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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON THE TREATMENT OF EXCULPATORY LIABILITIES FOR PURPOSES OF SECTION 704 AND SECTION 752

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I. Introduction.

This report[1] offers recommendations on how to resolve ambiguities in the application of Section 704(b) [2] and Section 752 regarding allocation of partnership items attributable to so-called "exculpatory liabilities." An exculpatory liability, as defined in the preamble to the regulations concerning the allocation of nonrecourse deductions (the "Section 704(b) Regulations"), is a liability of a partnership "that is not secured by any specific property and that is recourse to the partnership as an entity, but explicitly not recourse to any partner."[3]

In the preamble to the Section 704(b) Regulations adopted in 1991,[4] the Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "Service") noted that exculpatory liabilities do not fit neatly within the regime described by such Regulations and acknowledged that the Regulations do not prescribe precise rules addressing the allocation of income and loss attributable to exculpatory liabilities. The Treasury and the Service solicited suggestions on the appropriate treatment of allocations attributable to exculpatory liabilities that take into account the practical concerns of partnerships.[5]

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1 This report was drafted by an ad hoc committee of the Tax Section of the New York State Bar Association. The principal drafter of the report was David Mayo, with substantial assistance from Jason La. Substantial contributions were made by Phillip Gall, Eric Sloan and Alan Tarr; helpful comments were received from Stephen Foley, Amanda Nussbaum, Stuart Rosow, Michael Schler, David Sicular and Karen Sowell.

2 Unless otherwise indicated, all references herein to "Section" or "Sections" are to the Internal Revenue Code of 1986, as amended (the "Code"). References to "Regulation" or "Regulations" are to Treasury regulations in effect as of the date of this report.

3 T.D. 8385, 1992-1 C.B. 199, 203.

4 *Id*.

5 Unless otherwise indicated, all references herein to "partnership" or "partnerships" apply to all entities classified as partnerships for federal income tax purposes. References to "partner" or "partners" similarly apply to members of an entity classified as a partnership for federal income tax purposes.

Since that Regulation was adopted, limited liability companies have proliferated as a form in which businesses are organized and operated.[6] Modifications to the Section 704(b) Regulations and the regulations adopted under Section 752 (the "752 Regulations") in the intervening years have clarified various issues, but the Regulations still lack precise rules addressing exculpatory liabilities. This report comments on the ambiguities present in the current law and urges the Treasury to amend the Regulations to provide some precise rules and clarifications. Part II of the report summarizes our recommendations. Part III of the report provides background, and Part IV of the report discusses our recommendations.

II. Summary of Recommendations.

For the reasons described more fully in Part IV of this report, our principal recommendations are as follows:

1. *Definition of "exculpatory liability."* The Treasury and the Service should amend the Regulations to define the term "exculpatory liabilities," and should expand the definition from that included in the preamble to include obligations that are by their terms recourse to the borrower (but not any of its owners) and secured by all or part of the assets of the borrower. Under our proposal, the definition would be: a liability of a partnership "that is recourse to the partnership as an entity, but not recourse to any partner either by the terms of the obligation or by reason of the form of the obligor.

6 *See, e.g.*, Rodney D. Chrisman, *LLCs are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations and LPs Formed in the United States Between 2004-2007 and How LLCs were Taxed for the Tax Years 2002-2006*, 15 FORDHAM J. CORP. & FIN. L. 459 (2010).

2. *Characterization of an exculpatory liability for purposes of Sections 704(b) and 752.* The Treasury and the Service should confirm that exculpatory liabilities of an LLC are properly characterized as nonrecourse liabilities that are deemed to burden all of the partnership's assets in excess of the assets pledged to secure actual nonrecourse liabilities (up to the lesser of the fair market value of such assets or the amount of such nonrecourse liability) for purposes of Sections 752 and 704(b) regardless of their characterization for purposes of determining gain or loss upon a transfer of property under Section 1001.

3. *Minimum gain generated by exculpatory liabilities.* The Treasury and Service should amend Regulations Sections 1.704-2(d) and 1.704-2(b)(2) to clarify that, for purposes of those rules, the terms "subject to" and "encumber" can properly describe the relationship between exculpatory liabilities and the assets they economically burden.

4. *Allocation of liabilities.* The Treasury and the Service should amend the Section 704(b) and 752 Regulations to clarify that a partnership borrower is to treat an exculpatory liability as having a floating lien over all assets of the borrower (a "floating lien approach") for purposes of determining minimum gain.

5. *Definition of partner nonrecourse debt.* The Treasury and the Service should amend the definition of partner nonrecourse debt of an LLC in Regulations Section 1.704-2(b)(4) to include Section 1001 recourse liabilities for which a partner bears the economic risk of loss, including a loan by a partner to an LLC that is recourse in form but nonrecourse to the other partners.

III. Background.

A. In General.

As noted above, an exculpatory liability, as defined in the preamble to the Section 704(b) Regulations, is a liability of a partnership "that is not secured by any specific property and that is recourse to the partnership as an entity, but explicitly not recourse to any partner."[7] In our experience, exculpatory liabilities arise most frequently in the context of limited liability companies ("LLCs") classified as partnerships for U.S. federal income tax purposes. Under state law, the members of an LLC generally are not personally liable, absent agreement to the contrary, to the creditors of the LLC. Thus, an LLC can incur a general, unsecured liability that would be recourse to the entity itself without subjecting any of its members to personal liability.[8] We note that the same would be true of a liability of an LLC that is recourse in form and secured by some or all of the assets of the LLC but for which no member has personal liability.

The treatment of partnership liabilities is relevant for at least two purposes in subchapter K. First, pursuant to Section 752, a partner's basis in its interest in the partnership is increased or decreased for changes in its share of the liabilities of the partnership. Second, the Section 704 Regulations, relating to the determination of a partner's distributive share of partnership income or loss have detailed rules regarding the allocation of deductions generated by nonrecourse liabilities and of subsequent income

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[7] T.D. 8385, *supra* n. 3, at 203. We believe the word "explicitly" was used to reflect the fact that for most partnerships in 1991, at least one partner would have unlimited liability for the obligations of the partnership. Thus, a lender would be required to affirmatively waive that liability for the partnership liability to not be recourse to any partner and fit within this definition. We do not believe, however, that the fact that the liability shield arises by operation of law in the context of LLCs should change the status of the liability for this purpose and would propose to clarify the definition accordingly.

[8] We believe that the type of liabilities contemplated by the 1991 preamble – those created by a non-LLC partnership incurring a general liability not secured by any specific property that is recourse to the partnership itself but by agreement not recourse to any of the partners personally – are less common.

inclusions. The Section 752 and Section 704 rules also apply to an LLC classified as a partnership. Neither, however, directly addresses the treatment of exculpatory liabilities.[9] This lack of guidance is unsurprising given the relative novelty of LLCs at the time existing guidance was issued, but should be remedied now that LLCs and other types of partnerships that shield their owners from liabilities are common.

B. Characterization of Liabilities as Recourse or Nonrecourse.

1. Recourse and Nonrecourse Liabilities Under Section 752.

For purposes of determining a partner's share of partnership liabilities, the Section 752 Regulations distinguishes between recourse and nonrecourse liabilities. Regulations Section 1.752-1(a) defines the terms "recourse liability" and "nonrecourse liability." Under this Regulation, a partnership liability is a "recourse liability to the extent that any partner or related person bears the economic risk of loss."[10] In contrast, a partnership liability is a "nonrecourse liability to the extent that no partner or related person bears the economic risk of loss."[11]

Thus, the distinction between a recourse and nonrecourse liability for purposes of Section 752 turns on the concept of the partners' economic risk of loss.[12]

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[9] The Section 704 Regulations in their current form were initially promulgated in 1986; the current Section 752 Regulations were promulgated in 1991, in both cases well before LLCs became a common form of business organization. In a 1988 published ruling, the Service ruled that a Wyoming LLC, despite affording limited liability to its members, would be taxed as a partnership and not as a corporation under the now defunct four-factor *Kintner* Regulations (Rev. Rul. 88-76, 1988-2 C.B. 360). In 1997, the Treasury and the Service replaced the *Kintner* Regulations with the current elective entity classification Regulations (Reg. § 301.7701-3), permitting unincorporated entities wide latitude to elect their classification for federal tax purposes.

[10] Reg. § 1.752-1(a)(1).

[11] Reg. § 1.752-1(a)(1), (2).

[12] *See* NYSBA Tax Section Report No. 1311, "Proposed Regulations Regarding the Allocation of Recourse Liabilities" (Nov. 14, 2014); NYSBA Tax Section Report No. 1307, "The Proposed Regulations on the Allocation of Partnership Liabilities and Disguised Sales" (May 30, 2014). The characterization of liabilities for purposes of Section 1001 is discussed in the next section.

The extent to which any partner bears the economic risk of loss with respect to a liability is determined in accordance with a constructive liquidation pursuant to Regulations Section 1.752-2(b) in which:

- all of the partnership's liabilities become payable in full,
- all of the partnership's assets, including cash, have a value of zero,
- the partnership disposes of all of its property in a fully taxable transaction for no consideration except for relief from liability for which creditors' right to repayment is limited to one or more assets of the partnership,
- all items of income, gain, loss or deduction are allocated among the partners, and
- the partnership liquidates.

After this constructive liquidation, any partner (or a related person) that has an obligation to contribute to the partnership (for example, as a result of a deficit restoration obligation) or to make a payment to any person (for example, as a result of a guarantee or unlimited liability to a creditor) bears an economic risk of loss to the extent of the required payment. A partner's share of a recourse liability is the amount for which the partner bears the economic risk of loss, determined as described above.[13]

A partner's share of a nonrecourse liability is determined under different rules. These provide that the share is the sum of three tiers of items: (1) the partner's share of minimum gain determined under Section 704(b), (2) the amount of any taxable gain that would be allocated to the partner under Section 704(c) if the partnership disposed of all of its property subject to one or more nonrecourse liabilities for no consideration other than the satisfaction of such liabilities ("704(c) minimum gain") and (3) the partner's share of excess nonrecourse liabilities determined in accordance with applicable Regulations.[14]

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13 Reg. § 1.752-2(a).

14 Reg. § 1.752-3(a). This Regulation provides that the allocation of excess nonrecourse liabilities is made in accordance with the partner's share of partnership profits. The Regulation further provides,

The operation of these rules can be illustrated with the following example:

> Example 1. Partner B contributes to equal partnership AB appreciated property with a value of $100 and a basis of $10, encumbered by a liability of $60 with recourse limited to the contributed property. Partner A contributes $100 of cash to partnership AB. Pursuant to Section 704(c)(1)(A), the built-in gain in the property of $90 will be taken into account by Partner B.

Partner B has an initial basis in its partnership interest equal to $10 plus its share of nonrecourse liabilities. Partner B's share of nonrecourse liabilities consists of the following items: no amount under the first tier, because at the time of contribution, there is no Section 704(b) minimum gain because the book value of the asset (its fair market value) exceeds the amount of the liability encumbering it (we believe this would always be the case immediately following the contribution of an asset); regarding the second tier, the amount of taxable gain that would be attributable to Partner B if the partnership disposed of the property for no consideration other than satisfaction of the liability is $50 because Section 704(c) provides that the contributing partner recognizes gain upon disposition of a contributed asset with built-in gain; and these circumstances create $10 of excess nonrecourse liabilities, which would be allocated between Partner A and Partner B in the third tier.

2. Recourse and Nonrecourse Liabilities Under Section 704.

Pursuant to the Section 704 Regulations, the allocation of partnership items attributable to recourse liabilities and those attributable to nonrecourse liabilities are governed by different rules.[15] In defining the term "nonrecourse liability," the

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among other alternatives, that the partnership agreement may specify the partners' interest in partnership profits for this purpose, provided that the interests so specified are consistent with some other significant item of partnership income or gain. Reg. § 1.752-3(a)(3). *See also* Prop. Reg. § 1.752-3(a)(3) (specifying the use of "liquidation value").

[15] *See* Reg. § 1.704-2(b).

Section 704(b) Regulations merely cross-reference and adopt the Section 752 definition of recourse and nonrecourse liability.[16]

3. Definition of Recourse and Nonrecourse Liabilities Under Section 1001.

Section 1001 and the Regulations promulgated thereunder govern the amount of gain or loss a partnership must recognize upon the sale of property where a portion of the consideration is the assumption or discharge of a liability. In general, the amount realized on the sale of property includes the amount of liabilities from which the transferor is discharged.[17] The amount realized on the transfer of property secured by nonrecourse indebtedness includes the full amount of the indebtedness.[18] In contrast, the amount realized in the case of a transfer of property secured by a recourse obligation is limited to the fair market value of the property and does not include amounts that would be income from the discharge of indebtedness.[19] Rather, the transfer of property in satisfaction of a recourse indebtedness in excess of the value of the property is generally bifurcated and treated as in part a sale of the property and in part a cancellation of the debt.[20]

The Regulations promulgated under Section 1001 do not define recourse and nonrecourse debt, and authorities are not entirely clear as to how the distinction

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16 "'Nonrecourse liability' means a nonrecourse liability as defined in § 1.752-1(a)(2)." Reg. § 1.704-2(b)(3).

17 Reg. § 1.1001-2(a)(1).

18 *See Tufts v. Commissioner,* 461 U.S. 300 (1983); Section 7701(g) (for purposes of determining gain or loss with respect to any property, the amount realized from the disposition of such property shall be treated as not less than the amount of any nonrecourse indebtedness to which the property is subject). No portion of the income is considered to be cancellation of debt income.

19 Reg. § 1.1001-2(a)(2).

20 *See* Reg. § 1.1001-2(c), Ex. 8. *See also* Rev. Rul. 91-31, 1991-1 C.B. 19.

between the two is to be made.[21] Certain distinctions, however, can be gleaned from the examples in the Regulations promulgated under Section 1001,[22] including that a nonrecourse liability is one that limits the lender's remedy to one or more assets of the borrower.[23] Notably, there is no indication in the Regulations that the legal form of the borrower affects the recourse or nonrecourse nature of a liability under Section 1001. Although the terminology used to describe liabilities for purposes of Section 1001, on the one hand, and subchapter K, on the other, is the same, the underlying purposes for the distinction are different. We believe that it is not necessary to determine the characterization of an exculpatory liability as recourse or nonrecourse for purposes of Section 1001 in order to determine how such liabilities are to be treated for purposes of Section 704(b) and Section 752.

IV. Discussion.

A. Definition of Exculpatory Liabilities.

As discussed above, the Treasury has defined an exculpatory liability as a partnership liability "not secured by any specific property and that is recourse to the partnership as an entity, but explicitly not recourse to any partner."[24] That is, an exculpatory liability includes a general, unsecured liability of the partnership, with all of the assets of the partnership available to satisfy the liability. Regardless of the Section 1001 characterization, an exculpatory liability fits the definition of a nonrecourse liability

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21 *Cf. Great Plains Gasification Association v. Commissioner*, T.C. Memo. 2006-276 (citing authority relating to Section 752 in determining whether a liability is recourse for purposes of Section 1001).

22 *See, e.g.*, Reg. § 1.1001-2(c). *See also* Karen C. Burke, *Exculpatory Liabilities and Partnership Nonrecourse Allocations*, 57 TAX LAW. 33, 37 (2003); Clayton S. Reynolds, *Treatment of Recourse Liabilities in the Context of a Limited Liability Company*, 74 TAXES 397, 398-99 (1996).

23 *See, e.g.*, Reg. § 1.1001-2(c), Ex. 2, Ex 6.

24 T.D. 8385, *supra* note 3, at 203.

for purposes of Section 752 because no partner bears the economic risk of loss with respect to it. This is the case even though no specific partnership property is pledged in support of such a liability.

We note that the preamble to the Section 704(b) Regulations states that exculpatory liabilities are nonrecourse for purposes of Section 752. The preamble reads, in relevant part, as follows:

> A partnership may have a liability that is not secured by any specific property and that is recourse to the partnership as an entity, but explicitly not recourse to any partner (exculpatory liability). Section 1.704-2(b)(3) of the final regulations defines nonrecourse liability by referring to the definition of nonrecourse liability in the regulations under section 752. *Under that definition, an exculpatory liability is a nonrecourse liability.*[25]

We believe this treatment to be, or at least to have been, the ruling position of the Service.[26]

We believe the recommendations set out in this report should not be limited to liabilities that are both recourse in form and unsecured. It is common for borrowers to grant security interests in some or all of their assets to secure liabilities that are otherwise general obligations of the borrower. For the member of an LLC borrower, the grant of the security interest does not change its exposure to the liability – it has no

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25 *Id*. (emphasis added).

26 *See* Priv. Ltr. Rul. 200340024 (Oct. 3, 2003) (the portion of a general, unsecured obligation of a partnership for which there is no guarantee or deficit restoration obligation is a nonrecourse liability for purposes of Section 752); Priv. Ltr. Rul. 9815022 (Apr. 10, 1998) (a limited partnership's loan, not secured by any specific assets with no recourse to any partner, is a general obligation that is a nonrecourse liability for purposes of Section 752); Priv. Ltr. Rul. 9815001 (Apr. 10, 1998) (a general obligation of a partnership where the creditors have no claim against any of the partners is a nonrecourse liability for purposes of Section 752 because no partners bear the economic risk of loss); *see also* Priv. Ltr. Rul. 199906025 (Feb. 16, 1999) (a loan for which creditors have some claim to all of a partnership's assets but no claim to any of the partners is a nonrecourse liability for Section 752).

such exposure in the absence of an agreement to the contrary.[27] We believe the approach to such liabilities for purposes of Section 704 and Section 752 should generally be the same as for liabilities treated as "exculpatory" under the definition in the 1991 preamble. We also believe that the liability should not have to be "explicitly" nonrecourse to the partners to constitute an exculpatory liability.[28] Any liability that is a general obligation of the partnership but not recourse to the partners should qualify, even if the liability shield arises by operation of state law. Accordingly, we recommend that the Treasury and the Service amend the Regulations to define the term "exculpatory liabilities," and expand the definition from that included in the 1991 preamble to include obligations that are by their terms general obligations of the borrower and secured by all or part of the assets of the borrower.

B. Confirm Treatment of Exculpatory Liabilities as Nonrecourse.

As described below, we believe that the Section 752 liability allocation rules governing nonrecourse liabilities apply to exculpatory liabilities under existing law, although we believe it would be helpful for the Service to confirm such treatment.[29] A partnership must allocate partnership items in accordance with the rules of Section 704(b), regardless of the characterization of an exculpatory liability as recourse or nonrecourse. Regardless of the characterization of exculpatory liabilities under Section

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[27] The same could be true of an exculpatory liability of a non-LLC partnership, where the liability shield is by agreement.

[28] See *supra* note 7.

[29] Our view is shared by most commentators. *See e.g.*, Burke, *supra* note 22; Christine Rucinski Strong & Susan Pace Hamill, *Allocations Attributable to Partner Nonrecourse Liabilities: Issues Revealed by LLCs and LLPs*, 51 ALA. L. REV. 603 (2000); Reynolds, *supra* note 22. However, some commentators are less certain or disagree. *See e.g.*, Terence Floyd Cuff, *Indebtedness of a Disregarded Entity*, 81 TAXES 303 (2003); Bethany Atkins Rice, *Does Regulation Section 1.704-2 Permit Special Allocations of Nonrecourse Deductions Attributable to Exculpatory Liabilities?*, 56 TAX LAW. 155 (2002).

1001, we believe that the guiding principles of the economic risk of loss concept should govern the characterization of exculpatory liabilities as nonrecourse under Section 752. The literal application of the Section 752 and Section 704(b) rules to exculpatory liabilities, relying on the recourse form of the liability to determine the appropriate treatment, would lead to peculiar results under the constructive liquidation mechanism required by Regulations Section 1.752-2(b).

> Example 2. Assume that equal partners A and B each contribute $10 to an LLC and that the LLC borrows $80 on an unsecured recourse basis to finance the purchase of property for $100. Neither Partner A nor Partner B has a deficit restoration obligation. The limited liability shield results in this liability being nonrecourse to the partners, and as such, an exculpatory liability. If the LLC treats the liability as recourse for purposes of Sections 752 and 704(b), then the LLC would have a $100 loss ($100 basis less $0 amount realized) upon a constructive liquidation.[30] This loss would be allocated equally, $50 each to Partner A and Partner B, creating deficit capital accounts of $40 for each of Partner A and Partner B ($10 contribution less $50 loss).

Ignoring cancellation of debt ("COD") income, this cannot be correct. In the first instance, Partner A and Partner B are both protected by the statutory limited liability shield from the lender's reach (absent a guarantee or member loan). Accordingly, neither bears actual risk of loss with respect to the loan. Further, even in a constructive liquidation, an allocation that results in deficits in partner's capital accounts seems inappropriate because there is no deficit restoration obligation for either Partner A or Partner B.

The unwarranted capital account deficits suggest that an exculpatory liability is characterized as a nonrecourse liability. If so treated, then upon the

[30] Reg. § 1.752-2(b)(iii) provides that upon a constructive liquidation, the partnership disposes of all of its property in a fully taxable transaction for no consideration.

constructive liquidation, the LLC would only recognize a $20 loss ($80 amount realized as relief of liability less $100 asset basis).[31] This $20 loss would be allocated equally between Partner A and Partner B, reducing their capital accounts to zero ($10 contribution less $10 loss). This approach reaches the correct result reflecting the actual economic operation of the limited liability shield, namely that neither Partner A nor Partner B personally bears the economic risk of loss on the exculpatory liability.[32]

C. Application of the Minimum Gain and Nonrecourse Deduction Rules to Exculpatory Liabilities.

1. Overview.

Losses, deductions and certain other items attributable to partnership nonrecourse debt ("nonrecourse deductions"), most commonly attributable to depreciation of property burdened by a nonrecourse liability, are subject to special rules under Section 704(b). In general, nonrecourse deductions cannot have economic effect, because the risk of loss is borne by the creditor rather than any partner.[33] To the extent a nonrecourse liability exceeds the adjusted tax basis of the property it encumbers, a disposition of the property will result in gain in an amount at least equal to such excess ("minimum gain").[34] The allocations of gain attributable to decreases in minimum gain

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31 Reg. § 1.752-2(b)(1)(iii) provides that if the creditor's right to repayment is limited to one or more assets of the partnership (i.e., a nonrecourse liability), then the amount realized upon the constructive liquidation includes the relief from the liability.

32 The result described above that was reached by treating an exculpatory liability as recourse for purposes of Sections 752 could be avoided by taking into account COD income in connection with the Section 752 deemed liquidation. However, we believe that this approach at best creates extra steps and is inconsistent with the mechanical application of the Section 752 Regulations.

33 Reg. § 1.704-2(b)(1).

34 Reg. § 1.704-2(d)(1).

(a "minimum gain chargeback") also cannot have economic effect, because they merely reverse the effect of the prior nonrecourse deductions.[35]

Because these allocations cannot have economic effect, they must be allocated in accordance with the partners' interests in the partnership pursuant to Regulations Section 1.704-2(b)(1). In general, for allocations of nonrecourse deductions to be deemed to be allocated in accordance with the partners' interests in the partnership, among other requirements, they must be allocated in a manner reasonably consistent with allocations of another significant partnership item attributable to the property securing the debt and the partnership agreement must include a minimum gain chargeback provision.[36] The minimum gain chargeback provides that if there is a net decrease in minimum gain for a year, each partner must be allocated items of partnership income or gain equal to its share of the net decrease.[37] It should be noted that allocations of nonrecourse deductions to partners are permitted notwithstanding the fact that the allocation may create capital account deficits and the partners may not have actual deficit restoration obligations.[38] The nonrecourse liability regime addresses this by providing that a partner's share of minimum gain is treated as a deemed deficit restoration obligation, thereby permitting allocations that create a capital account deficit where that would otherwise be impermissible.[39]

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[35] Reg. § 1.704-2(b)(2).

[36] Reg. § 1.704-2(e)(2), (3).

[37] Reg. § 1.704-2(f). The allocation of nonrecourse liabilities under Section 752 ensures that the partners have sufficient outside basis to utilize these nonrecourse deductions.

[38] Reg. § 1.704-1(b)(2)(ii)(d), -2(g)(1). *See* Reg. § 1.704-2(m), Ex. 1(i).

[39] Without the deemed deficit restoration obligation built into a partner's share of minimum gain by Reg. § 1.704-2(g)(1), partnership allocations would fail to meet the alternate test for substantial economic effect under Reg. § 1.704-1(b)(2)(ii)(d).

In light of the characterization of exculpatory liabilities as nonrecourse liabilities for purpose of Sections 752 and 704(b), it follows that the minimum gain and nonrecourse deduction rules of the regime outlined in these sections should apply to exculpatory liabilities. Applying these rules to exculpatory liabilities, however, presents some technical and practical hurdles. [40] In the first instance, the operative provisions of the Section 704 rules use the terms "encumber" and "subject to," neither of which necessarily applies to an exculpatory liability, to determine the assets on which this minimum gain arises. Further, the rules do not provide guidance regarding the proper method of allocating a single exculpatory liability among multiple assets. Each of these issues is discussed below.

2. "Subject to" and "Encumber" for Purposes of Section 704(b).

A literal reading of the rules relating to the determination of minimum gain underscores the concern that the current nonrecourse liability regime of Section 704(b) may offer an imprecise fit for exculpatory liabilities. Regulations Section 1.704-2(b) defines minimum gain as the amount by which a nonrecourse liability exceeds the adjusted tax basis of property it encumbers. Similarly, Regulations Section 1.704-2(d), which provide rules for computing the amount of minimum gain, begins by determining for each property the amount of gain that would be realized by a partnership if it disposed of its property *subject to* nonrecourse liabilities for no consideration other than full satisfaction of the liability.[41]

[40] Indeed, the preamble to the Section 704 Regulations acknowledges this difficulty and identifies the calculation of minimum gain as one such practical difficulty. *See* T.D. 8385, *supra* note 3, at 203.

[41] Reg. § 1.704-2(c), in turn, provides that nonrecourse deductions in a given year equal the net increase in minimum during that year. As such, a liability that could give rise to minimum gain necessarily must also generate nonrecourse deductions.

Neither the Code nor the Regulations provides direct guidance as to the meaning of "subject to" and "encumber" within the meaning of these sections.[42] A common use of the term "subject to" contemplates a property that has been pledged as security for a liability. Similarly, the term "encumber" frequently describes the burden that a liability imposes on property securing that liability.[43] Referring to the definition provided by the 1991 preamble to the Section 704(b) Regulations, an exculpatory liability is "a liability that is not secured by any specific property and that is recourse to the partnership as an entity, but explicitly not recourse to any partner."[44] Under this definition, if "secured by" requires a specific security interest, no property is subject to an exculpatory liability of a type described in the 1991 preamble and such a liability cannot give rise to minimum gain or nonrecourse deductions.

Assuming that these interpretations of "subject to" and "encumber" are appropriate for purposes of Section 704(b), then exculpatory liabilities of a type described in the 1991 preamble would fall outside of the minimum gain and nonrecourse deduction regime. Exculpatory liabilities would not generate minimum gain because minimum gain only arises upon the disposition of property *subject to* nonrecourse liabilities. Absent minimum gain, exculpatory liabilities would also not generate nonrecourse deductions because those depend on net increases in minimum gain.[45] Under these circumstances, depreciation deductions attributable to property financed by

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[42] *See* Monte A. Jackel, *Confusion Galore: Subject to, Secured by, or Encumbered*, 139 TAX NOTES 2 (Apr. 8, 2013).

[43] *See* NYSBA Tax Section Report No. 1307, *supra* note 12.

[44] T.D. 8385, *supra* note 3, at 203.

[45] Reg. § 1.704-2(c).

exculpatory liabilities would not be eligible for the safe harbor rules of Regulations Section 1.704-2.

We believe that it would be inappropriate for a liability to be treated as nonrecourse under Section 752 and yet not eligible for the related Section 704(b) rules. The Treasury and the Service acknowledged as much in the preamble to the Section 704(b) Regulations, which states, in relevant part:

> The application of the nonrecourse debt rules of § 1.704-2 — more specifically, the calculation of minimum gain — may be difficult in the case of an exculpatory liability, however, because the liability is not secured by specific property and the bases of partnership properties that can be reached by the lender in the case of an exculpatory liability may fluctuate greatly. Section 1.704-2 does not prescribe precise rules addressing the allocation of income and loss attributable to exculpatory liabilities. Taxpayers, therefore, are left to treat allocations attributable to these liabilities in a manner that reasonably reflects the principles of section 704(b).[46]

Although, as described further below, the proposal is not free from complexity, we believe it appropriate to treat exculpatory liabilities as encumbering all of the assets of the borrower entity. As such, exculpatory liabilities would be treated as generating both minimum gain and nonrecourse deductions. Consistent with this approach, we recommend that Regulations Sections 1.704-2(d) and 1.704-2(b)(2) be amended to clarify that the terms "subject to" and "encumber," respectively, be treated as including the interaction between exculpatory liabilities and the borrowing partnership's assets notwithstanding that there is no formal pledge of the assets or that only a portion of the

[46] T.D. 8385, *supra* note 3, at 203.

assets of the entity are pledged.[47] This would be consistent with the Service's prior ruling position with respect to exculpatory liabilities.[48]

3. Computation of Minimum Gain — Multiple Assets.

As discussed above, minimum gain is determined by calculating the amount of gain that would be realized by a partnership if it disposed of its property subject to nonrecourse liabilities for no consideration other than full satisfaction of the liability.[49] In the case of a traditional nonrecourse loan secured by a single asset, the calculation of the amount of minimum gain is relatively straightforward.

Under existing rules relating to nonrecourse liabilities, the consequences of multiple properties securing a single loan (that is not an exculpatory liability) may be illustrated by the following example.

> Example 3. Assume a partnership acquires three properties with the proceeds of a single loan that is recourse only to the three properties and not to any cash from their operation or disposition. Property A cost $100, Property B cost $200, and Property C cost $300. Each property has a ten year life and depreciates on a straight line basis. At the end of year 3, Property A is sold for its adjusted tax basis of $70, and the proceeds are not required to be paid to the lender (for example, because the value of properties B and C exceed $600 by an agreed-upon multiple). At that time, the value of Property B and Property C, in the aggregate, exceeds $600, and their aggregate adjusted tax basis is $350 ($140 adjusted basis in property B; plus $210 adjusted basis in Property C).

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[47] We note that the term "subject to" and "encumber" are used in a number of provisions of subchapter K. In light of the purposes of the Section 704 and Section 752 rules, we believe it would be appropriate for the Service to make clear that the suggested provision relates only to these rules.

[48] *See* Priv. Ltr. Rul. 9815022 (Apr. 10, 1998) (finding that a limited partnership's assets are, for purposes of Section 752, "subject to" a general obligation of the partnership, which is not secured by any particular asset and with no recourse to any partner); Priv. Ltr. Rul. 9815001 (Apr. 10, 1998) (finding that a partnership's assets are "subject to" a general obligation of the partnership where the creditors have no claim against any of the partners); *see also* Priv. Ltr. Rul. 199906025 (Feb. 16, 1999) (finding that assets are "subject to" a liability when the creditor has recourse to all of the partnership's assets but has no claim against any of the partners).

[49] Reg. § 1.704-2(d).

Before the sale of Property A, the partnership's minimum gain was $180 ($600 loan minus adjusted basis in the encumbered property of $420). After the sale, there is an increase in the partnership's minimum gain to $250 ($600 loan minus basis on encumbered property of $350). Thus, there is no reduction in minimum gain and no minimum gain chargeback as a result of the sale of Property A. If, instead, the proceeds of the sale of Property A had been used to reduce the amount of the debt, minimum gain would have remained the same at $180 ($530 loan minus the basis of the encumbered property of $350). If instead of being sold for its basis of $70, Property A were sold for $90 (and the proceeds retained), the $20 of gain would not be subject to the minimum gain chargeback rules but would be allocated as the partnership agreement provided or based on the partners' interest in the partnership.

If our proposed definition of exculpatory liabilities is adopted, such liabilities would not necessarily be secured by any specific property. Rather, an exculpatory liability is recourse to the LLC itself and to all of its assets (subject to the security interests of other liabilities) so that the properties that could be reached by the lender of an exculpatory liability may shift greatly over time. We believe that a floating lien approach (as described below) is the best method to determine minimum gain in the case of exculpatory liabilities. We note that it would be possible to adopt a specific allocation approach, where a liability would be allocated to a specific asset at the time that it was incurred, but we believe that such a method would create undue complexity and the possibility of abuse.

(a) Floating Lien Approach.

An exculpatory liability is effectively "secured" by all of the assets of the borrower entity, except to the extent that any such assets are otherwise pledged to support senior liabilities (to the extent of the amount of such senior liabilities). Consistent with this, the floating lien approach would aggregate the basis of all properties subject to the exculpatory liability (reduced by the amounts of senior liabilities to which the properties are subject) to determine the amount, if any, of minimum gain. Consistent with the rules of Regulations Section 1.704-2(c), nonrecourse deductions would exist in any taxable year only to the extent of any increase in minimum gain so calculated.

> Example 4. Assume that an LLC has three assets: depreciable Asset A worth $60 with a basis of $45, non-depreciable Asset B worth $30 with a basis of $15 and $10 of cash. The aggregate fair market value of the assets is $100 and the aggregate adjusted tax basis of its assets is $70. The LLC then incurs a general unsecured liability (i.e., an exculpatory liability) of $80, increasing its cash by $80, which it then distributes to its members.

The aggregate basis of the assets burdened by the new liability totals $70 (Asset A's basis of $45 plus Asset B's basis of $15 plus $10 cash). The total minimum gain at the end of the year is $10 (exculpatory liability of $80 less aggregate basis of burdened assets of $70).[50]

> Example 5. Assume that one year has passed since Example 4 above. Asset A has depreciated; its adjusted basis is now $40, reduced from $45 in the prior year. Asset B's basis has not changed, and the LLC retained cash generated during the year so that it holds cash of $15.

In the second year, despite the depreciation deduction that reduced the adjusted basis of Asset A, the aggregate basis of the LLC's assets that are treated as subject to the exculpatory liability remains at $70 because of the increased amount of cash held by the partnership (Asset A's basis of $40 plus Asset B's basis of $15 plus $15 cash). The outstanding balance of the exculpatory liability remains at $80. Thus, the

50 If there were any deductions in this situation, they would be treated as nonrecourse deductions.

total minimum gain in the second year remains $10 (exculpatory liability of $80 less aggregate basis of burdened assets of $70). The floating lien approach created no net increase in minimum gain in the second year and therefore no nonrecourse deductions allocable to the partners.

Consistent with the principles found in the treatment of nonrecourse liabilities secured by multiple properties under the Section 752 Regulations, the floating lien approach as described above may not represent the only potential method of allocating an exculpatory liability among multiple assets for purposes of Section 704.[51] For example, to accommodate the practical difficulties of calculating minimum gain using the aggregate basis of all of a partnership's assets, we believe that it would be reasonable to permit partnerships to exclude cash and current assets from such calculation provided that such choice, once made, would be treated as a method of accounting that must be applied consistently from year to year.

We note that the floating lien approach may cause concern with respect to the consistency requirement of Regulation Section 1.704-2(e)(2). In general, that rule provides that nonrecourse deductions are to be allocated in a manner consistent with the allocation of another significant partnership item attributable to the property securing the debt. Under the floating lien approach, all property would be treated as securing the debt, potentially giving wide latitude to choose the relevant significant items. It may be

[51] Reg. § 1.752-2(b) provides that a partnership may allocate a single liability among the multiple assets securing that liability using "any reasonable method." A method is not reasonable if it allocates an amount of liability to a property in excess of the fair market value of that property at the time the liability is incurred.

appropriate to specify a method, for example a method similar to "liquidation value percentages" in the proposed Section 752 Regulations,[52] in order to limit such latitude.

(b) Specific Allocation Approach.

In contrast to the floating lien approach, the specific allocation approach would permit that specific portions of the exculpatory liability be designated as encumbering specific assets for purposes of determining minimum gain. Any asset not so designated would be treated as not subject to the exculpatory liability and would not give rise to nonrecourse deductions.

The specific allocation approach is generally consistent with the treatment of nonrecourse liabilities secured by multiple properties under the Section 752 Regulations. If a single nonrecourse loan to a partnership is secured by multiple properties, the partnership is generally permitted to use any reasonable method to allocate the loan among the properties,[53] with the portion allocated to each property treated as a separate loan for purposes of Section 752.[54] The Regulations specify that a method is not reasonable if it allocates to any asset an amount of liability (when combined with any other liabilities allocated to that asset) in excess of the fair market value of the asset at the time the liability is incurred. If one of the burdened assets ceases to be subject to the nonrecourse liability (for example, if a lien is released, the property sold, and the proceeds not used to repay debt), the Regulations reallocate the previously allocated portion of the liability among the existing assets still securing the liability.[55] Further, if

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52 Prop. Reg. § 1.752-3(a)(3).

53 A method is not reasonable if it allocates an amount of liability to a property greater than the fair market value of the property. Reg. § 1.752-3(b)(1).

54 *Id*.

55 *Id*.

the partnership reduces the outstanding balance of the nonrecourse liability, the Regulations allocate the reduction among the burdened assets in the same proportion that they were initially allocated using the chosen reasonable method.[56]

We do not believe, however, that it is necessary that the specific allocation approach be adopted or permitted for purposes of Section 704. A principal purpose of the Section 752 Regulations is to ensure that liabilities are allocated to a contributing partner to preserve Section 704(c) items. The purpose of Section 704 is broader: to govern allocations of income over the life of the partnership.

Further, we believe adoption of an allocation method would require decisions to be made regarding permissible allocation methods, whether it would be permissible to change methods, whether the method chosen for Section 752 would also be required to be applied for purposes of Section 704, and potentially other issues. Finally, we believe that a specific allocation method may give rise to potential for abuse. Accordingly, we believe that the potential complexity of permitting specific allocation for purposes of Section 704 outweighs any benefit.

4. Computation of Minimum Gain — Multiple Liabilities.

In the case of a partnership that has assets subject to multiple liabilities, the stacking rules of Regulation Section 1.704-2(d)(2) direct the partnership to allocate the bases of the properties subject to those liabilities first to the liability of the highest priority to the extent of the amount of such liability and then to each remaining liability in descending order of priority. We believe that in applying this rule an exculpatory liability that is a general, unsecured obligation should be treated in the same manner as

[56] Reg. § 1.752-3(b)(2).

described in the previous section. If the LLC has pledged a particular asset or assets in support of other liabilities (for example, traditional nonrecourse liabilities), then the exculpatory liability should be treated as subordinate to such other liabilities for purposes of allocating the assets' bases among the liabilities.[57] If the LLC has pledged certain assets in support of a liability that is otherwise an exculpatory liability, basis in the pledged assets should be allocated taking into account such security interests. The effect of these stacking rules accelerate minimum gain attributable to junior liabilities.[58]

> Example 6. Assume that an LLC's assets consist of $5 cash and a building with a basis of $50 and a fair market value of $200. The LLC has incurred two third-party nonrecourse liabilities and pledged the building as security for each. The first third-party liability is for $40 ("Loan A") and is senior to the second third-party liability ("Loan B"), which is for $20. Additionally, the LLC has incurred a general unsecured liability (*i.e.*, an exculpatory liability) of $30, which is subordinate to the other two liabilities.

Under the stacking rules of Regulation Section 1.704-2(d), the basis of the LLC's assets should be allocated to the nonrecourse liabilities in descending order of priority. Accordingly, the basis of the building is first allocated to Loan A, so $40 of the building's $50 basis is allocated to Loan A. Basis in the building is next allocated to Loan B, so the remaining $10 of the building's $50 basis is allocated to Loan B.[59] The $5 basis attributable to the cash is allocated to the exculpatory liability. The result is that the LLC has no minimum gain attributable to Loan A ($40 liability less $40 basis),

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[57] *See* Reg. § 1.704-2(d)(2)(ii).

[58] Again, minimum gain is determined as the difference between the amount of liability and the Section 704(b) basis of the assets subject to those liabilities. Because little basis is assigned to junior debt (assuming that the aggregate bases of the entity's assets is less than the aggregate amount of liabilities), the minimum gain, and thus, the nonrecourse deductions, attributable to the junior debt is accelerated relative to the nonrecourse deductions attributable to the senior debt.

[59] Presumably in a default, the lender of Loan B would foreclose and take the building subject to Loan A, resulting in at least $10 of gain on the foreclosure, regardless of the value of the building.

minimum gain of $10 attributable to Loan B ($20 liability less $10 basis) and minimum gain of $25 attributable to the exculpatory liability ($30 liability less $5 basis).

5. Deferral of Minimum Gain Chargeback.

In the case of traditional nonrecourse liabilities, a partnership with a nonrecourse liability will experience net increases in minimum gain (typically due to depreciation), which will typically generate nonrecourse deductions. The partners are able to utilize the nonrecourse deductions currently when the deductions are allocated to the partners despite the fact that the partners do not bear the economic risk of loss with respect to that liability. However, to offset the benefit of these nonrecourse deductions previously taken, the partners must eventually recognize items of income to "charge back" those nonrecourse deductions.

With a traditional nonrecourse liability, the minimum gain chargeback typically occurs when the asset securing the liability is disposed of or the amount of the liability is reduced. However, for a traditional nonrecourse liability secured by multiple properties, the minimum gain chargeback may be deferred until the last property is sold.[60] Similarly, minimum gain chargeback attributable to exculpatory liabilities may be significantly deferred, both because the amount of the liability does not factor into the amount realized upon disposition of any particular asset and because allocation of exculpatory liabilities among multiple assets counteracts decreases in minimum gain that would otherwise arise upon the disposition of individual assets. The minimum gain, however, continues to exist in the assets of the partnership, and any gain actually realized

[60] Reg. § 1.752-3(b)(1) provides that if one of the burdened assets ceases to be subject to the nonrecourse liability (for example, if a lien is released, the property sold, and the proceeds not used to repay the debt), then the previously allocated portion of the liability must be reallocated among the assets still securing that liability. The reallocation of the liability defers the juncture when minimum gain is decreased, resulting in a minimum gain chargeback.

on the disposition of an asset would be allocated to the partners under Regulations Section 1.704-1. Accordingly, we do not believe any changes to the minimum gain chargeback rules are necessary to counteract this deferral.

(a) Deferral Due to Differences in Amount Realized.

In the case of traditional nonrecourse liabilities, a minimum gain chargeback typically arises upon the disposition of the property securing the liability because the amount realized to determine gain and loss under Section 1001 on disposition must include the amount of the full amount of the nonrecourse liability.[61] If an exculpatory liability is treated as recourse for purposes of Section 1001, then upon disposition of property subject to that liability, the liability is included in the amount realized only if the purchaser assumes the liability, and then only to the extent of the fair market value of the transferred property.[62] In the absence of an assumption of the exculpatory liability by the buyer of property, the minimum gain generated by the difference between the exculpatory liability allocated to the property and the tax basis of the property disposed of could survive (assuming that there is sufficient minimum gain in other assets). Without a decrease in minimum gain, the minimum gain chargeback would not arise.[63] Thus, triggering of the minimum gain chargeback may occur at a much later juncture in the case of exculpatory liabilities as compared to traditional nonrecourse liabilities. Again, however, because the minimum gain rules are essentially timing rules and the minimum gain is not permanently avoided, we believe this result is acceptable and no special rules are necessary.

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61 Reg. § 1.1001-2(a)(4)(i).

62 Reg. § 1.1001-2(a)(4)(ii).

63 Reg. § 1.704-2(f).

(b) Deferral Due to Shifting Allocation of Liability.

Generally, Section 704(b) permits some deferral of decreases in minimum gain, thereby deferring minimum gain chargeback, in the case of liabilities secured by multiple assets.[64] For an exculpatory liability, under the floating lien approach, minimum gain would be computed by reference to the aggregate bases of all burdened properties (potentially all of the properties of the LLC) and the outstanding balance of the exculpatory liability.

> Example 7. Assume an LLC acquires three properties with the proceeds of a single loan that is an exculpatory liability. Property A cost $100, Property B cost $200 and Property C cost $300. Each property has a ten year life and depreciates on a straight line basis. At the end of year 3, Property A is sold for $90 (when its adjusted tax basis was $70), and the proceeds are not required to be paid to the lender. The value of Property B and Property C, in the aggregate, exceeds $600, and their aggregate adjusted tax basis is $350.

Before the sale of Property A, the partnership's minimum gain was $180 ($600 loan minus adjusted basis in the encumbered property of $420). After the sale, the partnership's minimum gain is $160 ($600 loan minus basis on encumbered property of $440), so $20 of minimum gain chargeback would be triggered. This would also be the case if the cash were invested into new property, but would not be if the cash were used to fund deductible expenditures or a distribution to members. In the latter cases, the $20 of gain would not be subject to the minimum gain chargeback rules but would be allocated as the partnership agreement provided or based on the partners' interest in the partnership.

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[64] *See* Reg. § 1.704-2(m), Ex. 2 (the disposition of one of three assets securing a single nonrecourse liability did not reduce minimum gain because of depreciation deductions attributable to the other two assets created a net increase in minimum gain).

D. Application of the Partner Nonrecourse Debt Rules to Otherwise Exculpatory Liabilities.

1. Partner Nonrecourse Debt and Partner Nonrecourse Deductions.

Generally, Section 704(b) establishes an additional set of rules, parallel to the nonrecourse liability regime of Section 704, that govern the partnership allocations attributable to partner nonrecourse debt. For purposes of those rules, partner nonrecourse debt is any partnership liability to the extent the liability is nonrecourse for purposes of Regulations Section 1.1001-2 and a partner bears the economic risk of loss within the meaning of Section 752.[65] Partner nonrecourse debt most commonly arises when a partner (or a related person) is the creditor or acts as a guarantor of a partnership nonrecourse liability.

The partner nonrecourse deduction rules operate to ensure that deductions are allocated only to those partners that bear the economic risk of loss.[66] On the disposition of the asset or reduction of the liability, the partner nonrecourse debt rules trigger a gain chargeback to reverse the benefit of those deductions.[67]

> Example 8. Assume that equal partnership AB incurs a Section 1001 nonrecourse liability of $100 to finance the purchase of a depreciable building worth $100. The liability is guaranteed by partner A. Neither Partner A nor Partner B has a deficit restoration obligation. In a hypothetical liquidation, if the lender forecloses on the building when the fair market value of the property is zero, partner A would pay the creditor $100 on the guarantee. Partner A is allocated the deductions attributable to the building's depreciation.

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65 *See* Reg. § 1.704-2(b)(4) (regarding the allocation of losses, deductions and certain other items attributable to partner nonrecourse liabilities to the partner that bears the economic risk of loss).

66 Reg. § 1.704-2(i).

67 Reg. § 1.704-2(i)(4).

In Example 8, the constructive liquidation mechanism reveals that partner B does not bear any economic risk of loss because of partner A's guarantee. [68] As the partnership operates, the allocation of partner nonrecourse deductions to A results in a deficit in A's capital account. The gain recognized in the constructive liquidation would be allocated to partner A to chargeback the prior deductions and eliminates partner A's capital account deficit.

2. Exculpatory Liabilities as Partner Nonrecourse Debt.

Regulations Section 1.704-2(b)(4) defines partner nonrecourse debt as a partnership liability to the extent that the liability is characterized as nonrecourse for purposes of Section 1001. By its terms, this definition expressly excludes Section 1001 recourse liabilities with respect to which a partner bears economic risk of loss. Therefore, if a member of an LLC were to guarantee an otherwise exculpatory liability, and the exculpatory liability were treated as a recourse liability for purposes of Section 1001, the liability would not be partner nonrecourse debt. It may well be the case that the Section 752 Regulations applicable to recourse liabilities would ultimately allocate the liability to the partner that bears the risk of loss and that deductions attributable to the liability would be appropriately allocated as well. We believe that it is unnecessary, however, to distinguish between Section 1001 recourse and nonrecourse liabilities of an LLC for this purpose, and recommend that the definition of partner nonrecourse debt in Regulations Section 1.704-2(b)(4) be amended to include liabilities that would be exculpatory liabilities but for which a partner bears the economic risk of loss.

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[68] Reg. § 1.704-2(i)(1) requires that partner nonrecourse deductions are allocated to those partners who bear the economic risk of loss.

Conforming changes should be made in the calculation of partner nonrecourse debt minimum gain.