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Tax Update

December 2, 2024

IRS and Treasury Finalize "Clean Up" Partnership Debt-Allocation Regulations Under Section 752

This alert discusses regulations under section 752 regarding the allocation of partnership recourse liabilities.[1] *The regulations were proposed more than a decade ago.*[2]

Earlier today, December 2, 2024, the IRS and Treasury published in the Federal Register final regulations (the "Final Regulations") regarding the allocation of partnership recourse liabilities.[3] The Final Regulations resolve some uncertainties and ambiguities surrounding the determination of which partner has "economic risk of loss" or "EROL" with respect to a liability by adding ordering and tie-breaking rules and expanding, ever so slightly, on the meaning of the term "economic risk of loss." The more significant changes are listed below, and a more detailed discussion of the Final Regulations follows.

1. ***Overlapping economic risk of loss***. The Final Regulations adopt an explicit proportionality rule to address situations in which the partners, in aggregate, otherwise would have more EROL with respect to a partnership liability allocated to them than the total amount of the liability.

2. ***Direct economic risk of loss***. The Final Regulations introduce the concept of "direct" EROL, which arises by reason of the actions or status of a person (as opposed to EROL

that arises by reason of the actions or status of a related person, which the Final Regulations implicitly define as "indirect").

3. ***Tiered partnerships***. The Final Regulations modify an existing tiered partnership rule to resolve a long-standing conflict between the general rule regarding the allocation of recourse liabilities and a special tiered partnership rule. Specifically, the Final Regulations allocate to an upper-tier partnership ("UTP") the portion of a liability of a lower-tier partnership ("LTP") with respect to which UTP and a UTP partner have direct EROL, unless that UTP partner is also a partner in LTP. If the UTP partner is also a partner in LTP, LTP allocates to that LTP partner the portion of the LTP liability with respect to which that partner has EROL.

4. ***Related-partner exception***. The Final Regulations clarify the scope of the related-partner exception, which was litigated in *IPO II v. Commissioner*.[4] Under the exception, if a person that holds a partnership interest (directly or indirectly through another partnership) has direct EROL for a partnership liability, that person is treated as unrelated to all other direct and indirect partners of that partnership for purposes of allocating that liability.

5. ***Person related to more than one partner***. If an unrelated third party has direct EROL for a partnership liability and is related to two or more partners, those partners share that liability in accordance with their interests in partnership profits.

The Final Regulations generally are applicable for partnership liabilities incurred on or after December 2, 2024, although a partnership generally may elect to apply the Final Regulations to all (but not some) of its previously incurred or assumed liabilities.

Background

The Final Regulations finalize regulations that were proposed in 2013.[5] The IRS and Treasury (somewhat wryly) note in the preamble that the government is "mindful" of that length of time.[6]

Section 752 and the regulations interpreting it (the "section 752 regulations") generally require a partnership to allocate its liabilities among its partners. Fundamental to the operation of the section 752 regulations is their initial division of liabilities into "recourse" and "nonrecourse" liabilities. Under what is often referred to as the "atom bomb" test, a liability is recourse for this purpose to the extent that a partner (or someone related to a partner) would be obligated to make a payment to the creditor if all of the partnership's assets, including cash, became worthless and the liability became due. To the extent that all or part of a liability is not recourse to a partner (or someone related to a partner), the liability is nonrecourse. Recourse and nonrecourse liabilities are allocated under two distinct sets of rules. Very generally, recourse liabilities are allocated to the partner who has the payment obligation (or, in the parlance of the section 752 regulations, bears the "economic risk of loss" with respect to the liability). Nonrecourse liabilities are allocated in accordance with a somewhat more complex (and flexible) regulatory framework that is beyond the scope of this alert.[7]

The Final Regulations deal only with a handful of specific but important rules (generally in the nature of "tie breaker" rules) regarding recourse liabilities, making changes to Treas. Reg. §§ 1.752-2 and 1.752-4. These changes are discussed below.

Treas. Reg. § 1.752-2

Treas. Reg. § 1.752-2 contains the core rules relating to recourse liabilities. The Final Regulations modify those rules in a handful of ways.

1. Overlapping economic risk of loss

The section 752 regulations have long provided that the amount of partnership liabilities is taken into account only once.[8] Before the Final Regulations, however, it was unclear how to address a situation in which more than one partner bears EROL for the same liability. Consider the following example:

> **Example 1**. A and B are 70:30 partners, respectively, in partnership AB, which has borrowed $100 from a bank. Each of A and B has guaranteed repayment of the entire amount of the loan.[9]

To avoid double counting EROL in this circumstance, under final Treas. Reg. § 1.752-2(a)(2), the amount of EROL each partner is treated as bearing is determined by multiplying the amount of the liability by a fraction, the numerator of which is the EROL the partner bears, and the denominator of which is the total EROL of all partners.

In Example 1, the amount of the liability is $100, and the fraction for each of A and B is $100/$200. Each partner has $100 EROL because each has guaranteed repayment of the liability; aggregate EROL is $200 because there are two partners, each of whom has $100 of EROL.

2. Direct economic risk of loss

For decades, the section 752 regulations have included only the concept of EROL. EROL can arise in various ways, including by the actions or status of the partner or someone related to a partner. For example, under the section 752 regulations, a partner may have EROL for a partnership liability because the partner (or the partner's child or other related person) guaranteed repayment of the liability.

The Final Regulations introduce the concept of "direct" EROL, which arises when a person itself takes action, such as guaranteeing repayment of a partnership liability, lending money to a partnership, or pledging property as collateral in respect of a partnership liability, that gives rise to EROL.[10] By implication, all other EROL is indirect. Although this is not a substantive change, it clarifies and simplifies portions of the section 752 regulations, making them easier to understand.

3. Tiered partnerships

The section 752 regulations have long provided that a UTP bears EROL for a liability of an LTP to the extent UTP or a partner in UTP has EROL for that liability. The section 752 regulations did not, however, explain how to allocate a liability of an LTP if a partner in UTP is also a partner in LTP and that partner bears EROL for a liability of LTP. That is, it was unclear whether LTP was required to allocate all or a portion of the liability directly to that partner under the general rule of Treas. Reg. § 1.752-2(a) or, instead, to UTP under the tiered partnership rule of Treas. Reg. § 1.752-2(i) (or, perhaps, to both combining the two rules).

> **Example 2**. A is a partner in UTP. A and UTP are the only partners in LTP, which has borrowed $100 from a bank. A has guaranteed repayment of the liability.

Under the section 752 regulations in effect before the Final Regulations, the answer was unclear. The Final Regulations address this relatively common situation by modifying the tiered partnership rule such that LTP allocates LTP liabilities to UTP to the extent UTP has direct EROL, as well as LTP liabilities for which a UTP partner bears EROL, but only if that partner is not also a partner in LTP.[11] Thus, in Example 2, LTP would allocate the $100 liability directly to A.

The tiered partnership rule applies before the overlapping EROL rule described above.[12]

Treas. Reg. § 1.752-4

Treas. Reg. § 1.752-4 contains a series of special rules—essentially rules that do not quite fit elsewhere in the section 752 regulations. The Final Regulations modify Treas. Reg. § 1.752-4 in three significant ways, each of which is described below.

1. Disregarding constructive ownership rules applicable to partnership subsidiaries

Since the Treas. Reg. § 1.752-4 regulations were first promulgated, they have provided that, for purposes of determining the extent to which a partner has EROL for a liability, the constructive ownership rules of sections 267 and 707 apply with certain modifications. Even as modified, however, the constructive ownership rules could inappropriately create the technical existence of EROL in situations in which none properly existed. The Final Regulations correct this shortcoming.

> **Example 3**. A and B are 80:20 partners in AB partnership, which owns all of the stock of Corporation. Corporation lends $100 to AB.

Under the section 752 regulations in effect before the Final Regulations, A was treated as owning 80 percent of the stock of Corporation, making Corporation a “related person” with respect to A. This caused A to be treated as bearing EROL with respect to AB’s liability. The Final

Regulations appropriately disregard those constructive ownership rules, with the result being that the liability is nonrecourse and generally allocated 80 percent to A and 20 percent to B.

Specifically, the Final Regulations modify the constructive ownership rules by (very generally) disregarding the application of sections 267(c)(1) and 1563(e)(2) in determining whether a subsidiary (whether a partnership or a corporation) of a partnership is treated as owned by its partner if the subsidiary bears direct EROL for a partnership liability.[13] In those situations, the constructive ownership rules will not cause that liability to be treated as recourse.

2. The related-partner exception

The "related-partner exception" was intended to ensure that if a direct or indirect partner bore direct EROL, persons related to that partner would not be treated as bearing EROL by reason of the applicable constructive ownership rules. The text of the section 752 regulations in effect before the Final Regulations was not particularly clear, leading to litigation and considerable uncertainty.[14]

The Final Regulations provide that if a person owns an interest in a partnership (either directly or through another partnership) and that person has direct EROL for a partnership liability, then that person is treated as unrelated to all other persons who own interests in that partnership (either directly or through another partnership).[15] This exception is best understood through two examples.

> **Example 4**. A owns all of the stock of corporations X and Y. A and Y own all of partnership AY, which has borrowed $100 from a bank. Each of A and X has guaranteed repayment of the $100.

Under the related-partner exception, A and Y are not treated as related because A is a person who owns an interest in AY (directly or indirectly through another partnership) and has direct EROL for the liability by reason of the guarantee. Because A and Y are not treated as related, X and Y are also not treated as related. As a result, none of A's EROL and none of X's EROL is attributed to Y. This causes A to be the only AY partner with EROL for the $100 liability (requiring that AY allocate the entire liability to A).

> **Example 5**. A owns all of the stock of corporations X and Y. X and Y are equal partners in partnership XY. Also, X owns 79 percent, and Y owns 21 percent, of the stock of corporation Z. XY has borrowed $100 from a bank, and X and Z have each guaranteed repayment of the borrowing.

Because X is a partner in XY and bears direct EROL (by reason of the guarantee), X is not treated as related to Y. Three conclusions follow from this. First, none of X's EROL is shared with Y. Second, because X and Y are not treated as related to each other and neither X nor Y owns 80 percent of Z, Z is treated as unrelated to both X and Y, with the result that its guarantee

has no effect on the allocation of the liability. Finally, and as a result, the entire liability is allocated to X.

3. Person related to more than one partner

What happens if a person who has direct EROL for a partnership liability is related to two or more partners, such that total EROL exceeds the amount of the partnership's liability? Although the overlapping EROL rule could apply in such a situation, the Final Regulations make the overlapping EROL rule inapplicable and instead apply a special rule.[16]

> **Example 6**. A owns all of the stock of corporation X, which owns all of the stock of corporation Y. A owns 40 percent, and X owns 60 percent, of partnership AX, which has borrowed $100 from a bank. Y has guaranteed repayment of the borrowing.

Under the constructive ownership rules, Y is related to both A and X. The overlapping EROL rule, discussed above, would allocate the liability equally to A and X. As explained in the preamble to the Final Regulations, however, the IRS and Treasury were not satisfied with this result and instead crafted a special rule to address this situation. Under that special rule, A and X will share the liability in proportion to their interests in the profits of partnership AX, which likely is consistent with the manner in which taxpayers would have expected the liability to be allocated.

Importantly, this approach differs from both the approach to the allocation of recourse liabilities (*i.e.*, in accordance with loss exposure) and the manner in which nonrecourse liabilities are allocated (*i.e.*, in accordance with the more complex rules of Treas. Reg. § 1.752-3(a), which includes a three "tier" approach). It is unclear whether the term "profits" in the Final Regulations should be interpreted so as to allow taxpayers to use some or all of the allocation methods described in Treas. Reg. § 1.752-3(a)(3).

The related-partner exception applies before the "person related to more than one partner" rule, which, in turn, applies before the overlapping EROL rule.[17]

Applicability dates

The Final Regulations apply to any liability incurred or assumed by a partnership on or after December 2, 2024, subject to three exceptions.[18]

- *Written binding contract exception*. A liability incurred or assumed by a partnership pursuant to a written binding contract in effect before December 2, 2024 generally is not subject to the Final Regulations.
- *Refinancing exception*. To the extent that the proceeds of a partnership liability (the "refinancing liability") are allocable under the rules of Temp. Treas. Reg. § 1.163-8T to payments discharging all or part of any other liability (the "old liability") of that partnership, the refinancing liability will be treated as though it had been incurred or assumed by the

partnership before December 2, 2024, but only to the extent of the amount and duration of the old liability.

- *Election to apply the Final Regulations to all partnership liabilities*. A partnership may apply the Final Regulations to all of its liabilities, including liabilities incurred or assumed before December 2, 2024, for any tax return filed on or after December 2, 2024, provided the partnership consistently applies all of the rules in the Final Regulations to its liabilities.

[1] Unless indicated otherwise, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" are to the Treasury regulations promulgated under the Code, in each case as in effect as of the date of this alert.

[2] A discussion of the proposed regulations can be found in New York State Bar Association Tax Section Report No. 1307, *The Proposed Regulations on the Allocation of Partnership Liabilities and Disguised Sales* (May 30, 2014). For a detailed discussion of the regulations governing the allocation of partnership recourse liabilities, including the more significant issues addressed by the regulations discussed in this alert, *see* Eric Sloan and Jennifer Alexander, *Economic Risk of Loss: The Devil We Think We Know*, 84 Taxes 239 (Mar. 1, 2006).

[3] T.D. 10014, 89 Fed. Register 231 (Dec. 2, 2024). The Final Regulations were released to the public on November 29, 2024.

[4] 122 T.C. 295 (2004).

[5] 78 Fed. Register 76092 (Dec. 16, 2013).

[6] The preamble also states that "[t]he regulations are issued under the express delegation of authority under section 7805(a) of the Code." Explicit references to section 7805(a) started to appear in Notices of Proposed Rulemaking published by the IRS and Treasury beginning in September 2024. Without an express grant of regulatory authority for the Final Regulations, it is unclear whether, or to what extent, the Final Regulations would receive more than *Skidmore* deference on judicial review. *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944). For a more detailed discussion of the deference issue, see our alert discussing the Supreme Court's recent decision in *Loper Bright Enterprises v. Raimondo*, 144 S. Ct. 2244 (2024).

[7] *See* Treas. Reg. § 1.752-3.

[8] Treas. Reg. § 1.752-4(c).

[9] The examples in this alert are drawn from or inspired by examples in the Final Regulations. In the examples in this alert, each partnership is a limited liability company, each member of each limited liability company is referred to as a partner, and there is no credit support arrangement with respect to any liability except as noted.

[10] Treas. Reg. § 1.752-2(a)(3).

[11] Treas. Reg. § 1.752-2(i)(1).

[12] Treas. Reg. § 1.752-2(i)(2).

[13] Treas. Reg. § 1.752-4(b)(iv).

[14] *IPO II*, *supra* note 4.

[15] Treas. Reg. § 1.752-4(b)(2). The related-partner exception does not apply when determining a partner's interest under the de minimis rules in Treas. Reg. §§ 1.752-2(d) and (e).

[16] Treas. Reg. § 1.752-4(b)(3).

[17] Treas. Reg. § 1.752-4(e).

[18] Treas. Reg. §§ 1.752-2(l)(4) and -5(a).

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