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<AT>Temporary and Proposed Section 752 Regulations: Progress or Regress?

<BY>Walter D. Schwidetzky[*]

<H1>Introduction

In October 2016, the Internal Revenue Service issued temporary and proposed regulations under Internal Revenue Code Sections 752 and 704 ("the 2016 Regulations").[1] In this article, I take a rigorous look at the 2016 Regulations. Ultimately, I conclude that while the 2016 Regulations at times address valid concerns, at other times they exceed the IRS's authority, lead to an inappropriate disjuncture with Section 465, and create impractical rules. My preference would be for the 2016 Regulations to be withdrawn and replaced with anti-abuse rules. Failing that, they should be brought into compliance with the IRS's authority and be subject to a de minimis rule.

<H1<Background

To provide the reader with a proper grounding, this section looks at the underlying law informing the regulations.[2]

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[1] See TD 9787, 2016-2 CB 878 (final regulations); TD 9788, 2016-2 CB 889 (final and temporary regulations); REG-122855-15, 2016-2 CB 922 (proposed regulations). (Final regulations also affected the disguised sale rules of IRC § 707(a), a subject I do not discuss.) For an excellent discussion of the 2016 Regulations and an article that informed my own effort, see Richard M. Lipton, Samuel P. Grilli & Nicole D. Renchen, "Final, Temporary, and Proposed Regulations: Is the Road to Hell Paved with Good Intentions?" 126 J. Tax'n 53 (2017) [hereinafter "Road to Hell"].

[2] In this section, I borrow liberally from Richard Lipton, Paul Carman, Charles Fassler & Walter Schwidetzky, *Partnership Taxation* **¶[AU, THIS IS SUPPOSED TO BE A ¶ SYMBOL, RIGHT?]** 3.04 (4th ed., 2017).

<H2>**At-Risk Rules.** Section 704(d) provides that a partner cannot deduct losses in excess of his basis in his partnership interest ("outside basis").[3] Even if a partner has sufficient outside basis to absorb a loss, however, the "at-risk rules" of Section 465 can require deferring all or part of the loss. Section 465 in turn can interact with Section 752 in ways relevant to this article, so I will begin with a brief discussion of the at-risk rules.

Generally, Section 465(a) provides that individuals and certain closely held corporations are only allowed to take a loss deduction from an activity to the extent of the taxpayer's amount at-risk for the taxable year in that activity, with any disallowed loss carried forward until a sufficient amount at-risk is developed.[4] The amount at risk includes money contributed by the taxpayer and the basis of property contributed by the taxpayer. It also includes amounts borrowed for use in the activity for which the taxpayer has unprotected personal liability or, alternatively, for which the taxpayer has provided property as security, to the extent of the net fair market value of the property, provided the property is not used in the activity.[5] As the Tax Court has noted, the critical inquiry, in the case of personal liability on debt, is who the obligor of last resort is when the partnership fails.[6]

Courts have varying opinions as to how probable a taxpayer's ultimate economic exposure on debt has to be in order for it to be included in the amount at risk. In the Sixth Circuit's view, the question is "whether, in a worst-case scenario, the individual taxpayer will

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[3] Under IRC § 704(d), any disallowed loss is carried forward to future years. Any allowed loss can be subject to the parallel loss limitation rules of IRC §§ 465 and 469. (Unless otherwise indicated, all references to Sections in the text are to the Internal Revenue Code of 1986, as amended, or the regulations thereunder.)
[4] IRC § 465(a).
[5] IRC § 465(b); generally, amounts borrowed are not considered at risk if borrowed from a person with an interest in the activity or from a person related to a person (other than the taxpayer) with an interest in the activity; see Pritchett v. Comm'r, 827 F2d 644 (9th Cir. 1987); Gefen v. Comm'r, 87 TC 1471 (1986); Abramson v. Comm'r, 86 TC 360 (1986).
[6] Melvin v. Comm'r, 88 TC 63, 75 (1987), aff'd, 894 F2d 1072 (9th Cir. 1990).

suffer any personal, out-of-pocket expenses."[7] The Tax Court and several other circuits apply a "realistic possibility test." Under this latter test, taxpayers have been held not to be at risk if a transaction is structured such that it removes any "realistic possibility" that the taxpayer will suffer an economic loss.[8] As I will discuss in the next section, in the past the regulations have applied similar principles when analyzing economic risk of loss under Section 752, and that was entirely appropriate. The at-risk rules and the economic risk of loss rules get at the same issue, bottom-line obligations on recourse debt.

<H2>Section 752 and (Mostly) Recourse Debt. Section 752(a) provides that an increase in a partner's share of partnership liabilities is treated as a contribution of money by the partner to the partnership, which increases the partner's outside basis under Section 722(a). This ability of entity-level debt to increase owner-level basis is unique to partnership taxation, which is why entities taxable as partnerships often are the preferred vehicle for business or investment purposes. Partnerships have an advantage over S corporations in this regard, where corporate liabilities do not increase a shareholder's basis in her stock. The partner's ability to include partnership liabilities in her basis for her partnership interest enables her to claim deductions flowing through the partnership in excess of the amount she actually contributed to the partnership. Concomitantly , Section 752(b) provides that a decrease in a partner's share of a partnership's liabilities is treated as a distribution to that partner, reducing the partner's outside basis under Section 733. If the reduction exceeds the partner's outside basis, the partner has gain under Section

[7] Pledger v. U.S., 236 F3d 315, 319 (6th Cir. 2000); see also Emershaw v. Comm'r, 949 F2d 841 (6th Cir. 1991).
[8] See, e.g., Waters v. Comm'r, 978 F2d 1310, 1316–17 (2d Cir.1992), cert. denied, 507 U.S. 1018 (1993); Young v. Comm'r, 926 F2d 1083, 1089 (11th Cir.1991); Moser v. Comm'r, 914 F2d 1040 (8th Cir.1990); Am. Principals Leasing Corp. v. U.S., 904 F2d 477 (9th Cir.1990). Levy v. Comm'r, 91 TC 838 (1988); Wag-a-Bag, Inc. v. Comm'r, TC Memo. 1992-581.

731(a)(1).

Finally, Section 752(d) provides that in the case of a sale or exchange of a partnership interest, liabilities are to be treated in the same manner as liabilities in connection with the sale of property other than a partnership interest—that is, liabilities associated with a selling partner's partnership interest are included in the amount realized.[9]

These rules may sound straightforward, but in application they can become challenging. To give one example, partners entering or leaving a partnership can change how debt is shared among all the partners. To address the many variations on the basic theme, the regulations implementing Section 752 are lengthy and complex.

The Section 752 Regulations have a very different scheme for allocating recourse and nonrecourse liabilities. Treasury Regulation Section 1.752-1(a)(1) provides that a "liability is a recourse liability of a partnership to the extent that any partner or related person bears the economic risk of loss for that liability under [Treasury Regulation Section] 1.752-2." Some basics: Generally, "economic risk of loss" speaks to bottom-line obligations of a partner on partnership debt, after taking into account all facts and circumstances, including rights of contribution among partners. Assume a general partnership, which is not a limited liability partnership, has two partners, one who holds a 60 percent interest and one who holds a 40 percent interest. Generally, and unsurprisingly, the two partners will typically share the economic risk of loss on any partnership recourse debt 60/40. Now assume a limited partnership, with one general partner and one limited partner. Since under state law, only the general partner

[9] Generally, when a taxpayer sells property, liabilities assumed by the purchaser, as well as liabilities to which the property sold is subject, are treated as part of the amount realized.

is liable to creditors in its capacity as a partner,[10] ordinarily the general partner has all the economic risk of loss on any partnership recourse debt and the limited partner has none. It is possible for a limited partner to voluntarily take on some part of that economic risk of loss, however, by making an agreement to that effect with the lender and/or the general partner. Limited partners often want to do this in order to increase their bases in their partnership interests, thereby allowing them to deduct more losses.

<H2>Capital Accounts: Interplay of Regulations Under Sections 752 and 704. The Section 752 regulations are intertwined with the Section 704(b) regulations for keeping capital accounts, which can be thought of as measures of partners' economic investment in the partnership. Commonly, each partner has a capital account. Generally, a capital account is increased by money contributed, the fair market value (not basis) of property contributed, and income. It is decreased by money distributed, the fair market value of property distributed, and losses.[11] Note that liabilities do not go into the calculation of capital accounts (other than reducing the value of contributed and distributed property), unlike tax basis of a partner's partnership interest. Tax basis can never be negative—one of the few rules in tax without an exception.[12] A capital account can be negative, however. One way this can happen is if debt increases a partner's outside basis. If a partner contributes cash and is allocated partnership liabilities, his outside basis will initially exceed his capital account balance. Losses allocated to a partner can reduce both his outside basis and his capital account. Since the outside basis was higher to begin with, the capital account will go negative before the tax basis is "used up."

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[10] Barring unusual circumstances.
[11] Treas. Reg. § 1.704-1(b)(2)(iv)(a).
[12] Outside the consolidated corporate group context.

<H3>*Economic Risk of Loss on Recourse Debt.* Generally, in the recourse debt context, a partner may have a negative capital account to the extent he has an obligation to pay to the partnership any negative balance no later than the liquidation of the partnership interest.[13]. Generally, a partner can have the economic risk of loss on recourse debt to the extent that the partner has an obligation to restore a negative capital account, since the money he is obligated to pay to the partnership can be used to pay the recourse debt.[14] As I will discuss below, the new Temporary Regulations change the general rule under unusual circumstances.

More specifically, Treasury Regulation Section 1.752-2(b)(1) generally provides that a partner or related person bears the economic risk of loss with respect to a liability to the extent that, on a constructive liquidation of the partnership: (1) the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because the liability became due and payable, and (2) the partner or related person would not be entitled to reimbursement from another partner or a person related to another partner.

<H3>*Constructive Liquidation.* In a constructive liquidation, all the following events are deemed to have occurred simultaneously (this is sometimes called "the nuclear bomb test"):

- All the partnership's liabilities become payable in full.
- All the partnership's assets, including cash, have a value of zero, other than property contributed by a partner to secure a partnership liability.

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[13] Technically, within 90 days of liquidation. See Treas. Reg. § 1.704-1(b)(2)(ii)(a)–(c).

[14] See Treas. Reg. § 1.752-2(b)(3)(ii). However, a "deficit restoration obligation" in the view of the Tax Court may not increase the partner's "at-risk" amount under IRC § 465. See Hubert Enters., Inc. v. Comm'r, TC Memo 2008-46, a heavily criticized opinion. See Walter Schwidetzky, "The Negative Capital Account Maze," 152 Tax Notes 1107 (2016) [(hereinafter "Maze")].

- The partnership disposes of all its property in a fully taxable transaction for no consideration other than the release of liability with respect to nonrecourse liabilities (Book values are commonly used for this calculation, since capital accounts are calculated using book values. Book value of a partnership asset starts at its fair market value upon acquisition. Like tax basis, it can be increased for additional investments in the property and decreased by, for example, depreciation deductions.)
- All items of income, gain, loss, etc. are allocated among the partners.
- (The partnership liquidates.[15] **<END BL>**

As indicated, in a constructive liquidation, property is generally considered to be sold for no consideration and thus generates losses that are allocated to the partners. These hypothetical losses could create negative capital accounts that partners could have an obligation to restore. A partner may have economic risk of loss on a debt to the extent of such a deficit restoration obligation.[16] Thus, under the nuclear bomb test, the regulations assign economic risk of loss based on a worst-case scenario.

Even if a partner is obligated to make a payment, the partner's obligation to make the payment is reduced to the extent that the partner or a related person is entitled to reimbursement from another partner or a person related to another partner.[17] In determining whether a person

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[15] Treas. Reg. § 1.752-2(b)(1).
[16] In the nuclear bomb test, there is an exception to the zero consideration rule for property subject to nonrecourse debt. In that case, the property subject to that debt is treated as sold for an amount equal to the amount of the subject nonrecourse debt, and gain or loss is recognized depending upon the partnership's basis for the asset subject to the nonrecourse debt. Treas. Reg. § 1.752-2(b)(2).
[17] Treas. Reg. § 1.752-2(b)(5).

has a payment obligation, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, notwithstanding their net worth, unless—in essence—they are not acting in good faith.[18] Notwithstanding this general rule, if the partner is a disregarded entity (most commonly, a single-member limited liability company (LLC)),[19] then different rules apply. A different rule is necessary because, for example, the single member of an LLC, in her capacity as a member, is not liable for the obligations of the LLC. For a disregarded entity, the payment obligation is generally taken into account only to the extent of the net value of the disregarded entity as of the date on which the determination of the partner's share of partnership liabilities is determined.[20] The net value of a disregarded entity is generally equal to the fair market value of all the assets of the disregarded entity that may be subject to creditors' claims under local law (excluding the disregarded entity's interest in the partnership in question), less obligations of the disregarded entity.[21]

At the end of the day, then, notwithstanding the literal language of Treasury Regulation Section 1.752-2(b)(1) and its nuclear bomb test, economic risk of loss is determined under all the facts and circumstances. Temporary Regulation Section 1.752-2T(b)(3)(i) reaffirms this view, providing that "the determination of the extent to which a partner or related person has an obligation to make a payment under [Treasury Regulation Section] 1.752–2(b)(1) is based on the facts and circumstances at the time of the determination."[22] This Temporary Regulation provides

[18] Treas. Reg. § 1.752-2(j).
[19] A disregarded entity is generally a business entity other than a corporation which has a single owner. A disregarded entity is treated as a sole proprietorship if it is owned by an individual and as a division if it is owned by another entity. Treas. Reg. §§ 301.7701-2(c)(2), 301.7701-3(b)(1)(ii).
[20] Treas. Reg. § 1.752-2(k)(1); If the owner of the disregarded entity is required to make a payment with respect to an obligation, however, then this rule generally does not apply to the extent of the owner's obligation. Id.
[21] Treas. Reg. § 1.752-2(k)(2). This is a simple look at what are fairly involved regulations.
[22] Temp. Treas. Reg. § 1.752-2T(b)(3)(i) replaced similar language previously contained in Treas. Reg. § 1.752-2(b)(3).

a nonexclusive list of relevant facts and circumstances: All statutory and contractual obligations relating to the partnership liability are taken into account, including (1) contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors, to other partners, or to the partnership; (2) obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership; and (3) payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state or local law, including the governing state or local law partnership statute.[23]

<H2>Section 752 and Nonrecourse Debt. I will keep this discussion brief, as nonrecourse debt plays a subsidiary role in this article. Nonrecourse debt is debt on which no partner has the economic risk of loss.[24] Nonrecourse liabilities are allocated based upon the following three-tier formula set forth in Regulation Section 1.752-3(a) (sometimes called a “stacking rule”):

- *Tier 1:* First, a nonrecourse liability is allocated to the partners based on their respective shares of partnership “minimum gain.” Minimum gain is determined in accordance with the rules of Treasury Regulation Section 1.704-2(d)(1), and a partner’s share of minimum gain is determined in accordance with Treasury Regulation Section 1.704-2(g)(1).

[23] Treas. Reg. § 1.752-2T (b)(3)(i). To the extent that the obligation of a partner or related person to make a payment with respect to a partnership liability is not recognized, Treas. Reg. § 1.752–2(b) is applied as if the obligation did not exist. Id.
[24] Treas. Reg. § 1.752-1(a)(2).

Generally, minimum gain is the amount by which a nonrecourse debt exceeds the book value of property. Assume a partnership buys a property for $1,000, paying $200 and financing the balance with an $800 nonrecourse loan which secures the property. Initially there is no minimum gain, as the book value of $1,000 exceeds the nonrecourse debt of $800. Assume depreciation deductions reduce the book value to $700 and that the nonrecourse debt remains unchanged, only interest having been paid on the debt. Now there is $100 of minimum gain.

- *Tier 2:* Second, a nonrecourse liability is allocated to the partners to the extent of their shares of the taxable gain that would be allocated to them under Section 704(c) (or in the same manner as Section 704(c) in the case of revalued partnership property) if the partnership disposed of the property subject to the nonrecourse liability in satisfaction of that liability and for no other consideration.[25] Assume partner A contributes property to a partnership with a fair market value of $1,000, a tax basis of $100, and the property is subject to a nonrecourse debt of $400. There is no minimum gain here, as minimum gain only exists to the extent that the nonrecourse debt exceeds book value, a fact that would almost never exist upon the contribution of property to a partnership. (That would mean the property is "underwater," which few partnerships are keen to acquire.) Here book value is $1,000. Under the second tier of the allocations, however, $300 of the nonrecourse debt is allocated to partner A (that is, the amount by which the nonrecourse debt exceeds tax basis, $400 − $100 = $300).

[25] This method is not reasonable, however, if the amount allocated, when added to other liabilities burdening a property, is in excess of the fair market value of the property. Treas. Reg. § 1.752-3(b)(1).

- *Tier 3:* Third, the partners are allocated their shares of the balance of the nonrecourse liabilities (referred to as “excess nonrecourse liabilities”) in accordance with the partners’ shares of partnership profits. Each partner’s interest in profits is determined by taking into account all the facts and circumstances relating to that partner’s interest in the partnership.[26]

<H1>Temporary Regulations and Bottom-Dollar Payment Obligations

The IRS[27] has promulgated new Temporary Regulation Section 1.752-2T (the “Temporary Regulations”) [28] that fundamentally changes how the economic risk of loss rules operate in certain contexts. A partner now generally does not have the economic risk of loss on a “bottom-dollar payment obligation,”[29] notwithstanding the fact that the partner has bottom-line liability on the debt, at least in a worst-case scenario. Consider the following example of a bottom-dollar payment obligation:

> ***Example:*** An LLC taxed as a partnership has a liability of $1000, and partner B gives a guarantee (without right of reimbursement) under which B is liable to the creditor only to the extent the creditor collects less than $200 in the aggregate on the debt from all other obligors. B thus has no liability if the creditor collects over $200 from the other obligors.

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[26] The regulations contain a number of variations on this theme, not relevant to this article. See Treas. Reg. § 1.752-3(a)(3).

[27] Technically, they were promulgated by the Treasury Department, of which the IRS forms a part.

[28] The Temporary Regulations became effective on October 5, 2016, and transition rules apply if a partner had the economic risk of loss on a debt under the regulations as promulgated before that effective date. Treas. Reg. § 1.752-2T(l)(2). The Temporary Regulations also contain an obligation to report any bottom dollar payment obligation. Treas. Reg. § 1.752-2T(b)(3)(ii)(D). The Temporary Regulations generally expire on October 4, 2019. Treas. Reg. § 1.752-2T(m)(1), but two parts expire on October 11, 2019. Treas. Reg. § 1.752-2T(m)(2).

[29] Treas. Reg. § 1.752-2T(b)(3)(ii)(A).

B has essentially guaranteed the bottom layer of the debt, hence the name.

In the past, B could have had the economic risk of loss on this type of guarantee, but typically not under the new Temporary Regulations. Generally, a bottom-dollar payment obligation exists unless a partner (or related person) is liable if any of the partnership's liability is unpaid.[30] Thus, in order for B to have the economic risk of loss on his $200 guarantee, under the general rule of the Temporary Regulations he must be liable for the $200 if any part of the partnership's $1,000 liability goes unpaid. Because partners are not considered to have the economic risk of loss on bottom-dollar payment obligations, the associated debt is not considered to be recourse debt and thus must be allocated under the rules for allocating nonrecourse debt. It is conceivable that a Tier 2 nonrecourse debt allocation could be triggered, but—like the Temporary Regulations—I will assume that there will be a Tier 3 allocation, and that the allocation will be based on partnership profits.

<H2>What Makes an Arrangement a Bottom-Dollar Payment Obligation? A payment obligation is not a bottom-dollar payment obligation merely because a maximum amount is placed on the partner's payment obligation, a partner's payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates, or there is a right of proportionate contribution running between partners who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.[31] Thus, in the example above, the fact that B's maximum liability is limited to $200 does not in and of itself

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[30] Treas. Reg. § 1.752-2T(b)(3)(ii)(C).
[31] Treas. Reg. § 1.752-2T(b)(3)(ii)(C)(2).

create a bottom-dollar payment obligation. Nor would a bottom-dollar payment obligation be created if, for example, B were liable for 20 percent of the partnership debt, or liable for all of it but with a right to contribution of $800 from the other partners.

<H3>*Catch-All Rule.* A bottom-dollar payment obligation includes an arrangement with respect to a partnership liability that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements, and with a principal purpose of avoiding having at least one of such liabilities or payment obligations with respect to such liabilities being treated as a bottom-dollar payment obligation.[32]

<H3> *Examples from Temporary Regulations.* Unfortunately, the Temporary Regulations do not give an example of when this catch-all rule would apply, but it seems clear that fancy footwork will not convert a bottom-dollar obligation into a non-bottom-dollar obligation.

The basics are laid out in Example 10 from the Temporary Regulations: A, B, and C are equal members of ABC LLC. ABC is treated as a partnership for federal tax purposes. ABC borrows $1,000 from Bank. Without more, the debt would be nonrecourse, since members of an LLC are not liable for the LLC's obligations and thus would have no economic risk of loss on the debt. But in the example there is more. Partner A guarantees payment of up to $300 of the

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[32] Treas. Reg. § 1.752-2T(b)(3)(ii)(C).

ABC liability if any amount of the full $1,000 liability is not recovered by Bank. Partner B guarantees payment of up to $200, but only if Bank otherwise recovers less than $200. Both A and B waive their rights of contribution against each other. Because A is obligated to pay up to $300 if, and to the extent that, any amount of the $1,000 partnership liability is not recovered by Bank, A's guarantee is not a bottom-dollar payment obligation. Therefore, A's payment obligation is recognized and the amount of A's economic risk of loss is $300. Because B is obligated to pay up to $200 only if and to the extent that Bank otherwise recovers less than $200 of the $1,000 partnership liability, however, B's guarantee is a bottom-dollar payment obligation and, therefore, is not recognized as a recourse liability. Accordingly, B bears no economic risk of loss for ABC's liability. Consequently, $300 of the debt is recourse and is allocated to A under Treasury Regulation Section 1.752–2(a), and $700 is nonrecourse and is allocated equally to A, B, and C because they share profits equally, under Treasury Regulation Section 1.752-3.

There is a *de minimis* exception for bottom-dollar payment obligations. A bottom-dollar payment obligation will not be considered to exist if the partner is liable for at least 90 percent of the partner's initial payment obligation.[33] Thus, in the above example, A can have the economic risk of loss on the entire $300 guarantee, as long as A is liable for up to at least $270 (90 percent of $300) should any part of the $1,000 debt go unpaid.

There is a special rule[34] for indemnities and reimbursement obligations, under which an indemnity, reimbursement agreement, or similar arrangement will be recognized only if, before taking into account the indemnity, reimbursement agreement, or similar arrangement, the indemnitee's or other benefited party's payment obligation is recognized and not treated as a

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[33] Treas. Reg. § 1.752-2T(b)(3)(ii)(B).
[34] Treas. Reg. § 1.752-2T(b)(3)(iii).

bottom-dollar payment obligation.

The Temporary Regulations begin to lose their way in Example 11: The facts are the same as in Example 10, except that, in addition, C agrees (1) to indemnify A up to $100 that A pays with respect to his guarantee and (2) to indemnify B fully with respect to his guarantee. The determination of whether C's indemnity is recognized under the Temporary Regulations is made without regard to whether C's indemnity itself causes A's guarantee not to be recognized. Because A's obligation would be recognized but for the effect of C's indemnity and C is obligated to pay A up to the full amount of C's indemnity if A pays any amount on its guarantee of ABC's liability, C's indemnity of A's guarantee is not a bottom-dollar payment obligation under the Temporary Regulations and, therefore, is recognized. The amount of C's economic risk of loss under Treasury Regulation Section 1.752–2(b)(1) for its indemnity of A's guarantee is $100. Because C's indemnity is recognized, A is treated as liable for $200—that is, to the extent any amount beyond $100 of the partnership liability is not satisfied. Because A is not liable if, and to the extent, any amount of the partnership liability is not otherwise satisfied—that is, A is not liable for the first (or top) dollar of any unpaid part of the debt—the Temporary Regulations conclude that A's guarantee is a bottom-dollar payment obligation.

Note that none of the exceptions applies in the Example 11 scenario. Thus, A bears no economic risk of loss under Treasury Regulation Section 1.752–2(b)(1) for any of ABC's liability. Because B's obligation is not recognized independent of C's indemnity of B's guarantee, C's indemnity with regard to B is not recognized either. Therefore, C bears no economic risk of loss under Treasury Regulation Section 1.752–2(b)(1) for its indemnity of B's guarantee. Consequently, according to Example 11, $100 of the debt is recourse and $900 is nonrecourse; $100 of ABC's liability is allocated to C under Treasury Regulation Section 1.752–

2(a) and the remaining $900 liability is allocated to A, B, and C equally because they share profits equally, under Treasury Regulation Section 1.752-3.

<H2>An Untenable Outcome. Example 11 illustrates how the Temporary Regulations can result in an untenable outcome. In Example 10, A has $300 of economic risk of loss, but A has no economic risk of loss whatsoever in Example 11 as a result of another partner's taking the first $100 of A's risk. Under the prior regulations, A and C would have split the $300 top dollar economic risk of loss, $200 allocated to A and $100 allocated to C. And that is the more logical outcome. A has $200 of legitimate and realistic economic risk of loss that Example 11 is ignoring, in my view indefensibly, for debt allocation purposes.[35] The IRS can appropriately ask what the probability is that a partner might have to pay on the debt. If it is too remote, then it would be fair to say that the partner does not have the economic risk of loss on the debt. But the IRS is not asking this question. If it did, A would have $200 of economic risk of loss, because the likelihood of A having to pay on the debt if the partnership gets into financial trouble is rather high. Once the first 10 percent of the debt is paid by C, A can be liable.

Furthermore, there is no doubt under current case law that in Example 11 A is at risk under Section 465 on $200 of the partnership debt, notwithstanding that A has no economic risk of loss under the Temporary Regulations. Under either the Sixth Circuit's worst-case test or other courts' realistic possibility test, A is at risk since he can be liable if between 10 percent and 30 percent of the debt goes unpaid, hardly an unrealistic possibility (and an inevitability under the Sixth Circuit's test). Consequently, the Temporary Regulations create a disjuncture between

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[35] A similar view is espoused in Road to Hell, supra note 1.

the at-risk rules and the economic risk of loss rules, notwithstanding that both sets of rules are designed to look at bottom-line obligations on debt. Without a doubt, both sets of rules are *in pari materia*, and under well-settled law should be interpreted following the same principles.[36] This disjuncture is not justified.

Finally, Congress made it clear that it wanted the Service to focus on economic risk of loss in its Section 752 regulations on recourse debt. The impetus for the congressional directive was the U.S. Claims Court's decision in *Raphan v. United States*,[37] which held that a general partner who guaranteed repayment of what was otherwise a nonrecourse debt of the partnership was not to be treated as personally liable for that debt, because the guarantee was not considered as given in the general partner's capacity as a partner. The debt thus retained its nonrecourse status, and the limited partners were entitled to take into account a portion of the debt in computing the bases of their partnership interests, allowing them loss deductions that otherwise would have been suspended under Section 704(d). Subsequently, in a Conference Report, Congress made it clear that it wanted the regulations to overrule *Raphan* and allocate recourse debt based on a partner's economic risk of loss: **<Q>**

> The conferees intend that the new regulations will reject the holding of the *Raphan* decision. . . . The conferees intend that the revisions to the [S]ection 752 regulations will be based largely on the manner in which the partners, and persons related to the partners, share the economic risk of loss with respect to partnership debt (other than bona fide

[36] See Erlenbaugh v. U.S., 409 U.S. 239 (1972); Robinson v. Comm'r, 675 F2d 774 (1982); Road to Hell, supra note 1.

[37] 3 Cl. Ct. 457 (1983); see Rev. Rul. 83-151, 1983-2 CB 105. The court was reversed on this issue. 759 F2d 879 (Fed. Cir. 1985).

nonrecourse debt, as defined by such regulations).[38] **<END Q>**

It is axiomatic that regulations cannot exceed a congressional mandate.[39] Yet in Example 11, with regard to A, it is clear that the IRS has done just that. Necessarily, economic risk of loss must look at a partner's obligation should the partnership find itself in financial difficulty. It cannot be assumed that the partnership will not find itself in financial difficulty, and that partnership revenues will pay the debt, or no one ever could have economic risk of loss on debt. Any such assumption ignores business realities. It is hardly uncommon for businesses to fail. In Example 11, if between 10 percent and 30 percent of the debt goes unpaid, hardly—as already noted— an extraordinary circumstance, A will have to pay on his guarantee. Thus, objectively, A has economic risk of loss on $200 of the partnership debt. For the IRS to deny a partner a share of debt for which the partner has the economic risk of loss defies the congressional mandate. Consequently, with regard to A, Example 11 should be invalid. If the difference between the debt allocated to a partner like A under the old and new rules were small (literally true in Example 11), there might be an argument that such small adjustments are within the IRS's discretion. But add a few zeros, and it becomes apparent that the difference can be quite large and in clear conflict with the congressional authorization.

There is a fair argument that, in Example 10, B neither is at risk (under the realistic possibility test)[40] nor has an economic risk of loss on his guarantee given that B's risk of paying on the debt is low because he has to pay only if 80 percent of the debt goes unpaid. The same

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[38] H.R. Rep. No. 98-861, at 869 (1984) (Conf. Rep.), 1984-3 CB Vol. 2 at 123.
[39] See Alexander v. Sandoval, 532 U.S. 275 (2001); Bowen v. Georgetown Univ. Hosp., 488 U.S. 204 (1988); Nat'l Petroleum Refiners Ass'n v. FTC, 482 F2d 672 (1973).
[40] Under the Sixth Circuit's "worst case scenario," B could still be at risk. See supra notes 7-8 and accompanying text.

argument applies to C's obligation, in Example 11, to reimburse B. Indeed, allowing either B or C in those examples to have economic risk of loss could be seen as a violation of the congressional mandate, which could be read to require significant economic exposure.

It would have been helpful if the Service had explained when and to what extent bottom dollar guarantees represent an abuse of the economic risk of loss rules. In my view, the Service should target only substantial abuses. Addressing insubstantial abuses through regulations runs the risk of creating what is sometimes called "hyperlexis" (i.e. a circumstance in which the cure is worse than the disease).[41] The attempt by a statute or regulation to address every problem, no matter how modest, can create more problems than it fixes. The result to partner A in Example 11 is arguably an example of this hyperlexis. In an attempt to address an abuse, the regulations keep someone from having economic risk of loss who objectively has it. That said, if bottom dollar guarantees are indeed a significant area of abuse, the Service should limit its Temporary Regulations to an anti-abuse rule, as I discuss in more detail below.

Another hyperlexis issue is that, as discussed up to this point, the regulations make it rather easy to have nonrecourse debt if that is the preferred outcome. Partners might prefer nonrecourse debt because, for example, it would give certain partners a higher basis in their partnership interests. But a lender might not want to make a pure nonrecourse loan. The partnership and/or some of its partners might try to find a way to reduce the lender's risk without technically creating economic risk of loss on the debt. Example 11 shows how that might be done. Note that Partners B and C are allocated more of the debt than would have been the case if

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[41] See Bayless Manning, Hyperlexis: Our National Disease," 71 Nw. U. L. Rev. 767 (1977); Gordon D. Henderson, "Controlling Hyperlexis--The Most Important 'Law and . . .,'" 43 Tax Law. 177 (1989); Richard M. Lipton, "'We Have Met the Enemy and He Is Us': More Thoughts on Hyperlexis," 47 Tax Law. 1 (1993); Walter Schwidetzky, "Hyperlexis and the Loophole," 49 Okla. L. Rev. 403, (1997); Walter Schwidetzky, "Hyperlexis and the Annual Exclusion Rule," 32 Suffolk U. L. Rev. 212 (1999).

A were treated as having economic risk of loss on $200 of the debt. Many lenders would be comfortable with a guarantee that kicks in, as in Example 11, only after the first 10 percent of the debt goes unpaid. It would be a fairly straightforward matter, therefore, to create what the Temporary Regulations would normally call nonrecourse debt, where a partner, in fact, has genuine economic risk of loss.

To address this problem, the Temporary Regulations contain what amounts to a substance-over-form rule that allows the IRS (but not the taxpayer) to treat a partner as having the economic risk of loss if in substance the partner does, irrespective of the form, if a principal purpose of the arrangement is to a permit a partner without economic risk of loss to include a portion of the loan in his outside basis.[42] This has been called the "heads we win, tails you lose" rule.[43] What the rule also demonstrates is the intellectual bankruptcy of the Temporary Regulations. They first create an Orwellian rule where economic risk of loss is said not to exist, even when it really does. Then, because this rule can backfire, the Temporary Regulations create an anti-backfire rule. This is a classic example of hyperlexis, where one bad rule leads to more bad rules. The solution, of course, is to eliminate the first bad rule.

The Temporary Regulations go still further. The IRS is given broad discretion to recast transactions generally, and the Temporary Regulations do not limit themselves to debt instruments. Virtually any contractual right can fall within their purview. For example, a lease between a partner and a partnership that is not on commercially reasonable terms may be tantamount to a guarantee by the partner of the partnership liability.[44] To the extent the Temporary Regulations are creating a substance-over-form rule, this aspect of the Temporary

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[42] Treas. Reg. § 1.752-2T(j)(2).
[43] See Road to Hell, supra note 1.
[44] Treas. Reg. § 1.752-2T(j)(2).

Regulations is not necessarily objectionable. But when placed in the context of the Temporary Regulations as a whole, there are concerns. A central tenet of the Temporary Regulations is to ignore economic risk of loss where it in fact exists. Couple the Temporary Regulations' being untethered from facts with the broad discretion given the IRS, and one must be concerned that outcomes could become random. Two similarly situated taxpayers may not be able to count on receiving the same treatment from the IRS. Taxpayers may find it difficult to reliably plan transactions in anything other the simplest circumstances.

<H1>Proposed Regulations

The Proposed Regulations can be thought of as the Temporary Regulations on steroids.[45] They would provide a broad framework for determining economic risk of loss and go well beyond the Temporary Regulations. While the current final Section 752 regulations are biased in favor of finding recourse debt, the Proposed Regulations could create the exact opposite bias. The 2016 Proposed Regulations replace regulations that were proposed in 2014. The 2014 Proposed Regulations were heavily criticized for fundamentally changing the way Section 752 operates without any significant expression of congressional concern with the current system, for sometimes leading to untenable results, and for being unduly rigid.[46] The Service withdrew the 2014 Proposed Regulations and replaced them with the 2016 Proposed Regulations. While the 2016 Proposed Regulations endeavor to respond to some of the criticisms of the 2014 Proposed Regulations, they are nonetheless likely also to prove controversial.

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[45] See REG-122855-15, 2016-2 CB 922.
[46] See Richard M. Lipton, "Proposed Regulations on Debt Allocations: Controversial, and Deservedly So," 120 J. Tax'n 4 (2014).

Under Proposed Regulation Section 1.752-2(j)(3)(i), an obligation of a partner or related person to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation.[47] Proposed Regulation Section 1.752-2(j)(3)(ii) provides a non-exclusive list of seven factors that may indicate a plan to circumvent or avoid the payment obligation. This Proposed Regulations provide that the presence or absence of a factor is based on all the facts and circumstances at the time the partner or related person makes the payment obligation, or, if the obligation is modified, at the time of the modification. The weight to be given to any particular factor depends on the particular case, and the presence or absence of a factor is not necessarily indicative of whether a payment obligation is or is not recognized. The 2014 Proposed Regulations made a similar list of factors mandatory.[48] As noted, none of the listed factors is mandatory under the 2016 Proposed Regulations. But optional factors have a way of becoming mandatory on audit, at least in part. The IRS cannot seriously claim that it would respect an obligation that met none of the factors. Furthermore, a revenue agent auditing a partnership would doubtless analyze the presence or absence of each factor. Thus, it is not a defense to a given factor that it is not mandatory under the Proposed Regulations. Each factor must stand or fall on its own merit.

<H2>The Proposed Seven-Factor List. Each of the proposed factors is set out and briefly commented on, in turn, below: **<Q>**

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[47] Under the Proposed Regulations, almost invariably a payment obligor includes disregarded entities and grantor trusts

[48] For a comparison of the factors in the two sets of proposed regulations, see Jeffery J. Bryant, "New Regulations Raise Critical Issues Concerning a Partner's Share of Liabilities and Partnership Disguised Sales," 34(4)_J. Tax'n Invs. 3 (Summer 2017).

(1) The partner or related person is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, including, for example, restrictions on transfers for inadequate consideration or distributions by the partner or related person to equity owners in the partner or related person. **<END Q>**

The difficulty with this factor is that there is no definition of "commercially reasonable,"[49] and reasonableness varies from transaction to transaction. The factor gives two examples, both of which would, if injurious to creditors, violate the Uniform Voidable Transactions Act. It is obvious that violating the act would not be commercially reasonable, but what is not obvious is what is commercially reasonable. Partners could never be certain of meeting this factor. **<Q>**

(2) The partner or related person is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party. **<END Q>**

[49] See Grant Esposito & Jessica Kaufman, "'Best Efforts,' 'Commercially Reasonable' and Other Terms No One Understands" (N.Y. L.J., (Mar. 14, 2016), available at https://advance.lexis.com/search?crid=2973d4de-9abb-42cf-9c9e-75a9dd2aacc7&pdsearchterms=LNSDUID-ALM-NYLAWJ-1202751855599&pdbypasscitatordocs=False&pdmfid=1000516&pdisurlapi=true. The following cases conclude that a transaction was or was not commercially reasonable, but do not define the term: Levy v. Comm'r, 91 TC 838 (1988); Spera v. Comm'r, TC Memo 1998-225; Rubin v. Comm'r, TC Memo 1989-284; Weigel v. Comm'r, TC Memo 1996-485.

This factor suffers from the same disability as the first factor. There is no set definition of “commercially reasonable documentation.” Again, partners could never be certain of meeting this factor. **<Q>**

> (3) The term of the payment obligation ends prior to the term of the partnership liability, or the partner or related person has a right to terminate its payment obligation, if the purpose of limiting the duration of the payment obligation is to terminate such payment obligation prior to the occurrence of an event or events that increase the risk of economic loss to the guarantor or benefited party (for example, termination prior to the due date of a balloon payment or a right to terminate that can be exercised because the value of loan collateral decreases). This factor typically will not be present if the termination of the obligation occurs by reason of an event or events that decrease the risk of economic loss to the guarantor or benefited party (for example, the payment obligation terminates upon the completion of a building construction project, upon the leasing of a building, or when certain income and asset coverage ratios are satisfied for a specified number of quarters). **<END Q>**

This factor is reasonable. If a guarantor has the right to end the guarantee when things look like they are getting serious, that indeed makes the guarantee suspect. It is helpful that the Service noted that the factor would not be created if a payment obligation terminated after the risk to the creditor drops. **<Q>**

(4) There exists a plan or arrangement in which the primary obligor or any other obligor (or a person related to the obligor) with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonable foreseeable needs of such obligor. **<END Q>**

Once again, the difficulty is that there is no fixed definition of what the liquidity needs of a business are. Liquidity needs vary both by business and by where a given business is in its life cycle. So, again, partners could never be certain of meeting this factor. **<Q>**

(5) The payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection. **<END Q>**

The fifth factor generally is not objectionable. If there is a default, a creditor should be able to pursue his remedies. It would be helpful, though, if the Service had noted that if the default is remedied in a timely way, the fact that the creditor could not pursue his remedies would not create the factor. **<Q>**

(6) In the case of a guarantee or similar arrangement, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee. **<END Q>**

The sixth factor, as a practical matter, is impossible to prove, and is seen by some as the most egregious factor. [50] It requires a partner to prove, possibly years after the guarantee was made, what would have happened in an alternative universe where the partner made no such guarantee, an alternative universe that never existed. Furthermore, negotiations with creditors can be complex, with much give and take. The creditor, the partnership, and the partners are agreeing to a host of provisions. Normally, no one can reliably say what might have happened if a given provision, such as a guarantee, were absent. And entirely gratuitous guarantees are doubtless rare. **<Q>**

> (7) The creditor or other party benefiting from the obligation did not receive executed documents with respect to the payment obligation from the partner or related person before, or within a commercially reasonable period of time after, the creation of the obligation. **<END Q>**

The final factor is not objectionable per se. It may be difficult to determine exactly what a commercially reasonable time is, but any significant delay in executing relevant documents would indeed be suspect. It would be helpful if the Service had provided a safe harbor of perhaps six months.

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[50] Id.

<H2>**Problems With the Factor List as A Whole.** It is very unlikely that any obligation, even one with clear economic substance, would unquestionably meet all seven factors.[51] Furthermore, as I am not the first to observe, lists of nonexclusive factors are inherently problematic.[52] Factors important in analyzing a given set of facts may not be listed, while factors that are listed may be relatively unimportant. But the listed, unimportant factors may be given outsized weight by dint of being listed. Taxpayers and auditors will tend to focus on them.

In addition, there is no weighting or hierarchy. How many factors can a partner not meet and still be safe? There is no way of knowing. A partner also has no way of knowing how much "credit" she will get for meeting a particular factor. What if a partner clearly meets three factors, is marginal on two others, and does not meet the final two? Does the fact that the partner clearly meets three factors offset the fact that she is marginal on two others? And what can one realistically expect of a revenue agent auditing the partnership? Can one expect the agent to engage in a sophisticated balancing act and give serious weight to relevant, but unlisted, factors? Probably not. These seven technically optional factors will likely become, to a large extent, mandatory in the field and be given close to equal weight. Thus, even if all seven factors were unobjectionable, this factor-approach would be seriously flawed. For these reasons, if the IRS truly wants to apply a facts-and-circumstances test, it should state that, and no more. The IRS might respond that its agents need guidance. That is surely true, but that guidance should not be given the force and effect of regulations. It instead belongs in the Internal Revenue Manual or similar document.

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[51] See Road to Hell, supra note 1.
[52] See Judge Posner's opinion in Exacto Spring Corp. v. Comm'r, 196 F3d 833 (7th Cir. 1999).

But even a pure facts and circumstances test is difficult to apply in a reliable manner. That fact will make planning more difficult and expensive and could even prevent agreements with solid economic substance from being made. It is vital to know reliably when liabilities will and will not be included in outside basis. Prior to the 2016 Regulations, this was a straight-forward determination. Under any Proposed Regulation-like system it would not be. Therefore, I propose a different approach. But first I will discuss the new proposed regulations for deficit restoration obligations, which are effectively intertwined with the Section 752 Proposed Regulations.

<H2>Deficit Restoration Obligations. As I discussed above, under the current regulations, a deficit restoration obligation (DRO) is highly relevant in determining the economic risk of loss. That may change in some circumstances. The Proposed Regulations[53] under Section 704 provide that a partner's DRO will not be respected to the extent it is a bottom-dollar payment obligation. A "standard" DRO—that is, one under which the partner is obligated to restore a deficit in all events on liquidation of his partnership interest—should never be a bottom-dollar payment obligation. While DROs are probably usually drafted in a way that prevents creditors from being third-party beneficiaries of the DRO, a partnership can be forced into bankruptcy involuntarily, and the trustee in bankruptcy can enforce the DRO.[54] Business bankruptcy is hardly a novel event. It is realistic that someone with a standard DRO will be obligated to fully restore a deficit, and the partnership creditors will have full access to those funds to the extent they go unpaid. Thus, a standard DRO is, effectively, a top-dollar obligation to the creditors. It would, of course,

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[53] Prop. Reg. § 1.704-1(b)(2)(ii)(b)(3) and 1.704-1(b)(2)(ii)(c)(4).

[54] For a detailed discussion of the interaction of DROs with the bankruptcy rules, see Maze supra note 14.

be possible to draft a nonstandard DRO that would be the equivalent of a bottom-dollar payment obligation. For example, a partner might only have an obligation to restore a deficit if the creditors are paid less than 20 percent of the debt owed to them by the partnership. The difficulty with that kind of DRO is that it would create other problems. It is possible for a standard DRO to create an at-risk amount under Section 465 for the same reason that it can create an economic risk of loss. The DRO can create a bottom-line obligation on partnership debt.[55] In many jurisdictions, a partner would not be at risk on a DRO drafted as a bottom-dollar payment obligation, at least to the extent there is not a realistic possibility that the partner will have to pay on the DRO.[56] The lack of an at-risk amount, in turn, could prevent the partner from deducting partnership losses, something that partners who agree to DROs typically want to be able to do.

A DRO drafted as a bottom dollar payment obligation would also likely run afoul of the Section 704(b)partnership allocation rules. A detailed discussion of these rules is beyond the scope of this article, but, generally, for partnership allocations of income and expense to the partners to be respected, those allocations must either have "substantial economic effect" or be in accordance with the "partner's interest in the partnership." The Section 704(b) regulations contain detailed rules on when an allocation has substantial economic effect. A partner's interest in the partnership is only loosely defined.[57] In order to be in compliance with the substantial-economic-effect rules, a partner must have an "unconditional" DRO.[58] A DRO drafted as a bottom dollar payment obligation would thus fail the substantial-economic-effect rules.

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[55] See supra notes 15-23 and accompanying text; Maze, supra note 14.
[56] See supra notes 7-8 and accompanying text.
[57] See Treas. Reg. § 1.704-1(b)(3).
[58] See Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3). The "qualified income offset" rules also require the DRO to be unconditional. See Treas. Reg. § 1.704-1(b)(2)(ii)(c).

It is probably the norm in larger deals for partnerships to not meet the requirements of the substantial-economic-effect rules and trust that the allocation regime is in accordance with the partners' interests in the partnership. But it would be harder to make the argument that an allocation to a partner which creates or increases a negative capital account would be in accordance with the partner's interest in the partnership, if the partner's DRO is not unconditional. The less likely it is that a partner will have to restore a deficit capital account, the less likely it is that the allocation is in accordance with the partner's interest in the partnership. Assuming the traditional rules are followed for keeping capital accounts, it is only possible to justify a negative capital account (outside the nonrecourse debt context) if the partner has a genuine obligation to restore it. Otherwise, the partner is only being allocated a tax effect, not the economically substantive effect necessary for the allocation to be in accordance with the partner's interest in the partnership.

I am not aware of any data on this subject, but it seems unlikely that DROs are commonly drafted as remote bottom dollar payment obligations. Having a rule that does not respect a DRO drafted as a remote bottom dollar payment obligation is not inherently objectionable, though it may be a solution in search of a problem. To the extent the rule draws within its application DROs that probably, but not certainly, would have to be fulfilled, it overreaches for the same reason the Temporary Regulations overreach.

The Proposed Regulations also provide that a partner's DRO will not be respected to the extent it is not legally enforceable, or the facts and circumstances otherwise indicate a plan to circumvent or avoid the DRO.[59] As to the first part of this rule, if the DRO is not legally

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[59] Prop. Reg. §§ 1.704-1(b)(2)(ii)(b)(3), 1.704-1(b)(2)(ii)(c)(4).

enforceable, it is a fraud, and not a true DRO. A DRO that is not legally enforceable is likely a rarity (and likely an act of malpractice by the relevant lawyer), but a rule against it is not objectionable.

It is the second part of this rule that is more likely to arise in the real world—that is, a DRO where the facts and circumstances indicate a plan to circumvent or avoid the obligation. The 2014 Proposed Regulations subjected the determination of economic risk of loss and DROs to the same factors. But many of the economic risk of loss factors were not relevant in the DRO context.[60] In response, the 2016 Proposed Section 704 Regulations provide a separate, shorter nonexclusive list of factors that may indicate a plan to circumvent or avoid a DRO.[61] As with the Proposed Section 752 Regulations, the weight to be given to any particular factor depends on the particular case and the presence or absence of any particular factor is not, in itself, necessarily indicative of whether or not the obligation is respected. The factors suffer from the same problem as do factors in the Temporary Regulations and should not be given regulatory status. Be that as it may, the factors are: **<Q>**

> (1) The partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation.
>
> (2) The partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership.

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[60] See Preamble, 81 Fed. Reg. 69301 (proposed Oct. 5, 2016).
[61] Prop. Reg. § 1.704-1(b)(2)(ii)(c)(4)(B).

(3) The obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account is negative.

(4) The terms of the obligation are not provided to all the partners in the partnership in a timely manner. **<END Q>**

The first two factors and the last one mirror factors in the Proposed Section 752 Regulations, and I will not discuss them again other than to note that they suffer from the same problems. Factor three is similar to one factor in the Proposed Section 752 Regulations, but raises additional issues. If a DRO is terminated before the capital account goes negative, there can be no loss to the fisc or creditors, and there would thus be no reason for concern. If, on the other hand, a DRO could be terminated while the capital account is negative, important questions indeed arise. For a partner to be able to take a loss allocated by the partnership, he must have a positive outside basis. As discussed earlier, normally the reason a partner has a positive basis and a negative capital account is because the partner was allocated liabilities. Thus, in the recourse debt context, the economic risk of loss rules and the DRO rules tend to be intertwined. Indeed, under the nuclear bomb test, a DRO can give a partner economic risk of loss. Often, then, terminating a DRO while a capital account is negative means that the debt allocation to the partner has dropped. That in and of itself can cause tax consequences, as a reduction in a partner’s share of debt is treated as a distribution of money under Section 752(b). If that distribution exceeds the partner’s basis in the partnership interest, likely in this context, the excess will be gain under Section 731(a)(1) to the partner, treated as gain from the sale or exchange of a partnership interest.

The potential for that gain would tend to be a disincentive to terminate a DRO, but hardly a complete one. The gain could be long term capital gain taxable at a 15 or 20 percent rate under Section 1(h)(1)).[62] It is better to pay 15 or 20 cents of tax on a dollar than have to contribute a whole dollar to the partnership. In other contexts, terminating a DRO could generate cancellation of indebtedness income, which is ordinary income.[63] Here the tax rate could be much higher, as high as 39.6 percent,[64] but again it is better to pay 39.6 cents on the dollar than contribute a dollar. So, while there are disincentives to terminating a DRO, they are hardly insurmountable hurdles, and it is fair to question the validity of a DRO if the partner has a right to terminate the obligation at will or with few significant preconditions when the capital account is negative.

That said, it is not always the case that a partner's ability to terminate a DRO should be fatal. There can be times when it would be fair for a partner to terminate a DRO. Thus, if the DRO is tied to a liability to a creditor, and that liability is paid, it might not be abusive to terminate the DRO before liquidation of the partnership interest. As long as this factor is not applied automatically to disregard a DRO, it might not be objectionable. But the risk is that an auditing revenue agent might do just that. And, as already discussed, that is the core issue with the Proposed Regulations. They create a lot of uncertainty. Of course, deals that are tax abusive should not get done. But the overreach of the Temporary and Proposed Regulations may mean that many legitimate deals will not get done either.

<H1>Alternative Approaches

[62]See IRC § 1(h)(1). also see IRC § 751(b).
[63] See Maze, supra note 14.
[64] See IRC § 1(a)-(d). There could also be a state income tax.

<H2>**Help for Smaller Businesses.** Factors 1, 2, and 6 of the 2016 Proposed Section 752 Regulations and Factors 1 and 2 of the 2016 Proposed Section 704 Regulations would create practical problems for most partnerships, but often would be an insurmountable hurdle for small and mid-sized partnerships. It would commonly be financially prohibitive, too impractical, and sometimes—inasmuch as there is no reliable definition of some terms—impossible for these partnerships to establish these factors in advance. Smaller partnerships often cannot afford sophisticated tax counsel and are also less likely to engage in abusive transactions. Accordingly, I recommend that, should the Proposed Regulations be finalized in substantially their current form, the referenced factors not apply to small and mid-sized partnerships. A reasonable definition of small and mid-sized partnerships would be those with a net asset value of less than $5 million at the time a liability is incurred or a DRO made, with the $5 million adjusted for inflation over time.

<H2>**Focus on True Abuse and Centralize the Anti-Abuse Rules.** But there is a preferable alternative not only for the Proposed Regulations, but also for the Temporary Regulations. As noted above, given the congressional mandate, it exceeds the IRS's authority to effectively ignore genuine economic risk of loss in the recourse debt context, creating an existential question for portions of the Temporary Regulations. What seems to be driving the 2016 Regulations, based on rules within the regulations and informal statements that the IRS has made, is that the IRS thinks that the better rule is to allocate recourse debt based on the likely source of payment, which seems to mean based on how profits are allocated. That is a flawed premise. Many businesses lose money. Profits from year to year are never assured. Persons who accept legitimate economic risk of loss are not engaging in a theoretical exercise. They are taking on

real risk, and allocating recourse debt based on that risk is entirely reasonable, in addition to being mandated by Congress.

The IRS normally does have the authority, on the other hand, to stop abusive conduct. If the economic risk of loss or the DRO is not real or is unduly remote, it is perfectly reasonable to have a regulatory rule to address that. There is no need or benefit to going further. Both because of the congressional grant of authority and the desire for sensible tax policy, the IRS should withdraw the 2016 Regulations (both the Temporary and Proposed Regulations). Instead the IRS should adopt a set of anti-abuse rules—with one caveat: Avoid hyperlexis and only adopt anti-abuse rules to address substantial abuses. The balance of this article assumes the abuses addressed in the 2016 Regulations are substantial, though to date I have seen no supporting data.

As one author has put it, the regulations are "littered" with anti-abuse rules.[65] There seems to be little value to continuing this decentralization. While it would be possible to further litter the regulations and place specific anti-abuse rules in the Section 704 and Section 752 regulations, a more sensible approach would be to begin the process of centralizing the anti-abuse rules by adding to the anti-abuse rules of Treasury Regulation Section 1.701-2. That regulation provides that three requirements are implicit in the intent of Subchapter K:

1. The partnership must be bona fide and each partnership transaction or series of related transactions must be entered into for a substantial business purpose.
2. The form of each partnership transaction must be respected under substance over form principles.

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[65] See Sheldon I. Banoff, "Anatomy of an Antiabuse Rule: What's Really Wrong with Reg. Section 1.701-2," 66 Tax Notes 1859 (1995) (hereinafter "Banoff"). THIS IS CITED IN A LATER FOOTNOTE.

3. The application of a given Code provision and the ultimate tax results, taking into account all the relevant facts and circumstances, must be clearly contemplated by that provision.[66] **<END Q>**

The regulation goes on to provide that, if a partnership is used in a transaction the principal purpose of which is to reduce the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K, the IRS is authorized to recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the intent of Subchapter K. The anti-abuse regulation specifically notes that literal compliance with the Subchapter K rules will not save the day. The transaction must also be consistent with Subchapter K's intent. This regulation gives the IRS broad authority to restructure a transaction, including disregarding the partnership, not treating a purported partner as a partner, adjusting the partnership's method of accounting, and reallocating income and loss. The anti-abuse regulation is controversial, but given its long standing—it was promulgated in 1995[67]—it can be assumed to be valid.[68]

Another advantage to addressing the IRS's concerns through the anti-abuse regulation is that doing so adds a measure of rigor to the process. As discussed above, the Proposed Regulations have a nonexclusive, non-mandatory list of facts and circumstances that can prevent taxpayers from ever being certain that their structure will pass muster. By withdrawing the 2016

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[66] Treas. Reg. § 1.701-2(a).
[67] 60 Fed. Reg. 23 (Jan. 3, 1995).
[68] But see Linda D. Jellum, "Dodging the Taxman: Why the Treasury's Anti-Abuse Regulation is Unconstitutional," 70 U. Miami L. Rev. 152 (2015); Alan Gunn, "The Use and Misuse of Antiabuse Rules: Lessons from the Partnership Antiabuse Regulations," 54 SMU L. Rev. 159 (2001); Banoff, supra note 62; Samuel C. Thompson, Jr., "Ex-Government Officials Challenge Partnership Antiabuse Reg.: An Analysis," 69 Tax Notes 1395 (1995).

Regulations, but adding provisions to the anti-abuse regulation, the IRS would be making clear that it is focused on abusive conduct. Accordingly, this change should not recreate the level of uncertainty created by the 2016 Regulations. Admittedly, there is no bright line between abusive and nonabusive transactions, but the change would be a big improvement over the Proposed Regulations, which have no line at all.

Many of the transactions that the IRS finds objectionable in the Temporary Regulations, particularly those of Partner A in Example 11, discussed earlier, would meet the three implicit requirements of Subchapter K provided in the anti-abuse regulation. Given that A had actual economic risk of loss, there should be a business purpose for the transaction, or A would not have taken on that burden. The form necessarily also had substance. And, as the congressional history makes clear, A's economic risk of loss was contemplated by Section 752. On the other hand, Partner B in both Examples 10 and 11 likely fails these standards, since his economic risk of loss is remote. An anti-abuse rule in this latter regard is sensible. The anti-abuse regulation might contain an assumption that anyone who bottom-guarantees debt below a certain threshold does not have economic risk of loss on the debt. There is no magically correct threshold percentage, but partners who guarantee only the bottom half or less of a debt would seem to be reducing their economic risk of loss below an acceptable level in most circumstances.

Other rules (with examples) could be added which reject nominal economic-risk-of-loss and DRO provisions that have little or no substance. For example, the anti-abuse regulation could not recognize DRO provisions that are not (at least in most real-world circumstances) unconditional or that can be terminated by a partner in a way that significantly injures creditors. Finally, it would make sense to align Sections 752 and 465. Thus, the anti-abuse regulation could provide that if a partner does not have economic risk of loss, he is also not at risk. By taking this

step, the regulation would effectively adopt the view of those courts that require a realistic possibility of economic exposure for a taxpayer to be at risk, the more sensible rule given the purpose of Section 465.

An objection to placing such provisions in the anti-abuse regulation is that, given the broad authority it gives the IRS to recast transactions, examiners must coordinate the application of the these regulations with both the Partnership Technical Specialists and the IRS National Office.[69] This is a rather large hurdle for the possible abuses under discussion. But there is a lot to be said for having regulatory anti-abuse rules (at least mostly) in one location. A simple solution would be to exempt economic-risk-of-loss, at-risk, and DRO provisions from these coordination requirements.

<H1>Conclusion

The good news about the Temporary Regulations is that they stop a genuine abuse, though it is not clear how often it arises. The bad news is that they are not in proposed form, which would have allowed the tax community to give the IRS feedback before finalizing rules, and—more seriously—which would have kept the IRS from adopting regulations that in places clearly exceed its authority. The good news about the Proposed Regulations is that they are in proposed form, and that they try to come to grips with certain abuses. The bad news is that they are not sensitive to the need of business for practical and clear rules that can readily be followed.

One sometimes wonders if IRS personnel spend too much time at ABA Tax Section meetings (mostly a large law firm universe), and not enough time talking to lawyers for small

[69] Internal Revenue Service, *Internal Revenue Manual* § 4.32.2.14 (2017).

and medium-sized businesses. As a package, the Temporary and Proposed Regulations are overkill, creating rules much broader than necessary to address what is likely a narrow set of abuses. Abuses should be addressed with anti-abuse rules, not overarching regulations that will pull in not just abusive transactions, but innocent ones as well, and that will make planning needlessly more difficult.