Mastering Partnership Minimum Gain Chargeback Provisions for the Tax Professional

WEDNESDAY, NOVEMBER 18, 2015, 1:00-2:50 pm Eastern

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Mastering Partnership Minimum Gain Chargeback Provisions for the Tax Professional

Nov. 18, 2015

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Mastering Partnership Minimum Gain Chargeback Provisions for the Professional

Reporting Requirements, Allocations and Planning Opportunities for Non-Recourse Deductions
Minimum Gain

Basic Partnership Structure

Limited Partner

90%

Partnership

10%

General Partner

CAPITAL Partner
Preferred Returns
IRR Thresholds
Residual Income

SERVICE Partner
Management Fees
Development Income
Promote Interest
Residual Income
<table>
<thead>
<tr>
<th>Basis Fact Pattern</th>
<th>1/1/10</th>
<th>activity</th>
<th>12/31/12</th>
<th>activity</th>
<th>12/31/14</th>
<th>activity</th>
<th>12/31/15</th>
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<tbody>
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<td>Minimum Gain</td>
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</table>
## Minimum Gain

### Business Context - Financial Distress

#### General Rule
- Sec 61(a)(12) COD Inclusion Rule
- Sec 108 COD Exclusion Rule

#### Exception
- Sec 1001 Sale or Exchange re: Foreclosure or Deed in Lieu Transaction
## Minimum Gain

### Basis Fact Pattern

<table>
<thead>
<tr>
<th></th>
<th>1/1/10</th>
<th>activity</th>
<th>12/31/12</th>
<th>activity</th>
<th>12/31/14</th>
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<td>NR distribution</td>
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# Minimum Gain

<table>
<thead>
<tr>
<th>MG Affects:</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Allocation of <strong>Nonrecourse Deductions</strong></td>
</tr>
<tr>
<td>- Allocation of <strong>Gain</strong> on Sale or Other Disposition of Collateral Property</td>
</tr>
<tr>
<td>- Allocation of <strong>Tax Losses</strong> under “Alternative Economic Effect Rules – Sec 704(b) Regs”</td>
</tr>
<tr>
<td>- Allocation of <strong>Nonrecourse Debt</strong> – Sec 752 Regs</td>
</tr>
</tbody>
</table>
Nonrecourse deductions do not have substantial economic effect. However, the allocation of NR deductions will be considered to have economic effect if:

1. Partnership agreement contains a minimum gain chargeback provision, and
2. Nonrecourse deductions are allocated in same manner as other substantial items of income & loss generated by the property that gave rise to the nonrecourse deduction.
## Partnership Agreement

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Capital Contributions</td>
<td>Section 704(b) Income Allocation Regulations</td>
</tr>
<tr>
<td>Distributions of Gross Cash</td>
<td>Section 704(c) Built-in Gain Regulations</td>
</tr>
<tr>
<td>Allocation of Profits / Losses</td>
<td>Section 706 Income Allocation / Partner Changes</td>
</tr>
<tr>
<td>Waterfall Provisions</td>
<td>Nonrecourse Deductions</td>
</tr>
<tr>
<td>Target Capital</td>
<td>Minimum Gain Chargeback</td>
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<td>Qualified Income Offset</td>
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<td>Curative Allocation Provision</td>
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<tr>
<td>Test</td>
<td>Description</td>
</tr>
<tr>
<td>------------</td>
<td>--------------------------------------------------</td>
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<tr>
<td>Test #1</td>
<td>Partner Interest in Partnership (PIP) Rules</td>
</tr>
<tr>
<td>Test #2</td>
<td>Substantial Economic Effect (SEE) Rules</td>
</tr>
<tr>
<td>Test #3</td>
<td>Economic Equivalence (SEE) Rules</td>
</tr>
</tbody>
</table>
A partner’s interest in the partnership means “the manner in which the partners have agreed to share the economic benefit or burden, corresponding to the income, gain, loss, deduction, and credit that is to be allocated.

Factors to consider when determining a partner’s interest in the partnership:

- Contributions of capital
- Distributions - current
- Distributions – liquidating
FIVE Targets of Substantial Economic Effect Rules

1. Tax Allocations must follow Book Allocations [General Rule]
2. QIO Loss Allocation Limitation Rule
3. Disallow Shifting and Transitory Allocations
4. Nonrecourse Deductions
5. Tax Credits
## TEST #2
Substantial Economic Effect (SEE) Rules

### Two-Part Test

<table>
<thead>
<tr>
<th>PART 1</th>
<th>PART 2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Economic Effect Test</strong></td>
<td><strong>Substantial Effect Test</strong></td>
</tr>
<tr>
<td>A. Maintain 704(b) Cap Accounts</td>
<td>Disallows:</td>
</tr>
<tr>
<td>B. Liquid distribution / positive capital</td>
<td>A. Shifting Allocations</td>
</tr>
<tr>
<td>C. DRO or QIO</td>
<td>B. Transitory Allocations</td>
</tr>
</tbody>
</table>
| TEST #3  
| Economic Equivalence (EE) Rules  
| Treas. Reg. 1.704-1(b)(2)(ii)(i)  

Allocations made to a partner that do not otherwise have economic effect [under the economic effect test of TEST #2] shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if requirements (1), (2), and (3) of paragraph (b)(2)(ii)(b) [capital account maintenance rules, distributions against positive capital only, and DRO or QIO provision present in partnership agreement].
<table>
<thead>
<tr>
<th>Negative Capital Account Balance created by:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Losses funded by loans</td>
</tr>
<tr>
<td>• Distributions in excess of capital investment</td>
</tr>
<tr>
<td><strong>Economic Effect</strong></td>
</tr>
<tr>
<td>---------------------</td>
</tr>
<tr>
<td><strong>DRO</strong></td>
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<tr>
<td>Negative capital balance eliminated by</td>
</tr>
<tr>
<td>➢ Cash contribution</td>
</tr>
<tr>
<td><strong>QIO</strong></td>
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<tr>
<td>Negative capital balance eliminated by</td>
</tr>
<tr>
<td>➢ Special allocation of taxable net or gross income</td>
</tr>
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<tr>
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</tr>
<tr>
<td>1.</td>
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<tr>
<td>2.</td>
</tr>
<tr>
<td>3.</td>
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</table>
## Allocation of Nonrecourse Debt

<table>
<thead>
<tr>
<th>Tier</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1</td>
<td>Sec 704(b) Minimum Gain</td>
</tr>
<tr>
<td>Tier 2</td>
<td>Sec 704(c) Minimum Gain</td>
</tr>
<tr>
<td>Tier 3</td>
<td>Profit Sharing Ratios (may take into account “Excess Sec. 704(c) Built-in Gain)</td>
</tr>
</tbody>
</table>
## Allocation of Nonrecourse Debt

**Example:** On 1/1/2015, partner contributes encumbered building to a partnership in exchange for 10% interest in ABC Partnership.

<p>| | |</p>
<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Mortgage</td>
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<td>Tax Basis</td>
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<tr>
<td>Sec 704(c) Min Gain</td>
<td>30</td>
</tr>
<tr>
<td>Sec 752 – Share in Debt</td>
<td>37</td>
</tr>
</tbody>
</table>

### Debt Allocation:
- **Tier 1** - $0
- **Tier 2** - $30
- **Tier 3** - $7 \[ (100 - 30) \times 10\% \]
“IRC Sec. 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) is determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if:

1. The partnership agreement does not provide for the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) or

2. The allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect” [“SEE”]

The details with respect to how SEE works is detailed in a number of sets of Treasury Regulations including
SEE Defined In The Regulations

[An allocation of income, gain, loss, or deduction (or item thereof) to a partner will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides—

(1) For the determination and maintenance of the partners' capital accounts in accordance with the rules of [Regulations § 1.704-1(b)(2)(iv)].

(2) Upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (2) and requirement (3) of [Regulations § 1.704-1(b)(2)(ii)(b)]), by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), and

(3) If such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (3)), he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances (in accordance with requirement (2) of [Regulations § 1.704-1(b)(2)(ii)(b)]).
Deemed Partner’s Interest in the Partnership

Generally, if an allocation lacks economic effect, the amounts involved must be reallocated in accordance with the partners' interests in the partnership,

Finally, an allocation is valid if it is “deemed” to be in accordance with the partners' interests in the partnership under a series of special rules set forth in Regulations § 1.704-1(b)(4). The “deemed interest” rules deal with allocations of tax items that have no economic corollary. Three of these rules are particularly significant and concern:

1."Book-ups’ pursuant to Regulations § 1.704-1(b)(2)(iv)(d) related to IRC Sec 704(c) or 704(c) like situations created in “book capital accounts under IRC Sec. 704(b)

2.Percentage Depletion and .

3. Allocations of loss or deduction attributable to partnership nonrecourse debt.
Definition of Non-Recourse Deductions

**Crane v. Commissioner**, 331 U.S. 1 (1947) - This case supports the doctrine of U.S. income tax law that a seller of property subject to a nonrecourse debt (as opposed to a recourse debt where the seller may remain liable for any unsatisfied balance remaining after the transfer) realizes an amount that includes the debt assumed by the purchaser. This is an important concept because a large percentage of real property is held subject to a mortgage or other debt and, therefore, the debt must be dealt with as a part of the sale of such property. As a result, when property encumbered by debt is sold, the tax consequences of the passing of the debt have a significant effect on the overall tax consequences of the sale.

It should be noted, as stated in the quoted text above, that the result in Crane is specifically limited to situations where the property mortgage was less than the value of the property mortgaged. See footnotes 37 and 42. The reasoning cited, that the taxpayer will treat the property as his own in order to protect his equity investment, has been called the "Crane Economic Benefit Rule." That reasoning was turned on its head 36 years later in the case **Commissioner v. Tufts**, 461 U.S. 300 (1983), which addressed the situation that Crane had left unresolved.

Minimum Gain = Adjusted Basis of Asset - NRD Encumbrance

Non-recourse Deductions for the Year = Increase in Minimum Gain

THE STARTING POINT IS COMPARATIVE TAX BASIS BALANCE SHEETS
Provisions Governing Allocation of NRD

The basic rules of the Temporary Regulations governing the allocation of nonrecourse deductions are worth quoting in full: Requirements to be satisfied. Allocations of nonrecourse deductions are deemed to be made in accordance with the partners' interests in the partnership if and only if—

(1) Throughout the full term of the partnership, requirements (1) and (2) of §1.704-1(b)(2)(ii)(b) are satisfied;

(2) Beginning in the first taxable year in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, the partnership agreement provides for allocations of nonrecourse deductions among the partners in a manner that is reasonably consistent with allocations, which have substantial economic effect, of some other significant partnership item attributable to the property securing nonrecourse liabilities of the partnership;

(3) Beginning in the first taxable year of the partnership in which the partnership has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in minimum gain and thereafter throughout the full term of the partnership, the partnership agreement contains a provision that complies with the requirements of paragraph (b)(4)(iv)(e) of this section (“minimum gain chargeback”); and

(4) All other material allocations and capital account adjustments under the partnership agreement are recognized under §1.704-1(b) (without regard to whether allocations of adjusted tax basis and amount realized under section 13A(c)(7)(D) are recognized under §1.704-1(b)(4)(v)).
Failure to Tie Minimum Gain To Allocations

At the beginning of the year, the equal AB general partnership owns a building subject to nonrecourse debt in an amount exactly equal to its basis. AB has no other assets, and both partners' capital accounts are zero. Since AB is an equal partnership, nonrecourse deductions must be shared approximately equally. A, however, would like to be allocated 100 percent of the tax losses of AB as long as there is no economic risk associated with those losses; A is willing to be liable for his deficit capital account balance if the associated economic risk is minimal. AB's rental income is $100, depreciation is $100, and interest expense is $100. Absent tax planning, the increase in minimum gain for the year is $100 and nonrecourse deductions for the year are $100, which must be shared equally between A and B. Remaining income is zero. A and B would thus each have a net tax loss of $50.
Distributions of Nonrecourse Refinance Proceeds

The equal CD limited partnership owns unimproved land. At the beginning of the year, nonrecourse liabilities encumbering the land equal its adjusted tax basis. During the year, the land is refinanced on a nonrecourse basis for an additional $100, which is distributed to limited partner D. Rental income and interest expense for the year are each $100. CD thus has zero net income.
Determining Share of Nonrecourse Deductions

Fill In Example
Background Facts

On January 1, 2004, G and L form a limited partnership to acquire and operate a rental apartment building. L, the limited partner, contributes $90 and G, the general partner, $10.

a. The partnership obtains a non recourse loan from an unrelated financial institution for $900 and purchases a building (on leased land) for $1,000.

b. The loan is secured by the building.

c. The loan requires interest to be paid currently, but does not call for any principal payment for 5 years.

d. The building is depreciable over 10 years at the rate of $100 per year.
The partnership agreement contains the following provisions:

The agreement satisfies the alternate test for economic effect under § 1.704-1(b)(2)(ii)(d), i.e., it contains the requisite provisions for capital account maintenance and distribution of liquidation proceeds.

Although G has a deficit makeup obligation L does not, but the agreement includes a "QIO" provision.

The agreement includes a "minimum gain chargeback" provision that complies with § 1.704-2(b).

All income and loss, other than nonrecourse deductions, are allocated 90% to L and 10% to G until the first time that the partnership recognizes income and gain that exceed losses sustained in prior years. Thereafter, all income, gain and loss are allocated 50% to G and 50% to L.

Nonrecourse deductions are allocated 80% to L and 20% to G.

Non-liquidating cash distributions are divided 10% to G and 90% to L until they have each recovered their initial capital contributions (i.e., $10 to G and $90 to L). Thereafter, all non-liquidating cash distributions are to be shared 50%-50%.
Allocations of NRD?

For the taxable years 2014-16, the partnership has rental income of $70, operating expenses of $10, interest expense of $60, and a cost recovery deduction of $100, for a net Loss of $100.

Is the 80/20 split of nonrecourse deductions permissible?

How much flexibility do G and L have to allocate partnership nonrecourse deductions? Specifically, which of the following would be permissible?

50% 50%
10% 90%
1% 99%
Refinancing Question

Assume that on January 1, 2017 the partnership defaults on the mortgage and transfers the building (then worth $600) to the lender by deed in lieu of foreclosure, and liquidates?

What are the appropriate tax allocations and cash distributions to G and L for 2014, 2015, 2016 and 2017?
Sale of The Asset

What if, instead, on January 1 2017 the partnership sells the building for $1,100 and liquidates.

What are the appropriate tax allocations and distributions to G and L?
Borrowings, PMG Calculation

What if, instead, in 2016 the partnership borrows an additional $100, using the building as security, and distributes the cash to the partners in the ratio of 10/90, in accordance with the partnership agreement.

What is the aggregate partnership minimum gain at the end of the year, and what is each partner's share of PMG?

If the partnership then sells the building on January 1, 2007 what are the appropriate allocations and distributions?
Continued Operations and Liquidation

What if in part (c) instead of selling the building in 2007, the partnership continues to operate throughout 2007, during which it earns net income of $600. It then sells the building on January 1, 2008 and liquidates.

What are the appropriate allocations and distributions?
Book Up Scenario

Suppose that in part (c) on January 1, 2016 G and L contribute cash to the partnership in the amounts of $40 and $160, respectively, and the partnership uses these contributions to reduce the balance of the mortgage from $900 to $700. What tax consequences occur in 2016 as a result of these transactions?
Addition of A Partner Guarantee

What difference would it make in part (a) if G had guaranteed the original $900 loan to the lender?