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PARTNERSHIPS, S CORPORATIONS, AND LLCs

Obligations, Liabilities, and Construction Partnerships: Regs. Clear Away a Trap

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Regulations that are intended to eliminate a taxpayer-favorable anomaly may have the beneficial but incidental effect of clearing away some unfavorable consequences of the same anomaly. Final Regulations under Section 752, refining the meaning of partnership "liabilities" and "obligations," may have—however unintended by Treasury and the IRS—solved a problem for construction partnerships that receive progress payments under the percentage-of-completion method.

If partnerships were pure pass-through entities—treated merely as aggregates of their owners—then inside and outside basis would always match up. Disparities between inside basis and outside basis do arise, however, and often have functioned as the building blocks of both tax shelters and tax traps. It has long been thought that partners in construction ventures are at risk of falling into one such trap. Recent developments in the law, however, have eliminated this problem. The most important of these developments is TD 9207, 5/23/05 (the "2005 Regulations"), adopting Reg. 1.752-1(a)(4)(i) among other provisions. These Regulations—almost incidentally—appear to effect an elegant solution to a persistent problem faced by construction partnerships.

The problem arose from the interaction of (1) the rules for including partnership liabilities in a partner's basis in its partnership interest and (2) the principles governing the tax accounting for long-term contracts. Each of these two elements will be reviewed below as a foundation for examining the trap.

SECTION 752 AND ‘INSIDE’ AND ‘OUTSIDE’ BASIS

Section 752 governs the treatment of partnership "liabilities"—a term lacking a statutory definition. Section 752(a) states that a partner is treated as contributing money to the partnership to the extent such partner's share of partnership liabilities increases or the partner assumes partnership liabilities. Section 752(b) provides that a partner is treated as receiving money as a distribution from the partnership to the extent such partner's share of partnership liabilities decreases or the partnership assumes such partner's individual liabilities. Deemed contributions increase the partner's basis in its partnership interest (under Section 722); deemed distributions decrease the partner's basis in its partnership interest (under Section 733).

Example: Partners A and B contribute $100 each to partnership AB (a total of $200). Thus, each of them starts out with a basis of $100 in its partnership interest under

Section 722. AB borrows $800, and acquires depreciable property for $1,000. AB has a $1,000 cost basis in the property, under Section 1012.

If not for Section 752, the partners in the aggregate would have a basis of $200 in their partnership interests, but the partnership would have a basis of $1,000 in its asset. Indeed, if AB had been a corporation—even an S corporation—rather than a partnership, the disparity in basis would exist. Section 752 has no counterpart among the rules governing corporate tax—not even in the rules for S corporations.

Because of Section 752, however, the partners together have an extra $800 basis in their partnership interests, representing the amount of the partnership's liability. If the extra $800 is allocated equally between the partners, [1] each partner has a basis of $500 (that is, $100 + $400). The two partners in the aggregate have a basis of $1,000 in their partnership interests, which is the same as the partnership's basis in its property.

Each of the partners generally may take deductions, or tax-free distributions, up to the amount of its $500 basis. Section 731 generally permits tax-free distributions to the extent of the partner's basis, although there are exceptions, including those contained in Sections 736 and 737. Section 704(d) generally limits the deduction of pass-through items to the partner's basis. Deductions may be subject to additional restrictions such as those in Sections 465 and 469.

The partners' ability to take deductions and tax-free distributions that are attributable to partnership borrowing is an advantage of partnerships over other business entities. It is not necessarily an advantage, however, over the use of no entity at all (or of a "disregarded" entity). A partner that is allocated a share of a partnership's debt-funded deductions, or takes a distribution of partnership loan proceeds, is not necessarily any better off than a taxpayer that simply borrows money on its own.

Section 752 contributes to the "aggregate" nature of partnerships. As the Preamble to former Temporary Regulations under Section 752 explained, "[b]y equalizing inside and outside basis, section 752 simulates the tax consequences that the partners would realize if they owned undivided interests in the partnership's assets, thereby treating the partnership as an aggregate of its partners." [2] Indeed, the IRS in recent litigation such as *Salina Partnership LP,* TC Memo 2000-352, RIA TC Memo ¶2000-352 , has sought to stress the policy of equalizing inside and outside basis. [3]

Nevertheless, Subchapter K is not, and has never been, a pure aggregate regime. Examples of both aggregate and entity concepts are strewn throughout the partnership tax rules. As we will see, the IRS itself has in the past interpreted Section 752 in ways that create "entity"-like disparities between inside and outside basis.

ACCOUNTING FOR LONG-TERM CONTRACTS

Section 460, first enacted in 1986, requires long-term contracts to be reported under special tax accounting rules. These rules supersede, to some extent, normal cash and accrual principles.

Section 460(f)(1) defines a "long-term contract" as "any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into." Personal service contracts do not count. For example, contracts for architectural services, engineering services, or even

construction management are not—in themselves—long-term contracts, because they do not require the taxpayer "to actually construct, build, or install anything." [4]

Because so much construction work is performed through partnerships, issues involving long-term contract tax accounting frequently arise in the partnership context. The interaction between the partnership rules and the long-term contract rules has provided countless opportunities for confusion. The confusion is intensified by the changes in law that have taken place since the issuance of the key rulings on the partnership tax implications of long-term contract accounting. These rulings actually predate Section 460.

The two main long-term methods are "percentage of completion" and "completed contract." Since the enactment of Section 460, relatively few construction contracts are reported under the completed contract method. [5] Most construction partnerships—at least the large ones—must instead use the percentage-of-completion method under Section 460. Before the enactment of Section 460, however, the completed contract method was widely available.

Under the percentage-of-completion method, a taxpayer generally includes a portion of the total contract price in income for each tax year in the same ratio that the taxpayer incurs contract costs allocable to the long-term contract. Stated another way, the percentage-of-completion method requires a taxpayer to recognize income based on the ratio of costs incurred to estimated total costs under the contract. To the extent any portion of the total contract price has not been included in taxable income by the completion year, Section 460(b)(1) and the Regulations require the taxpayer to include that portion in income for the tax year following the completion year. Essentially, the percentage-of-completion method provides that the taxpayer should completely recognize income once it is no longer required to incur additional costs to complete the contract.

Under the completed contract method, a taxpayer is required to include the total contract price in income and take into account all deductible costs allocated to the contract in the tax year in which the contract is completed. [6] Like the percentage-of-completion method, the completed contract method requires the taxpayer to have a final income recognition event once the taxpayer is no longer required to incur additional costs to complete the contract.

Under Section 460, the timing of the cash receipts is irrelevant to the income recognition. Income often is recognized before the corresponding cash, but may be recognized after. There seems to be no policy reason to alter the timing of the income recognition when cash received by a partnership is distributed to the partners.

EARLY RULINGS SET THE TRAP

The early Revenue Rulings under Section 752 make no efforts at a comprehensive definition of "liability." Perhaps because the language of the statute itself contains no clues as to the meaning of the term, early rulings seem guided by a general and nontechnical understanding of "liability." [7]

For example, Rev. Rul. 60-345, 1960-2 CB 211, *revoked by* Rev. Rul. 88-77, 1988-2 CB 128, held that a cash-method "partnership's obligations for the payment of outstanding trade accounts, notes, and accrued expenses" counted as liabilities under Section 752. The IRS did not provide an explanation for its holding, but presumably considered such obligations to constitute "liabilities" in the normal sense of the word. Also, the Ruling did not indicate whether the "liabilities" increased the basis of the partnership's assets.

The government began building the trap for construction partnerships in Rev. Rul. 73-301, 1973-2 CB 215. (We will refer to Rev. Rul. 73-301 and Rev. Rul. 81-241, 1981-2 CB 146, discussed below, collectively as the "progress payment Rulings.")

The ABC partnership described in Rev. Rul. 73-301 reported its income from a two-year construction project under the completed contract method. In accordance with the construction contract, ABC received a $100x "progress payment" during the first year for services performed. The payment was reflected as deferred income on the partnership's books. Since the partnership had already performed the services required to earn the $100x, "there was no obligation to return the payment or perform any additional services in order to retain it." Under the completed contract method, however, ABC did not include the $100x in income. As of the end of the year, ABC had the right to an additional $20x payment, but had incurred liabilities for $80x of costs under the contract. There seems to be no doubt that the $80x of liabilities for costs was properly treated as a liability under Section 752.

In Rev. Rul. 73-301, A, a 25% partner in ABC, started the year with a $4x capital account. A "withdrew" $17x from the partnership during the year. The Ruling does not discuss withdrawals, if any, by the partners other than A, but for present purposes we can assume that the withdrawals were pro rata. Since A was allocated no income or loss for the year, the withdrawal created a capital account deficit of $13x.[8] A's share of the $80x liability was $20x. Apart from A's share of liabilities, A had a $5x basis in ABC. The IRS calculated A's total basis as $25x. Had the $100x progress payments represented a partnership liability under Section 752, the outside bases of the partners would have been higher by $100x, and presumably $25x of that amount would have been allocated to A. Thus, A's basis would have been $50x rather than $25x. The IRS concluded, however, that the $100x was not a liability under Section 752.

This conclusion must have looked like common sense at the time, and the IRS may have felt no need to explain in detail the reasoning behind it. The closest the Ruling comes to analysis is when it points out that the $100x progress payments, along with the partnership's right to an additional $20x for work performed, constituted "unrealized receivables" within the meaning of Section 751(c). The implication seems to be that "unrealized receivable" and "liability" are mutually exclusive, so that an advance payment with respect to an unrealized receivable cannot represent a liability.

As defined by Section 751(c), an "�So unrealized receivable’ includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for ... (2) services rendered, or to be rendered." Under this definition, a partnership may receive in cash an amount attributable to an unrealized receivable, without necessarily "realizing" that receivable, because the partnership's method of accounting may permit or require that the amount not be taken into income. Thus in Rev. Rul. 73-301 ABC's unrealized receivables remained the same before and after receipt of the $100x progress payments. It is unclear, however, why ABC's liabilities necessarily remained the same.

In Rev. Rul. 79-51, 1979-1 CB 225, the IRS applied Rev. Rul. 73-301 to a partner that sold its 30% interest in a partnership which used the completed contract method. To the extent that the sale price was attributable to unrealized receivables under Section 751(c)—including progress payments and additional rights to payment—the selling partner realized ordinary income. Current Regulations confirm that rights under contracts accounted for under a long-term contract method of accounting are unrealized receivables within the meaning of Section 751(c), although the amount of the unrealized receivables is now determined under the "constructive completion" method.[9] Although

Rev. Rul. 79-51 relied on Rev. Rul. 73-301, it appears that the result in Rev. Rul. 79-51 would have been the same with or without the conclusion reached in Rev. Rul. 73-301.

Rev. Rul. 73-301 considered whether the $17x withdrawal represented a loan by the partnership to A rather than a distribution. Under the facts of the Ruling, despite A's negative capital account, A did not have "an unconditional and legally enforceable obligation ... to repay any of the amounts withdrawn to the partnership on or before a determinable date." Thus the withdrawal was a distribution and not a loan. Rev. Rul. 57-318, 1957-2 CB 362, could have been read as suggesting that the mere existence of a negative capital account creates a loan to the partner. Rev. Rul. 73-301 clarified the earlier Ruling to remove any such implication.

Rev. Rul. 73-301 did not dwell on the obligation of ABC to complete the project or to incur additional costs. Nevertheless, the tax consequences of the transactions would have been radically different had such obligations not existed. Under the completed contract method, on completion of the project, the progress payments would have become income for tax purposes, and the expenses would have become deductible. Thus, on completion of the contract the items previously deferred (including items of both income and expense) would have been taken into account. At that point, it is not likely that ABC would have had spare cash—in excess of earnings and capital contributions—to distribute to the partners. Had the project been complete, the cash distributions to A presumably would have represented A's share of income, and would not have been taxable to him. The incomplete status of the project was essential to the treatment of the progress payment in the Ruling, even though the partnership had "no obligation to return the payment or perform any additional services in order to retain it."

It seems that the $17x received by A in Rev. Rul. 73-301 would not have been taxable to A under any analysis. Under the Service's analysis, the $17x presumably reduced A's basis from $25 to $8. Under the alternative—in which the progress payment is treated as a Section 752 liability—the $17 presumably would reduce A's basis from $50 to $33. The facts of Rev. Rul. 73-301, therefore, fail to highlight the danger that excluding the progress payment from Section 752 can cause a cash distribution to be taxable to the partner. This danger is easy for partnerships to overlook, not only because Rev. Rul. 73-301 fails to underscore it but also—and more important—because the result is a departure from the more typical pattern of partnership tax, in which partners are taxed when income is earned but not when cash is distributed.

Other Rulings. Other Revenue Rulings bring the danger into plainer view. Rev. Rul. 73-300, 1973-2 CB 215—something of a companion piece to Rev. Rul. 73-301—held that "the money distributed to [a] partner in excess of the adjusted basis of his partnership interest is, to the extent of the partner's interest in the unrealized receivables of the partnership, treated as having been made in exchange for his interest in the partnership's unrealized receivables in accordance with Section 751(b)(1)(B) of the Code and is taxable to him as ordinary income." Thus, the distribution of progress payments, where taxable, is taxable as ordinary income.

Rev. Rul. 81-241 revoked Rev. Rul. 73-300, but without questioning Rev. Rul. 73-301. After Rev. Rul. 81-241, a distribution attributable to progress payments might be taxable, but at least it tended to generate capital gain. Rev. Rul. 81-241, like Rev. Rul. 73-301, dealt with the withdrawal of progress payments by the partners in a construction partnership that reported under the completed contract method. In Rev. Rul. 81-241, however, it is clear that the withdrawals were made in proportion to the partners' interests.

The Service ruled that the cash withdrawals were advances under Reg. 1.731-1(a)(1)(ii), and were therefore treated as current distributions made on the last day of the partnership tax year. Thus, the withdrawals were taxable to a partner to the extent the withdrawals exceeded the partner's basis in its partnership interest at year-end, but not as ordinary income. The IRS reasoned that since the amounts were advances against future income, they were not in exchange for the distributee partner's interest in unrealized receivables, and that the partners therefore did not have to recognize ordinary income under Section 751(b). Rev. Rul. 81-241 implicitly rejects any requirement that a partner be obligated to return "advances" that turn out to be in excess of the partner's share of income for the year.

Rev. Rul. 73-300 would have been correct if the distributions there had been "distributions in exchange for the distributee partner's interest in the partnership's unrealized receivables," rather than advances. Rev. Rul. 73-300 was revoked because it did not contain facts supporting the conclusion that the partner's interest in the partnership's unrealized receivables was reduced. Rev. Rul. 81-241 cites Rev. Rul. 73-301 with approval, however, and does not purport to revisit the Section 752 issue.

Impact of the Rulings. None of these Rulings delves into the effects that might be felt after the year the cash was withdrawn. The full extent of the partners' tax problem, however, will only hit the partners in later years. For example, in Rev. Rul. 81-241, when the contract is completed, the partnership presumably will recognize ordinary income, which will be passed through to the partners. Even if the partners were taxable on the distribution in prior years, they generally still will be fully taxable in the year of completion. [10] This second tax may not even be accompanied by cash. The partners might be able to recognize a loss by liquidating the partnership, or abandoning their partnership interests, if either of those alternatives is practical. Even then, however, the loss might be capital in nature, and there is no guarantee that the partners will be able to use it. [11]

It would be unfair to charge that the progress payment Rulings evince an anti-taxpayer animus. One might read into them, however, a desire by the IRS to restrict—to the extent possible without congressional action—the generous benefits of the completed contract method. Before Section 460 was enacted, taxpayers that were engaged in long-term contracts could readily defer income by electing the completed contract method. If the IRS could not prevent the use of that method, it could—under the progress payment Rulings—at least prevent taxpayers from getting the full benefit of that method in the partnership context.

Congress has since seen to it that the completed contract method is no longer in general use; the percentage-of-completion method is now mandatory for most long-term contracts. Looking back at the recent history of partnership tax shelters, the government might have been better served by accepting whatever distortion may be inherent in the completed contract method and other permissible forms of "open-transaction" reporting, than by introducing a second distortion (i.e., a disparity between inside and outside basis) that partly undid the first.

Another irony of the progress payment Rulings is that, while they originally cut back on the benefit of an extremely favorable accounting method, today they would have the effect of accentuating the detriment of an unfavorable method. The percentage-of-completion method is often thought to be unfavorable relative to normal accrual-method accounting. Taxpayers generally do not seek out the opportunity to be on the percentage-of-completion method, but rather are forced into it by Section 460.

In a decision from the same era as the progress payment Rulings, the Tax Court in *Helmer,* TC Memo 1975-160, PH TCM ¶75160 , held that a partnership's issuance of an option to acquire property did not create a Section 752 liability. In that case, the partnership granted an option to purchase partnership property. The option holder paid a premium up front for the option, and made additional annual payments. The partnership would have had to credit these payments against the purchase price, if the holder decided to exercise the option. There were no provisions, however, for repayment of the amounts paid under the option agreement in the event of a termination of the agreement by either party, and there were no restrictions on the partnership's use of the payments. The court determined that the partnership's obligations under the option agreement did not create a Section 752 liability because "the option agreement created no liability on the part of the partnership to repay the funds paid nor to perform any services in the future."

The Service's litigating position in *Helmer,* endorsed by the Tax Court, was similar to its position in the progress payment Rulings. In both situations, the IRS refused to count certain obligations as giving rise to "liabilities," and thereby created a disparity between inside and outside basis. The disparity in both instances appeared to offset, at least in part, the benefit to the taxpayer of open-transaction reporting. Further, in both, the IRS focused on the partnership's fixed right to retain certain cash payments that had not been taken into income, and accorded no significance to the fact that the open-transaction reporting was premised on the partnership's future obligations under the contract. It may have seemed common-sensical to assert that, if a taxpayer has a fixed right to retain cash, the cash does not represent a "liability." Common sense or not, the result violated the policy of equalizing inside and outside basis.

THE GOVERNMENT STARTS TO CHANGE DIRECTION

In the early Rulings discussed above, "liabilities" was interpreted without being defined. As the IRS began to reconsider the early Rulings, however, it began a serious effort to set out a general definition of the key term.

Rev. Rul. 88-77 was perhaps the turning point. Revoking Rev. Rul. 60-345, the 1988 ruling held that "accrued but unpaid expenses and accounts payable" of a cash-method partnership were not "liabilities" within the meaning of Section 752. Rev. Rul. 88-77 followed the cue given in the legislative history of the Deficit Reduction Act of 1984. The Conference Report expressed the view that, if a cash-method taxpayer contributes accounts payable to a cash-method partnership, then, "similar to the amendments recently made to section 357(c) (and contrary to Rev. Rul. 60-345, 1960-2 C.B. 211), these accrued but unpaid items should not be treated as partnership liabilities for purposes of section 752." [12]

The DRA ’84 Conference Report did not make this comment in the context of any change to Section 752. Rather, the statutory provision at issue was the requirement for partnerships to take into account the difference between FMV and basis of contributed property (in effect, making Section 704(c) mandatory rather than elective). Moreover, Section 357(c)(3), added in 1978, could be read to presuppose—contrary to the Conference Report's suggestion—that cash-method accounts payable are "liabilities," and that a legislative change was required to remove such liabilities from the reach of Section 357(c). If Congress intended the position taken by the Conference Report, it perhaps should have taken the trouble to amend Section 752. Nevertheless, the 1988 revocation of Rev. Rul. 60-345 seems well-justified in the absence of express language in Section 752 to the contrary, given the policies underlying Section 752—and given as well the arguably extraneous legislative history.

The definition of "liabilities" adopted by Rev. Rul. 88-77 already contains the core of the more precise formulation found in the 2005 Regulations. According to Rev. Rul. 88-77, "[f]or purposes of section 752 of the Code, the terms 'liabilities of a partnership and 'partnership liabilities' include an obligation only if and to the extent that incurring the liability [sic; presumably, the word should have been '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), currently decreases a partner's basis in the partner's partnership interest."

Shortly after Rev. Rul. 88-77, an almost identical position was adopted in Temp. Reg. 1.752-1T(g). When the Temporary Regulations were finalized in 1991, however, the definition of a "liability" was eliminated. The removal apparently was a response to comments that Rev. Rul. 88-77 obviated the need for a regulatory definition. [13] In *Salina,* the Tax Court commented that it was "unclear" why no definition was included in the 1991 final Regulations.

Continuing the approach of Rev. Rul. 88-77, the IRS ruled in Rev. Rul. 95-26, 1995-1 CB 131, that the obligation to deliver securities in a short sale transaction constituted a Section 752 liability. The short sale satisfied the 1988 definition because it created an obligation to deliver identical securities in the future, and resulted in an increase of partnership assets (i.e., the cash proceeds received from the sale). Not surprisingly, given the growing convergence between the interpretation of Section 752 and Section 357(c), the IRS also concluded that a corporation's assumption of its shareholder's obligation to provide replacement securities to a broker-dealer pursuant to a short sale was the assumption of a liability for purposes of Sections 357 and 358. [14]

In *Salina,* the Tax Court reached the same conclusion as the IRS did in Rev. Rul. 95-26, holding that a short sale gave rise to a liability for purposes of Section 752. The court determined that, consistent with the policy underlying Section 752 of promoting parity between inside basis and outside basis, the taxpayer's legal obligation to close its short sale by delivering the borrowed securities represented a Section 752 liability.

The taxpayer in *Salina* argued—quite plausibly, in our view—that Rev. Rul. 95-26 conflicted with both Rev. Rul. 73-301 and *Helmer.* The Tax Court, however, distinguished both the Ruling and the case. Similarly, in *COLM Producer, Inc.,* 98 AFTR 2d 2006-7494, 460 F Supp 2d 713 (DC Tex., 2006), the district court distinguished *Helmer* and several other cases from the short sale situation by arguing that in the other situations, the liabilities were "contingent as to the obligation itself or as to the amount of the obligation," and therefore did not qualify as liabilities for purposes of Section 752. As explained below, the Preamble to the Proposed Regulations that eventually were finalized as the 2005 Regulations forthrightly disavows *Helmer.* It would have been helpful to expressly disavow the progress payment Rulings as well, but even in the absence of such an express repudiation it is reasonably clear that the progress payment Rulings are inconsistent with the 2005 Regulations.

Also consistent with Rev. Rul. 88-77 and Rev. Rul. 95-26 is TAM 9823002, which ruled that prepaid subscription income deferred under Section 455 constitutes a Section 752 liability. The partnership described in that TAM received advance payments from subscribers, and elected under Section 455 to defer recognition of the income until the year the partnership delivered the magazines to its subscribers. The IRS observed that "Partnership's liability to deliver a magazine arises when Partnership receives prepaid subscription payments from its subscribers. Upon receipt of the payments, Partnership incurs an obligation to furnish a certain number of magazines to its subscriber. If Partnership fails to deliver the magazines, it is obligated to refund the prepaid amounts. The receipt of the payment increases Partnership's basis in cash, one of its assets, by the

amount of the payment. Accordingly, under the definition of liability relied on in Rev. Rul. 88-77 and Rev. Rul. 95-26, the advance subscriber payments represent a partnership liability for purposes of section 752."

The facts in TAM 9823002 arguably differ from those of the progress payment Rulings in two crucial respects. First, the obligation of the magazine partnership to perform in the future seems to arise from receipt of the payments. In the progress payment Rulings, on the contrary, the obligation arises on signing the contract; receipt of the payments does not create the obligation. Second, the magazine partnership is required to refund the "prepaid" amounts if it fails to perform. The construction partnerships in the progress payment Rulings, however, apparently were free to retain the amounts even if they failed to fulfill their obligations. As shown below, those two distinctions seem to be irrelevant under the 2005 Regulations.

THE 2005 REGULATIONS

Although the decision to forgo a regulatory definition seemed harmless in 1991, beginning in 2000 the government's opposition to a family of transactions known as "Son of BOSS" lent some urgency to the efforts to fill the gap left in 1991. The Community Renewal Tax Relief Act of 2000 (the "2000 Act") added new Section 358(h), and perhaps armed the IRS with additional weapons in its attacks on Son of BOSS.

Under 2000 Act section 309(c)(1), Treasury was to prescribe rules to provide "appropriate adjustments under subchapter K ... 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) ... in transactions involving partnerships." Section 358(h)(3) defines "liability" to include any fixed or contingent obligation to make payment, without regard to whether the obligation otherwise was taken into account for purposes of the Code. Thus Section 358(h)(3) implicitly distinguishes two kinds of "liabilities": those that otherwise are taken into account under the Code, and those that are not.

This distinction became part of the regulatory apparatus adopted under Section 752. We now have "Section 752 liabilities" properly speaking (Reg. 1.752-1(a)(4)) and so-called "section 1.752-7 liabilities" (Reg. 1.752-7), which essentially are all obligations other than or in excess of Section 752 liabilities. The need to distinguish clearly between these two kinds of liabilities gave impetus to the renewed effort to adopt a regulatory definition. According to the Preamble to the Proposed Regulations, "[b]ecause 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." [15]

The term "liability"—that is, a "Section 752 liability" in the strict sense—was not defined in final Regulations until TD 9207 was promulgated in May 2005. Current Reg. 1.752-1(a)(4)(i) provides that an "obligation" is a "liability" for Section 752 purposes "only if, when, 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."

Reg. 1.752-1(a)(4)(ii) defines an "obligation," for purposes of both the "liability" definition and Reg. 1.752-7, as "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." Examples of "obligations" include without limitation "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."

Under the 2005 Regulations, the nature of the underlying obligation is in many respects irrelevant to whether, when, and to what extent incurring the obligation gives rise to a liability. In particular, the obligation can be either fixed or contingent.

The definition of "liability" set forth in the 2005 Regulations is similar to the definition in the underlying Proposed Regulations [16] and in former Temp. Reg. 1.752-1T(g) and Rev. Rul. 88-77.

In the Preamble to the Proposed Regulations, Treasury stated expressly that the definition of a liability in the proposals did not follow *Helmer.* In that case, the partnership had a contingent obligation to deliver the property on the holder's exercise of the option. An obligation to deliver optioned property is not necessarily a liability. The obligation would have qualified as a liability under the 2005 Regulations, however, "if, when, and to the extent" the partnership received cash for incurring it. Once the option was exercised or lapsed, there was no further obligation, and no further liability, because the option premium then became either part of the sale proceeds of the property or ordinary income. [17] The 2005 Regulations followed the Proposed Regulations in relevant respects, and so are not intended to be consistent with *Helmer.* Unfortunately, Treasury did not express an opinion on the progress payment Rulings, even though, as will be shown below, they are every bit as inconsistent with the 2005 Regulations as *Helmer.*

THE PROGRESS PAYMENT RULINGS AND SECTION 460

Despite the ferment in the definition of "liabilities" from 1988, and the 1986 sea change in accounting for long-term contracts, there has been relatively little reconsideration of the progress payment Rulings.

In Proposed Regulations on partnership transactions involving Section 460, the IRS invited comments on whether there are circumstances under which the receipt of progress payments under a contract accounted for under a long-term contract method of accounting could give rise to a liability under Section 752 and, if so, how the Regulations would need to be revised to account for such liabilities. [18] Receiving no comments, however, the IRS wound up inserting a confusing and potentially misleading comment into the Preamble to the final Regulations under Section 460. After citing the progress payment Rulings, the Preamble seems to endorse those Rulings as reflecting the "ordinary" rule, while holding out the possibility for different treatment in special cases:

"Ordinarily, progress payments do not give rise to liabilities within the meaning of section 752 and the regulations thereunder. However, to the extent that there is a case in which a progress payment gives rise to such a liability, the Treasury Department and IRS agree that taxpayers should not be required to reduce their basis twice for the same progress payment, and believe that a similar rule should be provided for transfers to corporations." [19]

Reg. 1.460-4(k)(3)(iv)(A)(*1*)(*ii*) recognizes the possibility of cases that do not fit within the ordinary rule, and provides that on a contribution of a contract accounted for under a long-term contract method of accounting to a partnership or corporation, the old taxpayer must reduce its basis in the stock or partnership interest of the new taxpayer by "the amount of gross receipts the old taxpayer has received or reasonably expects to receive under the contract (except to the extent such gross receipts give rise to a liability other than a liability described in section 357(c)(3))." (It is also possible that the reason progress payments do not "ordinarily" give rise to liabilities is that progress payments often represent amounts that have already been taken into income for tax purposes.)

The final Regulations under Section 460 thus demonstrate that Treasury and the IRS are open to the possibility that contractual payments received by a partnership reporting under the percentage-of-completion method may represent "liabilities" within the meaning of Section 752.

PROGRESS PAYMENTS UNDER THE 2005 REGULATIONS

The implications of the 2005 Regulations for the progress payment Rulings are, we believe, surprisingly clear.

A partnership's obligation to provide the completed project or to incur additional construction costs constitutes an "obligation" under Reg. 1.752-1(a)(4)(ii). Even if the obligation were contingent, it still would count as an obligation under this definition. Where the partnership receives progress payments that have not yet been taken into income, however, the partnership's obligation does not seem to be contingent. If the partnership had no obligation to complete the project, then it would have taken all its earnings on the project into account.

The obligation to complete the project is not a liability in itself. It is a liability under Reg. 1.752-1(a)(4)(i) only *if, when, and to the extent* that incurring the obligation creates or increases the basis of any of obligor's assets, including cash (or gives rise to a deduction or nondeductible expense). Progress payments up to the amount taken into income do not represent an "obligation" or, therefore, a "liability." Progress payments in excess of that amount, however, are treated for tax purposes as received with respect to the obligation to complete the contract.

The reason those payments are not recognized as income is that the tax rules treat the payments as having been received on account of the partnership's future obligations. If the partnership were not required to finish the project or incur additional expenses with respect to the contract, the payments would be recognized as income. The fact that the partnership has or may have a fixed right to retain the payments should not be relevant to the tax treatment. Our position is that the progress payments must be treated either as earned or as giving rise to a liability; there is no third alternative.

The obligation to incur construction costs and complete the relevant construction project was not a Section 752 liability when the contract was signed; incurring the obligation did not give rise to tax basis at that time. *When* the contractual obligation creates basis, however, the obligation must *then* represent a liability. The contractual obligation creates basis when cash is received. In the progress payment Rulings, payments received and distributed were not taken into income because the partnership had to perform further work in completing the contract. The partnership had a fixed right to retain those payments, but the obligation of the partnership to complete the contract prevented those payments from being taken into income.

The 2005 Regulations define with precision the amount of the liability: there is a liability "*to the extent*" of the payment not yet taken into income. There is no need to determine whether the FMV of the future construction, or the amount of the future costs, is higher or lower than the amount of the cash. The rule is both theoretically correct and readily administered.

In a given situation, there may or may not be a possibility that progress payments in excess of income recognized will have to be returned to the owner by the partnership. The possibility of a refund should be irrelevant; the presence of such a possibility is not the reason for treating the amount of the payments as liabilities. The right of the owner to refunds or damages under the contract does not have any intrinsic connection to the characterization of the cash as earned or unearned under the percentage-of-completion method. The obligation that makes the excess cash a "liability" is the obligation to complete the project or incur expenses, not the obligation—which may or may not exist—to return the cash. Further, the liability is created when the cash is paid under the contract given that the cash, at that point, has created basis.

DISTINGUISHING THE PROGRESS PAYMENT RULINGS

If a partnership is still worried about the continuing validity of the progress payment Rulings—despite our argument to the contrary—the partnership may be able to distinguish the Rulings on the facts. The contract, whether explicitly or implicitly, may require the return of progress payments in the event the partnership fails to fulfill its future contractual obligations, or the partnership may be liable for damages at least equal to the unrecognized progress payments if the partnership fails to perform. In other words, in many instances the construction partnership has not performed all of the services and satisfied all the contractual obligations that would be required in order to retain the proceeds. In the progress payment Rulings, in contrast, the payments already had been earned by the taxpayer and no additional work was required to retain the payments. Situations where sellers have not yet satisfied their contractual obligations are more akin to TAM 9823002, where the taxpayer was obligated to perform additional services in order to retain the payments, and thus the deferred amounts were Section 752 liabilities.

CONCLUSION

A construction partnership has several alternatives to consider in dealing with progress payments that may have the potential, under the progress payment Rulings, for creating taxable income if distributed:

1. *Reinvest.* The partnership may leave the progress payments in the partnership, and reinvest the money in the same construction project, a different construction project, or whatever else the partnership chooses.

2. *Lend.* The partnership may lend the progress payments to the partners (a special form of reinvestment).

3. *Distribute.* A construction partnership often will want to reject alternatives 1 and 2 above, and to distribute the progress payments. There are several ways to justify the position that the distribution is tax-free:

A. *Allocate other debt.* As in Rev. Rul. 73-301, a distribution in excess of contributed capital plus earnings is not necessarily taxable to the partner if other debt (including accrued expenses of the partnership) is allocated to the partner.

B. *Distinguish the progress payment Rulings.* There may be an express or implicit requirement under the contract for the taxpayer to repay a portion of the proceeds received under the construction contract in the event that the taxpayer does not satisfy its contractual obligations to perform additional work.

C. *Reject the progress payment Rulings.* As argued above, the 2005 Regulations—if not the earlier authorities—are inconsistent with the progress payment Rulings. The authors believe that under current law the excess of the proceeds received by the partnership, over the income recognized under Section 460, is clearly a "liability" within the meaning of Section 752. Early authorities suggesting otherwise have been implicitly overruled.

Partnerships concerned that the distribution attributable to progress payments might be taxable should consider whether an election under Section 754 would mitigate the adverse effects of partner gain recognition by stepping-up inside basis. Taxpayers with lingering concerns might also consider whether an eventual liquidation of the partnership, or abandonment of partnership interests, if practical, would offset any double tax that might result from a taxable distribution of progress payments. Nevertheless, the authors emphasize that, in their view, the 2005 Regulations eliminate the grounds for all such concerns.

Practice Notes

If a construction partnership has received cash progress payments, and a distribution of the cash might trigger tax to the partners under the old progress payment Rulings, the partnership should consider whether—as this article argues—those Rulings have been implicitly superseded by recent Regulations, so that the cash may be distributed tax free.

1

Allocation of Section 752 liabilities is governed by a complex set of Regulations, which are beyond the scope of this article. See Regs. 1.752-1 through -5.

2

TD 8237, 12/29/88.

3

See also, e.g., COLM Producer, Inc., 98 AFTR 2d 2006-7494, 460 F Supp 2d 713 (DC Tex., 2006).

4

Rev. Rul. 82-134, 1982-2 CB 88. See also Rev. Rul. 84-32, 1984-1 CB 129; Rev. Rul. 80-18, 1980-1 CB 103; Rev. Rul. 70-67, 1970-1 CB 117. This article discusses the issues largely in the context of construction contracts. Some manufacturing contracts, however, also are subject to long-term contract tax accounting, and our discussion also would be relevant to manufacturing partnerships. For a useful overview of the Service's approach to the construction industry, see *MSSP Audit Guide on the Construction Industry* (Training 3147-123, 10-2005).

5

The completed contract method is not gone, however, and continues to be a thorn in the Service's side. See "Industry Director Directive on Super Completed Contract Method," LMSB-04-0207-012 (3/13/07).

6

Reg. 1.460-4(d)(1).

7

Appeals to the ordinary meaning of "liability" may have continuing influence, at least in court, although (as discussed below) the IRS has moved over the years towards a policy-driven technical definition. In COLM Producer, Inc., *supra* note 3, the court reasoned that the obligation to replace borrowed Treasury Notes that were sold short is a liability under Section 752. The court commenced its analysis with the "plain" and "ordinary" meaning of the statute. The decision even cites *Black's Law Dictionary* to the effect that "liability" is "the quality or state of being legally obligated or accountable" or "a financial or pecuniary obligation." The court in COLM, however, did attempt to back up that "plain" reading of the statute with a more technical analysis.

8

The negative capital account is irrelevant for our purposes, although it was important in Rev. Rul. 73-301, 1973-2 CB 215, because there the IRS wanted to clarify that a negative capital does not, without more, create a loan from the partnership to the partner. At least under modern capital accounting principles, ABC might have restated the capital accounts in connection with the distribution to A, and allocated an additional $25x to A's capital account. A distribution of $17x to A then would not have created a deficit capital account. In Rev. Rul. 81-241, 1981-2 CB 146, the partnership actually credited the progress payments to the partners' capital accounts.

9

Reg. 1.460-4(k)(2)(iv)(E).

10

A deemed exchange under Section 751(b) presumably would have resulted in an increase in inside basis in the year of withdrawal, but a taxable current distribution would have affected inside basis only if there had been a Section 754 election in place.

11

See generally Thomas, "The Art of Abandoning Securities and Taking an Ordinary Loss," 104 JTAX 22 (January 2006).

12

H. Rep't No. 98-861, 98th Cong., 2d Sess. 856-857 (1984), 1984-3 (Vol. 2) CB 110-111.

13

TD 8380, 12/23/91.

14

See Rev. Rul. 95-45, 1995-1 CB 53.

15

REG-106736-00, 6/24/03.

16

Id.

17

We read the Preamble to the Proposed Regulations as clearly expressing the view that Helmer, TC Memo 1975-160, PH TCM ¶75160 , is inconsistent with the definition of liability now found in Reg. 1.752-1(a)(4) (2005). Nevertheless, Klamath Strategic Investment Fund LLC, 98 AFTR 2d 2006-5495, 440 F Supp 2d 608 (DC Tex., 2006), seems to interpret the Preamble as pointing to an inconsistency between Helmer and current Reg. 1.752-6.

18

REG-128203-02, 8/6/03.

19

TD 9137, 7/15/04.

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