DISREGARDED ENTITIES AND PARTNERSHIP LIABILITY ALLOCATIONS: PROPOSED REGS CRITIQUE

By Blake D. Rubin and Andrea Macintosh Whiteway

Blake D. Rubin and Andrea Macintosh Whiteway are partners with Arnold & Porter LLP, Washington.

The Internal Revenue Service recently proposed regulations addressing the consequences of owning a partnership interest through a disregarded entity (such as a single-owner LLC) on the allocation of partnership liabilities under section 752. The proposed regulations, according to the authors, are unquestionably based on a sound analysis of the extent to which a partner who owns a partnership interest through a disregarded entity bears the economic risk of loss for a partnership liability. That theoretical purity, they argue, comes at a cost of significant taxpayer compliance burdens in an area where, based on informal conversations with government representatives involved in developing the regulations, there was no evidence of taxpayer abuse.

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I. Introduction

On August 12, 2004, the IRS issued proposed regulations addressing the consequences of owning a partnership interest through a disregarded entity (such as a single-owner limited liability company) on the allocation of partnership liabilities under Internal Revenue Code section 752. The new regulations seek to clarify the effect of the state law liability shield provided by the disregarded entity in determining the extent to which a partner who owns a partnership interest through a disregarded entity may be treated as bearing the economic risk of loss for a partnership liability. The regulations are proposed to be effective for liabilities incurred or assumed by a partnership on or after the date the regulations are published as final regulations in the Federal Register.

The proposed regulations are unquestionably based on a sound analysis of the extent to which a partner who owns a partnership interest through a disregarded entity bears the economic risk of loss for a partnership liability. That theoretical purity, however, comes at the cost of significant taxpayer compliance burdens in an area where, based on informal conversations with government representatives involved in developing the regulations, there was no evidence of taxpayer abuse. Moreover, in a closely related area, the existing section 752 regulations deliberately sacrifice theory for administrability, and the proposed regulations create inconsistencies with those existing provisions. This article discusses the new regulations.

II. Allocation of Partnership Liabilities

A. Sections 752 and 731 Generally

The allocation of partnership liabilities among partners is often of critical importance. Broadly speaking, a partner’s share of partnership liabilities is included in determining the partner’s basis in the partnership interest. The partner’s basis in the partnership interest in turn determines the extent to which the partner can receive tax-free distributions of cash. Moreover, decreases in a
partner's share of partnership liabilities can cause the partner to recognize taxable gain.

More technically, under section 752(a), any increase in a partner’s share of the liabilities of a partnership, or any increase in a partner’s individual liabilities by reason of the assumption by that partner of partnership liabilities, is treated as a distribution of money by that partner to the partnership. Under section 722, that deemed contribution of money by the partner to the partnership increases the partner’s basis in the partnership interest.

On the other side of the coin, under section 752(b), any decrease in a partner’s share of the liabilities of a partnership, or any decrease in a partner’s individual liabilities by reason of the assumption by the partnership of those individual liabilities, is treated as a distribution of money to the partner by the partnership. Under sections 733(1) and 705(a)(2), that deemed distribution of money by the partnership to the partner reduces the partner’s basis in the partnership interest, but not below zero. Under section 731(a), on a distribution of money to a partner by a partnership (including a deemed distribution of money under section 752(b)), gain is recognized by the distributee partner to the extent that the money distributed exceeds the adjusted basis of the partner’s interest immediately before the distribution.

Reg. section 1.752-1(f) provides that if, as a result of a single transaction, a partner incurs both an increase in the partner’s share of partnership liabilities (or the partner’s individual liabilities) and a decrease in the partner’s share of partnership liabilities (or the partner’s individual liabilities), only the net decrease is treated as a distribution of money and only the net increase is treated as a contribution of money.

**B. Partner’s Share of Recourse Liabilities**

A partner’s share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the “economic risk of loss.” In general, recourse liabilities are allocated to the partner who would be responsible for paying them if the partnership were unable to. To determine who bears the economic risk of loss for that liability, the existing section 752 regulations provide that all partners and related persons are assumed to actually perform their obligations, irrespective of their net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. Reg. section 1.752-2(b)(6). Thus, under that general “deemed satisfaction” rule, no inquiry is made as to the financial ability of a person to make a payment or otherwise perform a financial obligation imposed on that person.

Reg. section 1.752-2(j) provides antiabuse rules that, among other things, are intended to prevent manipulation or abuse of the “deemed satisfaction” rule. Reg. section 1.752-2(j)(1) states that an obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person for purposes of the section 752 regulations if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner’s economic risk of loss with respect to that obligation or to create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Likewise, reg. section 1.752-2(j)(3) provides that an obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation. Reg. section 1.752-2(j) contains an example of a plan to circumvent or avoid an obligation that involves a thinly capitalized corporate partner that is a member of a consolidated return group entering into a capital account deficit restoration obligation to allow the consolidated return group to enjoy the tax losses while limiting its monetary exposure for those losses. The example concludes that the rules of section 752 must be applied as if the deficit restoration obligation did not exist.

**C. The ‘Deemed Satisfaction’ Rule and Exception**

For purposes of determining the extent to which a partner or related person has a payment obligation and bears the economic risk of loss for a recourse liability, the existing section 752 regulations provide that all partners and related persons are assumed to actually perform their obligations, irrespective of their net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. Reg. section 1.752-2(b)(6). Thus, under that general “deemed satisfaction” rule, no inquiry is made as to the financial ability of a person to make a payment or otherwise perform a financial obligation imposed on that person.

Reg. section 1.752-2(j) provides antiabuse rules that, among other things, are intended to prevent manipulation or abuse of the “deemed satisfaction” rule. Reg. section 1.752-2(j)(1) states that an obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person for purposes of the section 752 regulations if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner’s economic risk of loss with respect to that obligation or to create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Likewise, reg. section 1.752-2(j)(3) provides that an obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation. Reg. section 1.752-2(j) contains an example of a plan to circumvent or avoid an obligation that involves a thinly capitalized corporate partner that is a member of a consolidated return group entering into a capital account deficit restoration obligation to allow the consolidated return group to enjoy the tax losses while limiting its monetary exposure for those losses. The example concludes that the rules of section 752 must be applied as if the deficit restoration obligation did not exist.

**D. Partner’s Share of Nonrecourse Liabilities**

A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability. Reg. section 1.752-1(a)(2). A partner’s share of partnership nonrecourse liabilities equals the sum of (1) a partner’s share of partnership minimum gain determined pursuant to the section 704(b) regulations (the first tier), (2) the amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as under section 704(c) if partnership property is revalued) if the partnership disposed of all partnership property subject to nonrecourse liabilities for no consideration other than full satisfaction of the liabilities (the second tier), and (3) the partner’s share of the excess
III. The Proposed Regulations

The proposed regulations provide that in determining the extent to which a partner bears the economic risk of loss for a partnership liability, payment obligations of a disregarded entity are taken into account for purposes of section 752 only to the extent of the “net value” of the disregarded entity as of the date on which the partnership determines the partner’s share of partnership liabilities under reg. sections 1.752-4(d) and 1.705-1(a). The new rules apply to business entities such as single-owner LLCs that are disregarded as separate from their owner under Treas. reg. sections 301.7701-1 through 301.7701-3, as well as to “qualified REIT subsidiaries” under section 856(i) and “qualified subchapter S subsidiaries” under section 1361(b)(3).

A. Net Value Determination

Under prop. reg. section 1.752-2(k)(2), the “net value” of a disregarded entity is equal to the fair market value of all assets owned by the disregarded entity that may be subject to the claims of creditors, less obligations of the disregarded entity that do not constitute, and are senior or of equal priority to, payment obligations of the disregarded entity that are taken into account under reg. section 1.752-2(b) in determining the extent to which a partner bears the economic risk of loss for a partnership liability. For that purpose, a disregarded entity’s assets include the entity’s enforceable rights to contributions from its owner but exclude the disregarded entity’s interest in the partnership (if any). Likewise, the value of any property of the disregarded entity that is pledged to secure a partnership liability and therefore taken into account under the pledge rule of reg. section 1.752-2(h) is excluded.

In determining the net value of the disregarded entity, the regulations require that any subsequent reduction in net value be taken into account if at the time the net value is determined it is anticipated that the reduction will occur and the reduction is part of a plan that has as one of its principal purposes creating the appearance that a partner bears the economic risk of loss for a partnership liability. Prop. reg. section 1.752-2(k)(3). Also, if one or more disregarded entities have payment obligations with respect to one or more partnership liabilities, or liabilities of more than one partnership, the partnership must allocate the net value of each disregarded entity among partnership liabilities in a reasonable and consistent manner, taking into account priorities among partnership liabilities. Prop. reg. section 1.752-2(k)(4).

B. Redetermination of Net Value

Under the proposed regulations, once the net value of the disregarded entity is determined, that net value is not redetermined unless (i) there is more than a de minimis contribution to or distribution from the disregarded entity, or (ii) the disregarded entity’s obligations that do not constitute, and are senior or of equal priority to, payment obligations of the disregarded entity that are taken into account under reg. section 1.752-2(b) in determining the extent to which a partner bears the economic risk of loss change by more than a de minimis amount. Prop. reg. section 1.752-2(k)(2). In the preamble to the proposed regulations, the IRS and Treasury requested comments on whether other events should also trigger a revaluation of the net value of the disregarded entity, such as a sale of substantially all of a disregarded entity’s assets, and whether an annual revaluation election should be made available to partners regardless of the occurrence of a revaluation event, with the understanding that any such election to revalue annually would be revocable only with the commissioner’s consent.

C. Reporting Requirement

The proposed regulations impose a reporting obligation on partners who own partnership interests through disregarded entities to enable the partnership to properly allocate liabilities. Prop. reg. section 1.752-2(k)(5) requires that a partner that may be treated as bearing the economic risk of loss for a partnership liability based on an obligation of a disregarded entity must provide information as to the entity’s tax classification and net value to the partnership on a timely basis.

D. Pledged Property; Conforming Changes

The proposed regulations clarify the rule of existing reg. section 1.752-2(h) (which generally provides that a partner bears the economic risk of loss to the extent of the value of the partner’s separate property pledged as security for a partnership liability) by providing that the value of the pledged property must be reduced by any other obligations that are senior or of equal priority to the partnership liability. The IRS and Treasury also requested comments regarding whether the pledged assets should be able to be revalued annually, pursuant to an election by the partners, revocable only with the commissioner’s consent.

The proposed regulations also include conforming changes to reg. section 1.704-2(f)(2), (g)(3), and (i)(4). Those rules provide exceptions from the minimum gain chargeback requirements of the section 704(b) regulations that apply when the character of partnership debt under section 752 changes as a result of a guarantee, lapse of a guarantee, conversion, refinancing, or other change in the debt instrument. Under the proposed regulations, those rules would apply on any change in the character of partnership debt under section 752, whether as a result of the circumstances specified in the current regulations or as a result of changes under the rules of the proposed regulations.

E. Extension of Proposed Rules to Other Entities

The preamble to the proposed regulations states that the “IRS and Treasury Department are considering and request comments regarding whether the rules of the
proposed regulations should be extended to payment obligations of other entities, such as entities that are capitalized with nominal equity.\footnote{Reg. section 1.752-2(f)(1) states that an obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person for purposes of the section 752 regulations if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or to create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Likewise, reg. section 1.752-2(f)(1) provides that an obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation.}

IV. Comments and Observations
A. ‘Deemed Satisfaction’ and Disregarded Entities
   As discussed above, the “deemed satisfaction” rule of reg. section 1.752-2(b)(6) provides that for purposes of determining the extent to which a partner or related person has a payment obligation and bears the economic risk of loss for a recourse liability, all partners and related persons are assumed to actually perform their obligations, irrespective of their net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. Reg. section 1.752-2(j) provides antiabuse rules that prevent manipulation or abuse of the “deemed satisfaction” rule.\footnote{Reg. section 1.752-1(i) states that if one or more partners bears the economic risk of loss as to part, but not all, of a partnership liability represented by a single contractual obligation, that liability is treated as two or more separate liabilities for purposes of section 752. The portion of the liability as to which one or more partners bear the economic risk of loss is a recourse liability and the remainder of the liability, if any, is a nonrecourse liability.}

   Instead of the net value approach taken by the proposed regulations, the regulations could simply have clarified that the “deemed satisfaction” rule and antiabuse backstop apply to obligations of disregarded entities. Under such an approach, the fact that a disregarded entity that provides state law liability protection is the obligor on a payment obligation would not be taken into account in determining whether the disregarded entity’s owner bears the economic risk of loss for a partnership liability, unless the facts and circumstances evidence a plan to circumvent or avoid the obligation. That is, the same rules that apply to regarded entities would be applied to disregarded entities.

   As illustrated by the following examples, the failure to apply the “deemed satisfaction” rule and antiabuse backstop results in economically similar arrangements being treated differently.

   Example 1. A taxpayer is the sole owner of an LLC that owns two assets: an interest as the sole general partner in a limited partnership and land worth $20,000. The partnership has a liability that constitutes a general obligation of the partnership of $100,000. Under prop. reg. section 1.752-2(k) and Treas. reg. section 1.752-1(i), the $100,000 liability is bifurcated and treated as a recourse liability of $20,000 for which the taxpayer bears the economic risk of loss and a nonrecourse liability of $80,000.\footnote{The LLC would bear the economic risk of loss for the $100,000 liability and thus would be allocated the entire liability. See reg. section 1.752-2(i). The $100,000 liability would then be treated as a liability of the LLC and allocated to the taxpayer and its affiliate in accordance with the rules for allocating nonrecourse liabilities (because neither the taxpayer nor its affiliate would bear the economic risk of loss for the liability). See reg. section 1.752-4(a).}

   Thus, the taxpayer includes $20,000 of the liability in the basis of its interest in the partnership as a recourse liability for which the taxpayer bears the economic risk of loss.

   Example 2. The facts are the same as in Example 1 except that the taxpayer owns a 99 percent interest in the LLC and the taxpayer’s affiliate owns a 1 percent interest. The proposed regulations are inapplicable because the LLC is a regarded entity taxable as a partnership. If the “deemed satisfaction” rule of reg. section 1.752-2(b)(6) applies, the entire $100,000 liability is treated as a recourse obligation of the LLC and is includable in the basis of the taxpayer and its affiliate.\footnote{In both Example 1 and Example 2, to the extent the $100,000 liability is treated as a nonrecourse liability of the partnership, some portion may still be allocated to the taxpayer and its affiliate under the rules relating to the allocation of nonrecourse liabilities. See generally reg. section 1.752-5.} However, if the antiabuse backstop rule of reg. section 1.752-2(j) applies because the facts and circumstances evidence a plan to circumvent or avoid the obligation, then the obligation of the LLC is not recognized, the liability is treated as nonrecourse, and no portion of the $100,000 liability is allocated to the LLC as a recourse liability.\footnote{The preamble states that “because only the assets of a disregarded entity may be available to satisfy payment obligations undertaken by the disregarded entity, a partner should be treated as bearing the economic risk of loss for a partnership liability as a result of those payment obligations only to the extent of the net value of the disregarded entity’s assets.” While that logic is unassailable, interests of administrability would argue in favor of extending the same rules that apply to regarded entities to disregarded entities.}

   In terms of their actual exposure to economic loss on account of the $100,000 liability, the taxpayers in Examples 1 and 2 are identically situated. Nevertheless, the regulations provide for three different allocations of the liability depending on the details of the ownership structure and the application of the antiabuse backstop rule.

   The preamble to the proposed regulations acknowledges that applying the “deemed satisfaction” rule would lead to the conclusion that payment obligations of a disregarded entity should be allocated to its owner for tax purposes because the owner and the disregarded entity are treated as a single entity for federal income tax purposes. Nevertheless, the regulations adopt the net value approach discussed above. The preamble states that “because only the assets of a disregarded entity may be available to satisfy payment obligations undertaken by the disregarded entity, a partner should be treated as bearing the economic risk of loss for a partnership liability as a result of those payment obligations only to the extent of the net value of the disregarded entity’s assets.” While that logic is unassailable, interests of administrability would argue in favor of extending the
“deemed satisfaction” rule to disregarded entities, particularly in light of the fact that government representatives involved in developing the regulations have indicated informally that they are not aware of any evidence of taxpayer abuse in this area. Nevertheless, Treasury and the IRS made the call the other way, and seem inclined to remedy the inconsistencies pointed out in Examples 1 and 2 by moving away from the “deemed satisfaction” rule in the context of disregarded entities.6

B. Time for Determining Liability Shares

Prop. reg. section 1.752-2(k)(1) requires that the net value of a disregarded entity be determined “as of the date on which the partnership determines the partner’s share of liabilities pursuant to sections 1.752-4(d) and 1.705-1(a).” Reg. section 1.752-4(d) states that a “partner’s share of partnership liabilities must be determined whenever the determination is necessary in order to determine the tax liability of the partner or any other person.” Reg. section 1.705-1(a) states that:

A partner is required to determine the adjusted basis of his interest in a partnership only when necessary for the determination of his tax liability or that of any other person. The determination of the adjusted basis of a partnership interest is ordinarily made as of the end of a partnership taxable year.

Under section 731(a)(1), a partner must recognize gain to the extent that any money distributed exceeds the adjusted basis of that partner’s interest in the partnership immediately before the distribution. Moreover, a decrease in a partner’s share of liabilities is treated as a deemed distribution of money under section 752(b) that potentially triggers gain under section 731(a)(1). As a result, it appears that a partnership must determine liability shares whenever there is a decrease in any partner’s share (which may be attributable to an increase in another partner’s share), because the decrease must be compared against the partner’s basis immediately before to determine if gain is triggered.

Nevertheless, examples in the proposed regulations appear to assume that the partnership determines liability shares only at the end of the tax year. In prop. reg. section 1.752-2(k)(6) Example 2, A forms a wholly owned LLC in 2005 with a capital contribution of $100,000, which LLC contributes to a limited partnership. LLC is the only partner with a capital account deficit restoration obligation. In 2006 LLC borrows $300,000 on a recourse basis. As of December 31, 2006, when the partnership first determines liability shares, no portion of the liability is treated as recourse with respect to LLC because LLC has no net value. Thereafter, on January 1, 2007, A contributes to LLC $250,000 of assets that decline in value to $175,000 by December 31, 2007.

In analyzing the results for 2007, prop. reg. section 1.752-2(k)(6) Example 2 concludes that because the partnership determines debt shares as of year-end, $175,000 of the partnership’s liabilities are treated as recourse with respect to LLC, which is equal to the net value of LLC on December 31, 2007. In fact, however, it appears that the partnership would be required by reg. section 1.752-4(d) to determine debt shares as of the January 1, 2007, date of A’s capital contribution to LLC, because as of that date a portion of the partnership’s liabilities would become recourse with respect to LLC, thereby producing a deemed distribution to the other partners under section 752(b) that is potentially taxable to them under section 731(a)(1). Moreover, applying the net value test on January 1, 2007, creates different results, because the value of the property contributed on January 1, 2007, is $250,000 (rather than $175,000 at year-end). Furthermore, no event occurs between January 1 and December 31, 2007, that would allow a redetermination of LLC’s net value. Thus, on the facts of prop. reg. section 1.752-2(k)(6) Example 2, whether $175,000 or $250,000 of partnership liabilities are treated as recourse with respect to LLC depends on the time the partnership is required to determine liabilities.

C. Reporting and Compliance Issues

As discussed above, prop. reg. section 1.752-2(k)(5) requires that a partner that may be treated as bearing the economic risk of loss for a partnership liability based on an obligation of a disregarded entity must provide information as to the entity’s tax classification and net value to the partnership on a timely basis. The proposed regulations do not address a variety of related reporting and compliance issues raised by the net value approach. What level of diligence is required of the disregarded entity in determining its net value? Are appraisals of assets required? Is expert evaluation of contingent obligations that may reduce net value required? Is annual reporting to the partnership sufficient, or is more frequent reporting required if an event occurs that requires redetermination of value? Is a statement that the net value of the disregarded entity exceeds its payment obligations sufficient, or must the disregarded entity report a dollar amount for its net value (thereby revealing potentially confidential financial information)? May the partnership simply accept the information as reported by the disregarded entity, or does the partnership have an obligation to investigate or confirm the information? How should the partnership allocate its liabilities if the disregarded entity fails to supply the required information? Those and other questions regarding compliance with the new rules await further explanation.

D. ‘Obligations’ Taken Into Account

As discussed above, under prop. reg. section 1.752-2(k)(2), the “net value” of a disregarded entity is equal to the fair market value of all assets owned by the disregarded entity that may be subject to the claims of creditors, “less obligations of the disregarded entity that do not constitute, and are senior or of equal priority to, obligations of the disregarded entity that are taken into account” under reg. section 1.752-2(b)(1). The second use of the word “obligations” in the quoted language clearly

6 As noted above, the preamble to the proposed regulations states that the “IRS and Treasury Department are considering and request comments regarding whether the rules of the proposed regulations should be extended to payment obligations of other entities, such as entities that are capitalized with nominal equity.”
refers to obligations described in reg. section 1.752-2(b)(1). The first use of the word “obligations” apparently is intended to refer to some broader category. Informal discussions with government officials involved in developing the regulations confirm that the first use of the word “obligations” is intended to be very broad and would encompass, for example, an obligation to make payments under a lease. Assuming that first use of the word “obligations” includes an obligation to make payments under a lease, it is not clear how such an obligation should be taken into account. For example, is the stream of required lease payments to be discounted to present value at a particular interest rate? Or is the obligation to make payments under a lease taken into account only to the extent that the lease is at an above-market rent such that the taxpayer would pay to be relieved of the obligation? In finalizing the proposed regulations, consideration should be given to using the definition of obligations contained in the proposed regulations regarding “non-tax basis” liabilities.7 Prop. reg. section 1.752-1(a)(1)(ii) defines obligation as follows:

(ii) Obligation. For purposes of this paragraph and section 1.752-7, an obligation is any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code. Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, and futures contracts. Presumably, the “amount” of any such obligation should be the amount of cash that a willing assignor would pay to a willing assignee to assume the obligation in an arm’s-length transaction.8

E. Redeterminations of Net Value

As discussed above, under the proposed regulations, once the net value of the disregarded entity is determined, that net value is not redetermined unless (i) there is more than a de minimis contribution to or distribution from the disregarded entity, or (ii) the disregarded entity’s obligations that do not constitute, and are senior or of equal priority to, payment obligations of the disregarded entity that are taken into account under reg. section 1.752-2(b) in determining the extent to which a partner bears the economic risk of loss change by more than a de minimis amount. Prop. reg. section 1.752-2(k)(2). Under prop. reg. section 1.752-2(k)(2), the net value of a disregarded entity also includes the entity’s enforceable rights to contributions from its owner. Changes in those enforceable contribution rights by more than a de minimis amount should also permit redetermination of net value. Informal discussions with government officials involved in developing the regulations indicate that the failure to include changes in those obligations as an event allowing redetermination of value was an oversight that will be remedied in final regulations.

F. Changes to Section 704(b) Regulations

The section 704(b) regulations contain an antiabuse rule that is similar to the antiabuse rule in the section 752 regulations that “backstops” the “deemed satisfaction” rule. Specifically, reg. section 1.704-1(b)(2)(ii)(c) provides:

A partner in no event will be considered obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section) to the extent such partner’s obligation is not legally enforceable, or the facts and circumstances otherwise indicate a plan to avoid or circumvent such obligation.

Consistent with the treatment of disregarded entities under the proposed regulations, reg. section 1.704-1(b)(2)(ii)(c) should be amended to provide that a deficit restoration obligation of a disregarded entity will be taken into account for purposes of the regulations under section 704(b) only to the extent of the net value of the disregarded entity.

G. Allocation of Net Value

Prop. reg. section 1.752-2(k)(4) provides that if one or more disregarded entities have payment obligations with respect to one or more partnership liabilities, or liabilities of more than one partnership, the partnership must allocate the net value of each disregarded entity among partnership liabilities in a reasonable and consistent manner, taking into account priorities among partnership liabilities. Prop. reg. section 1.752-2(k)(6) Example 4 concludes that an allocation of net value first to the partnership’s senior debt and only thereafter to its junior debt is a reasonable method of allocating net value. In fact, the partnership’s property will be used to satisfy its senior debt first, so it is more likely that the disregarded entity’s net value will be used to satisfy the partnership’s junior debt. Thus, arguably, it would make more sense to allocate the net value of the disregarded entity to junior debt first.5 Informal discussions with government personnel involved in developing the regulations indicate that they view the allocation of net value to senior debt first as consistent with the constructive liquidation test of the section 752 regulations, but that in certain circumstances, it might be reasonable to allocate to the junior debt first.

V. Conclusion

The proposed regulations are based on a sound analysis of the extent to which a partner who owns a partnership interest through a disregarded entity bears the economic risk of loss for a partnership liability. Nevertheless, the new regulations will create substantial complexity and compliance burdens. Also, application of the net value approach to disregarded entities, but application of the “deemed satisfaction” rule and antiabuse

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8 See prop. reg. section 1.752-7(b)(2)(ii).

9 Cf. reg. section 1.704-2(m) Example 1(vii).
backstop to regarded entities, results in arrangements that create similar economic risk of loss giving rise to different liability allocations. In light of those issues, perhaps theory should be sacrificed for practicality and the “deemed satisfaction” rule and antiabuse backstop simply extended to disregarded entities.