



Related Party Rules under Section 752

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Timeline

- Proposed regulations under Treas. Regs. Sections 1.752-2, 1.752-4, and 1.752-5 were published on December 16, 2013.
- Final regulations under Treas. Regs. Sections 1.752-2, 1.752-4, and 1.752-5 were published on December 2, 2024 (the “Final Regulations”).

Overlapping Risk of Loss - Proportionality Rule

- It is possible that more than one partner may bear the economic risk of loss with respect to a single partnership liability (or portion thereof). Stated differently, partners may have overlapping economic risk of loss with respect to the liability.
- For purposes of determining a partner's share of a partnership liability, the liability is taken into account only once.
- In general, if multiple partners bear the economic risk of loss for a partnership liability (or portion thereof), the partner's share of that liability (or that portion) is equal to the product of the liability multiplied by the fraction equal to the amount of the liability for which the partner bears the economic risk of loss, divided by the amounts borne by all such partners. The preamble to the Final Regulations refers to this concept as the "proportionality rule."

Overlapping Risk of Loss - Example

Each of Partner A and Partner B, who are unrelated, guarantee the entirety of Partnership's liability of \$1000. Partner A and Partner B are unrelated to each other.

Each of Partner A's and Partner B's share of the liability is \$500 (in the aggregate, \$1000).

This is determined by multiplying the amount of the liability guaranteed by both partners, \$1000, by the fraction equal to the amount of the liability for which each partner bears the economic risk of loss (\$1000), divided by the sum of the aggregate amounts for all partners (\$2000).

Overlapping Risk of Loss – Example

The facts are the same as set forth in Example 1, except that Partner A only guarantees the first \$500 of the liability, while Partner B guarantees the entire \$1000. The partners have overlapping economic risk of loss for \$500 of the liability, and therefore each have a \$250 share of that portion.

This is determined by multiplying the relevant portion of the liability (\$500), by the fraction equal to the amount of the liability for which the partner bears the economic risk of loss (\$500), divided by the sum of the aggregate amounts for all partners (\$1000).

Partner B also has economic risk of loss for the other \$500 of the liability not guaranteed by Partner A. Partner A's share of the liability is \$250; Partner B's is \$750.

Related Partner Exception

- In general, if one or more partners (or other persons who own a direct or indirect interest in a partnership through one or more other partnerships) *directly* bear the economic risk of loss for a single partnership liability (or a portion of that liability), the partner (or indirect equity owner) is not treated as related to other persons that own an interest in the partnership, directly or indirectly through one or more other partnerships, in the partnership. The Final Regulations refer to this concept as the “related partner exception.”
- This rule applies only for purposes of determining the extent to which those related persons share the economic risk of loss.

Related Partner Exception – Example

Each of Partner A and Partner B own equivalent 50% interests in Partnership. Partner A and Partner B, domestic C corporations, are wholly owned by X, a domestic C corporation. Partner A guarantees the entirety of Partnership's liability of \$1000.

For purposes of determining the extent to which Partner A and Partner B bear the economic risk of loss for the \$1000 liability, those partners are treated as unrelated notwithstanding that Partner A and Partner B otherwise are related under Treas. Regs. Section 1.752-4(b)(1). Partner A *directly* bears the economic risk of loss for the \$1000 liability because of its guarantee.

Pursuant to the related party exception, Partner B is treated as not related to Partner A, and therefore Partner B does not bear the economic risk of loss for the portion of the liability guaranteed by Partner A. As a result, Partner A's share of the \$1000 liability is \$1000; Partner B's share of the liability is zero.

Multiple (Related) Partner Rule

- It is possible that a non-partner (*i.e.*, a “person”) that bears the economic risk of loss with respect to a partnership liability may be related to multiple partners.
- Under the Final Regulations, a partnership liability for which a person *directly* bears the economic risk of loss is allocated between that person’s related partners in proportion to those partners’ interest of partnership profits.
- Because of the related party exception (and the ordering rule described below), this rule effectively would be “turned off” if the person that *directly* bears the economic risk of loss for a liability owns, directly or indirectly through one or more other partnerships, an interest in the borrower-partnership. The preamble to the Final Regulations refers to this concept as the “multiple partner rule.”

Multiple Partner Rule – Example

Each of Partner A and Partner B, domestic C corporations, are directly and wholly owned by X, also a domestic C corporation. Y, a domestic C corporation, also is directly and wholly owned by X. Partner A and Partner B own equivalent 50% interests in Partnership. Y makes a loan to Partnership of \$1000.

Under Treas. Regs. Section 1.752-2, Partner A and Partner B have 50% shares of the \$1000 partnership liability for which Y, a person related to both Partner A and Partner B, directly bears the economic risk of loss (as the lender).

This is because Partner A and Partner B have equivalent 50% shares of Partnership profits.

Ordering Rule

Step 1: determine those partners which directly bear the economic risk of loss for a partnership liability.

Step 2: apply the related partner exception, if applicable.

Step 3: apply the multiple partner rule, if applicable.

Step 4: apply the proportionality rule (for overlapping economic risk of loss).

Ordering Rule – Example

Partner A and Partner B are domestic C corporations. Partner A and Partner B are directly and wholly owned by X, which also is a domestic C corporation. Partner C is unrelated to each of Partner A and Partner B. Y, another domestic C corporation, also is directly and wholly owned by X. Partner A, Partner B, and Partner C have equivalent 33.334% interests in Partnership. Y, Partner A, and Partner C (but not Partner B) guarantee Partnership's \$1000 liability.

Applying the ordering rules, Y and Partner A, but not Partner B, bear *directly* the economic risk of loss for the \$1000 liability.

So, applying the related partner exception, Partner A and Partner B are treated as unrelated notwithstanding that Partner A and Partner B otherwise are related under Treas. Regs. Section 1.752-4(b)(1).

Ordering Rule – Example (cont'd)

It is then necessary to apply the multiple partner rule to determine the portion of the economic risk of loss directly borne by Y (which is related to both Partner A and Partner B) that is borne by each of Partner A and Partner B.

Because Partner A and Partner B have equivalent one-third interests in Partnership (and therefore Partnership profits), the economic risk of loss of Y's guarantee is allocated between Partner A and Partner B in equivalent amounts of \$500, based on the multiple partner rule (and Partner A therefore has total economic risk of loss of \$1500, equal to this \$500 plus the entire \$1000 for which it directly bears the economic risk of loss via its guarantee).

Ordering Rule – Example (cont'd)

Finally, applying the proportionality rule, Partner A's share of Partnership's liability is \$500 (the \$1000 liability for which there is overlapping economic risk of loss), multiplied by the quotient of \$1500 divided by the aggregate amounts of the three guarantees, \$3000). Partner B's share is \$167. Partner C's share of the liability is \$333.

Tiered Partnerships

- In a tiered partnership structure (an upper-tier partnership, or UTP, directly or indirectly owns an interest in another partnership (a lower-tier partnership, or LTP)), liabilities of the LTP are allocated to the UTP in an amount equal to the sum of:
 1. the amount of liabilities of the LTP for which the UTP *directly* bears the economic risk of loss, plus
 2. the amount of liabilities of the LTP for which a partner of the UTP bears (not necessarily directly) the economic risk of loss, provided that the UTP's partner is not also a partner of the LTP.

Tiered Partnerships

- Under the Final Regulations, a LTP takes into account the proportionality rule *before* the tiering rule.
- An UTP's share of the liabilities of a LTP (other than any liability of the LTP that is owed to the UTP) is treated as a liability of the UTP for purposes of applying Section 752 and the regulations thereunder to the partners of the UTP.



Rawat – Source Rules for Hot Assets Income under Pre-TJCA Law

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Framework of Section 751

- **Section 751(a)** - the amount of money and the fair market value received by a transferor partner in exchange for all or part of his partnership interest attributable to unrealized receivables to the partnership or inventory items of the partnership “shall be considered as an amount realized from the sale or exchange of property other than a capital asset.”
- **Section 751(b)** - to the extent that a partner receives in a distribution partnership property which is either unrealized receivables or substantially appreciated inventory in exchange for all or a part of his interest in other partnership property (including money), the transaction is considered, under regulations, as a sale or exchange of such property between the distributee partner and the partnership (as constituted after the distribution).

Sourcing for Sales of Personal Property

- In general, income or gain from the sale of personal property is sourced to the residence of the taxpayer.
- Gain from the sale of personal property that is attributable to the taxpayer's office or fixed place of business in the United States is treated as U.S. source.
- Gain generally is attributable to an office or fixed place of business if either (a) the gain is derived from assets held for use in the trade or business; or (b) the activities of the business are a material factor in the realization of the gain.

Sourcing for Sales of Personal Property (cont'd)

- In general, all U.S. source income (other than income described in Section 865(c)(2)) is treated as effectively connected income to the conduct of a trade or business within the United States.
- Under Section 856(b), gain from sales of inventory may be treated as U.S. source income pursuant to the rules set forth in Sections 861(a)(6), 862(a)(6), and 863(b)(3).

What the Case Was About

- The taxpayer had recognized gain under Section 731(a) in connection with a redemption of its interest in a partnership. A portion of the gain was, pursuant to Section 751(a), treated as ordinary income.
- The application of Section 751 itself seemingly was not at issue.
- The primary issue was whether the transaction should be analyzed for purposes of determining the source of the partner's income either as the sale of a partnership interest, on the one hand, or an indirect sale of the partner's interest in the partnership's "hot assets" (*i.e.*, the partnership's unrealized receivables and substantially appreciated inventory).

What the Case Was About (cont'd)

- If the taxpayer was treated, for purposes of determining the source of the gain recognized in connection with the distribution to her by the partnership, as having sold inventory, the gain would have been U.S. source at least in part and, as a result, treated at least in part as effectively connected income.
- If, by contrast, the taxpayer was treated for purposes of the sourcing analysis as having sold a partnership interest then, regardless of the char of the gain under Section 751, the gain would have been foreign source.
- The Tax Court ruled for the government.
- Note that the distribution occurred prior to the effective time of Section 864(c)(8).

Circuit Court's Ruling

- If D.C. Circuit reversed, holding for the taxpayer.
- The court highlighted that the language in Section 751(a) described the taxpayer's amount realized as being from the sale or exchange of property "other than a capital asset."
- The court emphasized that Congress, in drafting the text of Section 751, could have employed language like that in Section 897(g), or ultimately in Section 864(c)(8), and treated the sale of the partner's interest as an indirect sale of the partner's share of the partnership's hot assets.

Circuit Court's Ruling (cont'd)

- The court noted that Section 751(b), by comparison with Section 751(a), appeared to treat the transaction as a sale or exchange of the taxpayer's share of the partnership's hot assets (or non-hot assets, as appropriate) with the partnership.
- Instead, the court reasoned that the language of Section 751(b) was properly viewed as a framework for measuring the amount of the gain subject to be treated as ordinary income, rather than as a substantive recharacterization of the transaction.

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