



Warren & Selbert

Simple as ABC.

Share of Liabilities

Partnerships sometimes use debt to fund their assets or operations. When a partnership is encumbered by debt, the partners share the burden of loan repayment. Further, the outside basis of each partner reflects the amount of debt for which that partner is responsible. In general, the initial outside basis of a partner in a partnership is the amount of equity that the partner put into the partnership plus that partner's share of debt that is used to purchase underlying assets or support operations. As the debt is repaid over time, the partner's outside basis decreases by the principal portion of each payment.

Partnership borrowing falls into two categories: recourse debt and non-recourse debt. Recourse debt is borrowing that has been guaranteed directly by one or more partners. Non-recourse debt is borrowing that only looks to the asset as collateral in the event of a default. The type of debt is important in determining the partners' responsibility for debt repayment. In the case of recourse debt, the share of liability that applies to each partner is based upon that partner's level of repayment guarantee. For instance, if a single partner guarantees full repayment of a debt instrument, then the partner's outside basis shows the entire debt balance of that instrument.

The assignment of non-recourse debt repayment responsibility to each partner must follow certain rules known as "tier liabilities." The first tier looks to the balance of minimum gain for each partner, as defined by code section 1.704-2. Minimum gain tracks the sum of asset deductions taken by a partner whose risk is borne by the lender instead of the partner. When a partner receives depreciation on an adjusted asset basis that is less than the outstanding non-recourse debt obligation, this increases the partner's share of minimum gain. Because the IRS recaptures minimum gain upon liquidation, the partner bears the responsibility for that amount of debt in the basis.

The second tier is called 704(c) minimum gain, and can arise when a partner contributes property to the partnership with an adjusted basis less than the fair market value of the asset at the time of contribution. A contributing partner carries a built-in gain balance that is charged over time in the form of 704(c) adjustments. Similar to Tier 1 liabilities, the IRS recaptures the balance of built-in gain upon liquidation, so it should be included in the contributing partner's share of liabilities. Note that only partnerships with contributed property have Tier 2 liabilities.

The third and last tier is excess non-recourse liabilities. The code allows for some flexibility in how these are allocated to each partner. However, to satisfy the tenet of significant economic effect, it is likely that the share of this final tier coordinates with some aspect of sharing between the partners of partnership cash flow or taxable income. While no strict allocation split is indicated in the code, partners rely on legal counsel to determine the appropriate amount of Tier 3 liabilities to allocate to each partner.

In ABC, the PSHIP/LIABS report displays the calculation of each partner's share of liabilities.

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