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Chattanooga Tax Practitioners Meeting - June 12, 2024

Deconstructing the Partnership Debt Allocation Rules

Learning Objectives

Upon completion of this session, participants should be able to—

- Discuss how debt allocations affect the calculation of a partner's basis in the partnership;
- Distinguish between the treatment of partnership recourse and nonrecourse debt and its resulting allocations;
- Apply the guidance of Treasury Regulation Sections 1.752-2 & 1.752-3 to a set of facts.

Deconstructing the Partnership Debt Allocation Rules

- Agenda
  - What is a Liability?
  - Why is Partnership Debt Important?
  - Impact on Partnership Basis
  - Property Subject to a Liability
  - When to Adjust Partner's Basis As a Result of Liabilities
  - What is Partnership Recourse Debt?
    - How to Measure Economic Risk-of-Loss ("ERL"),
    - Constructive Liquidation: 5 Step Process
    - Various Exercises
  - Guarantees & Indemnifications
    - Bottom-Dollar Guarantee
  - What Is Partnership Nonrecourse Debt?
    - Tier 1, Tier 2 and Tier 3
  - Reflective Case Study – *Mighty Giants LP*

Overview – Debt Refresher

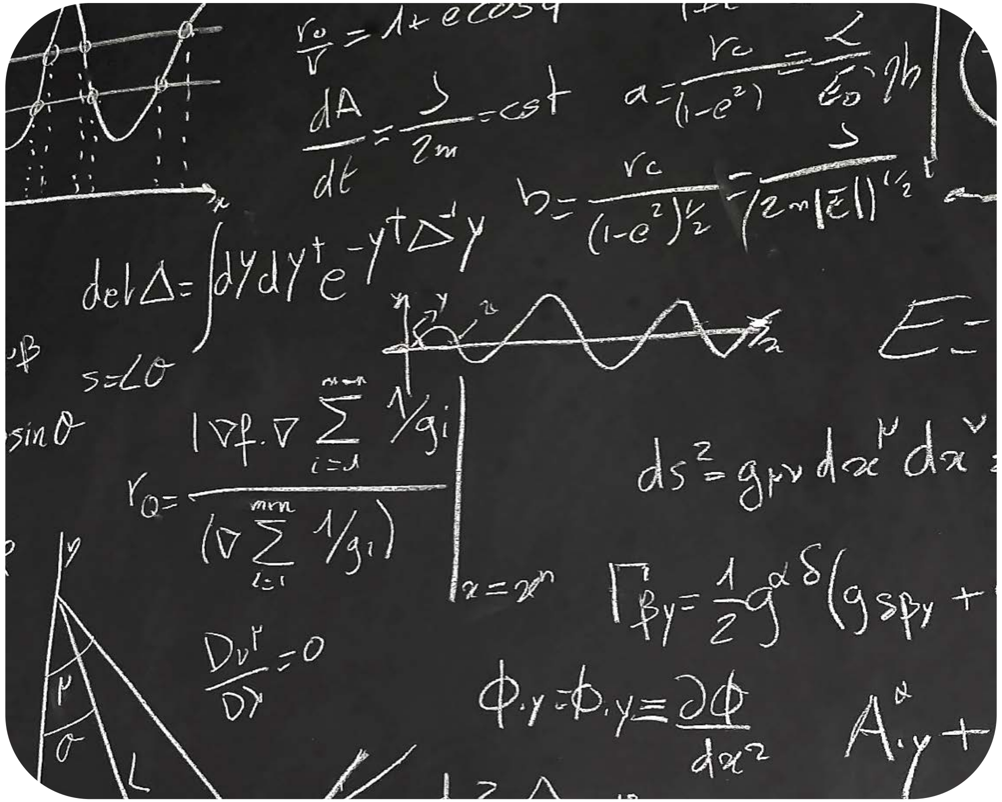
- What is a Liability?
  - The definition of a “liability” is very specific:

A “liability” is any “obligation” at the time and to the extent that incurring the obligation:

  - Creates or increases the basis of any of the obligor's assets (including cash);
  - Gives rise to an immediate deduction to the obligor; or
  - Gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.

Overview – Debt Refresher

- Why is Partnership Debt Important?
  - The basis rules of Subchapter K are intended to create and preserve a mathematical relationship in which the partnership's aggregate basis in its assets (inside basis) generally equals the aggregate bases of the partners in their partnership interests (outside basis)



Overview – Debt Refresher

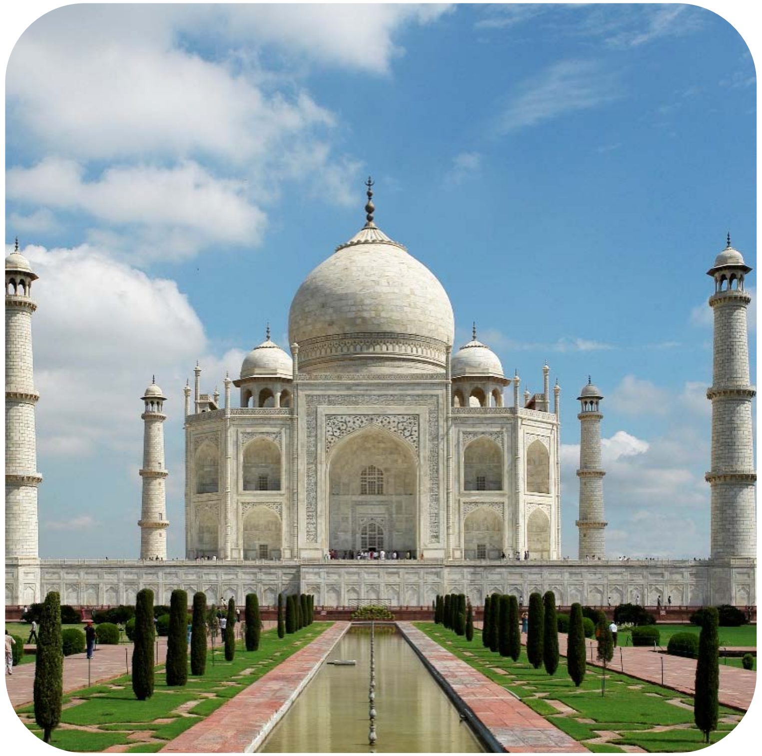
- Impact on Partnership Basis
  - Section 705 basis-adjustment rules and the contribution and distribution provisions of §722 and §§ 731 through 733) are impacted and extended by § 752.
  - Accordingly, under § 752, increases in a partner's share of partnership liabilities are treated as cash contributions by the partner (§ 752(a)) and decreases in a partner's share of partnership liabilities are treated as cash distributions to the partner (§ 752(b)).

Overview – Debt Refresher

- Impact on Partnership Basis
  - Sections 752(a) and 752(b) also treat the assumption of a partnership liability by a partner as a cash contribution by the partner and the assumption of a partner's liability by the partnership as a cash distribution to the partner.
    - Therefore, an increase in a partner's share of partnership liabilities or an assumption by a partner of a partnership liability increases the partner's basis for his partnership interest under §§ 705 and 722.
    - A decrease in his share of partnership liabilities or the partnership's assumption of a liability of such partner either decreases his basis under § 705(a) or is treated as a taxable distribution of money to him under § 731(a)(1).

Overview – Debt Refresher

- Property Subject to a Liability
  - Section 752(c) provides that a liability to which property is subject is treated as a liability of the owner of the property to the extent of the fair market value of the property. This rule ensures that most transfers of encumbered property will be treated the same, regardless of whether the encumbrance is actually assumed or the property is merely taken subject to the encumbrance.
  - A transferor of encumbered property whose transferee does not expressly assume a liability may remain personally liable to the lender.



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Overview – Debt Refresher

- When to Adjust Partner’s Basis As a Result of Liabilities
  - Liability changes are the subject of continuous adjustment. However, the § 752 Regulations require only that a partner's share of liabilities be determined whenever “necessary [under Regulations § 1.705-1(a)] in order to determine the tax liability of the partner or any other person”
    - (1) at the end of the partnership taxable year;
    - (2) in the event of a complete or partial sale of a partnership interest; or
    - (3) upon an actual or constructive distribution by the partnership.

Debt Allocations: Recourse Liabilities

- What is Partnership Recourse Debt?
  - A partnership liability is a recourse liability only to the extent that one or more partners (or related persons) bear the "economic risk of loss" with respect to the liability.
  - A partner's share of a partnership recourse liability "equals that portion of that liability, if any, for which the partner or related person bears the economic risk of loss." Thus, under the § 752 Regulations, the economic risk of loss concept is critical both in determining whether liabilities are recourse and in allocating recourse liabilities among the partners.

Poll Question #1

On what date was Abraham Lincoln inaugurated as our Nation's 16th president?

a. March 4,1861

b. March 18, 1861

c. January 8, 1861

d. March 4,1865

Debt Allocations: Recourse Liabilities

- What is Partnership Recourse Debt?
  - A liability that is treated as a nonrecourse liability for other tax and business purposes may nonetheless constitute a recourse liability under the § 752 Regulations.
    - For example, a partner is treated as bearing the economic risk of loss for a liability (and therefore the liability is treated as recourse) to the extent that the partner (or a related person) holds or guarantees the liability, even if the liability would be treated as nonrecourse.

Key Point: Recourse Debt

If at any time, a partner bears the economic risk of loss for a partnership liability to the extent that the partner (or a related person) would be legally obligated to make net payments, directly or indirectly, to satisfy the liability out of his non-partnership assets if, at such time, the partnership had no assets and all its liabilities were due.

Debt Allocations: Recourse Liabilities

- How to Measure Economic Risk-of-Loss (“ERL”)
  - Section 752 Regulation state that a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner.

Debt Allocations: Recourse Liabilities

- How to Measure Economic Risk-of-Loss ("ERL"), cont'd
  - Six (6) Considerations of ERL

1. Statutory and contractual obligations relating to partnership liabilities
2. Obligation of a partner to make a payment or a contribution; offsets, reimbursements and indemnifications by any other partner
3. Obligations and rights of persons related to a partner
4. Discharge of contractual obligations to make payments
5. Ignoring "bottom dollar guarantees" (potentially abusive)
6. Assumes partnership's assets, including any money, are worthless and that the partnership is liquidated

Debt Allocations: Recourse Liabilities

- Constructive Liquidation: 5 Step Process
  - A partner bears the economic risk of loss for a partnership liability only to the extent he would be obligated to satisfy the obligation out of his non-partnership assets if the partnership were wholly unable to pay the liability;
  - The following events are deemed to occur in connection with a constructive liquidation:
    - *Step 1: Liabilities Become Due*
    - *Step 2: Assets Become Worthless*
    - *Step 3: Partnership Disposes of Assets*
    - *Step 4: All Items Are Allocated*
    - *Step 5: Liquidation*

Debt Allocations: Recourse Liabilities

- Exercise #1

- A and B form a general partnership with each contributing $100 in cash;
- Office building purchased $1,000 ($200 in cash; note of $800);
  - The note is a general obligation of the partnership (i.e., no partner has been relieved from personal liability)
- Per partnership agreement, (a) all items are allocated equally EXCEPT that tax losses are specially allocated 90% to A and 10% to B, and (b) DRO language is present;
- Capital accounts will be maintained in accordance with 704(b)

How Will the Debt of $800 Be Allocated

Debt Allocations: Recourse Liabilities

- **Exercise #1 Answer**

- **Step 1: Liabilities Become Due = Total Amount Due: $800**
- **Step 2: Assets Become Worthless = -0- FMV**
- **Step 3: Partnership Disposes of Assets = 0- Asset FMV less $1,000 Asset Tax Basis = $1,000 Tax Loss**
- **Step 4: All Items Are Allocated**
  - **$1,000 Tax Loss | A (90%) = ($900) A | B (10%) = ($100)**
- **Step 5: Liquidation**
  - **See Below**

	A's Capital	B's Capital
Initial Contribution - Section 704(b)	$ 100	$ 100
Loss of Hypothetical Sale - Section 704(b)	(900)	(100)
	(800)	-

Debt Allocations: Recourse Liabilities

- **Exercise #1 Answer**

Other than the partners' obligation to fund negative capital accounts on liquidation, there are no other contractual or statutory payment obligations existing between the partners, the partnership and the lender. Therefore, $800 of the partnership liability is classified as a recourse liability because one or more partners bears the economic risk of loss for non-payment. B has no share of the liability since the constructive liquidation produces no payment obligation for B. A's share of the partnership liability is $800 because A would have an obligation in that amount to make a contribution to the partnership.

	A's Capital	B's Capital	
Initial Contribution - Section 704(b)	$ 100	$ 100	
Loss of Hypothetical Sale - Section 704(b)	(900)	(100)	
	(800)	-	
Required Capital Account Restoration Contribution	800	-	<= Bears ERL
	-	-	

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Debt Allocations: Recourse Liabilities

- **Exercise #1 Answer Observations:**

- **Before performing a ERL analysis, how would you have allocated the $800 recourse debt?**
- **As this is general partnership, the general partners are generally viewed as being “on-the-hook” - why isn’t B allocated of the $800 debt?**

	A's Capital	B's Capital	
Initial Contribution - Section 704(b)	$ 100	$ 100	
Loss of Hypothetical Sale - Section 704(b)	(900)	(100)	
	(800)	-	
Required Capital Account Restoration Contribution	800	-	<= Bears ERL
	-	-	

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Debt Allocations: Recourse Liabilities

- **Exercise #2**

- C and D form a general partnership with each contributing $500 in cash;
- Office building purchased $10,000 ($1,000 in cash; note of $9,000);
  - The note is a general obligation of the partnership (i.e., no partner has been relieved from personal liability)
- Per partnership agreement, (a) profits and losses are to be divided 40% to C and 60% to D, and (b) C and D are required to make up any deficit in their capital accounts;
- Capital accounts will be maintained in accordance with 704(b)

How Will the Debt of $10,000 Be Allocated

Debt Allocations: Recourse Liabilities

- Exercise #2 Answer

- Step 1: Liabilities Become Due = Total Amount Due: $10,000
- Step 2: Assets Become Worthless = -0- FMV
- Step 3: Partnership Disposes of Assets = 0- Asset FMV less $10,000 Asset Tax Basis = $10,000 Tax Loss
- Step 4: All Items Are Allocated
  - $10,000 Tax Loss | C (40%) = ($4,000) | D (60%) = ($6,000)
- Step 5: Liquidation
  - See Below

	C's Capital	D's Capital
Initial Contribution - Section 704(b)	$ 500	$ 500
Loss of Hypothetical Sale - Section 704(b)	(4,000)	(6,000)
	(3,500)	(5,500)

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Debt Allocations: Recourse Liabilities

- **Exercise #2 Answer**

C's capital account reflects a deficit that C would have to make up to $3,500 and D's capital account reflects a deficit that D would have to make up of $5,500. Therefore, the $9,000 mortgage note is a recourse liability because one or more partners bear the economic risk of loss for the liability. C's share of the recourse liability is $3,500 and D's share is $5,500.

	C's Capital	D's Capital	
Initial Contribution - Section 704(b)	$ 500	$ 500	
Loss of Hypothetical Sale - Section 704(b)	(4,000)	(6,000)	
	(3,500)	(5,500)	
Required Capital Account Restoration Contribution	3,500	5,500	<= Bears ERL
	-	-	

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Poll Question #2

Partnership debt allocation provide for the deductibility of what type of losses:

a. Passive Activity Losses

b. At-Risk Losses

c. Excess Business Losses

d. Ordinary & Separately Stated Losses

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Debt Allocations: Recourse Liabilities

- **Exercise #3**

- E and F form a limited partnership;
- E, the general partner, contributes $2,000 and F, the limited partner, contributes $8,000.
- Depreciable property purchased $10,000 ($10,000 in cash; note of $15,000);
  - The note is a general obligation of the partnership (i.e., no partner has been relieved from personal liability)
- Per partnership agreement, (a) losses are to be divided 20% to E and 80% to F, until F's capital account is reduced to zero, after which all losses are allocated to E.
- F’s guarantee of the $15,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership
- Capital accounts will be maintained in accordance with 704(b)

How Will the Debt of $15,000 Be Allocated

Debt Allocations: Recourse Liabilities

- **Exercise #3 Answer**

- **Step 1: Liabilities Become Due = Total Amount Due: $15,000**
- **Step 2: Assets Become Worthless = -0- FMV**
- **Step 3: Partnership Disposes of Assets = 0- Asset FMV less $25,000 Asset Tax Basis = $25,000 Tax Loss**
- **Step 4: All Items Are Allocated**
  - **$25,000 Tax Loss | E (20%) = ($17,000) | D (60%) = ($8,000)**
- **Step 5: Liquidation**
  - **See Below**

	E's Capital	**F's Capital**
Initial Contribution - Section 704(b)	$ 2,000	$ 8,000
Loss of Hypothetical Sale - Section 704(b)	(5,000)	(20,000)
	(3,000)	(12,000)
Re-Allocated of Tax Loss Due to Deficit	(12,000)	12,000
	(15,000)	-

Debt Allocations: Recourse Liabilities

- **Exercise #3 Answer**

E, as a general partner, would be obligated by operation of law to make a net contribution to the partnership of $15,000. Because E is assumed to satisfy that obligation, it is also assumed that F would not have to satisfy F's guarantee. The $15,000 mortgage is treated as a recourse liability because one or more partners bear the economic risk of loss. E's share of the liability is $15,000, and F's share is zero. This would be so even if E's net worth at the time of the determination is less than $15,000, unless the facts and circumstances indicate a plan to circumvent or avoid E's obligation to contribute to the partnership.

	E's Capital	F's Capital	
Initial Contribution - Section 704(b)	$ 2,000	$ 8,000	
Loss of Hypothetical Sale - Section 704(b)	(5,000)	(20,000)	
	(3,000)	(12,000)	
Re-Allocated of Tax Loss Due to Deficit	(12,000)	12,000	
	(15,000)	-	
Required Capital Account Restoration Contribution	15,000	-	<= Bears ERL
	-	-	

Debt Allocations: Recourse Liabilities

- **Exercise #3 Answer Observations:**

- **Before performing a ERL analysis, how would you have allocated the $15,000 recourse debt in light of F’s guarantee?**
- **As this is limited partnership, the general partner is generally viewed as being “on-the-hook” - why isn’t F allocated of the $15,000 debt?**

	E's Capital	F's Capital	
Initial Contribution - Section 704(b)	$ 2,000	$ 8,000	
Loss of Hypothetical Sale - Section 704(b)	(5,000)	(20,000)	
	(3,000)	(12,000)	
Re-Allocated of Tax Loss Due to Deficit	(12,000)	12,000	
	(15,000)	-	
Required Capital Account Restoration Contribution	15,000	-	<= Bears ERL
	-	-	

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Debt Allocations: Recourse Liabilities

- Guarantees & Indemnifications
  - Some contractual arrangements that are not direct payment or contribution obligations may shift the economic risk of loss with respect to partnership liabilities. The Regulations include an anti-abuse rule that describes these types of contracts as "*arrangements tantamount to a guarantee*" and provides that they will be treated as shifting the economic risk of loss under certain circumstances to the extent that:
    - The partner or a related person undertakes the obligation so that the partnership can obtain or retain a loan;
    - The obligation significantly reduces the lender's default risk on the loan; and
    - Either (a) one of the principal purposes of using the obligation is to enable partners who are not directly liable on the loan to include a portion of the loan in the basis of their partnership interest, or (b) a principal purpose of using the obligation is to cause the payment obligations of other partners to be disregarded.

Debt Allocations: Recourse Liabilities

- "Bottom-Dollar" Guarantees
  - A "bottom-dollar" payment obligation requires the guarantor to satisfy its obligation only to the extent the collateral value falls below the guarantee level.
  - Therefore, the guarantor arguably has minimal risk of ultimately being called upon to remit payment to the lender.
  - To curb this perceived abuse, in October of 2016, Treasury and the IRS published temporary regulations under Sec. 752.
    - Final regulations were published in the Federal Register on October 9, 2019 (T.D. 9877).

Debt Allocations: Recourse Liabilities

- “Bottom-Dollar” Guarantees, cont’d
  - Under the final regulations, a bottom-dollar payment obligation generally does not create an economic risk of loss for the guarantor, and, therefore, the bottom-dollar payment obligation does not result in the allocation of a recourse liability to the guarantor.
  - Regs. Section 1.752-2(b)(3)(ii)(C)(1) defines a bottom-dollar payment obligation as any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of that partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.

Debt Allocations: Recourse Liabilities

- “Bottom-Dollar” Guarantees, cont’d
  - Regs. Sec. 1.752-2(b)(3)(ii)(B) provides that a guarantee (or similar arrangement) that is treated as a bottom-dollar payment obligation under the general rule, where the partner or related person is liable for at least 90% of the partner's or related person's payment obligation is still recognized as a payment obligation under Regs. Sec. 1.752-2(b)(3).
  - Therefore, if the obligor's ultimate liability under the guarantee (or similar arrangement) is reduced by no more than 10% of the total liability as the result of an indemnity, reimbursement agreement, or similar arrangement made by another partner, then the partner's obligation for the remaining amount is still recognized as a payment obligation potentially creating an economic risk of loss.

Debt Allocations: Recourse Liabilities

- **Exercise #4**

- A, B, and C are equal members of a limited liability company, ABC, that is treated as a partnership for federal tax purposes.
- ABC borrows $1,000 from Bank.
- A guarantees payment of up to $300 of the ABC liability if any amount of the full $1,000 liability is not recovered by Bank.
- B guarantees payment of up to $200, but only if the Bank otherwise recovers less than $200.
- Both A and B waive their rights of contribution against each other.

What is the Effect of the Guarantee by A & by B

Debt Allocations: Recourse Liabilities

- **Exercise #4 Answer**

- 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 under paragraph (b)(3)(ii)(C) of this section. Therefore, A's payment obligation is recognized under paragraph (b)(3) of this section. The amount of A's economic risk of loss under §1.752- 2(b)(1) is $300.

- Because B is obligated to pay up to $200 only if and to the extent that the Bank otherwise recovers less than $200 of the $1,000 partnership liability, B's guarantee is a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section and, therefore, is not recognized under paragraph (b)(3)(ii)(A) of this section. Accordingly, B bears no economic risk of loss under §1.752-2(b)(1) for ABC's liability.

Debt Allocations: Recourse Liabilities

- **Exercise #5**

- **The facts are the same as in Exercise #4 except that, in addition, C agrees to indemnify A up to $100 for amounts that A pays with respect to its guarantee and agrees to fully indemnify B with respect to its guarantee.**

What is the Effect of the C's Indemnification on the Guarantee by A & by B?

Debt Allocations: Recourse Liabilities

- Exercise #5 Answer

- The determination of whether C's indemnity 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. The amount of C's economic risk of loss under §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 only to the extent any amount in excess of the first $100 of the partnership liability is not satisfied. Thus, A does not share in the first dollar of loss on the loan. Accordingly, A’s guarantee is a bottom dollar payment obligation and is not recognized. The 90% exception in does not apply. A bears no economic risk of loss under §1.752-2(b)(1) for ABC's liability.

- Because B’s obligation is a bottom dollar payment obligation and is not recognized independent of C’s indemnity, C’s indemnity of B is not recognized.

- $100 of ABC’s liability is a recourse liability allocated to C and the remaining $900 liability is a nonrecourse liability allocated equally to A, B, and C.

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Poll Question #3

Non-Recourse Deductions are:

a. Deductions that have the potential to create an audit

b. Items of depreciation or cost recovery deductions from property subject to nonrecourse debt

c. Deductions that are separately stated on Schedule K

d. Deductions that are limited to 7.5% of AGI

Debt Allocations: Recourse Liabilities

- **Exercise #6**

- **The facts are the same as in Exercise #5 except that the amount of C's indemnity to A is for up to $30 (not $100) for amounts that A pays with respect to its $300 guarantee.**

What is the Effect of the C's Indemnification on the Guarantee by A & by B?

Debt Allocations: Recourse Liabilities

- Exercise #6 Answer

- As in Exercise 5, C's guarantee is within the carve-out for top dollar obligations and therefore is recognized in the amount of $30.
- Because C's indemnity is recognized, A is treated as liable for $270 only to the extent any amount beyond $30 of the partnership liability is not satisfied. Thus, A is protected against loss with respect to only 10 percent of its $300 "initial payment obligation" and the 10 percent exception in Regulations § 1.752-2(b)(3)(ii)(B) applies to prevent A's guarantee from being treated as a bottom dollar payment obligation. Instead, the net amount is recognized.
- As in Exercise 5, both B's guarantee and C's indemnity of it are bottom dollar payment obligations and are not recognized.
- In sum, $30 of ABC's liability is a recourse liability allocated to C, $270 is a recourse liability allocated to A, and the remaining $700 liability is a nonrecourse liability allocated equally to A, B, and C.

Debt Allocations: Nonrecourse Liabilities

- What is Partnership Nonrecourse Debt
  - The § 752 Regulations define "nonrecourse liability" by exclusion.
  - A nonrecourse liability is any liability of the partnership "to the extent that no partner or related person bears the economic risk of loss for that liability."

TIER 1 | Nonrecourse liabilities of the partnership are allocated to each partner to the extent of his share of partnership "minimum gain"

TIER 2 | Nonrecourse liabilities are allocated to each partner to the extent that each partner would be allocated gain under § 704(c)

TIER 3 | Partnership's remaining nonrecourse liabilities are allocated to each partner in accordance with that partner's share of partnership profits.

Debt Allocations: Nonrecourse Liabilities

- Tier 1 – Partnership Minimum Gain
  - A partner's share of partnership minimum gain generally is determined in accordance with the § 704(b) Regulations.
  - Partnership minimum gain is the excess of partnership nonrecourse liabilities over the § 704(b) book value of the partnership assets that they encumber.

Partnership Non-Recourse Liabilities

(-): Partnership Section 704(b) Asset Basis

= Partnership Minimum Gain

Debt Allocations: Nonrecourse Liabilities

- Tier 1 – Partnership Minimum Gain
  - **Illustration #1**

A and B form partnership PRS. A contributes depreciable property subject to a nonrecourse liability of $6,000. The property has a basis of $4,000 and value of $10,000. B contributes $4,000 in cash. The initial § 704(b) book value of the property is $10,000 even though its tax basis is $4,000. Thus, the initial capital accounts of A and B are equal and A and B agree to share § 704(b) "book" profits and losses equally.

Under these circumstances, immediately after the transfer there is no partnership minimum gain, even though the partnership's nonrecourse liabilities ($6,000) exceed the basis of the encumbered property ($4,000). This is because the § 704(b) book value of the property ($10,000) is greater than its nonrecourse liabilities and it is book value, not adjusted basis, that is used to compute minimum gain. Thus, initially, none of the nonrecourse liability is allocated under tier 1.

Debt Allocations: Nonrecourse Liabilities

- Tier 1 – Partnership Minimum Gain
  - **Illustration #1, cont'd**

TAX BASIS		
	A's Capital	**B's Capital**
A's Property Contribution, net of Debt	$ 4,000	
B's Cash Contribution		$ 4,000
Total Capital - Post Contribution	$ 4,000	$ 4,000

704(b) BASIS		
	A's Capital	**B's Capital**
A's Property Contribution, net of Debt	$ 10,000	
B's Cash Contribution		$ 10,000
Total Capital - Post Contribution	$ 10,000	$ 10,000
Total Nonrecourse Liabilities	$ 6,000	
(-): Partnership Section 704(b) Asset Basis	(10,000)	
Partnership Minimum Gain	NONE	[Basis Exceeds Debt]

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Debt Allocations: Nonrecourse Liabilities

- Tier 2 – Section 704(c) Minimum Gain
  - Under Tier 2 of Regulations § 1.752-3(a), a partner is allocated nonrecourse liabilities in an amount equal to the gain that such partner would realize under § 704(c) if the partnership sold the assets encumbered by the nonrecourse liabilities for no consideration other than those liabilities.
  - 704(c) prevents a contributing partner from using the partnership entity to avoid paying taxes on gains related to appreciated property that such partner contributed;
  - The contributing partner "pays" for the built-in gain either when the property is sold by the partnership or is distributed;
  - The contributing partner "pays" by either being allocated the built-in gain or by having tax basis depreciation deductions reduced.

Debt Allocations: Nonrecourse Liabilities

- Tier 2 – Section 704(c) Minimum Gain
  - **Illustration #2**

Same facts as Illustration #1, A contributed property subject to a $6,000 nonrecourse liability, having a basis of $4,000 and a value of $10,000. There is no tier 1 allocation (book value of $10,000 is in excess of the $6,000 debt). The $6,000 difference between the initial book value of the property ($10,000) and its initial basis to the PRS partnership ($4,000) must be accounted for under § 704(c) using one of three methods: the "traditional" method, the traditional method with "curative" allocations, or the "remedial" allocation method.

Under the traditional method, if the property were disposed of immediately after its contribution for no consideration other than the $6,000 nonrecourse liability, PRS would recognize a § 704(b) book loss of $4,000 and a tax gain of $2,000. This $2,000 tax gain would be allocated solely to A under § 704(c) and would be treated as a tier 2 allocation to A. A book-tax difference of $2,000 for each partner would remain unresolved (A's book capital account would be $2,000 but his tax basis for his interest would be zero; B would have a $2,000 book capital account but a $4,000 tax basis)

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Debt Allocations: Nonrecourse Liabilities

- Tier 2 – Section 704(c) Minimum Gain
  - **Illustration #2, cont'd**

Under the remedial method, if PRS disposed of the property for the nonrecourse liability, A would be allocated $4,000 of gain under § 704(c), computed as follows: First, $2,000 of gain would be allocated to A as in the traditional method; second, A would be allocated $2,000 as an additional "remedial" gain allocation to offset a $2,000 § 704(b) loss that would be created and allocated to B under the remedial method. Accordingly, under Regulations § 1.752-3(a)(2), use of the remedial method for § 704(c) purposes would cause A to be allocated $4,000 of nonrecourse liabilities under tier 2. This, of course, is $2,000 more nonrecourse liabilities than would be allocated to A if PRS used the traditional method.

If the partnership elects to use the traditional method with curative allocations for § 704(c) purposes, Revenue Ruling 95-41 concludes that only $2,000 of the nonrecourse liabilities are allocated to A under tier 2 because it is not certain whether there will be any items of income available to "cure" the $4,000 ceiling rule distortion that results from the application of the traditional method alone.

Debt Allocations: Nonrecourse Liabilities

- Tier 2 – Section 704(c) Minimum Gain
  - A single nonrecourse obligation oftentimes will encumber multiple properties. In order to apply the Tier 2 rules, this type of liability must be divided among the encumbered properties.
  - The § 752 Regulations permit this to be done using any “reasonable method.
  - A method cannot be reasonable if it allocates to any property an amount of the liability that, when combined with any other liability allocated to the property, exceeds the fair market value of that property at the time the liability is incurred.
    - Once allocated, the liability is treated as separate loans encumbering single properties.
    - After a liability is allocated among properties, a partnership may not change the method for allocating the liability. However, if an encumbered property ceases to be encumbered, the portion of the liability then allocated to it must be reallocated to the other encumbered properties in a way that does not violate the fair market value limit.

Debt Allocations: Nonrecourse Liabilities

- Tier 3 – Excess Nonrecourse Liabilities
  - The § 752 Regulations give the partners considerable latitude in allocating tier 3 liabilities, requiring only that they must be allocated among the partners in accordance with the partners' share of partnership profits.
  - The Regulations identify four permissible methods of allocating excess nonrecourse deductions to reflect the partners' shares of profits. A partnership is not locked into its selection of method, and may change it from year to year.

Debt Allocations: Nonrecourse Liabilities

- Tier 3 – Excess Nonrecourse Liabilities

Facts and circumstances	Consistent with other significant items of income or gain
How deductions attributable to those nonrecourse liabilities will be allocated	Built-In Gains Allocation Approach

Reflective Case Study Example: *Mighty Giants LP*

- **Mighty Giants, LP, operates a TN-based NBA league team**
- **In Year 1, Mighty Giants, LP was owned 70% & 30% by its majority owner, Partner 1, and by its minority owner, Partner 2.**
- **In Year 2, as a result of a series of capital calls and contributions, Mighty Giants, LP was owned 91.31% and 8.69% by its majority owner, Partner 1, and by its minority owner, Partner 2, respectively.**
- **The following computations reflect Mighty Giants LP total nonrecourse liabilities at December 31, Year 1, December 31, Year 2 and December 31, Year 3:**

Total Non-Recourse Liabilities	Year 1	Year 2	Year 3
NBA Credit Facility Loan Payable	$ 100,000,000	$ 100,000,000	$ 100,000,000
Senior Secured Notes	36,600,000	36,600,000	36,600,000
Deferred Relocation	10,000,000	10,000,000	10,000,000
Total Non-Recourse Liabilities	$ 146,600,000	$ 146,600,000	$ 146,600,000

Reflective Case Study Example: *Mighty Giants LP*

- The following computations reflect Mighty Giants LP the Taxpayer's partnership minimum gain was computed as the excess of (1) total nonrecourse liabilities over (2) the assets securing the debt (the Taxpayer's National Basketball Association ("NBA") franchise). Essentially, the franchise value considers the book basis of the partnership's franchise, players' contracts less naming rights, and other paid expenditures. For the Taxpayer's calendar years ended December 31, Year 1, December 31, Year 2 and December 31, Year 3, the following partnership minimum gains were computed:

Computation of Partnership Minimum Gain	Year 1	Year 2	Year 3
NBA Credit Facility Loan Payable	$ 100,000,000	$ 100,000,000	$ 100,000,000
Senior Secured Notes	36,600,000	36,600,000	36,600,000
Deferred Relocation	10,000,000	10,000,000	10,000,000
Total Non-Recourse Liabilities	$ 146,600,000	$ 146,600,000	$ 146,600,000
Less: Adj. Basis of Assets Pledged Against Non-Recourse Debt	$ (79,469,966)	$ (79,023,334)	$ (79,023,334)
Total Partnership Minimum Gain	$ 67,130,034	$ 67,576,666	$ 67,576,666

Reflective Case Study Example: *Mighty Giants LP*

- Under Treas. Reg. § 1.704-2(d)(1), for any taxable year, the net increase or decrease in partnership minimum gain is determined by comparing the partnership minimum gain on the last day of the immediately preceding taxable year with the partnership minimum gain on the last day of the current taxable year. Based upon this application (as noted below), an increase, and not a decrease, in partnership minimum gain occurred during Year 2 (Year 3 resulted in no increase in PMG):

Increase/(Decrease)in Partnership Min. Gain	12/31/Y2
Partnership Minimum Gain – 12/31/Y1	$ 67,130,034
Partnership Minimum Gain – 12/31/Y2	67,576,666
Inc./(Dec.) in Partnership Minimum Gain	**$ 446,632**

Increase/(Decrease)in Partnership Min. Gain	12/31/Y3
Partnership Minimum Gain – 12/31/Y2	$ 67,576,666
Partnership Minimum Gain – 12/31/Y3	67,576,666
Inc./(Dec.) in Partnership Minimum Gain	**$ -**

Reflective Case Study Example: *Mighty Giants LP*

- The guidance for determining a partner's share of partnership minimum gain is contained with Treas. Reg. § 1.704-2(g)(1). It states that a partner's share of partnership minimum gain at the end of any partnership taxable year equals:
  - (i) the sum of nonrecourse deductions allocated to that partner (and to the partners' predecessor in interest) up to that time and the distributions made to that partner (and up to the partners' predecessor in interest) up to that time of proceeds of a nonrecourse liability allocable to an increase in partnership minimum gain; minus
  - (ii) the sum of that partner's (and that partner's predecessors' in interest) aggregate share of the net decrease in partnership minimum gain plus their aggregate share of decrease resulting from revaluation of partnership property subject to one or more partnership nonrecourse liabilities.

Partner Allocation of Non-Recourse Deductions

	General Partner	Limited Partner
Total Partnership Non-Recourse Deductions at 12/31/Y1	$ 67,130,034	$ 67,130,034
Partner Ownership Percentage	x 70%	x 30%
Total Allocated Non-Recourse Deductions as of 12/31/Y1	$ 46,991,024	$ 20,139,010
Net Increase in Non-Recourse Deductions	$ 446,632	$ 446,632
Year 2 Average Partnership Ownership Percentage	x 91.31%	x 8.69%
Year 2 Partner Non-Recourse Deductions (B)	$ 407,820	$ 38,812
Total Allocated Non-Recourse Deductions as of 12/31/Y2	**$ 47,398,843**	**$ 20,177,823**

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Reflective Case Study Example: *Mighty Giants LP*

- The above computations reflect the application of Treas. Reg. § 1.704-2(g)(1) which states that a partner's share of partnership minimum gain "at the end of any partnership taxable year" equals "the sum of nonrecourse deductions allocated to that partner… up to that time…" Accordingly, this analysis and the above calculations illustrate that the Limited Partner was allocated $20,139,010 of non-recourse deductions up to December 31, Year 1, and, for the year in question, MBPLP should share in the net increase in the partnership minimum gain and be allocated its share of the net increase accordingly. In effect, this allocation preserves the prior year's allocations of partnership minimum gain allocated to the Limited Partner up to December 31, Year 1, and the Limited Partner's share of the Year 2 net increase becomes an addition to the Limited Partner's previously allocated share of partnership minimum gain. Therefore, the sum of nonrecourse deductions allocated to the Limited Partner at December 31, Year 2 becomes the amount of partnership minimum gain allocated to the Limited Partner at December 31, Year 2.

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Reflective Case Study Example: *Mighty Giants LP*

Partner Allocation of Non-Recourse Liabilities	General Partner	Limited Partner	TOTAL
Year Ended December 31, Year 1			
Tier I Non-Recourse Debt Allocations (A)	$ 46,991,024	$ 20,139,010	$ 67,130,034
Tier II Non-Recourse Debt Allocations (B)	$ 22,276,301	----	$ 22,276,301
Tier III Non-Recourse Debt	57,193,665	57,193,665	
Allocation Percentages	x 70%	x 30%	
Tier III Non-Recourse Debt Allocations (C)	$ 40,035,566	$ 17,158,100	$ 57,193,665
Total Non-Recourse Debt Allocations (A+B+C)	**$ 109,302,891**	**$ 37,297,110**	**$ 146,600,000**
Year Ended December 31, Year 2			
Tier I Non-Recourse Debt Allocations (A)	$ 47,398,843	$ 20,177,822	$ 67,676,666
Tier II Non-Recourse Debt Allocations (B)	$ 22,123,815	----	$ 22,123,815
Tier III Non-Recourse Debt	56,799,519	56,799,519	
Allocation Percentages	x 91.31%	x 8.69%	
Tier III Non-Recourse Debt Allocations (C)	$ 51,863,641	$ 4,935,878	$ 56,799,519
Total Non-Recourse Debt Allocations (A+B+C)	**$ 121,386,299**	**$ 25,113,700**	**$ 146,600,000**

Poll Question #3

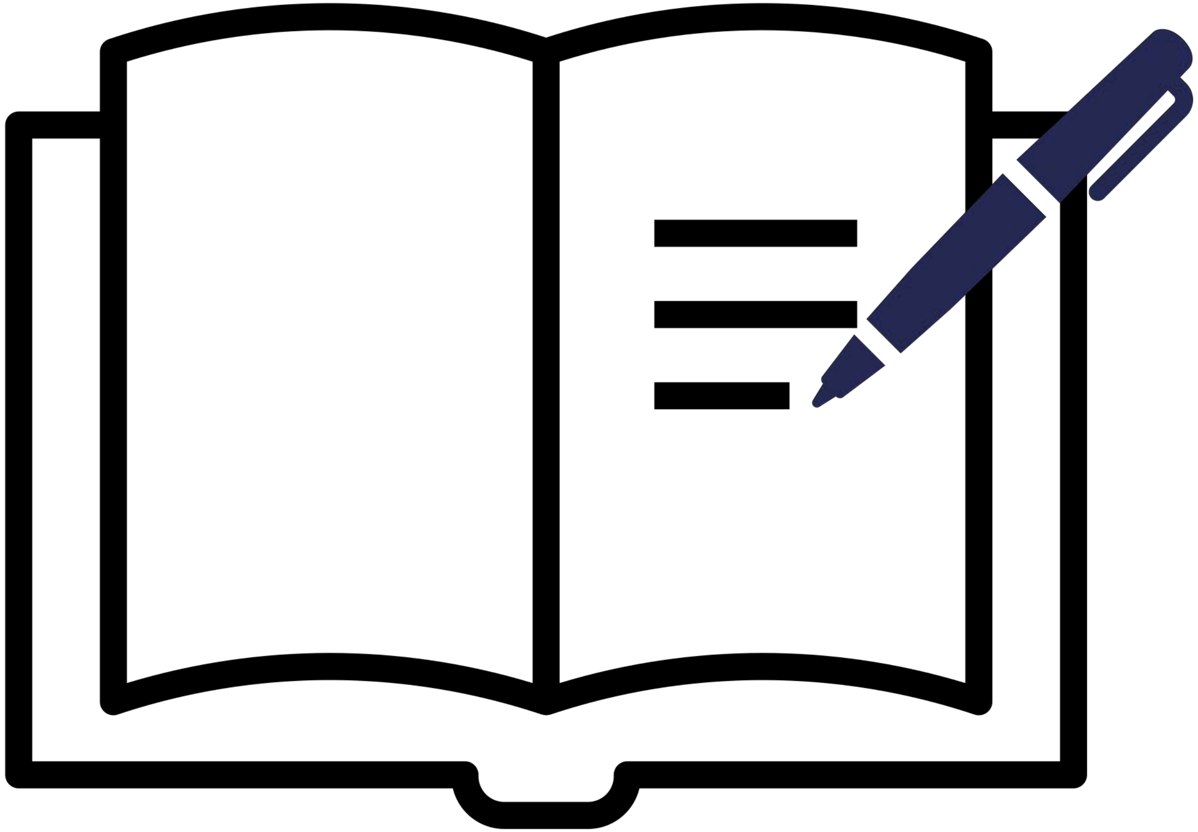
The NFL Superbowl 2025 will be player at what arena:

a. Caesar's Superdome

b. State Farm Stadium

c. AT&T Stadium

d. SoFi Stadium



Conclusion & Questions

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