Originally published in the:
New York Law Journal **_December 18, 2024_**

Treasury Issues New Regulations on Allocation of Partnership Liabilities

By: Ezra Dyckman and Charles S. Nelson

The allocation of a partnership's liabilities can have important tax consequences. A partner's tax basis in his partnership interest includes his share of the partnership's liabilities. A partner's tax basis in his partnership interest is significant because any losses the partner is allocated from the partnership in excess of his basis are suspended, and cash distributions the partner receives from the partnership are generally taxable only to the extent they exceed his basis.

If a partner's share of partnership liabilities increases, the increase is treated as a contribution of money to the partnership, thereby increasing his tax basis in his partnership interest. Conversely, if a partner's share of partnership liabilities decreases, the decrease is treated as a distribution of money by the partnership to the partner, which decreases his tax basis (and to the extent the deemed distribution exceeds the partner's tax basis, it will be taxable to him).

Longstanding Treasury Regulations provide different rules for allocating a partnership's recourse liabilities and its nonrecourse liabilities. A nonrecourse liability—that is, a liability for which no partner (and no person related to a partner) bears the economic risk of loss—is generally allocated among the partners in accordance with their interests in the partnership's profits. In contrast, a recourse liability is generally allocated to a partner to the extent the partner (or a person related to the partner) bears the economic risk of loss with respect to the liability. A person is generally treated as bearing the economic risk of loss with respect to a liability to the extent that the person would be required to make a payment in the event that all of the partnership's liabilities become due and payable and all of the partnership's assets become worthless. Thus, for, example, a partner would generally be treated as bearing the economic risk of loss with respect to a liability if he personally guarantees the liability or if he is the lender with respect to the liability.

On December 2, 2024, the Treasury Department issued final regulations providing more detail on how a partnership's recourse liabilities must be allocated and in some cases changing the result under existing regulations. The new regulations were first proposed in 2013.

The regulations make several important additions to prior law. First, the regulations provide that for purposes of determining partners' shares of a recourse partnership liability, the amount of the liability is taken into account only once. If multiple partners bear the economic risk of loss with respect to a liability, each partner's share of the liability is equal to the amount of the liability multiplied by the partner's economic risk of loss with respect to the liability divided by the aggregate such amounts for each partner. Under prior law, it was unclear how to handle such a situation.

For example, assume that A is a 99% partner in a partnership and B is a 1% partner in the partnership. Assume that A and B have both personally guaranteed all of the partnership's liabilities. Under the new regulations, A and B would each be allocated 50% of the partnership's liabilities. This result could lead to strange tax results. In this example, notwithstanding the liability allocation, the partnership would likely allocate its losses and make distributions 99% to A and 1% to B. This could result in A having insufficient tax basis in his partnership interest, with the result that loss allocations to him may be suspended and distributions to him may be taxable. Meanwhile, B may have more tax basis than he needs to absorb his shares of losses or distributions.

Another situation addressed by the new regulations relates to tiered partnerships. Assume that X is a partner in an upper-tier partnership (UTP), and that UTP is a partner in a lower-tier partnership (LTP), but X is not directly a partner in LTP. Assume further that X has personally guaranteed a liability of LTP. Under both prior law and the new regulations, LTP would allocate the liability to UTP, which would then allocate it to X.

However, the new regulations create a strange result if X is both a direct partner in LTP and an indirect partner in LTP through UTP. Under those facts, the new regulations would provide that LTP must allocate the entire liability to X and not to UTP. This could result in X having insufficient basis in his partnership interest in UTP to be able to absorb losses and tax-free distributions from UTP, even though he has more than sufficient basis in his direct interest in LTP.

Finally, the regulations provide more detailed rules regarding related parties. Generally, under both prior law and the new regulations, a partner is allocated a recourse partnership liability if a person related to the partner bears the economic risk of loss with respect to the liability. However, the new regulations clarify that if both the person who directly bears the economic risk of loss and related persons are partners in a partnership, the liability is allocated entirely to the person who directly bears the economic risk of loss.

For example, assume that an individual and a non-grantor trust of which the individual is a beneficiary are equal partners in a partnership. Assume that the individual personally guarantees a liability of the partnership. Under the new regulations, the liability would be allocated entirely to the individual. This could result in the trust having insufficient basis in its partnership interest to be able to absorb losses and distributions, with the individual having more basis than he needs.

In sum, the new regulations provide more clarity in situations regarding partnership recourse liabilities than prior law. However, as the above examples illustrate, the regulations can result in allocations of recourse partnership liabilities that are sometimes unintuitive, even in fairly simple cases, and could have the result of some parties unnecessarily recognizing gain or not being able to use allocations of partnership losses. Thus, taxpayers will need to plan carefully to avoid unintended results and examine all current partnerships, as debt shares may shift dramatically as a result of these regulations.

Ezra Dyckman and Charles S. Nelson are partners of Roberts & Holland LLP.

Reprinted with permission from the December 18, 2024 edition of the *New York Law Journal* © 2024 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. ALMReprints.com 877-257-3382 – reprints@alm.com.