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The Final Regulations Under Irc Sections 704(B) And 752: Envisioning Economic Risk Of Loss Through A Glass Darkly

Ed R. Haden

NOTES

THE FINAL REGULATIONS UNDER IRC SECTIONS 704(b) AND 752: ENVISIONING ECONOMIC RISK OF LOSS THROUGH A GLASS DARKLY

I. INTRODUCTION

When a partnership borrows money and spends the proceeds on a deductible expenditure, which partners may deduct the partnership expense? When a sole proprietor[1] borrows one hundred dollars to pay wages to an employee, the Internal Revenue Code (IRC) allows the sole proprietor a deduction for compensation expense.[2] Allowance of the deduction makes sense because the sole proprietor made the wage payment and will have to forfeit his personal assets to the extent he defaults on his one hundred dollar loan. Thus, the sole proprietor taxpayer bears the economic cost of the payment that gives rise to the deduction. Similarly, if a corporation[3] borrows one hundred dollars to pay wages to an employee, the IRC allows the corporation a deduction for compensation expense.[4] Again, this makes sense because the corporation made the payment, and the creditor can attach the corporation's assets, rather than the assets of its shareholders, if the corporation fails to repay its one hundred dollar loan.[5] Thus, the corporate taxpayer bears the economic cost of the payment that gives rise to the deduction. If a partnership[6] borrows one hundred dollars to pay wages,

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1. *See* BLACK'S LAW DICTIONARY 1392 (6th ed. 1990) (defining sole proprietorship as form of business in which one person owns all assets in contrast to partnership, trust or corporation). BLACK'S LAW DICTIONARY also states, "The sole proprietor is soley liable for all the debts of the business." *Id.* at 1392.

2. I.R.C. § 162(a)(1) (1988). Section 162(a)(1) allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business, including—a reasonable allowance for salaries or other compensation for personal services actually rendered." *Id.*

3. *See* BLACK'S LAW DICTIONARY 340 (6th ed. 1990) (defining corporation as artificial person or legal entity created by or under authority of state law). BLACK'S LAW DICTIONARY also provides, "The law treats the corporation as a person which can sue and be sued." *Id.* at 340.

4. *See supra* note 2 and accompanying text (allowing deduction for salary expense).

5. *See* MODEL BUSINESS CORP. ACT § 6.22(b) (1985) (providing limited liability for corporate shareholders). The text of § 6.22(b) provides, "Unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debt of the corporation . . . ." *Id.* Thus, creditors of a corporation generally must look only to the corporation and not to the shareholders for payment of liabilities. *Id.*

6. *See* BLACK'S LAW DICTIONARY 1120 (6th ed. 1990) (defining partnership as business owned by two or more persons and not organized as corporation). The UNIFORM PARTNERSHIP

however, two problems arise. First, because the partners, and not the partnership, pay tax on partnership income,[7] the partnership must determine which partners should receive allocations of the compensation expense.[8] Second, because the creditor can reach through the partnership and attach some of the partners' personal assets if the partnership does not repay its one hundred dollar loan,[9] general partners may actually bear the economic cost of the one hundred dollar payment while limited partners, if any, may not.[10] In order to be consistent with the sole proprietor and corporate scenarios, the partnership should allocate the deduction to the partner taxpayers that bear the economic cost of generating the deduction.[11]

Until recently, consistency in deducting losses between partnerships and other business forms did not exist. Partnerships enjoyed extensive flexibility in allocating items of income and loss among partners, and only limited guidance existed regarding the determination of which partners could include partnership liabilities in the bases of their partnership interests.[12] Prior to

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ACT defines a general partnership as "an association of two or more persons to carry on as co-owners a business for profit." UNIF. PARTNERSHIP ACT § 6(1), 6 U.L.A. 22 (1914). The UNIFORM PARTNERSHIP ACT also provides that general partners assume joint and personal responsibility for partnership debts. UNIF. PARTNERSHIP ACT § 15, 6 U.L.A. 174 (1914).

Black 's Law Dictionary defines a limited partnership as:

> A partnership consisting of one or more general partners, jointly and severally responsible as ordinary partners, and by whom the business is conducted, and one or more special partners, contributing in cash payments a specific sum as capital to the common stock, and who are not liable for the debts of the partnership.

BLACK'S LAW DICTIONARY 1121 (6th ed. 1990). The Revised Uniform Limited Partnership Act defines a limited partnership as "a partnership formed by two or more persons under the laws of this State and having one or more general partners and one or more limited partners." REVISED UNIF. LIMITED PARTNERSHIP ACT § 101(7), 6 U.L.A. 271 (1976) (amended 1985) (Supp. 1991). Further, a limited partner that does not participate in the control of the partnership is not liable for the limited partnership's debts. REVISED UNIF. LIMITED PARTNERSHIP ACT § 303(a), 6 U.L.A. 325 (1976) (amended 1985) (Supp. 1991).

7. *See* I.R.C. § 701 (1988) (providing that partners reflect their share of partnership income and loss on their individual income tax returns).

8. *See* I.R.C. § 704(b) (1988) (describing distributive share of partnership income for each partner).

9. *See* UNIF. PARTNERSHIP ACT § 15, 6 U.L.A. 174 (1914) (providing for personal liability of general partners for partnership debts).

10. *See supra* note 6 (comparing personal liability of general partners with that of limited partners).

11. *See supra* notes 1, 3, 5 and accompanying text (describing who bears cost of business liabilities). If a liability provides the cash with which a business pays for a deductible item of expense, the individual(s) or entity that will pay off the liability should receive the deduction. The individual(s) or entity that must liquidate the liability that generated the deduction bears the economic risk of loss with respect to that deduction. *See* Treas. Reg. § 1.752-2(a) (1991) (outlining technique for determining which partners bear economic risk of loss).

12. Michael J. Close & Dan A. Kusnetz, *The Final Section 704(b) Regulations: Special Allocations Reach New Heights Of Complexity*, 40 TAX LAW. 307, 308-09 (1987); William A. Rosoff, *The Road to Oz After the Execution of the Wizard: The Section 704(b) Nonrecourse Deduction Regulations and Section 752 Debt Allocations After Tax Reform*, 46 N.Y.U. TAX INST. ch. 25 at 1 (1988).

1976, the IRC imposed few limits on the allocation of items of partnership income and loss among partners.[13] The IRC disallowed only those special allocations, allocations that did not parallel the partners' interests in partnership capital or profits, motivated by tax avoidance.[14] However, the IRC did limit the extent to which a partner could deduct partnership losses by the amount of his investment, or basis, in the partnership.[15]

While the IRC allowed partners to increase their bases in their partnership interests by their share of partnership liabilities, the regulations provided only simplistic rules for the allocation of partnership liabilities among the partners.[16] Recourse liabilities of the partnership, those for which at least one partner personally bore risk of repayment if the partnership defaulted, increased the bases of general partners according to the general partners' respective interests in partnership losses.[17] Nonrecourse liabilities of the

13. *See* Close & Kusnetz, *supra* note 12, at 308-09 (describing history of IRC § 704(b) distribution rules).

14. *See* Treas. Reg. § 1.704-1(b)(2) (1956) (disallowing tax avoidance allocations). Prior to 1976, the IRC § 704(b) regulations only limited the flexibility of partnership income and loss allocations if tax avoidance composed the principal purpose of such allocations. *Id.*

15. I.R.C. § 704(d) (1988). IRC § 704(d) provides that a deduction for "[a] partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred." *Id.*

A partner's basis in his partnership interest includes his contributions to the partnership, his share of partnership income, and his share of partnership liabilities. I.R.C. §§ 722, 705(a)(1), 752(a) (1988). IRC § 722 provides that a partner's basis in his partnership interest includes the amount of money he contributes to the partnership plus the adjusted basis, usually the cost, of property he contributes to the partnership. I.R.C. § 722. IRC § 705(a)(1) provides that a partner's basis in his partnership interest increases by the sum of his cumulative allocable shares of partnership income. I.R.C. § 705(a)(1). IRC § 752(a) treats a partner as having made a cash contribution to the partnership equal to any increase in his share of partnership liabilities. I.R.C. § 752(a). Thus, the deemed cash contribution caused by an increase in a partner's share of partnership liabilities under IRC § 752 causes an increase in the relevant partner's basis under IRC § 722. I.R.C. §§ 752(a), 722.

IRC §§ 465 and 469 provide further limitations on partnership loss deductions. *See* I.R.C. § 465 (limiting loss deductions from certain partnership interests to amount of partner's investment in partnership that is "at risk"); I.R.C. § 469 (limiting deductibility of losses from certain partnership investments to amount of partner's "passive income"). The "at risk" and "passive loss" rules of IRC §§ 465 and 469 are beyond the scope of this note which strives to analyze the theoretical basis and mechanical techniques employed to produce initial allocations of partnership income and loss.

16. *See* Treas. Reg. § 1.752-1(e) (1956) (providing that general partners share recourse liabilities according to their interests in partnership losses and that both general and limited partners share nonrecourse liabilities according to their interests in partnership profits).

17. *Id.* Regulation § 1.752-1(e) provided that general partners share partnership recourse liabilities based on their loss sharing percentages. *Id.* The Treasury apparently based this rule on the theory that recourse liabilities would only have to be paid by the general partners (in lieu of the partnership) if the partnership experienced losses. *See* Rosoff, *supra* note 12, at 25-23 (describing which partners would liquidate recourse and nonrecourse partnership liabilities, respectively); Treas. Reg. § 1.752-1(a)(1) (1991) (defining nonrecourse liabilities as those partnership debts for which no partner personally bears economic risk of loss).

partnership, generally loans secured by mortgages on real property for which no partner bore a personal obligation to repay if the partnership defaulted, increased the bases of both general and limited partners according to the general and limited partners' respective interests in partnership profits.[18] By changing the profit and loss ratios of the partners, the partnership could shift liabilities among the partners and, thus manipulate the partners' bases in their partnership interests that directly affected the deductibility of the allocated losses.[19] The following example illustrates the abuses possible under the old loss and liability allocation rules.

> EXAMPLE 1—General partner, G, and limited partner, L, form a limited partnership that divides profits and losses equally. The partnership borrows $1,000,000 on a nonrecourse note secured by a mortgage on an office building the partnership purchases with the loan proceeds. To obtain the loan, the creditor requires G to guaranty the debt. Because the simplistic liability regulations did not provide for the effect of personal guarantees of nonrecourse liabilities, the partners could still treat the note as nonrecourse. Thus, L could increase his basis by one half of the debt even though G actually bore the entire economic risk of loss with respect to the liability.[20] Further, because the Treasury offered little guidance

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18. Treas. Reg. § 1.752-1(e) (1956). Regulation § 1.752-1(e) provided that both general and limited partners' bases increased to the extent of their profit percentages times the nonrecourse liability. *Id.* The Treasury apparently based this portion of the regulation on the theory that the partners, in lieu of the partnership, would only have to pay a nonrecourse debt if the partnership earned profits. *See* Rosoff, *supra* note 12 at 25-23 (describing theoretical underpinnings of Treas. Reg. § 1.752-1(e)). Otherwise, the creditor would simply repossess the mortgaged property. Because both general and limited partners would have to sacrifice profits to pay off the nonrecourse debt, both classes of partners should share in the basis benefits according to their profits interest. *See* Rosoff, *supra* note 12, at 25-23 (discussing use of profits to liquidate partnership liabilities); Treas. Reg. § 1.752-1(a)(2) (1991) (defining nonrecourse debt as those partnership liabilities for which no partner personally bears economic risk of loss).

19. *See* H.R. CONF. REP. No. 861, 98th Cong., 2d Sess. 1235-36 (1984), *reprinted in* 1984 U.S.C.C.A.N. 697, 899-900 (decrying abuse potential of old IRC § 752 regulations).

20. *See* Raphan v. Commissioner, 3 Ct. Cl. 457, 465-66 (1983) (holding that nonrecourse debt guaranteed by general partner could still increase basis of limited partner's interest in partnership), *aff'd in part and rev'd in part*, 759 F.2d 879, 885 (Fed. Cir. 1985) (holding that general partner's guarantee of nonrecourse debt converted debt to recourse and, thus, partnership could not allocate any of this debt to limited partners). The shock wave set off by the lower court decision in *Raphan* resulted in congressional direction to the Treasury even before the appellate court could rule. Howard E. Abrams, *Long-Awaited Regulations Under Section 752 Provide Wrong Answers*, 44 TAX L. REV. 627, 628-29 (1989). Congress directed the Treasury to issue regulations that reversed this result by taking into account guarantees, assumptions, etc. in determining which partners received liability allocations. *Id.* The final regulations would now treat a previously nonrecourse debt guaranteed by a general partner, as in *Raphan*, as a recourse liability and allocate all of the liability to the guaranteeing partner. *See* Treas. Reg. §1.752-1(a)(1) (1991) (defining recourse liabilities as those liabilities for which any partner bears economic risk of loss); Treas. Reg. § 1.752-2(b) (1991) (defining economic risk of loss as obligation to make payment after constructive liquidation of partnership); Treas.

in determining what constituted tax avoidance,[21] the partnership could allocate disproportionately large amounts of losses, more than fifty percent, to L. In future years, when the partnership became profitable, it could distribute enough cash to L with which L could pay the tax on his share of partnership income.[22] Further, the partnership could allocate no income to L if the partners so desired.

Consequently, a limited partner could receive basis generated by debt he would never have to repay, disproportionately high amounts of losses to deduct against this basis, and distributions of enough cash to pay any tax liabilities in profitable years. This scenario encouraged taxpayers in high tax brackets to purchase limited partnership interests for tax benefits rather than for economic gains.[23]

To combat the abusive allocations of tax losses and liability-generated bases, the Treasury began issuing regulations that promoted consistency between partnerships and other entities in determining who received loss allocations and who could deduct them. In 1983, the Treasury issued proposed regulations under IRC section 704(b) that severely restricted the amount of flexibility that partnerships enjoyed over the allocation of income and losses.[24] In 1988, the Treasury issued temporary regulations under IRC section 752 that limited the flexibility allowed in shifting partnership liabilities among the partners to give certain partners enough basis to deduct losses.[25] After numerous proposed regulations, temporary regulations, and amendments to regulations, the Treasury issued the purported "final" installment of regulations under IRC sections 704(b) and 752 on December 23 and 27, 1991, respectively.[26] The Treasury based these extremely complex

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Reg. § 1.752-2(b)(3)(i) (1991) (requiring consideration of guarantees in determining ultimate obligation to make payment after constructive liquidation).

21. *See* Treas. Reg. § 1.704-1(b)(2) (1964) (omitting thorough definitions of tax avoidance and substantial economic effect). Prior to 1976, the regulations under IRC § 704 did not treat an allocation of partnership loss as having tax avoidance as its principal purpose if the allocation had "substantial economic effect." *Id.* However, the regulations did not provide an adequate definition of "substantial economic effect." *Id.*

22. *See* I.R.C. §§ 705(a)(2), 733(1), 731(a)(1) (1988) (decreasing partner's basis under IRC § 705(a)(2) for cash distributions and requiring gain recognition under IRC § 733(a)(1) for cash distributions in excess of basis). IRC §§ 705(a)(2), 733(1), and 731(a)(1) treat any cash distributions to partners in a limited partnership in excess of the partners' bases in their partnership interests as taxable income. *Id.* However, given a tax rate of less than 100%, partners that received cash could use the after-tax proceeds to pay the tax on the flow through of partnership income items. *See* I.R.C. § 1 (1988) (providing a maximum individual income tax rate of 31%).

23. Stephen G. Utz, *Partnership Taxation in Transition: Of Form, Substance, and Economic Risk*, 43 TAX LAW. 693, 694 (1990) (describing incentive for abuse provided by pre-1985 loss and liability allocation rules).

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

25. Temp. Treas. Reg. § 1.752-1T to 4T (as amended by T.D. 8274, 1989-2 C.B. 101).

26. Treas. Reg. § 1.704-2 (1991); Treas. Reg. §§ 1.752-0 to 5 (1991). The following tables show the effective dates, allocations affected and controlling rules for both sets of the regulations from their initial issuance until December 31, 1991:

sets of regulations and their more recent supplements on the "economic

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EFFECTIVE DATES
THE IRC § 704(b) REGULATIONS

PARTNERSHIP TAX YEARS	ALLOCATIONS AFFECTED	CONTROLLING RULES
Beginning after May 1, 1986.	Income, loss, etc. *not* attributable to non-recourse debt.	Treas. Reg. § 1.704-1(b)(1) to (5) (as amended in 1988). See A below.
Beginning before May 1, 1986 and after December 31, 1975.	Income, loss, etc. *not* attributable to non-resource debt.	Treas. Reg. § 1. 704-1(b)(1) to (5) (as amended in 1988) or relevant case law and legislative history prior to May 6, 1986. See B below.
Beginning after December 28, 1991.	Income, loss, etc. attributable to non-resource debt.	Treas. Reg. § 1. 704-2 (1991). See C below.
Beginning before December 28, 1991 and after December 29, 1988.	Income, loss, etc. attributable to non-recourse debt.	Temp. Treas. Reg. § 1.704-1T(b)(4) (iv). See D below.
Beginning before December 29, 1988 and after December 31, 1986.	Income, loss, etc. attributqable to non-recourse debt.	Treas. Reg. § 1. 704-1(b)(4)(iv) (1986). See E below.
Beginning before January 1, 1987 and after December 31, 1975.	Income, loss, etc. attributable to non-recourse debt.	Treas. Reg. § 1.704-1-(b)(4)(iv) or relevant case law and legislative history prior to May 1, 1986. See F below.

CITATIONS TO TRANSITIONAL RULES

A. Treas. Reg. § 1.704-1(b)(1)(ii) (as amended in 1988).
B. *Id.*
C. Treas. Reg. § 1.704-2 (1991). *See* Treas. Reg. § 1.704-2(l) (1991) (providing special transitional and elective rules with respect to effective dates of final IRC § 704(b) nonrecourse regulations).
D. Temp. Treas. Reg. § 1.704-1T(b)(4)(iv)(m) (as amended by T.D. 8274, 1989-2 C.B. 101).
E. Treas. Reg. § 1.704-1(b)(1)(ii) (as amended in 1988).
F. *Id.*

risk of loss" theory.[27] In other words, the Treasury adopted this simple concept for allocating both losses and liabilities: The partners who bear the economic cost of generating a partnership expense should deduct that expense.[28]

Unfortunately, after reading the lengthy and complex regulations promulgated under IRC sections 704(b) and 752, the tax practitioner can see the application of the economic risk of loss concept only "through a glass darkly."[29]

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27. *See* Temp. Treas. Reg. § 1.752-1T(a)(1)(iv) (as amended in 1989) (describing economic risk of loss).

EFFECTIVE DATES
THE IRC § 752 REGULATIONS

Liability Incurred	Type of Liability	Controlling Rules
After December December 27, 1991.	All liabilities.	Treas. Reg. § 1. 752-0 to 5 (1991). See G below.
Before December 28, 1991 and after January 29, 1989.	All liabilities except partner loans and guarantees of non-recourse debt.	Temp. Treas. Reg. § 1.752-OT to 4T (as amended in 1989). See H below.
Prior to January 30, 1989.	All liabilities except partner loans and guarantees of non-resource debt.	Treas. Reg. § 1.752.1(e) (1956) See I. below.
Before December 28, 1991 and after February 28, 1984.	Partner loans and guarantees of nonresource debt.	Temp. Treas. Reg. § 1.752.OT to 4T (as amended in 1989). See J. below.
Before March 1, 1984.	Partner loans and guarantees of nonresource debt.	Treas. Reg. § 1.752-1(e) (1956) See K. below.

CITATIONS TO TRANSITIONAL RULES

G. Treas. Reg. § 1.752-5(a) (1991). *See* Treas. Reg. § 1.752-5(b)(1) (1991) (providing election to apply final regulations to all partnership liabilities, regardless of when incurred, for partnership taxable years beginning on or after December 28, 1991).

H. Temp. Treas. Reg. § 1.752-4T(a) (as amended by T.D. 8274, 1989-2 C.B. 101). *See* Temp. Reg. § 1.752-4T(d)(1) (1991) (as amended by T.D. 8274, 1989-2 C.B. 101) (providing election to apply temporary regulations to all partnership liabilities, regardless of when incurred, for partnership taxable years ending after December 29, 1988). *See* Temp. Reg. § 1.752-4T(d)(2) (as amended by T.D. 8274, 1989-2 C.B. 101) (providing election to apply temporary regulations to all liabilities incurred after December 27, 1991, but before January 1, 1992).

I. Treas. Reg. § 1.752-1(e) (1956).

J. Temp. Treas. Reg. § 1.752-4T(b)(1) (as amended by T.D. 8274, 1989-2 C.B. 101). *See* Temp. Treas. Reg. § 1.752-4T(d)(1) (as amended by T.D. 8274, 1989-2 C.B. 101) (providing election to apply temporary regulations to all partnership liabilities, regardless of when incurred, for partnership taxable years ending after December 29, 1988. *See* Temp. Treas. Reg. § 1.752-4T(d)(2) (as amended by T.D. 8274, 1989-2 C.B. 101) (providing election to apply the temporary regulations to all liabilities incurred after December 27, 1991 but before January 1, 1992).

K. Treas. Reg. § 1.752-1(e) (1956).

28. *Id.*; Rosoff, *supra* note 12, at 25-4.

29. *See* I Corinthians 13:12 (King James) ("For now we see through a glass darkly; but

An analysis of how the economic risk of loss theory drives the IRC § 704(b) regulations' allocation of items of partnership income and loss and the IRC § 752 regulations' allocation of partnership liabilities will brighten the glass and determine if the regulations result in practice that parallels theory.

II. THE SECTION 704(b) REGULATIONS[30]

The IRC section 704(b) regulations determine to which partners a partnership may allocate items of income or loss.[31] These regulations limit a partnership's flexibility in allocating income and loss to partners by requiring that all allocations have "substantial economic effect."[32] Generally, the regulations allow a partnership to allocate losses to partners who bear the economic risk with respect to the loss[33] and who do not receive disproportionate tax benefits

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then, face to face; now I know in part, but then shall I know even as also I am known"); ARTHUR B. WILLIS, ET AL., PARTNERSHIP TAXATION, § 62.12 at 62-33 (4th ed. 1989) (describing IRC § 752 temporary regulations as new level of complexity); Edward Poreba, *New Regulations Describe Rules for Allocating Partnership Liabilities*, TAX'N FOR ACCT., April 1989, at 198, 203 (describing compliance with temporary regulations as burdensome); Richard E. Levine, et al., *A Practical Guide to the Section 752 Temp. Regs.-Part I*, J. TAX'N, April 1989, at 196, 196 (describing temporary regulations issued under both IRC § 704(b) and IRC § 752 as lengthy and complex); Abrams, *supra* note 20, at 640 ("Quite simply, the temporary regulations [under IRC § 752] cannot be understood"); Close & Kusnetz, *supra* note 12, at 307 (brandishing self-explanatory title).

30. *See* Treas. Reg. § 1.704-2 (1991) (superseding regulation § 1.704-1T's treatment of nonrecourse deductions and modifying minimum gain and minimum gain chargeback provisions); Treas. Reg. § 1.704-1 (as amended in 1988) (applying substantial economic effect analysis to all partnership items of income and deductions including nonrecourse deductions); T.D. 8274, 1989-2 C.B. 101 (amending Temp. Reg. § 1.704-1T dealing with allocation of nonrecourse deductions); T.D. 8237, 1989-1 C.B. 180 (amending Treas. Reg. § 1.704-1 for allocations attributable to nonrecourse liabilities); Temp. Treas. Reg. § 1.704-1T (1988) (providing new rules for the allocation of nonrecourse deductions); T.D. 8099, 1986-2 C.B. 84 (amending Treas. Reg. § 1.704-1 to provide for treatment of nonrecourse deductions); T.D. 8065, 1986-1 C.B. 255 (promulgating first set of final substantial economic effect regulations); Prop. Treas. Reg. § 1.704-1, 48 Fed. Reg. 9871 (1983) (constituting Treasury's first effort at comprehensively defining substantial economic effect and encompassing all allocations of partnership income and loss items including nonrecourse deductions); T.D. 6771, 1964-2 C.B. 177 (listing substantial economic effect as an indicator of tax avoidance); T.D. 6175, 1956-1 C.B. 211 (providing first partnership allocation regulations).

31. Treas. Reg. § 1.704-1(b)(1)(i) (as amended in 1988).

32. *Id.*

33. *See* Treas. Reg. § 1.704-1(b)(2)(ii) (as amended in 1988) (providing that effect on partners' capital accounts should serve as guide to allocations). Regulation § 1.704-1(b)(2)(ii)'s capital account device serves as the talisman for loss allocation and thus, helps conform partnership loss deductions to nonpartnership loss deductions. *Id.*; *supra* notes 2-9 and accompanying text (discussing loss allocation in nonpartnership contexts). For example, if a sole proprietor paid $100 of salary expense he could deduct $100 on his individual return. I.R.C. § 162 (1988). Similarly, if a partnership paid $100 of salary expense from its cash reserves, each partner in a two person partnership that divided losses equally could deduct $50 in salary expense. I.R.C. §§ 162, 701, 702 (1988). In each case the payment of cash resulted in a decrease in the economic value of the business to the owner(s). The tracing of deductions through liabilities requires a two-step analysis. First, the partnership borrows $100 and uses the money to pay salary expense. Thus, the liability gives rise to a deduction. Second, if only one of our two partners bears responsibility for repayment

from such allocations.[34] The regulations divide these two concepts into the economic effect test and the substantiality test.[35] To the extent that an allocation of income or loss lacks either economic effect or substantiality, the partnership must reallocate the items in accordance with the partners' interests in the partnership.[36]

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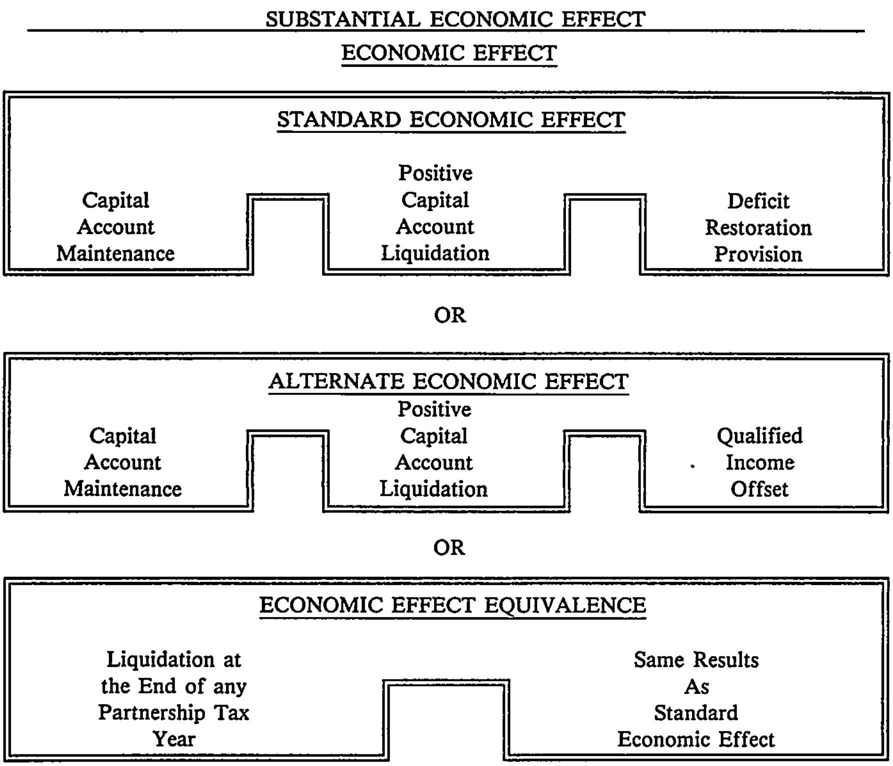
of the debt, he alone has his economic investment reduced. For example, if G, a general partner bore sole liability for the repayment of the $100 while L, a limited partner, did not, only G would have his economic value reduced. Thus, the we may trace the liability giving rise to the deduction to G.

34. *See* Treas. Reg. § 1.704-1(b)(2)(iii) (as amended in 1988) (providing substantiality test for inhibiting tax avoidance).

35. *See* Treas. Reg. §1.704-1(b)(2)(i) (as amended in 1988) (providing that allocations must display economic effect and that economic effect must reflect substantiality). The regulations provide that allocation attributable to nonrecourse debt cannot have substantial economic effect because the creditor alone bears the economic cost of those allocations. Treas. Reg. § 1.704-2(b)(1) (1991). The partnership must allocate such items in accordance with the partners' interests in the partnership. *Id.* The regulations provide a "minimum gain chargeback" technique for determining whether an allocation of a nonrecourse item corresponds to the recipient partner's interest in the partnership. Treas. Reg. § 1.704-2(e) (1991). The methods of allocating nonrecourse items lie beyond the scope of this note, which seeks to explain how the economic risk of loss concept influences the basic operation of the IRC §§ 704(b) and 752 regulations.

36. Treas. Reg. § 1.704-1(b)(1)(i) (as amended in 1988). The following diagram illustrates the concepts embodied in the substantial economic effects test:



A. *Economic Effect*

In general, the regulations determine whether a partner bears the economic risk with respect to a loss allocation by determining if the allocation has an adverse "economic effect" on the partner's ultimate investment in the partnership.[37] The regulations provide for three types of economic effect: (1) standard economic effect,[38] (2) alternate economic effect[39] and (3) economic effect equivalence.[40] The regulations determine economic effect by using a three-part measurement system: capital account maintenance, liquidation proceeds measurement, and deficit restoration measurement.[41] Basically, this measurement system determines whether a loss allocation has an economic effect on what

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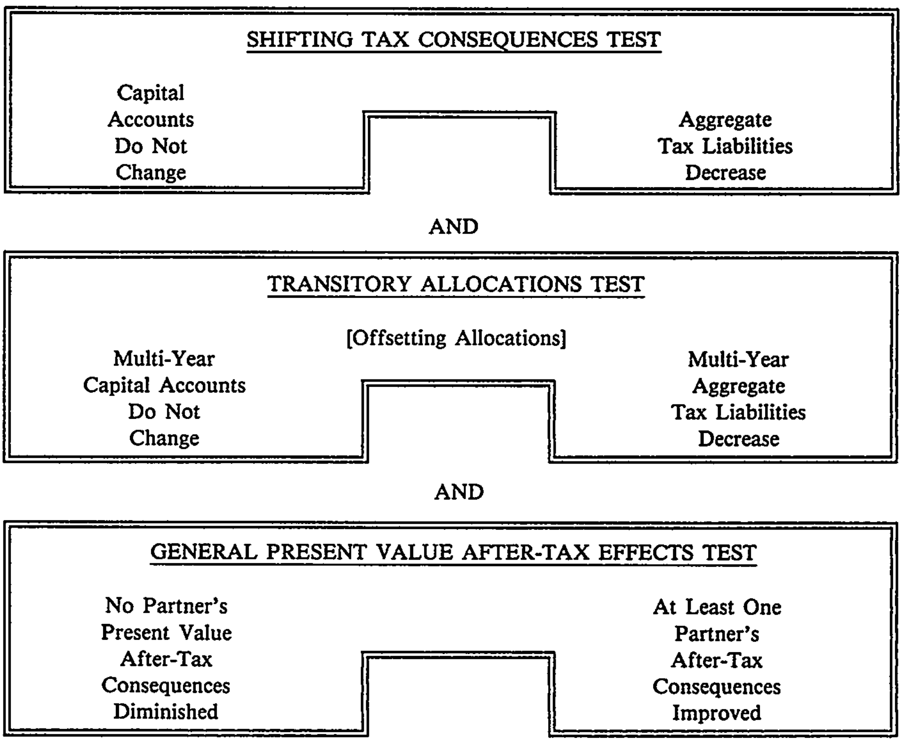
Treas. Reg. § 1.704-1(b)(2)(ii) (as amended in 1988).

SUBSTANTIALITY



Treas. Reg. § 1.704-1(b)(2)(iii) (as amended in 1988).

37. Treas. Reg. § 1.704-1(b)(2)(ii) (as amended in 1988).
38. Treas. Reg. § 1.704-1(b)(2)(ii) (as amended in 1988).
39. Treas. Reg. § 1.704-1(b)(2)(ii)(d) (as amended in 1988).
40. Treas. Reg. § 1.704-1(b)(2)(ii)(i) (as amended in 1988).
41. Treas. Reg. § 1.704-1(b)(2)(ii)(b) (as amended in 1988).

the partner has invested in the partnership now, what the partner would get out of the partnership if it liquidated and had excess assets, and what the partner would have to contribute back to the partnership if it liquidated with insufficient assets.[42]

1. Standard Economic Effect

The standard economic effect test provided by the regulations creates a safe harbor under which the regulations deem allocations to have economic effect.[43] A partnership can comply with the safe harbor by drafting into its agreement provisions dealing with capital account maintenance, the distribution of liquidation proceeds, and the obligation to restore deficit capital account balances.[44]

The "capital account maintenance" provision of the regulations measures each partner's investment in the partnership in accordance with certain rules to determine if allocations to the partners have standard economic effect.[45] The regulations accomplish this measurement by requiring the partnership agreement to incorporate an accounting device referred to as a "capital account."[46] Each

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42. *Id.*; *see also* Orrisch v. Commissioner, 55 T.C. 395, 402-04 (1970) (constituting first judicial opinion that allocations should affect amount partners would have to contribute to eliminate any deficit in their capital accounts and amount of liquidation proceeds in which partners could share).

43. Treas. Reg. § 1.704-1(b)(2)(ii) (as amended in 1988).

44. Treas. Reg. § 1.704-1(b)(2)(ii)(b) (as amended in 1988) (describing safe harbor partnership agreement provisions). Regulation § 1.704-1(b)(2)(ii)(b) provides:

> [A]n allocation of income, gain, loss, or deduction (or item thereof) to a partner will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides—
>
> (1) For the determination and maintenance of the partner's capital accounts in accordance with the rules of paragraph (b)(2)(iv) of this section,
>
> (2) Upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (2) and requirement (3) of this paragraph (b)(2)(ii)(b)), by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), and
>
> (3) If such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (3)), he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances (in accordance with requirement (2) of this paragraph (b)(2)(ii)(b)).

Id.

45. Treas. Reg. § 1.704-1(b)(2)(iv) (as amended in 1988).

46. *Id.* The partnership will keep a set of books to record partnership financial trans-

partner's capital account merely sums the total of a partner's contributions of property and cumulative shares of income and subtracts distributions to the partner and his share of cumulative partnership losses.[47] Unlike a partner's basis in his partnership interest, his capital account includes the fair market value,[48] rather than the adjusted tax basis,[49] of property contributions and distributions. Further, only partnership liabilities that a partner personally assumes will increase his capital account.[50] Otherwise, the regulations trace the effect of a partner's liability for partnership recourse debt via the deficit restoration requirement.[51] The following example illustrates how a partner's capital account measures his economic investment in the partnership.

> EXAMPLE 2—A and B form a general partnership by contributing $100 each. During Year 1, the partnership pays a salary expense of $25 and no other events generating income or deduction occur. The partners agree to allocate the $25 expense to B.

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actions. From these books, the partnership must compute each partner's capital account. Once computed, the capital account serves as the touchstone for income and loss allocation to the various partners. At the end of the year, the partnership will file a Form 1065, U.S. Partnership Return of Income, with the Internal Revenue Service. Treas. Reg. § 1.6033-1(a) (as amended in 1978). The Schedule K of the Form 1065 will reflect all of the partnership income and loss items. *Instructions to Form 1065*, (IRS 1991). The partnership will then send each partner a Schedule K-1 that reflects that partner's individual share of partnership income. *Id.* The partner then reports the items on his Schedule K-1 on his individual Form 1040, U.S. Individual Income Tax Return. *Partner's Instructions for Schedule K-1 (Form 1065)*, (IRS 1991). Thus, if a partner avoids involvement in the preparation of the partnership's financial statements and tax return data, he will never compute his own capital account even though this account directly influences how much income or loss flows through the partnership to his tax return.

47. *See supra* note 46 (describing capital account maintenance).

48. Treas. Reg. § 1.704-1(b)(2)(iv)(b) (as amended in 1988).

49. *See* I.R.C. § 722 (1988) (increasing partner's basis in his partnership interest by adjusted tax basis of contributed property).

50. *See* Treas. Reg. § 1.704-1(b)(2)(iv) (as amended in 1988) (providing for computation of partners' capital accounts). The following table compares the computation of a partner's capital account with a partner's basis in his partnership interest:

Capital Account	Basis
Value of Property Contributed	Basis of Property Contributed
+ Income Allocations	+ Income Allocations
− Value of Property Distributed	− Basis of Property Distributed
− Loss Allocations	− Loss Allocations
-----	+ Increase in P'ship Liabilities
-----	− Decrease in P'ship Liabilities
Partner's Capital Account	Partner's Basis

See Treas. Reg. § 1.704-1(b)(2)(iv) (as amended in 1988) (regarding computation of capital accounts); I.R.C. §§ 705, 722, 752 (1988) (regarding computation of partner's basis in his partnership interest).

51. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3) (as amended in 1988). The regulations use the minimum gain technique for allocating nonrecourse deductions. Treas. Reg. § 1.704-2(b)(2) (1991). *See infra* notes 138-44 (discussing minimum gain utilization).

	A	B	Total
Beginning Capital Account	$100	$100	$200
Salary Expense	-0-	(25)	(25)
Ending Capital Account	$100	$75	$175

Both partners have initial capital accounts equal to their contributions. The allocation of the $25 expense to B will affect will reduce B's capital account and thus, the value of his economic investment in the partnership.

The positive capital account liquidation provision of the regulations maintains the integrity of the above capital account analysis of a partner's economic investment in the partnership when the partnership liquidates and distributes its assets.[52] The regulations require the partnership agreement to provide that if the partnership liquidates, it will distribute partnership assets based on the partners' positive capital account balances.[53] Accordingly, distributions based on some other motive that does not reflect the partner's investment in the partnership as measured by the capital account cannot occur on liquidation. The following example illustrates how the capital accounts determine the portion of partnership assets each partner will ultimately receive upon liquidation.

EXAMPLE 3—A and B form a general partnership by contributing $100 each. During Year 1, the partnership pays a salary expense of $75 and no other items of income or deduction occur. The partnership then liquidates at the end of Year 1. Both partners have initial capital accounts equal to their contributions. If the partners decide to allocate the $75 expense to B, the allocation will reduce the amount B would receive if the partnership liquidated at the end of Year 1.

	A	B	Total
Beginning Capital Account	$100	$100	$200
Salary Expense	-0-	(75)	(75)
Ending Capital Account	$100	$25	$125

Upon liquidation of the partnership, the partners received their ending capital account balances. Thus, B incurred an economic loss of $75 by having the entire salary expense allocated to him because the allocations reduced his liquidation proceeds by $75.

The deficit restoration requirement of the regulations takes into consideration the possibility that the partners could have negative capital account balances if the partnership was insolvent upon liquidation.[54] To retain the accuracy of the capital account measurement device, the regulations provide that a partnership agreement should require the partners with deficit capital

52. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2) (as amended in 1988) (requiring liquidating distributions to track positive capital account balances).

53. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2) (as amended in 1988).

54. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3) (as amended in 1988).

accounts to contribute enough cash to the partnership upon liquidation to extinguish their respective deficits.[55] The following example illustrates how the deficit restoration obligation maintains the integrity of the capital account measurement device when partners have negative capital accounts upon liquidation.

EXAMPLE 4-A and B form a general partnership by contributing $100 each. The partnership then borrows another $100 and spends all $300 of the cash on tax advice. The partners agree to allocate the deduction to B. The partnership then liquidates.

	A	B	Total
Beginning Capital Account	$100	$100	$200
Salary Expense	-0-	(300)	(300)
Ending Capital Account	$100	($200)	($100)

Upon liquidation of the partnership, B must contribute $200 to the partnership of which the creditor receives $100 and A receives $100. Thus, A lost nothing as he receives his $100 investment back. B, however, suffered an economic loss of $300, his original investment of $100 plus the $200 deficit contribution. Accordingly, the allocation of the $300 expense to B had standard economic effect.

2. Alternate Economic Effect

Limited partnership agreements usually do not contain a deficit restoration requirement because the limited partners will not agree to contribute more cash to the partnership.[56] The regulations accommodate this by providing that if a partnership agreement includes a "qualified income offset" in lieu of a deficit restoration requirement, the allocations may achieve alternate economic effect.[57] The regulations define a "qualified income offset" as a provision in the partnership agreement that requires disproportionate allocations of income to partners whose capital account balances unexpectedly drop below zero due to distributions or certain types of loss allocations.[58] If the partnership agreement contains a qualified income offset, allocations of partnership income and loss to a partner will have alternate economic effect to the extent they do not cause or increase a deficit in a partner's capital account balance.[59] Generally, a partnership must reallocate loss allocations in excess of the balance in a partner's capital account in accordance with the partners' interests in the partnership, as shown in the following example.

55. *Id.*

56. *See* Edward J. Schnee & Ed Haden, *Section 704(b) Final Regulations and the Tax-Shelter Investment: A Review*, 17 CUMB. L. REV. 731, 739 (1987) (describing alternate economic effect test); *supra* note 6 (describing limited partner's limited liability).

57. Treas. Reg. § 1.704-1(b)(2)(ii)(d)(3) (as amended in 1988).

58. *Id.*

59. *Id.*

EXAMPLE 5—General partner, G, and limited partner, L, form a limited partnership by contributing $500 and $100, respectively. The partnership agreement includes a capital account maintenance provision and a provision requiring liquidation in accordance with positive capital accounts, but no requirement for partners to restore deficit capital account balances. Instead, the partnership agreement contains a qualified income offset. The partnership spends $250 on tax advice during its first year of operations. The partners agree to allocate the $250 deduction to L.

	G	L	Total
Beginning Capital Account	$500	$100	$600
Salary Allocation	-0-	(100)	(100)
Excess Allocation	(150)	-0-	(150)
Ending Capital Accounts	$350	$-0-	($350)

Only $100 of the expense allocation to L will have alternate economic effect because any excess would cause a deficit capital account balance. The excess allocation would actually reduce the amount G, but not L, would receive if the partnership liquidated. Consequently, the regulations allocate the excess expense to the G.[60]

3. Economic Effect Equivalence

If the partnership agreement does not contain the provisions necessary to satisfy the standard economic effect tests, an allocation can still achieve economic effect equivalence under the "dumb, but lucky" test.[61] Under this provision, an allocation will have economic effect equivalence if the liquidation of the partnership at the end of the current or any future year would have the same effect as if the partnership agreement contained all three of the standard economic effect requirements regardless of the profitability of the partnership.[62] As the following example illustrates, economic effect equivalence generally will only protect a partnership that allocates income and loss in accordance with the partner's proportional capital accounts.

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60. *See* Treas. Reg. § 1.704-1(b)(3) (as amended in 1988) (describing alternate economic effect test).

61. Treas. Reg. § 1.704-1(b)(2)(ii)(i) (as amended in 1988); *see also* TAXATION OF PARTNERS AND PARTNERSHIPS, Ernst & Whinney Continuing Education Materials, ch. 5 at 15 (1987) (denoting economic equivalence as "dumb-but-lucky" test).

62. Treas. Reg. § 1.704-1(b)(2)(ii)(i) (as amended in 1988). The regulation provides:

> Allocations made to a partner that do not otherwise have economic effect under this paragraph (b)(2)(ii) shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if requirements (1), (2), and (3) of paragraph (b)(2)(ii)(b) of this section had been satisfied, regardless of the economic performance of the partnership.

Id.

EXAMPLE 6—A and B form a general partnership by contributing $750 and $250, respectively. The partnership allocates profits and losses seventy-five percent to A and twenty-five percent to B. The partnership agreement does not require capital account maintenance and does not require the distribution of liquidation proceeds to the partners in accordance with their positive capital account balances. While the partnership agreement does not contain a deficit restoration requirement, state law requires general partners to pay off partnership debts in accordance with their proportional capital account interests under a right of contribution.[63] The partnership incurs a $400 expense in year 1. If the partnership agreement required capital account maintenance, the partners would determine their capital accounts as follows:

	A	B	Total
Beginning Capital Account	$750	$250	$1,000
Expense	(300)	(100)	(400)
Ending Capital Account	$450	$150	$600

If the partnership liquidated at the end of year one, each partner would receive his ending capital account balance under state law. Further, if in future years, losses resulted in negative capital accounts, state law would require the partners to make proportional contributions to the partnership upon liquidation.[64] Thus, due to state law, the proportional allocations affect the partners' investments in the partnership, the amount of positive liquidation proceeds and the amount of contributions back to the partnership in case of liquidation with insufficient assets. Because the partners face the same effects on their investments as if the partnership agreement contained the three standard economic effect provisions, the allocations achieve economic effect equivalence.[65]

B. Substantiality

If a partnership allocation has economic effect, the regulations will respect, or allow, the allocation if the allocation also reflects substantiality.[66] Even if an allocation affects the total dollar amount of a partner's capital account, the allocation could produce an artificial lowering of the partners' aggregate tax liability. To attain substantiality, an allocation must not run afoul of any of the following three substantiality tests: The shifting tax consequences test; the transitory allocations test; and the general present value after-tax effects test.[67]

63. UNIF. PARTNERSHIP ACT § 15, 6 U.L.A. 174 (1914).
64. *Id.*
65. Treas. Reg. § 1.704-1(b)(5), Example 4(ii) (as amended in 1988).
66. Treas. Reg. § 1.704-1(b)(1)(i) (as amended in 1988).
67. Treas. Reg. § 1.704-1(b)(2)(iii) (as amended in 1988).

1. Shifting Tax Consequences

First, the regulations do not respect a special allocation if the allocation fails to produce a substantial change in the partners' capital accounts, but results in a lowering of the partners' aggregate tax liabilities.[68] As the following example illustrates, this can occur when the partnership agreement specially allocates tax favored items, such as tax-exempt income.

> EXAMPLE 7—A and B form a general partnership by contributing $100 each. A and B usually share all profits and losses equally under a partnership agreement that contains the three standard economic effect provisions. The partnership earns $50 in tax-exempt interest and $50 in taxable dividends. A pays tax at a marginal rate of thirty-one percent and B pays tax at a marginal rate of fifteen percent. A and B agree to allocate all of the tax-exempt interest to A and all of the taxable dividends to B.[69]

	A	B	Total
Beginning Capital Accounts	$100	$100	$200
Tax-Exempt Interest	50	-0-	50
Taxable Dividends	-0-	50	50
Ending Capital Accounts	$150	$150	$300
Tax Liabilities:			
With Special Allocations[70]	$-0-	$7.50	$7.50
With Equal Allocations[71]	(7.75)	(3.75)	(11.50)
Difference	($7.75)	$3.75	($4.00)

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68. Treas. Reg. § 1.704-1(b)(2)(iii)(b) (as amended in 1988). The text of the regulation providing the shifting tax consequences test appears below:

> The economic effect of an allocation (or allocations) in a partnership taxable year is not substantial if, at the time the allocation (or allocations) becomes part of the partnership agreement, there is a strong likelihood that—
>
> (1) [t]he net increases and decreases that will be recorded in the partners' capital accounts for such taxable year will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such year if the allocations were not contained in the partnership agreement, and
>
> (2) [t]he total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership).

Id.

69. Treas. Reg. § 1.704-1(b)(5), Example 7(ii) (as amended in 1988).

70. A's tax liability equals $-0- ($-0- taxable income X 31%). B's tax liability equals $7.50 ($50 in taxable dividends X 15%).

71. A's tax liability equals $7.75 ($25 of taxable dividends X 31%). B's tax liability equals $3.75 ($25 of taxable income X 15%).

The special allocation did not change the partners' capital accounts, but did reduce the aggregate tax liability of the partners. Even though the allocation has economic effect, it lacks substantiality because it shifted one-half of the beneficial tax consequences of the tax-exempt income from B to A.[72]

2. Transitory Allocations

Second, if the regulations classify an allocation as transitory, the allocation fails the substantiality test.[73] The regulations define transitory allocations as a group of equal and offsetting allocations spanning two or more years[74] that:

1. When viewed together do not substantially affect the partners' capital accounts,[75] and
2. Result in an overall lowering of the partners' aggregate tax liability.[76]

The following example illustrates how the "flip-flop"[77] of allocations may violate the transitory allocation test and thus, vitiate substantiality.

EXAMPLE 8—A and B form a general partnership by contributing $100 each. Usually, A and B share profits and losses equally. For each of Years 1 and 2, the partnership earns $100 of taxable interest and incurs $50 in salary deductions. In Year 1, A wins $1,000,000 in a lottery and pays tax at a marginal rate of thirty-one percent. In Year 2, A returns to his usual marginal rate of fifteen percent. B Pays tax at a marginal rate of fifteen percent for both Years 1 and 2. In order to lessen A's combined two-year tax burden, A and B agree to allocate the entire salary deduction to A and the entire interest income to B for Year 1. In Year 2, A and B agree to reverse the Year 1 allocation.

72. *See supra* note 68 and accompanying text (describing shifting tax consequences test).

73. Treas. Reg. § 1.704-1(b)(2)(iii)(c) (as amended in 1988). This regulation only applies this test if a strong likelihood exists at the time the partnership agreement adopts allocation that the allocations will be transitory. *Id.*

74. Treas. Reg. § 1.704-1(b)(2)(iii)(c)(1) (as amended in 1988).

75. *Id.*

76. Treas. Reg. § 1.704-1(b)(2)(iii)(c)(3) (as amended in 1988). If the offsetting allocation occurs more than five years after the original allocation, the regulations presume the substantiality of the allocation. *Id.* Further, if the partnership agreement provides for allocations spanning several years, the regulations measure offsetting allocations on a first-in, first-out basis. *Id.*

77. *See* Schnee & Haden, *supra* note 56, at 749-50 (discussing effect of allocation "flip-flop" on substantiality of allocations); WILLIS, ET AL., *supra* note 29, at 62-23 (discussing partnership "flips" in profits or losses).

	Year 1		Year 2	
	A	B	A	B
Beginning Cap. Acct.	$100	$100	$50	$200
Taxable Interest	-0-	100	100	-0-
Salary Deduction	(50)	-0-	-0-	(50)
Ending Cap. Accounts	$50	$200	$150	$150
Tax Liabilities	$(15.50)	$15.00	$15.00	$(7.50)
Tax Liab. with Equal Alloc.	$7.75	$3.75	$3.75	$3.75
Two-Year Totals:				
With Special Allocations			$(.50)	$7.50
With Equal Allocations			11.50	7.50
Difference			$11.00	$-0-

While the capital accounts remain equal after the end of Year 2, the total tax liabilities do not. Because A received a deduction at thirty-one percent in Year 1 and paid tax on two years worth of partnership income in Year 2 at fifteen percent, the special allocation decreased his two-year total tax liability. The regulations will hold the allocation insubstantial.[78]

3. General Present Value After-Tax Effects

Third, if a special allocation yields an increase in the present value of one partner's after-tax consequences without significantly decreasing the present value after-tax consequences of any other partner, the regulations deem the allocation insubstantial.[79] In effect, this test requires a comparison of the after-tax results to each partner with the allocation to the after-tax results without the allocation.[80] While this comparison approximates the shifting tax consequences test, its use of present value analysis requires consideration of the long-term effects of various allocation schemes similar to the transitory allocations test.[81] The following example illustrates the operation of the present value after-tax effects test.

EXAMPLE 9—A and B form a general partnership by contributing $100 each. The partnership buys a long-term municipal bond and a long-term taxable bond. For the next several years, the partnership will earn $5 of taxable interest and $5 of tax-exempt interest each year. A has significant net operating loss carryovers and will pay no taxes during the next 10 years. B, however, expects to pay tax at a marginal rate of thirty-one percent for the foreseeable future. A and B agree to allocate the $5 of tax-exempt interest to B and the $5 of taxable interest to A for the next ten years. While the

78. Treas. Reg. § 1.704-1(b)(2)(iii)(c) (as amended in 1988).

79. Treas. Reg. § 1.704-1(b)(2)(iii)(a) (as amended in 1988).

80. *Id.*

81. *See* Gregory J. Marich, *Substantial Economic Effect and the Value Equals Basis Conundrum*, 42 TAX L. REV. 509, 545-46 (1987) (describing present value after-tax effect test for determining partners' interests).

capital accounts of the partners will remain equal after the above allocations, the after-tax results will not.

	Sum of Years 1 - 10		
	A	B	Total
Beginning Capital Accounts	$100	$100	$200
Tax-Exempt Interest	-0-	50	50
Taxable Interest	50	-0-	50
Ending Capital Accounts	$150	$150	$300
After-Tax Results:	$ 50	$ 50	$100
With Special Allocation			
Tax-Exempt Interest	(25)	(25)	(50)
Taxable Interest	(25)	(17.25)	(42.25)
Difference	$ -0-	$7.75	$7.75
Present-Value of After-tax Results (6%):			
With Special Allocation	$36.80	$36.80	$73.60
With Equal Allocations	(36.80)	(31.10)	(67.90)
Difference	$ -0-	$ 5.70	$ 5.70
% Difference	-0-%	15.5%	7.75%

Because of his net operating losses, A pays no tax regardless of whether the partnership comprises his $5 per year allocation of taxable interest or tax-exempt interest. Since B pays tax at a thirty-one percent rate, he would pay $7.75 in tax, $25 of taxable interest times 31 percent, if the partnership allocated one-half of the taxable interest to him. On a present value basis, using a discount rate of six percent, B's cumulative after-tax income would increase by $5.70, or fifteen and one-half percent, if the partnership allocates all the tax-exempt income to him and all the taxable interest to A for the ten-year period. Thus, the special allocation of all the taxable interest to A and all the tax-exempt interest to B does not effect A's present value after-tax consequences while it increases B's present value after-tax consequences. Thus, the regulations will deem the special allocation insubstantial and reallocate the income amount in accordance with the partners interests in the partnership.[82]

C. *Partners' Interests in the Partnership*

If an allocation of partnership income or loss lacks economic effect or substantiality, the regulations will reallocate the item for tax purposes among

82. *See* Treas. Reg. § 1.704-1(b)(5), Example 5 (as amended in 1988) (holding similar allocation insubstantial); *infra* note 83 and accompanying text (discussing partners' interests in partnership). The example in the regulations deems the special allocation insubstantial when it only increases the after-tax consequences of the benefitting partner by approximately 6.7%. The regulations do not specify a bright-line percentage for determining when a special allocation that increases the present value after-tax consequences to a partner, goes too far. *Id.*

the partners based on their interests in the partnership.[83] The regulations provide three methods for determining the partners' interests in the partnership: the proportional changes in capital accounts technique, the mock adjusted tax basis liquidation technique, and the general facts and circumstances test.[84]

1. Proportional Changes in Capital Accounts

First, where a special allocation involves tax favored items, such as tax-exempt interest,[85] the regulations determine each partner's interest in the allocation by determining the net increases and decreases in the partners' capital accounts caused by all allocations.[86] The regulations, as the following example shows, then require the partnership to reallocate proportional

83. Treas. Reg. § 1.704-1(b)(1)(i) (as amended in 1988).

84. *See* Treas. Reg. § 1.704-1(b)(3) (as amended in 1988). The following diagram illustrates the concepts regarding the partners' interests in the partnership embodied in the regulations.

PARTNERS' INTERESTS IN THE PARTNERSHIP

PROPORTIONAL CHANGES IN CAPITAL ACCOUNTS

[Allocations Involve Tax-Favored Items]

Every Partner Gets a Proportion of Each Item

OR

MOCK ADJUSTED TAX BASIS LIQUIDATION

[Allocations Lack Economic Effect Because No Deficit Restoration Requirement Exists]

Liquidation Before Allocations	Liquidation After Allocations

OR

FACTS AND CIRCUMSTANCES TEST

General Division of Profits and Losses

85. *See* Treas. Reg. § 1.704-1(b)(5), Examples 5(i), (ii), 6, 7(i), (ii), 10(ii) (as amended in 1988) (describing use of proportional changes in capital accounts technique when allocations involve tax favored items). While the regulations do not define "tax favored items" they indicate by example that this term includes those items that could generate less tax liability than an equivalent allocation of ordinary income. *Id.*

86. *Id.*

amounts of all items of income and loss to each partner based on the proportion of total gross income each partner received under the special allocation scheme.[87]

EXAMPLE 10—A and B form a general partnership by contributing $100 each. A and B usually share all profits and losses equally. The partnership earns $50 in tax-exempt interest and $50 in taxable dividends. A pays tax at a marginal rate of thirty-one percent and B pays tax at a marginal rate of fifteen percent. A and B agree to allocate all of the tax-exempt interest to A and all of the taxable dividends to B. The allocation of all the tax-exempt interest to A would lack substantiality under the shifting tax consequences test.[88] Consequently, the regulations reallocate both the tax favored items, the tax-exempt interest, and the nontax favored items, the taxable dividends, among the partners according to the proportion of gross income each partner received. A received 50% of the total gross income, $50 of tax-exempt interest divided by the sum of $50 of tax-exempt interest and $50 of dividend income. Thus, each partner must receive a like proportion of each type of partnership income.

	A		B	
	%	Amount	%	Amount
Tax-Exempt Interest	50%	$25	50%	$25
Taxable Dividends	50%	25	50%	25
Total Reallocation		$50		$50

Because each partner's capital account increased by fifty percent of the total partnership gross income, each partner has a fifty percent interest in each item of partnership income.[89]

2. Mock Adjusted Tax Basis Liquidation

Second, if an allocation lacks substantial economic effect solely because the partnership does not contain a deficit restoration requirement, the regulations determine the interests of the partners via the legal fiction of a constructive liquidation.[90] The regulations compare the results of a constructive liquidation of the partnership before and after the allocation.[91] The regulations assume that the partnership sells all of its assets for their adjusted tax bases and then liquidates: the "mock adjusted tax basis liquidation."[92]

87. *Id.*
88. *See supra* Example 7 (illustrating shifting tax consequences test).
89. *Id.*
90. *See* Treas. Reg. § 1.704-1(b)(3)(iii) (as amended in 1988) (discussing constructive liquidation).
91. *Id.*
92. *Id.*

As the following example illustrates, this technique mirrors the capital account tracking methodology employed by the standard economic effect test.

EXAMPLE 11—General partner, G, and limited partner, L, form a limited partnership by contributing $40 and $10, respectively. The partnership then borrows $450 and buys a piece of machinery for $500. The machinery generates a depreciation expense of $100 during Year 1. The partners agree to allocate all the depreciation expense to L. Because the partnership agreement does not require the partners to restore a deficit in their capital accounts upon liquidation of the partnership, the allocation does not have economic effect under the regulations.[93] Accordingly, the depreciation must be reallocated to the partners based on their interests in the partnership. To determine these interests, the regulations assume the partnership sells the machine at the beginning of the year before any depreciation deduction, and liquidates by distributing all the proceeds to the partners.[94]

	Distribution of Sales Proceeds			
	Bank	G	L	Total
Beginning of Year 1:				
Machine Sold For $500	$450	$ 40	$ 10	$500
End of Year 1:				
Machine Sold for $400	- 450	- (50)	-0-	- 400
Difference	$-0-	$90	$10	$100

In the above example, local law would require G, the general partner, to restore sufficient funds, $50, to the partnership to pay off the bank's debt at the end of Year 1.[95] Thus, G bore $90 of the economic burden associated with the $100 depreciation deduction and L bore $10 of the burden. The regulations reallocate the depreciation deduction in accordance with the economic burden borne by each partner: $90 to G and $10 to L.[96]

3. Facts and Circumstances

Finally, if an allocation does not involve tax favored items and lacks substantial economic effect for a reason other than the absence of a deficit

93. *See supra* note 6 and accompanying text (discussing joint and several liability of partners).

94. *Id.*

95. *See* UNIF. PARTNERSHIP ACT § 15, 6 U.L.A. 174 (1914) (imposing liability on partners).

96. *See* Treas. Reg. § 1.704-1(b)(5), Example 15 (as amended in 1988) (illustrating mock adjusted tax basis liquidation technique). The example in the text illustrates the general principles of the mock adjusted tax basis liquidation technique in a somewhat more simplified manner.

restoration requirement, the regulations determine the partners' interests in the partnership by examining the surrounding facts and circumstances.[97] Using these facts and circumstances, the regulations determine the general division of profits and losses in the partnership.[98]

Thus, the section 704(b) regulations use various accounting devices to determine if a loss allocation affects each partner's investment in the partnership.[99] If the allocation affects a partner's economic investment in the partnership without producing substantial tax avoidance consequences,[100] the regulations allow the partner to receive the loss allocation from the partnership.[101]

III. THE SECTION 752 REGULATIONS[102]

While the IRC section 704(b) regulations determine which partner receives the allocation of partnership loss,[103] the IRC section 752 regulations determine whether that partner will have sufficient liability-generated basis to deduct the loss.[104] The IRC section 752 regulations allocate partnership

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97. Treas. Reg. § 1.704-1(b)(3)(i) (as amended in 1988). The regulation provides the following nonexhaustive list of factors for consideration:

> (a) The partners' relative contributions to the partnership,
>
> (b) The interests of the partners in the economic profits and losses (if different than the taxable income or loss),
>
> (c) The interests of the partners in cash flow and other non-liquidating distributions, and
>
> (d) The rights of the partners to distributions of capital upon liquidation.

Id.

98. *Id.*

99. *See* Treas. Reg. § 1.704-1(b)(2)(ii) (as amended in 1988) (describing economic effect test).

100. *See* Treas. Reg. § 1.704-1(b)(2)(iii) (as amended in 1988) (describing substantiality test).

101. *See* Treas. Reg. § 1.704-1(b)(1)(i) (as amended in 1988) (validating allocations that have substantial economic effect).

102. *See* Treas. Reg. § 1.752-1 to 5 (1991) (applying economic risk of loss analysis to partnership liabilities and modifying Prop. Treas. Reg. §§ 1.752-1 to 5 for guarantees of interest, pledges of assets, and certain de minimis rules); Prop. Treas. Reg. §§ 1.752-1 to 5, 56 Fed. Reg. 36707 (1991) (suggesting modifications in temporary regulations application of economic risk of loss theory to partnership liabilities); Temp. Treas. Reg. §§ 1.752-1T to 4T (as amended in by T.D. 8274, 1989-2 C.B. 101) (applying economic risk of loss theory to partnership liabilities for first time); Treas. Reg. § 1.752-1(e) (1956) (promulgating original loss percentages for recourse debt and profit percentages for nonrecourse debt rules).

Fortunately, the Treasury abandoned attempts to draft all possible ambiguity out of the IRC section 752 regulations. *See generally*, Bayless Manning, *Hyperlexis and the Law of Conservation of Ambiguity: Thoughts on Section 385*, 36 TAX LAW. 9, 10-12 (1982) (lamenting Treasury's practice of promulgating overly long and complex regulations to deal with rare fact situations instead of issuing simple rules that deal with ninety percent of real life fact scenarios).

103. *See supra* notes 30-55 and accompanying text (requiring loss allocations to reflect substantial economic effect).

104. *See* Treas. Reg. § 1.752-1 to 5 (1991) (determining which partners receive allocations of partnership liabilities that increase their bases in their partnership interests). Section 704(d)

liabilities[105] to the partners who bear the economic risk of loss with respect to those liabilities.[106] First, the IRC section 752 regulations borrow and

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limits the amount of partnership loss that may flow through to a partner by the amount of the partner's basis in his partnership interest. I.R.C. § 704(d) (1988). Section 722 provides that cash contributions increase a partner's basis in his partnership interest. I.R.C. § 722 (1988). Section 752(a) treats an increase in a partner's share of partnership liabilities as a cash contribution by the partner to the partnership. I.R.C. § 752(a) (1988). Thus, an increase in a partner's share of liabilities increases his basis in his partnership interest and consequently, the amount of partnership losses that can flow through to him.

Temp. Treas. Reg. § 1.752-1T(a)(1)(iv) discussed the theoretical kinship of the regulations issued under IRC § 704(b) and IRC § 752:

> The economic risk of loss analysis employed in this section generally corresponds to, and further develops, the economic risk of loss employed in the regulations under section 704(b). The coordination of these two sections reflects the fact that one of the principal purposes for including partnership liabilities in the bases of the partners' interests in the partnership is to support the deductions that will be claimed by the partners for the items attributable to those liabilities.

Temp. Treas. Reg. § 1.752-1T(a)(1)(iv) (as amended by T.D. 8274, 1989-2 C.B. 101).

105. *See* Treas. Reg. § 1.752-2(f), Example 8 (1991) (disregarding contingent liabilities for purposes of IRC § 752); *see also* Treas. Reg. § 1.752-2(g) (1991) (requiring computation of liabilities using time value of money principles). Thus, if the partnership agreement allows a partner to wait more than 90 days to restore his capital account deficit upon actual liquidation of the partnership, the regulations will discount that partner's share of partnership liabilities. *See* Treas. Reg. § 1.752-2(g)(4) (1991) (giving example of when partners must make discount computation). The regulations assign the discount amount relating to the delayed contribution obligation to partners who must restore their deficits within the ninety-day period, as mandated by the IRC § 704(b) regulations. *Id.*; Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2) (as amended in 1988). This assignment of the discount to the nondelayed partner seems illegitimate, however, because the nondelayed payor will never pay that amount to the partnership and thus, would not appear to bear the economic risk of loss with respect to that amount. The partners could potentially shift economic risk of loss via the time value of money principles by delaying the deficit restoration requirements of certain partners who do not need liability-generated basis. Unlike the final regulations, the temporary regulations defined a liability as:

> [A]ny obligation . . . to the extent . . . that holding such obligation gives rise to (1) [t]he creation of, or increase in, the basis of any property owned by the obligor (including cash attributable to borrowings); (2) [a] deduction that is taken into account in computing the taxable income of the obligor; or (3) [a]n expenditure that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.

Temp. Treas. Reg. § 1.752-1T(g) (as amended in 1989).

Temp. Treas. Reg. § 1.752-1T(k), Example 2(ii) (as amended in 1989) illustrates that the above definition will deny liability classification to interest expense accrued by a cash basis partnership. This result occurs because the cash basis partnership would not take into account accrued expenses in determining its taxable income. The Treasury omitted these definitions from the final regulations without official comment.

106. *See* Treas. Reg. § 1.752-2(a) (1991) (allocating liabilities based on economic risk of loss principles). This regulation reflects the direction of Congress in Section 79 of the Deficit Reduction Act of 1984. THE DEFICIT REDUCTION ACT OF 1984, Pub. L. No. 98-369, § 79, 98 Stat. 597 (1984). After the Claims Court ruled in Raphan v. United States, 3 Ct. Cl. 457 (1983), that a general partner's guarantee of a nonrecourse debt did not vitiate the nonrecourse character of the debt, Congress instructed the Treasury to issue regulations regarding the allocation of liabilities among the partners. H.R. CONF. REP. No. 861, 98th Cong., 2d Sess. 1235-36 (1984), *reprinted in* 1984 U.S.C.C.A.N. 697, 899-900. ". . . [T]he conferees intend

modify the mock adjusted tax basis liquidation technique employed by the IRC section 704(b) regulations to analyze the effect on partners capital accounts of a constructive liquidation.[107] Second, the IRC section 752 regulations impose a three-level obligations analysis to determine which partners bear the economic risk of loss with respect to liabilities and thus, which liabilities constitute recourse liabilities and which constitute nonrecourse liabilities of the partnership.[108] Third, the regulations allocate recourse liabilities to those partners who would have to make a net payment under the three-level obligations analysis[109] and allocate nonrecourse liabilities using a three-step allocation scheme.[110]

A. *The Zero-Sale Constructive Liquidation*

In general, the regulations determine the effect on the partners if the partnership sold its assets for nothing, liquidated, and paid off the outstanding balance of all the liabilities: the zero-sale constructive liquidation.[111] The zero-sale constructive liquidation technique enables the partnership to apply the three-level obligations analysis for purposes of classifying a liability as recourse or nonrecourse and for purposes of determining which partner would have to ante up if the partnership entered insolvency and the creditors appeared at the gate.[112] Specifically, the zero-sale constructive liquidation

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that the revisions to the section 752 regulations will be based largely on the manner in which the partners . . . share the economic risk of loss with respect to partnership debt . . . ." *Id.* In response to this congressional directive, the Treasury issued temporary regulations under IRC § 752 in 1988 based on the economic risk of loss theory. Temp. Treas. Reg. § 1.752-1T(1)(i) (as amended by T.D. 8274, 1989-2 C.B. 101).

107. *See* Treas. Reg. § 1.752-1(a)(1), (2) (1991) (requiring constructive liquidation of partnership to determine which partners, if any, bear economic risk of loss with respect to partnership liabilities).

108. Treas. Reg. § 1.752-2(b)(1), (3) (1991). The regulation provides:

> [A] partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because the liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner.

Treas. Reg. § 1.752-2(b)(1) (1991).

109. *See* Treas. Reg. § 1.752-2(a)(1) (1991) (requiring allocation of recourse liabilities to those partners who bear economic risk of loss with respect to those liabilities).

110. Treas. Reg. § 1.752-3(a)(1), (2), (3) (1991).

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

112. *See* Treas. Reg. § 1.752-1(a)(1), (2) (1991) (describing recourse liabilities as those liabilities for which at least one partner bears economic risk of loss and nonrecourse liabilities as those liabilities for which no partner bears economic risk of loss); Treas. Reg. § 1.752-2(b)(1) (1991) (providing that constructive liquidation technique determines which partners, if any, bear economic risk of loss with respect to partnership liabilities).

See also Treas. Reg. § 1.752-2(b)(1) (1991) (considering all types of payments that partners must make upon liquidation). This takes into account the possibility that a partner may have to pay a creditor directly (guaranty), another partner directly (indemnification) or the partnership (through a deficit restoration provision in the partnership agreement). Because the IRC technique measures each partner's capital accounts after the following fictional events take place:

1. The partnership sells all of its assets, including cash, for their deemed "fair market values,":[113]
   a. unsecured assets for zero,[114] and

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§ 704(b) regulations require a partnership agreement to mandate capital account deficit restoration in order to achieve standard economic effect, general partnerships must use the capital accounts to determine the economic risk of loss. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3) (as amended in 1988). Further, the IRC § 704(b) regulations deem a partnership agreement to contain a deficit restoration requirement if local law effectively requires the partners to make up any deficit account balances. Treas. Reg. § 1.704-1(b)(2)(iii)(c) (as amended in 1988). Because the IRC § 704(b) regulations increase capital accounts by the fair market value of property rather than its basis, local law contribution requirements (e.g., UNIF. PARTNERSHIP ACT § 15, 6 U.L.A. 174 (1914)) may produce somewhat different results than the standard deficit restoration requirement provided by the IRC § 704(b) regulations. Treasury Regulation § 1.704-1(b)(2)(iv)(b) (as amended in 1988).

Regulation § 1.752-2(b)(1) describes the constructive liquidation now required under IRC § 752 as follows:

> Upon a constructive liquidation, all of the following events are deemed to occur simultaneously:
>
> (i) All of the partnership's liabilities become payable in full;
>
> (ii) With the exception of property contributed to secure a partnership liability (see § 1.752-2(h)(2)), all of the partnership's assets, including cash, have a value of zero;
>
> (iii) The partnership disposes of all of its property in a fully taxable transaction for no consideration (except for relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership);
>
> (iv) All items of income, gain, loss, or deduction are allocated among the partners; and
>
> (v) The partnership liquidates.

Treas. Reg. § 1.752-2(b)(1) (1991).

113. *See* Treas. Reg. § 1.752-2(b)(1)(ii) (1991) (deeming fair market value of all assets, except those contributed to partnership to secure partnership debt, to equal $-0-). The final regulations provide that a partner bears the economic risk of loss with respect to a liability to the extent of the fair market value of his separate property that he pledges as security for the partnership liability. Treas. Reg. § 1.752-2(h)(1) (1991). Further, the final regulations clarify that a partner bears the economic risk with respect to a partnership liability to the extent of the fair market value of property that the partner contributes to the partnership solely to secure the liability. Treas. Reg. § 1.752-2(h)(2) (1991).

While the regulations actually spell out five steps, the author compressed these into three steps in the name of conciseness, hopefully, without sacrificing substance. *See supra* note 112 and accompanying text (quoting text of regulations).

114. *See* Treas. Reg. § 1.752-2(b)(1)(iii) (1991) (providing $-0- amount realized regardless of liability relief). *But cf.* Crane v. Commissioner, 331 U.S. 1, 14 (1947) (including debt released on sale or exchange of assets in amount realized). The regulations do not assume the partnership's creditors release the partners from the debt; rather, the partners pay the debts with their personal assets. Treas. Reg. § 1.752-2(b)(1) (1991).

The regulations provide that where the capital accounts reflect a fair market value that differs from the adjusted tax bases of partnership property, the book value rather than the adjusted tax basis will determine the loss upon a constructive liquidation. *See* Treas. Reg. § 1.752-2(b)(ii) (1991) (stating, "[the] loss on the deemed disposition of the partnership's assets

b. secured assets for the remaining principal amount of the respective liabilities,[115]

2. The partnership allocates the gains and losses resulting from 1. to the partners,[116] and

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is computed [by recognizing] a loss equal to the value of the remaining tax basis (or book value to the extent section 704(c) or § 1.704-1(b)(4)(i) applies) of all the partnership's assets . . ."). *See* I.R.C. § 704(c) (1988) (allocating gain generated by asset sale to partner that contributed asset to extent that asset's fair market value exceeded its adjusted basis when contributed). The cited IRC § 704(b) regulation provides:

> If partnership property is, under paragraphs (b)(2)(iv)(d) [contributed property] or (b)(2)(iv)(f) [revalued property] of the section, properly reflected in the capital accounts of the partners and on the books of the partnership at a book value that differs from the adjusted tax basis of such property, then depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property will be greater or less than the depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to such property. In these cases, the capital accounts of the partners are required to be adjusted solely for allocations of the book value to such partners (see paragraph (b)(2)(iv)(g) of this section), and the partners' shares of the corresponding tax items are not independently reflected by further adjustments to the partners' capital accounts. Thus, separate allocations of these tax items cannot have substantial economic effect under paragraph (b)(2)(ii)(b)(1) of this section, and the partners' distributive shares of such tax items must (unless governed by section 704(c)) be determined in accordance with the partners' interests in the partnership. These tax items must be shared among the partners in a manner that takes account of the variation between the adjusted tax basis of such property and its book value in the same manner as variations between the adjusted tax basis and fair market value of property contributed to the partnership are taken into account in determining the partners' shares of tax items under section 704(c).

Treas. Reg. § 1.704-1(b)(4)(i) (as amended in 1988).

In effect, the regulations provide that the differential between fair market value and adjusted tax basis with respect to partnership property must be allocated to the appropriate partners. *Id.* The appropriate partners will be the contributing partners in the case of property with a pre-contribution value-basis differential and the revaluing partners in the case of revalued partnership property. *See* Treas. Reg. § 1.704-1(b)(5), Example 18 (as amended in 1988) (showing how value differentials affect income and loss allocations). Thus, the constructive liquidation called for under Treas. Reg. § 1.752-2(b)(1) will result in the allocation of book losses to partners' capital accounts in order to determine which partners, if any, must use personal assets to liquidate partnership liabilities. Treas. Reg. § 1.752-2(b)(2)(ii) (1991).

115. *See* Treas. Reg. § 1.752-2(b)(1)(iii) (1991) (including relief from nonrecourse liabilities, those liabilities limited to repayment from securing assets, in amount realized). Thus, the partnership can actually have gain on the constructive liquidation to the extent that the face amount of securing debt exceeds the adjusted tax basis, or book value, of the securing asset. *Id.* The partnership must allocate both the gains generated from the sale of secured property for the remaining principal balance of the nonrecourse debt and the losses generated by the deemed sale of unsecured assets in the zero-sale liquidation. Treas. Reg. § 1.752-2(b)(1)(iv) (1991).

116. *See* Treas. Reg. § 1.752-2(b)(1)(iv) (1991) (allocating all items of "income, gain, loss, or deduction" to partners after deemed sale of assets). However, since the partnership sells all of its assets for $-0-, a loss equal to the adjusted basis of the assets will generally result. *Id.*

3. The partnership liquidates and pays off the remaining principal amounts of its liabilities.[117]

The following examples illustrate two basic applications of the zero-sale constructive liquidation technique.

EXAMPLE 12—A and B form a general partnership by contributing $100 each. The partnership uses the $200 and borrows another $800 on an unsecured recourse note to purchase a storage building. The partnership agreement provides that A and B will receive ninety percent and ten percent, respectively, of all profits and losses. Immediately upon purchase of the storage building, a zero-sale constructive liquidation would result in a loss of $1,000 to the partnership, $-0- amount realized minus $1,000 basis for the storage building. The following table shows the capital account effects of the ninety and ten percent allocation:

	A	B	Total
Beginning Capital Accounts	$100	$100	$200
Loss Allocation	(900)	(100)	(1,000)
Ending Capital Accounts	($800)	$ -0-	($800)

Thus, A bears the economic risk of loss with respect to the entire $800 liability.

EXAMPLE 13—A and B form a general partnership by contributing $100 each. The partnership uses the $200 and $800 borrowed on a recourse note to purchase a storage building. The partnership agreement provides that A and B will receive sixty percent and forty percent, respectively, of all profits and losses. Immediately upon purchase of the storage building, a zero-sale constructive liquidation would result in a loss of $1,000 to the partnership, $-0- amount realized minus $1,000 basis for the storage building. The following table shows the capital account effects of the sixty percent/forty percent allocation:

	A	B	Total
Beginning Capital Accounts	$100	$100	$200
Loss Allocation	(600)	(400)	(1,000)
Ending Capital Accounts	($500)	($300)	($800)

Thus, A bears $500 and B bears $300 of the economic risk of loss with respect to the $800 liability.

Depending on how partners share profits and losses, the zero-sale constructive liquidation technique will result in different negative capital account balances for the partners. The regulations then require the appli-

117. Treas. Reg. § 1.752-2(b)(1)(i), (v) (1991).

cation of the three-level obligations analysis to determine which partner, if any, would have to make a contribution to the partnership, or a creditor, to satisfy outstanding partnership liabilities.[118]

B. Three-Level Obligations Analysis

The three-level obligations analysis determines which partner, if any, must make such a contribution[119] by taking into account deficit restoration provisions in the partnership agreement,[120] guarantees,[121] assumptions,[122] and

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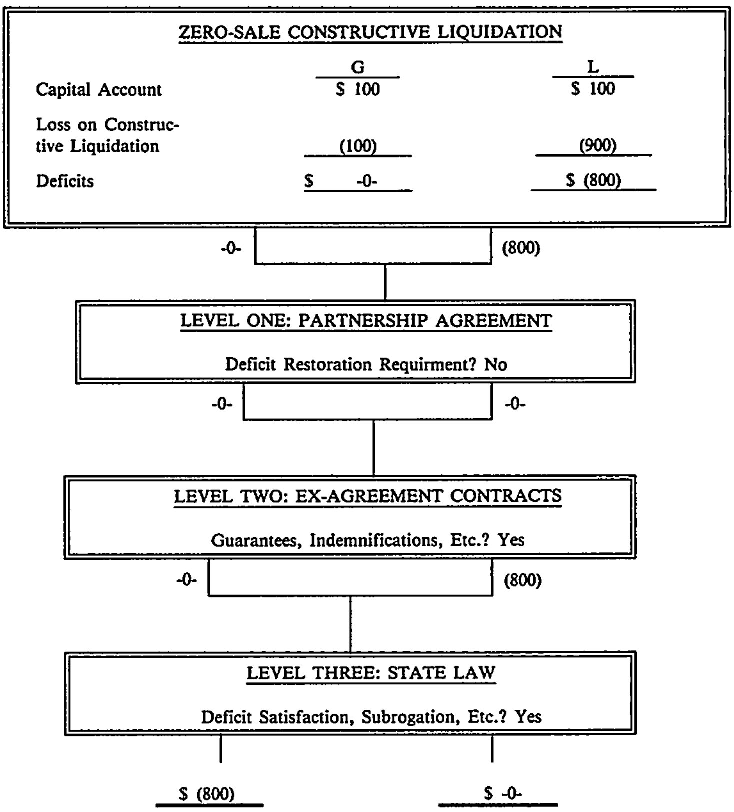
118. Treas. Reg. § 1.752-2(b)(3) (1991).

119. Treas. Reg. § 1.752-2(b)(3) (1991). The following diagram illustrates the three-level obligations analysis:



Id.

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

121. Treas. Reg. § 1.752-2(b)(3)(i) (1991). The temporary regulations under IRC § 752 provided that where one or more partners undertake a contractual obligation that eliminates substantially all of the risk to the creditor of a default by the partnership because the contracting partner or partners will pay off the debt if the partnership cannot, the partners have guaranteed the loan. Temp. Treas. Reg. § 1.752-1T(d)(3)(iv) (as amended in 1989). BLACK'S LAW DICTIONARY defines the verb "guaranty" as follows: "To undertake collaterally

state law contribution requirements.[123] The first level in the analysis examines the partnership agreement to determine if it mandates that partners contribute money to the partnership upon liquidation.[124] Under level one, the partners in Examples 12 and 13 would bear the economic risk of loss to the extent of their negative capital accounts if the partnership agreement contained a deficit restoration provision.[125] Second, the regulations analyze contracts outside the partnership agreement, ex-agreement contracts, to determine if partners would pay creditors directly or indemnify other partners if the creditors demanded payment.[126] Third, the regulations analyze how applicable state law may affect the results produced by the partnership agreement and any ex-agreement contracts.[127] If, after application of all three analytical levels, any partner would have to make a payment to the partnership, another partner, or a creditor with respect to a partnership liability, the regulations classify the liability as recourse and allocate it to the partner on whom the payment burden would fall.[128] The following example illustrates the three-level obligations analysis:

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to answer for the payment of another's debt or the performance of another's duty, liability, or obligation . . . ." BLACK'S LAW DICTIONARY 705 (6th ed. 1990).

122. Treas. Reg. § 1.752-1(d) (1991). Unlike the final regulations, the temporary regulations defined an assumption as occurring where an agreement subjects the assuming partner to personal liability with respect to the assumed obligation and, in the case of a partnership obligation, the creditor is aware of the assumption and can directly enforce it and no other partner would bear the economic risk of loss for such liability. Temp. Treas. Reg. § 1.752-1T(f) (as amended in 1989). This definition closely parallels the definition used in the IRC § 704(b) regulations for determining when the assumption of a partnership liability will increase a partner's capital account. Treas. Reg. § 1.704-1(b)(2)(c) (as amended in 1988). Black's Law Dictionary defines "assumption" as "[t]he undertaking or adoption of a debt or obligation primarily resting upon another, as where the purchaser of real estate 'assumes' a mortgage resting upon it, in which case he adopts the mortgage as his own and becomes personally liable for its payment." BLACK'S LAW DICTIONARY 120 (6th ed. 1990). The examples in the regulations appear to indicate that a guarantor will only have to pay the debt if the original debtor defaults, while a creditor may look directly to the assuming party for payment. Treas. Reg. § 1.752-2(f), Examples 3, 4 (1991).

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

124. *See* Treas. Reg. § 1.752-2(b)(3)(ii) (1991) (requiring consideration of obligations imposed on partners by partnership agreement including deficit restoration provisions).

125. *See* Treas. Reg. § 1.752-2(f), Examples 1, 2 (1991) (providing partners under obligations to make up deficit capital accounts bear economic risk of loss to that extent).

126. *See* Treas. Reg. § 1.752-2(b)(3)(i) (1991) (requiring consideration of agreements such as guarantees, indemnifications, reimbursement agreements, and other obligations binding partners to make payments to other partners individually or in partnership, or to creditors). *See also* Treas. Reg. § 1.752-2(b)(5) (1991) (reducing partner's obligation to make payment upon constructive liquidation to extent of any reimbursement right one partner holds against other partners). However, the regulations provide a de minimis exception for partners with 10 percent or less interests in each item of income, gain, loss, etc. that guaranty qualified nonrecourse financing. Treas. Reg. § 1.752-2(d)(2) (1991).

127. Treas. Reg. § 1.752-2(b)(3)(iii) (1991) (requiring consideration of state law in modifying or creating obligations of partners to make payments to other partners individually or in partnership, or to creditors).

128. *See supra* noted 126-27 and accompanying text (requiring determination of ultimate liability by considering partnership agreement, ex-agreement contracts and state law effects).

EXAMPLE 14—General partner, G, and limited partner, L, form a partnership by contributing $100 each. The partnership uses the $200 and borrows $800 on a recourse note to purchase a storage building. The partnership agreement provides that G and L will receive ninety percent and ten percent, respectively, of all profits and losses. The partnership agreement does not contain a deficit restoration requirement in order to preserve L's limited liability status with respect to general claims against the partnership. However, the bank making the $800 loan requires L to guarantee the loan. Immediately upon purchase of the storage building, a zero-sale constructive liquidation would result in a loss of $1,000 to the partnership, $-0- amount realized minus $1,000 basis for the storage building. The following table shows the capital account effects of the ninety and ten percent allocation:

	G	L	Total
Beginning Capital Accounts	$100	$100	$200
Loss Allocation	(900)	(100)	(1,000)
Ending Capital Accounts	($800)	$-0-	($800)

First, because the partnership agreement does not require the partners to restore deficits in their capital account balances, no partner bears the economic risk of loss under the level one.[129] Second, L's guarantee of the note imposes ex-partnership arrangement risk of loss on L under level two.[130] Third, state law could shift the ultimate obligation for payment determined under the ex-agreement level of analysis. If state law: 1) requires G to satisfy a negative capital account balance even in the absence of a deficit restoration requirement, or 2) subrogates the creditor's rights of collection against G to L after L pays off the loan, G would bear the economic risk of loss under the regulations.[131] Alternatively, if state law did not require deficit restoration or subrogation of the creditor's rights to L, the regulations would place the economic risk of loss with respect to the $800 note on L.[132]

Consequently, the partners must examine the partnership agreement, contractual guarantee arrangements and all the possible effects of state law to determine who would pay off recourse liabilities if the partnership sold all its unsecured property for zero.[133] Thus, while the regulations remain

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129. Treas. Reg. § 1.752-2(b)(3)(ii) (1991).
130. Treas. Reg. § 1.752-2(b)(3)(i) (1991).
131. *See* Treas. Reg. § 1.752-2(f), Examples 3, 4 (1991) (explaining how right of contribution and rights of subrogation affect inter-partner liability allocation).
132. Treas. Reg. § 1.752-2(b)(3)(i) (1991).
133. Treas. Reg. § 1.752-2 (1991).

true to the economic risk of loss theory, they add significant complexity to the allocation of recourse liabilities among the partners.[134]

C. *Nonrecourse Liabilities*

After the zero-sale constructive liquidation technique and the three-level obligations analysis classify certain partnership liabilities as recourse and allocate them to those partners who bear the economic risk of loss with respect to those liabilities, the regulations classify the remaining liabilities as nonrecourse.[135] The regulations then require a partnership to allocate its nonrecourse liabilities in accordance with a three-step system.[136] Under this

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134. *See supra* note 29 and accompanying text (decrying complexity of § 752 regulations).

135. *See* Treas. Reg. § 1.752-1(a)(2) (1991) (classifying partnership liabilities as nonrecourse to extent no partner bears economic risk of loss under constructive liquidation). Traditionally, the treatment of nonrecourse liabilities has been crucial to determining a partner's basis in his partnership interest. *See supra* note 20 and accompanying text (explaining *Raphan* abuse). *See generally*, I.R.C. § 752(c) (codifying holding in Crane v. Commissioner; 331 U.S. 1 (1947) and Tufts v. Commissioner, 461 U.S. 300 (1983) by providing that basis of property securing nonrecoursé debt includes the amount of the nonrecourse debt). *See also*, United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931) (including canceled debt in amount realized because where no shrinkage of assets occurred); Gerskowitz v. Commissioner, 88 T.C. 984, 1012-14 (1987) (including relief of nonrecourse debt in cancellation of indebtedness income because basis included debt); Estate of Michael E. Newman, 59 TCM (CCH) 543, 543-44 (1990) (including relief of nonrecourse debt in cancellation of indebtedness income because basis included debt), *rev'd on other grounds*, 934 F.2d 426 (2d Cir. 1991)).

136. Treas. Reg. § 1.752-3(a) (1991). Regulation § 1.752-3(a) provides:

> A partner's share of the nonrecourse liabilities of a partnership equals the sum of paragraphs (a)(1) through (a)(3) of this section as follows—
>
> (1) The partner's share of partnership minimum gain determined in accordance with the rules under section 704(b) and the regulations thereunder;
>
> (2) The amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration; and
>
> (3) The partner's share of excess nonrecourse liabilities (those not allocated under paragraphs (a)(1) and (a)(2) of this section) of the partnership as determined in accordance with the partner's share of partnership profits. The partner's interest in partnership profits is determined by taking into account all the facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify the partner's 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 section 704(b) regulations) of some other significant item of partnership income or gain. Alternatively, excess nonrecourse liabilities may be allocated in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. Excess nonrecourse liabilities are not required to be allocated under the same method each year.

Treas. Reg. § 1.752-3(a)(1), (2), (3) (1991).

system, a partner's share of the partnership's nonrecourse debt equals the sum of the following three items: The partner's share of partnership minimum gain; any IRC section 704(c) gain allocable to the partner; and the partner's share of excess nonrecourse liabilities.[137]

1. Share of Minimum Gain

First, the regulations allocate nonrecourse liabilities to a partner to the extent of his share of partnership minimum gain.[138] A partner's share of minimum gain generally equals the sum of all past nonrecourse deductions allocated to the partner.[139] The amount of nonrecourse deductions equal an amount of partnership deductions, usually depreciation on property secured by the nonrecourse liability, equivalent to the increase in partnership minimum gain.[140] Partnership minimum gain, in turn, equals the gain the partnership would realize if it sold the assets which secure its nonrecourse debts in satisfaction of such debts.[141] Generally, minimum gain equals the excess of the remaining principal balance on a nonrecourse note over the adjusted tax basis of the secured property.[142] If a partnership finances all

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137. Treas. Reg. § 1.752-3(a) (1991).

138. Treas. Reg. § 1.752-3(a)(1) (1991).

139. Preamble to Treas. Reg. § 1.704-2, 56 Fed. Reg. 66981 (1991).

140. Treas. Reg. § 1.704-2(c) (1991). Regulation § 1.704-2(c) states:

> The amount of nonrecourse deductions for a partnership taxable year equals the net increase in partnership minimum gain during the year (determined under paragraph (d) of this section), reduced (but not below zero) by the aggregate distributions made during the year of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain (determined under paragraph (b) of this section). . . . However, increases in partnership minimum gain resulting from conversions, refinancings, or other changes to a debt instrument (as described in paragraph (g)(3)) do not generate nonrecourse deductions. Generally, nonrecourse deductions consist first of certain depreciation or cost recovery deductions and then, if necessary, by a pro rata portion of other partnership losses, deduction, and section 705(a)(2)(B) expenditures for that year; excess nonrecourse deductions are carried over.

Id.

141. Treas. Reg. § 1.704-2(d) (1991). Regulation § 1.704-2(d) provides:

> The amount of partnership minimum gain is determined by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains. The amount of partnership minimum gain includes minimum gain arising from a conversion, refinancing, or other change to a debt instrument, as described in paragraph (g)(3) of this section, only to the extent a partner is allocated a share of that minimum gain. For any partnership taxable year, the net increase or decrease in partnership minimum gain is determined by comparing the partnership minimum gain on the last day of the immediately preceding taxable year with the partnership minimum gain on the last day of the current taxable year.

Id.

142. *See id.* (providing exact computation of minimum gain which would equal sales price of remaining principal balance less adjusted tax basis of property).

of the purchase price of a building with a balloon nonrecourse note, the difference in the principal of the note and the adjusted basis of the property will equal the depreciation deductions with respect to the property.[143] Thus, as shown in Example 15, *infra*, a partner's share of minimum gain would generally equal the prior depreciation deductions allocated to him from the nonrecourse financed property.[144]

2. Share of IRC Section 704(c) Gain

Second, if the amount of partnership nonrecourse liabilities surpasses the aggregate of partners' shares of minimum gain, the regulations allocate the surplus liabilities to the partners based on their share of any IRC section 704(c) gain as shown in Example 15, *infra.*[145] A partner's share of IRC section 704(c) gain generally equals the unrealized appreciation on property that he contributed to the partnership at the time of the contribution.[146]

3. Share of Excess Nonrecourse Liabilities

Third, if any nonrecourse liabilities remain after assigning them to partners based on a partner's shares of minimum gain and IRC section 704(c) gain, the regulations allocate the excess nonrecourse liabilities generally based on the partners' profit percentages.[147] A partner's share of excess nonrecourse liabilities equals the excess of the total nonrecourse liabilities of the partnership over the total minimum gain and total IRC section 704(c) gain multiplied by the partner's percentage in the partnership profits.[148] The following example illustrates the assignment of nonrecourse debt under each of the three steps provided by the regulations.

EXAMPLE 15—General partner, G, and limited partner, L, form a limited partnership by contributing $1,000 cash and $1000 worth of land, respectively. L had a $950 adjusted basis in the land he

143. *See* I.R.C. § 168(b)(3)(A) (1988) (describing depreciation deductions for real estate).

144. *See* Treas. Reg. § 1.704-2(m), Example 1(i) (1991) (showing how depreciation deductions create differences in nonrecourse debt principal and adjusted basis of secured property).

145. Treas. Reg. § 1.752-3(a)(2) (1991).

146. Treas. Reg. § 1.752-3(a)(2) (1991). IRC § 704(c) requires the partnership to track the excess of the fair market value of property contributed to the partnership over its adjusted basis. I.R.C. § 704(c) (1988). If the partnership sells the contributed property, IRC § 704(c) mandates the allocation of the gain, up to the unrealized pre-contribution gain, to the contributing partner. *Id.*

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

148. Treas. Reg. § 1.752-3(a)(3) (1991). The final regulations, unlike the temporary regulations, provide that in lieu of allocating in accordance with profit interests, a partnership may allocate excess nonrecourse liabilities in accordance with the allocation of deductions attributable to the property securing the nonrecourse debt. *Id.*; Temp. Treas. Reg. § 1.752-3T(e)(3)(ii) (as amended by T.D. 8274, 1989-2 C.B. 101).

contributed. The partnership uses the $1,000 to buy adjacent land and $8,000, borrowed on a ten-year balloon nonrecourse note, to purchase a storage building. The partnership agreement provides that G and L will share profits and losses equally. At the end of Year 1, the partnership deducts $200 in depreciation related to the building. Thus, the partnership minimum gain would equal $200, $8,000 face amount of the nonrecourse note minus $7,800 adjusted basis of the storage building after the $200 depreciation deduction.

	G	L	Total
Share of Minimum Gain	$100	$100	$200
Share of § 704(c) Gain	-0-	50	50
Share of Excess Liability	3,875	3,875	7,750
Total Share of Liability	$3,975	$4,025	$8,000

Because the partnership agreement would allocate fifty percent of the $200 depreciation deduction to each partner, each receives $100 of minimum gain.[149] The partnership has $50 of IRC section 704(c) gain because the fair market value of L's land, $1,000, exceeded its basis, $950, by $50. Thus, the partnership must allocate $50 of the nonrecourse debt to L. The excess nonrecourse liability equals $7,750, $8,000 total liability minus $200 previously allocated under the minimum gain category and $50 previously allocated under the IRC section 704(c) category.[150] Each partner's profit percentage, fifty percent, times the excess nonrecourse liability, $7,750 yields a product of $3,875. Accordingly, G's basis in his partnership interest increases by a total of $3,975, $100 minimum gain plus $3,875 excess nonrecourse liability, and L's basis increase by $4,025, $100 of minimum gain, $50 of IRC section 704(c) gain and $3,875 of excess nonrecourse liability.[151]

As the foregoing examples indicate, the regulations under IRC sections 704(b) and 752 generally produce results consistent with the economic risk of loss theory. However, the interrelationship of the regulations under IRC sections 704(b) and 752 may indicate a gap in the application of the economic risk of loss theory and a failure to reflect of true economic risk of loss.

IV. Theory and Application

Both the IRC section 704(b) regulations and the IRC section 752 regulations purport to allocate losses and the basis against which those

149. *See* Treas. Reg. § 1.704-2(g)(1) (1991) (computing minimum gain as difference between nonrecourse note balance and adjusted basis of property).

150. *See* Treas. Reg. § 1.752-3(a)(3) (1991) (requiring computation of excess nonrecourse liabilities).

151. *See* Treas. Reg.§ 1.752-3(b), Example 1 (1991) (showing how partnerships must allocate nonrecourse liabilities).

losses may be deducted to the partners that bear the ultimate economic risk of loss.[152] Nevertheless, certain problems exist in the application of the technical rules provided by the regulations. First, the two sets of regulations approach the economic risk of loss definition from different theoretical perspectives. The IRC section 704(b) regulations determine economic risk of loss by using the fair market value of property contributed by a partner in computing his capital account.[153] The IRC section 752 regulations, however, emphasize the ultimate legal obligation of the partners, rather than the fair market value of contributed property, in determining economic risk of loss.[154] This theoretical variance can result in loss allocations under IRC section 704(b) that outpace liability allocations under IRC section 752.[155] Second, the zero-sale constructive liquidation technique assumes the worst possible scenario; the value of all partnership assets falls to zero and the creditors demand immediate payment.[156] In reality, however, many partnerships pay liabilities out of partnership earnings without requiring the partners to contribute personal assets.[157] Thus, the partners who forego cash distributions so the partnership can make debt service payments bear the true economic cost of debt repayment, rather than the guarantor partner(s) as the regulations assume.[158]

A. Potential Mismatch of Loss Allocations and Liability Assignments

When a partnership applies the alternate economic effect test, the dichotomy between the IRC section 704(b) regulations' value emphasis and the IRC section 752 regulations' legal obligation emphasis may result in allocations of losses to partners that do not have the liability generated basis to deduct the losses: the "valuation trap."[159] The following example illustrates this apparent gap in the allocation scheme employed by the IRC section 704(b) and 752 regulations.

> EXAMPLE 16—General partner, G, and limited partner, L, form a limited partnership. G contributes land with a fair market value and a basis of $100. L contributes an old machine with a fair

152. *See supra* note 104 and accompanying text (describing basis of regulations as economic risk of loss).

153. *See* Treas. Reg. 1.704-1(b)(2)(iv)(b) (as amended in 1988) (increasing partners' capital accounts by fair market value of contributed property).

154. *See* Treas. Reg. § 1.752-2(b)(3) (1991) (using ultimate obligations under state law to determine economic risk of loss).

155. *See generally* Marich, *supra* note 81, at 513-28 (denoting added flexibility allocations based on capital account computed with fair market values rather than with basis of contributed property).

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

157. *See* Utz, *supra* note 23, at 709 (expounding that for profitable partnerships, partners will sacrifice profit shares in order to liquidate partnership liabilities).

158. *Id.*

159. *See supra* note 155 and accompanying text (discussing allowance of allocations based on capital accounts computed with fair market values rather than adjusted bases).

market value of $100, but a basis of $-0-. The partnership agreement provides for capital account maintenance and the distribution of liquidation proceeds in accordance with positive capital account balances. The partnership agreement does not require the partners to restore deficit capital account balances, but does contain a qualified income offset provision. The partnership borrows $1,000 on a recourse note and spends the entire amount on advertising in the first year of operations. The partnership agreement calls for the equal allocation of all losses.

	G	L	Total
Beginning Capital Account	$100	$100	$200
Initial Allocation	(500)	(100)	$200
Excess Allocation	(400)	-0-	(400)
Ending Capital Accounts	($800)	$-0-	($800)

The initial allocation of loss to L will only have alternate economic effect to the extent that it does not cause a deficit in L's capital account that reflects the fair market value of the property he contributed.[160] Unfortunately, L cannot deduct the $100 loss that the IRC section 704(b) regulations did allocate to him due to the valuation trap. This result occurs because the IRC section 752 regulations allocate all the debt-generated basis to G on whom state law places the obligation to repay the loan if the partnership cannot.[161]

The IRC section 752 regulations correctly render the allocation of loss to L impotent because L does not bear the economic risk of loss with respect to the liability that generated the deduction.[162] However, the IRC

160. Treas. Reg. § 1.704-1(b)(2)(ii)(d)(3) (as amended in 1988). The regulations would reallocate the excess losses from L to G under the mock adjusted tax basis technique. *See* Treas. Reg. § 1.704-1(b)(3)(iii) (as amended in 1988) (describing mock adjusted tax basis liquidation technique).

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

162. *See* Treas. Reg. § 1.752-2(a) (1991) (allocating recourse liabilities to partners that bear economic risk of loss with respect to such liabilities). *See also* Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954) (treating fair market value of amount received as amount realized in order to correctly measure basis). If L receives $100 of basis for the fair market value of his contribution, he could deduct $100 of loss against it, bringing his basis back to $-0-. The partnership could then sell the machine and allocate the gain to L under IRC section 704(c), bringing his basis up to $100. Thus far, L would have $100 of taxable income that would exactly offset the loss allocation. If L received a distribution of the $100 of cash from the sale of the machine and his basis dropped back to $-0-, L would have received $100 of cash in exchange for his investment tax-free due to the incorrect allocation of loss. The following "T-account" traces the additions and subtractions affecting L's basis:

L's Basis

section 704(b) regulations' focus on value in the capital account as the talisman for loss allocation allows this exercise in futility.[163] Consequently, in certain instances, the value-based allocation flexibility of the IRC section 704(b) regulations can outstrip the ultimate obligation-based liability allocations of the IRC section 752 regulations.[164]

B. Risk of Economic Loss or Ultimate Legal Liability

In addition to the above potential mismatching of loss allocations and basis caused by the IRC section 704(b) regulations, the IRC section 752 regulations assume that the partner who would have to pay off the liability in a worst case scenario bears the true economic risk of loss.[165] However, in many instances, a partnership will pay off its liabilities with operating profits rather than calling upon the partners to restore deficits in capital account balances or satisfy guarantees.[166] Thus, while debt service payments will generally reduce the profits distributed to all partners, the regulations only allow the partner who bears the ultimate legal repayment obligation in a worst case scenario to increase his basis by the amount of the liability.[167]

Decreases			Increases
		$-0-	Beginning Balance
		100	Value Increase
Loss Deduction	$100		
		100	Gain Allocation
Cash Distribution	100		
		$-0-	Ending Balance

163. *See supra* note 162 and accompanying text (explaining how value-based flexibility in allocations can result in allocations without basis support).

164. *Cf.* Treas. Reg. § 1.752-2(h) (1991) (providing that partners who pledge separate assets to secure partnership liabilities bear an economic risk of loss equal to fair market value of pledged assets). Further, the regulations assign the economic risk of loss to a partner who contributes specific property solely for the purpose of securing the liability to the extent of the fair marke value of the property. Treas. Reg. § 1.752-2(h)(2) (1991). The preamble to the final regulations indicated that the Treasury made the above modification for contributed property in order to "provide some flexibility in applying the rule [regarding pledged assets] in situations where allocation are mandated by the provisions of section 704 and the regulations thereunder." 56 Fed. Reg. 66349 (1991).

165. *See supra* note 112 and accompanying text (discussing zero-sale constructive liquidation where value of all partnership assets including cash fall to zero).

166. *See* WILLIS, ET AL. *supra* note 29, § 62.11 at 62-31 (discussing use of profits to liquidate partnership liabilities); Utz, *supra* note 23, at 709 (1990) (indicating that profits pay off partnership liabilities in many cases). The old IRC § 752 regulation reflected this theory by providing that all partners share nonrecourse debts based on profit percentages. *See supra* note 17 and accompanying text (discussing text of Treas. Reg. § 1.752-1(e) (1956)).

167. *See* Treas. Reg. § 1.752-2(a) (1991) (allocating recourse liabilities based on economic risk of loss determined by using zero-sale liquidation technique); This will result even though state law may define a partner's interest in a partnership to include his interest in profits and surplus. These profits and surplus will usually produce the cash with which the partnership will retire the debt. *Id.*; UNIF. PARTNERSHIP ACT § 26, 6 U.L.A. 349 (1914). *See also* Utz, *supra* note 23, at 709 (expounding that for profitable partnerships, partners will sacrifice profit shares in order to liquidate partnership liabilities).

The following example shows how the IRC section 752 regulations allocate a partnership liability to one partner while the other partner's future profits actually satisfy the liability.

> EXAMPLE 17—General partner, G, and limited partner, L, form a limited partnership and agree to allocate ninety percent of profits and losses to G, and the balance to L. G contributes a building worth $1,000,000 with a basis of $-0-. L personally guarantees a $1,000,000 recourse note for the purchase of a second building.[168] Fire completely destroys the second building which the partnership did not insure. The partnership manages to pay off the note over a 10-year period due to an extremely profitable rental agreement on the first building. Under a zero-sale constructive liquidation, L would have to pay the note off and thus, the regulations would increase L's basis in his partnership interest by the entire $1,000,000. The partnership agreement, however, would allocate ninety percent of the loss from the destruction of the second building, or $900,000, to G. Unfortunately, since G cannot include any of the liability in his basis, he could not deduct any of the loss in the year it occurs. The regulations produce this result even though the partnership uses all of its profits over the next ten years, ninety percent of which would have accrued to G, to pay off the liability. While G does not bear the legal risk of having to use his personal assets to pay off the note, he does bear the economic risk of losing his share of partnership profits for the next ten years.

The regulations focus on the ultimate legal liability to the partners at the end of each year rather than the profits the partnership will probably earn in the future.[169] Thus, the regulations sacrifice economic substance for legally certain form in determining liability allocations.[170] Perhaps the Treas-

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168. *See* Treas. Reg. § 1.752-2(f), Examples 3, 4 (1991) (indicating that L would bear economic risk of loss and thus, would receive basis assignment).

169. *See* Treas. Reg. § 1.752-2 (1991) (providing zero-sale constructive liquidation technique). As the partnership allocated profits to G, in the above example, over the next ten years, his basis would increase and allow him to deduct a part of the loss. I.R.C. § 705(a)(1) (1988). In other words, when the partnership allocates the profits to G, G then has a risk to lose something he owns. Prior to actual accrual of the profits, the regulations apparently deem G's future interest in potential profits as too tenuous to justify liability-generated basis allocation. *See generally* Treas. Reg. § 1.752-2 (1991) (denying recourse liability allocation on any basis except economic risk of loss). This seems an appropriate general rule because the liability represents a present claim on the assets of the partnership and the partnership should allocate this present claim to the partner that would have to pay it off with presently owned assets.

170. *Cf.* Treas. Reg. § 1.752-2(j) (1991) (providing anti-abuse rules for preventing inclusion of liabilities in basis where allocation has principal purpose of tax avoidance). Regulation § 1.752-2(j) provides:

> (j)(1) *Anti-abuse rules*—(1) *In general.* An obligation of a partner or a related person to make a payment may be disregarded or treated as an obligation of another

ury should rename its theory the "Crash and Burn Theory," rather than the more substantive sounding "Economic Risk of Loss Theory" in order to more accurately reflect the methodology employed by the regulations.

V. Conclusion

In general, the Treasury successfully drafted final regulations under IRC sections 704(b) and 752 that allocate losses and the liability-generated basis against which to deduct the losses to the partners that bear the economic risk with respect to those losses and liabilities.[171] However, the regulations do not create complete consistency between the partnership and other entities. The valuation trap created by the IRC section 704(b) regulations and the rigid focus on the immediate liquidation by the IRC section 752 regulations highlight areas of contention that either the Treasury can address

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> person for purposes of this section if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the partner of related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Circumstances with respect to which a payment may be disregarded include, but are to limited to, the situations described in paragraphs (j)(2) and (j)(3) of this section.
>
> (j)(2) *Arrangements tantamount to a guarantee.* Irrespective of the form of a contractual obligation, a partner is considered to bear the economic risk of loss with respect to the partnership liability, or a portion thereof, to the extent that:
> (i) The partner or related person undertakes one or more contractual obligations so that the partnership may obtain a loan;
> (ii) The contractual obligations of the partner or related person eliminate substantially all the risk to the lender that the partnership will not satisfy its obligation under the loan; and
> (iii) One of the principal purposes of using the contractual obligation is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests.
> The partners are considered to bear the economic risk of loss for the liability in accordance with relative economic burdens for the liability pursuant to the contractual obligations. For example, a lease between a partner and a partnership which is not on commercially reasonable terms may be tantamount to a guarantee by the partner of a partnership liability.
> (3) *Plan to circumvent or avoid the obligation.* An obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation.

Treas. Reg. § 1.752-2(j) (1991). These anti-abuse rules do not encompass, however, the concept that future profits, even certain profits (e.g., guaranteed long-term lease payments), will actually pay off the debt. *See supra* note 169 and accompanying text (discussing use of profits to liquidate partnership recourse liabilities).

171. *See supra* notes 33-44 and accompanying text (discussing use of capital accounts to determine if allocation affects partners' ultimate partnership investments and thus, whether loss allocations will decrease value of recipient partners' investments); *supra* notes 106-12 and accompanying text (discussing incorporation of economic risk of loss theory in IRC § 752 regulations).

or the taxpayer, courts and congress will face.[172] Meanwhile, the tax practitioner must struggle to understand the extremely complex and interrelated regulations in order to determine which partners may receive loss allocations and which partners may deduct the loss allocations they receive.

Ed R. Haden

172. *See supra* notes 159-64 and accompanying text (describing valuation trap and emphasis on worst case scenario liquidation rather than diversion of profits to pay off partnership liabilities).