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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

TD 9289

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Treatment of Disregarded Entities Under Section 752

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 752 for taking into account certain obligations of a business entity that is disregarded as separate from its owner under section 856(i) or section 1361(b)(3) of the Internal Revenue Code, or §301.7701-1 through 301.7701-3 of the Procedure and Administration Regulations.

These final regulations clarify the existing regulations concerning when a partner may be treated as bearing the economic risk of loss for a partnership liability based upon an obligation of a disregarded entity. The rules affect partnerships and their partners.

DATES: Effective Date: These regulations are effective on October 11, 2006.

Applicability Date: These regulations generally are applicable for liabilities incurred or assumed by a partnership on or after October 11, 2006.

FOR FURTHER INFORMATION CONTACT: Charlotte Chyr, 202-622-3070 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1905. Response to this collection of information is mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information, unless the collection of information displays a valid control number.

The estimated annual burden per respondent varies from 6 minutes to 4 hours, depending on individual circumstances, with an estimated average of 2 hours. Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books and records relating to these collections of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and return information are confidential, as required by 26 U.S.C. 6103.

Background

On August 12, 2004, the IRS and the Treasury Department issued proposed regulations under section 752 providing rules for taking into account certain obligations of disregarded entities (69 FR 49832). Comments were received in response to the notice of proposed rulemaking, and a public hearing was scheduled. However, the

public hearing was later cancelled when no one requested to speak. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision.

Summary of Comments and Explanation of Provisions

1. Net Value Approach In General

The proposed regulations provide that a payment obligation under §1.752-2(b)(1) (§1.752-2(b)(1) payment obligation) of a disregarded entity for which a partner is treated as bearing the economic risk of loss is taken into account only to the extent of the net value of the disregarded entity. Certain commentators disagreed with the approach taken in the proposed regulations, arguing that the regulations will result in inconsistent treatment of similar economic situations and unwarranted complexity.

Some commentators argued that the presumption of deemed satisfaction of §1.752-2(b)(1) payment obligations of partners and related persons that is provided in §1.752-2(b)(6) (presumption of deemed satisfaction) should be applied to disregarded entities that have §1.752-2(b)(1) payment obligations. Other commentators argued that the presumption of deemed satisfaction should apply only to certain disregarded entities, such as disregarded entities that comprise substantially all of the owner's assets, or disregarded entities that hold active trades or businesses.

The IRS and the Treasury Department believe that applying the presumption of deemed satisfaction to a disregarded entity that shields the federal tax partner from liability for the entity's obligations would, in many cases, cause partnership liabilities that are economically indistinguishable from nonrecourse liabilities to be classified as recourse for purposes of section 752. Applying the presumption of deemed satisfaction

to disregarded entities would distort the allocation of partnership liabilities in those cases. Accordingly, these comments are not adopted in the final regulations.

One commentator suggested that §1.752-2 be amended to provide that, in addition to statutory and contractual obligations, statutory and contractual limitations should be taken into account in determining a partner's economic risk of loss. The IRS and the Treasury Department believe that such limitations are already taken into account under §1.752-2(b)(3). As a result, the comment is not adopted.

Another commentator suggested that the goal of the proposed regulation could be better achieved by adding an example to the current anti-abuse rule in §1.752-2(j) (or by publishing a revenue ruling) to illustrate a situation under which a partner's §1.752-2(b)(1) payment obligation is limited because the partner holds its interest in a partnership through a disregarded entity with a principal purpose to eliminate the partner's economic risk of loss with respect to the partnership's liabilities. The IRS and the Treasury Department agree that, in certain circumstances, the current anti-abuse rule under section 752 prevents allocation of partnership liabilities to a partner that is a disregarded entity. However, if a partner holds a partnership interest through a disregarded entity, and only the assets of the disregarded entity are available to satisfy §1.752-2(b)(1) payment obligations undertaken by the disregarded entity, the IRS and the Treasury Department believe that a partner should be treated as bearing the economic risk of loss for a partnership liability only to the extent of the net value of a disregarded entity's assets, whether or not the principal purpose of the arrangement is to limit the partner's economic risk of loss. As a result, the comment is not adopted.

2. Net Value Approach Not Extended To Other Entities

The proposed regulations requested comments regarding whether the rules of the proposed regulations should be extended to the §1.752-2(b)(1) payment obligations of other entities, such as entities that are capitalized with nominal equity. Some commentators opposed expanding the approach of the proposed regulations to thinly capitalized entities as unnecessary. Other commentators suggested that the anti-abuse rule of §1.752-2(j) could be expanded to cover certain situations involving thinly capitalized entities. Specifically, a commentator suggested that the anti-abuse rule should apply if a substantially undercapitalized subsidiary of a consolidated group of corporations or a substantially undercapitalized passthrough entity (other than a disregarded entity) is utilized as the partner (or related obligor) for a principal purpose of limiting its owner's risk of loss in respect of existing partnership liabilities, and obtaining tax benefits for its owners (or other members of the consolidated group) that would not be available but for the additional tax basis in the partnership interest that results from the presumption of deemed satisfaction rule. The commentator also suggested that the regulations provide a safe harbor for determining entities that are not substantially undercapitalized.

Under the anti-abuse rule of §1.752-2(j), a §1.752-2(b)(1) payment obligation of a partner or a related person may be disregarded if the 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 to create the appearance of the economic risk of loss where the substance of the arrangement is otherwise. Thus, the anti-abuse rule of §1.752-2(j) can apply to abusive transactions involving thinly capitalized entities. Although these regulations do not modify the anti-

abuse rule of §1.752-2(j) and do not extend the net value approach to thinly capitalized entities, the IRS and the Treasury Department may continue to study these issues in connection with future guidance projects.

3. Calculating The Net Value of A Disregarded Entity

Under the proposed regulations, the net value of a disregarded entity equals the fair market value of all assets owned by the disregarded entity that may be subject to creditors' claims under local law, including the disregarded entity's enforceable rights to contributions from its owner but excluding the disregarded entity's interest in the partnership for which the net value is being determined (if any) and the fair market value of property pledged to secure a partnership liability (which is already taken into account under §1.752-2(h)(1)), less obligations of the disregarded entity that do not constitute, and are senior or of equal priority to, §1.752-2(b)(1) payment obligations of the disregarded entity.

One commentator suggested that the final regulations should provide (or clarify) that the net value of a disregarded entity can vary depending upon the priority of the §1.752-2(b)(1) payment obligation for which the value is being computed. A commentator also suggested that obligations of the disregarded entity that are of equal priority to §1.752-2(b)(1) payment obligations of the disregarded entity should not be subtracted in their entirety. Instead, the commentator suggested that in determining the net value of the disregarded entity, the final regulations should subtract only the pro rata portion of the amount of any obligation of the disregarded entity that is not a §1.752-2(b)(1) payment obligation of the disregarded entity and that is of equal priority to the §1.752-2(b)(1) payment obligation of the disregarded entity. Other commentators

suggested that prorating a disregarded entity's net value among equal priority obligations would add unnecessary complexity.

The comments illustrate the difficulty of taking into account priorities among obligations of the disregarded entity in determining the net value of the entity and the divergent views regarding the approach that best measures the economic risk of loss of a partner. The IRS and the Treasury Department believe that the regulations should provide clear and administrable rules that avoid unwarranted complexity. As a result, the final regulations provide that the net value of a disregarded entity is determined by subtracting all obligations (regardless of priority) of the disregarded entity that do not constitute §1.752-2(b)(1) payment obligations from the fair market value of the assets of the entity. That net value is reported by the owner to each partnership for which the disregarded entity may have one or more §1.752-2(b)(1) payment obligations. Each such partnership independently takes the net value of the disregarded entity into account under §1.752-2(k)(3) and allocates the net value among liabilities of that partnership in a reasonable and consistent manner, taking into account the relative priorities of those liabilities.

One commentator suggested that the final regulations clarify that a disregarded entity's interest in another partnership (other than the one for which the net value is being determined) is included as an asset to be valued for purposes of the net value calculation. This comment is adopted.

4. Valuation Events

Under the proposed regulations, after the net value of a disregarded entity is initially determined, the net value of the disregarded entity is not redetermined unless

(1) the obligations of the disregarded entity that do not constitute, and are senior or of equal priority to, §1.752-2(b)(1) payment obligations of the disregarded entity change by more than a de minimis amount or (2) there is more than a de minimis contribution to or distribution from the disregarded entity, of property other than property pledged to secure a partnership liability under §1.752-2(h)(1). In the preamble to the proposed regulations, the IRS and the Treasury Department requested comments on whether other events (such as a sale of substantially all of a disregarded entity's assets) should be specified as valuation events.

One commentator suggested that the disposition of a non-de minimis asset should require an adjustment to the net value of the disregarded entity only to the extent such asset changed in value, without valuing other assets held by the disregarded entity. The final regulations adopt this suggestion.

A commentator suggested that the regulations provide that changes in the owner's legally enforceable obligation to contribute to the disregarded entity be a valuation event. The final regulations adopt this comment.

Commentators suggested that certain events that would require the net value of a disregarded entity to be redetermined under the proposed regulations be eliminated as valuation events. For example, one commentator suggested that net value should not be redetermined if a disregarded entity refinances an obligation of the disregarded entity in the same amount. The IRS and the Treasury Department believe that the refinancing of a disregarded entity's obligation is an appropriate and administrable time to redetermine the net value of a disregarded entity. Accordingly, this suggestion is not adopted.

Another commentator suggested that the net value of a disregarded entity should not be redetermined with respect to a particular partnership in which the disregarded entity holds an interest if (1) a contribution by the owner of the disregarded entity to the disregarded entity corresponds to an equal contribution by the disregarded entity to the partnership or (2) a distribution from the partnership to the disregarded entity corresponds to an equal distribution by the disregarded entity to the owner of the disregarded entity. The IRS and the Treasury Department agree that these transfers to a disregarded entity, which remain in the disregarded entity only briefly, should not be valuation events. Accordingly, the final regulations adopt this comment.

5. Timing Issues

Commentators requested that the final regulations clarify the timing of the reallocation of partnership liabilities that may occur as a result of a change in the net value of a disregarded entity. The commentators suggested that, under the proposed regulations, a change in net value could result in a deemed distribution under section 752(b) that would require a determination of a partner's share of partnership liabilities for basis purposes under §1.705-1(a) and 1.752-4(d).

The final regulations clarify when the net value of a disregarded entity initially must be determined if a partnership interest is held by a disregarded entity, and the partnership has or incurs a liability, all or a portion of which may be allocable to the owner of the disregarded entity under §1.752-2(k). The final regulations clarify that a disregarded entity's net value generally is determined as of the earlier of (A) the first date occurring on or after the date on which the requirement to determine the net value of a disregarded entity arises on which the partnership otherwise determines a partner's

share of partnership liabilities under §§1.705-1(a) and 1.752-4(d), or (B) the end of the partnership's taxable year in which the requirement to determine the net value of a disregarded entity arises. For example, if a valuation event occurs during the partnership's taxable year, and subsequently, but before the end of the taxable year, the partnership makes a distribution that requires a determination of the distributee partner's basis in the partnership, the net value of the disregarded entity must be redetermined as of the date of the distribution.

Several commentators requested that the final regulations permit an election to redetermine the net value of a disregarded entity annually, regardless of the occurrence of a valuation event, and that if only one valuation event occurs during a partnership's taxable year, the owner have the option of using the net value of the disregarded entity as of the date of the valuation event rather than as of the date on which the partnership allocates liabilities under section 752. Because a change in the net value of a disregarded entity may require a shift of liabilities among partners, the IRS and the Treasury Department believe that valuations should be limited and should be required only as the result of a valuation event. Moreover, the timing of the net value determination should generally coincide with the date on which the partnership otherwise determines partners' shares of partnership liabilities. Accordingly, the final regulations do not adopt these comments.

6. Value of Pledged Property

Some commentators suggested that the final regulations conform the rules regarding the valuation of property pledged by partners as security for partnership liabilities with the rules regarding the determination of the net value of a disregarded

entity. The commentators also suggested allowing, but not requiring, partners to revalue pledged property annually. In response to these comments, the final regulations provide that if additional property is made subject to a pledge, the addition is treated as a new pledge and the net fair market value of all of the pledged property must be determined at that time. The IRS and the Treasury Department may continue to study whether further modifications to the pledge rule are necessary.

7. Compliance, Reporting, and Effective Date

Some commentators asked that the regulations provide that the partnership may make certain assumptions if a partner does not provide the information required. The IRS and the Treasury Department believe that partnerships are responsible for obtaining the required information in order to allocate partnership liabilities correctly among the partners, and that the partnership agreement should require that partners comply with the reporting requirements in the regulations. Thus, the final regulations do not adopt this comment.

Some commentators suggested that the estimated burden of complying with the paperwork requirements in the proposed regulations was too low. The estimated number of respondents has been increased from 500 to 1,500, and the average estimated time per respondent has been increased from 1 hour to 2 hours.

A commentator also suggested certain grandfathering provisions for partnerships with existing liabilities as of the effective date of the regulations. The IRS and the Treasury Department believe that the same rules should apply to all partnership liabilities incurred or assumed by a partnership on or after the date the regulations are final. Accordingly, this comment is not adopted.

Effective Date

The final regulations apply to liabilities incurred or assumed by a partnership on or after October 11, 2006, other than liabilities incurred or assumed by a partnership pursuant to a written binding contract in effect prior to October 11, 2006.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the amount of time necessary to report the required information will be minimal. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Charlotte Chyr, Office of Associate Chief Counsel (Passthroughs and Special Industries).

List of Subjects**26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.704-2 is amended as follows:

1. The text of paragraph (f)(2), the first sentence of paragraph (g)(3), and the third sentence of paragraph (i)(4) are revised.

2. Paragraph (l)(1)(iv) is added.

The revisions and addition read as follows :

§1.704-2 Allocations attributable to nonrecourse liabilities.

* * * * *

(f) * * *

(2) * * * A partner is not subject to the minimum gain chargeback requirement to the extent the partner's share of the net decrease in partnership minimum gain is caused by a recharacterization of nonrecourse partnership debt as partially or wholly recourse debt or partner nonrecourse debt, and the partner bears the economic risk of loss (within the meaning of §1.752-2) for the liability.

* * * * *

(g) * * *

(3) * * * A partner's share of partnership minimum gain is increased to the extent provided in this paragraph (g)(3) if a recourse or partner nonrecourse liability becomes partially or wholly nonrecourse. * * *

* * * * *

(i) * * *

(4) * * * A partner is not subject to this minimum gain chargeback, however, to the extent the net decrease in partner nonrecourse debt minimum gain arises because a partner nonrecourse liability becomes partially or wholly a nonrecourse liability. * * *

* * * * *

(l) * * *

(1) * * *

(iv) Paragraph (f)(2), the first sentence of paragraph (g)(3), and the third sentence of paragraph (i)(4) of this section apply to liabilities incurred or assumed by a partnership on or after October 11, 2006, other than liabilities incurred or assumed by a partnership pursuant to a written binding contract in effect prior to October 11, 2006. The rules applicable to liabilities incurred or assumed (or subject to a binding contract in effect) prior to October 11, 2006, are contained in this section in effect prior to October 11, 2006 (see 26 CFR part 1 revised as of April 1, 2006).

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Par. 3. Section 1.752-2 is amended as follows:

1. Paragraph (a), the last sentence of paragraph (b)(6), and paragraph (h)(3) are revised.
2. Paragraphs (k) and (l) are added.

The revisions and additions read as follows:

§1.752-2 Partner's share of recourse liabilities.

(a) * * * A partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the economic risk of loss. The determination of the extent to which a partner bears the economic risk of loss for a partnership liability is made under the rules in paragraphs (b) through (k) of this section.

* * * * *

(b) * * *

(6) * * * See paragraphs (j) and (k) of this section.

* * * * *

(h) * * *

(3) Valuation. The extent to which a partner bears the economic risk of loss for a partnership liability as a result of a direct pledge described in paragraph (h)(1) of this section or an indirect pledge described in paragraph (h)(2) of this section is limited to the net fair market value of the property (pledged property) at the time of the pledge or contribution. If a partner provides additional pledged property, the addition is treated as a new pledge and the net fair market value of the pledged property (including but not limited to the additional property) must be determined at that time. For purposes of this paragraph (h), if pledged property is subject to one or more other obligations, those obligations must be taken into account in determining the net fair market value of pledged property at the time of the pledge or contribution.

* * * * *

(k) Effect of a disregarded entity--(1) In general. In determining the extent to which a partner bears the economic risk of loss for a partnership liability, an obligation under paragraph (b)(1) of this section (§1.752-2(b)(1) payment obligation) of a business entity that is disregarded as an entity separate from its owner under sections 856(i) or 1361(b)(3) or §301.7701-1 through 301.7701-3 of this chapter (disregarded entity) is taken into account only to the extent of the net value of the disregarded entity as of the allocation date (as defined in paragraph (k)(2)(iv) of this section) that is allocated to the partnership liability as determined under the rules of this paragraph (k). The rules of this paragraph (k) do not apply to a §1.752-2(b)(1) payment obligation of a disregarded entity to the extent that the owner of the disregarded entity is otherwise required to make a payment (that satisfies the requirements of paragraph (b)(1) of this section) with respect to the obligation of the disregarded entity.

(2) Net value of a disregarded entity--(i) Definition. For purposes of this paragraph (k), the net value of a disregarded entity equals the following--

(A) The fair market value of all assets owned by the disregarded entity that may be subject to creditors' claims under local law (including the disregarded entity's enforceable rights to contributions from its owner and the fair market value of an interest in any partnership other than the partnership for which net value is being determined, but excluding the disregarded entity's interest in the partnership for which the net value is being determined and the net fair market value of property pledged to secure a liability of the partnership under paragraph (h)(1) of this section); less

(B) All obligations of the disregarded entity that do not constitute §1.752-2(b)(1) payment obligations of the disregarded entity.

(ii) Timing of the net value determination--(A) Initial determination. If a partnership interest is held by a disregarded entity, and the partnership has or incurs a liability, all or a portion of which may be allocable to the owner of the disregarded entity under this paragraph (k), the disregarded entity's net value must be initially determined on the allocation date described in paragraph (k)(2)(iv) of this section.

(B) Other events. If a partnership interest is held by a disregarded entity, and the partnership has or incurs a liability, all or a portion of which may be allocable to the owner of the disregarded entity under this paragraph (k), then, if one or more valuation events (as defined in paragraph (k)(2)(iii) of this section) occur during the partnership taxable year, except as provided in paragraph (k)(2)(iii)(E) of this section, the net value of the disregarded entity is determined on the allocation date described in paragraph (k)(2)(iv) of this section.

(iii) Valuation events. The following are valuation events for purposes of this paragraph (k):

(A) A more than de minimis contribution to a disregarded entity of property other than property pledged to secure a partnership liability under paragraph (h)(1) of this section, unless the contribution is followed immediately by a contribution of equal net value by the disregarded entity to the partnership for which the net value of the disregarded entity otherwise would be determined, taking into account any obligations assumed or taken subject to in connection with such contributions.

(B) A more than de minimis distribution from a disregarded entity of property other than property pledged to secure a partnership liability under paragraph (h)(1) of this section, unless the distribution immediately follows a distribution of equal net value

to the disregarded entity by the partnership for which the net value of the disregarded entity otherwise would be determined, taking into account any obligations assumed or taken subject to in connection with such distributions.

(C) A change in the legally enforceable obligation of the owner of the disregarded entity to make contributions to the disregarded entity.

(D) The incurrence, refinancing, or assumption of an obligation of the disregarded entity that does not constitute a §1.752-2(b)(1) payment obligation of the disregarded entity.

(E) The sale or exchange of a non-de minimis asset of the disregarded entity (in a transaction that is not in the ordinary course of business). In this case, the net value of the disregarded entity may be adjusted only to reflect the difference, if any, between the fair market value of the asset at the time of the sale or exchange and the fair market value of the asset when the net value of the disregarded entity was last determined. The adjusted net value is taken into account for purposes of §1.752-2(k)(1) as of the allocation date.

(iv) Allocation Date. For purposes of this paragraph (k), the allocation date is the earlier of--

(A) The first date occurring on or after the date on which the requirement to determine the net value of a disregarded entity arises under paragraph (k)(2)(ii)(A) or

(B) of this section on which the partnership otherwise determines a partner's share of partnership liabilities under §§1.705-1(a) and 1.752-4(d); or

(B) The end of the partnership's taxable year in which the requirement to determine the net value of a disregarded entity arises under paragraph (k)(2)(ii)(A) or (B) of this section.

(3) Multiple liabilities. If one or more disregarded entities have §1.752-2(b)(1) payment obligations with respect to one or more liabilities of a partnership, the partnership must allocate the net value of each disregarded entity among partnership liabilities in a reasonable and consistent manner, taking into account the relative priorities of those liabilities.

(4) Reduction in net value of a disregarded entity. For purposes of this paragraph (k), the net value of a disregarded entity is determined by taking into account a subsequent reduction in the net value of the disregarded entity if, at the time the net value of the disregarded entity is determined, it is anticipated that the net value of the disregarded entity will subsequently be reduced and the reduction is part of a plan that has as one of its principal purposes creating the appearance that a partner bears the economic risk of loss for a partnership liability.

(5) Information to be provided by the owner of a disregarded entity. A partner that may be treated as bearing the economic risk of loss for a partnership liability based upon a §1.752-2(b)(1) payment obligation of a disregarded entity must provide information to the partnership as to the entity's tax classification and the net value of the disregarded entity that is appropriately allocable to the partnership's liabilities on a timely basis.

(6) Examples. The following examples illustrate the rules of this paragraph (k):

Example 1. Disregarded entity with net value of zero. (i) In 2007, A forms a wholly owned domestic limited liability company, LLC, with a contribution of \$100,000.

A has no liability for LLC's debts, and LLC has no enforceable right to contribution from A. Under §301.7701-3(b)(1)(ii) of this chapter, LLC is a disregarded entity. Also in 2007, LLC contributes \$100,000 to LP, a limited partnership with a calendar year taxable year, in exchange for a general partnership interest in LP, and B and C each contributes \$100,000 to LP in exchange for a limited partnership interest in LP. The partnership agreement provides that only LLC is required to make up any deficit in its capital account. On January 1, 2008, LP borrows \$300,000 from a bank and uses \$600,000 to purchase nondepreciable property. The \$300,000 debt is secured by the property and is also a general obligation of LP. LP makes payments of only interest on its \$300,000 debt during 2008. LP has a net taxable loss in 2008, and under §§1.705-1(a) and 1.752-4(d), LP determines its partners' shares of the \$300,000 debt at the end of its taxable year, December 31, 2008. As of that date, LLC holds no assets other than its interest in LP.

(ii) Because LLC is a disregarded entity, A is treated as the partner in LP for Federal tax purposes. Only LLC has an obligation to make a payment on account of the \$300,000 debt if LP were to constructively liquidate as described in paragraph (b)(1) of this section. Therefore, under this paragraph (k), A is treated as bearing the economic risk of loss for LP's \$300,000 debt only to the extent of LLC's net value. Because that net value is \$0 on December 31, 2008, when LP determines its partners' shares of its \$300,000 debt, A is not treated as bearing the economic risk of loss for any portion of LP's \$300,000 debt. As a result, LP's \$300,000 debt is characterized as nonrecourse under §1.752-1(a) and is allocated as required by §1.752-3.

Example 2. Disregarded entity with positive net value. (i) The facts are the same as in Example 1 except that on January 1, 2009, A contributes \$250,000 to LLC. On January 5, 2009, LLC borrows \$100,000 and LLC shortly thereafter uses the \$350,000 to purchase unimproved land. LP makes payments of only interest on its \$300,000 debt during 2009. As of December 31, 2009, LLC holds its interest in LP and the land, the value of which has declined to \$275,000. LP has a net taxable loss in 2009, and under §1.705-1(a) and 1.752-4(d), LP determines its partners' shares of the \$300,000 debt at the end of its taxable year, December 31, 2009.

(ii) A's contribution of \$250,000 to LLC on January 1, 2009, constitutes a more than de minimis contribution of property to LLC under paragraph (k)(2)(iii)(A) of this section and the debt incurred by LLC on January 5, 2009, is a valuation event under paragraph (k)(2)(iii)(D) of this section. Accordingly, under paragraph (k)(2)(ii) of this section, LLC's value must be redetermined as of the end of the partnership's taxable year. At that time LLC's net value is \$175,000 (\$275,000 land - \$100,000 debt). Accordingly, \$175,000 of LP's \$300,000 debt will be recharacterized as recourse under §1.752-1(a) and allocated to A under this section, and the remaining \$125,000 of LP's \$300,000 debt will remain characterized as nonrecourse under §1.752-1(a) and is allocated as required by §1.752-3.

Example 3. Multiple partnership liabilities. (i) The facts are the same as in Example 2 except that on January 1, 2010, A forms another wholly owned domestic

limited liability company, LLC2, with a contribution of \$120,000. Shortly thereafter, LLC2 uses the \$120,000 to purchase stock in X corporation. A has no liability for LLC2's debts, and LLC2 has no enforceable right to contribution from A. Under §301.7701-3(b)(1)(ii) of this chapter, LLC2 is a disregarded entity. On July 1, 2010, LP borrows \$100,000 from a bank and uses the \$100,000 to purchase nondepreciable property. The \$100,000 debt is secured by the property and is also a general obligation of LP. The \$100,000 debt is senior in priority to LP's existing \$300,000 debt. Also, on July 1, 2010, LLC2 agrees to guarantee both LP's \$100,000 and \$300,000 debts. LP makes payments of only interest on both its \$100,000 and \$300,000 debts during 2010. LP has a net taxable loss in 2010 and, under §1.705-1(a) and 1.752-4(d), must determine its partners' shares of its \$100,000 and \$300,000 debts at the end of its taxable year, December 31, 2010. As of that date, LLC holds its interest in LP and the land, and LLC2 holds the X corporation stock which has appreciated in value to \$140,000.

(ii) Both LLC and LLC2 have obligations to make a payment on account of LP's debts if LP were to constructively liquidate as described in paragraph (b)(1) of this section. Therefore, under paragraph (k)(1) of this section, A is treated as bearing the economic risk of loss for LP's \$100,000 and \$300,000 debts only to the extent of the net values of LLC and LLC2, as allocated among those debts in a reasonable and consistent manner pursuant to paragraph (k)(3) of this section.

(iii) No events have occurred that would allow a valuation of LLC under paragraph (k)(2)(iii) of this section. Therefore, LLC's net value remains \$175,000. LLC2's net value as of December 31, 2010, when LP determines its partners' shares of its liabilities, is \$140,000. Under paragraph (k)(3) of this section, LP must allocate the net values of LLC and LLC2 between its \$100,000 and \$300,000 debts in a reasonable and consistent manner. Because the \$100,000 debt is senior in priority to the \$300,000 debt, LP first allocates the net values of LLC and LLC2, pro rata, to its \$100,000 debt. Thus, LP allocates \$56,000 of LLC's net value and \$44,000 of LLC2's net value to its \$100,000 debt, and A is treated as bearing the economic risk of loss for all of LP's \$100,000 debt. As a result, all of LP's \$100,000 debt is characterized as recourse under §1.752-1(a) and is allocated to A under this section. LP then allocates the remaining \$119,000 of LLC's net value and LLC2's \$96,000 net value to its \$300,000 debt, and A is treated as bearing the economic risk of loss for a total of \$215,000 of the \$300,000 debt. As a result, \$215,000 of LP's \$300,000 debt is characterized as recourse under §1.752-1(a) and is allocated to A under this section, and the remaining \$85,000 of LP's \$300,000 debt is characterized as nonrecourse under §1.752-1(a) and is allocated as required by §1.752-3. This example illustrates one reasonable method of allocating net values of disregarded entities among multiple partnership liabilities.

Example 4. Disregarded entity with interests in two partnerships. (i) In 2007, B forms a wholly owned domestic limited liability company, LLC, with a contribution of \$175,000. B has no liability for LLC's debts and LLC has no enforceable right to contribution from B. Under §301.7701-3(b)(1)(ii) of this chapter, LLC is a disregarded entity. LLC contributes \$50,000 to LP1 in exchange for a general partnership interest in LP1, and \$25,000 to LP2 in exchange for a general partnership interest in LP2. LLC

retains the \$100,000 in cash. Both LP1 and LP2 have taxable years than end on December 31 and, under both LP1's and LP2's partnership agreements, only LLC is required to make up any deficit in its capital account. During 2007, LP1 and LP2 incur partnership liabilities that are general obligations of the partnership. LP1 borrows \$300,000 (Debt 1), and LP2 borrows \$60,000 (Debt 2) and \$40,000 (Debt 3). Debt 2 is senior in priority to Debt 3. LP1 and LP2 make payments of only interest on Debts 1, 2, and 3 during 2007. As of the end of taxable year 2007, LP1 and LP2 each have a net taxable loss and must determine its partners' shares of partnership liabilities under §1.705-1(a) and 1.752-4(d) as of December 31, 2007. As of that date, LLC's interest in LP1 has a fair market value of \$45,000, and LLC's interest in LP2 has a fair market value of \$15,000.

(ii) Because LLC is a disregarded entity, B is treated as the partner in LP1 and LP2 for federal tax purposes. Only LLC has an obligation to make a payment on account of Debts 1, 2, and 3 if LP1 and LP2 were to constructively liquidate as described in paragraph (b)(1) of this section. Therefore, under this paragraph (k), B is treated as bearing the economic risk of loss for LP1's and LP2's liabilities only to the extent of LLC's net value as of the allocation date, December 31, 2007.

(iii) LLC's net value with respect to LP1 is \$115,000 (\$100,000 cash + \$15,000 interest in LP2). Therefore, under paragraph (k)(1) of this section, B is treated as bearing the economic risk of loss for \$115,000 of Debt 1. Accordingly, \$115,000 of LP1's \$300,000 debt is characterized as recourse under §1.752-1(a) and is allocated to B under this section. The balance of Debt 1 (\$185,000) is characterized as nonrecourse under §1.752-1(a) and is allocated as required by §1.752-3.

(iv) LLC's net value with respect to LP2 is \$145,000 (\$100,000 cash + \$45,000 interest in LP1). Therefore, under paragraph (k)(1) of this section, B is treated as bearing the economic risk of loss with respect to Debts 2 and 3 only to the extent of \$145,000. Because Debt 2 is senior in priority to Debt 3, LP2 first allocates \$60,000 of LLC's net value to Debt 2. LP2 then allocates \$40,000 of LLC's net value to Debt 3. As a result, both Debts 2 and 3 are characterized as recourse under §1.752-1(a) and allocated to B. This example illustrates one reasonable method of allocating the net value of a disregarded entity among multiple partnership liabilities.

(l) Effective dates. Paragraph (a), the last sentence of paragraph (b)(6), and paragraphs (h)(3) and (k) of this section apply to liabilities incurred or assumed by a partnership on or after October 11, 2006, other than liabilities incurred or assumed by a partnership pursuant to a written binding contract in effect prior to that date. The rules applicable to liabilities incurred or assumed (or subject to a binding contract in effect)

prior to October 11, 2006, are contained in §1.752-2 in effect prior to October 11, 2006 (see 26 CFR part 1 revised as of April 1, 2006).

PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 5. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805

Par. 6. Section 602.101 paragraph (b) is amended by adding a new entry to the table for "1.752-2" to read as follows:

§602.101 OMB Control numbers.

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(b) * * *

CFR part or section where identified and described	Current OMB control No.
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1.752-2	1545-1905
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/s/ Mark E. Matthews

Deputy Commissioner for Services and Enforcement.

Approved: June 30, 2006

/s/ Eric Solomon

Acting Deputy Assistant Secretary of the Treasury.