Notice of Proposed Rulemaking and Notice of Public Hearing

Allocation of Partnership Debt

REG–103831–99

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the allocation of nonrecourse liabilities by a partnership. The proposed regulations revise tier three of the three-tiered allocation structure contained in the current nonrecourse liability regulations, and also provide guidance regarding the allocation of a single nonrecourse liability secured by multiple properties. This document also contains a notice of public hearing on these proposed regulations.

DATES: Written comments must be received by April 12, 2000. Requests to speak (with outlines of oral comments) at a public hearing scheduled for May 3, 2000, at 10 a.m., must be received by April 12, 2000.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–103831–99), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–103831–99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at: http://www.irs.ustreas.gov/tax_regs/regslist.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Christopher Kelley, (202) 622-3070; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Introduction

This document proposes to revise §§1.752–3 and 1.752–5 of the Income Tax Regulations (26 CFR part 1) relating to the allocation by a partnership of nonrecourse liabilities.

Background

Treasury regulation §1.752–3 currently provides a three-tiered system for allocating nonrecourse liabilities. The three-tiered system applies sequentially. Thus, as a portion of a liability is allocated to a partner under the first tier, that portion is not available to be allocated under the second tier. Similarly, as a portion of a liability is allocated to a partner under the second tier, that portion is not available to be allocated in the third tier.

Under the first tier, a partner is allocated an amount of the liability equal to that partner's share of partnership minimum gain under section 704(b). See §1.704–2(g)(1). Under the second tier, to the extent the entire liability has not been allocated under the first tier, a partner will be allocated an amount of liability equal to the gain that partner would be allocated under section 704(c) if the partnership disposed of all partnership property subject to one or more nonrecourse liabilities in full satisfaction of the liabilities (section 704(c) minimum gain). Under the third tier, a partner is allocated any excess nonrecourse liabilities under one of several methods that the partnership may choose. One allocation method is based on the partner's share of partnership profits. The partnership may specify in its partnership agreement the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the specified interests are reasonably consistent with allocations of some other significant item of partnership income or gain. The partnership also may allocate excess nonrecourse liabilities in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. The partnership may change its allocation method under the third tier from year to year.

In Rev. Rul. 95–41, 1995–1 C.B. 132, the IRS and Treasury addressed the effect of the three section 704(c) allocation methods under §1.704–3 upon the three tiers of §1.752–3(a). Rev. Rul. 95–41 also stated that in determining the partners' interests in partnership profits, solely for purposes of the third tier, section 704(c) built-in gain (i.e., the excess of a property's book value over the contributing partner's adjusted tax basis in the property upon contribution) that was not taken into account under §1.752–3(a)(2) (the second tier) is one factor, but not the only factor, to be considered. This gain (excess section 704(c) gain) is equal to the excess of the amount of section 704(c) built-in gain attributable to an item of property over the amount of section 704(c) minimum gain on that property.

Explanation of Provisions

Modifications to Third Tier

The three tiers of §1.752–3(a) are structured to allocate liabilities to those partners who generally would be allocated income or gain upon the relief of those liabilities. Under section 752(b), any decrease in a partner's share of the liabilities of a partnership will be considered a distribution of money to the partner by the partnership. Under section 731(a), a partner will recognize gain on the distribution of money by the partnership to the extent that the distribution exceeds the partner's adjusted basis in its partnership interest. Section 704(c) generally ensures that any built-in gain on contributed property will be recognized by the contributing partner upon the disposition of the property by the partnership. The partnership liability allocation rules arguably should not accelerate the contributing partner's recognition of that gain when the amount of the partnership's liability attributable to such property is sufficient, if allocated to the contributing partner, to prevent such partner from recognizing gain.

In response to comments received, the proposed regulations modify the third tier to allow a partnership to allocate the portion of a nonrecourse liabilities in excess of the portions allocated in tiers one and two (excess nonrecourse liabilities) based on the excess section 704(c) gain attributable to the property securing the liability. Thus, to the extent a portion of a partnership nonrecourse liability is available to be allocated in the third tier, the partnership may allocate that portion to the contributing partner based on the excess section 704(c) gain inherent in the property.

Under §1.704–3(a)(2), section 704(c) generally applies on a property-by-property basis. Therefore, in determining the amount of excess section 704(c) gain, the built-in gains and losses on items of contributed property cannot be aggregated.

Section 1.704–3(a)(3)(i) provides that the book value of contributed property is equal to its fair market value at the time of contribution and is subsequently adjusted for cost recovery and other events that affect the basis of the property. Section 1.704–3(a)(3)(ii) provides that the section 704(c) built-in gain with respect to a property is the excess of the property's book value over the contributing partner's adjusted tax basis in the property upon contribution. The built-in gain is thereafter reduced by decreases in the difference between the property's book value and adjusted tax basis. Similarly, the excess section 704(c) gain will decline as the difference between the property's fair market value and tax basis declines.

If a partnership holds section 704(c) property subject to the ceiling rule of §1.704–3(b)(1), in certain situations, the first tier of §1.752–3(a) can gradually shift the allocation of liabilities away from the partner that contributed the property (the contributing partner) to a non-contributing partner who does not necessarily need, for tax purposes, the entire amount of the liability allocated to the non-contributing partner in the first tier. This can give rise to deemed distributions to the contributing partner, resulting in gain recognition under section 731(a)(1) at a time that arguably is earlier than appropriate. The IRS and Treasury considered other alternatives for amending §1.752–3 that would address these liability shifts caused by the ceiling rule, but rejected them because of their complexity. The proposed alternative was adopted because it is simple and seems to address the predominant concerns raised by practitioners regarding the contribution of section 704(c) property. The IRS and Treasury request comments on whether further modifications to the three-tiered structure of §1.752–3(a) are necessary to more appropriately allocate nonrecourse liabilities among partners and, if so, what type of modifications would be appropriate.

The holding in Rev. Rul. 95–41, 1995–1 C.B. 132, that excess section 704(c) gain is one factor to consider in determining a partner's interest in partnership profits will remain relevant where a partner does not allocate nonrecourse debt under the third tier based on the excess section 704(c) gain attributable to the property that is subject to the debt. However, once a partner has allocated nonrecourse indebtedness pursuant to the rule in these proposed regulations based upon excess section 704(c) gain, that excess section 704(c) gain cannot again be considered in determining a partner's interest in partnership profits.

Allocation of Single Liability Among Multiple Properties

Several commentators have requested that the IRS and Treasury issue guidance regarding the calculation of section 704(c) minimum gain under the second tier when a partnership holds multiple properties subject to a single nonrecourse liability. This situation typically arises when a partnership that holds several properties, each subject to an individual liability, refinances the individual liabilities with a single nonrecourse liability.

To apply the second tier, partnerships must determine the amount of the liability that encumbers each asset. This allows the partnerships to determine the section 704(c) minimum gain in each asset. See §1.704–3(a)(2).

The proposed regulations provide that if a partnership holds multiple properties subject to a single liability, the liability may be allocated among the properties based on any reasonable method. Under the proposed regulations, a method is not reasonable if it allocates to any property an amount that exceeds the fair market value of the property. Thus, for example, the liability may be allocated to the properties based on the relative fair market value of each property.

The portion of the nonrecourse liability allocated to each item of partnership property is treated as a separate loan under §1.752–3(a)(2). The proposed regulations provide that once a liability is allocated among the properties, a partnership may not change the method for allocating the liability. However, if one of the properties is no longer subject to the liability, the portion of the liability allocated to that property must be reallocated to the properties still subject to the liability so that the amount allocated to any property does not exceed the fair market value of such property at the time of the reallocation.

If the outstanding principal of a liability is reduced, the reduction will affect the amount of section 704(c) minimum gain under the second tier. The proposed regulations provide that as the outstanding principal of a liability is reduced, the reduction in principal outstanding is allocated among the properties in the same proportion that the principal originally was allocated to the properties.

These rules affect only the calculation of section 704(c) minimum gain under the second tier of §1.752–3(a).

Allocation of Single Liability Among Multiple Partnerships

Some commentators also have requested guidance on allocations of a nonrecourse liability among multiple partnerships. This situation may arise when a partner contributes multiple properties subject to the same nonrecourse liability to more than one partnership. It also may arise in a division of a partnership under section 708. Although the proposed regulations do not address this issue, the IRS and Treasury request comments regarding appropriate methods of allocating such liabilities.

Proposed Effective Date

These regulations are proposed to apply to any liability incurred or assumed by a partnership on or after the date final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 3, 2000, at 10 a.m., in Room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons that wish to present oral comments at the hearing must submit timely written comments and an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by April 12, 2000.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Christopher Kelley, Office of Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *.

Par. 2. Section 1.752–3 is amended as follows:

1. Paragraph (a)(3) is amended by adding two sentences immediately before the last sentence in the paragraph.

2. Paragraph (b) is redesignated as paragraph (c).

3. New paragraph (b) is added.

4. Paragraph (d) is added.

The revision and additions read as follows:

§1.752–3 Partner's share of nonrecourse liabilities.

(a) * * *

(3) * * * Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain on section 704(c) property (as defined under §1.704–3(a)(3)(ii)) that is allocable to the partner on the property subject to that nonrecourse liability to the extent that such built-in gain exceeds the gain described in paragraph (a)(2) of this section with respect to such property. To the extent a partnership uses this additional method and the entire amount of the excess nonrecourse liability is not allocated to the contributing partner, the partnership must allocate the remaining amount of the excess nonrecourse liability under one of the other methods in this paragraph (a)(3).* * *

(b) *Allocation of a single nonrecourse liability among multiple properties*—(1) *In general*. For purposes of determining the amount of taxable gain under paragraph (a)(2) of this section, if a partnership holds multiple properties subject to a single nonrecourse liability, the partnership may allocate the liability among the multiple properties under any reasonable method. A method is not reasonable if it allocates to any item of property an amount of the liability in excess of the fair market value of the property at the time the liability is incurred. The portion of the nonrecourse liability allocated to each item of partnership property is then treated as a separate loan under paragraph (a)(2) of this section. In general, a partnership may not change the method of allocating a single nonrecourse liability under this paragraph (b) while any portion of the liability is outstanding. However, if one or more of the multiple properties subject to the liability is no longer subject to the liability, the portion of the property allocated to that property must be reallocated among the properties still subject to the liability so that the amount of the liability allocated to any property does not exceed the fair market value of such property at the time of reallocation.

(2) *Reductions in principal*. For this paragraph (b), when the outstanding principal of a partnership liability is reduced, the reduction of outstanding principal is allocated among the multiple properties in the same proportion that the partnership liability originally was allocated to the properties under paragraph (b)(1) of this section.

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(d) *Effective date*. This section applies to partnership liabilities incurred or assumed on or after the date final regulations are published in the **Federal Register**.

Par. 3 The first sentence of paragraph (a) of §1.752–5 is revised to read as follows:

§1.752–5 Effective dates and transition rules

(a) *In general*. Except as otherwise provided in §1.752–3(d), unless a partnership makes an election under paragraph (b)(1) of this section to apply the provisions of §§1.752–1 through 1.752–4 earlier, §§1.752–1 through 1.752–4 apply to any liability incurred or assumed by a partnership on or after December 28, 1991, other than a liability incurred or assumed by the partnership pursuant to a written binding contract in effect prior to December 28, 1991 and at all times thereafter. * * *

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Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

(Filed by the Office of the Federal Register on January 12, 2000, 8:45 a.m., and published in the issue of the Federal Register for January 13, 2000, 65 F.R. 2081)

Notice of Proposed Rulemaking and Notice of Public Hearing

Partnership Mergers and Divisions

REG–111119–99

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations on the tax consequences of partnership mergers and divisions. The proposed regulations affect partnerships and their partners. This document also contains a notice of public hearing on these proposed regulations.

DATES: Written comments must be received by April 10, 2000. Requests to speak (with outlines of oral comments) at the public hearing scheduled for May 4, 2000, must be submitted by April 13, 2000.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–111119–99), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–111119–99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at: http://www.irs.ustreas.gov/tax_regs/regslist.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Dan Carmody, (202) 622-3080; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita VanDyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

This document proposes to amend sections 708, 743, and 752 of the Income Tax Regulations (26 CFR part 1) regarding partnership mergers and divisions.

Partnership Mergers

Background

Section 708(b)(2)(A) provides that in the case of a merger or consolidation of two or more partnerships, the resulting partnership is, for purposes of section 708, considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership. Section 1.708–1(b)(2)(i) of the Income Tax Regulations provides that if the resulting partnership can be considered a continuation of more than one of the merging partnerships, the resulting partnership is the continuation of the partnership that is credited with the contribution of the greatest dollar value of assets to the resulting partnership. If none of the members of the merging partnerships own more than a 50 percent interest in the capital and profits of the resulting partnership, all of the merged partnerships are considered terminated, and a new partnership results. The taxable years of the merging partnerships that are considered terminated are closed under section 706(c).

Although section 708 and the applicable regulations provide which partnership continues when two or more partnerships merge, the statute and regulations do not prescribe a form for the partnership merger. (Often, state merger statutes do not provide a particular form for a partnership merger.) In revenue rulings, however, the IRS has prescribed the form of a partnership merger for Federal income tax purposes.

In Rev. Rul. 68–289 (1968–1 C.B. 314), three existing partnerships (P1, P2, and P3) merged into one partnership with P3 continuing under section 708(b)(2)(A). The revenue ruling holds that P1 and P2, the two terminating partnerships, are treated as having contributed all of their respective assets and liabilities to P3, the resulting partnership, in exchange for a partnership interest in P3. P1 and P2 are considered terminated and the partners of P1 and P2 receive interests in P3 with a basis under section 732(b) in liquidation of P1 and P2 (Assets-Over Form). Rev. Rul. 77–458 (1977–2 C.B. 220), and Rev. Rul. 90–17 (1990–1 C.B. 119), also follow the Assets-Over Form for a partnership merger.

Explanation of Provisions

A. *Form of a Partnership Merger*

The IRS and Treasury are aware that taxpayers may accomplish a partnership merger by undertaking transactions in accordance with jurisdictional laws that follow a form other than the Assets-Over Form. For example, the terminating partnership could liquidate by distributing its assets and liabilities to its partners who then contribute the assets and liabilities to the resulting partnership (Assets-Up Form). In addition, the partners in the terminating partnership could transfer their terminating partnership interests to the resulting partnership in exchange for resulting partnership interests, and the terminating partnership could liquidate into the resulting partnership (Interest-Over Form).

In the partnership incorporation area, a taxpayer's form generally is respected if the taxpayer actually undertakes, under the relevant jurisdictional law, all the steps of a form that is set forth in one of three situations provided in Rev. Rul. 84–111 (1984–2 C.B. 88). The three situations that Rev. Rul. 84–111 sets forth are the Assets-Over Form, Assets-Up Form, and Interest-Over Form. Rev. Rul. 84–111 explains that, depending on the form chosen to incorporate the partnership, the adjusted basis and holding periods of the various assets received by the corporation and the adjusted basis and holding periods of the stock received by the former partners can vary. Like partnership incorporations, each form of a partnership merger has potentially differ-