Mandatory Optionality: Allocation of Nonrecourse Partnership Liabilities in the Absence of Default Rules

By Eric B. Sloan, James Jennings, and David Horton*

I. Introduction

The inclusion of partnership liabilities in partners' outside bases is one of the great wonders of subchapter K, permitting partners to receive distributions of debt-financed cash without recognition of gain and allocations of debt-financed deductions that can be used to reduce tax liability unrelated to the partnership.[1] Although it is clear from the operation of the Code that partnership liabilities are included in outside basis,[2] the text of the Code provides no guidance regarding how a partnership's liabilities are to be allocated among its partners. The regulations, on the other hand, are lengthy.

Those regulations begin, in effect, by dividing partnership liabilities into two flavors: recourse and nonrecourse. Unlike the regulations addressing the allocation of partnership recourse liabilities, the regulations addressing the allocation of nonrecourse liabilities are brief, leave many gaps to be filled, and provide—implicitly and explicitly—taxpayers with considerable latitude.[3] As a result, it simply is not possible for a taxpayer to comply with the regulations without exercising judgment and discretion.

Part II of this paper summarizes the history of the nonrecourse liability regulations. Part III of this paper details the tripartite scheme of the current regulations, highlighting the flexibility and constraints inherent in the regulations. Part IV discusses a number of policy recommendations for potential changes to the law.

II. History, Theory, and Development of the Regulations

A. Basis Attributable to Nonrecourse Liabilities—General

Generally, a taxpayer's initial basis in property it acquires is equal to its cost, which is the amount paid for the property.[4] For this purpose, cost generally includes

ERIC B. SLOAN and **JAMES JENNINGS** are partners in the New York office, and **DAVID HORTON** is an associate in the Los Angeles office, of Gibson, Dunn & Crutcher.

liabilities incurred in financing the purchase and the amount of any liabilities to which the property is subject, even if the lender has no recourse to the taxpayer other than foreclosure.[5]

The rationale for including liabilities in a taxpayer's basis was first articulated by the Supreme Court in *Crane v. Commissioner*.[6] In *Crane*, the taxpayer had inherited real property worth $262,000, subject to a $262,000 mortgage that the taxpayer did not personally assume.[7] The taxpayer held the property for seven years and claimed depreciation deductions each year, totaling $25,500.[8] At the end of the seventh year, the taxpayer sold the property for $3,000, subject to the mortgage.

The taxpayer then reported taxable gain of $1,250 on the theory that the "property" was only the equity value of the property (*i.e.*, the excess of the gross fair market value of the property over the total amount of the mortgage) on its acquisition date and, correspondingly, the "amount realized" on the sale did not include relief from the mortgage.[9] This equity value was zero at the time of the taxpayer's acquisition and $3,000 at the time of disposition.[10] This amount, reduced by certain selling expenses and an exemption then in effect for half of the recognized capital gain,[11] resulted in only $1,250 of the proceeds being treated as taxable gain. The Commissioner disagreed, arguing that "property" was the physical property, not just the equity—and, therefore, the mortgage was included both in the taxpayer's basis and the amount realized.

The Court made relatively short work of the taxpayer's argument, observing that the taxpayer's theory would substantially distort depreciation deductions. Under the taxpayer's theory, if depreciation deductions were calculated only with reference to (*i.e.*, were limited to) a taxpayer's equity basis in property, then depreciation deductions for encumbered properties would be proportionately reduced by the debt-financed portion of the acquisition cost.[12] If economic depreciation exceeded tax depreciation, the result would be a timing difference because "the remainder of [the economic cost could] be effected only by the reduction of [] taxable gain in the year of sale."[13] For this reason, the Court agreed with the Commissioner, finding that the property initially had a basis equal to the $262,000, even though the property had no net equity value, and holding that the outstanding amount of the mortgage was included in the "amount realized" when the taxpayer sold the property.[14]

After *Crane*, the Tax Court expanded on the rationale for including nonrecourse liabilities in basis that had been established in *Crane*, noting that nonrecourse borrowing is a "common business practice[]" and that "[t]axpayers who are not personally liable for encumbrances on property should be allowed depreciation deductions affording competitive equality with taxpayers who are personally liable for encumbrances or taxpayers who own unencumbered property."[15]

The notion that a partner's outside basis may include a share of the partnership's nonrecourse liabilities is a corollary to *Crane* and has its roots in the aggregate model of partnerships (and, thus, in the general principle of subchapter K that a partnership's basis in its asset (or "inside basis") generally ought to equal the sum of the partners' outside bases). For example, if A and B each contribute $20 to a partnership, the partnership borrows $60 and purchases an asset for $100, the partnership's basis in the asset is $100. The sum of A's and B's outside bases ought to equal $100 as well. If one views the partnership as an aggregate, each of A and B would have a $50 share of the asset basis, which includes the portion of the asset basis attributable to the borrowing. If one instead views the partnership as an entity, the path is somewhat more complicated but the end result ought to be the same; it would be inappropriate for A and B to each have an outside basis of $20 while the partnership has a basis in its assets of $100. Among other things, if the rules were designed that way, there would be a mismatch between inside and outside basis and (arguably) inappropriate optionality for partners. Specifically, if a partner wanted higher outside basis, that partner would borrow (presumably on a nonrecourse basis and secured solely by its partnership interests) and then contribute the money (or acquired property) to the partnership. If a partner wanted lower outside basis, the borrowing would instead be at the partnership level.[16]

B. Pre-1954 History

Before the enactment of subchapter K in 1954, the rules applicable to partnerships were sparse and somewhat confusing.[17] A mere nine sections of the 1939 Code dealt with partnership taxation, and even that humble number arguably overstates the amount of guidance they provided taxpayers. The pre-1954 regulations under the 1939 Code followed an entity approach to the determination of outside basis.[18] Much like the current conceptual framework, those regulations provided that a partner's basis in its interest was initially (i) the basis of any property or money that the partner contributed to the partnership in exchange for the partnership interest, (ii) the amount paid by the partner if the partner acquired its interest by purchasing it from an existing partner, or (iii) the value of the interest if the partner inherited it from a partner.[19] Thereafter, the partner's basis was adjusted to reflect the partner's distributive share of taxable income, gain, and loss as well as any contributions and distributions.[20]

The pre-1954 regulations did not address partnership liabilities. As a result, there was considerable uncertainty surrounding the impact of partnership liabilities on the partners' bases in their partnership interest.[21]

C. Partnership Tax Reform in the 1940s and 1950s: ALI's Project and Proposal

In April 1942, the Harvard Law Review published a seminal article by Jacob Rabkin and Mark Johnson discussing the then-current state of the treatment of partnerships under federal income tax laws.[22] Rabkin and Johnson's article highlighted that an increasing number of private businesses were choosing to organize themselves as partnerships, in part due to the heavy federal tax burden imposed corporations at that time.[23] In many cases, those tax burdens were significant enough to outweigh the typical advantages of corporate form, including limited liability, centralized management, and continuity of enterprise.[24] Because corporations had been the preferred business form until that time, federal tax law had not conclusively answered many fundamental questions concerning the taxation of partnerships.[25] After the publication of Rabkin and Johnson's article, the tax community devoted substantial resources to proposing reforms to the rules applicable to partnerships.[26]

More than a decade later, after years of debate among partnership tax practitioners, those efforts culminated in the American Law Institute's 1954 draft proposal for revisions to the federal income tax treatment of partnerships and partners, along with accompanying commentary (the "ALI Report").[27] From the outset, the ALI Report criticized the entity approach predominantly taken in pre-1954 tax law, noting that the aggregate approach "most nearly conforms to the understanding of the parties in the usual small business." Except where necessary to "meet the dictates of normal business activity, equitable treatment, or administrative convenience," the ALI Report proposed that the entity theory would be applied only on an elective basis for larger partnerships or those with complex assets.[28]

In its commentary regarding the determination of outside basis, the ALI Report raised two main criticisms of the pre-1954 approach of the existing regulations, which, as noted, increased the partners' outside basis for the "distributive share of any partnership gain taxed to the partner."[29] First, the ALI Report noted that this meant that in connection with certain transactions (including sales of partnership interests), partners were effectively taxed on their share of the partnership's non-taxable income.[30] Second, the ALI Report highlighted the complexity of needing to recompute a partner's basis in its partnership interests every time the partnership recognized gain or loss or made a distribution.[31]

To address these issues, the ALI Report proposed an aggregate approach to outside basis, pursuant to which "each partner's basis for his interest in the partnership [would be] equal to his share of the partnership's aggregate basis for all of its assets (including money) . . . ."[32] Basis adjustments resulting from a transaction with respect to a partnership interest would be reflected in the partnership's basis in its property but would be allocated solely to the transferee partner.[33] Although the ALI Report did not directly discuss liability allocations, the approach reflected in the ALI Report implicitly allocated basis attributable to recourse and nonrecourse liabilities among the partners *pro rata* based on their distributive shares.[34]

D. The 1954 Code

On March 9, 1954, the House Ways and Means Committee introduced its version of the Internal Revenue Code of 1954. Rather than following the ALI Report's proposed aggregate approach to basis (which specifically provided that a partner's outside basis equaled its share of the partnership's inside basis), the bill preserved the pre-1954 entity-based approach and required separate outside and inside bases. To bridge the gap between the two, however, the bill included Code Sec. 752 in its current form.[35] Section 752 of the 1954 Code achieved the same goal as the approach taken in the ALI Report by creating deemed contributions to, and distributions from, a partnership based on increases and decreases in each partner's share of the partnership's liabilities.[36]

In December 1954, a few months after enactment of the 1954 Code, the authors of the ALI Report published an article in the Columbia Law Review discussing the newly enacted subchapter K provisions.[37] The article's discussion of the impact of partnership liabilities on outside basis is sparse. In fact, the only discussion of section 752 of the 1954 Code arises in the context of the article's discussion of Code Sec. 704(d). The article notes section 752 of the 1954 Code as offering a mitigation of the rule in section 704(d) of the 1954 Code by creating additional outside basis when a partner might otherwise be unable to claim losses due to having insufficient outside basis.[38]

E. The 1956 Regulations

In 1955, Treasury issued a notice of proposed rulemaking that included the first set of proposed regulations under subchapter K.[39] Proposed Reg. §1.752-1 provided rules under section 752 of the 1954 Code. The proposed regulations made clear that nonrecourse liabilities were included in basis. For example, Proposed Reg. §1.752-1(b)(2) explained that if a partnership owns property subject to[40] a mortgage, each partner's basis in its partnership interest includes its

share of the mortgage debt.[41] The rules did not, however, address how to determine a partner's share of a liability (other than assuming that if partners were equal partners, the liability would be shared equally between the partners).

Between the notice of proposed rulemaking and the promulgation of the final regulations, Treasury realized this deficiency and added Reg. §1.752-1(e), which provided:

> A partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement. In the case of a limited partnership, a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership, and the total contribution which he is obligated to make under the limited partnership agreement. However, where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under [Code Sec.] 752(c), in the same proportion as they share the profits.[42]

The regulations also included the following example:

> G is a general partner and L is a limited partner in partnership GL. Each makes equal contributions of $20,000 cash to the partnership upon its formation. Under the terms of the partnership agreement, they are to share profits equally but L's liabilities are limited to the extent of his contribution. Subsequently, the partnership pays $10,000 for real property which is subject to a mortgage of $5,000. Neither the partnership nor any of the partners assume any liability on the mortgage. The basis of such property to the partnership is $15,000. The basis of G and L for their partnership interests is increased by $2,500 each, since each partner's share of the partnership liability (the $5,000 mortgage) has increased by that amount. However, if the partnership had assumed the mortgage so that G had become personally liable thereunder, G's basis for his interest would have been increased by $5,000 and L's basis would remain unchanged.[43]

F. Case Law Under the 1956 Regulations

Following the adoption of the 1956 Regulations, the courts and the IRS considered the application of the rules under section 752 of the 1954 Code in various fact patterns, reaching results that contemporary commentators noted could "fairly be characterized as arbitrary."[44] The overwhelming majority of the published guidance and caselaw during this time period involved partner recourse debt.[45]

In the early 1980s, a series of court decisions concerning partner guarantees of nonrecourse debt prompted a congressional response. In 1980, in *Block v. Commissioner* and *Brown v. Commissioner*, the Tax Court decided that, unless the partnership agreement requires a limited partner to guarantee a partnership debt, a guarantee by that limited partner of partnership debt does not result in the debt being treated as recourse to the limited partner and does not increase the limited partner's outside basis.[46]

In 1983, the Court of Claims extended the holdings of *Block* and *Brown* to a general partner's guarantee of otherwise nonrecourse debt.[47] In *Raphan*, the taxpayers were indirect owners of a limited partnership that had acquired unimproved land. The limited partnership, in connection with a corporation affiliated with the limited partnership's general partner, obtained a construction loan that was guaranteed by the general partner. The general partner and its affiliates, without the knowledge of the limited partners, then misappropriated the funds, diverting them to other projects and for their personal use. The *Raphan* court concluded that the construction loan increased the limited partners' outside bases, notwithstanding the general partner's guarantee.[48] In doing so, the court found that a guarantee of an otherwise nonrecourse debt does not make the guaranteeing partner personally liable for the obligation, because the guaranteeing partner could obtain creditor's remedies against the partnership by paying off the nonrecourse debt and subrogating the creditor's rights of foreclosure.[49]

G. Introduction of the Three-Tier Scheme (1988–1991)

The congressional response to *Raphan* was swift: The Tax Reform Act of 1984 specifically overruled *Raphan* and directed the Treasury and the IRS to prescribe regulations on liability allocations.[50]

Following that Congressional directive, Treasury and the IRS issued temporary, and proposed regulations in 1988 (the "1988 Proposed Regulations").[51] Although the 1988 Proposed Regulations focused on recourse borrowing, they also introduced a three-tier framework for the allocation of nonrecourse borrowing under which partners would share in nonrecourse liabilities:

(i) first, under what became Reg. §1.752-3(a)(1) ("Tier 1"), nonrecourse liabilities are allocated based on their shares of "partnership minimum gain" determined under Reg. §1.704-2;

(ii) second, under what became Reg. §1.752-3(a)(2) ("Tier 2"), nonrecourse liabilities are allocated based on the amount of gain that would be allocated to the partners under Code Sec. 704(c) (forward and reverse) if the partnership disposed of all its property subject to one or more nonrecourse liabilities of the partnership in a taxable transaction in full satisfaction of the liabilities and for no other consideration ("Code Sec. 704(c) Minimum Gain"); and

(iii) thereafter, under what became Reg. §1.752-3(a)(3) ("Tier 3"), nonrecourse liabilities are allocated in proportion to the partners' interests in partnership profits.[52]

In the preamble to the 1988 Proposed Regulations, the IRS and Treasury explained that the reasoning for this three-tier approach was because "one of the principal purposes for including partnership liabilities in the bases of the partners' interests in the partnership is to support the deductions that will be claimed by the partners for the items attributable to those liabilities."[53] That is, the three-tier approach was designed to ensure that the liabilities would be allocated to the partner that needed the liabilities to support the deductions.

The 1988 Proposed Regulations were finalized in 1991 with only minor changes to the provisions governing the allocation of nonrecourse liabilities (the "1991 Final Regulations").[54] In particular, the 1991 Final Regulations moved the provisions relating to nonrecourse liability allocations to their own section—*i.e.*, Reg. §1.752-3—and added language providing that excess nonrecourse liabilities need not be allocated under the same method each year.[55]

The three-tier scheme largely accomplishes its stated goal of causing debt to be allocated to the partners that need it. That is, liabilities are first used to "plug the gap" between Code Sec. 704(b) book basis and fair market value by supporting (i) nonrecourse deductions (*i.e.*, permitting a partner to claim debt-financed deductions without their being suspended under Code Sec. 704(d)) or (ii) leveraged distributions (*i.e.*, permitting a partner to receive a distribution of borrowed proceeds without recognizing gain). Said differently, Tier 1 is something of a technical solution to a technical problem created by the Code Sec. 704(b) capital account regime. If a partnership were required to revalue its assets every time it borrowed money and regularly thereafter, there would be no need for Tier 1 except in the case of distressed partnerships.[56] That is, a lender generally will not lend money to a partnership in an amount that exceeds the fair market value of the partnership's assets (if it did, the partnership would be insolvent). And, once a partnership has borrowed money, the fair market value of its assets generally is not expected to decline below the amount of the loan unless there is some kind of calamity. Thus, if the capital accounting rules required regular marking-to-market of assets, there would rarely be partnerships that have debt in excess of Code Sec. 704(b) book basis and Tier 1 would be largely unused.[57]

Once the liabilities have been used to address this capital accounting quirk, they are then used to plug any remaining gap between tax basis and fair market value. That is, the liabilities are used to prevent a partner with Code Sec. 704(c) gain from recognizing that Code Sec. 704(c) gain before it otherwise would.[58] Unlike Tier 1, the difference between tax basis and fair market value is not merely a Code Sec. 704(b) capital account convention but rather is a core feature of subchapter K. In essence, Tier 1 and Tier 2 are the same in many respects.[59]

H. The Modern Era—Regulations from 1991 to Present

The first round of changes to the 1991 Final Regulations were presaged by Revenue Ruling 95-41.[60] In Revenue Ruling 95-41, the IRS considered the application of the 1991 Final Regulations to a partnership in which one partner contributed appreciated property subject to a nonrecourse loan, and the other partner contributed cash.[61] In its discussion of Tier 3 allocations, the IRS stated that, in determining the partners' shares of partnership profits, one relevant fact "is a partner's share of [Code Sec. 704(c)] built-in gain to the extent that the gain was not taken into account in making an allocation of nonrecourse liabilities under [Tier 2]."[62]

In January 2000, the IRS and Treasury issued proposed regulations (the "2000 Proposed Regulations") formalizing one of the holdings of Revenue Ruling 95-41.[63] Under the 2000 Proposed Regulations, "a partnership [may] allocate the portion of a nonrecourse liabilities [*sic*] in excess of the portions allocated in tiers one and two (excess nonrecourse liabilities) based on the excess [Code Sec.] 704(c) gain attributable to the property securing the liability."[64] The preamble explains that this change was intended to deal with a situation in which there is more Code Sec. 704(b) book depreciation than there is tax depreciation (*i.e.*, there is a ceiling rule limitation) and, as a result an ever-increasing portion of the liability is allocated under Tier 1. The preamble explains that such a shift could result in the contributing partner's recognizing gain as a result of the deemed cash distributions resulting from a shift in liability allocations under Code Sec. 752(b). In particular, the preamble highlighted that "[t]he partnership liability

allocation rules arguably should not accelerate the contributing partner's recognition of that gain when the amount of the partnership's liability attributable to such property is sufficient, if allocated to the contributing partner, to prevent such partner from recognizing gain."[65]

To understand what the preamble was getting at with this observation, consider the following example. (Readers with a less detailed existing knowledge of these rules might consider skipping this example and returning to it after reading Part III.)

Example 1. A contributes an asset worth $120, and B contributes $120 of cash, to LLC. The asset has a $24 tax basis (*i.e.*, has built-in gain of $96) and is depreciable over 3 years. LLC borrows $90 on a nonrecourse basis secured only by the asset. (For simplicity, this example assumes there is no interest payable by LLC on the $90.) The LLC agreement requires all items to be allocated equally unless otherwise required by law. The agreement also requires LLC to use the traditional method with respect to the asset.

At the time of contribution, there is no partnership minimum gain because the asset's Code Sec. 704(b) book basis of $120 is greater than the $90 liability. As a result, none of the liability is allocable under Tier 1. There is $66 of Code Sec. 704(c) Minimum Gain because if the asset were transferred to the lender for no consideration other than satisfaction of the liability, LLC would recognize $66 of gain (the $90 liability minus the $24 tax basis), all of which would be allocable to A under Code Sec. 704(c). Thus, A is allocated $66 of the liability under Tier 2. The remaining $24 of the liability is allocable under Tier 3. The Additional Method under Tier 3 permits LLC to allocate liabilities to A "up to the amount of built-in gain that is allocable to the partner on [Code Sec.] 704(c) property ... to the extent that such built-in gain exceeds the [Code Sec. 704(c) Minimum Gain]."[66] Thus, using the Additional Method, the entire $24 can be allocated to A because A has $30 of Code Sec. 704(c) gain in excess of the $66 of Code Sec. 704(c) Minimum Gain (*see* Table 1).

A's outside basis is $114 ($24 from the contributed property plus the $90 share of liabilities) and B's outside basis is $120 (the amount of cash B contributed).

In year 1, the Code Sec. 704(b) book basis of the asset decreases from $120 to $80.[67] The $40 of Code Sec. 704(b) book depreciation deductions are allocated equally between A and B. There is only $8 of tax depreciation, however, because the asset has $24 tax basis and LLC uses the traditional method. All $8 of tax depreciation is allocated to B.[68] (There are no items other than the depreciation.)

After the year 1 depreciation, therefore, there is $10 of partnership minimum gain because the Code Sec. 704(b) book basis of the asset ($80) is less than the amount of the liability ($90). Because each member has a $5 share of that partnership minimum gain,[69] each will be allocated $5 of the liability under the basic operation of Tier 1. This leaves $80 of the liability to be allocated under Tiers 2 and 3.

A's total Code Sec. 704(c) gain with respect to the property has decreased from $96 to $64 (*i.e.*, the $80 Code Sec. 704(b) book basis minus the $16 tax basis).[70] If LLC transferred the asset to the lender in satisfaction of the liability and for no other consideration, LLC would recognize $74 of gain (the $90 liability minus the $16 of tax basis), only $64 of which would be allocable under Code Sec. 704(c). Thus, A is allocated $64 under Tier 2, leaving a total of $16 to allocate under Tier 3.

Because A's entire Code Sec. 704(c) amount with respect to the asset is accounted for under Tier 2 (*i.e.*, there is no remaining Code Sec. 704(c) gain in excess of the Code Sec. 704(c) Minimum Gain), LLC can no longer use the Additional Method under Tier 3. (This, in part, explains why the regulations expressly permit the Tier 3 method to change every year.) LLC instead allocates the remaining $16 of liability in accordance with the member's profit shares (*i.e.*, equally) (*see* Table 2).

TABLE 1.

	A's Allocation	B's Allocation	Total
Tier 1	-	-	-
Tier 2	$66	-	$66
Tier 3	$24	-	$24
Total	**$90**	**-**	**$90**

TABLE 2.

	A's Allocation	B's Allocation	Total
Tier 1	$5	$5	$10
Tier 2	$64	-	$64
Tier 3	$8	$8	$16
Total	**$77**	**$13**	**$90**

A's outside basis is now $101 (the $24 of basis from the contributed property plus the $77 share of the liability) and B's is $125 (the $120 of cash B contributed, minus the $8 of tax depreciation B was allocated, plus the $13 share of the liability).

In each of years 2 and 3, the partnership minimum gain will increase by another $40 because there is $40 of Code Sec. 704(b) book depreciation and there is no change in the amount of the liability. This will increase the amount of the liability allocated under Tier 1, which will decrease the amount that is allocated under Tiers 2 and 3. When the asset is fully depreciated at the end of year 3, the entire liability is allocated under Tier 1 as shown in Table 3.

At the end of year 3, A's outside basis is $69 ($24 of basis from the contributed property plus the $45 share of the liability) and B's is $141 (the $120 of cash B contributed, minus the $24 of tax depreciation B was allocated plus the $45 share of the liability).

This reduction in A's outside basis potentially has undesirable and inefficient consequences that the regulations expressly seek to avoid (such as A's recognizing gain under Code Sec. 731(a) or having deductions suspended under Code Sec. 704(d)). Meanwhile, B has more outside basis than it needs due to the additional $45 of liability it is now allocated.

The Additional Method is designed to give taxpayers more flexibility under Tier 3 to mitigate the ill effects of this situation in at least some cases. That is, when there is enough Code Sec. 704(c) gain, the partnership may be able to allocate liabilities under Tier 3 to undo some or all of the liability shifting described above. (Example 1 is not one of those cases because there is only one asset.)

The preamble acknowledges that the Additional Method solution is not comprehensive and mentions that the IRS and Treasury considered other alternatives (but does not go into detail as to what they were other than to say that they were very complicated). Tackling this problem head on would, in our view, require modifying the regulations to make them purposive rather than prescriptive.[71] That is, the regulations would need to state the end result that they are aimed at and then empower the partnership to use whatever methodology is needed to accomplish that result. Instead, the IRS and the Treasury effectively doubled down on a process-driven set of rules designed to achieve an outcome, even while acknowledging that the outcome may not be possible within the confines of the rules.

TABLE 3.

	A's Allocation	B's Allocation	Total
Tier 1	$45	$45	$90
Tier 2	-	-	-
Tier 3	-	-	-
Total	**$45**	**$45**	**$90**

The 2000 Proposed Regulations were finalized in the same year (the "2000 Final Regulations") with a few notable changes, including adding additional flexibility by clarifying that the new "additional" method for nonrecourse liability allocations would take into account reverse Code Sec. 704(c) amounts in addition to forward Code Sec. 704(c) amounts.[72] Additionally, the preamble to the 2000 Final Regulations reiterated that the purpose of the tripartite scheme is to allocate liabilities to the partner that "needs" those liabilities and to give taxpayers sufficient flexibility to make sure that happens:

> One commentator asked that the rule for allocating a single liability among multiple properties under the second tier also apply to third tier allocations ... There is no need to bifurcate cross-collateralized debt under this tier [three], since excess [Code Sec.] 704(c) gain is not limited by the amount of debt attributable to specific partnership property. So long as a partner's share of excess [Code Sec.] 704(c) gain is attributable to property that is "subject to" the debt being allocated, the debt may be allocated in accordance with that partner's share of such excess [Code Sec.] 704(c) gain. Multiple properties may be subject to the same indebtedness. Bifurcating the debt among multiple properties so that each property is treated as subject to only a portion of the debt actually would limit taxpayers' flexibility ... Accordingly, the commentator's recommendation is not adopted.[73]

Through the early 2000s, the IRS and Treasury updated the nonrecourse liability allocation regulations for a number of technical matters. First, in 2003, in response to the Community Renewal Tax Relief Act of 2000,[74] the IRS and Treasury proposed (and, in 2005, finalized) Reg. §1.752-7 (with attendant tweaks to Reg. §1.704-3) which was intended to prevent (in the partnership context) abuses similar to those for which Code Sec. 358(h) had been enacted.[75]

In 2014, the IRS and Treasury issued a set of proposed regulations (the "2014 Proposed Regulations") that

would have replaced the "significant item method" and "alternative method" with a bright-line test providing that the allocation of liabilities under Tier 3 would be based on each partner's "liquidation value percentage," which would be determined upon formation and redetermined each time an event occurred that could give rise to a revaluation under Reg. §1.704-1(b)(2)(iv)(*f*)(*5*).[76] The entire rationale provided for this change was that "[t]he IRS and the Treasury Department believe that the allocation of excess nonrecourse liabilities in accordance with the significant item method and the alternative method may not properly reflect a partner's share of partnership profits that are used to repay such liabilities because the allocation of the significant item may not necessarily reflect the overall economic arrangement of the partners."[77]

In response to commenters' concerns with the proposed approach, the final regulations limited the removal of the significant item method and alternative method to determining a partner's share of a partnership liability for disguised sale purposes, leaving the core rules of Reg. §1.752-3 untouched.[78]

III. The Modern Regulations: Flexibility in the Tripartite Scheme in Reg. §1.752-3(a)

This Part III discusses each of the three tiers, focusing on the flexibility partnerships have, and the judgment they must exercise, in allocating nonrecourse liabilities under current law.

A. Introduction

For purposes of Code Sec. 752, Reg. §1.752-1(a)(4) provides that a "liability" is an obligation, the incurrence of which:

(A) creates or increases the basis of any of the obligor's assets (including cash);
(B) gives rise to an immediate deduction to the obligor; or
(C) gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.[79]

An "obligation," in turn, is any fixed or contingent obligation to make a payment, including a debt obligation.[80] Thus, a typical borrowing (for example, under a credit agreement, indenture, or promissory note) constitutes (i) an obligation because it gives rise to an obligation to make a payment (*i.e.*, repay the principal) and (ii) a liability because incurring that obligation increased the basis of the obligor's assets (*i.e.*, cash or the asset acquired with the proceeds).

The regulations further classify liabilities as "recourse" or "nonrecourse." 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.[81] Conversely, 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.[82]

Under Reg. §1.752-3, all nonrecourse liabilities are allocated among the partners under a three-tier system, each tier of which is discussed in more detail below.

B. Tier 1

First, Reg. §1.752-3(a)(1) provides that nonrecourse liabilities are allocated to each partner to the extent of the partner's share of partnership minimum gain, determined in accordance with Reg. §1.704-2.[83]

Very generally, a partner has a share of minimum gain when the partner (i) was allocated deductions attributable to a nonrecourse borrowing or (ii) received a distribution out of the proceeds of a nonrecourse borrowing and, in either case, the borrowing gave rise to partnership minimum gain. Under Reg. §1.704-2, partnership minimum gain is the amount by which the partnership's nonrecourse liabilities exceed the Code Sec. 704(b) book basis of the properties that are subject to the liabilities.[84] As noted above, a partner's share of partnership minimum gain at the end of the partnership's taxable year is (i) the sum of nonrecourse deductions allocated to that partner in that year and the distributions made to that partner allocable to the proceeds of a nonrecourse liability in that year, minus (ii) the partner's share of the net decreases in partnership minimum gain (including from the revaluation of partnership property subject to a nonrecourse liability).[85]

The regulations also provide that items attributable to a decrease in partnership minimum gain are allocated to the partner that was allocated the associated nonrecourse deduction or that received the associated distribution of nonrecourse borrowing proceeds (the determination regarding which partner is to receive an allocation of income or gain is made under the "chargeback" rules in the regulations).[86]

1. Minimum Gain Attributable to Nonrecourse Deductions

Because nonrecourse deductions cannot have substantial economic effect, Reg. §1.704-2 includes a detailed set of rules governing their allocation.[87] In essence, the rules provide that nonrecourse deductions must be allocated in a

manner that is "reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities" or in accordance with the partners' interests in the partnership.[88]

The following example illustrates the allocation of nonrecourse liabilities under Tier 1.

Example 2. A contributes $270, and B contributes $30, of cash to LLC. The LLC agreement complies with the alternate test for economic effect.

Under the LLC agreement, all profit and loss is allocated 90 percent to A and 10 percent to B until A has been allocated $300 of net profit over the life of the LLC. Thereafter, all items are allocated 40 percent to A and 60 percent to B. LLC reasonably expects to reach the 40 : 60 level of the allocation waterfall in a few years.

The LLC agreement also provides that nonrecourse deductions will be allocated as determined by the members.

LLC borrows $600 from Bank and purchases an asset for $900. No member provides credit support. The asset is depreciable over 3 years (straight line).

In year 1, LLC allocates $270 of deductions to A and $30 to B pursuant to the 90 : 10 rule in the LLC agreement. (These deductions are not nonrecourse deductions because there is no partnership minimum gain, meaning that the deductions are not attributable to an increase in partnership minimum gain.)

In year 2, LLC has another $300 of depreciation deductions to allocate. These deductions are nonrecourse deductions because they are attributable to an increase in partnership minimum gain, so the members may determine how to allocate them provided the allocation is "reasonably consistent" with some other significant item. Because LLC reasonably expects that items eventually will be allocated under the 40 : 60 level of the waterfall, "reasonable consistency" means any allocation ratio between 90 : 10 and 40 : 60.

LLC determines to allocate the nonrecourse deductions equally. A's minimum gain chargeback exposure is $150 and B's is also $150. The liability is allocated under Tier 1 accordingly.[89]

2. Minimum Gain Attributable to Distributions

The regulations similarly include rules governing the determination of the extent to which a partner received a distribution allocable to the proceeds of a nonrecourse borrowing that increased partnership minimum gain. Under those rules, a partnership first determines the amount of the increase in partnership minimum gain and then determines which partner's share of partnership minimum gain increased as a result of the borrowing and distribution. For this purpose, a nonrecourse liability is "allocable to an increase in partnership minimum gain" to the extent the increase in minimum gain results from the borrowing (*i.e.*, to the extent the liability encumbers assets with a basis less than the amount of the liability).[90]

To determine which partner's share of partnership minimum gain is increased by a borrowing and distribution, the regulations require the partnership to use "any reasonable method."[91] Although the regulations do not go into detail on what a "reasonable" method might be, they expressly provide that tracing of proceeds under Reg. §1.163-8T is reasonable.[92] Thus, if there are more nonrecourse borrowing proceeds than the amount of the increase in partnership minimum gain, the partnership must determine which partner(s) receive a distribution that out of proceeds that increased partnership minimum gain and in what amounts using any reasonable method, including tracing. Said differently, if only a portion of the borrowing gives rise to partnership minimum gain, the partnership effectively is required simply to designate which partner received the dollars that resulted in an increase in minimum gain, as illustrated by the following example.[93]

Example 3. LLC has three equal members, A, B, and C. LLC has an asset with a fair market value of $2,000 and a Code Sec. 704(b) book basis of $1,000 and $800 in nonrecourse liabilities. Before the transactions described in the next paragraph, A has an outside basis of $80, B has an outside basis of $30, and C has an outside basis of $40. There is no partnership minimum gain because the amount of the liabilities ($800) does not exceed the Code Sec. 704(b) book basis of the asset ($1,000).

LLC borrows $300 on a nonrecourse basis and distributes $100 to each of A, B, and C. Accordingly, LLC's partnership minimum gain increases from $0 to $100 ($1,100 liabilities exceeds $1,000 Code Sec. 704(b) book basis).

LLC is required to allocate $100 of the liability under Tier 1 using any reasonable method including tracing proceeds.

LLC determines to allocate the $100 *pro rata* in accordance with the amount of gain the members would recognize under Code Sec. 731(a) without regard to the allocation of the liability. Specifically, if the liability were not allocated among the partners, A would have recognized $20, B would have recognized $70, and C would have recognized $60, of gain under Code Sec. 731(a). LLC thus determines that $13.33 of A's distribution, $46.67 of B's distribution, and $40 of C's distribution, was attributable to the increase in partnership minimum gain.

As a result, the Tier 1 portion of the liability is allocated: $13.33 to A, $46.67 to B, and $40 to C.

In this example, LLC could have determined that anywhere from $0 to $100 of the distribution to each of A, B, or C is attributable to an increase in that member's share of LLC's minimum gain as long as the total of the three amounts is $100.

3. Flexibility and Its Limits

As demonstrated above, Tier 1 provides broad flexibility in determining the initial allocation of nonrecourse liabilities. A partnership may, in effect, determine the partners' shares of nonrecourse liabilities under Tier 1 using the flexible "reasonable consistency" approach in the case of partnership minimum gain arising as a result of nonrecourse deductions and the even more flexible "any reasonable method" approach in the case of partnership minimum gain arising as a result of distributions of nonrecourse borrowings. Once a partnership selects an initial allocation method under Reg. §1.704-2, however, it seems that the partnership generally cannot change which partner has that share of partnership minimum gain and thus cannot change which partner is allocated liabilities under Tier 1. That is, once nonrecourse deductions have been allocated or nonrecourse debt proceeds have been distributed, the partnership cannot change how those allocations were made or those proceeds were distributed. As a result, the partnership generally cannot change the partners' shares of partnership minimum gain.

There is one qualification to the preceding paragraph that bears mention. If the partnership revalues its assets (*i.e.*, brings their Code Sec. 704(b) book values up to fair market value), the partnership minimum gain disappears because the Code Sec. 704(b) book basis after the revaluation exceeds the amount of the debt.[94] The amount that was partnership minimum gain before the revaluation becomes reverse Code Sec. 704(c) gain, thereby resulting in an allocation under Tier 2 (assuming the amount of the debt is greater than the tax basis of the assets). Under Reg. §1.704-2(d)(4), such a revaluation does not result in a minimum gain chargeback.[95]

Thus, the partnership has at least some flexibility to change the allocation of a liability currently allocated under Tier 1 if the partnership can cause a revaluation of the partnership's assets because doing so causes any liabilities allocated under Tier 1 to become allocable under Tier 2.[96] This movement from Tier 1 to Tier 2 is, in essence, the reverse of the effect described in Example 1, in which liabilities allocated under Tier 2 or Tier 3 gradually shift into Tier 1 because of a ceiling rule limitation.

Example 4. LLC has two equal members, A and B. LLC has an asset with a fair market value of $300, a Code Sec. 704(b) book basis of $100, a tax basis of $100, and $150 in nonrecourse liabilities. There is, therefore, $50 of partnership minimum gain, and each of A and B has a $25 share of the partnership minimum gain. LLC revalues its asset, increasing its Code Sec. 704(b) book basis to $300. As a result, there is no longer any partnership minimum gain because the amount of the liability does not exceed the Code Sec. 704(b) book basis. There is now, however, reverse Code Sec. 704(c) gain of $200, because there is a $200 difference between the Code Sec. 704(b) book basis of $300 and the tax basis of $100.[97] As a result, if the asset were transferred to the lender for no consideration other than satisfaction of the liability, the members would be allocated gain under Code Sec. 704(c). Thus, the liability is no longer allocable under Tier 1 and instead is allocable under Tier 2.

C. Tier 2

Any nonrecourse liabilities not allocated under Tier 1 are next allocated under Tier 2 (*i.e.*, Reg. §1.752-3(a)(2)) to each partner in an amount equal to the amount of any Code Sec. 704(c) Minimum Gain.[98] Example 5 illustrates the basic application of Tier 2.

Example 5. A, B, and C form LLC, with A contributing a nondepreciable asset ("Asset") with a fair market value of $700 and a tax basis of $300, subject to a $400 nonrecourse liability, and B and C each contributing $200 of cash. The lender does not have

recourse to any of LLC's assets (including its cash) other than Asset.

LLC has no partnership minimum gain because the amount of the liability, $400, is not greater than the $700 Code Sec. 704(b) book basis of Asset. As a result, none of the liability is allocated under Tier 1.

There is, however, Code Sec. 704(c) Minimum Gain because if Asset were disposed of for no consideration other than satisfaction of the $400 liability, LLC would recognize $100 of gain (the $400 liability less the $300 tax basis), and that gain would be allocated to A under Code Sec. 704(c)(1)(A).

Therefore, under Reg. §1.752-3(a)(2), $100 of the liability is allocated to A because A is the only member of LLC that has a share of LLC's Code Sec. 704(c) Minimum Gain.[99]

Code Sec. 704(c) Minimum Gain is calculated on a property-by-property basis.[100] Under Reg. §1.752-3(b), if a partnership holds multiple properties subject to a single nonrecourse liability, the partnership may allocate the liability under Tier 2 among the multiple properties using any reasonable method.[101] This rule is discussed in detail below.

Determining the amount of each partner's Code Sec. 704(c) Minimum Gain is, of course, not always as simple as subtracting the partnership's tax basis in an asset from the amount of a nonrecourse liability that is allocated to that asset under Reg. §1.752-3(b). Because Tier 2 refers to the taxable gain that would be allocated to a partner under Code Sec. 704(c), a partnership's chosen Code Sec. 704(c) allocation method can affect the amount of liabilities allocated to the partner under Tier 2.[102] For example, if a partnership uses the remedial method under Reg. §1.704-3(d) with respect to an asset, it is quite possible that, upon a sale of partnership property solely in satisfaction of the encumbering liability, the partnership would allocate more tax gain under Code Sec. 704(c) to the Code Sec. 704(c) partner than would have been allocated under the traditional method. This, in turn, would cause the partner to have more Code Sec. 704(c) Minimum Gain and, thus, be allocated more liabilities under Tier 2.[103]

Tier 2 is perhaps the least well understood of the three tiers. Indeed, our experience suggests many practitioners assume that Tier 2 is largely mechanical and prescriptive. It is not. Instead, in all but the simplest cases, taxpayers and their advisors must exercise a high degree of discretion and judgment simply to apply the rules. Much of that discretion relates to the interaction between the multiple properties rule of Reg. §1.752-3(b) and the rules of Code Sec. 704(c).

Below we discuss the multiple properties rule and then outline three conceptual approaches that a taxpayer can use to apply the rule.

1. Multiple Properties Rule

As noted above, if a partnership holds multiple properties subject to a single nonrecourse liability, Reg. §1.752-3(b) requires the partnership to allocate the liability among those properties to determine the amount of Code Sec. 704(c) Minimum Gain. This, in turn, determines the amount of liabilities to be allocated under Tier 2. Reg. §1.752-3(b)(1) provides that the portion of the nonrecourse liability allocated to each item of partnership property is then treated as a separate liability for purposes of Tier 2.

Under these rules, a partnership may allocate the nonrecourse liability under Tier 2 among the multiple properties using any reasonable method.[104] The regulation does not define "reasonable method" other than by imposing two limitations: (i) the partnership is not permitted to allocate to any item of property an amount of the liability that, when combined with any other liabilities allocated to the property, is in excess of the fair market value of the property at the time the liability is incurred and (ii) in some contrast with Tier 3, the partnership may not change the method of allocating a single nonrecourse liability while any portion of the liability is outstanding.[105] Moreover, it is clear that a reasonable method can allocate liabilities among assets in a manner other than *pro rata* among assets in accordance with their relative values or relative Code Sec. 704(c) amounts. Indeed, Reg. §1.752-3(c) *Example 3* specifically contemplates allocations that are not *pro rata* in accordance with relative values or relative Code Sec. 704(c) amounts. In Reg. §1.752-3(c) *Example 3*, a partner contributes two items of property to a partnership. At the time of contribution, property X has a fair market value of $70 and is subject to a nonrecourse liability of $50, and property Y has a fair market value of $120 and is subject to a nonrecourse liability of $70. Each piece of property has a $40 tax basis. Immediately after contribution, the partnership refinances the two liabilities into a single nonrecourse liability of $120. The partnership, in accordance with (and as permitted by) Reg. §1.752-3(b), allocates the liability $60 to property X and $60 to property Y. As noted above, this allocation is not *pro rata* in accordance with relative values (which are approximately 37 : 63), nor is it *pro rata* in accordance with relative built-in gain amounts (which are approximately 28 : 72). It is also

different from the amount of the liability by which each asset was encumbered before the refinancing.[106]

Reg. §1.752-3(b) provides two additional rules that apply to the allocation of liabilities among multiple properties. First, "if one or more of the multiple properties subject to the liability is no longer subject to the liability, the portion of the liability allocated to that property must be reallocated among the properties still subject to the liability so that the amount of the liability allocated to any property does not exceed the fair market value of such property at the time of reallocation."[107] Second, when the outstanding principal of a partnership liability is reduced, the reduction is allocated among the multiple properties *pro rata* in accordance with the original allocation to the properties under the principles described above.[108]

2. Three Conceptual Approaches on Which to Base a Reasonable Method

Because Reg. §1.752-3(a)(2) effectively requires a partnership to calculate Code Sec. 704(c) Minimum Gain with respect to each partner but does not provide any express guidance on how to do so when there is more Code Sec. 704(c) gain with respect to the partnership's assets than there is Code Sec. 704(c) Minimum Gain. Example 6 illustrates this issue in its simplest form.

> **Example 6.** Each of A and B contributes $100 of cash to a newly formed LLC. LLC uses the $200 to buy a depreciable asset, which it fully expenses. LLC borrows $120 secured by the asset. When the asset has a tax basis of $0 and a fair market value of $200, LLC revalues the asset. There is $200 of reverse Code Sec. 704(c) gain with respect to the asset but only $120 of Code Sec. 704(c) Minimum Gain because if LLC transferred the asset to the lender in a taxable transaction for no consideration other than the satisfaction of the liability, LLC would recognize only $120 of gain that would be allocable under the principles of Code Sec. 704(c)(1)(A).

Reg. §1.752-3(a)(2) does not expressly provide how to determine how much of the $120 of Code Sec. 704(c) Minimum Gain would be attributable to A and how much to B. As discussed in greater detail below, in our view, a partnership must, therefore, make that determination using the "reasonableness" principles of Reg. §1.704-3 and Reg. §1.752-3.

There are at least three conceptual approaches to making this determination. The primary difference between the approaches is in what they consider to be an "asset" to which a portion of a liability may be allocated. The first approach (the "Unitary Asset Approach") treats each separate item of property for state law purposes as a single separate asset for purposes of Reg. §1.752-3(b). The second approach (the "Separate Layers Approach") further subdivides each item of state-law property by treating each Code Sec. 704(c) layer with respect to that item of property as a separate asset. The final approach (the "Separate Shares Approach") treats each partner's share of each Code Sec. 704(c) layer with respect to each separate item of property as a separate asset for purposes of Reg. §1.752-3(b).[109]

Although conceptually different, each approach requires the partnership to exercise judgment to determine the amount of the partners' Code Sec. 704(c) Minimum Gain. Each of the three conceptual approaches can serve as the foundation for a reasonable method that complies with Reg. §1.752-3(b), and, importantly, none of the three approaches requires an allocation of liabilities that results in an allocation under Reg. §1.752-3(a)(2) that is *pro rata* in accordance with the partners' relative Code Sec. 704(c) amounts.

a) The Unitary Asset Approach. The Unitary Asset Approach has the advantage of conceptual simplicity and intuitiveness. Unlike the other two approaches, it can be understood without a deep expertise in the framework of subchapter K because each item of partnership property is treated as a single asset regardless of its particular tax characteristics. Said differently, for purposes of allocating nonrecourse liabilities among the multiple properties subject to that liability under Reg. §1.752-3(b), no partnership asset is divisible into separate notional assets; instead, each partnership asset is treated as a single asset. This approach is illustrated by the following example:

> **Example 7.** LLC has three equal members, A, B, and C. A contributed an asset with a fair market value of $200 and a tax basis of $0, and B and C each contributed $200 of cash. LLC retains the cash and has no other assets. When the asset contributed by A is worth $500, LLC revalues its assets, reflecting the $300 of revaluation gain in the capital accounts of the members, with each member's capital account increasing from $200 to $300. There are, therefore, two Code Sec. 704(c) layers with respect to the asset: A $200 forward layer and a $300 reverse layer. LLC uses the traditional method under Reg. §1.704-3(b) with respect to both layers and uses the Unitary Asset Approach with respect to Reg. §1.752-3(b).
>
> LLC incurs a $90 nonrecourse liability, which it allocates entirely to the asset contributed by A. Thus,

if LLC disposed of that asset for no consideration other than the satisfaction of the liability, LLC would recognize $90 of gain that would be allocable under Code Sec. 704(c)(1)(A). As a result, there is less Code Sec. 704(c) Minimum Gain ($90) than total Code Sec. 704(c) gain ($500).

Under the Unitary Asset Approach, if the amount of the liability allocated to an asset is less than the total amount of Code Sec. 704(c) gain with respect to that asset, the partnership may be required to make two decisions to determine the amount of Code Sec. 704(c) Minimum Gain upon a disposition of the asset in satisfaction of the liability allocated to that asset and no other consideration. First, if there is more than one Code Sec. 704(c) layer with respect to the asset, the partnership must determine which Code Sec. 704(c) layers would be recognized and to what extent each layer should be recognized.[110]

Example 8. LLC has two equal members, A and B. A contributed $100 in cash and B contributed a nondepreciable asset with a fair market value of $100 and a tax basis of $0. LLC retains the cash and has no other assets. When the asset contributed by B is worth $300, LLC admits a new member and revalues its assets, reflecting the $300 of revaluation gain in A's and B's capital accounts. There are, therefore, two Code Sec. 704(c) layers with respect to the asset: A $100 forward layer and a $200 reverse layer. LLC borrows $120 secured by the asset and distributes it equally to A and B. There is, therefore, $300 of total Code Sec. 704(c) gain but only $120 of Code Sec. 704(c) Minimum Gain.

In Example 8, LLC must first determine how much of the $120 of Code Sec. 704(c) Minimum Gain is attributable to the forward layer and how much is attributable to the reverse layer. Imagine that the Code Sec. 704(c) Minimum Gain represents a full bucket of water and the forward and reverse layers represent empty buckets of different sizes (*see* Figure 8.1).

What methods can LLC use to distribute the Code Sec. 704(c) Minimum Gain between the two empty buckets? There are at least five possible methods for determining the *inter*-layer allocation, each of which is illustrated below (*see* Figure 8.2).[111]

Specifically, LLC could (i) first fill up the $100 forward bucket before moving onto the reverse bucket, (ii) first fill up the reverse bucket, leaving nothing for the forward, (iii) fill up the two buckets *pro rata* in accordance with their size (*i.e.*, 1 : 2), (iv) fill the two buckets equally, or (v) do anything in between the two extremes (*i.e.*, follow a "reasonable consistency" approach akin to the allocation of nonrecourse deductions under Reg. §1.704-2) (*see* Figure 8.3).

Once LLC has made the *inter*-layer decision, if any Code Sec. 704(c) layer would be partially (but not completely) recognized and more than one partner has a share of the gain in that layer, the partnership must determine how the partners share the portion of the gain that is recognized. The amount of gain that the partnership determines would be allocated to each partner under Code Sec. 704(c) in such a disposition is that partner's Code Sec. 704(c) Minimum Gain. For example, suppose that LLC determines that all of the Code Sec. 704(c) Minimum Gain is attributable to the reverse layer. Both A and B have a $100 share of the reverse layer, but there is only $120 of Code Sec. 704(c) Minimum Gain. Thus, LLC must perform essentially the same bucket filling exercise *intra*-layer as it performed *inter*-layer. The possible approaches are essentially the same.[112]

Because the regulations do not provide guidance regarding the determination of which partners are treated as having Code Sec. 704(c) Minimum Gain (and in what

FIGURE 8.1.

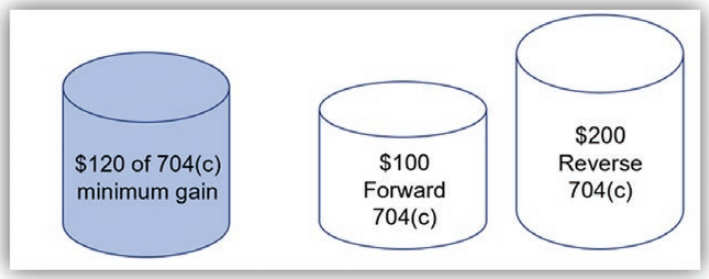


FIGURE 8.2.

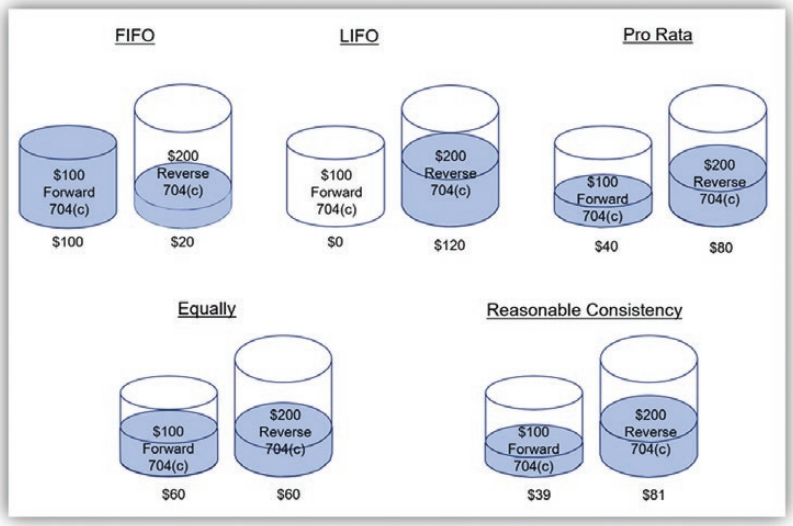
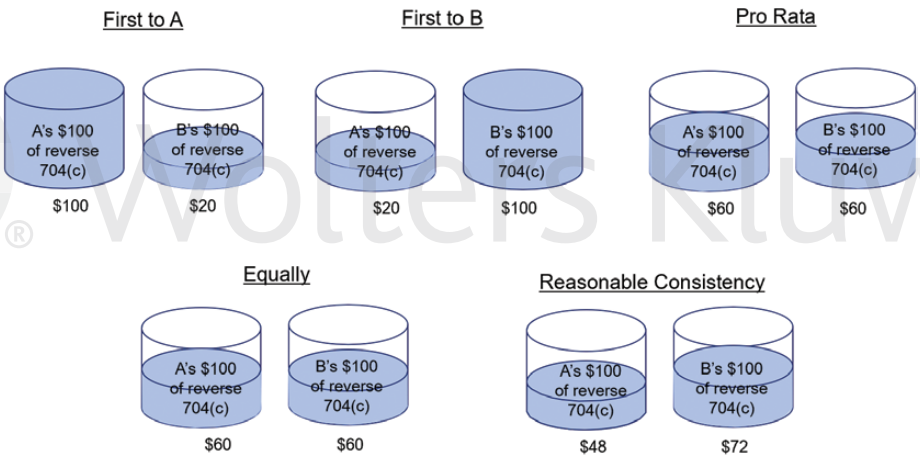


FIGURE 8.3.



proportions), we believe that a partnership must follow the general rule of Reg. §1.704-3(a)(1) and use "any reasonable method" to make this determination. As discussed below, we believe each of these *inter*- and *intra*-layer methods is appropriate and can be "reasonable" within the meaning of Reg. §1.704-3. In addition, just as different Code Sec. 704(c) methods can be used for different Code Sec. 704(c) layers,[113] it is appropriate to use different approaches to *inter*- and *intra*-layer allocations as long as doing so is "reasonable." Example 9 illustrates the use of a LIFO method for *inter*-layer allocation and a reasonable consistency method for the *intra*-layer allocation.

Example 9. The facts are the same as in Example 6 (*i.e.*, three equal members; LLC has a single non-cash asset, with respect to which there is a $200 forward Code Sec. 704(c) layer and a $300 Code Sec. 704(c) reverse layer). Under the Unitary Asset Approach, LLC must decide whether the $90 of gain that is allocable under Code Sec. 704(c)(1)(A) is attributable to the $200 forward Code Sec. 704(c) layer, the $300 reverse Code Sec. 704(c) layer, or both. In addition, if LLC determines that any of the gain is attributable to the reverse Code Sec. 704(c) layer, LLC must determine the manner in which A, B, and C share that gain.

LLC adopts a "last-in, first-out" ("LIFO") approach such that LLC determines that the $90 of gain is attributable to the most recently created Code Sec.

> 704(c) layer—that is, the reverse Code Sec. 704(c) layer. Further, LLC determines that $50 is attributable to A, $25 to B, and $15 to C. LLC could have used any other allocation among A, B, and C because the total amount of gain to be allocated is less than each partner's share of the gain in the reverse layer. Thus, for example, all $90 could have been allocated to any one partner.

The IRS and Treasury explicitly addressed the *inter*-layer flexibility in the preamble to 2014 proposed regulations that would amend Reg. §1.704-3 to clarify the interaction between multiple Code Sec. 704(c) and reverse Code Sec. 704(c) layers and allocations of tax items between the multiple layers.[114] In a response to a request for comments on the treatment of Code Sec. 704(c) layers in partnership mergers in IRS Notice 2009-70, the New York State Bar Association Tax Section suggested that tax items could be allocated among multiple Code Sec. 704(c) layers using one of three methods: (1) allocating items to the oldest layer first, (2) allocating items to the newest layer first, or (3) allocating items *pro rata* among the layers.[115] The IRS and Treasury agreed "that partnerships should be permitted to use any reasonable method in allocating tax items," acknowledging that each of these methods would be reasonable, but declined to adopt a default rule because "no single method is more appropriate than other methods."[116] The preamble then confirms that "a partnership may use any reasonable method to allocate items of income, gain, loss, and deduction associated with an item of property among the property's forward and reverse [Code Sec.] 704(c) layers subject to the anti-abuse rule in [Reg.] §1.704-3(a)(10)."[117]

The *inter*-layer flexibility is also apparent from the example in Reg. §1.752-7(c)(2), in which two partners contribute cash and the third contributes fair market value basis property subject to a Reg. §1.752-7 liability with a negative value of $100. In year 2, the liability has increased to $200. The partnership earns $200 and uses it to satisfy the liability. Because the partnership "elects to treat the deductions or losses attributable to the §1.752-7 liability as coming first from the built-in loss," the first $100 of deductions resulting from the satisfaction of the liability are allocated to the partner who contributed the property subject to the Reg. §1.752-7 liability. That is, the example effectively approves of a "first-in-first-out" ("FIFO") approach in which the forward layer is recognized first.[118]

Finally, in a letter ruling issued after the finalization of Reg. §1.752-7, the IRS took the same approach with respect to Code Sec. 704(c) property. In PLR 200829023, the IRS ruled that when a partnership disposed of property with multiple Code Sec. 704(c) layers in a partially taxable Code Sec. 1031 exchange, the partnership could determine which layers the gain recognition related to using "a reasonable method." In the ruling, a partnership held property that had been contributed with built-in gain. Subsequent revaluations had resulted in one or more reverse Code Sec. 704(c) layers with respect to the property. Upon disposition of the property in a Code Sec. 1031 exchange, the partnership received cash in an amount that was (i) greater than the amount of Code Sec. 704(b) book gain recognized in the transaction but (ii) less than the sum of the Code Sec. 704(b) book gain recognized in the transaction plus the amount of Code Sec. 704(b) book gain recognized in previous upwards revaluations. The amount of cash received meant that some (but not all) of the gain in the reverse Code Sec. 704(c) layers would have to be recognized.

The partnership chose to adopt a LIFO methodology for determining the layer to which the taxable gain related. The partnership first allocated taxable gain to the partners that recognized Code Sec. 704(b) book gain in the transaction in an amount equal to that Code Sec. 704(b) book gain. Then it allocated the remaining taxable gain to the partners whose capital accounts had previously been increased to reflect revaluation gain (*i.e.*, in respect of reverse Code Sec. 704(c) layers) beginning with the most recent such revaluations. If there had been unallocated gain after all reverse layers were recognized, it would have been allocated to the partner with respect to the pre-contribution gain (*i.e.*, in respect of the forward Code Sec. 704(c) layer). The ruling concludes that the proposed "LIFO" methodology is a reasonable method because it "preserves any unamortized [Code Sec. 704(c)] built-in gain in full in the replacement of property while respecting the allocations of [Code Sec.] 704(b) book gain actually realized in the exchange or constructively realized *via* book-up" of the property."

The IRS, in concluding that the taxpayer's use of a LIFO method was reasonable, acknowledged that the determination of the layers to which the recognized gain relates is not provided for in regulations. That is:

> [H]aving applied the dictates of [Reg.] §1.704-1(b)(1)(vi), the issue arises as to how to prioritize the amortization of the remaining book-tax disparity in the property through the allocation of this remaining "excess" tax gain. It is the manner in which this excess tax gain with no current book corollary is attributed under [Code Sec.] 704(c) to the pre-contribution and post-contribution layers of book gain inherent in the contributed or revalued property that will

directly determine the manner in which such excess tax gain is allocated between the contributing and revaluation partners and, in turn, determine the priority given to burning-off the pre-contribution and post-contribution layers of built-in gain.

The logical extension of the IRS's statement, as shown by the conclusion that a LIFO methodology is acceptable, is that the determination of the layers to which the recognized gain relates is, in essence, a matter of judgment for the partnership.

The IRS and Treasury's approval of any reasonable approach, including LIFO, FIFO or *pro rata*, in the preamble to the 2014 proposed regulations under Code Sec. 704(c) and its analysis and approval of a LIFO methodology in PLR 200829023—particularly when combined with the regulatory approval of a FIFO approach in the example in Reg. §1.752-7(c)(2), and the general "reasonableness" framework of both Reg. §§1.704-3 and 1.752-3—makes clear that a partnership has broad discretion to determine the order in which Code Sec. 704(c) gain would be recognized if an asset were transferred (in a taxable transaction) for no consideration other than the satisfaction of the nonrecourse liability encumbering that asset.

As noted above, in addition to determining which layers' Code Sec. 704(c) gain is recognized, it often will be the case that, for each item of property, there will be at least one Code Sec. 704(c) layer with respect to which some, but not all, of the gain is recognized. For example, if using a FIFO approach, it is possible that all of the gain in the forward Code Sec. 704(c) layer would be recognized, but only a portion of the earliest reverse layer's gain would be recognized. If there is more than one partner with a share of the gain in the partially recognized layer, the partnership must determine which of those partners recognizes what amount of gain. Although there is no express guidance on this issue, the same "reasonableness" standard governs the partnership's decision in this regard as the decision of which Code Sec. 704(c) layers are recognized. That is, the rules for *inter*-layer allocations ought to apply to *intra*-layer allocations, meaning that a partnership may (or rather, must) make that determination in any reasonable manner that preserves the built-in gain and respects the allocations of book gain that actually would be realized in an exchange or has been "constructively" realized through a revaluation of the partnership's assets. In our view, this permits the partnership to determine that (i) all of one partner's gain within the layer is recognized before the other partners recognize any, (ii) the partners recognize gain *pro rata* in accordance with their amounts of gain in the layer, or (iii) each partner recognizes an amount of gain in the layer determined by the partnership in any manner so long as that amount does not exceed the partner's share of the gain in that layer. This flexibility is consistent with the regulatory scheme and Reg. §§1.7523 and 1.704-3, as well as the specific guidance discussed above.[119]

b) The Separate Layers Approach. Under the Separate Layers Approach, each Code Sec. 704(c) layer with respect to an item of property is treated as a separate asset for purposes of allocating liabilities under Reg. §1.752-3(b).

Although perhaps less intuitive than the Unitary Asset Approach, the Separate Layers Approach arguably is more consistent with the structure of subchapter K because, like other portions of subchapter K, the Separate Layers Approach treats each separate Code Sec. 704(c) layer as a separate item of property. This principle is demonstrated by the structure of Reg. §1.704-3(a). Reg. §1.704-3(a)(2) provides that a partnership must use a single Code Sec. 704(c) method for each item of contributed property. Reg. §1.704-3(a)(6), therefore, implicitly treats each Code Sec. 704(c) layer with respect to an item of property as a separate item of property by permitting a partnership to use a different Code Sec. 704(c) method for each such layer.[120] Similarly, when a partnership uses the remedial method under Code Sec. 704(c), Reg. §1.704-3(d)(2) requires the partnership to, effectively, divide a single piece of contributed property into two assets: One is the actual asset (with a value equal to its tax basis) and the other is a notional asset composed entirely of an inchoate item (*i.e.*, the remedial income and deduction).

Because the purpose of the allocation under Reg. §1.752-3(b) is to determine the amount of Code Sec. 704(c) Minimum Gain, it is appropriate (and consistent with subchapter K's general approach to Code Sec. 704(c) discussed in the previous paragraph) to view each Code Sec. 704(c) layer as a separate asset for purposes of allocating liabilities among assets under Reg. §1.752-3(b). Just as with the Unitary Asset Approach, the Separate Layers Approach has the effect of permitting an allocation of liabilities among the partners other than *pro rata* in accordance with relative Code Sec. 704(c) amounts because the amount allocated to each separate layer can be any amount that (when combined with other amounts already allocated to the asset) does not exceed the fair market value of the asset. The fair market value of each separate asset generally is the amount of Code Sec. 704(c) gain with respect to the layer.[121] And, as with the Unitary Asset Approach, the partnership will need to determine which partner's share of the gain in each Code Sec. 704(c) layer is treated as being recognized for purposes of determining each partner's Code Sec. 704(c) Minimum Gain.

If a partnership uses the Separate Layers Approach, the partnership allocates liabilities under Reg. §1.752-3(b) to each Code Sec. 704(c) layer. That is, instead of allocating the liability to a single item of property and then determining the manner in which Code Sec. 704(c) layers are recognized (using LIFO, FIFO, or some other reasonable approach as in the Unitary Asset Approach), the partnership determines the amount of the liability allocated to each Code Sec. 704(c) layer and then treats each such layer as being disposed of in a taxable transaction in satisfaction of the liability allocated to that layer (and for no other consideration). This determines the amount of gain recognized with respect to each layer. And, just as with the Unitary Asset Approach, for each Code Sec. 704(c) layer with respect to which some but not all of the gain in a layer would be recognized in the hypothetical sale, the partnership must determine which partners' shares of that gain within that layer are recognized.

The following example illustrates the Separate Layers Approach.

Example 10. LLC has three equal members, D, E, and F. D contributed property with a Code Sec. 704(b) book basis of $200 and a tax basis of $0, and E and F each contributed $200 of cash. LLC retains the cash and has no other assets. When the asset contributed by D is worth $500, LLC revalues its assets, reflecting the $300 of revaluation gain in the capital accounts of the members, with each member's capital account increasing from $200 to $300. LLC uses the traditional method under Reg. §1.704-3(b) for all Code Sec. 704(c) allocations and uses the Separate Layers Approach with respect to Reg. §1.752-3(b).

As a result, LLC has two separate non-cash assets: A $200 forward Code Sec. 704(c) layer with respect to D and a $300 reverse Code Sec. 704(c) layer with respect to each of D, E, and F.

LLC incurs a $90 nonrecourse liability. LLC may allocate the liability in any reasonable manner among its assets (treating each layer as a separate asset). For example, it could allocate the entire $90 to the forward Code Sec. 704(c) layer, with the result that D would have $90 of Code Sec. 704(c) Minimum Gain. Alternatively, it could allocate the entire $90 to the reverse Code Sec. 704(c) layer, yielding a total of $90 of Code Sec. 704(c) Minimum Gain that LLC would need to allocate among D, E, and F in the same manner as if it had followed the Unitary Asset Approach. Moreover, if LLC had not spent the proceeds of the borrowing, it could have allocated the liability to those proceeds such that there is no Code Sec. 704(c) Minimum Gain.

Example 10 demonstrates that, when using the Separate Layers Approach, the decision of which Code Sec. 704(c) layer is recognized is made concurrently with the allocation of liabilities among assets (as opposed to being made *after* liabilities have been allocated to the assets as in the Unitary Asset Approach).

c) The Separate Shares Approach. The Separate Shares Approach is similar to the Separate Layers Approach except that it further divides Code Sec. 704(c) layers by treating *each partner's share* of each Code Sec. 704(c) layer as a separate notional asset for purposes of allocating nonrecourse liabilities under Reg. §1.752-3. As discussed above, under Reg. §1.752-3(b), a partnership may allocate an amount of liabilities encumbering each partner's separate asset up to the fair market value of the separate asset.[122]

Example 11. The facts are the same as Example 10 except that, instead of treating the reverse layer as a single asset, LLC treats each member's share of the gain in that layer as a separate asset. Thus, LLC has four non-cash assets: The $200 forward Code Sec. 704(c) layer with respect to D and the $100 portion of the reverse Code Sec. 704(c) layer with respect to each of D, E, and F.

The Separate Shares Approach is appropriate for all the same reasons as the Separate Layers Approach and has the added advantage of giving credence to the general "partner-by-partner" nature of Code Sec. 704(c).[123] In addition to being embedded in the framework of Reg. §1.704-3, the partner-by-partner approach is apparent from the provisions of Reg. §1.704-4 dealing with undivided interests in property. In that regard, Reg. §1.704-4(c)(6) provides that, when a partner contributes an undivided interest in property and the partnership later distributes an undivided interest in the same property, Code Sec. 704(c)(1)(B) does not apply unless the undivided interest that is distributed exceeds the undivided interest that the partner contributed. Thus, under those regulations, when a partner contributes an undivided interest in property, that undivided interest in a single appreciated asset is treated as a separate item of property with respect to that partner.

If a partnership uses the Separate Shares Approach, there is only one conceptual step involved in allocating liabilities: The partnership allocates liabilities under Reg. §1.752-3(b) to each partner's share of each Code Sec.

704(c) layer in any reasonable manner (up to the fair market value cap described previously). Because each asset that is transferred for no consideration other than the satisfaction of the liability is owned entirely by one partner, there is no need to take any additional steps to determine the allocation of Code Sec. 704(c) Minimum Gain among partners. It should be noted that although there is only one conceptual step in this approach, the partnership, by using the Separate Shares Approach, essentially is making the same two decisions as in the other two approaches.

Example 12. LLC has three equal members, A, B, and C. LLC has $300 cash and one non-cash asset (goodwill) with a zero Code Sec. 704(b) book and tax basis. When the goodwill is worth $300, LLC revalues its assets, reflecting the $300 of revaluation gain in the capital accounts of the members, with each member's capital account increasing from $100 to $200. LLC uses the traditional method under Reg. §1.704-3(b) and uses the Separate Shares Approach with respect to Reg. §1.752-3(b).

As a result of the Separate Shares Approach, LLC has three separate assets (other than cash), each with a $100 value for purposes of Reg. §1.752-3(b).

LLC incurs a $90 nonrecourse liability and may allocate the liability in any reasonable manner among each asset. As a result, it could allocate the $90 liability equally to each partner's notional asset, with the result that each has $30 of Code Sec. 704(c) Minimum Gain and is allocated $30 of the liability; it could allocate the entire $90 liability to one partner's notional asset, with the result that that partner has $90 of Code Sec. 704(c) Minimum Gain and is allocated the entire $90 of the liability; or any allocation in between.

As with the other approaches, the Separate Shares Approach has the effect of permitting an allocation of liabilities among the partners other than *pro rata* in accordance with relative Code Sec. 704(c) amounts because the amount allocated to each separate asset can be any amount that does not exceed fair market value. Once the asset is divided analytically into multiple assets, Reg. §1.752-3(b) simply operates according to its terms.

3. Comparison Among the Three Approaches

Each of the three conceptual approaches both provides flexibility and requires the exercise of discretion in making Tier 2 allocations. There are two principal differences among the three approaches.

The first difference is at what stage in the analytical process the conceptual "leap of faith" needs to be made. With the Unitary Asset Approach, there is essentially no doubt regarding the framework of the approach (*i.e.*, treating an item of property, such as a cell phone, as a unitary asset). There is, however, much less guidance that tells taxpayers how to apply the rules of Reg. §§1.752-3(a)(2) and (b) with respect to that unitary asset; the taxpayer must use its understanding of Code Sec. 704(c) and judgment to apply the rules. By contrast, the Separate Shares Approach requires the taxpayer to use its understanding of Code Sec. 704(c) and judgment to justify the framework of the approach (*i.e.*, treating each share of a Code Sec. 704(c) layer as a separate asset) in the first place. Once the taxpayer has decided to use the Separate Shares Approach, however, the application of the rules is mechanical—the taxpayer simply follows Reg. §1.752-3(b). (The Separate Layers Approach falls between the two and requires both "leaps of faith.")

The second difference is the extent to which the use of the approach allows for or limits flexibility. As with many facets of tax law, there are two types of flexibility at play: initial flexibility to set the allocation up front and temporal flexibility to change the allocation over time once it has been set.

Because the Separate Assets Approach results in the largest number of assets to which a liability may be allocated, it offers the greatest initial flexibility. By contrast, the Unitary Asset Approach offers the fewest assets and therefore the least initial flexibility. (As discussed above, both approaches are very flexible and this relative difference matters only at the margins.[124]) That is, it is relatively easy to see why more assets leads to more initial flexibility—the more actual or notional assets the partnership has, the more ability it has to pick and choose how to allocate the liability among those assets.

The difference in temporal flexibility is a little less obvious and more nuanced. As discussed above, when allocating a single nonrecourse liability among multiple assets to determine the amount of Code Sec. 704(c) Minimum Gain, Reg. §1.752-3(b) limits flexibility *via* two rules: (i) it prohibits a partnership from changing the methodology used for the liability while any portion of the liability is outstanding and (ii) it requires that, upon reductions in principal, requires the "the reduction of outstanding principal [be] allocated among the multiple properties in the same proportion that the partnership liability originally was allocated to the properties." The extent to which a partnership is constrained by those two rules depends on the extent to which the partnership relied on Reg. §1.752-3(b) to accomplish its Tier

2 allocation. That, in turn, depends on which approach the partnership used.

The Separate Shares Approach relies entirely on Reg. §1.752-3(b) to set its Tier 2 allocation. That is, the partnership first divides its assets into notional assets and then allocates an amount of liability to each such asset. The allocation of a liability to the notional assets completely determines the liability allocation under Tier 2; no additional determinations are made, and no additional conceptual steps are needed. As a result, once a partnership adopts the Separate Shares Approach and sets its allocation under Reg. §1.752-3(b), the two rules discussed above apply mechanically to limit the temporal flexibility.

The Unitary Asset, by contrast, has relatively little reliance on Reg. §1.752-3(b). To take an extreme example, imagine a partnership with three equal partners. The partnership has a single asset with respect to which there is a forward layer and a reverse layer shared among three partners. The Separate Shares Approach sees only one asset, making the application of Reg. §1.752-3(b) relatively inconsequential (*i.e.*, there is only one possible allocation—the entire liability must be allocated to the single asset). Instead of relying on Reg. §1.752-3(b) to set the allocation, the partnership relies on the *inter-* and *intra*-layer determinations discussed above. Those determinations simply are not subject to the two flexibility limiting rules of Reg. §1.752-3(b).

Whether the difference in the scope of the limitations in Reg. §1.752-3(b) is meaningful (or appropriate) depends on whether the Unitary Asset Approach is subject to a similar limitation on temporal flexibility, which is somewhat less clear. One might view the *inter-* and *intra*-layer allocation decisions as one or more Code Sec. 704(c) method(s) that cannot be changed once selected.[125] If that were the case, the Unitary Asset Approach would be subject to the same type of restrictions that Reg. §1.752-3(b) imposes with respect to the other two methods (albeit at a different stage of the analysis).

In addition to the question of whether a partnership's *inter-* and *intra*-layer allocation choices constitute Code Sec. 704(c) methods, there also are questions about whether there are consistency requirements in future reporting that effectively limit temporal flexibility. Perhaps most saliently, if a partnership using the Unitary Asset Approach determines that Code Sec. 704(c) Minimum Gain is attributable to a particular Code Sec. 704(c) layer and later disposes of the asset in a taxable transaction, does the Code Sec. 704(c) gain have to be allocated consistently with the partnership's original determination? For example, in Example 9 (regarding the Unitary Asset Approach), LLC determined that (i) the $90 of Code Sec. 704(c) Minimum Gain was attributable to the most recent (*i.e.*, reverse) Code Sec. 704(c) layer and (ii) $50 was attributable to A's share of the reverse layer, $25 to B's share of the reverse layer, and $15 to C's share of the reverse layer. If LLC later disposes of the asset in a taxable transaction and, recognizing $90 of taxable gain, is LLC required to allocate that gain $50 to A, $25 to B, and $15 to C? Does it matter whether the taxable transaction is a foreclosure or a sale to a third party?

Although there is no guidance on these points, it seems difficult to argue that a partnership can simply change its mind on an ad hoc basis if the asset actually is disposed of in a foreclosure. That is, if the LLC described above actually transferred the asset to the lender for no consideration other than satisfaction of the liability and recognized $90 of taxable gain, it would seem inappropriate for the LLC to allocate the taxable gain other than 50 : 25 : 15 (at least absent extenuating circumstances).

But what if, at the time of the borrowing, LLC adopted a written method providing that "if the asset is disposed of in a foreclosure within the first 12 months after the date of the borrowing, the section 704(c) gain will be allocated among A, B, and C $50 : $25 : $15 in respect of the reverse layer. If the gain is recognized in any other situation, the managing member will determine how to allocate the gain at the time the gain is recognized"? That certainly is a "method."[126] Relatedly, what happens if the partnership does not adopt a detailed written method and simply determines that the gain would be allocable to A if there were a foreclosure (but makes no other determinations)?[127] If that asset later is sold in a taxable transaction to an unrelated third party (not the creditor), and the proceeds of the sale are used in whole or in part to satisfy the liability, is the partnership required to allocate the Code Sec. 704(c) gain in the same way that it would have if there had been a foreclosure?

In our view, it is meaningfully less concerning for a partnership to allocate gain recognized in a non-foreclosure disposal differently from the manner in which the partnership determined that gain would be allocated when calculating the amount of Code Sec. 704(c) Minimum Gain. This is especially true if the partners are acting at arm's-length and have adverse interests and/or agree up front how Code Sec. 704(c) gain will be allocated in different situations.[128] For example, if, at the time of the borrowing, unrelated partners with adverse interests agree that Code Sec. 704(c) is to be allocated in one manner if there is a foreclosure and in another if the asset is sold to a third party, there is no statutory, regulatory, or policy reason why that agreement should not be respected.

Examples 13 and 14 illustrate the differences between the Unitary Asset Approach and the Separate Shares Approach.

Example 13. At the start of year 1, A contributes a nondepreciable asset ("Asset A") with a fair market value of $800 and a tax basis of $80 to LLC in exchange for Class A units. B contributes a nondepreciable asset ("Asset B") with a fair market value of $200 and a tax basis of $20 to LLC in exchange for Class B units.

LLC's distribution waterfall provides that all profit and loss economically accrued (i) before the end of year 2 will be shared between the Class A and Class B units 80 : 20 and (ii) from and after the start of year 3 will be shared 50 : 50. The LLC agreement requires LLC to use the traditional method with respect to all Code Sec. 704(c) layers. Immediately after the contribution, there is a forward Code Sec. 704(c) layer with respect to Asset A of $720 and a forward Code Sec. 704(c) layer with respect to Asset B of $180 (each, a "Forward" layer).

At the end of year 2, the members agree to amend the LLC agreement to (i) change the profit and loss sharing ratio such that, beginning in year 3, profit and loss will be shared between the Class A and Class B units 40 : 60 rather than 50 : 50 and (ii) issue a profits interest to new member, C.[129] C's profits interest entitles C to 10 percent of the net fair market value of LLC on an exit to the extent that value exceeds $2,600. In connection with the admission of C, LLC revalues its assets. At the time of the revaluation, Asset A is worth $1,000 (an increase of $200), and Asset B is worth $240 (an increase of $40).

As a result of the revaluation, there is a reverse Code Sec. 704(c) layer with respect to each asset ("Reverse I") that is shared 80 : 20 between A and B. The table below shows A's and B's Code Sec. 704(c) amounts with respect to the Forward and Reverse I layers (*see* Table 4).

TABLE 4.

	A's 704(c)	B's 704(c)	Total
Asset A - Forward	$720	$0	$720
Asset B - Forward	$0	$180	$180
Asset A - Reverse I	$160	$40	$200
Asset B - Reverse I	$32	$8	$40
Total	**$912**	**$228**	**$1,140**

In year 5, LLC issues an additional profits interest to C and revalues its assets in connection with the issuance. After the issuance, C is entitled to 15 percent of the value of LLC on an exit to the extent the value exceeds $2,600. At the time of the revaluation, Asset A is worth $2,200 (increase of $1,200 since the revaluation in year 3) and Asset B is worth $300 (increase of $60 since revaluation in year 3). LLC has no other assets and no liabilities. Because LLC's net fair market value is only $2,500, C would not be entitled to any proceeds if the LLC sold its assets.

After the revaluation in year 5, there are three Code Sec. 704(c) layers with respect to each asset: the Forward and Reverse I layers and a reverse layer that is shared 40 : 60 ("Reverse II") (*see* Table 5).

Immediately after the second issuance to C, LLC borrows $500 from Bank. No member provides any credit support. LLC is planning to distribute the proceeds to B in partial redemption of B's interest. Before the borrowing, B's outside basis is $20, so B will recognize gain on the distribution unless B is allocated at least $480 of the liability under Reg. §1.752-3(a). LLC's goal is to ensure that B does not recognize gain on the distribution.

There is no partnership minimum gain because the Code Sec. 704(b) book basis of the assets is greater than the amount of the liability.[130]

To determine the amount of Code Sec. 704(c) Minimum Gain, LLC must allocate the $500 liability among its assets using any reasonable method under Reg. §1.752-3(b). To do so, it must first decide which approach it is going to use.

a) Unitary Asset Approach. LLC uses the Unitary Asset Approach and decides to allocate the liability entirely to Asset A. Asset A has a tax basis of $80, so there is $420 of Code Sec. 704(c) Minimum Gain.

TABLE 5.

	A's 704(c)	B's 704(c)	Total
Asset A - Forward	$720	$0	$720
Asset B - Forward	$0	$180	$180
Asset A - Reverse I	$160	$40	$200
Asset B - Reverse I	$32	$8	$40
Asset A - Reverse II	$480	$720	$1,200
Asset B - Reverse II	$24	$36	$60
Total	**$1,416**	**$984**	**$2,400**

LLC uses a LIFO *inter*-layer approach and a "first-to-B" *intra*-layer approach. Thus, the $420 (shown in green below) of Code Sec. 704(c) Minimum Gain relates entirely to B's share of the Reverse II layer (*see* Table 6).

As a result, $420 of the liability is allocated to B under Tier 2. The remaining $80 is allocated under Tier 3. Using the Additional Method, LLC can allocate up to the entire $80 to B.

What if LLC instead allocated the liability $200 to Asset A and $300 to Asset B (*i.e.*, had maximized the allocation to Asset B)? As shown below, this makes it impossible for LLC to accomplish its goal of allocating at least $480 of the liability to B.

- If $200 of the liability is allocated to Asset A, there is $120 of Code Sec. 704(c) Minimum Gain with respect to Asset A (because Asset A has a tax basis of $80).
- If $300 of the liability is allocated to Asset B, there is $280 of Code Sec. 704(c) minimum gain with respect to Asset B (because Asset B has a tax basis of $20).
- The total amount of Code Sec. 704(c) Minimum Gain is, therefore, $400 ($120 plus $280).

To maximize the liability allocation to B, LLC uses a reasonable consistency approach for both *inter*- and *intra*-layer allocations. A reasonable consistency method permits LLC to select which shares of which layers are Code Sec. 704(c) Minimum Gain (*i.e.*, which Code Sec. 704(c) amounts would be recognized in a foreclosure) as long as, for each share of each layer, the amount is between the greatest amount and lowest amount that could be achieved using the other approaches discussed in above (*e.g.*, FIFO, LIFO; all to A, all to B).

In this case, LLC determines that B's $40 share of Reverse I with respect to Asset A is Code Sec. 704(c) Minimum Gain and $80 of B's share of Reverse II with respect to Asset A is Code Sec. 704(c) Minimum Gain. That results in B's having all $120 of the Code Sec. 704(c) Minimum Gain with respect to Asset A, as shown in Table 7. (LLC could also have decided that all $120 of Code Sec. 704(c) Minimum Gain attributable to B's share of Reverse II.)

Asset B has $280 of Code Sec. 704(c) Minimum Gain. Again, to maximize the allocation to B, LLC adopts a reasonable consistency approach and determines that all $180 of the Forward layer, all $8 of B's share of Reverse I, and all $36 of B's share of Reverse II (shown in green in Table 8) constitute Code Sec. 704(c) Minimum Gain. That totals $224. The remaining $56 must be allocated to A in respect of A's shares of Reverse I and Reverse II (shown in red in Table 8).

The remaining $100 of the liability is allocated to B under the Additional Method in Tier 3. The result is that B is allocated a total of $444 ($120 of Code Sec. 704(c) Minimum Gain with respect to Asset A, $224 of Code Sec. 704(c) Minimum Gain with respect to Asset B, and $100 using the Additional Method in Tier 3).

Thus, allocating $300 of the liability to Asset B makes it impossible for LLC to accomplish its goal of allocating at least $480 of the liability to B; the best it can do is $444. As a result, if LLC uses the Unitary Asset Approach, LLC should instead allocate all $500 of the liability to Asset A, which, as shown above, permits LLC to accomplish its goal.

b) Separate Shares Approach. How would this work if LLC instead used the Separate Shares Approach? Using the Separate Shares Approach makes the analysis a lot simpler. As shown in the tables above and in the diagram below, there are ten different shares of Code Sec. 704(c) layers, so LLC has ten assets among which to allocate the liability (as shown in Diagram 1). LLC allocates the entire liability to the notional asset that represents B's $720 share of Reverse II. This results in $500 of Code Sec. 704(c) Minimum Gain, all of which is allocable to B. Thus, B is allocated all $500 of the liability under Tier 2.

TABLE 6.

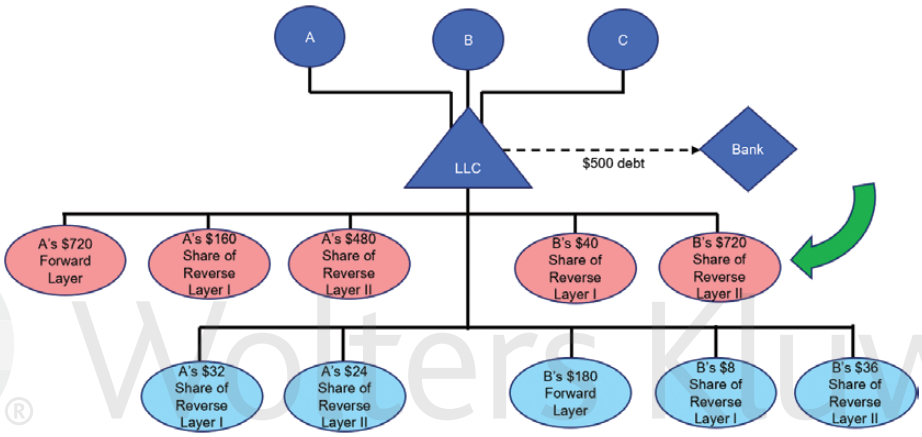
	A's 704(c)	B's 704(c)	Total
Asset A - Forward	$720	$0	$720
Asset B - Forward	$0	$180	$180
Asset A - Reverse I	$160	$40	$200
Asset B - Reverse I	$32	$8	$40
Asset A - Reverse II	$480	$420 704(c) MG $720 total 704(c)	$1,200
Asset B - Reverse II	$24	$36	$60
Total	**$1,416**	**$984**	**$2,400**

TABLE 7.

	A's 704(c)	B's 704(c)	Total
Asset A - Forward	$720	$0	$720
Asset B - Forward	$0	$180	$180
Asset A - Reverse I	$160	$40 704(c) MG $40 total 704(c)	$200
Asset B - Reverse I	$32	$8	$40
Asset A - Reverse II	$480	$80 704(c) MG $720 total 704(c)	$1,200
Asset B - Reverse II	$24	$36	$60
Total	**$1,416**	**$984**	**$2,400**

TABLE 8.	A's 704(c)	B's 704(c)	Total
Asset A - Forward	$720	$0	$720
Asset B - Forward	$0	$180 704(c) MG $180 total 704(c)	$180
Asset A - Reverse I	$160	$40	$200
Asset B - Reverse I	$32 704(c) MG $32 total 704(c)	$8 704(c) MG $8 total 704(c)	$40
Asset A - Reverse II	$480	$720	$1,200
Asset B - Reverse II	$24 704(c) MG $24 total 704(c)	$36 704(c) MG $36 total 704(c)	$60
Total	**$1,416**	**$984**	**$2,400**

DIAGRAM 1.



(Asset A is shown in salmon and Asset B in light blue.)

Example 14. The facts are the same as in Example 13, except that, at the time of contribution, Asset A had tax basis of $780 (*i.e.*, built-in gain of only $20) and Asset B had tax basis of $190 (*i.e.*, built-in gain of only $10) (*see* Table 9).

c) Unitary Asset Approach. If LLC allocates all of the liability to Asset A, there will be no Code Sec. 704(c) Minimum Gain because the amount of the liability ($500) does not exceed the tax basis of the asset ($780). That is, if the asset were transferred to a lender in satisfaction of the liability and for no other consideration, LLC would not recognize any gain. Thus, none of the liability is allocated under Tier 2.

If LLC instead allocates the liability $200 to Asset A and $300 to Asset B, (i) there would be no Code Sec. 704(c) Minimum Gain with respect to Asset A (for the reason discussed in the preceding paragraph) and (ii) there would be $10 of Code Sec. 704(c) Minimum Gain with respect to Asset B because the amount of the liability allocated to Asset B ($300) exceeds the tax basis of Asset B ($190) by $10.

TABLE 9.	A's Total 704(c)	B's Total 704(c)	Total
Asset A - Forward	$20	$0	$20
Asset B - Forward	$0	$10	$10
Asset A - Reverse I	$160	$40	$200
Asset B - Reverse I	$32	$8	$40
Asset A - Reverse II	$480	$720	$1,200
Asset B - Reverse II	$24	$36	$60
Total	**$716**	**$814**	**$1,530**

Thus, the maximum amount that can be allocated under Tier 2 if LLC uses the Unitary Asset Approach is $110. The remaining $390 must be allocated under Tier 3. Using the Additional Method, LLC can allocate all $390 to B because B has more than $390 of total Code Sec. 704(c) gain with respect to the assets. (Of course, in this example, because B's outside basis is $190, LLC does not actually need to allocate $390 to B.)

d) Separate Shares Approach. As in Example 13, LLC can allocate the entire liability to the notional asset that represents B's $720 share of Reverse II with respect to Asset A. This results in $500 of Code Sec. 704(c) Minimum Gain because the amount of the liability ($500) exceeds the tax basis with respect to the notional asset ($0) by $500. All of that gain is allocable to B, and B is therefore allocated all $500 of the liability under Tier 2.

LLC could instead have allocated the entire liability to the notional asset that represents A's Forward layer. Because the Forward layer includes the $780 of contributed tax basis, LLC would recognize no gain if that asset were transferred to a lender in satisfaction of the liability and for no other consideration. This results in Code Sec. 704(c) Minimum Gain of $0, meaning that none of the debt is allocated under Tier 2. The liability would, therefore, be allocated entirely under Tier 3. Using the Additional Method, LLC could allocate all $500 to B because B has more than $500 of total Code Sec. 704(c) gain with respect to the assets.

Thus, the range of amounts that can be allocated under Tier 2 using the Separate Shares Approach is anywhere from $0 to $500, which is a much larger range than the Unitary Asset Approach permits.

D. Tier 3

Nonrecourse liabilities not allocated under Tier 1 or Tier 2 (the "Excess Nonrecourse Liabilities") are allocated under Tier 3 (*i.e.*, Reg. §1.752-3(a)(3)). The regulations prescribe four methods for the allocation of Excess Nonrecourse Liabilities under Tier 3.[131] Notably, Excess Nonrecourse Liabilities allocated under Tier 3 are not required to be allocated under the same method each year.[132]

1. The Four Methods[133]

The default rule provides that Excess Nonrecourse Liabilities are allocated among the partners in accordance with each partner's share of partnership profits (the "Profits Method").[134] A partner's interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners.[135]

The partnership agreement may specify the partners' interests in partnership profits for purposes of allocating Excess Nonrecourse Liabilities, provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the Code Sec. 704(b) regulations) of some other significant item of partnership income or gain (the "Significant Item Method").[136]

Alternatively, Excess Nonrecourse Liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated (the "Alternative Method").[137]

Although Reg. §1.752-3(a)(3) does not explain what deductions qualify as "deductions attributable to those nonrecourse liabilities," it is reasonable to interpret the phrase in light of the nearly identical language in Reg. §1.704-2(b)(1)—"losses, *deductions*, or [Code Sec.] 705(a)(2)(B) expenditures *attributable to partnership nonrecourse liabilities* ('nonrecourse deductions')."[138] Of course, it is not entirely clear to what extent the phrases in Reg. §1.752-3(a)(3) and Reg. §1.704-2 are co-extensive, though the preambles to the proposed and final regulations under Code Sec. 752 do not draw any distinction between the two phrases.[139] Moreover, the text of Reg. §1.704-2(b)(1) and the preamble to the final Code Sec. 704 regulations (published four days after the final Code Sec. 752 regulations) indicates that the two phrases are synonymous.[140] Thus, it strikes us that any deduction that is a nonrecourse deduction under Reg. §1.704-2 is a nonrecourse deduction for purposes of Tier 3, but it may well be that there are deductions that are not nonrecourse deductions under Reg. §1.704-2 that are "deductions attributable to those nonrecourse liabilities" for purposes of Tier 3.

Notably, the Alternative Method does not require that the deductions ultimately be allocated in accordance with the "reasonable expectation" used to support the allocation under the Alternative Method. Failure to allocate deductions in accordance with the expected allocations under the Alternative Method may result in a determination that the expectation was not "reasonable," but the text of the Alternative Method seems plainly to allow for some variance between expected allocation and final allocation of deductions.

Finally, the partnership may first allocate Excess Nonrecourse Liabilities to a partner up to the amount of that partner's Code Sec. 704(c) gain that was not already taken into account in determining the partner's Code Sec. 704(c) Minimum Gain (under Tier 2) with respect to the property (the "Additional Method").[141] Because the Additional Method depends on the difference between built-in gain and Code Sec. 704(c) Minimum Gain, the amount a partner can be allocated under the Additional Method depends in part on the determinations the partnership makes for purposes of Tier 2 (*i.e.*, the amount of Code Sec. 704(c) Minimum Gain allocable to each partner). An advisor who is trying to accomplish a particular allocation and/or preserve flexibility over time would, therefore, be wise to consider the Additional Method when applying the rules under Tier 2.

Example 15 illustrates an LLC's using the Additional Method under Tier 3 to make allocations of liabilities that are non-*pro rata*.

Example 15. A, B, and C form LLC, with A contributing a nondepreciable Asset with a tax basis of $300 and fair market value of $600, subject to a $400 nonrecourse liability, and B and C each contributing $200 of cash. The lender does not have recourse to any of LLC's assets (including its cash) other than Asset.

There is no partnership minimum gain because the amount of the liability ($400) is less than the Code Sec. 704(b) book basis of Asset ($600); therefore, no portion of the liability is allocated under Tier 1. There is $100 of Code Sec. 704(c) Minimum Gain because the amount of the liability ($400) exceeds the tax basis of Asset ($300) by $100. Because all of the Code Sec. 704(c) gain with respect to Asset is allocable to A (because A contributed Asset with $300 of built-in gain, and Asset has not been revalued), $100 of the liability is allocated to A under Reg. §1.752-3(a)(2).

This leaves $300 of the liability to be allocated under Tier 3. Under the Profits Method, the $300 could be allocated equally to A, B, and C because they are equal members in LLC.

Under the Additional Method, however, up to $200 of the liability could be allocated to A because this is the amount of A's $300 Code Sec. 704(c) gain in Asset that exceeds the $100 of Code Sec. 704(c) Minimum Gain. The remaining $100 would be allocated equally to A, B, and C under the Profits Method.

2. Flexibility and Its Limits

As discussed above, the four methods under Tier 3 provide a high degree of flexibility for a partnership to set the initial allocation of a partnership liability. And, as mentioned, Tier 3 allows the partnership to change its allocation from one taxable year to the next.[142] As a result, Tier 3 undoubtedly provides the most flexibility of the three tiers.

That is not to say, however, that Tier 3 provides limitless flexibility. For example, in a partnership with no Code Sec. 704(c) property and no special allocations of items, a partner that has a 10 percent interest may not be able to receive an allocation of more than 10 percent of a liability, assuming that the partners have proportional outside basis (which may not be the case for a number of reasons, including previous non-*pro rata* distributions and/or special allocations of deductions). The corollary of that observation (and a foundation of the three-tier system) is that a 10-percent partner in that partnership likely *would not need* more than 10 percent of the liability. If the loan proceeds are going to be distributed *pro rata*, the 10-percent partner will need 10-percent of the liability to support the distribution (*i.e.*, to receive the cash proceeds without recognizing gain under Code Sec. 731(a)). Similarly, if the loan proceeds are going to be spent in a manner that produces deductions, the 10-percent partner will be allocated 10 percent of the deductions and needs 10 percent of the liability allocated to it to permit it to claim deductions without limitation under Code Sec. 704(d). If, on the other hand, the proceeds are going to be distributed non-*pro rata* to the 10-percent partner, the distribution generally would be a revaluation event under Reg. §1.704-1(b)(2)(iv)(*f*)(*5*)(*ii*), which can reasonably be expected to give rise to Code Sec. 704(c) gain that can be used to support an allocation of liabilities to the 10-percent partner under Tier 2 or under the Additional Method in Tier 3. As a result, while Tier 3 certainly does not permit every theoretically possible allocation, it generally permits any allocation that the partners might actually want (or, at least, any allocation the partners need).

IV. Policy Recommendations

The issues raised by the regulations regarding the allocation of nonrecourse liabilities pose a number of different levels of interesting policy questions, from some high-level philosophical questions about the nature of basis and property, to policy questions about the appropriate limits on flexibility, to very granular technical points about the regulations.

A. High Level Policy Questions About Basis

At the highest level, one might fairly ask whether nonrecourse liabilities should be included in basis at all. Although that is a fascinating question, revisiting *Crane* and *Tufts* is beyond the scope of this article.

A somewhat more nuanced version of that question might be to ask whether a partner's share of partnership nonrecourse liabilities should be included in the partner's outside basis. In fact, the IRS and Treasury considered an approach like that in the early 2000s on the grounds that it might limit the potential for abuse of Code Sec. 752.[143] The proposal was never adopted. Indeed, among the many problems with modifying Code Sec. 752 to exclude the allocation of nonrecourse liabilities is the potential for abuse. As noted above, repealing Code Sec. 752 would

create a high degree of optionality for taxpayers that could, among other things, be used to facilitate basis shifting transactions. Moreover, such a change would be inconsistent with an underlying premise of subchapter K—the notion that the consequences to the partners ought to be the same whether the partners act directly or through a partnership (unless there is a good reason to change that result). As a result, we are also not going to spend much time considering the possibility of such a change to Code Sec. 752.

B. Questions About the Overarching Design of the Reg. §1.752-3 Regime

Assuming that Congress is not going to make changes to the foundation of subchapter K (or the tax law regarding nonrecourse liabilities more generally), the most important policy question is whether the tripartite regime of Reg. §1.752-3 is serving the purpose for which it was designed. As is hopefully clear by now, Treasury and the IRS designed Reg. §1.752-3 to permit partnerships to allocate liabilities to the partners that "need" those liabilities to support deductions and to prevent partners from recognizing gain under Code Sec. 731(a) in connection with distributions of cash. As is probably also clear, the rules in their current form are sufficiently complex and flexible that a well-advised taxpayer usually can accomplish whatever allocation is desired (within reason). Of course, the key is "well-advised"—without a tax lawyer or accountant who is intimately familiar with these rules and their vagaries, taxpayers are unlikely to be able to navigate the complexities discussed in Part III.

As a result, the tax community finds itself in a position remarkably similar to the entity classification regime under the so-called *Kintner* regulations before the effectiveness of the check-the-box regulations in 1997. In the preamble to the proposed check-the-box regulations, Treasury and the IRS explained that:

> [T]axpayers generally can achieve partnership tax classification for a nonpublicly traded organization that, in all meaningful respects, is virtually indistinguishable from a corporation. To accomplish this, however, taxpayers and the IRS must expend considerable resources on classification issues ... Meanwhile, small business organizations may lack the resources and expertise to achieve the tax classification they want under the current classification regulations ... In light of these developments, Treasury and the IRS believe that it is appropriate to replace the increasingly formalistic rules under the current regulations with a much simpler approach that generally is elective.[144]

Change a few words in that quotation and you would have a strong argument for making Reg. §1.752-3 elective. That being the case, why not simply permit taxpayers to allocate nonrecourse liabilities however they want each year? Or, perhaps, make the rules of Reg. §1.752-3 a set of default rules that taxpayers can override if they choose?

As with any elective regime, there would be concerns about abuse. Any such concerns, however, already largely exist today. That is, as noted, the nonrecourse liability allocation regime is already essentially elective for taxpayers with experienced advisors. If anything, making the regime expressly elective and including an anti-abuse rule could well temper abuse concerns. Moreover, in commercial partnerships in which the partners are unrelated, the fact that a liability allocation is a double-edged sword mitigates any concerns about abuse. (A greater share of a liability allocated to one partner means a smaller share of the liability allocated to the other partners. And a later reallocation of partnership liabilities can cause the recognition of gain under Code Sec. 731(a).) Both the initial allocation of a liability and a change in the allocation of the liability in a later year therefore can have real after-tax economic consequences to the partners, and, for this reason, the tax system can rely in large part on their economic self-interest to prevent inappropriate game-playing.

C. Specific Changes to, and Questions About, Reg. §1.752-3

The final category of policy recommendation is specific technical clarifications and tweaks to the existing regulations. (If the nonrecourse liability rules are replaced by a purely elective regime, these will largely be unnecessary.)

1. *Definition of "Subject To."* Both Reg. §1.704-2(d) and Reg. §1.752-3 use the phrase "subject to" in determining the amount of partnership minimum gain or Code Sec. 704(c) Minimum Gain. Neither describes what it means for an asset to be "subject to" a liability. The regulations should clarify that an item of property is "subject to" a liability if a creditor can reach that item of property (*i.e.*, no security interest is required). This seems self-evident but is a frequently asked question by tax lawyers and accountants who do not spend much time with the rules.[145]
2. *Multiple Properties Rule for Tier 1.* Reg. §1.704-2 should be coordinated with (or include a rule akin to) Reg. §1.752-3(b). That is, there is no rule in Reg. §1.704-2 governing the allocation of a single liability among multiple assets for purposes of determining partnership minimum gain. This appears to be a holdover from simpler times and should be updated.

3. *Additional Examples for Tier 1*. Tier 1 should include clear examples in the regulations that confirm the application of the rules.
4. *Methods for Tier 2*. Building on guidance issued by the IRS and Treasury discussed above, Tier 2 should describe the permissible methods (LIFO, FIFO, *pro rata*, equally, and reasonable consistency) and make clear that each is reasonable.[146] The regulations also should make clear that the method of allocation under Tier 2 can change each year just as under Tier 3.
5. *Reduction in Principal Rule in Reg. §1.752-3(b)*. The reduction in principal rule currently requires that, if the principal amount of a loan is reduced, the reduction be allocated among the assets *pro rata* in accordance with the liability allocation. This is an odd fit with the rest of the rules in the regulations and should be restyled as a default rule that applies only if the taxpayer's method fails to specify what happens in the case of a partial repayment.
6. *Permit Changes to Reg. §1.752-3(b) Method*. The rule preventing taxpayer from changing their Reg. §1.752-3(b) method should be removed, and taxpayers should be permitted to change methods at any relevant time. There is no policy rationale of which we are aware for preventing a partnership's changing its allocation of liabilities among the assets under Reg. §1.752-3(b)(1), and the rule runs contrary to the nonrecourse liability regime's overarching aim of giving taxpayers flexibility to ensure liabilities are allocated where they are needed.

   Even if this change is not made, Reg. §1.752-3(b)(1) should at the very least make clear what the rule means. That is, under current law, the method cannot change, but a method can be, and, in our experience typically is, not merely a specific dollar designation. As a result, the amounts of a liability allocated among various assets may well change even if the method itself does not. For example, if a methodology requires the partnership to allocate a liability among its assets *pro rata* in accordance with their relative fair market values at the end of each year, the dollar amount of the allocation will change from year to year unless the relative fair market values of the assets stay identical.
7. *Examples of Reg. §1.752-3(b) Methods.* The regulations should include examples that illustrate the application of two common Reg. §1.752-3(b) methods: (i) *pro rata* in accordance with basis (but not in excess of fair market value) and (ii) the "gain minimization" method (*see* Appendix A).
8. *Reasonableness of Reg. §1.752-3(b) Methods.* The regulations should either elaborate on the reasonableness requirement for Reg. §1.752-3(b) methods or remove it. That is, if the only way a method can be unreasonable is by allocating more liabilities to an asset than that asset's fair market value at the time the liability is incurred, the regulations should say so. If there are other ways in which a method can be unreasonable, the regulations should say what those are.
9. *Coordination of Significant Item Method and PIP*. The Significant Item Method in Tier 3 should be expanded to cover the allocation of any significant item that is made in accordance with the partners' interests in the partnership. Currently, the Significant Item Method applies only if the partnership complies with the primary or alternate test for economic effect or the economic effect equivalence rules of Reg. §1.704-1(b)(2)(ii)(*b*), (*d*), and (*i*) (respectively), because the Significant Item Method relies on allocations that have substantial economic effect. This makes the Significant Item Method technically unavailable to most contemporary commercial partnerships that make PIP-based allocations.
10. *Expansion of Alternative Method*. The Alternative Method permits liabilities to be allocated under Tier 3 in accordance with the manner in which the deductions attributable to the borrowing are reasonably anticipated to be allocated. The Alternative Method should also permit an allocation in accordance with the reasonably anticipated distribution of proceeds. This would align the rule of Tier 3 with the equivalent rule in Tier 1.
11. *Interaction with Reg. §1.731-1(a)(1)(ii).* The "drawing rule" in Reg. §1.731-1(a)(1)(ii) provides that an advance or draw against a partner's distributive share of income is treated as occurring on the last day of the partnership's taxable year. The result is that the partner is not treated as receiving a distribution until the partner also receives the income allocation at the end of the year, with the result that the partner's outside basis is increased by the income allocation *before* the partner is treated as receiving the distribution. This limits the recognition of Code Sec. 731(a) gain by the partner. Consistent with IRS guidance, Reg. §1.752-3 should include a rule that makes clear that the drawing rule applies to deemed distributions resulting under Code Sec. 752.[147] That is, if there is a liability shift or a reduction in principal under Reg. §1.752-3, the deemed distribution should be treated

as occurring at the end of the taxable year to ensure that no unnecessary gain is recognized.[148]

12. *Numbering*. Saving the most important request for last, tax lawyers and accountants would (greatly) appreciate a reorganization of the long block paragraph that constitutes Tier 3 to create numbered or lettered subparagraphs listing the separate methods.

APPENDIX A. SAMPLE REG. §1.752-3(B) METHODS

Version 1

Version 1 is intended to allocate liabilities under Tier 2 in a manner that minimizes the amount of Code Sec. 731(a) gain recognized by the partners, with a "tie breaker" if it is not possible to fully protect all partners.

For purposes of Reg. §1.752-3(b), LLC will allocate the liabilities among LLC's assets in a manner that (i) ensures that Member A is allocated enough liabilities under Reg. §1.752-3(a)(2) such that it does not recognize gain under section 731(a), and (ii) ensures that Member B is allocated enough liabilities under Reg. §1.752-3(a)(2) such that it does not recognize gain under Code Sec. 731(a). If it is not possible to accomplish the objective in both clause (i) and clause (ii) of the preceding sentence, the objective in clause (i) shall take priority unless otherwise determined by LLC.

Version 2

Version 2 is intended to minimize the allocation of liabilities under Tier 2 so that the maximum amount of liabilities are allocated under the more flexible rules of Tier 3. The method works by minimizing the creation of Code Sec. 704(c) Minimum Gain when there are Code Sec. 704(c) assets and non-Code Sec. 704(c) assets.

First, Liabilities will be allocated to the 704(c) Assets in proportion to, and to the extent of, each 704(c) Asset's adjusted basis, but not in excess of that asset's fair market value.

Second, remaining Liabilities will be allocated to the Full Basis Assets that are non-amortizable in proportion to, and to the extent of, each such asset's fair market value (reduced by any liabilities allocated under a previous tier of this method);

Third, remaining Liabilities will be allocated to the Full Basis Assets that are amortizable in proportion to, and to the extent of, each such asset's fair market value (reduced by any liabilities allocated under a previous tier of this method); and

Thereafter, remaining Liabilities will be allocated in proportion to the relative fair market values of the 704(c) Assets, but not in excess of each such asset's fair market value (reduced by any liabilities allocated under a previous tier of this method).

ENDNOTES

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1 Unless indicated otherwise, all "Code Sec." references are to the Internal Revenue Code of 1986, as amended (the "Code"), all "subchapter" references are to subchapters of chapter 1 of the Code, and all "Reg. §," "Temporary Reg. §," and "Proposed Reg. §" references are to the regulations promulgated or proposed under the Code by the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS"), all as in effect as of the date of this paper.

2 A partner's "outside basis" is its basis in its partnership interest. Under Code Sec. 752(a) and (b), an increase (or decrease) in a partner's share of the liabilities of a partnership is treated as a contribution by (or distribution to) that partner to (or from) the partnership. These deemed contributions and distributions increase or decrease the relevant partner's outside basis under Code Secs. 722 and 733.

3 For an in-depth discussion of the rules for recourse liabilities, *see* Eric B. Sloan and Jennifer H. Alexander, *Economic Risk of Loss: The Devil We Think We Know*, 84 TAXES 217 (Mar. 1, 2006).

4 Code Sec. 1012; Reg. §1.1012-1(a).

5 *See Crane v. Comm'r*, 331 U.S. 1, 3 (1947); *Mayerson v. Comm'r*, 47 T.C. 340 (1966). These types of liabilities are commonly referred to as "nonrecourse liabilities," given that the lender has no personal recourse against the borrower. Note, however, that to the extent the amount of nonrecourse debt incurred in acquiring a property exceeds the fair market value of the property, the excess may not be respected as indebtedness. *See Pleasant Summit Land Corp. v. Comm'r*, 863 F.2d 263, 276 (3d Cir. 1988) ("[I]t is appropriate to disregard only the portion of nonrecourse debt in excess of the fair market value of the property when it was acquired for purposes of calculations of the depreciation and interest deductions and to regard the nonrecourse debt as genuine indebtedness to the extent it is not disregarded."); *Odend'hal v. Comm'r*, 748 F.2d 908, 912 (4th Cir. 1984) ("[T]he principal of the nonrecourse loan which exceeds fair market value does not represent a real investment in the property by a taxpayer

and he may not include that nonrecourse amount in his basis"). *See also Franklin's Est. v. Comm'r*, 544 F.2d 1045, 1048-49 (9th Cir. 1976) (purchase money debt was not respected when the amount of the liability dramatically exceeded the fair market value of the property because the buyer had limited economic incentive to make principal payments on the debt); Reg. §1.83-3(a)(2) (certain compensatory transfers of property subject in exchange for nonrecourse debt are treated as options). Indeed, Code Sec. 752(c) reflects this logic by providing that if partnership property is subject to a liability, it is treated as a partnership liability only to the extent of the fair market value of the property. Except where otherwise noted, the remainder of this article assumes that any property encumbered by a nonrecourse loan has a fair market value that exceeds the amount of that nonrecourse loan and that all liabilities are properly treated as indebtedness for U.S. federal income tax purposes.

[6] 331 U.S. 1 (1947).

[7] *Id.* at 3.

[8] *Id.* at 3 n.2.

[9] Somewhat ironically, the taxpayer's position in *Crane* suggests that she had improperly claimed depreciation deductions each year. By the time the matter was litigated, however, the statute of limitations for those years had already closed. *Crane v. Comm'r*, 3 T.C. 585 (1944).

[10] The taxpayer had acquired the rental property in question through bequest, subject to a nonrecourse mortgage. The taxpayer and the Commissioner had stipulated at trial that the sum of the outstanding principal and unpaid interest on the mortgage was equal to the fair market value of the rental property at the time of the decedent's death. *Id.* at 3; *see* Code Sec. 1014(a).

[11] 26 U.S.C. §117 (1938) (*repealed by* Internal Revenue Code of 1939, H.R. 2762, 76th Cong. (1939)).

[12] *Crane*, 331 U.S. at 9-11. Note that the Court's logic implicitly assumes that tax depreciation accurately reflects economic depreciation, which, since the advent of accelerated depreciation regimes, is frequently inaccurate. *See, e.g.*, Theodore S. Sims, *Income Taxation and Asset Valuation (I): Economic Depreciation, Accrual Taxation, and the Samuelson Theorem*, 66 Tax L. Rev. 217, 218 n.3 (2013).

[13] *Crane*, 331 U.S. at 9-11. The Court also discussed and rejected the possibility of allowing depreciation deductions based on the value of the property and reducing equity basis by the amount of the reductions, as this would either require (1) permitting the taxpayer to have (and take deductions on) a negative basis in property, or (2) denying deductions in excess of basis, which would allow taxpayers to time depreciation deductions based on the amortization of, and prepayments of, a mortgage. *Id.*

[14] *Crane*, 331 U.S. at 9-11. In so holding, the Court noted *in dicta*, "Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage." *Id.* at 14, FN 37.

[15] *Mayerson v. Comm'r*, 47 T.C. 340, 351-52 (1966). But *see* the discussion of *Franklin's Estate v. Comm'r*, in note 5, above. Additionally, since the Supreme Court's decision in *Comm'r v. Tufts*, 461 U.S. 300 (1983), nonrecourse borrowings are included in both a taxpayer's basis in property and the taxpayer's amount realized on a sale of the property when the purchaser takes the property subject to the nonrecourse liability, even if that nonrecourse liability exceeds the fair market value of the property at the time of sale. *See generally* Erik M. Jensen, *The Unanswered Question in* Tufts*: What Was the Purchaser's Basis?*, 10 Va. Tax Rev. 455 (1991).

[16] For a discussion of why partners might, in certain circumstances, want a disparity between inside and outside basis, *see* Certain Partnership Related-Party Basis Adjustment Transactions as Transactions of Interests, 89 Fed. Reg. 51476 (June 18, 2024) (withdrawn by Notice 2025-23, 2025-19 I.R.B. 1428). In addition, permitting such a disparity would undermine a foundational pillar of subchapter K—the tax consequences associated with an event or occurrence ought to be the same to a partner whether the event or occurrence happens inside or outside the partnership. That is, acting through a partnership should not change the consequences unless there is a very good reason for that change.

[17] Or, as Mark Johnson described them in his 1950 ABA Tax Section report "hopelessly obscure and confused." Mark P. Gergen, *The Story of Subchapter K: Mark H. Johnson's Quest*, *in* Steven A. Bank and Kirk J. Stark, Business Tax Stories 205, 208 (2005).

[18] *See* Matt Donnelly, *The Imperfect Approach*, 102 Taxes 25, 50 n. 5 (2024) (collecting sources).

[19] 26 C.F.R. §39.113(a)(13)-2(a) (1951) ("When a partner retires from a partnership, or the partnership is dissolved, the partner realizes a gain or loss measured by the difference between the price received for his interest and the sum of the adjusted cost or other basis to him of his interest in the partnership plus the amount of his share in any undistributed partnership net income earned since he became a partner on which the income tax has been paid.").

[20] *Id.*

[21] *See, e.g.*, Paul Little, Federal Income Taxation of Partnerships, 163 (1952) (discussing the basis-related complications introduced by the presence of a mortgage on property to be distributed by a partnership to a partner).

[22] Rabkin and Johnson, *The Partnership Under the Federal Tax Laws*, 55 Harv. L. Rev. 909 (1942).

[23] *Id.* at 910. These taxes included, in addition to the federal corporate income tax and surtax (the top combined marginal rate of which was increased from 31 percent to 40 percent under the Revenue Act of 1942), an excess profits tax that was imposed at a flat 90 percent rate. Pub. L. No. 77-753, Ch. 619, 56 Stat. 798 (Oct. 21, 1942); *see* Arthur H. Kent, *The Revenue Act of 1942*, 43 Colum L. Rev. 1 (Jan. 1943).

[24] Partnerships in which one or more partners have limited liability have been a feature of the American business landscape since 1822, when New York first permitted a limited partnership. *See* Eric Hilt and Katharine E. O'Banion, *The Limited Partnership in New York, 1822-1853: Partnership Without Kinship*, National Bureau of Economic Research (Oct. 2008), *https://www.nber.org/papers/w14412*. The first state statute providing for limited liability companies was not adopted until 1977, when Wyoming adopted its limited liability company statute. *See* Susan P. Hamill, *The Origins Behind the Limited Liability Company*, 59 Ohio St. L. J. 1459, 1460 (1998) (citing Wyoming Limited Liability Company Act, ch. 158, 1977 Wyo. Sess. Laws 537 (enacted March 4, 1977)).

[25] *See, e.g.*, Rabkin and Johnson, *supra* note 22, at 920 (noting, for example, with respect to the question of when a partner is taxed on pre-contribution gains or losses that "the postponement of gain or loss *until* sale is an expedient and reasonable application of the coownership concept. It has never been decided, however, whether that result is correct . . . Clarification of the statute would be extremely simple. The present structure is but another example of the piece-meal thinking which has contributed to the uncertainties of the partnership tax law.") (emphasis in original).

[26] For an outstanding account of these efforts, *see* Gergen, *supra* note 17, at 207.

[27] 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 (Jan. 1954).

[28] *Id.* at 113.

[29] *See supra* notes 17-21 and accompanying text.

[30] ALI Report at 118.

[31] *Id.*

[32] *Id.* Specifically, Section X752 of ALI's proposed draft of subchapter K provided that "the basis of a partner's interest in the aggregate partnership property shall be the portion which he would be entitled to receive, upon the winding up of the partnership, of the aggregate basis of all the partnership properties (including money)."

[33] ALI Report, Section X756(b).

[34] This result follows from the fact that the partnership would have basis in its assets attributable to both recourse and nonrecourse borrowings. *See supra* Part II.A.

[35] Pub. L. No. 83-591, Ch. 736, H.R. 8300 (*codified at* section 752 of the 1954 code). Curiously, neither the House nor Senate report mentions section 752 of the 1954 code. The drafters appear to have assumed that if they were going to use the entity approach to basis, section 752 of the 1954 code was a necessary mechanism. It is possible that, given the conceptual similarities between sections 358(d) and 752 of the 1954 Code, the House Way and Means Committee simply realized the need for subchapter K to include a rule akin to section 358(d) of the 1954 code, a precursor to which was included in the Internal Revenue Code of 1939 as section 113(a)(6).

[36] Later commentators drew parallels between the logic underlying Code Sec. 752 and the Supreme Court's reasoning in *Crane*, 331 U.S. 1 (1947). *See, e.g.*, Burke and Friel, *Allocating Partnership Liabilities*, 41 Tax L. Rev. 173, 178 (Winter 1986) ("[Code Sec.] 752 . . . draws no distinction between recourse and nonrecourse liabilities, and thus causes the outside bases of the partners to be increased for nonrecourse as well as recourse liabilities. In doing this, [Code Sec.] 752 incorporates the principle of *Crane v. Commissioner*—generally equating nonrecourse liability with recourse liability for basis purposes—and places a partner in a position comparable to that of an individual owner of encumbered property.").

[37] J. Paul Jackson et al., *The Internal Revenue Code of 1954: Partnerships*, 54 Colum. L. Rev. 1183 (Dec. 1954).

[38] *Id.* at 1190 (noting that the zero-basis limitation for claiming partnership losses "may be obviated if the partnership borrows money and the partner [is] responsible for a portion of the debt *vis-à-vis* the other partners and not merely the creditor," as "[u]nder [Code Sec.] 752(a) a partner's basis for his partnership interest is increased by any increase in his share of the partnership's liabilities."). Note that there is a clear conceptual relationship between a partner's having a share of partnership liabilities and what has come to be known as a deficit restoration obligation, particularly in the case of partner recourse liabilities (*e.g.*, where one partner guarantees an otherwise nonrecourse obligation).

[39] T.D. 6175, 20 Fed. Reg. 5854 (Aug. 12, 1955).

[40] *See* discussion in Part IV regarding the meaning of "subject to." Consistent with our recommendation, this paper assumes that the proper interpretation of this phrase is that a creditor can reach the asset.

[41] Proposed Reg. §1.752-1(b)(2) (1955). Although not always the case, commercial mortgages generally are nonrecourse borrowings. *See* Frederick H. Robinson, *Nonrecourse Indebtedness*, 11 Va. Tax Rev. 1, 2 (1991) ("The use of indebtedness for which the borrower has no personal liability is a commercially recognized form of financing, particularly in the case of real estate.").

[42] Reg. §1.752-1(e) (1956) (emphasis added).

[43] Reg. §1.752-1(e), Ex. (1956).

[44] Burke and Friel, *supra* note 36, at 180 (Winter 1986).

[45] As previously noted, the first domestic limited liability company statute was not adopted until 1977, and before the adoption of that statute, the general partners of a partnership were generally liable under state law for the debts of the partnership. *See supra* note 24. For examples of cases that involved nonrecourse debt, *see Long v. Comm'r*, 77 T.C. 1045, 1075 (1981) ("On the other hand, since none of the partners of Venture Twenty-One are liable on the mortgage indebtedness to which its property is subject, all of the general partners including petitioners will share the partnership liability in the same proportion as they share partnership profits."); *Brountas v. Comm'r*, 73 T.C. 491, 571 (1979), ("In general, a partner's basis in his partnership interest is increased by his share of the liabilities of the partnership. This general rule also applies to nonrecourse obligations of a limited partnership if no partner is individually liable for such obligation.") (internal citation omitted). For a comprehensive summary of the caselaw and guidance applying the 1956 Regulations, *see* Sloan and Alexander, *supra* note 3, at 220-22.

[46] *Block v. Comm'r*, 41 T.C.M. (CCH) 546, 522 (1980); *Brown v. Comm'r*, 40 T.C.M. (CCH) 725, 733 (1980). For examples of IRS guidance with similar conclusions, *see* Rev. Rul. 69-223, 1969-1 C.B. 184; T.A.M. 8504005 (Sep. 28, 1984).

[47] *Raphan v. United States*, 3 Cl. Ct. 457, 466 (1983) (*rev'd in part*, 759 F.2d 879 (Fed. Cir. 1985)) ("[T]he guaranteeing of a partnership debt does not make the guaranteeing partner 'personally liable' under [Reg. §] 1.752-1(e) and does not preclude the remaining partners from sharing in the step up in basis on account of such debt.").

[48] *Id.* at 466.

[49] *Id.*

[50] Pub. L. No. 98-369, §79, 98 Stat. 494, H.R. 4170 (1984). Note that these provisions of the Tax Reform Act of 1984 did not amend the Code and instead directed Treasury and the IRS to adopt regulations under section 752 of the 1954 code as already in effect. The Tax Reform Act of 1986 made no change to section 752 of the 1954 code.

[51] T.D. 8237, 53 Fed. Reg. 53140 (Dec. 30, 1988).

[52] Temporary Reg. §1.752-1T(a)(2) (1988). As is customary in the partnership tax community, we refer to the three tiers as "Tier 1", "Tier 2", and "Tier 3." These terms are defined in Part III.

[53] 53 Fed. Reg. at 53144-45.

[54] T.D. 8380, 56 Fed. Reg. 66348 (Dec. 20, 1991).

[55] Reg. §1.752-3 (1991).

[56] The current capital accounting regulations do not require a partnership to revalue (or mark to market) its assets except in connection with certain distributions, contributions, exercises of noncompensatory options, or the use of the gain deferral method in a tiered partnership under the Code Sec. 721(c) regulations. Reg. §1.704-2(b)(iv)(*e*), (s)(1), and (*f*)(6). Proposed regulations under Code Sec. 751(b) also would require revaluations in connection with a distribution by a partnership that owns Code Sec. 751 property of money or property (other than a *de minimis* amount) to a partner as a consideration for an interest in the partnership. Proposed Reg. §1.751-1(b)(iv) (2014).

[57] Indeed, traditionally it has been uncommon to encounter partnership minimum gain outside the real estate context because most partnerships, hold nondepreciable property (like stock or goodwill), regularly acquire new property (like property, plant, and equipment), or revalue their assets somewhat often. For these reasons, a partnership's assets tend to have Code Sec. 704(b) book basis that is reasonably high compared with the amount of the partnership's liabilities. The advent of Code Sec. 197 and various bonus depreciation regimes has made partnership minimum gain somewhat more common in recent decades.

[58] Thus, Tier 2 plays a critical role in connection with revaluation events by ensuring that liabilities that were allocated to a partner before the revaluation event under Tier 1 continue to be allocated to that partner after the revaluation event. That is, to the extent a partnership has partnership minimum gain before a revaluation event, the amount of that partnership minimum gain will become Code Sec. 704(c) Minimum Gain in connection with that revaluation.

[59] Although the preamble does not go into detail on the rationale behind the order of Tier 1 and Tier 2, it makes sense when one considers the goals of the regulations. Specifically, the regulations expressly are aimed at ensuring debt is allocated to the partner that needs it to (i) support deductions attributable to the debt proceeds and (ii) prevent a partner's recognizing gain under Code Sec. 731(a) (*i.e.*, the regulations are aimed at keeping gain recognition inside the partnership).

In general, the first goal may be somewhat harder to achieve because supporting the allocation of deductions often is more time sensitive than preventing gain recognition and/or the deductions are allocated based on economic percentages without taking into account the partners' tax positions. On the other hand, the second goal is relatively easier because the operation of Code Sec. 704(c) does some of the heavy lifting in preventing outside gain recognition. That is, the contributing partner's outside basis builds up due to the natural operation of Code Sec. 704(c). For example, assume a 50:50 partnership has two Code Sec. 704(b) book items: $100 of gross income and $80 of depreciation with respect to contributed property. There is only $10 of tax depreciation, however, because the contributed property had built-in gain at the time it was contributed. The partnership uses the traditional method. As a result, all $10 of depreciation is allocated to the noncontributing partner. The contributing partner is allocated $50 of income and no deductions, so its outside basis increases by $50, giving the contributing partner $50 of buffer before it recognizes gain under Code Sec. 731(a). Thus, over time, the operation of Code Sec. 704(c) often mitigates or eliminates the gain recognition that Tier 2 seeks to avoid.

Another (more conceptual) way of thinking about the order of Tier 1 and Tier 2 is that partnership minimum gain and Code Sec. 704(c) gain are, in essence, different ways of describing the same economic gain with respect to an item of property. Because Code Sec. 704(b) book basis usually is higher than tax basis, partnership minimum gain is, in most situations, the smaller number (or, if you like Venn diagrams, is a subset of Code Sec. 704(c) minimum gain).

[60] 1995-1 C.B. 132.

[61] Specifically, partner A contributes property with a fair market of $10,000 and an adjusted basis of $4,000 subject to a $6,000 nonrecourse liability,

and partner B contributes $4,000 of cash. 1995-1 C.B. at 132.

[62] 1995-1 C.B. at 133.

[63] Allocation of Partnership Debt, 65 Fed. Reg. 2081 (Jan. 13, 2000); *see generally* James E. Wreggelsworth, *New Regulations under Code Section 752 Provide Increased Flexibility (and a Bit More Complexity) in Allocating Nonrecourse Liabilities Among Partners*, 4 J. PASSTHROUGH ENTITIES 35 (2001).

[64] 65 Fed. Reg. at 2082. This method is referred to in this paper (and the regulations) as the "Additional Method."

[65] 65 Fed. Reg. at 2082. It is interesting to note the use of the word "accelerate" in the preamble. In particular, it arguably suggests that the IRS and Treasury believed that the partner that is allocated the liability eventually will recognize the gain.

[66] Proposed Reg. §1.752-3(a)(3) (2002).

[67] Reg. §1.704-1(b)(2)(iv)(*g*)(3) (first sentence).

[68] Reg. §1.704-3(b)(1).

[69] Reg. §1.704-2(g)(1)(i).

[70] Reg. §1.704-3(a)(3)(ii).

[71] *See* the policy recommendations in Part IV.

[72] T.D. 8906, 65 Fed. Reg. 64888, 64889 (Oct. 31, 2000).

[73] *Id*. at 64889.

[74] Community Renewal Tax Relief Act of 2000, §309, Pub. L. No. 106-554 App. G, 114 Stat. at 2763A-638 (2001).

[75] T.D. 9062, 68 Fed. Reg. 37414 (June 24, 2003) (proposed regulations); T.D. 9207, 70 Fed. Reg. 30334 (May 26, 2005) (final regulations).

[76] Proposed Reg. §1.752-3(a)(3) (2014).

[77] Section 707 Regarding Disguised Sales, 79 Fed. Reg. 4826, 4831 (Jan. 30, 2014).

[78] Reg. §1.752-3(a)(3) (2016). Before this change, the carve out from the disguised sale rules applied only to the additional method.

[79] Reg. §1.752-1(a)(4).

[80] Reg. §1.752-1(a)(4)(ii).

[81] Reg. §1.752-1(a)(1).

[82] Reg. §1.752-1(a)(2).

[83] Reg. §1.752-3(a)(1).

[84] Reg. §1.704-2(d)(1).

[85] Reg. §1.704-2(g)(1). It bears mentioning that the rules of Reg. §1.704-2 apply only to partnerships that follow the safe-harbor rules in Reg. §1.704-1. Because reliance on those rules is relatively uncommon, for most partnerships, Reg. §1.704-2 often is not technically applicable. Of course, the rules of Reg. §1.704-2 may be relevant if the partnership agreement incorporates the rules in its PIP-based allocation rule or may otherwise be relevant in informing a PIP-based approach. (References to "PIP" are to the rules for allocations based on the partners' interests in the partnership.).

[86] Reg. §1.704-2(b)(2). For this reason, an allocation under Tier 1 can be something of a double-edged sword; an allocation of liabilities may, for example, reduce the amount of gain a partner recognizes under Code Sec. 731(a) at the time of the distribution but only at the expense of exposing that partner to future allocations of income as a result of the minimum gain chargeback provisions. Depending on the timing and character of the chargeback, this could be an unfortunate trade-off.

[87] An allocation of nonrecourse deductions cannot have substantial economic effect because no partner bears the economic risk with respect to the expenditures ("the creditor alone bears any economic burden that corresponds to those allocations"). Reg. §1.704-2(b)(1).

[88] Reg. §1.704-2(e)(2). For this purpose, "reasonably consistent" means any ratio between the highest allocation ratio and the lowest allocation ratio of partnership items under the partnership agreement. Reg. §1.704-2(m) Ex. 1 (when a partnership agreement provides that the LP is allocated 90 percent of profits until a threshold is reached and then the LP and GP share profits equally, the partnership may allocate nonrecourse deductions in any ratio between 90:10 and 50:50). The Significant Item Method of Tier 3, discussed below, also includes a "reasonably consistent" standard.

[89] This example is based on Example 1 in Reg. §1.704-2(m).

[90] Reg. §1.704-2(h)(1).

[91] Reg. §1.704-2(h)(2).

[92] *Id*.

[93] As with any application of proceeds tracing rules, a well-advised partnership might consider ordering the borrowing and distributions or using separate bank accounts to remove any doubt about the efficacy of the tracing. As helpful as this may be, it is not, in our view, necessary in light of (i) the regulatory directive that a partnership use "any reasonable method" to make the determination, (ii) the fact that tracing under Temporary Reg. §1.163-8T is just one example of a reasonable method, and (iii) the fact that Temporary Reg. §1.163-8T itself includes deeming rules. Temporary Reg. §1.163-8T(c)(1); I.R.S. Notice 89-35, 1989-1 C.B. 675 ([Temporary Reg. §1.163-8T] provides that debt generally is allocated by tracing disbursements of the debt proceeds to specific expenditures and that interest expense on such debt is allocated in the same manner as the debt to which such interest expense relates.).

It is also worth noting that, to the extent a distribution to a partner does not exceed the amount of the partner's deficit restoration obligation, the partnership is permitted to treat that partner as receiving amounts that are not attributable to an increase in partnership minimum gain. Reg. §1.704-2(h)(3). Although the regulation does not explain the rationale for this rule, the rule makes sense because if a partner has a deficit restoration obligation, the partner in many senses is not receiving a distribution of nonrecourse debt proceeds—the partner effectively bears at least some economic risk with respect to the proceeds because if the lender seeks repayment, the partnership can demand the partner restore its capital account deficit. This logic is also reflected in Treas. Reg. §1.704-2(i)(5) (which treats a partner's share of partner nonrecourse debt minimum gain as a limited deficit restoration obligations) and Reg. §1.704-1(b)(2)(ii)(*d*)(*6*) (which ensures that the qualified income offset allocation required by the alternate test for economic effect does result in a "double" allocation to the partner (*i.e.*, that the partner is not allocated income under both the minimum gain chargeback rule and the qualified income offset rule).

[94] Even if the fair market value of the assets is less than the amount of the debt, Reg. §1.704-1(f)(1) and Code Sec. 7701(g) operate to cause the fair market value to be treated as equal to the amount of the nonrecourse liabilities.

[95] Reg. §1.704-2(d)(4).

[96] Of course, although the revaluation technically eliminates the partners' minimum gain chargeback exposure, it does not eliminate the tax consequences to the partners. Rather, the revaluation effectively converts a partner's share of partnership minimum gain into reverse Code Sec. 704(c) gain. Reg. §1.704-2(m) Ex. 3 (demonstrating how two partners' shares of partnership minimum gain are eliminated in a revaluation and noting that "under [Code Sec.] 704(c) principles, the tax capital accounts of [the partners] will eventually be charged $35,000 each, reflecting their 50 percent shares of the decrease in partnership minimum gain that resulted from the revaluation."). As a result, the benefit of the flexibility is somewhat tempered; if a partnership makes a determination regarding partnership minimum gain with the goal of ensuring an allocation of liabilities under Tier 1, the partners that are allocated the liability are, one way or another, exposed to income or gain in the future.

[97] Reg. §1.704-3(a)(6).

[98] Reg. §1.752-3(a)(2).

[99] The remaining $300 of the liability is allocated under Reg. §1.752-3(a)(3), which is discussed in subpart 3 below.

[100] Reg. §1.704-3(a)(2).

[101] Reg. §1.752-3(b)(1).

[102] *See* Rev. Rul. 95-41, 1995-1 C.B. 132 (providing that a partnership's Code Sec. 704(c) method must be taken into account in determining a partner's share of Code Sec. 704(c) Minimum Gain for purposes of Tier 2 (discussed below)).

[103] *Id*.

[104] Reg. §1.752-3(b)(1). *See* Appendix A for two sample Reg. §1.752-3(b) methods.

[105] *Id*.

[106] Reg. §1.752-3(c), Ex. 3.

[107] Reg. §1.752-3(b)(1).

[108] Reg. §1.752-3(b)(2).

[109] Other practitioners supported the view that an "asset" in subchapter K does not need to be a separate item of state-law property. *See*, *e.g.*, Jennifer Ray, *Dividing the Indivisible: Identifying the "Property" in Partnership Transactions*, 100 TAXES 95, 107-08 (2022) (arguing that the property contributed or distributed can either be the actual state-law property or the relevant 704(c) amounts in the context of property distributions from partnerships).

[110] Those who favor collapsing Code Sec. 704(c) layers might argue that this step is conceptually

unnecessary. One could simply say that there is $300 of Code Sec. 704(c) gain and treat that gain as a single layer. The authors do not believe that is the correct way to think about Code Sec. 704(c).

[111] Any resemblance between this illustration and that scene from the third *Die Hard* movie is purely coincidental.

[112] In this case, the *pro rata* and equal allocations are the same because A and B have 50 percent each of the gain in the reverse layer. This will not always be the case.

[113] Reg. §1.704-3(a)(6).

[114] Disallowance of Partnership Loss Transfers, Mandatory Basis Adjustments, Basis Reduction in Stock of a Corporate Partner, Modification of Basis Allocation Rules for Substituted Basis Transactions, Miscellaneous Provisions, 79 Fed. Reg. 3042, 3054 (Jan. 16, 2014).

[115] New York State Bar Association Tax Section, Report on the Request for Comments on Code Sec. 704(c) Layers Relating to Partnership Mergers, Divisions, and Tiered Partnerships, Report No. 1202 (Jan. 22, 2010).

[116] 79 Fed. Reg. at 3054.

[117] *Id*.

[118] Although a Reg. §1.752-7 liability is not "property" in the traditional sense, Reg. §1.704-3(a)(12) provides that "[Reg.] §1.752-7 liabilities . . . are [Code Sec.] 704(c) property (built-in loss property that at the time of contribution has a book value that differs from the contributing partner's adjusted tax basis) for purposes of applying the rules of [Reg. §1.704-3]." Because of the close conceptual relationship between Reg. §1.752-3(a)(2) and Reg. §1.704-3 (*i.e.*, the reliance of the former on the latter), it is appropriate to view a Reg. §1.752-7 liability as a "contra-asset" that is "property" for purposes of Reg. §1.752-3(a)(2). In that regard, we note that treating an income item as property for purposes of partnership taxation is consistent with other rules in subchapter K. Most notably, for purposes of allocating a [Code Sec.] 743(b) adjustment, Reg. §1.755-1(a)(1) provides that "properties and potential gain treated as unrealized receivables under [Code Sec.] 751(c) and the regulations thereunder shall be treated as separate assets that are ordinary income property."

[119] *See*, *e.g.*, Reg. §1.704-3(a) ("allocation must be made using a reasonable method that is consistent with the purpose of [Code Sec.] 704(c)"); Reg. §1.752-3(a)(3) (permitting multiple methods for allocating Excess Nonrecourse Liabilities, including permitting taxpayers to allocate Excess Nonrecourse Liabilities "up to" the partner's respective Code Sec. 704(c) amounts under the additional method); Reg. §1.752-3(b) ("the partnership may allocate the liability among the multiple properties under any reasonable method"); and Reg. §1.752-3(a)(2) (effectively incorporating both Reg. §§1.704-3 and 1.752-3(b)).

[120] Reg. §1.704-3(a)(6) ("Partnerships are not required to use the same allocation method for reverse [Code Sec.] 704(c) allocations as for contributed property, even if at the time of revaluation the property is already subject to [Code Sec.] 704(c) and paragraph (a) of this section. In addition, partnerships are not required to use the same allocation method for reverse [Code Sec.] 704(c) allocations each time the partnership revalues its property.").

[121] In our view, an asset's tax basis is properly associated with the first Code Sec. 704(c) layer with respect to that asset. A corollary of that view is that, for these purposes, the value of the first layer includes the amount of tax basis in addition to the amount of Code Sec. 704(c) gain. For example, if an asset is contributed with $100 of value and $30 of tax basis and then is revalued to $140, there is $70 of Code Sec. 704(c) gain in the forward layer and $40 in the reverse layer. In this case, it would be appropriate to treat the "value" of the forward layer as $100 rather than $70. Alternatively, it may be appropriate to treat there as being, in effect, three separate assets—a $30 asset, a $70 asset, and a $40 asset. (Such an approach would be conceptually consistent with the remedial method of Reg. §1.704-3(d)(2).)

[122] Reg. §1.752-3(b)(1).

[123] *See generally* Reg. §1.704-3.

[124] For example, when one asset has relatively high tax basis, the total amount of Code Sec. 704(c) gain with respect to that asset may be low. For that Code Sec. 704(c) gain to become Code Sec. 704(c) Minimum Gain, however, the partnership must allocate a relatively large amount of the liability to that asset, effectively "wasting" the portion of the liability attributable to the tax basis. Thus, although the Unitary Asset Approach allows for non *pro rata* allocations of Code Sec. 704(c) gain, using the Unitary Asset Approach may make it harder to achieve exactly the result desired. By using the Separate Shares Approach or Separate Layers Approach, the partnership can decide not to allocate to the high basis notional assets thereby avoiding wasting the liability. *See* Examples 13 and 14.

[125] Reg. §1.704-3(a)(2).

[126] It could be argued that, although this is a method, it is not a reasonable one. It is not clear what the textual basis for such an argument would be, other than that the result of the method simply seems a bit "too cute."

[127] This is a classic problem of proof—if the partnership does not write down its determination, how can the partnership show that it was limited to foreclosures?

[128] Even when the partnership does not adopt a written method limiting the determination about the allocation of gain to foreclosures, it may be appropriate to infer that the general partner's determination for purposes of Tier 2 is confined to the determination that actually needs to be made by Reg. §1.752-3(b) (*i.e.*, a rational general partner generally does not make a binding determination earlier than the law requires).

[129] Even if no profits interest were being issued, LLC would be permitted to revalue its assets in reliance on Proposed Reg. §1.704-1(b)(2)(iv)(*f*) if LLC follows the hypothetical sale approach in the proposed Code Sec. 751(b) regulations. *See* Proposed Reg. §1.751-1(f) (2014).

[130] As discussed above, there is no "multiple properties" rule in Reg. §1.704-2. In this example, because of the revaluation, the [Code Sec.] 704(b) book basis of each property equals its fair market value. Thus, it is not possible for there to be partnership minimum gain; the only way there could be partnership minimum gain is if either Asset A or Asset B were subject to a liability in excess of its fair market value. As noted above, this would be impossible because of [Code Sec.] 7701(g). *See supra* note 94.

[131] Reg. §1.752-3(a)(3).

[132] *Id*.

[133] Many in the tax community believe there are only three methods (*i.e.*, the Profits Method is not a separate method but rather a meta-method). We do not feel strongly about the question but have decided on a four-method framework for ease of explication.

[134] Reg. §1.752-3(a)(3).

[135] *Id*.

[136] *Id*. In T.A.M. 200436011 (Apr. 30, 2004), the IRS concluded that an allocation of 100 percent of "gross income" up to the amount of the senior preferred return is not a "significant item of partnership income or gain," reasoning that this phrase refers to a "significant class of partnership income" and not to a tranche of bottom-line gross or net income. Therefore, the partnership's allocation of 100 percent of its Excess Nonrecourse Liabilities to a partner based on its allocation of 100 percent of its gross income to that partner was inappropriate. Although the conclusion reached by the IRS in the TAM seems correct on its facts, the legal analysis is arguably in some tension with the text of Example 1 in Reg. §1.704-2(m).

[137] Reg. §1.752-3(a)(3).

[138] Emphasis added. Specifically, Reg. §1.704-2(b)(1) provides that "allocations of losses, deductions, or [Code Sec.] 705(a)(2)(B) expenditures attributable to partnership nonrecourse liabilities ('nonrecourse deductions') cannot have economic effect because the creditor alone bears any economic burden that corresponds to those allocations.".

[139] T.D. 8237, 53 Fed. Reg. 53140 (Dec. 30, 1988) (proposed regulations); T.D. 8380, 56 Fed. Reg. 66348 (Dec. 23, 1991) (final regulations).

[140] T.D. 8385, 56 Fed. Reg. 66978, 66979 (Dec. 27, 1991) ("Accordingly, allocations of *deductions attributable to partnership nonrecourse liabilities (nonrecourse deductions)* cannot have substantial economic effect because the nonrecourse lender, rather than the partners, ultimately bears any economic loss attributable to those deductions.") (emphasis added).

[141] Reg. §1.752-3(a)(3). The Additional Method does not apply for purposes of Reg. §1.707-5(a)(2)(ii). *Id*.

[142] *Id*.

[143] Joint Committee on Taxation, Options to Improve Tax Compliance and Reform Tax Expenditures (JCS-02-05), Jan 27, 2005, 161-171.

[144] Simplification of Entity Classification Rules, 61 Fed. Reg. 21989, 21990 (Jun. 10, 1996).

[145] The meaning of "subject to" is closely related to the myriad questions about "exculpatory liabilities" that have been discussed over the years. *See e.g.*, New York State Bar Association Tax Section, Report on the Treatment of Exculpatory Liabilities for Purposes of Section 704 and Section 752, Report No. 1323 (Jun. 17, 2015). An exculpatory liability is one that is "not secured by any specific property and that is recourse to the partnership as an entity, but explicitly not recourse to any partner." T.D. 8385, 56 Fed. Reg. 66978, 66982 (Dec. 27, 1991). The same issues arise in other contexts, most notably Reg. §1.707-5.

[146] *See* New York State Bar Association Tax Section, Report on the Proposed Regulations on the Allocation of Partnership Liabilities and Disguised Sales, Report No. 1307 (May 30, 2014).

[147] Rev. Rul. 92-97, 1992-2 C.B. 124; Rev. Rul. 94-4, 1994-1 C.B. 195; T.A.M. 9619002 (Jan. 31, 1996); Rev. Rul. 2003-56, 2003-1 C.B. 985.

[148] One common situation in which this arises is professional services firms that have lumpy income. For example, many law firms collect a disproportionate amount of fees at the end of their fiscal years; many accounting firms collect a majority of their fees around tax filing seasons. To fund partner distributions, these firms sometimes have a revolving credit facility that they draw on during dry months, which they then pay down when they collect fees. If a firm draws on its facility in April and distributes the proceeds *pro rata* to the partners, the partners do not recognize gain at the time of the distribution because the distribution is supported by the liability (assuming the liability was allocated *pro rata*). If, however, the liability is paid down in October, but the taxable income does not flow through to adjust the partners' outside bases until December 31, it is possible that the partners will recognize gain. This is contrary to the policy of both the drawing rule and Reg. §1.752-3 and plainly is not the intended (or correct) result.