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Final Regulations Issued on Allocation of Partnership Liabilities Under Section 752

Tax Talks on **February 12, 2025**

Introduction

On December 2, 2024, the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") published final regulations (the "Final Regulations") on section 752[1] regarding the allocation of partnership recourse liabilities in situations in which multiple partners and related parties bear part or all of the economic risk of loss ("EROL") for partnership liabilities.[2] The Final Regulations largely adopt the proposed regulations (the "Proposed Regulations") published on December 16, 2013 and, as such, should not result in substantial changes to the application of the rules under section 752.[3] In particular, these rules generally do not limit the ability of partners and related parties to use contractual arrangements, including guarantees, to specify the manner in which debt will be allocated among the partners.[4]

Background

Very generally, section 752 governs the allocation of liabilities and income or loss arising from debt among partners in a partnership and specifies how these liabilities affect a partner's tax basis in its partnership interest.[5] Section 752 has been interpreted in the Treasury Regulations as intending to maintain the proper alignment between a partner's basis and its share of a partnership's debts based on the partner's economic risk of loss with respect to the partnership, an approach which Congress has broadly endorsed.

The rules for determining a partner's share of a partnership's liabilities depend on whether the debt is recourse or nonrecourse. For a liability to be considered recourse, a partner or a related person must bear the EROL in respect to that liability – roughly speaking, a liability is nonrecourse to the extent that no partner or related person bears the EROL with respect to the liability. The Final Regulations address only the allocation of a partnership's recourse liabilities.

A partner generally bears the EROL for a partnership liability to the extent that, in a constructive liquidation of the partnership where all of its assets (including cash) become worthless and all of its liabilities become due and payable, the partner or a related person would have a payment obligation to any person (or a capital contribution obligation to the partnership) with respect to the liability. Additionally, a partner generally bears the EROL for a partnership liability to the extent that the partner or a related person (i) is a lender of a nonrecourse loan for which no other partner bears the EROL; (ii) guarantees interest payments on a partnership nonrecourse liability (but only with respect to liability for such guaranteed interest); or (iii) pledges property as security for the partnership liability. The basic rule under section 752 is that a partner is allocated a share of a partnership liability to the extent that it bears the EROL with respect to that liability. The Final Regulations provide details on various, more complicated fact patterns that frequently arise in interpreting the EROL principle of allocating partner recourse debt for purposes of section 752.

The Final Regulations

As discussed in further detail below, the Final Regulations provide guidance on the (i) allocation of liabilities where there is overlapping EROL, (ii) application of section 752 in situations involving tiered partnerships, and (iii) allocation of liabilities among related parties. The Final Regulations additionally modify the section 704 regulations to provide clarity in rules for allocating nonrecourse deductions in tiered partnerships.

I. Overlapping EROL

The Final Regulations include a proportionality rule for determining each partner's share of a partnership liability in situations in which multiple partners bear the EROL with respect to the same liability ("overlapping EROL").

When the proportionality rule is triggered, each partner's EROL for a partnership liability (or portion thereof) is determined by multiplying the total amount of the partnership liability (or portion thereof) by the following fraction: (i) the amount of EROL borne by the partner (i.e., the numerator); divided by (ii) the aggregate the EROL borne by all partners (i.e., the denominator). This rule prevents double counting of EROL with respect to the same liability.

For example, assume that A and B are 50:50 partners in partnership AB, which has borrowed $100 from a bank. A has guaranteed repayment of $100, and B has guaranteed repayment of $50 (if any amount of the loan is not repaid). The partnership liability is $100, or the amount of the loan.[6] The sum of the EROL borne by all partners with respect to this liability (as determined prior to application of the overlapping EROL rules) is $150. Thus, the amount of EROL borne by each of A and B is calculated as follows.

- With respect to A: $100 (the total partnership liability) multiplied by the quotient of $100/$150 (the amount of EROL borne by A individually over the aggregate EROL borne by both A and B) for an EROL of $66.67 for A.
- With respect to B: $100 (the total partnership liability) multiplied by the quotient of $50/$150 (the amount of EROL borne by B individually over the aggregate EROL borne by both A and B) for an EROL of $33.33 for B.

II. Tiered Partnerships

Under the Final Regulations, with respect to a partnership (the "upper-tier partnership" or "UTP") that owns an interest in another partnership (the "lower-tier partnership" or "LTP"), the liabilities of the LTP are allocated to the UTP in a total amount equal to (without duplication) (i) the EROL directly borne by the UTP with respect to such liabilities, plus (ii) the EROL for such liabilities borne by any partner of the UTP, but only if the partner is not also a partner in the LTP. The Final Regulations also clarify that if an LTP liability is treated as a UTP liability under Treas. Reg. Sec. 1.752-4(a), the UTP is considered to bear the EROL for that liability, and therefore, partner nonrecourse deductions attributable to the LTP's liability must be allocated to the UTP under Treas. Reg. Sec. 1.704-2(i). If a partner of the UTP is also a partner of the LTP, such partner bears the EROL with respect to a LTP liability directly, then prior to determining the amount of LTP liabilities that are allocated to the UTP, the LTP must first determine the allocation of the LTP liability to the direct partner, applying the proportionality rule discussed above as necessary.

An example adapted from the Final Regulations that illustrates the application of the proportionality rule in the case of a tiered partnership is below.

A and B (which is unrelated to A) contribute $810 and $90 to UTP, a limited liability company treated as a partnership for U.S. federal income tax purposes, in exchange for a 90% and 10% respective interest in UTP. UTP contributes the $900 to LTP, a partnership for Federal tax purposes, in exchange for a 90% interest in LTP and A contributes $100 directly to LTP in exchange for a 10% interest in LTP. UTP and LTP both reported losses in their initial years that reduced the basis of each partner in UTP and LTP to zero. LTP borrows $100 UTP and LTP both had no income in the year at issue. A and B both provide their personal guaranty for the entire amount of the LTP's liability.

A's share of the LTP liability is calculated by determining A's EROL and then applying the proportionality rule. A and B each have an EROL of $100 with respect to the LTP liability as a result of their personal guarantees. Applying the proportionality rule, A's share of the LTP liability is $50, or the product of $100 (the total amount of the LTP liability) by $100 (A's EROL) over $200 (the aggregate EROL borne by A and B). B's share of the LTP liability is similarly $50.

The LTP allocates $50 of liabilities to A for A's direct interest in the LTP liability. LTP allocates $50 of liabilities for which B bears the EROL to UTP under the tiered partnership rules. The UTP treats its $50 share of the LTP liability as a liability of UTP. Because the $50 liability allocated to UTP only includes amounts for which B alone bears the EROL, UTP allocates all $50 to B and none to A.[7]

III. Related Party Rules

A partner is generally treated as bearing the EROL with respect to a partnership liability to the extent a person related to the partner directly bears the EROL.[8] The preamble to the Final Regulations include a "related partner exception," which provides that "if a person who owns (directly or indirectly through one or more partnerships) an interest in a partnership is a lender or has a payment obligation with respect to a partnership liability, or portion thereof, then other persons owning interests directly or indirectly (through one or more partnerships) in that partnership would not be treated as related to that person for purposes of determining the EROL borne by each of them for the partnership liability, or portion thereof."

For example, assume AB partnership is owned 60/40 by A and B. A and B are related persons for purposes of the section 752 regulations. A personally guarantees a $100 loan made to AB. Under the related party exception, because A directly bears the EROL for the loan as a result of its guaranty, B and A are not treated as a related persons for purposes of determining B's EROL with respect to the loan. Because A is bears the EROL for the entire $100 liability and B does not bear any EROL, the $100 liability is allocated solely to A.

In addition, the Final Regulations include a special rule for an instance of overlapping EROL where a person (other than a direct or indirect partner of the partnership) that directly bears the EROL for a partnership liability is considered related to multiple partners of the partnership.[9] Under this rule, those partners related to the person directly bearing the EROL for the partnership liability share the liability in proportion to each related partner's interest in the partnership.

For example, assume that A owns all of the stock of a corporation X, which in turn owns all of the stock of corporation Y. A and X are 70:30 partners in AX, a partnership for U.S. federal income tax purposes, which borrows $100. Y has guaranteed repayment of the $100 loan. Applying constructive ownership rules, Y is related to both A and X. Under the Proposed Regulations, because A and X are both related to the person directly bearing the EROL, the $100 liability would be allocated equally between A and B. In contrast, under the Final Regulations A and X share the liability in proportion to their interests in AX profits, with $70 allocated to A and $30 allocated to X.

Finally, the Final Regulations provide an ordering rule for the related party rules and proportionality rules. Under this ordering rule, the related partner exception applies first, followed by the rule for allocating liabilities where multiple partners are related to a non-partner directly bearing the EROL for a partnership liability, and then finally the proportionality rule.

Implications & Effective Date

As the Final Regulations largely adopt the Proposed Regulations, for many taxpayers, the Final Regulations will not result in substantial changes to the application of the section 752 rules that have existed in proposed form since 2013. Still, the Final Regulations helpfully clarify ambiguities in the Proposed Regulations, which results in greater certainty for taxpayers.

The Final Regulations are generally effective for all partnership liabilities incurred or assumed on or after December 2, 2024. However, the Final Regulations do not apply to any liabilities incurred or assumed by a partnership pursuant to a written binding contract in effect prior to December 2, 2024. Further, partnerships may elect to apply the Final Regulations to all liabilities with respect to returns filed on or after December 2, 2024 (including preexisting partnership liabilities), as long as the partnership applies the rules consistently and in their entirety to all its liabilities. In addition, the Final Regulations treat certain refinanced debt of a partnership that is modified or refinanced on or after December 2, 2024 as incurred or assumed by the partnership prior to December 2, 2024 to the extent of the amount and duration of the pre-modified debt; accordingly, the Final Regulations do not apply to such refinanced debt (absent the election described above).

Partnerships may wish to consult with their tax advisors regarding the desirability of an election to apply the Final Regulations to all liabilities with respect to returns that will be filed on or after December 2, 2024.

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[1] All references to "section" are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

[2] T.D. 10014.

[3] REG-136984-12.

[4] Such allocations must correspond to economic reality and in particular the allocation of debt must generally be to creditworthy partners.

[5] More specifically, section 752(a) treats an increase in a partner's share of partnership liabilities (or an increase in a partner's individual liabilities through its assumption of the partnership's liabilities) as if the partner contributed money to the partnership (thus, increasing the partner's tax basis in its partnership interest). Section 752(b) treats a decrease in a partner's share of partnership liabilities (or a decrease in a partner's individual liabilities through the partnership's assumption of the partner's liabilities) as if the partnership distributed money to the partnership (thus, decreasing the partner's tax basis in its partnership interest).

[6] This example further assumes that no applicable state or local law or contract provides for reimbursement from the other party or otherwise differently allocates responsibility for the liability as between A and B.

[7] This assumes that no state or local law or contract specifies otherwise.

[8] Parties are considered related when one party has a significant level of ownership or control over another party. To determine relatedness for these purposes, the constructive ownership rules under sections 267 and 707 apply. The Proposed Regulations and Final Regulations apply the constructive ownership rules of sections 267 and 707, except that "80 percent or more" is substituted for "more than 50 percent" in each section; a person's family is determined by excluding brothers and sisters; and sections 267(e)(1) and 267(f)(1)(A) are disregarded. Under the Proposed Regulations, these rules applied with certain modifications but still resulted in a partner being treated as bearing the EROL with respect to a partnership liability, even when that partner's risk was limited to its equity investment in the partnership. The Final Regulations adopt two additional modifications to the constructive ownership rules: disregarding section 267(c)(1) (upward attribution through entities) with respect to the determination of whether a UTP's interest in an LTP is owned proportionally by the UTP's partners; and disregarding section 1563(e)(2) when determining whether a corporate partner in a partnership and a corporation owned by the partnership are members of the same controlled group.

[9] This rule is a deviation from the Proposed Regulations in response to comments expressing concern that the multiple partners rule may result in related partners recognizing uneconomic gain.

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