

**MANAGING LIABILITY ALLOCATIONS IN PARTNERSHIPS
AND LIMITED LIABILITY COMPANIES**

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INTRODUCTION

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.

Various techniques are available to manage a partner's share of liabilities, *i.e.*, to ensure that the partner receives an allocation of liabilities that is adequate to achieve the partner's tax planning purposes. A domestic limited liability company ("LLC") is, of course, taxable as a partnership unless it elects to be taxed as a corporation under the "check-a-box" regulations.² Nevertheless, the liability allocation rules of Code Sec. 752 apply differently to LLCs than they do to general or limited partnerships. As a result, great care must be taken in structuring arrangements in LLCs that are intended to shift liabilities to a particular member.

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² See Reg. §301.7701-3(b)(1).

This article will first briefly discuss the statutory and regulatory framework for the allocation of partnership liabilities. Thereafter, using a series of examples, this article will illustrate various planning techniques to shift liabilities to partners and to members of LLCs.

ALLOCATION OF PARTNERSHIP LIABILITIES

Code Secs. 752 and 731 Generally

Under Code Sec. 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 such partner of partnership liabilities, is treated as a contribution of money by such partner to the partnership. Under Code Sec. 722, this deemed contribution of money by the partner to the partnership increases the partner's basis in the partnership interest.

Under Code Sec. 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 such individual liabilities, is treated as a distribution of money to the partner by the partnership. Under Code Secs. 733(1) and 705(a)(2), this deemed distribution of money by the partnership to the partner reduces the partner's basis in the partnership interest, but not below zero. Under Code Sec. 731(a), upon a distribution of money to a partner by a partnership (including a deemed distribution of money pursuant to Code. Sec. 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. §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. Partnership liabilities are classified as either recourse or nonrecourse, and this classification determines the allocation rules that apply

Partner's Share of Partnership Recourse Liabilities

A partnership liability is a recourse liability to the extent that any partner or related person bears the "economic risk of loss" for that liability. Reg. §1.752-1(a)(1). In general, recourse liabilities are allocated to the partner who would be responsible for paying them if the partnership were unable to. In order to determine who bears the economic risk of loss for a recourse liability, the regulations employ a "constructive liquidation" test.

Reg. §1.752-2(b)(1) provides that upon a constructive liquidation, all of the following events are deemed to occur simultaneously:

- (i) All of the partnership's liabilities become payable in full;
- (ii) With the exception of property contributed to secure a partnership liability, all of the partnership's assets, including cash, have a value of zero;
- (iii) The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership);
- (iv) All items of income, gain, loss, or deduction are allocated among the partners; and

(v) The partnership liquidates.

A partner bears the economic risk of loss for a liability to the extent that if the partnership constructively liquidated, the partner (or a related person) would be obligated to either pay a creditor or make a contribution to the partnership because the liability would be due and the partner (or a related person) would not be entitled to reimbursement. Reg. §1.752-2(b).

Partner's Share of Partnership 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. §1.752-1(a)(2). A partner's share of partnership nonrecourse liabilities equals the sum of the following:

- (1) A partner's share of partnership minimum gain determined pursuant to Code Sec. 704(b); Reg. §1.752-3(a)(1) (minimum gain is generally the excess of the nonrecourse liability over the Code Sec. 704(b) "book value" of property securing the liability) [the "First Tier"];
- (2) The amount of any taxable gain that would be allocated to the partner under Code Sec. 704(c) (or in the same manner as under Code Sec. 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; Reg. §1.752-3(a)(2) [the "Second Tier"];
- (3) The partner's share of the excess nonrecourse liabilities determined in accordance with the partner's share of partnership profits. The partner's interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the Code Sec. 704(b) regulations) of some other significant