

account for purposes of the Internal Revenue Code (Code).

Congress recognized that taxpayers were attempting to use partnerships and S corporations to carry out the same types of abuses that section 358(h) was designed to deter. Therefore, in section 309(c) and (d)(2) of the Act, Congress directed the Secretary to prescribe rules to provide "appropriate adjustments under subchapter K of chapter 1 of the Code to prevent the acceleration or duplication of losses through the assumption of (or transfer of assets subject to) liabilities described in section 358(h)(3) * * * transactions involving partnerships" and to prescribe similar rules for S corporations. Under the statute, these rules are to "apply to assumptions of liability after October 18, 1999, or such later date as may be prescribed in such rules."

In response to this directive, these proposed regulations provide rules to prevent the duplication and acceleration of loss through the assumption by a partnership of a § 1.752-7 liability from a partner. For this purpose, a partnership that takes property subject to a liability is generally treated as assuming the liability. A § 1.752-7 liability is any fixed or contingent obligation to make payment that is not described in § 1.752-1(a)(1), without regard to whether the obligation is otherwise taken into account for purposes of the Code.

The proposed regulations also provide that section 704(c) principles shall apply to a § 1.752-7 liability assumed by a partnership from a partner. Accordingly, the § 1.752-7 liability is treated under section 704(c) principles as having a built-in loss equal to the amount of such liability at the time of its assumption by the partnership. The amount of the § 1.752-7 liability is the amount that a willing assignor would pay to a willing assignee to assume the § 1.752-7 liability in an arm's-length transaction.

In addition, the proposed regulations make conforming amendments to §§ 1.704-1(b)(2)(iv)(b) (by providing that a partner's capital account be reduced by the § 1.752-7 liabilities that the partnership assumes from the partner), 1.704-2(b)(3) (by treating a § 1.752-7 liability as a nonrecourse liability for purposes of the partnership allocation rules), and 1.705-1 (by directing taxpayers to § 1.358-1(b) and § 1.752-7 for basis adjustments necessary to coordinate section 705 with section 358(h) and § 1.752-7).

Moreover, the proposed regulations provide rules under section 358(h) for assumptions of liabilities by corporations from partners and

partnerships. In addition, in the Explanation of Provisions section of this preamble, the IRS and Treasury are alerting taxpayers that they are considering adopting the definition of liability proposed in these regulations as an appropriate interpretation of the term *liability* for purposes of subchapter C of chapter 1 of the Code. The IRS and Treasury are also considering issuing regulations to conform the exceptions to section 358(h) to the exceptions described in these regulations. These regulations will be retroactive to the extent necessary to prevent abuse.

Section 358(h) applies to S corporations. The Act states that the Secretary may prescribe comparable rules which provide appropriate adjustments under subchapter S. These proposed regulations do not address the assumption of liabilities by S corporations; however, any rules applicable to assumptions of liabilities by corporations would, in the absence of provisions to the contrary, apply equally to S corporations. Comments regarding the assumption of liabilities by S corporations are requested.

Explanation of Provisions

1. Addition of § 1.752-1(a)(1)—*Definition of Liability*

The question of what constitutes a liability for purposes of section 752 was addressed in Rev. Rul. 88-77 (1988-2 C.B. 128). Rev. Rul. 88-77 holds that partnership liabilities include an obligation only if, and to the extent that, incurring the obligation creates or increases the basis to the partnership of any of the partnership's assets (including cash attributable to borrowings), gives rise to an immediate deduction to the partnership, or, under section 705(a)(2)(B) (relating to noncapital, nondeductible expenditures of a partnership) currently decreases a partner's basis in the partner's partnership interest. Section 1.752-1T(g) (1989-1 C.B. 180), included a definition of a liability for purposes of section 752 that reaffirmed the position of the IRS in Rev. Rul. 88-77. This definition was removed from the final version of those regulations in response to comments that the definition was redundant and therefore unnecessary. The Service continues to follow the definition of liability set forth in Rev. Rul. 88-77. See Rev. Rul. 95-26 (1995-1 C.B. 131).

Because these proposed regulations define a § 1.752-7 liability as a fixed or contingent obligation to make payment to which section 752 does not apply, Treasury and the IRS believe that it is appropriate to describe in these

regulations the liabilities to which section 752 does apply. Therefore, following the principles set forth in § 1.752-1T(g) and Rev. Rul. 88-77, the proposed regulations provide that an obligation is a liability if and to the extent that incurring the obligation: (A) Creates or increases the basis of any 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. An obligation for this purpose is any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the 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, and futures contracts. The definition of a liability contained in these proposed regulations does not follow *Helmer v.*

Commissioner, T.C. Memo 1975-160. (The Tax Court, in *Helmer*, held that a partnership's issuance of an option to acquire property did not create a partnership liability for purposes of section 752.)

Treasury and the IRS are considering adopting the definition of liability proposed in these regulations as an appropriate interpretation of the term *liability* for purposes of subchapter C of chapter 1 of the Code. Treasury and the IRS request comments on the scope and substance of such regulations, which will be retroactive to the extent necessary to prevent abuse.

2. § 1.752-7—*Partnership Assumption of Partner's § 1.752-7 Liability*

In the corporate context, section 358(h) prevents the duplication and acceleration of loss with respect to obligations not encompassed by section 358(d) by reducing the transferor shareholder's basis in corporate stock received in the exchange. Treasury and the IRS do not believe that this is the best approach for partnerships given their passthrough nature. Ultimately, the partners' shares of a partnership's deductions are limited by the partners' bases in their partnership interests (their outside bases). If, at the time of an assumption of a § 1.752-7 liability by a partnership from a partner (the § 1.752-7 liability partner), the partner's outside basis were reduced by the amount of the § 1.752-7 liability, then the partner would not have sufficient outside basis