(iii), 57 Fed. Reg. 61,349 (1992).
[144] For book purposes the contributing partner had a $1000 capital account. For

§ 704(c) results, which are the same whether or not the property secures any debt. The example, in fact, did not involve any liabilities.

Section 704(c) affects the allocation of nonrecourse liabilities under § 752 only if the lesser of the nonrecourse liabilities[145] *or* the pledged asset's book value exceeds the pledged asset's tax basis.[146] In other words, if the amount of the nonrecourse liabilities is greater than the pledged asset's book value, the excess cannot be § 704(c) gain by definition since § 704(c) gain is the excess of book value over tax basis.[147] If, on the other hand, the amount of nonrecourse liabilities is less than the pledged assets' book value, the regulations' 'ceiling rule' assumes that the asset will be sold for the amount of the nonrecourse liabilities. The regulations' ceiling rule limits any § 704(c) gain adjustment to the realized gain.[148]

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illustrative purposes, the other partner contributed $1000 cash for a $1000 capital account. The partnership carried the asset on its books at $1000. Therefore, when the partnership sold the asset for $1100, it recognized a $100 profit. If the two partners shared profits equally, each partner increases her respective capital accounts by $50 so that each would have a $1050 capital account.

The goal of § 704(c) is to end up having tax capital accounts as close as possible to the book capital accounts after the sale. On the tax books, the contributing partner had a $600 account and the other partner started with a $1000 account. On the sale of the asset for $1100, the partnership recognized a $500 profit. Because the difference between the value of the asset for book and tax purposes was $400, the regulations require allocation of the $400 to the contributing partner. The remaining $100 is allocated equally because the partners share profits equally. Thus, the contributing partner's tax account after the sale is $1050 *($600 + $400 + $50)* and the other partner also has a tax account of $1050 *($1000 + $50)*. The accounts equal the book accounts at this stage. The contributing partner must report as income $450 and the other partner must report only the $50 allocated to her.

145 Nonrecourse liabilities as used here means nonrecourse debts less any part of the debts allocated pursuant to guarantees and other arrangements. See *supra* notes 140-44 and *infra* notes 146-49 and accompanying text.

146 *See supra* notes 140-45, and *infra* notes 147-49 and accompanying text.

147 The excess of nonrecourse liabilities over the asset's book value is allocated under § 704(b) instead of under § 704(c). Section 704(b) partnership minimum gain is the excess of nonrecourse liabilities over the book value of the partnership property subject to the nonrecourse liabilities. Treas. Reg. § 1.704-2(d)(3) (1991). Generally, the property's book value will equal the property's tax basis; and nonrecourse partnership minimum gain can be determined by calculating the excess of the nonrecourse liability over the property's tax basis. *Id.* § 1.704-2(b)(2). The § 704(c) gain is the excess of the property's book value over its tax basis. I.R.C. § 704(c) (1988 & Supp. IV 1993). Section 704(c) gain is determined initially by calculating the difference between the property's fair market value and the property's tax basis at the time of contribution. Book value may be revaluated on the happening of certain events. Treas. Reg. §§ 1.704-2(d)(4) (1991), 1.704-1(b)(2)(iv)(f) (as amended 1991). *See generally* McKEE, *supra* note 12, ¶10.02[2][c][ii] (discussing contributions, distributions, and revaluations of property). Section 704(c) by its nature will not apply to assets purchased from unrelated parties unless subsequently a revaluation event occurs. *Id.*

148 *See* Prop. Treas. Reg. § 1.704-3(b)(1), 57 Fed. Reg. 61,349 (1992).

To illustrate, assuming in the previous example that the property was subject to an $800 nonrecourse liability (not allocated to any partner as a guarantee or otherwise), the § 704(c) gain would be $200 (*$800 - $600* basis), all of which would be allocated to the contributing partner. Therefore, $200 of the nonrecourse liability would be allocated to the contributing partner in addition to one-half of the remaining $600 liability.

If the nonrecourse liabilities are equal to or less than the securing asset's tax basis, § 704(c) would not be implicated for partnership debt allocation purposes. To illustrate, if the nonrecourse note in the example had been $500 (or any amount $600 or less), the partnership would not have recognized a gain on the default of the nonrecourse note for partnership debt allocation purposes, despite the asset's having both a book value and perhaps a fair market value in excess of its tax basis.[149]

3. Excess Nonrecourse Liabilities

The partners enjoy near unfettered discretion in allocating excess nonrecourse liabilities. Although the regulations require a partner to share the excess nonrecourse liabilities "in accordance with the partner's share of partnership profits,"[150] the regulations stipulate the partnership agreement "may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities" as long as the specified interests are reasonably consistent with the interests in some other significant item of partnership gain or income.[151] Alternatively, the partners can eschew allocation by interests in profits in favor of allocation in the manner in which the deductions attributable to the nonrecourse liabilities will be allocated.[152] Finally, the partnership can alter its allocation method annually.[153]

B. The Pure Passthrough Alternative

In sharp contrast to the current regulations, this Article's proposals allocate nonrecourse debts separately from recourse debts

149 An asset's book value and its tax basis become equal over time, eliminating any § 704(c) adjustments. For liability allocation, however, latent § 704(c) adjustments may arise in future periods. An asset may not have any § 704(c) gains for debt allocation in one year but then have § 704(c) gains for § 752 allocation purposes the next year.

150 Treas. Reg. § 1.752-3(a)(3) (1991).

151 *Id.*

152 *Id.*

153 *Id.*

(and eschew the regulations' recourse liability/nonrecourse liability dichotomy). Besides simplifying the understanding, the proposed approaches shift the allocation of more sophisticated nonrecourse obligations to the nonrecourse liabilities section, thereby shielding most partnerships, those burdened only with recourse debts, from the potentially complex nonrecourse liabilities allocation process. Allocation of nonrecourse liabilities under the proposed methods, moreover, despite applying to more nonrecourse debts than does the regulations' allocation of nonrecourse liabilities, would be simpler to understand and apply.

This Article offers three acceptable alternatives to allocating nonrecourse liabilities. The most sensible option would allocate all nonrecourse liabilities according to the partners' individual rights to the property securing the debt as demonstrated by the Pure Passthrough model.[154] The only consideration given to guarantees, indemnities, and other arrangements in which the obligating partner compensates other partners directly or indirectly for the loss of the underlying property, are those that may be enforced without the creditor first foreclosing on the property (with the guarantor having no right of reimbursement for paying the liability) and those where the nonrecourse liabilities exceed the fair market value of the pledged assets.[155] No adjustment would be made for § 704(b) or § 704(c) gain allocations.

A fundamental precept in allocating liabilities holds that the partnership is an aggregate of its individual partners.[156] Each partner has a proportionate economic interest in the partnership assets, including the pledged assets. To the extent any asset secures a nonrecourse debt, then, each partner having an interest in the asset bears the economic risk of loss up to her share of the asset's fair market value, and not merely to its book value or its tax basis.[157]

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154 *See supra* notes 100-12 and accompanying text (discussing the Pure Passthrough model).

155 If the value of the partnership's assets securing the debt is much lower than the note, the economic reality may be that the obligated partner may be the principal debtor with no realistic right of reimbursement. The partner then rightfully should be allocated a portion of the liabilities. *Cf.* Selfe v. United States, 778 F.2d 769 (11th Cir. 1985) (involving loan to corporation).

156 If not, the proper result would be to follow the S corporation solution, which allocates loans from only the shareholders themselves. *See generally* HOWARD E. ABRAMS & RICHARD L. DOERNBERG, FEDERAL CORPORATE TAXATION 285-87 (2d ed. 1990).

157 As a point of clarification, debt must be allocated based on the sharing of the risk of loss of something of value to a partner. That something of value can be the partner's share of the partnership assets as well as the partner's nonpartnership assets. The mere pledging of an asset, whether a partnership asset or a partner's nonpartner-

Section 704(b) partnership minimum gain and § 704(c) gain are immaterial. If the partners share gains and losses differently with respect to any property, then the loss sharing ratios should apply to the amount of the nonrecourse liabilities equal to the asset's remaining book value, not tax basis, and the profit sharing ratios should apply to the remaining amount of the liabilities.[158]

This Pure Passthrough alternative does not require segregating recourse liabilities from nonrecourse liabilities. The approach as applied to nonrecourse liabilities works the same as the Pure Passthrough allocation of recourse liabilities. The Pure Passthrough, of all alternatives, is the most easily understood and administered.

The regulations and the remaining alternatives developed below give priority to guarantees, indemnities and other agreements. The Treasury's granting guarantees such preeminence apparently centers on taxpayers' manipulative use of guarantees to turn an ostensible nonrecourse debt into the equivalent of a recourse debt for a partner guaranteeing the debt. The perceived abuse occurs because recourse liabilities are allocated only to those partners having some economic risk of loss, i.e., only the general partners in a limited partnership, while nonrecourse debts are allocated to all partners, i.e., both general and limited partners in a limited partnership.

Quite correctly, a nonrecourse note guaranteed by the general partners should be allocated the same as a recourse note. What should be reconsidered is how the two should be allocated. Arguably, as long as the value of partnership assets securing a debt exceeds the amount of the debt secured, the debt should be allocated according to the ownership percentages of the pledged partnership property. Following this line of reasoning, limited partners should share in recourse liabilities just as they share in nonre-

ship asset, however, is not conclusive. Liability does not follow property. Only when the asset serves as the primary, and most likely the ultimate, source of payment is the identity of the property significant. Thus, pledged property is more significant for nonrecourse loans than for recourse loans. Nonetheless, pledged property securing recourse loans is relevant. Most payments of recourse obligations secured by partnership property come from the value of the underlying asset or from operations using the asset. Some loans do exceed the value of the assets, of course, and some loans are made without adequate asset security, especially if used for operating expenses. For these loans, the creditor looks primarily to the nonpartnership assets, often unpledged assets, to satisfy any shortfall. These should be allocated according to who bears the payment obligation.

158 This follows because the book value already reflects the allocation of value at risk to the partners for the book value amount while the profit sharing ratios reflect the profit allocations to be made on the disposition of the securing partnership asset.

course liabilities. Likewise, limited partners should not be denied any allocations of nonrecourse liabilities when general partners guarantee nonrecourse debts. The Pure Passthrough alternative accepts this reasoning as reflecting actual non-tax risk allocation.

The current regulations, however, implicitly reject this approach. Instead, in drafting the regulations, the Treasury began with the premise that allocation of liabilities should give weight to guarantees and other arrangements and dismissed considering the value of the partnership's underlying assets. In fact, a fundamental premise of the regulations' allocation formula is that the underlying assets are worthless for recourse debt and worth only the amount of any nonrecourse debt not otherwise allocated based on guarantees, indemnifications, and other arrangements.[159] Viewing the partnership property's value as the significant source of debt satisfaction merits serious consideration. Implementation would alter the allocation of both recourse and nonrecourse debt.

C. *Alternative Accepting Guarantees and Other Agreements*

The remaining alternatives supplement the Zero Value alternative of allocating recourse liabilities. The Zero Value approach accepts the regulations ill-conceived premise that a partnership's assets have no value, except for assets securing liabilities (as authorized by the regulations). One alternative allocates nonrecourse liabilities according to the partners' loss-sharing ratios after giving effect to guarantees, indemnities, and other agreements, but omitting § 704(b) and § 704(c) considerations. This alternative, in line with the regulations, elevates guarantees, indemnities, and other arrangements to a higher priority of economic risk than does the Pure Passthrough alternative, which recognizes the importance of the partnership property as the primary payment source.

This second alternative (the Pure Passthrough being the first alternative) only reluctantly accepts the regulations' view that guarantees and other arrangements deserve precedence. The major differences between the allocation method proposed here as the second alternative and the regulations' allocation system, other than the emphasis on the debt rather than the nebulous concept of partner obligations for partnership liabilities, are the proposal's not considering §704(b) partnership minimum gain and §704(c) gains in the allocation, and a simplified, albeit less flexible, allocation of excess nonrecourse liabilities. The premise of this second

159 *See* Treas. Reg. § 1.752-2(b)(2)(i) (1991).

alternative is that the only material difference between allocating recourse liabilities and nonrecourse liabilities should be that nonrecourse liabilities be allocated to any partner that makes a nonrecourse loan to the partnership, guarantees the note, or indemnifies anyone who makes payment on the note, without having any right to reimbursement from the partnership or any partner.[160]

All other bona fide, third-party nonrecourse liabilities should be allocated according to the partners' loss sharing interest in the underlying property for book purposes.[161] In contrast, the current regulations coordinate with the § 704 regulations to allocate non-

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160 Other arrangements fall into the same category as guarantees. A partner, for example, should be allocated any nonrecourse liability if the partner or a related person made the nonrecourse loan to the partnership and does not have recourse to any other partner or related person for payment. The same rules should apply to recourse liabilities of limited liability companies. A member that guarantees a limited liability company's recourse debt, for example, should be allocated that debt. Likewise, a member making a recourse loan to a limited liability company should be allocated that partnership liability.

The current regulations' treating a wrapped nonrecourse debt as two nonrecourse debts, one to a partner and one to a third party should continue. Treas. Reg. § 1.752-2(c)(2) (1991). The creditor party should be allocated only that part of the wrapped debt in excess of the amount she owes to the third party. The regulations legitimately could continue its special de minimis exceptions for some guarantees and its special rule treating guarantees of interest as part guarantee of the underlying nonrecourse note.

161 Using loss-sharing ratios rather than profit-sharing ratios would not exceed the Treasury's discretion, although it looks so at first blush. The pre-1984 regulations allocated the liability as the partners shared profits, not losses. Treas. Reg. § 1.752-1(e) (1960). The 1984 legislative history indicated that Congress did not expect the regulations to make major changes in how nonrecourse liabilities were allocated. *See* STAFF OF THE JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 251 (Comm. Print 1984). Legislative and regulatory changes in determining a partner's distributive share of income and loss as developed in the 1980s, however, emphasize an allocation of income and loss based on substantial economic effect. In essence, this requires taxpayers who have contributed assets with a fair market value different from the tax basis to minimize the variation in allocating tax consequences and also requires partners who are allocated nonrecourse deductions (deductions attributable to nonrecourse liabilities) to recognize profits and gains in the same ratios until the partners have recaptured the deductions. *See* I.R.C. § 704 (1988 & Supp. IV 1992); Treas. Reg. §§ 1.704-1(b)(iv), 1.704-1(f) & (g) (as amended 1991); *see also id.* § 1.704-2(b)(2) (as amended 1992) ("Thus, to avoid impairing the economic effect of other allocations, allocations pursuant to a minimum gain chargeback must be made to the partners that either were allocated nonrecourse deductions or received distributions of proceeds attributable to a nonrecourse borrowing.").

Losses allocated to the partners, therefore, will be allocated to the partners as gains equal to their loss sharing ratios until the partners have recaptured all nonrecourse deductions before the partners are allocated any profits according to any other profit sharing ratios. Thus, allocating bona fide, third-party nonrecourse liabilities according to partners' loss ratios not only identifies the profit and gain ratios required by statute and regulations to recapture the nonrecourse losses, but also avoids

recourse liabilities so as to avoid limiting deductions under § 704(d).[162] Contrary to the complicated manner the regulations prescribe for allocating nonrecourse liabilities, this second alternative achieves the same result[163] by allocating nonrecourse liabilities, to the extent not allocated based on guarantees, according to the partnership's allocation of deductions and losses for capital account purposes with respect to the assets associated with the nonrecourse debt.[164] Generally, this entails an asset purchase with the associated depreciation and loss charges.

D. *Alternative Accepting Partnership Minimum Gain Adjustments*

The third and least palatable of the three alternatives closely resembles the current regulations. As in the second alternative, this alternative allocates nonrecourse liabilities initially to those persons who in some fashion have incurred liability for the note through partners' guarantees, partners' pledging of nonpartnership assets to secure a loan without recourse to the partnership or any partner for reimbursement, partners' nonrecourse loans to the partnership, and partners' other arrangements tantamount to a guarantee. Any liabilities remaining after allocations based on the above would be allocated according to the § 704(b) partnership minimum gain[165] and then according to the partners' loss-sharing ratios for capital account purposes with respect to the assets associated with the nonrecourse debt.[166] The proposed method differs from the current regulations by not adjusting for § 704(c) gain.

The third alternative reluctantly would continue the regulations' § 704(b) partnership minimum gain allocation. The liabili-

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inquiry into changes in profit and loss ratios after the nonrecourse deductions have been recaptured or that may occur before all nonrecourse deductions are realized.

162 *See* Temp. Treas. Reg. § 1.752-1T(a)(1)(iv) (as amended in 1989) ("[O]ne 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.").

163 The proposed approach in most cases achieves even a better result because basing allocation on guarantees, even though the guarantee is not likely to be called, distorts the allocation away from the partner likely to need the basis to avoid the § 704(d) loss limitation.

164 The Pure Passthrough method allocates debt to the partners based on the partners' relative ownership of assets associated with the debt. Pure Passthrough allocates the liabilities to the partner most likely to need to use the basis to avoid the § 704(d) limitations. The regulations giving precedent to guarantees and other arrangements force further manipulations for avoiding § 704(d) problems.

165 *See* Treas. Reg. § 1.752-3(a)(1) (1991).

166 See *supra* notes 127-53 and accompanying text for a discussion on allocating nonrecourse liabilities.

ties allocated at this point are those for which only the assets of the partnership can satisfy the debt. No partner has any nonpartnership assets at risk. If a partner is liable in some capacity, as a guarantor for example, that part of the nonrecourse liability already has been allocated to the partner liable (as long as the partner has no right of reimbursement against the partnership or against any other partner).[167]

The Treasury's stated goal is to allocate liabilities to those partners taking deductions related to those liabilities.[168] Because no partner is personally liable for the nonrecourse liabilities under discussion here, the regulations seek to allocate the nonrecourse liabilities to the partners taking the deductions attributable to the liabilities. The regulations accomplish this feat by assuming the partnership realizes the nonrecourse liabilities in the disposition of its assets.[169] The excess of the liabilities over the securing property's book basis will be a taxable gain. The amount of the gain must be allocated to the partners under § 704(b). Under the § 752 regulations, the partners who are allocated the gain are allocated the same amount of the supporting nonrecourse liabilities.

If § 704(b) partnership minimum gain resulted only from allocated deductions, a simpler allocation process based exclusively on the Pure Passthrough alternative's ratios[170] would serve perfectly because excess deductions attributable to nonrecourse liabilities would be recaptured in the same ratio as the deductions were taken.[171] Excess nonrecourse liabilities would be allocated to the partners to support expected deductions just as the Treasury seeks to do under its more involved procedures. Loss and profit ratios would be identical. There no longer would be a reason to consider specifically the § 704(b) partnership minimum gain.

Unfortunately, the analysis is muddied by two quirks inherent in the partner's share of partnership minimum gain from § 704(b). First, partners' profit and loss sharing ratios may change over time. As long as partners' shares of the partnership minimum gain results from allocated deductions to the partners or to their predecessors in interest, and the § 704 regulations require partnership minimum gain to be charged back to the partners taking the de-

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167 *See supra* notes 136-39.

168 Temp. Treas. Reg. § 1.752-1T(a)(2)(ii) (as amended in 1989).

169 *See, e.g.*, Treas. Reg. § 1.752-3(b) ex. 1 (1991).

170 See *supra* notes 100-12 and accompanying text for a discussion of the Pure Passthrough alternative.

171 *See* Treas. Reg. § 1.704-2(b)(2) (as amended in 1991).

ductions,[172] the Pure Passthrough alternative and the second alternative allocates nonrecourse liabilities the same as the regulations in most instances.

The second alternative and the regulations produce different results, however, when the partners' loss-sharing or asset-ownership ratios change, either by an amendment to the partnership agreement or by the occurrence of an event that shifts the relevant ratios under the present agreement. Then, the Pure Passthrough and the second alternative allocate nonrecourse liabilities according to the revamped ratios while the regulations (and this third alternative) continue giving effect to the nonrecourse deductions already taken.

A second, albeit less troublesome, quirk occurs because partnership minimum gain may result from distributions of proceeds on nonrecourse borrowings.[173] The distributions may not be in the same proportion as the partner's loss-sharing or asset-ownership ratios. The question then becomes whether the § 752 liability allocation regulations should adjust for the imbalance caused by the disproportionate distributions. The Pure Passthrough and the second alternative accept the conclusion that no adjustment should be made. The distributions rightfully should reduce a partner's basis.

Unlike the § 704 adjustment for nonrecourse liability distributions that avoids a harsh, nonsensical § 704 income allocation consequence,[174] no similar harsh results under § 752 demand complicating the liabilities allocation procedure. The nonrecourse liability that supports the pledged asset's book value is allocated to the partner taking the related deductions. Distributions possible because of a nonrecourse liability under the current Internal Revenue Code rightfully should be taxed if they reduce a partner's adjusted basis below zero.[175] Only the actual distributions to the partners would cause a taxable event.[176]

172 *Id.* § 1.704-2(b)(2).

173 *See* Treas. Reg. § 1.704-2(h) (1991).

174 *See* MCKEE, *supra* note 12, at 10-69.

175 I.R.C. § 731(a) (1988).

176 Notwithstanding this paragraph, if the Treasury adjusts liability allocations for changes in loss-sharing ratios, its continuing the adjustment for distributions would be tolerable, even though undesirable.

E. The Needless Complications of § 704(c) Gain Allocations

All three proposed alternatives reject allocating nonrecourse abilities based on § 704(c) gain.[177] Each partner owns a share of each asset and is liable for her share of the liabilities. The economic allocation of liabilities should be based on the assets' fair market values, not their tax bases. For administrative convenience, allocation based on book value suffices, and definitely is superior to allocation based on tax basis. The difference between the asset's book value and its tax basis, so critical to § 704(c) allocations, is irrelevant as a foundation of liability allocation.

The major virtue of including § 704(c) in the allocation mix is the prevention of a deemed distribution being taxed under § 731. To illustrate, an asset worth $1000 with a tax basis of $300, subject to a nonrecourse liability of $800, contributed to an equal partnership under this Article's proposal, would allocate the debt $400 to the contributing partner and $400 to the noncontributing partner. Therefore, the contributing partner receives an initial $300 carryover basis equal to the asset's basis. Then, because he is relieved of $800 debt[178] and allocated $400 of the same debt, he is considered to have been relieved of a net $400 liability.[179] This is considered a $400 distribution of money to the contributing partner.[180] Because the amount of net debt relief exceeds the partner's basis by $100, the contributing partner must report $100 as income from the sale of a partnership interest.[181] This is the same result as under the former regulations.[182]

The current regulations prevent this result by allocating $650 of the nonrecourse liability to the contributing partner. The regulations' mechanics begin by allocating the difference between the amount of the nonrecourse liability and the asset's tax basis—the $500 adjustment from § 704(c)—to the contributing partner.[183] The partners may allocate the remaining $300 a number of ways, the most likely being $150 to each partner.[184] Thus, the contribut-

[177] See *supra* notes 140-49 and accompanying text for a discussion of § 704(c) allocations.

[178] *See* I.R.C. § 752(c) (1988) ("[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.").

[179] *See* Treas. Reg. § 1.752-1(f) (1991) (Netting of increases and decreases in liabilities resulting from same transaction).

[180] I.R.C. § 752(b) (1988).

[181] I.R.C. § 731(a)(1) (1988).

[182] Treas. Reg. §1.752-1(c) (1988) (repealed 1989).

[183] Treas. Reg. § 1.752-3(a)(2) (1991).

[184] *Id.* § 1.752-3(a)(3).

ing partner receives a $300 carryover basis, the same as under the proposed approach, but because his net debt relief is only $150,[185] no § 731(a) taxable event occurs.

Despite the arguably desirable result under the regulations, it is a strained interpretation to avoid the undesirable § 731 consequences. The better way to avoid these consequences is to revise § 731 head-on, not to complicate § 752 allocations.[186]

V. Conclusion

The § 752 regulations, even as shortened in the final regulations, rely on too many fictions and are too difficult to understand and apply. The proposed alternatives are simpler to administer and are at least as precise as the current regulations.

An unexpected conclusion this Article reaches is that the long-standing premise so integral to the former and current regulations that limited partners should not share in recourse liabilities is, upon close analysis, erroneous. The proposed Pure Passthrough alternative evaluates the partners' bearing the economic risk of loss as those who may sacrifice an asset to satisfy the liability being allocated. Because limited partners as much as general partners own a share of the partnership assets reasonably expected to be used to pay the liability, the limited partners do have an economic risk of loss in recourse liabilities. The loss is a real asset loss, not an income accounting loss. Only in relatively rare situations where the partnership assets are insufficient to satisfy the recourse liability should limited partners be denied their full share of the liability. In the same vein, guarantees and other arrangements should not be accorded the preeminent role they have under the regulations unless those agreements shield the partnership from using its assets to retire the liability.

Anticipating resistance to the Pure Passthrough alternative, the Article reluctantly accepted the current regulations' premise that all recourse liabilities are to be satisfied with nonpartnership assets. Even under this assumption, the Article takes exception to the regulations. The regulations' deficit account restoration assumption needlessly complicates the allocation process with no improvement in precision of allocation. In fact, resort to deficit

[185] This result obtains via $800 debt relief reduced by $650 debt allocated to the partner.

[186] For an excellent example of the confusing interaction of §§ 704(b) and 704(c) in allocating nonrecourse liabilities, see William P. Bowers & Michael K. Stone, *The Section 752 Regulations: A Critical Analysis*, 68 Taxes 99, 114-15 (1990).

account restoration confuses the issue by using liabilities allocation to rectify proportionately unequal capital accounts. An additional fiction that partners bring their capital accounts into balance before the regulations' requisite constructive liquidation process would reflect more accurately the liabilities allocation by allocating losses according to the partners' loss sharing ratios.

Allocations emphasizing partnership liabilities as debts to be allocated rather than partner obligations would clarify the regulations tremendously. The regulations' counterintuitive search for partners' obligations that in some cases relate only tangentially to the partnership's debts unnecessarily complicates the analysis. A more comprehendible approach identifies liabilities and debts as recourse or nonrecourse at the partnership level. Then, one section of the regulations can give guidance on allocating recourse debt and a separate section can stipulate the steps to allocate nonrecourse debt.

Nonrecourse liabilities could be allocated according to the Pure Passthrough alternative just as can recourse liabilities. The primary benefit of the Pure Passthrough method in allocating nonrecourse liabilities is that guarantees and other arrangements become less important in the process. Limited partners under this approach also share in recourse liabilities so the manipulative arrangements so troubling under the former regulations cease to be abusive. A simple, workable allocation approach, even if the Pure Passthrough method is rejected, would allocate nonrecourse liabilities without the complications involved in using § 704(b) partnership minimum gain and § 704(c) gain to allocate nonrecourse liabilities.