IRC Sect. 704(b): Partnership Allocations
Navigating Complex Rules to Determine Valid Allocation of Income, Gain, Loss, Deductions or Credits

WEDNESDAY, OCTOBER 8, 2014, 1:00-2:50 pm Eastern

IMPORTANT INFORMATION

This program is approved for 2 CPE credit hours. To earn credit you must:

• **Participate in the program on your own computer connection and phone line (no sharing)** - if you need to register additional people, please call customer service at 1-800-926-7926 x10 (or 404-881-1141 x10). Strafford accepts American Express, Visa, MasterCard, Discover.

• **Respond to verification codes presented throughout the seminar.** If you have not printed out the “Official Record of Attendance”, please print it now. (see “Handouts” tab in “Conference Materials” box on left-hand side of your computer screen). To earn Continuing Education credits, you must write down the verification codes in the corresponding spaces found on the Official Record of Attendance form.

• Complete and submit the “Official Record of Attendance for Continuing Education Credits,” which is available on the program page along with the presentation materials. Instructions on how to return it are included on the form.

• To earn full credit, you must remain on the line for the entire program.

WHOM TO CONTACT

For Additional Registrations:
- Call Strafford Customer Service 1-800-926-7926 x10 (or 404-881-1141 x10)

For Assistance During the Program:
- On the web, use the chat box at the bottom left of the screen
- On the phone, press “0” (“star” zero)

If you get disconnected during the program, you can simply call or log in using your original instructions and PIN.
Tips for Optimal Quality

**Sound Quality**
If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-866-320-7825** and enter your PIN when prompted. Otherwise, please [send us a chat](#) or e-mail [sound@straffordpub.com](mailto:sound@straffordpub.com) immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

**Viewing Quality**
To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.
Program Materials

If you have not printed the conference materials for this program, please complete the following steps:

• Click on the ^ symbol next to “Conference Materials” in the middle of the left-hand column on your screen.

• Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides and the Official Record of Attendance for today’s program.

• Double-click on the PDF and a separate page will open.

• Print the slides by clicking on the printer icon.
IRC Sect. 704(b):
Partnership Allocations

Oct. 8, 2014

David Forst
Fenwick & West
dforst@fenwick.com

Amanda Wilson
Lowndes Drosdick Doster Kantor & Reed
amanda.wilson@lowndes-law.com
Notice

ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY THE SPEAKERS’ FIRMS TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.

You (and your employees, representatives, or agents) may disclose to any and all persons, without limitation, the tax treatment or tax structure, or both, of any transaction described in the associated materials we provide to you, including, but not limited to, any tax opinions, memoranda, or other tax analyses contained in those materials.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.
Today’s Program

Review of Partnership Allocation Rules  
[Amanda Wilson]  

Partnership Non-Recourse Debt Allocations  
[David L. Forst]  

Two Approaches to Capital Account Maintenance  
[David L. Forst]
REVIEW OF PARTNERSHIP ALLOCATION RULES
Circular 230

To comply with Treasury Department regulations, we inform you that, unless otherwise expressly indicated, any tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties that may be imposed under the Internal Revenue Code or any other applicable tax law, or (ii) promoting, marketing or recommending to another party any transaction, arrangement, or other matter.
Allocations – Section 704(a)

One of the key benefits of a partnership is the flexibility in allocating partnership items among the partners.

Section 704(a) provides that a partner’s distributive share of partnership income, gain, loss, deductions or credit shall, except as otherwise required by the IRC, be determined by the partnership agreement.
Allocations – Section 704(b)

Section 704(b) requires a partner’s distributive share of partnership income, gain, loss, deductions or credit to be determined in accordance with the partner’s interest in the partnership if

(1) Partnership agreement does not provide for distributive share or

(1) Partnership agreement allocations do not have substantial economic effect.
Allocations

Thus, allocations of a partner’s distributive share of partnership income, gain, loss, deductions or credit will be respected if they

(1) are either in accordance with the partners’ interests in the partnership or

(2) if they have substantial economic effect.
Partners’ Interest in the Partnership

Factors to consider:

• The partners' relative contributions to the partnership,

• The interests of the partners in economic profits and losses (if different than that in taxable income or loss),

• The interests of the partners in cash flow and other non-liquidating distributions, and

• The rights of the partners to distributions of capital upon liquidation.
Partners’ Interest in the Partnership

Allocations are generally in accordance with the partners’ interests in the partnership if all allocations are being made in accordance with the respective contributions of the partners.

For example, if A and B each contributed $100, allocations would be in accordance with the partners’ interests in the partnership if all partnership items are shared 50-50.

Liquidating distributions can be made in accordance with the partners’ respective interests in the partnership.
Substantial Economic Effect

AB is a partnership that owns 3 properties. All income allocated 50% to A, except 60% of income from property 1 is allocated to A. This is a special allocation.

Special allocations will be respected if they have substantial economic effect. Substantial economic effect is a safe harbor.

Two part analysis. Allocations must

(1) Have economic effect; and

(2) The economic effect must be substantial.
Economic Effect

General principle: If there is an economic benefit or burden that corresponds to an allocation, the partner to whom the allocation is made must receive the economic benefit or burden.

More simply, if a partner gets the benefit of an allocation of $100 of tax loss, the partner must suffer the $100 economic loss. If a partner suffers the burden of $100 of tax gain, the partner must get the $100 of cash.

This is accomplished by maintaining capital accounts and liquidating in accordance with those accounts.
Basic Test for Economic Effect

There are three requirements to satisfy the basic economic effect test:

1. Capital account requirement
2. Liquidation requirement
3. Deficit make up requirement
Capital Account Requirement

To have economic effect, the partnership must maintain its capital accounts in accordance with the rules of Reg. §1.704-1(b)(2)(iv).

Generally, this is accomplished with a provision in the partnership agreement stating that “a capital account will be established and maintained for each partner in accordance with Treasury Regulation §1.704-1(b)(2)(iv).”

What does this do? A partner’s capital account tracks and reflects the partner’s equity investment in the partnership.
Capital Account Maintenance Rules

A partner’s capital account equals

- FMV of contributions
- Plus allocable share of partnership income
- Less FMV of distributions
- Less allocable share of partnership loss

Partnership liabilities generally are not taken into account in calculating capital account balances.
Liquidation Requirement

For economic effect, liquidating distributions to the partners must be made based on positive capital accounts. In other words, no waterfall distributions.

If allocations have gone awry, positive capital account balances will not be the same amount as what would be received under the waterfall distributions. Consider including a savings clause in the partnership agreement to avoid/minimize this risk.
Deficit Make Up Requirement

If a partner has a deficit in his capital account upon liquidation of the partnership, the partner must have an unconditional obligation to restore the deficit. This deficit restoration obligation (“DRO”) may be provided for in the partnership agreement or by state law.

A DRO may come from a partner contributing a promissory note to the partnership or having an obligation (whether imposed by the partnership agreement or state law) to make subsequent contributions to the partnership.

A partner can have a limited DRO.
Example

A and B contribute $100 each to AB partnership. The partnership agreement provides that 60% of partnership items are allocated to A and 40% are allocated to B. AB has a $200 loss.

<table>
<thead>
<tr>
<th>A’s CA</th>
<th>B’s CA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contribution</td>
<td>100</td>
</tr>
<tr>
<td>Income</td>
<td>(120)</td>
</tr>
<tr>
<td>(20)</td>
<td>20</td>
</tr>
</tbody>
</table>

For the entire allocation to have economic effect, A must have a DRO. Otherwise, B is bearing the economic risk for $20 of the losses.
Planning Opportunity

Treas. Reg. §1.761-1(c) provides a “partnership agreement” can be modified or amended with respect to a taxable year after the close of the taxable year, provided the amendment occurs on or before the due date for the partnership return (without extension).

This gives partners a planning opportunity to amend how they allocate income and losses after the close of the year. In particular, to provide for a limited DRO to the extent necessary to support a loss allocation.
Alternate Test for Economic Effect

(1) Capital account requirement.

(2) Liquidation requirement.

(3) Partnership agreement has a qualified income offset (“QIO”) provision. The QIO must require that any partner with an unexpected negative capital account be allocated all of the next items of partnership income so as to eliminate the negative balances as quickly as possible.

(4) The allocation does not create or increase a deficit in a partner’s capital account in excess of the partner’s obligation to restore a deficit.
Substantiality

The economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.

In short, an allocation lacks substantiability if the allocation has favorable tax consequences to one partner without corresponding detrimental tax consequences to the other partners and no overall change on the partners’ capital accounts.
Substantiality

If the only effect of an allocation is to reduce taxes without substantially affecting the partners’ pre-tax distributive shares, the economic effect is not substantial.
Substantiality

Even if the general rule is satisfied, the economic effect is not substantial in the following cases:

(1) Shifting Tax Consequences
(2) Transitory Allocations
(3) After-Tax Effect
Shifting Tax Allocations

Occurs if there is a strong likelihood that:

(1) the net increases and decreases that will be recorded in the partners’ respective capital accounts for such taxable year will not differ substantially from the net increases and decreases that would be recorded in the partners’ capital accounts if the allocations were not contained and

(2) the total tax liability of the partners will be less than if the allocations were not contained in the partnership agreement (taking into account the tax consequences that result from the interaction of the allocation with the partner’s tax attributes even if unrelated to the partnership).
Example

A and B are equal partners, but A is a tax exempt entity. AB has $100 of ordinary income and $100 of tax exempt income.

The partnership agreement allocates A the $100 of ordinary income and B the $100 of tax exempt income. The economic effect to both partners is the same, but the total tax liability for the partners is $0. Without the special allocation, the total tax liability would be $17.5 ($50 x 35%).

This allocation lacks substantiality under the shifting tax consequences rule.
Shifting Allocations

Exception: Value equals basis rule.

A partnership’s assets are irrebuttably presumed to have a value equal to their basis (or book value if different from basis).

So, even if there is appreciated or depreciated property in the partnership that could be used to make future allocations, the appreciation or depreciation is ignored.
Transitory Allocations

If a partnership agreement provides for a possibility that one or more allocation ("original allocation") will be largely offset by one or more allocation ("offsetting allocation") and there is a strong likelihood that:

(1) the net increases and decreases that will be recorded in the partners’ respective capital accounts for such taxable year will not differ substantially from the net increases and decreases that would be recorded in the partners’ capital accounts if the allocations were not contained and
Transitory Allocations

(2) the total tax liability of the partners will be less than if the allocations were not contained in the partnership agreement (taking into account the tax consequences that result from the interaction of the allocation with the partner’s tax attributes even if unrelated to the partnership.)
A and B are equal partners, but A has $100 of NOLs that are expiring in the next 2 years. AB has $50 of income each year. AB allocates all $100 of income to A in years 1 and 2, and then $100 of income to B in years 3 and 4. Thereafter, income is shared equally.

The economic result is unchanged by this special allocation, but the allocation allows A to take advantage of expiring NOLs. The total tax liability is $17.5 ($50 x 35%), instead of $52.5 ($150 x 35%).

This is a transitory allocation and lacks substantiality.
Transitory Allocations

Exceptions:

• Value equals basis rule.

• 5 year rule: If at the time of allocation, there is a strong likelihood that the original allocation will not be largely offset within 5 years, presumption that economic effect of allocation is not transitory.

• Risky ventures. Because a risky venture is speculative in nature, there is not a strong likelihood that the offsetting profits/income will ever materialize.
After-Tax Rule

An allocation does not have substantial economic effect if, at the time the allocation is added to the partnership agreement,

1. the after-tax economic consequences of at least one partner may be enhanced compared to such consequences if the allocation were not contained in the partnership agreement, and

2. there is a strong likelihood that the after-tax consequences of no partner will be substantially diminished compared to the consequences if the allocation were not in the partnership agreement.
Example

Same as prior example, but AB allocates $90 of income to A in years 1 and 2, and $110 to B in years 2 through 4.

This allocation passes the other two tests, because there is a material effect on capital accounts (A gets $10 less). But, on an after-tax basis, A’s economic position is improved, and B’s economic position is not substantially diminished (it is actually better).

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th></th>
<th>B</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tax</td>
<td>After-Tax</td>
<td>Tax</td>
<td>After-Tax</td>
</tr>
<tr>
<td>With</td>
<td>$0</td>
<td>$90</td>
<td>$38.5</td>
<td>$71.5</td>
</tr>
<tr>
<td>W/O</td>
<td>$17.5</td>
<td>$82.5</td>
<td>$35</td>
<td>$65</td>
</tr>
</tbody>
</table>

This allocation violates the after-tax rule and lacks substantiality.
After-Tax Rule

The focus of this rule is on after-tax consequences, not pre-tax capital accounts. Thus, you cannot avoid lack of substantiality by using an unequal number of years.

Exceptions:

- Value equals basis rule.
- Risky venture.
No Substantial Economic Effect

If no substantial economic effect, a reallocation will occur in accordance with the partners’ interest in the partnership. Presumption that partners share per capita (i.e., 50-50 if 2).

Factors to consider in rebutting this presumption:

- the partners’ relative contributions to the partnership;
- the interests of the partners’ in economic profits and losses (if different from taxable income and loss);
- interests in cash flow or other nonliquidating distributions; and
- rights to distribution on liquidation.
Allocations of tax credits are not generally reflected by adjustments to the partners’ capital accounts and thus they lack economic effect.

Tax credits are allocated in accordance with the partners’ interests in the partnership.
General Rule

At issue is the partners’ interests in the year the credit arises.

If the expenditure that results in a tax credit also results in allocations of partnership loss or deductions, partners’ interest in the partnership with respect to the credit is in the same proportion as the partners’ distributive shares of the loss or deduction.

More simply, the credits must be allocated in accordance with the general allocation of partnership losses or deductions, or where there are special allocations of partnership items, with the allocation of partnership items to which the credits are attributable.
Example

A and B form a partnership AB. The partnership agreement provides that all profits and losses will be allocated 75% to A and 25% to B. The partnership agreement has provisions such that the allocations have substantial economic effect. The agreement also provides that any credits will be allocated equally between A and B.

AB incurs expenses that give rise to a $1000 tax credit. Because the expense will be allocated 75% to A and 25% to B, the credit must likewise be allocated 75% to A and 25% to B. The allocation of the credit 50-50 to A and B will not be respected.
Special Rules

Special allocation rules for certain tax credits. For example:

- For Section 38 general business credit, allocations of cost or qualified investments made pursuant to Treas. Reg. 1.46-3(f) or 1.48-8(a)(4)(iv) are in accordance with partners’ interests in the partnership.

- For Section 45 wind energy production tax credits, see safe harbor set forth in Notice 2007-65.
Special allocation rules for certain tax credits. For example:

- For creditable foreign tax expenditures (CFTE), Treas. Reg. 1.704-1(b)(viii)(a)(2) provides that an allocation deemed in accordance with partners’ interest in partnership if:

  1. CFTE allocated in proportion to distributive share of income to which CFTE relates; and

  2. Allocation of all other partnership items that, in the aggregate, have a material effect on the amount of CFTEs allocated to the partners in (1) are valid (i.e., have substantial economic effect).
Recent Tax Credit Guidance

Historic Boardwalk Hall, LLC v. Commissioner (Third Circuit 2012)

• LLC created by NJ government entity to renovate convention hall. LLC generated significant rehabilitation tax credits.
• Pitney Bowes acquired a 99.9% ownership interest in the LLC.
• Received 99.9% of tax credits plus 3% preferred return on its $20 million capital investment.
• Tax Court held that the LLC was a valid partnership and Pitney Bowes a bona fide partner.
• Third Circuit determined that Pitney Bowes was not a bona fide partner as it did not have a meaningful share of risks/benefits.
Recent Tax Credit Guidance

Historic Boardwalk

- No meaningful downside as Pitney Bowes was clearly going to recoup its economic investment through the tax credits and preferred return. The Project was fully-funded and almost complete before Pitney Bowes came in and Pitney Bowes had no audit risk because of a tax benefits guaranty.

- No meaningful upside as share of 99.9% of cash flow was illusory. There was debt financing that would strip out all of the net cash flow and the project was anticipated to generate large operating deficits.
Recent Tax Credit Guidance

Chief Counsel Advice 20124002F

- Fund invested in a partnership that was generating historic tax credits. Fund put in $0.90 for each $1 of credits generated. Fund entitled to credits and a preferred return (guaranteed by other partner). Fund had no obligation other than its capital contribution.

- Fund could put its interest to other partner for amount of unpaid preferred return.

- Call option to acquire Fund’s interest at FMV.
Recent Guidance

Chief Counsel Advice 20124002F

- Fund was not a bona fide partner as it did not have any meaningful downside of risk or meaningful upside of benefit.

- Fund had guaranty of receiving preferred return and tax credits.

- Fund was entitled to cash flow and FMV on the call right, but these were found to be illusory as there was no cash flow or value after credits, management and development fees were netted out.
Section 704(c)

Section 704(c) applies where the Section 704(b) book value of partnership property differs from the tax basis in the property.

- For example, A contributes property with basis of $60 and FMV of $100.

Section 704(c) overrides the general allocation rules of Section 704(b) and provides a separate allocation mechanism for the tax items related to Section 704(c) property.
Section 704(d)

Section 704(d) provides that a partner’s distributive share of partnership loss shall only be allowed to the extend of the partner’s basis in the partnership as of the end of partnership year. Any excess loss is suspended.

Thus, if a partner is allocated losses in excess of his or her basis, the partner can only deduct the allocated losses to the extent of basis. Any excess is a suspended loss and carried forward until the partner has sufficient basis.

• For example, A is allocated $100 in losses, but has basis of $60. A can only deduct $60 currently. Remaining $40 of loss suspended.
PARTNERSHIP NON-RE COURSE DEBT ALLOCATIONS
General principles

- Allocation of tax items attributable to partnership nonrecourse liabilities (nonrecourse deductions) cannot have economic effect because the creditor alone bears the economic burden attributable to the debt.

- Therefore, nonrecourse deductions must be allocated in accordance with the partner’s interest in the partnership.

- But Treas. Reg. § 1.704-2(e) provide a safe harbor.
Safe Harbor:  
Reg. § 1.704-2(e)

- Throughout term of the partnership:
  - Capital accounts are properly maintained.
  - Partnership liquidates with positive capital accounts.
  - Either full capital account deficit restoration obligation or qualified income offset

- Through term of partnership after year of NR borrowing:
  - Partnership has minimum gain chargeback provision.
  - Partnership agreement allocates NR deductions “in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities.”

- All other material allocations and capital account adjustments are proper.
Partner NR Liabilities: Reg. § 1.704-2(i)

- Partnership losses, deductions or Sect. 705(a)(2)(B) expenditures that are attributable to a particular partner non-recourse liability ("partner nonrecourse deductions") must be allocated to the partner that bears the economic risk of loss for the liability.

- The amount of partner non-recourse deductions with respect to a partner non-recourse debt equals the net increase during the year in minimum gain attributable to the partner non-recourse debt ("partner nonrecourse debt minimum gain"), reduced (but not below zero) by proceeds of the liability distributed during the year to the partner bearing the economic risk of loss for the liability that are both attributable to the liability and allocable to an increase in the partner non-recourse debt minimum gain.
Definitions

- “Nonrecourse liability” is a non-recourse liability as defined in § 1.752-1(a)(2) (or a § 1.752-7 liability assumed by the partnership from a partner on or after June 24, 2003). Reg. § 1.704-2(b)(3)

- “Partner nonrecourse liability” means any partnership liability, to the extent the liability is non-recourse for purposes of § 1.1001-2, and a partner or related person (within the meaning of § 1.752-4(b)) bears the economic risk of loss under § 1.752-2 because, for example, the partner or related person is the creditor or a guarantor. Reg. § 1.704-2(b)(4)
Distinction between Recourse and Non Recourse Debt

- Recourse debt is a partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss (EROL) for that liability under Treas. Reg. § 1.752-2. Treas. Reg. § 1.752-1(a)(1)

- Non-recourse debt is a partnership liability that is a non-recourse liability to the extent that no partner or related person bears the EROL for that liability under Treas. Reg. § 1.752-2. Treas. Reg. § 1.752-1(a)(2)
Partnership Minimum Gain—Reg. § 1.704-2(d)(1)

- The amount of partnership minimum gain is determined by first computing for each partnership non-recourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains.

- For any partnership taxable year, the net increase or decrease in partnership minimum gain is determined by comparing the partnership minimum gain on the last day of the immediately preceding taxable year with the partnership minimum gain on the last day of the current taxable year.
A Partner’s Share Of Minimum Gain: Reg. § 1.704-2(g)

- The sum of—
  - Non-recourse deductions allocated to that partner (and to that partner’s predecessors in interest) up to that time; and
  - The distributions made to that partner (and to that partner’s predecessors in interest) up to that time of proceeds of a non-recourse liability allocable to an increase in partnership minimum gain.

- Minus the sum of—
  - that partner’s (and that partner's predecessors in interest) aggregate share of the net decreases in partnership minimum gain; and
  - Their aggregate share of decreases resulting from revaluations of partnership property subject to one or more partnership non-recourse liabilities.
A Partner’ Share of Decrease In Minimum Gain: Reg. § 1.704-2(g)(2)

- The amount of the total net decrease multiplied by the partner’s percentage share of the partnership’s minimum gain at the end of the immediately preceding taxable year.

- A partner’s share of any decrease in partnership minimum gain resulting from a revaluation of partnership property equals the increase in the partner’s capital account attributable to the revaluation, to the extent the reduction in minimum gain is caused by the revaluation.
Distributions Of NR Debt Proceeds: Reg. § 1.704-2(h)

If, during its taxable year, a partnership makes a distribution to the partners allocable to the proceeds of a non-recourse liability, then the distribution is allocable to an increase in partnership minimum gain to the extent the increase results from encumbering partnership property with aggregate non-recourse liabilities that exceed the property’s adjusted tax basis.
If, during a partnership taxable year, there is a net decrease in partner non-recourse debt minimum gain, then any partner with a share of that partner non-recourse debt minimum gain as of the beginning of the year must be allocated items of income and gain for the year (and, if necessary, for succeeding years) equal to that partner’s share of the net decrease in the partner non-recourse debt minimum gain.

If there is a net decrease in partnership minimum gain for a partnership taxable year, then the minimum gain chargeback requirement applies, and each partner must be allocated items of partnership income and gain for that year equal to that partner’s share of the net decrease in partnership minimum gain.
A partner is not subject to the minimum gain chargeback requirement to the extent the partner’s share of the net decrease in partnership minimum gain is caused by a recharacterization of non-recourse partnership debt as partially or wholly recourse debt or partner non-recourse debt, and the partner bears the economic risk of loss (within the meaning of Reg. § 1.752-2) for the liability.
A partner is not subject to the minimum gain chargeback requirement, to the extent the partner contributes capital to the partnership that is used to repay the non-recourse liability or is used to increase the basis of the property subject to the nonrecourse liability; and the partner’s share of the net decrease in partnership minimum gain results from the repayment or the increase to the property’s basis.
Items To Use For Chargeback: 
Reg. § 1.704-2(f)(6)

Any minimum gain charge-back required for a partnership taxable year consists first of certain gains recognized from the disposition of partnership property subject to one or more partnership non-recourse liabilities; and then, if necessary, consists of a pro rata portion of the partnership’s other items of income and gain for that year. If the amount of the minimum gain charge-back requirement exceeds the partnership's income and gains for the taxable year, then the excess carries over.
Slide Intentionally Left Blank
TWO APPROACHES TO CAPITAL ACCOUNT MAINTENANCE
Two Approaches

- The partnership agreement contains detailed *allocations* of book profits and losses, and these allocations determine distributions.

- The “wizard” decides:
  - Generally partnership agreement contains a provision stating that at the end of the taxable year allocations are made so that, each partner’s capital account is equal to:
    - The amount that would be distributed to that partner in liquidation if all partnership assets were sold at their § 704(b) book value, less
    - The partner’s share of minimum gain.
Typical detail of allocations

- **Profit allocations**
  - Reverse prior losses
  - Preferred return
  - Residual sharing ratio (with threshold amounts for profits interests)

- **Loss allocations**
  - Reverse prior profits (in reverse order)
  - Residual sharing ratio
Effect of this Approach

- Allocations drive distributions
- Judgment exercised upfront
- Role of return preparer is to read carefully.
Steps the Wizard must take

- Determine amounts each partner would get on hypothetical year-end liquidation
- Take into account interim distributions
- Make appropriate annual allocations and adjustments to capital accounts.
Effect of Wizard Approach

- Economic deal reflected in distributions.
- Generally preferred by non-tax principals
- The wizard must make annual hypothetical distribution determinations
- Substantial economic effect safe harbor compliance depends on wizard.