Chapter 1

Allocation of Partnership and LLC Income Under Section 704(b)

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Learning objectives

- Analyze a partnership or LLC agreement to determine whether any special allocations in the agreement will be allowed under the Title 26 *U.S. Code of Federal Regulations* (CFR) Section 704(b) regulations, and when they will not be recognized by the IRS).
- Identify the potential economic consequences of special allocations to a partner or LLC member.
- Recognize the sections of a partnership agreement that must exist in order for a special allocation to be valid.
- Identify the potential tax consequences when a partner or LLC member has a negative balance in his or her capital account.
- Recognize the relationship between partnership and LLC allocations of profit and loss and the allocation of the risks and rewards of entity operations.
- Distinguish between the requirements for substantiality and those for economic effect under the regulations and understand the importance of future expectations when determining whether a proposed allocation will be both appropriate to achieve the economic objectives of the partners or members and legitimate under the Section 704(b) regulations.

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Introduction

Section 704 affords investors a wide degree of latitude in dividing partnership and LLC profits and losses. Section 704(a) allows the partners or members to divide items of entity income or loss in any manner they choose,[1] subject only to the constraints of Sections 704(b) and 704(c).[2] Section 704(c) requires special allocations with respect to contributed property. Section 704(b) requires that the partnership's tax allocations have substantial economic effect.

The criteria which must be satisfied before an allocation is considered to have substantial economic effect have been meticulously set forth in two sets of final regulations issued in September 1986 and December 1991. The basic premise of the regulations is very straightforward.

The tax consequences of partnership or LLC allocations must follow the economic consequences of those allocations. A partner or LLC member who receives the economic benefit of a partnership or LLC gain must be allocated the associated tax burden (the tax on the additional income). Conversely, an investor cannot be allocated the tax benefits of an entity loss unless he or she bears the economic burden of that loss. If an allocation has no significant economic consequence, it will be disregarded for tax purposes.

Allocations that are determined not to have substantial economic effect are disregarded and the investors' distributive shares of affected item(s) are determined according to their respective interests in the partnership.

The regulations establish the following two-part test to determine whether an allocation has substantial economic effect:

- First, the allocation must have economic effect.
- Second, the economic effect of the allocation on the partner or member must be substantial.

[1] Special allocations should be clearly stated in the partnership or LLC agreement.
[2] Further restraints have been laid out by the courts with respect to family partnerships. Allocations in family partnerships are governed by Section 704(e).

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Economic effect: The general test

General requirements

For an allocation to have economic effect, it must affect the amount the partner or LLC member will receive upon liquidation of the entity. Thus, if an LLC member is allocated all of the LLC's depreciation expense, he or she must be entitled to a lesser share of the proceeds from an eventual liquidation of the LLC. That is, he or she must bear the economic burden of any depreciation in the value of LLC property.

This means that the entity must accurately record income or loss allocations in the investors' capital accounts and must tie the investors' rights at liquidation to the balances in those capital accounts. Accordingly, the regulations set forth three requirements for an allocation to have economic effect:[3]

1. The partnership or LLC agreement must provide for the proper determination and maintenance of partner or member capital accounts throughout the life of the entity;
2. The agreement must provide that upon liquidation of either the entity, or of an individual investor's interest, liquidating distributions must be made in accordance with the positive capital balances of the investors; and
3. The agreement must require investors with negative balances in their capital accounts at liquidation to restore the deficits in those accounts.

The third requirement above assures that sufficient funds will be available to the partnership or LLC to repay its creditors and to liquidate the interests of those partners or members with remaining positive capital balances.

Tax Planning Point: Note that under the substantial economic effect rules, tax losses allocated to partners and LLC members will generally be associated with real economic losses. Thus, practitioners whose clients receive so-called special allocations of losses from an LLC or partnership should take care to ensure that those clients understand the potential economic costs that may accompany those tax allocations. Indeed, investors in an LLC or partnership who receive disproportionate loss allocations will often be required to make additional contributions to capital if the entity is unsuccessful, particularly when the partnership is liquidated. The purpose of the regulations under Section 704(b) is to ensure that tax loss allocations are accompanied by real dollar costs to recipients.

Maintenance of capital accounts

Because tax basis capital accounts seldom reflect fair market values, the regulations require the creation and maintenance of a separate set of investor capital accounts. These capital accounts are similar to the partnership's tax capital accounts with a few minor differences. They are intended to reflect as accurately as possible the economic relationship between the partners or members.

[3] Regulation Section 1.704-1(b)(2)(ii)(b).

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The regulations require that capital accounts be increased by

- cash contributions (including increases in the partners' or members' shares of partnership or LLC liabilities);[4]
- the fair market value of property contributed to the partnership or LLC by the partners or members (net of liabilities assumed by the partnership or LLC); and
- allocated items of book income and gain as determined under Section 704(b) and the regulations thereunder, including non-taxable income and gain.

Capital accounts must be decreased by

- distributions of cash from the partnership or LLC to a partner or member (including partner or member liabilities assumed by the entity, but not including guaranteed payments made to the partner or member by the partnership or LLC);
- the fair market value of any property distributed to a partner or member (net of liabilities assumed by the distributee in connection with the distribution);
- allocated expenditures that are not deductible in computing partnership or LLC income under Sections 702 or 703 and are not properly chargeable to capital (for example, syndication costs, expenses incurred in generating tax-exempt income, and so on); and
- allocated items of book loss and deduction as determined under Section 704(b) and the regulations thereunder, including simulated oil and gas depletion.[5]

Knowledge check

1. In 201X, J contributed $10,000 for a 10% interest in JDR Partners. On the 201X Schedule K-1 that J received from the partnership, the following items were reported:

   - J's initial cash contribution of $10,000
   - J's allocable share of partnership ordinary business income = $6,500
   - J's allocable share of partnership rental loss = ($12,100)
   - J's allocable share of partnership charitable contributions = $2,500
   - J's allocable share of partnership nondeductible expenses = $800

   J was unable to deduct the passive losses allocated to her by the partnership due to the passive loss limitations. Assuming there are no differences between book and tax income for the year, what will be the balance in J's capital account as of the first day of the next year?

   a. $ 1,100.
   b. $13,200.
   c. $ 1,900.
   d. $4,400.

[4] Regulation Section 1.704-1(b)(2)(iv)(c).
[5] Regulation Section 1.704-1(b)(2)(iv)(b).

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Partnership agreement: Maintenance of capital accounts

At times, accountants must go back to the partnership agreement to determine the correct tax treatment of partnership income and deduction items. The following is a sample paragraph from a partnership agreement addressing the maintenance of capital accounts in a manner consistent with the requirements of the regulations under Section704(b):

Section x.x. capital accounts

> The Partnership shall establish and maintain a Capital Account for each Partner. A Partner's Capital Account shall be (i) increased by (a) the amount of such Partner's Capital Contributions, (b) such Partner's allocations of Operating Income and Investment Gain…, and (c) items of income or gain specially allocated to such Partner…, (ii) decreased by the amount of money and the fair market value of any property distributed to such Partner by the Partnership, such Partner's allocations of Operating Loss and Investment Loss…, and items of loss, deduction, or expenditure specially allocated to such Partner…, adjusted to reflect any liabilities that are assumed by such Partner or the Partnership or that are secured by property contributed by or distributed to such Partner, all in accordance with 26 CFR Sections 1.704-1(b)(2)(iv) and 1.704-2 of the Treasury Regulations. Except as otherwise provided in the Treasury Regulations, a transferee of an interest in the Partnership shall succeed to the Capital Account of its transferor to the extent allocable to the transferred interest.

Note that this is only an example of how one partnership agreement handled the capital account requirements, and the authors of this course make no representations as to its legality. You should always consult an attorney whenever you are involved in the drafting of a partnership agreement or other legal documents. The above reproduced section of the sample partnership agreement does address the capital account requirements concerning, for example, treatment of distributions of property at fair market value, treatment of liabilities contributed to the partnership, and the effect of partnership income on the capital accounts. All of these requirements must typically be contained in the partnership agreement in order to have a valid special allocation.

Section 704(B) versus GAAP

It should be noted that Section 704(b) requires that partnership distributions be recorded at fair market value (FMV). As a result, the distribution of property by a partnership or LLC generally requires that either a gain or loss be recorded for Section 704(b) purposes.

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Example 1-1

A and B form the AB partnership with equal cash contributions of $50,000. The partnership then borrows $200,000 and purchases several tracts of land at a total cost of $250,000. Immediately after the acquisition, the partnership's Section 704(b) balance sheet appears as follows:

Assets:	
Cash	$ 50,000
Tract 1	20,000
Tract 2	80,000
Tract 3	150,000
	$ 300,000
Liabilities	$ 200,000
Capital, A	50,000
Capital, B	50,000
	$ 300,000

Assume that Tract 1 is subsequently distributed to A in a nonliquidating distribution. If Tract 1 is valued at $40,000 at the date of distribution, A's Section 704(b) capital account must be reduced by $40,000. In order for the partnership's Section 704(b) books to remain in balance, the $20,000 appreciation in the value of Tract 1 at the date of distribution must first be recorded and the partners' capital accounts increased accordingly. Thus, assuming the partners share partnership profits and losses equally, their capital accounts will be adjusted as follows:

	Capital, A	Capital, B
Beginning balance	$ 50,000	$ 50,000
Gain on distribution of T1	10,000	10,000
Distribution of T1	(40,000)	—
Post-distribution balances	$ 20,000	$ 60,000

The Section 704(b) balance sheet would be as follows:

Assets:	
Cash	$ 50,000
Tract 2	80,000
Tract 3	150,000
	$ 280,000
Liabilities	$ 200,000
Capital, A	20,000
Capital, B	60,000
	$ 280,000

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Some Section 704(b) departures from GAAP concern the recording of items that are treated differently for book and tax. For example, start-up expenses and organization costs are (at the taxpayer's election) deductible up to $5,000. The $5,000 limit for start-up or organizational expenses is reduced (but not below zero) by the amount by which the start-up or organizational expenses exceed $50,000, respectively. Any remaining start-up or organizational expenses are allowed as a deduction ratably over a 180-month period (Section 195(b) and Section 709(b)). These amortization expenses should be recorded in the partner capital accounts. Additionally, depreciation expense must generally be computed at the same rate both on the entity's tax return and in its Section 704(b) capital accounts.[6]

Example 1-2

On January 1, Y3, B contributes 5-year property to BCD Investors, a limited liability company that has chosen to be taxed as a partnership for federal income tax purposes.

The property, which B purchased in Y1 for $20,000, has an approximate value of $15,000 at the date of contribution.

B elected in Y1 to depreciate the property over 5 years using the statutory method under Section 168. Accordingly, its basis at the date of contribution is $9,600.

For tax purposes, the asset's basis to the LLC is also $9,600, and depreciation expense for Y3 will be $3,840 (19.2% of $20,000).

For purposes of Section 704(b), the asset will be recorded at its fair market value as of the date of contribution. Thus, in the LLC's Section 704(b) records, the property will be recorded at $15,000 and Section 704(b) book depreciation expense will be $6,000 ([3,840/9,600] × $15,000) in Y3.[7]

Treatment of liabilities

The treatment of liabilities under Section 704(b) is consistent with the general accounting treatment of debt. Direct transfers of liabilities between investors and a partnership or LLC are reflected in the investors' capital accounts, while mere increases or decreases in the investors' shares of partnership liabilities are not. Promissory notes between the partner or member and the partnership or LLC are not accounted for until converted into cash.

It is important to distinguish in this regard between the allocation of liabilities under Section 752, which determines a partner or member's basis in his or her partnership or LLC interest, and the method of

[6] Regulation Section 1.704-1(b)(2)(iv)(g)(3). The only exception to this rule applies when the partnership or LLC opts to use the remedial allocation method under Regs. Section 1.704-3(d)(2) to make allocations with respect to contributed property.

[7] This example assumes that the partnership uses the traditional method or the traditional method with curative allocations to make allocations with respect to contributed property under Section 704(c).

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accounting for those liabilities under Section 704(b), which is concerned merely with measuring his or her capital account. A partner's tax basis in the partnership interest represents the amount he or she stands to lose if the partnership becomes worthless. As such, it includes both the amounts the partner has previously invested in the partnership (less tax deductions claimed in connection with the partnership interest) plus amounts he or she will be required to pay should the partnership fail. Thus, a partner's tax basis includes the partner's share of partnership liabilities.

In contrast, the partner's capital account reflects how much the partner will be entitled to receive from (or contribute to) the partnership if the partnership were to sell all its assets for their book value and liquidate immediately. Tax basis thus reflects the net cost (unrecovered) paid, or to be paid, by the partner for the partnership interest. The capital account, in contrast, reflects the partner's legal claim against the partnership's assets in the event of a liquidation of either the partnership or the partner's interest therein.

Example 1-3

A and B form AB, a limited liability partnership, with the following contributions. A contributes $50,000 cash in exchange for a 50% interest in the entity. B receives the remaining 50% interest in exchange for a contribution of property with a basis and fair market value of $65,000, but encumbered by a nonrecourse liability of $15,000.

Under Section 704(b), the balance in A's capital account is $50,000 ($50,000 contributed, less 0 debt transferred to the partnership). Her basis in her partnership interest will be $50,000, plus her 50% share of the partnership's debt, $7,500.

Although the fair market value of the property contributed by B is $65,000, the balance in her Section 704(b) capital account will be only $50,000 ($65,000 contributed less $15,000 liability transferred); her basis in her partnership interest will be $50,000, plus her $7,500 share of the partnership's liabilities.

Liquidating distributions

The economic effect of an allocation under the regulations is tied directly to the effect of that allocation on a partner or member's rights to the partnership's assets in the event of a liquidation of either the entity or the investor's interest therein. Thus, even if capital accounts have been established and properly maintained over the life of the partnership or LLC, allocations will not be considered to have economic effect unless the partners or members' rights in liquidation are tied to the balances in those capital accounts. Section 704(b) requires that liquidating distributions be made in accordance with the positive Section 704(b) capital account balances of the investors. Only in this way do special allocations affect the rights of the investors in liquidation.

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Example 1-4

A and B establish AB Co., a limited liability company choosing to be taxed as a partnership for federal income tax purposes. The two investors establish the company with equal contributions of $1,500 cash. The LLC borrows $12,000 and purchases video arcade equipment for $15,000. The equipment is placed in convenience stores in exchange for a share of the income from use of the machines. Income before depreciation in the first year of LLC operations is $3,000. Depreciation expense is $3,000. The agreement between A and B provides that depreciation expense will be allocated entirely to A. All other items of income and expense are shared equally. As a result, the balances in the members' capital accounts at the end of year 1 are as follows:

	A	B
Beginning balances	$ 1,500	$ 1,500
Income before depreciation	1,500	1,500
Depreciation expense	(3,000)	—
Ending balances	$ —	$ 3,000

If the members' rights in liquidation are tied to their capital accounts, a disposition of the equipment for its book value followed by liquidation of the LLC would entitle B to receive a payment of $3,000 while A receives nothing. Thus, the allocation of the depreciation expense entirely to A has economic effect and will be recognized under Section 704(b). If, on the other hand, the LLC agreement provides that liquidation proceeds will be split equally between the members (regardless of the balances in their capital accounts), the allocation of depreciation can be seen to have had no effect on A's economic rights in liquidation and therefore will not be recognized under Section 704(b).

Knowledge check

2. Claire is a 50% partner in Elk Horn Partners. She acquired her partnership interest two years ago in exchange for a $150,000 cash contribution to the partnership. The partnership subsequently borrowed $700,000 on a nonrecourse note and purchased an office building. In its first two years of operations, the partnership reported net profits, of which Claire's share was $50,000 in year 1 and $64,000 in year 2. The allocations were recognized by the IRS under Section 704(b). Claire has received distributions totaling $30,000 over this two-year period. If the partnership were to sell all of its assets for their book values and liquidate at the end of year 2, how much of the liquidating proceeds would Claire be entitled to receive?

   a. $150,000.
   b. $234,000.
   c. $84,000.
   d. $264,000.

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Restoration of deficit capital balances

A corollary to the requirement that liquidating distributions be made in accordance with positive balances in the partner or members' capital accounts is that partners or members with deficit balances in their capital accounts must be obligated to restore those balances upon liquidation. The partnership or LLC agreement must require such restoration by the later of 90 days after the date of liquidation or the end of the partnership or LLC year in which the liquidation occurs.[8] Absent such a requirement, allocations to a partner or member of losses or deductions in excess of his or her capital contribution(s) would not affect his or her rights in a liquidation of the entity and thus could not have economic effect.

The regulations define liquidation very broadly. Deficit restoration is required upon the termination either of the partnership or LLC itself or of the individual partner or member's interest therein.[9] For this purpose, the term liquidation includes the unintended termination of a partnership or LLC resulting from the disposition of greater than 50% of the capital and profits interests, even if the remaining partner or members intend to continue operations.[10] Where the partners do intend to liquidate the partnership, but delay the distribution of liquidating payments in order to defer the required restoration of negative capital accounts, the regulations provide that liquidation will occur upon the termination of the partnership's primary business activity(ies).[11] Thus, a partner or LLC member will not be able to avoid satisfying his or her deficit restoration obligation by having the partnership or LLC enter into protracted liquidation proceedings.

[8] Regulation Section 1.704-1(b)(2)(ii)(c).
[9] Where a partner or member retires or otherwise terminates his/her interest in the entity, and the departure of that partner or member does not terminate the partnership/LLC under Section 708(b)(1), the departing partner/member is obligated to restore any deficit balance in his/her capital account; other partners or members who may have deficit capital balances do not have to restore those deficit balances to zero.
[10] Regulation Section 1.704-1(b)(2)(ii)(g).
[11] Id.

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Partnership agreement: Liquidating distributions and restoration of negative capital account balances

Below is a sample paragraph from a partnership agreement addressing liquidating distributions and the restoration of negative capital account balances:

> Section x.x. Distributions upon liquidation
>
> Upon the liquidation of the Partnership, the assets of the Partnership shall first be applied to the payment of, or the establishment of adequate reserves or other provision for the payment of, the debts and obligations of the Partnership. Thereafter, there shall be made a final allocation of Operating Income or Loss and Investment Gain or Loss, as the case may be, and other items to the Partners' Capital Accounts…If the General Partner has a negative balance in its Capital Account after such final allocation, it shall contribute to the Partnership an amount of cash equal to the excess of such negative balance over the amount that it is required to pay to the Partners…
>
> The assets of the Partnership, including any Portfolio Securities, …remaining after the payment or other provision for the Partnership's debts and obligations shall then be distributed to the Partners in proportion to the positive balances in their Capital Accounts, determined after the final allocation of Operating Income or Loss and Investment Gain or Loss, and of other items to Capital Accounts has been made.

Note again that this is only an example of how one partnership agreement handled the negative capital account restoration requirement, and the authors make no representations as to its legality. However, the above partnership agreement section does give the partnership directions concerning the steps it must take in the event that one or more partners have negative balances in their capital accounts upon liquidation. In order for a special allocation to be valid, the partnership agreement must include a paragraph to this effect, or state law must require deficit restoration upon liquidation of the partnership or a partner's interest therein.

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Deemed economic effect

The regulations generally require that each of the three economic effect criteria,

1. capital account maintenance,
2. liquidating distributions according to capital accounts, and
3. deficit capital account restoration,

be clearly spelled out in the partnership or LLC agreement. Where the agreement is silent with regard to these issues, but the allocations are made in such a way that a liquidation of the partnership or LLC at the end of each taxable year would have the same consequences as if these requirements had been met, partnership allocations will be deemed to have economic effect.[12]

[12] Regulation Section 1.704-1(b)(2)(ii)(i).

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Alternate test for economic effect

Rationale

The regulations recognize that even if a partner or LLC member is not obligated to restore deficits in his or her capital account, the allocation of profits or losses to such partner or member will still have economic effect to the extent they do not create or enlarge a deficit in his or her capital account — assuming that the first two requirements of Section 704(b) are met. That is, as long as liquidation proceeds must be distributed in accordance with positive balances in the partners' or members' capital accounts, and as long as those capital accounts are properly maintained, allocations that do not reduce a partner's or member's capital account below zero will affect his or her rights at liquidation. Accordingly, the regulations provide an alternate test for economic effect.

Requirements

Under the alternate test, allocations will be considered to have economic effect if the following requirements are met:[13]

1. The first two requirements of the general test for economic effect must be satisfied.
2. The partnership or LLC agreement must contain a qualified income offset provision.
3. The allocations must not cause or increase an excess deficit balance in any partner's or member's capital account after certain special adjustments are made.

Qualified income offset: Correcting inadvertent errors

A qualified income offset is a provision in the partnership or LLC agreement which requires that in the event a partner or member unexpectedly (outside of what would be considered normal operations) receives an allocation, a distribution, or some other capital adjustment which creates a deficit in his or her capital account in excess of the amount he or she is obligated to restore, he or she will be allocated sufficient income and/or gain to eliminate the resulting excess deficit as quickly as possible.[14] This may require an allocation of gross income to the offending partner or LLC member if sufficient amounts of other income are not available.

Thus, under the alternate test, as long as capital accounts are properly maintained, liquidation proceeds are distributed in accordance with such capital accounts, and the partnership or LLC agreement contains a qualified income offset provision, allocations will have economic effect to the extent they do not create deficits in any investor's capital account in excess of the amount he or she is obligated to restore.

[13] Regulation Section 1.704-1(b)(2)(ii)(d).
[14] Regulation Section 1.704-1(b)(2)(ii)(e).

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Partnership agreement: Qualified income offset

Following is an example of how the qualified income offset was provided for in one partnership agreement:

Section x.x. Special provisions

The following provisions shall be complied with notwithstanding any provision of this Agreement…:

A. If any Partner unexpectedly receives any adjustment, allocation or distribution described in Section 1.704-1(b)(2) (ii)(d)(4), 1.704-1(b)(2)(ii)(d)(5), or 1.704-1(b)(2)(ii)(d)(6) of the Treasury Regulations which causes it to have an, or increases the amount of its, Adjusted Capital Account Deficit, items of Partnership income and gain shall be specially allocated to such Partner in an amount and manner sufficient to eliminate, to the extent required by the Treasury Regulations, such Partner's Adjusted Capital Account Deficit as quickly as possible, provided that an allocation…shall be made to a Partner only if and to the extent that such Partner would have an Adjusted Capital Account Deficit after all other allocations provided for…have been tentatively made… This Section…is intended to constitute a qualified income offset as defined in Section 1.704-1(b)(2)(ii)(d) of the Treasury Regulations.

B. …an allocation of Operating Loss or Investment Loss shall not be made to a Partner to the extent that such allocation would cause such Partner to have an Adjusted Capital Account Deficit. An allocation that would be made to a Partner… shall instead be made to the other Partners to the extent, and in the proportions, that they could then be made such allocation without causing them to have Adjusted Capital Account Deficits. Any excess allocation of Operating Loss or Investment Loss shall be made to the General Partner.

While no representation as to the legality of the above agreement section is intended here, the above sample language provides a representative illustration of how a qualified income offset provision might be written in a partnership agreement.

Partial economic effect

It is important to note here that the regulations under Section 704(b) specifically provide that allocations may have partial economic effect.[15] Allocations under the alternative test for economic effect will be disregarded only to the extent that they reduce an investor's capital account below the amount he or she is required to restore upon liquidation. To the extent the allocation does not reduce the investor's capital account below this level, it will be considered to have economic effect. Where an allocation is only partially reallocated, however, both the portion that is reallocated and the portion that is considered to have economic effect shall consist of a proportionate share of all items making up the allocation.

[15] Regulation Section 1.704-1(b)(2)(ii)(e).

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Example 1-5

Recall the facts of example 1-4. A and B form a limited liability company to purchase video arcade equipment. The investors each contribute $1,500 cash to the LLC, which then borrows $12,000 and purchases the equipment for $15,000. A is to be allocated all of the depreciation expense. All other items of partnership income or loss are to be allocated equally. A is not required to restore any deficit in his capital account.

Assume that in the LLC's first year of operations, it reports income before depreciation of $2,000. As in example 1-4, it reports depreciation expense of $3,000. Absent Section 704(b), the investors' capital accounts at the end of the first year would be as follows:

	A	B
Beginning balances	$ 1,500	$ 1,500
Income before depreciation	1,000	1,000
Depreciation expense	(3,000)	—
Ending balances	$ (500)	$ 2,500

Because A is not obligated to restore the deficit in his capital account, the above allocations will not be considered to have economic effect under the general provisions of Section 704(b). If the partnership agreement meets the requirements of the alternate test, however, the allocations to A will be considered to have economic effect to the extent they do not reduce the balance in his capital account below zero (because he is not obligated to restore a deficit balance in his capital account). Thus, under the alternate test only $(500) of the net allocation must be reallocated. Because A's net allocation was $(2,000), 1/4 of each item allocated to A must be reallocated to B. Accordingly, B will be allocated approximately $250 of the income before depreciation that was originally allocated to A, and $750 of the depreciation originally allocated to A. The new allocations will be as follows:

	A	B
Beginning balances	$ 1,500	$ 1,500
Income before depreciation	750	1,250
Depreciation expense	(2,250)	(750)
Ending balances	$ —	$ 2,000

As illustrated, the reallocations will leave A with a zero balance in his capital account. B's capital balance will be $2,000.

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Adjusted capital accounts

The regulations require that in determining whether an allocation will reduce a partner's or member's capital account below the allowed level, adjustments must be made to account for certain reasonably expected future reductions to that account.[16] In applying the alternate test, capital accounts must be adjusted for

- *Reasonably expected* future depletion allowances (because depletion is computed at the partner or member level rather than at the entity level);
- *Reasonably expected* future net distributions (annual distributions of partnership income are disregarded); and
- *Reasonably expected* future allocations under Sections 704(e)(2) (relating to gifted interests in family partnerships), 706(d) (relating to changes in partners' or members' interests), and 1.751-1(b)(2)(ii) (relating to distributions of Section 751 property).

Thus, the regulations require that anticipated future events must be considered in determining the effect of a partnership allocation on the balance in a partner's capital account. Unexpected future events are covered by the required qualified income offset provision.

[16] Regulation Section 1.704-1(b)(2)(ii)(d).

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Substantiality

Overview

Once an allocation is determined to have economic effect, it must be determined whether that economic effect is substantial. The substantiality criterion requires that the allocation substantially affect the dollar amounts to be received by the investors upon liquidation, independent of tax consequences. The regulations outline three situations in which an allocation will not satisfy the substantiality criterion.

Shifting tax consequences

Perhaps the most obvious type of allocation that would meet the economic effects test(s) without substantially affecting the investor's non-tax economic interests in the entity is an allocation of capital gain or loss, or non-taxable income, to one investor accompanied by an equivalent allocation of ordinary income or loss to another investor. Here both investors would receive equivalent shares of income or loss, but each would face potentially different tax consequences. The regulations provide that such allocations lack substantiality, even if the requirements for economic effect are met. Specifically, the regulations reject the substantiality of allocations where there is a strong likelihood that

- The net changes in the investors' capital accounts would not differ substantially without the allocation; and
- The total (aggregate) tax liability of the investors will be less than if the allocation were not recognized.[17]

Example 1-6

A and B are equal partners in the AB partnership. Each is in the 30% tax bracket. At the beginning of Y5, the balance in each of their capital accounts was $9,000. For Y5, the partnership reported taxable income consisting of $6,000 of ordinary income from the rental of residential real property and $6,000 of capital gains. The partnership has been in existence since Y1.

The partners agree to allocate all of the rental net income to A and all of the capital gain to B. Assume the allocations have economic effect. If both partners have the same tax attributes outside the partnership (for example, assume that neither has passive losses from any other source, neither has net capital loss carryforwards, and both are in the same tax bracket), then the above allocations may be considered to have substantial economic effect.

[17] Regulation Section 1.704-1(b)(2)(iii)(b).

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Example 1-6 (continued)

However, if A has passive losses from other sources, so that the allocation of the partnership passive income will not increase his tax liability (and the capital gain would), then the allocations would reduce the combined tax liability of the partners. Alternatively, if B has capital loss carryforwards so that the capital gain allocation does not increase his tax liability (though it would increase A's tax liability), then the allocations would reduce the combined tax liability of the partners. Finally, if B is in a higher tax bracket than A, so that the benefit of the 15% tax rate on capital gains would be more beneficial to B than to A, then the allocation will again reduce the aggregate tax liability of the two partners.

In any of the above three situations, the balances in the partners' capital accounts do not differ from those that would result from an equal allocation of each item of partnership income, yet the partners' combined tax liabilities will be reduced by the allocations.

Accordingly, the allocations lack substantiality (although they may have economic effect) and will not be recognized under Section 704(b).

Given that it is less likely that there is a reason to make special allocations of the character, as opposed to the amount, of partnership or LLC income or loss items, allocations of this nature should always draw special scrutiny from practitioners (as they probably will from the IRS). The regulations provide an example where there is a non-tax reason for the allocation of a certain character of income. In that example, 90% of a partnership's foreign income was allocated to a non-resident partner.[18] Because the amount of foreign income could not be predicted with any reasonable certainty, the allocation was deemed to be substantial.

Transitory allocations

The Section 704(b) regulations also reject allocations in a taxable year that are likely to be largely offset by other allocations in a subsequent year. The criteria under this test are the same as above. That is, the economic effect of partnership allocations will be deemed insubstantial if there is a strong likelihood that

- The net changes in the investors' capital accounts would not differ substantially without the allocations; and
- The total tax liability of the investors would be less than if the allocations were disregarded.

[18] Reg, Section 1.704-1(b)(5), Ex. 10(i).

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Transitory allocations versus shifting tax consequences

The difference between the criteria under the transitory allocation rules and those under the shifting tax consequences guidelines is one of application rather than substance.

The provisions of the transitory allocations test are applied over a five-year period. In contrast, an allocation will be denied under the shifting tax consequences rules only if it violates the above criteria within a single year.

Example 1-7

E and F form the EF Company, a limited liability company, with equal cash contributions of $10,000. The LLC, which opts to be taxed as a partnership, then uses the money to purchase depreciable five-year equipment.

The LLC elects to depreciate the equipment using the straight-line method. E, who has a sizable net operating loss carryforward that is about to expire, agrees to allocate depreciation expense on the equipment entirely to F for the first two years of such equipment's useful life.

In the 3rd year, E and F will share the depreciation equally, and in years 4 and 5, depreciation will be allocated entirely to E.

If the partnership agreement contains the necessary provisions, the allocations will have economic effect.

However, the economic effect will not be substantial, because the net increases and decreases to the partners' capital accounts over the 5 year period will be the same as they would have been in the absence of the special allocations, and the partners' total tax liability will be reduced by virtue of E's opportunity to use a portion of the expiring NOL carryforward.

Tax Planning Point: An allocation will be disregarded under the transitory allocations rules only if there is a strong likelihood that it will be offset by another allocation within five years.[19] Furthermore, in applying these rules, it is assumed that the fair market value of partnership property is equal to its Section 704(b) book value.[20] Adjustments to book value are presumed to be matched by corresponding changes in fair market value. As a result, there cannot be a strong likelihood that the economic effect of an allocation will be largely offset by a subsequent allocation of gain or loss from the disposition of partnership or LLC property.

[19] Regulation Section 1.704-1(b)(2)(c)(2).

[20] Id.

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Example 1-8

A and B form the AB partnership for purposes of drilling an oil well. A contributes the leasehold on which the well is to be drilled, and B agrees to drill the well.

The partnership agreement provides that all leasehold depletion will be allocated to A and all intangible drilling costs will be allocated to B. Assume that these allocations will have economic effect.

The partnership agreement also provides that any gain or loss from the subsequent disposition of the property will be allocated in such a way as to balance the partners' capital accounts to the extent possible.

Thus, in the event there is sufficient gain or loss from the disposition of the property to make it possible, the partners will share liquidation proceeds equally. If there is insufficient gain or loss, the partners will share liquidation proceeds in accordance with their capital account balances after allocating gain or loss from disposition in such a way as to bring the capital accounts as close as possible to one another.

The partners fully expect to realize a sizable gain from disposition of the property within two years. However, because the regulations presume that there will be no gain or loss upon disposition of the property, there is not a strong likelihood that the current year allocations of depletion and/or IDC will be largely offset by future allocations of gain or loss.

Accordingly, the economic effect of the current allocations will be substantial.

Knowledge check

3. G and S form a partnership to drill for oil and gas. G contributes a leasehold with a tax basis and fair market value of $250,000. S contributes $250,000 cash to cover the costs of drilling the well. The partnership agreement allocates 100% of the costs of drilling to S. After spending $150,000 on drilling the well, the partners realize that the well is going to be a dry hole. The partners decide to sell the leasehold and liquidate. To that end, they sell the leasehold for $200,000. The partnership agreement provides for balancing allocations of any gain or loss on sale of the leasehold, meaning that the partnership will make liquidating distributions to the partners as close to 50:50 as possible. What is the largest portion of the remaining $300,000 in partnership assets that can be distributed to S if the partnership agreement complies with the requirements of Section 704(b)?

   a. Zero.
   b. $50,000.
   c. $150,000.
   d. $100,000.

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Overall tax effects test

The final test which must be met before the economic effect of an allocation will be deemed substantial is much broader than those previously discussed. In an attempt to catch questionable allocations which avoid the limitations of the more specific provisions against transitory allocations and allocations which merely shift the tax consequences of partnership or LLC operations among the investors, the regulations provide an overall tax effects test.

Under this test, the economic effect of an allocation will not be substantial if

- the allocation may, in present value terms, enhance the after-tax economic consequences of at least one partner or LLC member; and
- there is a strong likelihood that no partner or LLC member will suffer substantially diminished after-tax economic consequences, again in present value terms.[21]

Essentially, these provisions provide that allocations that leave some partners or members better off after taxes, while leaving no partners or members worse off after taxes, will not be recognized. As with all the substantiality tests, in applying these rules, the interaction between entity allocations and the investors' individual tax attributes outside the entity will be taken into account.

Knowledge check

4. Yellowhouse Partners is a general partnership with two equal partners, A and B. In the current year, the partnership has operating income of $18,000 and a net capital loss of ($15,000). A has a large capital gain outside the partnership, whereas B does not, and therefore would be able to deduct only $3,000 of her share of the capital loss. Accordingly, the partners agree to amend the partnership agreement so that ($12,000) of the capital loss (80%) is allocated to A. She will be allocated 50% of the partnership's net operating income. The partners agree that future capital gain, if any, will be disproportionately allocated to B to rebalance the two partners' capital accounts. Will this allocation have substantial economic effect?

    a. No. The allocation will enhance the after-tax economic consequences to partner A and will not substantially diminish the after-tax economic consequences to partner B.
    b. Yes. The allocation reduces A's economic interest in the partnership by $4,500 ($12,000 reduction for the capital loss allocation, versus $7,500 reduction if the capital loss were allocated 50/50). It increases B's economic interest by the same amount.
    c. No. The agreement to use future capital gains to rebalance the partners' capital accounts violates the requirements of the transitory allocations test.
    d. Yes. Although the allocation reduces A's tax liability outside the partnership, it increases B's tax liability, so the requirements of the overall tax effects test are not violated.

[21] Regulation Section 1.704-1(b)(2)(iii)(a).

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Denied allocations: Determining the partners' or LLC members' interests in the entity

In general

Where allocations are determined not to have substantial economic effect, the affected items must be reallocated in accordance with the partners' or LLC members' interests in the entity. Although not clearly defined, any determination of the investors' interests in the entity should reflect the manner in which the investors have agreed to share the economic benefit or burden of a particular item of income or loss. Where this economic arrangement is not clear, the regulations establish a rebuttable presumption that all investors have an equal interest in each item of entity income or loss.

The determination of the investors' interests in the entity is made on an item-by-item basis. The regulations identify the following four factors which will be considered in the analysis:[22]

1. The investors' relative contributions to the partnership or LLC.
2. The investors' interests in the entity's economic profits and losses.
3. The investors' interests in entity cash flows and other nonliquidating distributions.
4. The investors' liquidation rights.

No deficit restoration requirement

A special rule applies where the reallocation results from the entity's failure to include an unlimited deficit restoration requirement in its agreement. In this situation, if the other two rules of the economic effect test are satisfied, and the substantiality provisions are not violated, the investors' interests will be determined by comparing the manner in which contributions or distributions would be made if all properties of the partnership or LLC were sold at book value and the partnership or LLC were liquidated at the end of the current year to the manner in which such contributions or distributions would have been made upon a similar liquidation at the end of the prior year.[23]

[22] Regulation Section 1.704-1(b)(3)(ii).
[23] Regulation Section 1.704-1(b)(3)(iii).

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Example 1-9

Q and R form a limited partnership for the purpose of purchasing residential real property to lease. Q, the limited partner, contributes $9,000, and R, the general partner, contributes $1,000.

The partnership purchases a building for $100,000, incurring a recourse mortgage of $90,000. The partners agree to share all items 90% to Q and 10% to R. Though Q is not required to restore deficits in her capital account, the requirements of the alternate economic effect test are met.

In its first year of operations, the partnership reports a net loss of $(8,000), comprised of depreciation expense of $12,000 and other income of $4,000. The allocation of this loss 90% to Q and 10% to R has substantial economic effect because it does not create a deficit in Q's capital account.

In the second year, the partnership again reports an $(8,000) loss, comprised of the same items. Allocation of this loss 90% to Q and 10% to R results in the following capital balances:

	Q	R
Beginning balances	$ 9,000	$ 1,000
Year 1 loss	(7,200)	(800)
[$12,000 x .90] + [.90 x 4000]		
Year 2 loss	(7,200)	(800)
Ending balances	$ (5,400)	$ (600)

Thus, $(5,400) of the year 2 loss allocation does not have economic effect because it reduces Q's capital account below zero.

If the partnership had sold its assets for book value and liquidated at the end of year 1, the $88,000 proceeds from the sale, when added to the $4,000 income retained by the partnership, would enable the partnership to pay off its $90,000 mortgage, leaving $2,000 to be divided among the partners.

Of this $2,000, Q would be entitled to $1,800 ($9,000 beginning capital balance, less $7,200 loss allocation) and R would receive $200. Liquidation at the end of the second year will net the partnership only $76,000 from the sale of its assets to add to its $8,000 in retained earnings.

All $84,000 will be paid to the creditor, leaving the partnership still $6,000 in debt. Because Q is a limited partner, this $6,000 will have to be contributed by R. Comparing these outcomes over the two years in question reveals that R bore $(6,200) of the year 2 loss (loss of his $200 right to receive a distribution in year 1 plus $6,000 required contribution in year 2). Q bore only $(1,800) of the loss (Q would have been entitled to $1,800 at the end of year 1, but gets nothing at the end of year 2). Thus, in addition to the $(800) originally allocated to R in year 2, $(5,400) of the year 2 loss will be reallocated to R from Q.

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Knowledge check

5. LG is a limited partnership with one general partner (G), and a group of limited partners (L). The partnership agreement allocates profits and losses 20% to G and 80% to L. Because the limited partners cannot be compelled to make additional contributions to capital, the partnership agreement contains a qualified income offset. At the beginning of the year, the partners' capital balances were as follows:

Capital, G	$ 10,000
Capital, L	$ 50,000

The partnership lost $100,000 this year. No portion of the loss was attributable to nonrecourse deductions. How much of this loss will be allocable to the general partner G?

a. $10,000.
b. $20,000.
c. $50,000.
d. $100,000.

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Other issues

Distributions of partnership property

As previously noted, Section 704(b) requires that investors' capital accounts be reduced by the fair market value of property distributed to them. Where book value differs from fair market value, this requires that a gain or loss be recorded.[24] Such gain or loss must be recorded in the investors' capital accounts in the ratios in which they would share it if the partnership had sold the property in a taxable transaction.

Tax Planning Point: Many partnerships may desire to specially allocate the deemed gain or loss associated with a partnership distribution in order to avoid the creation or expansion of a deficit balance in the retiring partner's capital account. Alternatively, the partnership or LLC could opt to revalue all its property in order to alleviate this problem.

Example 1-10

A, a 1/3 member in the ABC limited liability company, receives a distribution of property with a Section 704(b) book value of $50,000 and a fair market value of $75,000 in liquidation of his interest.

A's Section 704(b) capital account prior to the distribution is $60,000. Because the distribution must be recorded in the partnership's Section 704(b) records at $75,000, the LLC must first record a gain of $25,000.

This gain would presumably be shared equally by the 3 investors, increasing the balance in each of their capital accounts by $8,333. In this case, however, an $8,333 increase in A's capital account would still leave her with a deficit of $(6,667) after the distribution, which she would be required to restore. If $75,000 is the true value of A's partnership interest, restoration of any deficit would not be consistent with the purpose of the distribution. Thus, the LLC agreement should be amended to provide that $15,000 of the Section 704 (b) book gain from the distribution be allocated to A, with the remaining $10,000 allocated between B and C. This will prevent the distribution from creating a deficit in A's capital account.

Section 734(B) adjustments

The distribution of property by a partnership or LLC to a partner or member may allow the entity to adjust the basis of its remaining property under Section 734(b). Where the distribution is in complete liquidation of an investor's interest, these basis adjustments are required to be reflected in the distributee investor's

[24] Regulation Section 1.704-1(b)(2)(iv).

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capital account,[25] subject to two restrictions. First, the adjustment can be made to the distributee investor's capital account only to the extent the corresponding basis adjustment can be made to one or more items of partnership property under Section 755.Second, adjustments must result in an increase or decrease in the amount at which the applicable property is carried on the entity's books.

Example 1-11

Q, R and S form a general equal partnership, to which each contributes $30,000.

The partnership makes an Internal Revenue Code (IRC) Code Section 754 election. The partnership uses $50,000 of its funds to buy stock of X Corp. After several years the X stock and cash are still the only partnership assets, and the value of the X stock is $80,000.

The partnership then liquidates Q's interest in exchange for $40,000 cash. Assuming Q's basis and capital account are still $30,000, the distribution will cause Q to recognize gain of $10,000. The partnership must increase its basis in the X stock by $10,000 (the amount of gain Q recognizes). Q's capital account must be increased by the $10,000 gain, and must then be reduced by the amount of the distribution, $40,000.

The result is that Q's capital account after the liquidating distribution will be zero. R's and S's capital accounts are not adjusted.

Where a Section 734(b) adjustment arises from a distribution other than in liquidation of a partner's interest, the resulting capital account adjustments are to be reflected in the capital accounts of all the investors, subject to the same restrictions as above. The adjustment is allocated among the investors in the manner in which the unrealized income or loss inherent in the distributed property would have been allocated had the property been sold.

At first glance, the provisions governing the treatment of Section 734(b) adjustments under Section 704(b) may appear to conflict with the general rule of Section 734(b), which says that these special basis adjustments apply to the common basis of all partnership or LLC property to the benefit or detriment of all partners or members therein. It must be noted, however, that the Section 704(b) provisions apply only to the mechanical adjustment of investor capital accounts.

Allocation of the adjustment entirely to the liquidating investor's account is necessary to balance his or her capital account. The adjustment to partnership or LLC basis is still made under the general principle of Section 734(b) to the common basis of partnership or LLC property and thus to the benefit or detriment of all remaining investors.

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[25] Regulation Section 1.704-1(b)(2)(iv)(m)(4).

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Example 1-12

Q, R, and S form a general partnership, to which each contributes $30,000. The partnership makes an IRC Code Section 754 election. The partnership uses $50,000 of its funds to buy stock of X Corp.

After several years the X stock and cash are still the only partnership assets, and the value of the X stock is $80,000. The partnership then distributes $40,000 in cash to Q in a nonliquidating distribution.

Assuming Q's basis and capital account are still $30,000, the distribution will cause Q to recognize gain of $10,000. The partnership must increase its basis in the X stock by $10,000 (the amount of gain Q recognizes).

Each partner's capital account must be increased by their share of the $10,000 gain, and Q's capital account must then be reduced by the amount of the distribution, $40,000.

The result is that Q's capital account after the nonliquidating distribution will be $30,000 + $3,333 – $40,000+$6,667 = 0. Q's capital account will be brought to zero because he recognized $10,000 of gain ($3,333 +$6,667). Otherwise Q's capital account would be – $6,667.

A partners' capital account cannot be negative if it is caused by a cash distribution.

Transfers of partnership interests

The general rule of Section 704(b) requires that upon the transfer of all or a part of an investor's interest in a partnership or LLC, the capital account of the transferor carries over to the transferee.[26] Adjustments to the tax basis of partnership or LLC property under Section 743(b) are not reflected in the Section 704(b) book capital account of the transferee or any other investor.[27] This rule also applies where the entity does not have a Section 754 election in effect and an investor is allowed a special basis adjustment under Section 732(d). If the transfer causes a partnership or LLC termination under Section 708, capital accounts will carry over to the new partnership that is formed as a result of the technical termination.[28]

Please see chapter 6 for a more detailed discussion of IRC Sections 734(b) and 743(b).

[26] Regulation Section 1.704-1(b)(2)(iv)(m)(1).
[27] Regulation Section 1.704-1(b)(2)(iv)(m)(2).
[28] Regulation Section 1.704-1(b)(2)(iv)(1).

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Optional revaluation of partnership property

The regulations allow a partnership or LLC to revalue all its property to fair market value, and to make the related necessary adjustments to the partners' or members' capital accounts, in the following four situations:[29]

1. In connection with a contribution of property, including money, to the entity in exchange for an interest therein.
2. In connection with a distribution of property, including money, by the entity in liquidation of all or part of an investor's interest therein.
3. In connection with the grant of an interest in the partnership (after May 5, 2004) in consideration for the provision of services, by either an existing partner or a new partner.
4. In connection with the issuance by the partnership of a noncompensatory option (other than an option for a *de minimis* partnership interest).
5. Under generally accepted industry accounting practices, provided substantially all of the entity's property, excluding money, consists of tradable securities.

Tax Planning Point: Although they may increase accounting costs, asset revaluations will generally be advisable for many partnerships and LLCs. Especially when an investor's interest in an ongoing entity is liquidated, a revaluation may be the best way to avoid the creation of an artificial deficit in the retiring investor's capital account.

The adjustment of the investors' capital accounts in the event of a revaluation must reflect the manner in which the unrealized income, gain, loss, or deduction inherent in partnership or LLC property would be allocated among the investors if there were a taxable disposition of all the entity's property at fair market value at the date of the revaluation. Subsequent computations of book depreciation must be made at the same rate as before the revaluation.

Proposed Regulations: Under Proposed Regulations[30], a revaluation of partnership property is required for a partnership that distributes money or property (other than a *de minimis* amount) to a partner as consideration for an interest in the partnership, and that owns section 751 property immediately after the distribution. In addition, if the partnership (upper-tier partnership) owns another partnership directly or indirectly through one or more partnerships (lower-tier partnership), and the same persons own, directly or indirectly (through one or more entities), more than 50% of the capital and profits interests in both the upper-tier partnership and the lower-tier partnership, the lower-tier partnership must also revalue its assets immediately prior to the distribution if the lower-tier partnership owns section 751 property. If the same persons do not own, directly or indirectly, more than 50% of the capital and profits interests in both the upper-tier partnership and the lower-tier partnership, the upper-tier partnership must allocate its distributive share of the lower-tier partnership's items among its partners in a manner that reflects the allocations that would have been made had the lower-tier partnership revalued its property.

[29] Regulation Section 1.704-1(b)(2)(iv)(f).
[30] Proposed Regulation Section 1.751-1(b)(2)(iv).

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Partnership agreement: Adjustment of capital accounts

Following is the provision used by one partnership to assure that capital accounts were properly adjusted:

> Notwithstanding any provision of this Agreement…the General Partner shall revalue Partnership properties, and make corresponding adjustments to the Partners' Capital Accounts, as prescribed by Section 1.704-1(b)(2)(iv)(f) of the Treasury Regulations in connection with any contribution to or distribution by the Partnership of more than a de minimis amount of money or other property in exchange for an interest in the Partnership unless the General Partner reasonably determines that such revaluations and adjustments are not necessary to reflect the economic interests of the Partners in the Partnership. In addition, the book values of Partnership properties shall be increased or decreased, as the case may be, to reflect any adjustments to the adjusted tax bases of such properties pursuant to Section 734(b) or Section 743(b) of the Code to the extent that such basis adjustments are taken into account in determining Capital Account balances pursuant to Treasury Regulations Section 1.704-1(b)(2)(iv)(m) and have not been reflected in adjustments to the book values of such properties…

Note that the above provision addresses the adjustment of capital accounts when contributions or distributions are made to or from the partnership.

Determining fair market value

Partnerships and LLCs are given much flexibility in determining the fair market values of their property. The regulations provide that the values assigned to property by a partnership or LLC will generally be presumed accurate as long as such values are reasonably agreed upon by the investors in arm's-length negotiations, and the investors have adverse interests.[31] The penalty for abuse of these provisions is severe, however. Where the IRS determines that partnership or LLC property has been significantly under- or over-valued, the capital account maintenance requirements of Section 704(b) will be considered not to have been met, and all items of partnership or LLC income, gain, loss, and deduction will be subject to reallocation.[32]

[31] Regulation Section 1.704-1(b)(2)(iv)(h).
[32] Id.

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Allocation of deductions attributable to nonrecourse debt

Overview

Nonrecourse debt creates special problems under Section 704(b). For a partnership or LLC loss allocation to have economic effect, those partners or members sharing in the allocation must bear the economic burden of that loss. Generally, this requires that the allocation either reduce the amount to which the recipient investors are entitled at liquidation, or increase the amount they are obligated to contribute in the event of a partnership or LLC liquidation. If the loss being allocated is supported by nonrecourse debt (for example, depreciation), neither of these conditions will be satisfied.

For example, if tax depreciation on a building purchased with nonrecourse debt is matched by actual economic depreciation (as is presumed under Section 704(b)), depreciation in excess of the partners' or members' original contributions (plus any undistributed partnership or LLC income) will not be borne by the partners or LLC members. Because they are not personally liable on a nonrecourse note, only the creditor(s) can bear the economic burden of the depreciation. Thus, the depreciation allocations would not have economic effect under the general provisions of Section 704(b).

Because the outstanding balance of a nonrecourse note is treated as part of the amount realized upon the disposition of the encumbered property (even in foreclosure), however, nonrecourse deductions will affect the tax consequences to the investors if the partnership or LLC disposes of all its assets and liquidates. Because nonrecourse deductions (those deductions supported by nonrecourse debt) will reduce the entity's basis in the encumbered property, they increase the tax gain to be recognized upon disposition of such property. Thus, nonrecourse deductions will increase the eventual tax liability of the partners or members upon liquidation of the entity, and, as a result may be considered to have economic effect if certain requirements are met.

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Knowledge check

6. QL and RR form a limited partnership. QL, the general partner, contributes $50,000. RR, the limited partner, contributes $200,000. The partnership obtains a $750,000 nonrecourse note and purchases depreciable machinery for $1,000,000. The partnership agreement provides that depreciation, computed on a straight-line basis over five years, will be allocated entirely to RR. Everything else will be allocated 80% to RR and 20% to QL. The partnership agreement meets the requirements of the alternate test for economic effect and does contain a minimum gain chargeback provision. If the partnership breaks even before depreciation, what portion of the first year's depreciation allocation will be reallocated to QL under Section 704(b)? (Assume that year 1 depreciation expense equals $200,000.)

   a. Zero.
   b. $40,000.
   c. $100,000.
   d. $160,000.

Nonrecourse deduction defined

A nonrecourse deduction is defined as one that reduces the entity's net assets (on the Section 704(b) balance sheet) to a level below the outstanding principal of its nonrecourse liabilities.[33] Thus, for a nonrecourse deduction to exist, there must be no remaining partner or member capital, or recourse debt, to absorb the partnership loss. At that point, only the nonrecourse creditors will bear economic risk for the loss.

Where a partnership or LLC loss is composed of more than one item, the nonrecourse deduction is composed only of those items specifically attributable to the property encumbered by the nonrecourse debt (typically depreciation expense). Where some partnership or LLC capital exists to support a part of the deduction, but not all of it, only the excess of the deduction over such remaining capital is a nonrecourse deduction.

[33] Regulation Section 1.704-2(i)(2).

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Example 1-13

A and B form AB, a limited liability company, with contributions of $20,000 each. AB obtained a $110,000 nonrecourse loan and purchased real estate for $150,000. In its first eight years of operations, the LLC had total gross income of $160,000, which was exactly offset by interest and other operating expenses of $160,000. In addition, AB reported total depreciation expense over the eight years of $40,000. The LLC had no nonrecourse deductions in years one through eight. The remaining basis of its real estate was $110,000. It owned no other assets.

Over the next eight years, the LLC's expenses before depreciation again exactly offset its operating income. It again reported depreciation expense of $40,000, giving it a net loss of $(40,000). At the end of this eight-year period, AB's basis in its realty was only $70,000. Assume that it still had no other assets. If the outstanding principal balance of its nonrecourse note were still $110,000, the LLC's nonrecourse deductions would total $40,000. This nonrecourse deduction would be comprised entirely of depreciation expense on the real estate.

General requirements for economic effect

The regulations under Section 704(b) establish the following four conditions which must be satisfied for an allocation of nonrecourse deductions to have economic effect:[34]

1. The first two requirements of the general test for economic effect (capital account maintenance and distribution of liquidation proceeds) must be satisfied.
2. The allocation of nonrecourse deductions must be reasonably consistent with allocations of some other significant partnership or LLC item(s) attributable to the encumbered property and those other allocations must have substantial economic effect.
3. The partnership or LLC agreement must either require that partners or members are obligated to restore deficit balances in their capital accounts, without limitation, or contain a minimum gain chargeback.
4. All other material entity allocations and capital account adjustments must be recognized under the regulations.

Consistency with other significant items

Essentially, the regulations treat the allocation of a nonrecourse deduction as meaningful if it follows other allocations that have substantial economic effect and the partnership or LLC agreement provides protection against the creation of deficits in partner or member capital accounts. The regulations are quite flexible with regard to the determination of whether an allocation is reasonably consistent with the allocation of other items attributable to the property encumbered by the nonrecourse debt. For example,

[34] Regulation Section 1.704-2(e).

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where partnership or LLC income and losses are allocated 90% to one partner or member and 10% to another until such time as aggregate income equals prior losses, and allocated equally thereafter, the regulations treat any allocation of nonrecourse deductions between 90:10 and 50:50 as reasonably consistent with significant other allocations.[35] The primary question under the regulations is what constitutes a significant other item attributable to the property securing the nonrecourse liability. It seems that depreciation supported by partner or member capital contributions (plus undistributed income) should qualify as a significant other item.

Minimum gain chargeback

Partnership or LLC minimum gain is that minimum amount of gain that will result from the disposition of the property securing the nonrecourse debt. Because the forgiveness (by the lender) or assumption (by the buyer) of nonrecourse liabilities is considered an amount realized from the sale of the encumbered property, in no case can the partnership or LLC recognize less gain than the difference between the property's basis and the remaining principal balance of the nonrecourse note upon disposition or abandonment of the property. Thus, minimum gain is computed as the difference between the basis under Section 704(b) of the securing property and the remaining balance of the nonrecourse note.

Each investor's share of partnership or LLC minimum gain is the sum of the nonrecourse deductions previously allocated to such investor (or his or her predecessor in interest), reduced by his or her share of previous decreases in minimum gain.[36] Such minimum gain is added to the investor's deficit restoration obligation to determine the maximum deficit that can be allowed to accumulate in such investor's capital account. Thus, minimum gain increases the amount of losses that can be allocated to a partner or LLC member without creating an improper deficit.

The minimum gain chargeback provision then plays the same role as the qualified income offset provision in the alternate test for economic effect. The minimum gain chargeback provisions are triggered in certain circumstances where there is a decrease in partnership or LLC minimum gain (for example, as when the entity repays a portion of the loan). Minimum gain chargeback is only required in specific situations where minimum gain decreases. Where a partner or member's capital account unexpectedly falls below the permissible deficit, as a result of a decrease in entity minimum gain,[37] the minimum gain chargeback provision requires that such partner or member must be allocated sufficient income (including gross income) to eliminate the excess deficit in his or her capital account.

[35] Regulation Section 1.704-2(f)(7), Example 1.
[36] Regulation Section 1.704-2(g)(1).
[37] Decreases in minimum gain generally result from principal payments on a nonrecourse note.

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Partnership agreement: Allocation of nonrecourse deductions

The allocation of nonrecourse deductions is provided for by this representative section of a partnership agreement:

> If the Partnership incurs any borrowings, the Partnership (i) shall allocate any non-recourse deductions, computed and determined in accordance with Sections 1.704-2(b)(1), 1.704-2(c) and 1.704-2(j) of the Treasury Regulations, it may have twenty percent (20 percent) to the General Partner and eighty percent (80 percent) to the Partners in proportion to their Percentages of Contributed Capital, (ii) shall allocate any partner non-recourse deductions, computed and determined in accordance with Sections 1.704-2(i)(1), 1.704-2(i)(2) and 1.704-2(j) of the Treasury Regulations, it may have so as to comply with Section 1.704-2(i) of the Treasury Regulations and (iii) shall make such allocations as are necessary to comply with the minimum gain chargeback provisions of Sections 1.704-2(f), 1.704-2(i) and 1.704-2(j) of the Treasury Regulations, taking into account all exceptions provided by such provisions to the applicability of this clause.

As before, the authors make no representations as to the legality of this provision, but it might provide a basis from which similar nonrecourse deduction provisions in other partnership agreements can be identified.

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Summary

The Section 704(b) regulations are based on a simple premise. Tax allocations will only be recognized if they mirror the allocations of the economic benefits and detriments of partnership or LLC activities. The economic effects of partnership or LLC activities are best measured over time by reference to the cash flows ultimately attributable to the partners or LLC members. Thus, for a tax allocation to stand, it must ultimately affect the cash receipts to be received by the investor from the entity. It must be properly accounted for in a set of capital accounts that will ultimately be used to determine the distribution of partnership or LLC net assets upon liquidation.

Where deductions are supported by nonrecourse debt, so that only creditor cash flows can be affected, this premise is altered somewhat. Nonrecourse deductions must be allocated in accordance with the manner in which investors will ultimately share the tax gains, and thus the tax liabilities, arising from those nonrecourse deductions. The tax benefits of nonrecourse deductions, rather than following the allocation of associated economic burdens, must be allocated in such a way as to follow the tax burdens that will someday arise from the basis reductions associated with the nonrecourse deductions. Again, these burdens are best reflected in partner or member capital accounts.

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