



Internal Revenue Service

DEPARTMENT OF THE TREASURY

LB&I Concept Unit

Unit Name	Determining Liability Allocations	
Primary UIL Code	752.00-00	Treatment of Certain Liabilities

Library Level	Title
Knowledge Base	Partnerships
Shelf	General Concepts
Book	Partnership Liabilities
Chapter	Liability Allocations

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General Overview

Determining Liability Allocations

The concept of liability allocation is covered under IRC 752 and the related regulations.

Partnership liability allocations have a major impact on the computation of a partner's basis in his partnership interest (outside basis). A partner must calculate outside basis in many situations, including when he receives a routine distribution of money, when he is allocated a loss, when the partnership redeems his interest in a liquidating distribution, or when he sells his interest in the partnership.

The partnership reports each partner's share of partnership liabilities at the end of the year on Schedule K-1 Part II, Section K. Liabilities are reported on Schedule K-1 in three categories: recourse, nonrecourse, and qualified nonrecourse. Qualified nonrecourse financing is nonrecourse financing borrowed for use in an activity of holding real property and is primarily relevant for purposes of the at-risk rules (which are beyond the scope of this practice unit). The subchapter K rules for allocating liabilities to partners distinguish only between nonrecourse and recourse debts.

An increase in a partner's share of partnership liabilities is treated as a contribution of money by the partner to the partnership and thus increases his outside basis. A decrease in a partner's share of partnership liabilities is treated as a distribution of money to the partner and thus decreases his outside basis. IRC 752(a) and (b).

General Overview (cont'd)

Determining Liability Allocations

Not all liabilities shown on a partnership's tax return balance sheet (Form 1065, Schedule L) are recognized as liabilities for tax purposes.

Treas. Reg. 1.752-1 defines partnership liabilities. In general, for a liability to be recognized for tax purposes, it must (1) create or increase the basis of any of the partnership's assets, (2) give rise to a tax deduction, or (3) give rise to an expense not properly deductible or chargeable to capital. With some liabilities such as environmental obligations, tort obligations, contract obligations, and pension obligations, the obligation might be recognized for Generally Accepted Accounting Principles (GAAP) purposes but do not meet the tests set forth in Treas. Reg. 1.752-1 and do not affect basis for tax purposes until satisfied. For additional information, see the Practice Unit on Recourse vs. Nonrecourse Liabilities.

Detailed Explanation of the Concept

Determining Liability Allocations

Recourse and Nonrecourse Liability Allocations

Analysis	Resources
<p><u>Allocating Recourse Liabilities</u></p> <p>Publication 541 and Treas. Reg 1.752-2 discuss the allocation rules for recourse liabilities.</p> <p>A partnership liability is a recourse liability to the extent that any partner or a related person has an economic risk of loss for that liability. A partner's share of a recourse liability equals his economic risk of loss for that liability. A partner has an economic risk of loss if that partner or a related person would be obligated, whether by agreement or law, to make a payment to the creditor or a contribution to the partnership with respect to the liability if the partnership were constructively liquidated. A partner who is the creditor for a liability that would otherwise be a nonrecourse liability of the partnership has an economic risk of loss in that liability.</p> <p>In sum, a partner bears the economic risk of loss if the partner or related person (1) has a payment obligation, Treas. Reg 1.752-2(b) (except for 1.752-2(d)(2)); (2) is a lender to the partnership, 1.752-2(c) (except for 1.752-2(d)(1)); (3) guarantees payment of interest, 1.752-2(e); or (4) pledges property as security for a partnership liability, 1.752-2(h).</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.752-2▪ Pub. 541

Detailed Explanation of the Concept (cont'd)

Determining Liability Allocations	
Analysis	Resources
<p><u>Allocating Recourse Liabilities (cont'd)</u></p> <p>A partner has an economic risk of loss if that partner or a related person would be obligated, whether by agreement or law, to make a payment to the creditor or a contribution to the partnership with respect to the liability if the partnership were constructively liquidated. This constructive liquidation test is a mechanical test used to quantify the extent of each partner economic risk.</p> <p>The constructive liquidation test has the following steps that are deemed to occur at the same time:</p> <ol style="list-style-type: none">1. The partnership liabilities are due and payable in full.2. Except for property contributed to secure a partnership liability, the assets held by the partnership are assumed to be worthless (including cash).3. The assets are sold in a taxable exchange for zero sales proceeds.4. The resulting losses and other attributes are allocated to the partners based on the partnership agreement.5. The partnership liquidates. <p>The result of this hypothetical liquidation will normally produce deficits in the capital accounts of one or more partners. The extent to which a partner would be required to contribute capital to eliminate these deficits represents the extent to which the partner is economically at risk on the recourse debt.</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.1001-2▪ Treas. Reg. 1.752-4(b)▪ Treas. Reg. 1.752-2(b)(4)▪ Treas. Reg. 1.752-2(d)(2)

Detailed Explanation of the Concept (cont'd)

Determining Liability Allocations	
Analysis	Resources
<p><u>Allocating Recourse Liabilities (cont'd)</u></p> <p>In limited liability companies (LLCs), LLC members are usually not economically at risk on LLC debt, absent a deficit-restoration obligation or member-level guarantee. If, however, an LLC member is economically at risk on an LLC liability, the constructive liquidation test will indicate the extent to which the LLC liability is allocated to that member under the recourse liability rules.</p> <p>A partner's nonrecourse loan to a partnership is a recourse loan to the partner to the extent another partner does not bear the economic risk of loss.</p> <p><u>Allocating Nonrecourse Liability With a Greater Than 25% Interest Guaranteed by a Partner</u></p> <p>If partner or related person guarantees the payment of more than 25% of the total interest that will accrue on the partnership nonrecourse liability, and the guarantor will be required to pay substantially all of the guaranteed future interest if the partnership fails to do so, then the liability is treated as two separate partnership liabilities. The partner or related person is treated as bearing the economic risk of loss for the liability to the extent of the present value of the guaranteed future interest. The remainder of the stated principal amount of the liability constitutes a nonrecourse liability. This rule does not apply for guarantees that do not exceed the lesser of five years or one-third of the term of the liability. Under a de minimis exception, this rule also does not apply if a partner or related person is a 10 percent or less partner any year when a partner and guarantees the interest on a partnership loan that is qualified nonrecourse financing.</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.752-2(e)▪ Treas. Reg. 1.704-2(b)(4)▪ Treas. Reg. 1.752-2(c)▪ Treas. Reg. 1.752-2(e)

Detailed Explanation of the Concept (cont'd)

Determining Liability Allocations	
Analysis	Resources
<p><u>Nonrecourse Debt</u></p> <p>A partnership liability is a nonrecourse liability if no partner or related person has an economic risk of loss for that liability.</p> <p>A partner's share of a nonrecourse liability is the sum of the following three components determined in the following order:</p> <ol style="list-style-type: none">1. The partner's share of partnership IRC 704(b) minimum gain (the amount by which nonrecourse debt exceeds the book basis of property securing the debt)2. The partner's share of IRC 704(c) minimum gain. IRC 704(c) minimum gain is amount by which the nonrecourse debt exceeds the tax basis of property securing the debt. This gain is generally allocated to the partner who contributed encumbered property.3. The partner's share of excess nonrecourse liabilities (the amount of debt not allocated by steps one and two above).	<ul style="list-style-type: none">▪ Treas. Reg. 1.752-3▪ IRC 704(b), (c)▪ Treas. Reg. 1.752-1(a)(2)

Detailed Explanation of the Concept (cont'd)

Determining Liability Allocations	
Analysis	Resources
<p><u>Minimum Gain</u></p> <p>Determining a partner's share of "minimum gain" is the first of the three steps in determining if nonrecourse debts are allocated properly to a partner.</p> <p>Minimum gain with respect to each nonrecourse loan is the amount of hypothetical gain (if any) that the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability. The amount outstanding on each nonrecourse loan is treated as sales proceeds for property securing the loan. For purposes of this hypothetical sale, the property's basis is the book basis and not the tax basis.</p> <p>Minimum gain commonly occurs when:</p> <ol style="list-style-type: none">1. Depreciation deductions on the property securing the debt reduce the property's basis below the balance on the debt;2. The partnership refinances the debt or takes out additional nonrecourse loans using partnership property as collateral; or3. The partnership makes a nonrecourse distribution to its partners. This occurs when the partnership borrows against the property on a nonrecourse basis and distributes the proceeds to its partners. If the resulting liability exceeds the securing property's book basis, the difference will result in minimum gain.	<ul style="list-style-type: none">▪ IRC 704(b)▪ Treas. Reg. 1.704-2▪ Treas. Reg. 1.704-1▪ Treas. Reg. 1.752-3(a)(1)

Detailed Explanation of the Concept (cont'd)

Determining Liability Allocations

Analysis

Resources

Nonrecourse Liability Allocation Under IRC 704(c) IRC 704(c) Minimum Gain

The second of the three steps in determining if a partnership has allocated nonrecourse liabilities correctly is to see if there is any IRC 704(c) minimum gain. IRC 704(c) minimum gain usually occurs when a partner contributes property subject to nonrecourse debt and the fair market value of the property is greater than its tax basis. This “built in” gain is known as IRC 704(c) gain. The excess of the nonrecourse debt over the tax basis of the contributed property is the amount of IRC 704(c) minimum gain. That is, it is the amount of IRC 704(c) gain that the contributing partner would recognize if the lender foreclosed on the contributed property and the partnership received nothing other than relief of the liability.

One way to determine if a partner contributed built-in gain property is to review the partners' Schedules K-1 and see if Part II, Section M indicates that the partner contributed property with a built-in gain or loss.

- IRC 704(c)
- Treas. Reg. 1.752-3(a)(2)

Detailed Explanation of the Concept (cont'd)

Determining Liability Allocations	
Analysis	Resources
<p><u>Excess Nonrecourse Liabilities</u></p> <p>The third of the three steps in allocating nonrecourse liabilities is to allocate the excess nonrecourse liabilities; i.e., the amount left over after allocating under the first and second steps.</p> <p>Generally, excess nonrecourse liabilities are allocated to the partners in proportion to how they share profits.</p> <p>The partnership may specify in the partnership agreement each partner's share of profits for purposes of allocating excess nonrecourse liabilities. The shares specified must be consistent with allocations of other significant items of partnership income and gain having substantial economic effect. All the facts and circumstances of the economic arrangement of the partners must be taken into account.</p> <p>The partnership can also allocate excess nonrecourse liabilities in the same manner it reasonably expects to allocate deductions attributable to the nonrecourse liabilities.</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.752-3(a)(3)▪ Rev. Rul. 95-41

Examples of the Concept

Determining Liability Allocations

Examples

Allocation of a Nonrecourse Liability

X and Y form Partnership XY, a general partnership. X contributes \$40 and Y contributes \$360.

Partnership XY purchases a building for \$2,000 and obtains a loan of \$1,600 with the building securing the loan.

Depreciation expense is \$180 per year and is allocated 75% to X and 25% to Y. All other expenses are allocated 50% to each partner.

Partnership XY pays only interest on the loan for the first 5 years. As of the end of year 3, the building has an adjusted tax basis of \$1,460 (\$2,000 original cost basis – \$540 tax depreciation).

Because Partnership XY made no principal payments on the loan, the balance of the loan is still \$1,600. The reduction in adjusted tax basis below the loan balance results in IRC 704(b) “minimum gain” of \$140 (\$1,600 loan balance - \$1,460 tax basis).

1. The liability is first allocated in accordance with how the partners share minimum gain. The minimum gain resulted from nonrecourse depreciation deductions (75%/25%). X’s share of minimum gain = \$105 (\$140 multiplied by 75%) and Y’s share = \$35 (\$140 multiplied by 25%).
2. Since the building was purchased by the partnership, it was not contributed by either partner. Under these facts, there is no IRC 704(c) minimum gain.
3. The partnership allocates the remaining liability, \$1,460 (\$1,600 total balance minus \$140 minimum gain) equally based on how the partners share items other than depreciation, \$730 each.

The result is that X’s share of nonrecourse liabilities is \$835 (\$105 minimum gain plus \$730 excess nonrecourse liabilities) and Y’s share is \$765 (\$35 minimum gain plus \$730 excess nonrecourse liabilities).

Examples of the Concept (cont'd)

Determining Liability Allocations

Examples

Allocation of a Recourse Liability

A and B form Partnership AB, a general partnership. A contributes \$40,000 and B contributes \$40,000.

The partnership borrows \$120,000 on a fully recourse basis and purchases a building for \$200,000. Partnership AB allocates losses 90% to A and 10% to B.

Both A and B are jointly and severally liable for the loan and the partnership agreement provides each has a full deficit restoration obligation.

In a constructive liquidation, Partnership AB's assets are deemed worthless and "sold" in a taxable transaction resulting in a loss of \$200,000 (the basis of the building).

The resulting loss of \$200,000 is allocated as follows:

A \$180,000 (\$200,000 multiplied by 90%).

B \$20,000 (\$200,000 multiplied by 10%).

Examples of the Concept (cont'd)

Determining Liability Allocations

Examples

Allocation of a Recourse Liability (cont'd)

The impact of the loss on the partners' capital accounts is as follows:

	<u>Partner A</u>	<u>Partner B</u>
Beginning Capital (initial contribution)	\$40,000	\$40,000
Loss on hypothetical sale	(\$180,000)	(\$20,000)
Ending Capital	(\$140,000)	\$20,000

The extent to which any partner is required to restore a negative capital account reflects the extent the partner's economic risk on the recourse debt. All facts and circumstances must be developed in the analysis, as other items may affect the requirement to restore the deficit. Such items may include contractual obligations outside of the partnership agreement (e.g. indemnification agreements, loss limiting arrangements, etc.).

Index of Referenced Resources

Determining Liability Allocations

IRC 704

IRC 752

Treas. Reg. 1.704-1

Treas. Reg. 1.704-2

Treas. Reg. 1.705-1

Treas. Reg. 1.752-1

Treas. Reg. 1.752-2

Treas. Reg. 1.752-3

Treas. Reg. 1.752-4

Treas. Reg. 1.1001-2

Rev. Rul. 95-41

Pub. 541

Training and Additional Resources

Determining Liability Allocations	
Type of Resource	Descriptions
Reference Materials – Treaties	<ul style="list-style-type: none">▪ Partnership Knowledge Base, Recourse/Nonrecourse Liabilities▪ Partnership Knowledge Base, Liability Allocations▪ 1065 Deskbook, Chapter 25
Other Training Materials	<ul style="list-style-type: none">▪ Integrated Talent Management. Partnership Liabilities 76268r.▪ Integrated Talent Management. Partnership Liabilities 76268.▪ Integrated Talent Management. Partnership Allocations 49430.

Glossary of Terms and Acronyms

Term/Acronym	Definition
GAAP	Generally Accepted Accounting Principles

Index of Related Practice Units

Associated UILs	Related Practice Unit
752-0	<i>Recourse vs. Nonrecourse Liabilities</i>
705-0	<i>Partner's Outside Basis</i>