THE PARTNER'S PERSPECTIVE by *Charles R. Levun, Esq.*

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Allocating Deductions From Contingent Liabilities— Code Sec. 704(c) vs. Reg. §1.752-7

Perhaps one of the biggest tax shelters in years was the "Son of Boss" transaction and its numerous offshoots, which appeared in both the corporate and partnership arenas. The transaction has had far-reaching implications and fallout, including criminal charges, the fall of a major national law firm, a boatload of audits, an IRS settlement policy, numerous malpractice actions, the complete revision of Circular 230, major tax legislation and regulatory action.

Simplifying certain versions of the "Son of Boss" transaction to more understandable facts, a taxpayer would purchase (i.e., enter into a "long" position) and sell (i.e., enter into a "short" position) substantially identical securities (such positions having little net equity value), and contribute the offsetting positions to a partnership. The contributing taxpayer would not treat the short position as a liability for Code Sec. 752 purposes. Consequently, on contribution of the offsetting securities positions to the partnership, the taxpayer took the cost of the long position as the basis for his partnership interest, i.e., it was not reduced by the partnership's assumption of his short position. When the interest was subsequently redeemed for its negligible value, the taxpayer would claim a loss (and no offsetting gain would ever be recognized).

Underlying the transaction in the partnership arena was the uncertain definition of a liability and the treatment of contingent liabilities. This uncertainty was eliminated with the issuance of Reg. §1.752-1(a)(4), which defines the term liability, and the issuance of Reg. §1.752-7, which addresses the manner in which the deduction attributable to the satisfaction of a contingent liability is satisfied. These regulations are discussed in detail in the July, 2005 Partner's Perspective column at ¶9,698.

The basic concept of the contingent liability regulations is to prevent a taxpayer from accelerating a deduction associated with an unpaid liability and to prevent trafficking of losses associated with such liabilities. This concept is accomplished by applying Code Sec. 704(c) principles to contingent liabilities. However, the contingent liability regulations and their exceptions sometimes are difficult to understand and apply. This month's Partner's Perspective will discuss these regulations in the context of a garden-variety partnership transaction.

The Economic Deal

Mike has been operating a health care consulting business since 1980 in MM Inc., an S corporation. MM Inc. has C e&p from its pre-S years, which many years ago was used to acquire potentially developable vacant land currently held in a single-member LLC. Unfortunately, several years ago, when Mike was contemplating development of the property, he learned that the land might be subject to environmental liabilities. However, notwithstanding the environment issues, Mike has decided that he would like to go forward with the development of the property. He has been negotiating a couple of different transactions with Jeff, one of which would include participation by Jeff solely in the development of the property, and another one might be a purchase by Jeff of a 50% interest in MM Inc. or its business. At present, MM Inc. has the following economic balance sheet:

	BASIS	VALUE
Cash	$ 500,000	$ 500,000
Unrealized receivables	0	300,000
Land (in single-member EA LLC)	2,000,000	2,500,000
Intangible value	0	5,000,000
	$2,500,000	$8,300,000
Accounts Payable	$ 0	$ 400,000
Potential environmental liability	0	1,000,000
C e&p	2,000,000	2,000,000
AAA	500,000	4,900,000
	$2,500,000	$8,300,000

Mike, as he nears retirement, also knows that a sale of any remaining interest he has in the business after the transaction with Jeff may be on the horizon. He has already spoken with Butch, one of his key employees, about acquiring any remaining interest in the business. Butch is not ready for the acquisition today, and that is why Mike has been negotiating with Jeff. However, Butch is expected to acquire Mike's remaining interest at the time of Mike's future retirement. Butch's acquisition may take the form of an acquisition of Mike's stock or an asset sale by MM Inc. to Butch.

Under potential scenario one, assume that Jeff will become an equal member in EA LLC, strictly to develop the property. (At this time, MM Inc. might consider dropping its operating business into a single-member LLC to isolate the land from the business operations.) Pursuant to Code Sec. 721, MM Inc. will be deemed to contribute to EA LLC its land having a value of $2,500,000 subject to a potential environmental liability that the parties have agreed to value at $1,000,000; Jeff will contribute cash of $1,500,000, which will be used, together with financing, to develop the property. The parties have agreed that they will be equally responsible for any environmental liability in excess of $1,000,000, and will share equally in any savings, if the liability is satisfied for less than $1,000,000. At a later date, assume that MM Inc. sells its 50% membership interest in EA LLC to Butch for $1,500,000.

The Application of Code Sec. 704(c) and Reg. §1.752-7

When EA LLC becomes a partnership for federal income tax purposes (i.e., upon Jeff's contribution of $1,500,000), the land deemed to be contributed to EA LLC by MM Inc. is a Code Sec. 704(c) asset, and the built-in gain in such land remains the responsibility of MM Inc. In addition, the $1,000,000 agreed amount of the potential environmental liability remains the responsibility of MM Inc. pursuant to Reg. §1.704-3(a)(12), which provides:

§1.752-7 liabilities.—Except as otherwise provided in §1.752-7, §1.752-7 liabilities (within the meaning of §1.752-7(b)(3)) are section 704(c) property (built-in loss property that at the time of contribution has a book value that differs from the contributing partner's adjusted tax basis) for purposes of applying the rules of this section. See §1.752-7(c). To the extent that the built-in loss associated with the §1.752-7 liability exceeds the cost of satisfying the §1.752-7 liability (as defined in §1.752-7(b)(3)), the excess creates a "ceiling rule" limitation, within the meaning of §1.704-3(b)(1), subject to the methods of allocation set forth in §1.704-3(b), (c) and (d).

In general, a §1.752-7 liability is an obligation that does not fall within the penumbra of the definition of the term "liability," which is set forth in Reg. §1.752-1(a)(4):

> *Liability defined*.—(i) *In general*. An obligation is a liability for purposes of section 752 and the regulations thereunder (§1.752-1 liability), only if, when, and to the extent that incurring the obligation—
>
> (A) Creates or increases the basis of the obligor's assets (including cash);
>
> (B) Gives rise to an immediate deduction to the obligor; or
>
> (C) Gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.
>
> (ii) *Obligation*. For purposes of this paragraph and §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, futures contracts, and swaps.

Because the environmental liability is an "obligation" that is not yet a "liability" under the foregoing definition, it is a §1.752-7 liability. As such, the provisions of Code Sec. 704(c) (as noted in Reg. §1.704-3(a)(12) quoted above) apply, and the $1,000,000 agreed upon amount of such liability remains the tax responsibility of MM Inc. When the liability becomes fixed for federal income tax deductibility purposes, the corresponding deduction will be allocated to MM Inc. Note that if the liability is satisfied for less than $1,000,000, the ceiling rule applies (i.e., the amount of the "built-in" deduction allocated to MM Inc. cannot exceed the amount paid to satisfy the liability), unless the parties agree to a curative or remedial allocation, as discussed in more detail below.

Now assume that when MM Inc. later sells its membership interest to Butch, there has been no change in the basis, value and amount of EA LLC's assets and liabilities, so that the sale price to Butch is $1,500,000. On the sale, Butch will step into MM Inc.'s Code Sec. 704(c) responsibility with respect to the $500,000 built-in gain in the land ($2,500,000 agreed upon value on contribution less $2,000,000 basis), pursuant to the provisions of Reg. §1.704-3(a)(7):

> *Transfer of a partnership interest*.—If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner.…This rule does not apply to any

> person who acquired a partnership interest from a §1.752-7 liability partner in a transaction to which paragraph (e)(1) of §1.752-7 applies. See §1.752-7(c)(1). (Emphasis added.)

As discussed in more detail below, the emphasized language means that Butch will not step into MM Inc.'s shoes insofar as the environmental liability is concerned. However, he does step into MM Inc.'s shoes with respect to the $500,000 of built-in gain in the land. Assuming a Code Sec. 754 election is made in connection with the sale, Butch will have a $500,000 Code Sec. 743(b) basis adjustment to offset his Code Sec. 704(c) responsibility when there is a disposition of the land.

Note that there will be a technical termination of EA LLC under Code Sec. 708(b)(1)(B) because of the sale of the 50% membership interest; however, the termination does not eliminate the need for the Code Sec. 754 election. A termination merely means that EA LLC is deemed to transfer its assets and liabilities to Newco LLC in exchange for interests in Newco LLC that are distributed to Jeff and Butch in liquidation of EA LLC. Such transaction does not eliminate Butch's inside/outside basis disparity, which can only be eliminated by a Code Sec. 754 election and a corresponding Code Sec. 743(b) basis adjustment.

As noted above, Butch normally would step into MM Inc.'s shoes insofar as Code Sec. 704(c) responsibility is concerned. However, this is not the case with respect to Code Sec. 704(c) responsibility relating to a deduction associated with a §1.752-7 liability that is governed by the provisions of Reg. §1.752-7(e)(1). As noted above, the §1.752-7 regime was issued in response to tax shelter transactions such as the "Son of Boss" transactions, and part of its purpose is set forth at the outset of the regulation in Reg. §1.752-7(a):

> *Purpose and structure*.—The purpose of this section is to prevent the acceleration or duplication of loss through the assumption of obligations not described in §1.752-1(a)(4)(i) in transactions involving partnerships. Under paragraph (c) of this section, any such obligation that is assumed by a partnership from a partner in a transaction governed by section 721(a) is treated as section 704(c) property. Paragraphs (e), (f), and (g) of this section provide rules for situations where a partnership assumes such an obligation from a partner and, subsequently, that partner transfers all or part of the partnership interest, that partner receives a distribution in liquidation of the partnership interest, or another partner assumes part or all of that obligation from the partnership. These rules prevent the duplication of loss by prohibiting the partnership and any person other than the partner from whom the obligation was assumed from claiming a deduction, loss, or capital expense to the extent of the built-in loss associated with the obligation. (Emphasis added.)

As noted above, what Reg. §1.752-7 essentially does is to apply Code Sec. 704(c) concepts to the §1.752-7 liability and the §1.752-7 liability partner. In general, what occurs is that if the partnership satisfies the §1.752-7 liability while the §1.752-7 liability partner is still a partner of the partnership, the §1.752-7 liability partner is allocated the amount of the deduction, applying Code Sec. 704(b) and Code Sec. 704(c)-type concepts to changes in the amount of the liability after its assumption by the partnership. In other words, if the §1.752-7 liability is satisfied for an amount in excess of the amount taken into account in valuing the contribution by the §1.752-7 liability partner, the excess would be shared by the partners in accordance with their economic arrangement. If the liability is satisfied for an amount that is less than the amount taken into account in valuing the contribution by the §1.752-7 liability partner, the "ceiling rule" concepts contained in the regulations under Code Sec. 704(c) would apply and the partners would be entitled to adopt one of the reasonable methods specified in Reg. §1.704-3 to correct any ceiling rule disparities. (For instance, if the environmental liability were satisfied by EA LLC for $800,000 prior to MM Inc.'s sale to Butch and the remedial method were adopted by the LLC, MM Inc., the §1.752-7 liability partner, would receive a deduction of $1,000,000 and the LLC would create notional items of income to the extent of the $200,000 shortfall, which would be allocated equally between MM Inc. and Jeff in accordance with their 50/50 economic arrangement.)

The Application of Reg. §1.752-7 After the Transfer of a Membership Interest

The real meat of Reg. §1.752-7 kicks in when MM Inc. sells its membership interest to Butch. In general, in the case of a disposition (i.e., sale or redemption) of the partnership interest by the §1.752-7 liability partner, or a shift of the §1.752-7 liability from the partnership to another person, which causes there to be a separation of the §1.752-7 liability from the §1.752-7 liability partner, there is a reduction in the basis of the partnership interest of the §1.752-7 liability partner that is deemed to occur immediately prior to such separation. The amount of the basis reduction is equal to the <u>lesser of</u> (1) the remaining built-in loss associated with the §1.752-7 liability or (2) the excess of the §1.752-7 liability partner's basis in the partnership interest over the adjusted value of the interest (i.e., its fair market value, as increased by the partner's share of partnership liabilities). Under this concept, MM Inc.'s basis for its membership interest is reduced by $500,000, which is the lesser of (1) the $1,000,000 remaining built-in loss in the §1.752-7 liability, and (2) the excess of MM Inc.'s $2,000,000 basis for its membership interest over its $1,500,000 value. As a result, at a sale price of $1,500,000, MM Inc. does not recognize a loss, as the $2,000,000 basis for its membership interest is reduced by the §1.752-7 basis reduction of $500,000.

In the case of a separation event and basis reduction, the remaining partners are not entitled to any deduction upon satisfaction of the §1.752-7 liability that related to the prior §1.752-7 party, unless the liability is satisfied for an amount greater than the agreed upon amount of the §1.752-7 liability. In other words, when EA LLC satisfies the environmental liability, neither Jeff nor Butch is entitled to any deduction, unless the liability is satisfied for an amount in excess of $1,000,000. However, the deduction does not necessarily disappear into thin air; there still is an avenue by which the §1.752-7 liability partner (i.e., MM Inc.) can receive benefit of the deduction when economic performance of the liability occurs, even though such person is no longer a partner in the partnership. Reg. §1.752-7(e)(1) provides, in pertinent part:

> If the partnership (or any successor) notifies the §1.752-7 liability partner of the satisfaction of the §1.752-7 liability, then the §1.752-7 liability partner is entitled to a loss or deduction….To the extent of the amount that the partnership would, but for this section, take into account on the satisfaction of the §1.752-7 liability, the character of that deduction or loss is determined as if the §1.752-7 liability partner had satisfied the liability. To the extent that the §1.752-7 liability reduction exceeds the amount that the

> partnership would, but for this section, take into account on the satisfaction of the §1.752-7 liability, the character of the §1.752-7 liability partner's loss is capital.

Note, however, that the regulations do not impose any affirmative requirement on the partnership to notify the §1.752-7 liability partner of the satisfaction of a §1.752-7 liability after a separation event. Consequently, it is important for such a partner to enter into an agreement that requires the partnership to provide such notice.

Also note that the §1.752-7 partner still has basis to deduct the allocated deduction because of the basis reduction occurring on the transfer of its membership interest. In other words, if EA LLC satisfies the $1,000,000 environmental liability after MM Inc.'s transfer of its membership interest, MM Inc. has $500,000 of "suspended basis" available to absorb the deduction. If the liability is satisfied for less than $500,000, MM Inc. would have a capital loss. The rule that the loss is capital makes sense, given that had MM Inc. taken less of a basis reduction at the time of the sale of its partnership interest, it would have had a capital loss at that time.

Interestingly, the regulations provide that if a §1.752-7 liability partner is not notified of the payment of the liability, any basis reduction remains suspended and never creates any loss of any kind. On the other hand, if the liability is satisfied for less than the basis reduction, the §1.752-7 partner is entitled to a capital loss of the unused basis reduction. It puts a premium on negotiating a notice provision with the partnership, and given that some of these transactions involve sales of a partnership interest in which the partnership may not be involved, it probably makes sense that any time a §1.752-7 liability is <u>contributed</u> to a partnership, the contributing partner elicits a covenant from the partnership to notify it of any payment of the liability, even if the payment of the liability occurs post-sale of its partnership interest.

The Exceptions to Reg. §1.752-7

Under potential scenario two, assume instead that MM Inc. contributes its business operations to newly formed Operating LLC, and then forms Holding LLC to which it contributes its 100% owned membership interests in Operating LLC and EA LLC. Thereafter, Jeff contributes $6,900,000 to Holding LLC to become a 50% member. The environmental liability still is a §1.752-7 liability, and for that matter so is the deferred compensation, meaning that the rules of Code Sec. 704(c) apply to require the deductions for such items to be allocated to MM Inc. However, unlike what happens under scenario one with the environmental liability, on the sale by MM Inc. of its membership interest to Butch, the "liability isolation" rules of Reg. §1.752-7 do not apply, because there are two notable exceptions to this regulation.

First, there is a trade or business exception. Reg. §1.752-7(d)(2)(A) provides for non-application of Reg. §1.752-7 "[i]f the partnership assumes the §1.752-7 liability as part of a contribution to the partnership of the trade or business with which the liability is associated, and the partnership continues to carry on that trade or business after the contribution…." Reg. §1.752-7(b)(10) defines trade or business as follows:

> A trade or business is a specific group of activities carried on by a person for the purpose of earning income or profit, other than a group of activities consisting of

> acquiring, holding, dealing in, or disposing of financial instruments, if the activities included in that group include every operation that forms a part of, or a step in, the process of earning income or profit. Such group of activities ordinarily includes the collection of income and the payment of expenses. The group of activities must constitute the carrying on of a trade or business under section 162(a) (determined as though the activities were conducted by an individual).

The foregoing is a broad definition of trade or business, and it would appear that the definition may include property that is being triple net-leased, even though such an activity might not be considered a trade or business for other purposes under the Code.

The second exception contained in Reg. §1.752-7(d)(2)(B) is a de minimis exception, which provides that Reg. §1.752-7 does not apply "[i]f, immediately before the testing date [i.e., the date of the sale, exchange or other disposition of the §1.752-7 partnership interest or the date of the partnership's distribution in liquidation of the §1.752-7 partner's partnership interest, as applicable (§1.752-7(b)(9))], the amount of the remaining built-in loss with respect to all §1.752-7 liabilities assumed by the partnership (other than §1.752-7 liabilities assumed by the partnership with an associated trade or business) in one or more §1.752-7 liability transfers is less than the lesser of 10% of the gross value of partnership assets or $1,000,000."

Example 1 under Reg. §1.752-7(b)(10) essentially reflects the facts described in scenario one of this column, providing that the separation of the land subject to an environmental liability would not satisfy the trade or business exception and would be subject to the §1.752-7 rules discussed above. With the entire business being allocated under scenario two, Reg. §1.752-7 would not be applicable. As a result, on MM Inc.'s sale of its membership interest to Butch under scenario two, MM Inc. would not reduce its basis by the unpaid environmental liability. Correspondingly, Butch would step into MM Inc.'s Code Sec. 704(c) responsibility with respect to the unpaid environmental liability and would receive the benefit of the deduction when the liability is paid.

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