Subchapter K: Do You Really Get It?

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The Complexity of The Code

From 1987 to 1998, Money magazine conducted an annual study in which it submitted facts to a group of tax return preparers. In Money's 1998 report, forty-six tax return preparers had forty-six different tax results, with the tax liability ranging from $34,240 to $68,912. This was the 7th time that Money noted that none of the tax return preparers came to the same conclusion.

The Complexity of The Code

In April 2001, Congress's Joint Committee on Taxation issued a 1,292 page, 5 pound report on how to simplify the Federal Tax Code.

The Complexity of The Code

"It is time for a complete overhaul of our income tax system… it is a disgrace to the human race."

Jimmy Carter, accepting the Democratic Nomination in 1976.

The Complexity of The Code

“The [tax] code today encompasses 9,500 pages of very small print. While every word…has some justification, in its entirety it is an abomination."

Paul O'Neal, former Treasury Secretary during the George W. Bush administration (2008).

The Complexity of The Code

“The words of…the Income Tax… merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer [me] no handle to seize hold of [and that] leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time. I know that these monsters are the result of fabulous industry and ingenuity, plugging up this hole and casting out that net, against all possible evasion; yet at times I cannot help... wondering whether to the reader they have any significance save that the words are strung together with syntactical correctness." *Judge Learned Hand, 1947*

The Complexity of The Code

"If [a United States Supreme Court Justice is] in the doghouse with the Chief [Justice], he gets the crud. He gets the tax cases."

Supreme Court Justin Harry Blackmun

The Complexity of The Code

IRC §509(a), defining a charity, reads:

"For purposes of paragraph (3), an organization described in paragraph (2) shall be deemed to include an organization described in section 501(c)(4), (5), or (6) which would be described in paragraph (2) if it were an organization described in section 501(c)(3)."

The Complexity of The Code

IRS formula in Treasury Regulation §1.170A-12 formula for the valuation of a remainder interest in real estate:

$$(1+\frac{i}{2})\sum_{t=0}^{n-1} v^{(1+t)}\left[\left(1-\frac{l_{x+t+1}}{l_x}\right)\left(1-\frac{l_{y+t+1}}{l_y}\right)-\left(1-\frac{l_{x+t}}{l_x}\right)\left(1-\frac{l_{y+t}}{l_y}\right)\right]\left(1-\frac{1}{2n}-\frac{t}{n}\right)$$

Complexity: One Solution

Youtube Rand Paul's campaign video – what would you use to kill the Internal Revenue Code – a woodchipper, chainsaw, or fire?

"I believe that the only way to reign in big government is to starve the beast. I'd eliminate the more than 70,000 pages of the tax code, replace it with one page, and start over."

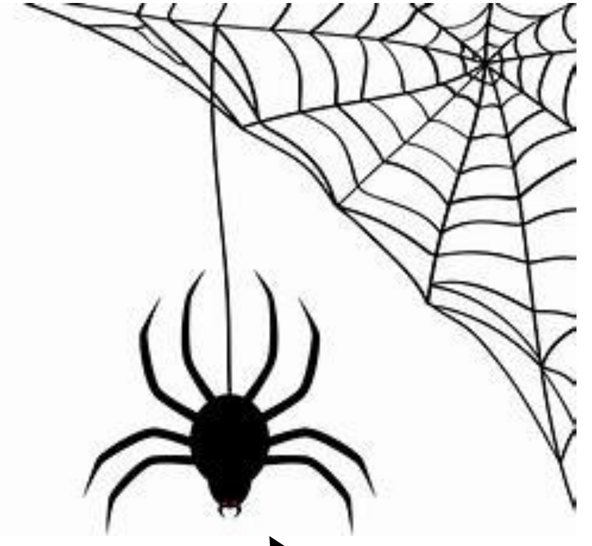
Subchapter K: The Respect

"Subchapter K is truly extraordinary. It is an intricate system that highlights what is possible through legal craft. Designing a system as intricate and nuanced as subchapter K is an **awe-inspiring** reminder of what talented tax professionals can do."

"What We Talk About When We Talk About Tax Complexity", Andrea Monroe, Michigan Business & Entrepreneurial Law Review, 2016

Subchapter K: The Darkness

“Today’s subchapter K is a **byzantine web** of technical language, multi-factored analyses, and computational tests.”



IRS

Subchapter K: The Complexity

- Piecemeal legislation
- Regulations to prevent abusive transactions by sophisticated tax practitioners
- Aggregate vs. entity approach
- Competing goals of equity, efficiency, flexibility, and simplicity

Subchapter K: The Problem

- "The goal of modern partnership rule design is often targeted, surgical rules that attempt to address every possible statutory or regulatory gap that a small number of sophisticated partnerships might exploit; it is not the development of broad-based rules that provide a reasonable system of taxation for most partners most of the time…. From both a theoretical and a practical perspective, subchapter K's system is **dysfunctional, with incoherent rules and policies often working at cross-purposes.**"

"Subchapter K, Gateway Drugs, & Tax Reform", Andrea Monroe, Tax Notes, 2015

Subchapter K: The Problem

“Complexity in fact plays a larger role in the tax shelter problem. Complicated statutory and regulatory provisions lead to abusive transactions. These abuses, in turn, lead to complicated government responses, and then the cycle repeats, with subchapter K becoming more complicated and abusive transactions persisting.”

“What We Talk About When We Talk About Tax Complexity”, Andrea Monroe, Michigan Business & Entrepreneurial Law Review, 2016

The §704 Crisis

- Goal A = flexibility for a very broad & diverse range of business arrangements – from the simplest to the most sophisticated.
- Goal B = requirement that transactions have "substance" – that economic consequences and tax consequences are parallel.
- How can they be reconciled? Can it always be done?
- Is it an "impossible balancing act"?

Partner’s Distributive Share

- §704(a): “A partner’s distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement.”
- General rule: Distributive share (what is reported on the K-1) as determined by agreement will be respected.
- Agreement: capital, profits, loss %; special allocations; elections made.

Partner's Distributive Share

- Exception: If allocation in agreement lacks **substantial economic effect** under the rules of §704(b).
- If allocation does not have SEE, IRS can reallocate items in accordance with "the partners' interests in the partnership".
- This provision is the "guardian" of the substance principle in Subchapter K.

§704(b) Rules

Allocation per the partnership agreement is valid if meets one of 3 tests:

1. Has **SUBSTANTIAL ECONOMIC EFFECT** (safe harbor)
2. It is in accordance with partners' interests in partnership as determined by facts and circumstances <u>or</u>
3. It is "deemed" to be in accordance with their interests.

Reg. §1.704-1(b)(1)(i)

§704(b) Rules: Rationale

- Allocations must affect the dollar amount of the partners' shares of income or loss independently of the tax consequences.
- Allocation must follow **economic benefit or burden**.
- If partner **benefits** economically from an item of partnership income or gain (ex: receives a cash distribution), that item must be allocated to him so that he bears the correlative tax burden.
- If partner will suffer the economic **burden** of an item of partnership loss or deduction, he must be allocated the associated tax benefit.
- TAX MUST FOLLOW BOOK.

§704(b) Economic Effect

Reg. §1.704-1(b)(2)(ii)(b)

1. **Capital accounts** must be maintained. Allocation of items must be reflected in capital accounts.
2. Partnership must be **liquidated according to capital accounts**. Distributions must be made to partners in accordance with their positive capital account balances.
3. **Deficit restoration** agreement: partners with deficit balances in their capital account are unconditionally required to restore the deficit.
   Alternative: qualified income offset

§704(b) Economic Effect

Reg. §1.704-1(b)(2)(ii)(d): **Qualified income offset**

- The absence of an unlimited deficit capital account makeup provision is not fatal! (Alternative #3)
- QIO: requires a member who unexpectedly receives an adjustment, allocation, or distribution that causes or increases a deficit balance in such member's capital account, **to be allocated income and gain** in an amount and manner sufficient to eliminate such deficit balance as quickly as possible.
- Most LLCs use QIO option because they do not require their members to restore negative capital account balances.

Great Inventions & Ideas: How They Were Discovered

- Benjamin Franklin & electricity: lightning strike & kite
- Percy Spencer & microwave: magnetron & chocolate bar in pocket
- Ira Remsen & Sweet 'n' Low: did not wash hands after experiment at John Hopkins
- Dr. Harry Coover & Super Glue: intended to be precision gun sight but stuck to everything
- George de Mestral & Velcro: burrs stuck to his hunting dog's fur
- All British poetry & literature of 17^{th} century: opium dream.

Ideas & Inventions in Accounting & Tax

- Italian monk Luca Pacioli & accounting equations/journal/ledge: He warned that "a person should not go to sleep at night until the debits equaled the credits."
- Rep. Rostenkowski, Sen. Packwood, & passive loss rules: Irish pub with beer and hamburgers

Ideas & Inventions in Accounting & Tax

Who wrote Subchapter K?

- Mark H. Johnson, founding chair of the ABA Partnership Tax Section & the "forgotten protagonist"
- Johnson thought that "the partner who reaped an economic gain or bore an economic loss should pay the tax or get the deduction."

"The Story of Subchapter K: Mark H. Johnson's Quest", Mark P. Gergen, <u>Business Tax Stories</u>, 2005.

Subchapter K: History

- One of the founding fathers = **Mark H. Johnson**
- Started with 1942 Harvard Law Review article on partnership taxation.
- 1948: founding chair of ABA Partnership Tax section.
- 1949: recommended a system for taxing partnerships that closely resembles today's law, mostly following the aggregate theory.
- 1954 Code: overhauled partnership tax, mostly adopted entity approach.

Subchapter K: History

- Per Johnson: "The argument for the aggregate approach is that…[t]he partnership does not pay tax by itself; it is the partners who pay the tax. Therefore, we have an immediate method for working out an equitable adjustment between the parties. It is perfectly simple to work out be charging the taxable gain to the person who was initially responsible for that gain, and that is the only fair way to work justice between the parties."

History of §704(b)

- 1954: IRC of 1954 including first comprehensive set of rules governing partnerships & partners.
  - Goal: "To provide flexible and fair rules consistent with the contemporary commercial expectations of persons doing business in partnership form."
  - Sec. 704(c) was part of this.
- 1976: §704(b) enacted.
- 1983: Proposed regulations issued.
- 1984: §704(c) amended.
- 1992: New proposed §704(c) regulations – 3 methods.

Two Capital Accounts: The Heart of It

- §704(b) book capital = economic investment; the amount the partner is entitled to receive on the liquidation of the partnership or the partner's interest.
- Tax capital = tax investment
- Accounts measured separately.
- Example: If a partner is allocated $100 of taxable income on his K-1, he is entitled to receive $100 additional economic dollars on liquidation. This is accomplished through the maintenance of the book capital account.

Two Capital Accounts: The Heart of It

- Book capital account
  - Intended to serve as Subchapter K's proxy for the economic arrangement between the partners.
  - Tracks economic circumstances
  - The "benchmark" against which the tax allocations are measured.
- The allocations on the K-1 must reflect each partner's actual economic circumstances.
- Tax allocations must be made to same partner, in same amount, and at same time as book allocations.

§704(b) Book Capital

Capital (**§704(b) book**) account maintenance rules:

- Rules based on tax accounting concepts, **not financial accounting**.
  - Cash vs. accrual basis
  - Book-tax differences
- Generally corresponds to economic agreement among partners.

Reg. §1.704-1(b)(2)(iv)

§704(b) Book Capital

Capital (**§704(b) book**) account maintenance rules:

- Increase/credit for: contributions (FMV property) and distributive share of income and tax-exempt income
- Decrease/debit for: distributions (FMV property), and distributive share of expenses and losses and nondeductible expenditures.
- Also: Any inherent gain/loss in property distributed must be taken into account for book purposes.

Reg. §1.704-1(b)(2)(iv)

§704(b) Book Capital

Why do we have to reduce capital by the FMV of distributions?

- X and Y are equal partners and have a balance in their capital accounts of $50,000 each.
- The partnership plans to distribute $20,000 of cash to X and $20,000 worth of stock to Y. The stock was purchased for $15,000.
- Economically, X and Y are entitled to half of that appreciation ($2,500 each). XY must recognize the $5,000 book gain in the stock.

X capital: $50,000 + 2,500 - 20,000 = $32,500

Y capital: $50,000 + 2,500 - 20,000 = $32,500

Tax (Outside) Basis Computation

\+ Original basis of contribution
\+ Additional contributions
\+ Increase in share of liabilities
\+ Distributive share of taxable K income
\+ Distributive share of tax-exempt K income
– Distributions of cash and property
– Decrease in share of liabilities
– Distributive share of nondeductible expenses
– <u>Distributive share of losses</u>
= Partner’s outside basis for interest

Tax (Outside) Basis Computation

- Why do you want basis?
  Distributions are tax-free; losses are deductible; less gain/more loss on sale of interest
- Purpose of §705: To keep tract of a partner's "tax investment" in the partnership – to prevent double taxation or exclusion from taxation of income items upon ultimate disposition of the interest.

The Simplest Example of The Logic

- 3 individuals form a partnership. Each contribute equal amounts of cash. They agree to share capital, profits, and loss 1/3 each.
- Cash contributions immediately increase tax capital and book capital.
- Partnership uses cash to purchase property. Any gains or losses recognized on the property would be shared 1/3 each for both book and tax purposes. Share of ratable gain (loss) would increase (decrease) partner’s tax capital and book capital accordingly.

The Simplest Example of The Logic

- Upon liquidation, each partner would be entitled to distribution equal to positive balance in his book capital account. That book capital account reflects his economic investment, the original contribution plus shares of gains/losses on the property.
- The tax burden of the profit earned by the partnership is borne by the partner who received the economic benefit of those earnings, as reflected in that partner's liquidating distribution! The tax allocations paralleled the book allocations – creating harmony between flexibility & substance goals.

Blatant §704(b) Violations

- XYZ Partnership has 3 equal partners: X is a tax-exempt entity, and Y and Z are not.
- What would you do if you could?
- Give 100% of income allocation to X, 100% of loss allocation to Y and Z, and split cash distributions 1/3.
- §704(b) regulations obviously prohibit this!

Blatant §704(b) Violations

- XYZ Partnership provides that taxable income/loss will be allocated 60% to X and 20% to each Y and Z. XYZ generated $100,000 of taxable income this year, $60,000 of which was reported as X's distributive share on his K-1, and $20,000 of which was reported on each of Y and Z's K-1's. Each partner's capital account was increased by $33,333.
- Why is this a problem? How could this be an advantage to Y and Z?
- WHAT IS THE TRUE "BUSINESS" INTENTION OF THE PARTIES?

Blatant §704(b) Violations

- XYZ Partnership provides that taxable income will be allocated equally to X, Y, Z. Upon liquidation, distributions of remaining property will be split: 50% to X, and 25% each to Y and Z.
- **Why would someone want to do this? What would they be accomplishing? Why would the IRS be against it?**

§704(b) Example

- Michelle and Melania created the M1M2 Partnership by contributing \$100,000 each. The \$200,000 cash was used by the partnership to acquire a depreciable asset. The partnership agreement provides that MACRS will be allocated 20% to Michelle and 80% to Melania. All other items will be allocated equally.
- In the first year, MACRS is \$40,000 and no other operating transactions occur. The property is sold at the end of the year for \$160,000 and the partnership is liquidated. How must you allocate the \$160,000?

§704(b) Example

Michelle	Melania
100,000	100,000
(8,000)	(32,000)
92,000	68,000

This is how you would have to allocate the proceeds upon liquidation.

§704(b) Substantiality

- Economic effect must also be substantial.
- Major source of uncertainty and controversy.
- So follow mechanical safe harbor rules!
- Is there a reasonable possibility that the allocation will "affect substantially" the dollar amounts to be received by the partners from the partnership, irrespective/independent of tax consequences?
- Must apply test by taking into account the tax consequences resulting from the interaction of the allocation with the tax attributes of any owner of a pass-through entity partner!

Reg. §1.704-1(b)(2)(iii),(3)(iii)

§704(b) Substantiality

An allocation that affects dollar amounts may still not be substantial if:

1. The allocation enhances the after-tax consequences to any partner but does not substantially reduce the after-tax consequences to other partners;
2. The allocation merely shifts tax consequences among the partners without changing the economic consequences to them; evidence of an insubstantial allocation is that capital accounts remain substantially the same as if the allocation were not made; or
3. The allocation is **transitory** because the economic effects of the original allocation are likely to be offset by a subsequent allocation.

§704(b) Economic Effect

Reg. §1.704-1(b)(5), Example 3:

- E and F enter into a partnership agreement to develop and market experimental electronic devices. E contributes $2,500 cash and agrees to devote his full-time services to the partnership. F contributes $100,000 cash and agrees to obtain a loan for the partnership for any capital needs.
- The agreement provides that all deductions for research expenditures and interest on loans are to be allocated to F. In addition, F will be allocated 90%, and E 10%, of taxable income or loss, computed net of the deductions for such research expenditures and interest, until F has received allocations of taxable income equal to the sum of such research expenditures, such interest expense, and his share of such taxable loss.

§704(b) Economic Effect

Reg. §1.704-1(b)(5), Example 3:

- Thereafter, E and F will share all taxable income and loss equally. Operating cash flow will be distributed equally between E and F.
- The partnership agreement requires maintenance of capital accounts, liquidation in accordance with those accounts, and restoration of deficit capital accounts.
- The allocations **will have economic effect**.

§704(b) Economic Effect

Reg. §1.704-1(b)(5), Example 3:

- In view of the nature of the partnership's activities, there is not a strong likelihood at the time the allocations become part of the agreement that the economic effect of the allocations to F of deductions for research and experimental expenditures and interest on partnership loans will be largely offset by allocations to F of partnership net taxable income.
- The economic effect of the allocations **is substantial**.

§704(b) Substantiality

Reg. §1.704-1(b)(5), Example 5:

- Not-for-Profit Co. and Jarvis form a partnership to invest in taxable and tax-exempt securities. Each contributes $6,000 cash. Not-for-Profit Co. is tax-exempt and Jarvis is in the top marginal tax bracket.
- The partners agree to allocate 80% of the interest on the tax-exempt securities to Jarvis and 20% to Not-for-Profit Co., to allocate 100% of the interest/dividends on the taxable securities to Not-for-Profit Co., and to share equally in gains and losses from their disposition. The partners expect to realize between $450 and $550 of tax-exempt interest and $450 to $550 of taxable interest and dividends each year.
- This has economic effect, but is **not substantial**.

§704(b) Economic Effect

Reg. §1.704-1(b)(5), Example 7:

- M and N are partners in the MN general partnership, which is engaged in an active business. Income, gain, loss, and deduction is allocated equally between M and N.
- The partnership agreement requires maintenance of capital accounts, liquidation in accordance with those accounts, and restoration of deficit capital accounts.
- In order to enhance the credit standing of the partnership, the partners contribute surplus funds to the partnership, which the partners agree to invest in equal dollar amounts of tax-exempt bonds and corporate stock for the partnership's first 3 taxable years.

§704(b) Economic Effect

Reg. §1.704-1(b)(5), Example 7:

- M is expected to be in a higher marginal tax bracket than N. During the 3-year period of the investment, M will be allocated 90% and N 10% of the interest income from the tax-exempt bonds as well as any gain or loss from the sale, and that M will be allocated 10% and N 90% of the dividend income from the corporate stock as well as any gain or loss from the sale.
- At the time the allocations become part of the agreement, there **is not** a strong likelihood that the gain or loss from the sale of the stock will be substantially equal to the gain or loss from the sale of the tax-exempt bonds, but there **is** a strong likelihood that the tax-exempt interest and the taxable dividends realized from these investments during the 3-year period **will not differ** substantially.

§704(b) Economic Effect

Reg. §1.704-1(b)(5), Example 7:

- These allocations **have economic effect**. The economic effect of the allocations of the gain or loss on the sale of the tax-exempt bonds and corporate stock **is substantial**.
- The economic effect of the allocations of the tax-exempt interest and the taxable dividends **is not substantial.** There is a strong likelihood, at the time the allocations become part of the agreement, that at the end of the 3-year period, the net increases and decreases to M's and N's capital accounts will be <u>the same</u> with such allocations as they would have been in the absence of such allocations, and that the total taxes of M and N for the taxable years to which such allocations relate **will be reduced** as a result of such allocations.

§704(b) Economic Effect

Reg. §1.704-1(b)(5), Example 7:

- If in fact the amounts of the tax-exempt interest and taxable dividends earned by the partnership during the 3-year period are equal, the tax-exempt interest and taxable dividends will be reallocated to the partners in equal shares.
- If not, the tax-exempt interest and taxable dividends will be reallocated between M and N in proportion to the net increases in their capital accounts during such 3-year period due to the allocation of such items under the partnership agreement.

§704(b) Economic Effect

Reg. §1.704-1(b)(5), Example 8:

- O and P are equal partners in the OP partnership. Partner O has a NOL carryover from another venture that is due to expire at the end of the second taxable year. Otherwise, both partners expect to be in the 50% tax bracket in the next several years.
- The partnership agreement requires maintenance of capital accounts, liquidation in accordance with those accounts, and restoration of deficit capital accounts.
- The partnership agreement is amended (at the beginning of the partnership's second taxable year) to allocate all the partnership net taxable income for that year to O.

§704(b) Economic Effect

Reg. §1.704-1(b)(5), Example 8:

- Future partnership net taxable loss is to be allocated to O, and future partnership net taxable income to P, until the allocation of income to O in the partnership's second taxable year is offset. It is further agreed orally that in the event the partnership is liquidated prior to completion of such offset, O's capital account will be adjusted downward to the extent of one-half of the allocations of income to O in the partnership's second taxable year that have not been offset by other allocations, P's capital account will be adjusted upward by a like amount, and liquidation proceeds will be distributed in accordance with the partners' adjusted capital account balances.

§704(b) Economic Effect

Reg. §1.704-1(b)(5), Example 8:

- All allocations of partnership net taxable income and net taxable loss made pursuant to the amendment executed at the beginning of the partnership's second taxable year **lack economic effect** and will be disregarded.
- Under the partnership agreement other allocations are made equally to O and P, and O and P will share equally in liquidation proceeds, indicating that the partners' interests in the partnership are equal. Thus, the disregarded allocations will be reallocated equally between the partners.

Target Allocations: All The Rage

- Newest model of drafting partnership agreements: target allocations.
- Moo. Baa. La-la-la.
- Agreement specifies how cash will be distributed from operations and from liquidation of partnership. Income and loss items are allocated to partners' capital accounts so that these capital accounts conform to the cash distribution scheme in liquidation.

Target Allocations: All The Rage

- Partnership usually liquidates in accordance with stated percentages, not in accordance with capital account balances.
- Allocations of income and loss are made in such a manner that capital accounts are adjusted to be consistent with the plan for liquidating distributions of cash.
- We need more advice from IRS! May be problem with nonrecourse deduction regulations.

§704(c) Special Allocations

The Reality of Capital Accounts

Complications arise when “book-tax disparity” is created:

- **Partners contribute property.**
- New partners come in.
- Old partners leave.
- The partnership distributes property.

§704(c) Special Allocations

- Pre-contribution ("built-in") gains and losses must be allocated to the partner making the contribution.
- **If no §704(c), allocation of gain to partners who contribute property other than cash would have no substantial economic effect!**
- Any difference between item for TAX purposes and for BOOK purposes at the time of the contribution <u>must be allocated to the contributing partner</u> when the partnership disposes of the asset. Remainder of the item is allocated normally.

§704(c) Special Allocations

- Each **noncontributing** partner's share of income, loss, deduction, etc. with respect to the contributed property should be the SAME for both book and tax. (Beware: ceiling rule).
- **TAX FOLLOWS BOOK for noncontributing partners. Leftovers to contributing partner.**
- Rule allocates tax deductions on an annual basis, based on how partners share book deductions.
- Eliminates difference between contributing partner's initial outside basis (tax capital) and his initial book capital account.

§704(c)(1)(A)

§704(c) Example 1

- Partner A contributes land with FMV of \$100,000 and adjusted basis of \$60,000 to Partnership for 10% interest. Partnership sells land for \$120,000.
- All \$40,000 of built-in gain is allocated all to A ("special allocation").
- Remaining gain of \$20,000 is allocated in accordance with profit-sharing ratios (10% x \$20,000 = \$2,000).
- Total gain to A of \$42,000.

§704(c) Depreciation

- What if asset is depreciable?
- Remember purpose of §704(c) – to eliminate difference between initial outside basis and initial capital account.
- Don’t wait until sale of depreciable property; instead, **fix it as you depreciate!**
- Rule: **Tax depreciation first allocated to noncontributing partners = book depreciation. Remaining allocated to contributing partner.**

§704(c) Example 2

- X contributes a depreciable asset with FMV \$100,000 and adjusted basis of \$80,000. Y contributes cash of \$300,000 to XYZ Partnership. X receives 25% interest; Y receives 75% interest. Asset is depreciable over five years on the straight-line basis.
- Tax depreciation= \$100,000 x 1/5 = \$20,000
- Book depreciation = \$80,000 x 1/5 = \$16,000

§704(c) Example 2

Consequences to X:

	Outside Basis	Book Capital
Initial	$80,000	$100,000
Tax depr, yr 1	($1,000)	($5,000)
Tax depr, yr 2	($1,000)	($5,000)
Tax depr, yr 3	($1,000)	($5,000)
Tax depr, yr 4	($1,000)	($5,000)
Tax depr, yr 5	($1,000)	($5,000)
Total	$75,000	$75,000

*Tax = Noncontributing partner Y first gets his share of book (20,000 x 3/4 = $15,000); remainder to D ($1,000).

§704(c) Example 2

Consequences to Y:

	Outside Basis	Book Capital
Initial	$300,000	$300,000
Tax depr, yr 1	($15,000)	($15,000)
Tax depr, yr 2	($15,000)	($15,000)
Tax depr, yr 3	($15,000)	($15,000)
Tax depr, yr 4	($15,000)	($15,000)
Tax depr, yr 5	($15,000)	($15,000)
Total	$225,000	$225,000

*Tax: Noncontributing partner Y first gets his share of book (20,000 x 3/4 = $15,000); remainder to X ($1,000).

§704(c) Ceiling Rule

- What if basis of X's asset had been $60,000?
- Total tax depreciation per year would be $12,000 ($60,000 x 1/5), but Y is entitled to $15,000!
- This is an example of the ceiling rule. Only $12,000 can be allocated to E.
- Allocation to partner is limited to actual amount realized for tax purposes by the K.
- If you have chosen the curative or remedial method, you can fix this!

Reg. §1.704-3(b)(1)

§704(c) Depreciation Allocation Methods

Reg. §1.704-3

1. **Traditional** method with ceiling rule
2. Traditional method with **curative** allocations:
   - If ceiling rule limits amount that can be allocated to the noncontributing partner, allocate other items of income or loss of same character to cure shortage.
   - If insufficient curative items, can do next year.
3. **Remedial** method:
   - If ceiling rule limits amount that should be allocated to the noncontributing partner, cure by allocating whatever is necessary to noncontributing partner and an offsetting allocation to contributing partners.
   - Create items if don’t have enough to cure!

Revaluation

§704(b) Economic Effect

Capital account maintenance rules – **revaluation**:

- Regulations permit capital accounts to be increased or decreased to reflect the revaluation of partnership property as a result of:
  - contribution or distribution of property as part of acquisition or relinquishment of interest in partnership or
  - generally accepted industry practices, if substantially all assets of K are publicly traded securities or
  - Grant of a K interest in consideration for services provided to the K.
- Includes goodwill and other intangible property.

Reg. §1.704-1(b)(2)(iv)(f)

§704(b) Economic Effect

Capital account maintenance rules – **revaluation**:

- Must be made for substantial non-tax business purpose.
- Generally advisable to "book up" partners' capital accounts upon acquisition or relinquishment of partnership interest in order to avoid **economic distortions**.
- Warning: Failure to restate or fix with special allocation could have adverse potential tax consequences.
- Optional but very commonly elected.

§704(b) Economic Effect

Capital account maintenance rules – **revaluation**:

- The book-up ensures partners that their capital accounts reflect appreciation in the property that occurred prior to the new partner's entry into the business.
- **Revaluing when a new partner enters protects the economic interests of existing partners by revising the values on which distribution allocations are made, and in many cases determining the liquidation rights of the partners.**
- A book-up may be controversial since the entering partner would have to agree on the booked-up value to be allocated to the existing partners.

§704(b) Economic Effect

Reverse §704(c) built-in gain or loss

- The original partners' capital accounts are adjusted so that their capital accounts equal their share of the FMV of the revalued property plus the FMV of the contributed property. If the revaluation increases the property's value, **the inherent gain should also be allocated to the original partners.**
- As if continuing partners contributed property to a new partnership!
  - Like a §743(b) adjustment to incoming partner, although no new basis created.

Reg. §1.704-1(b)(2)(iv)(f)

Minimum Gain Chargeback

§752 Nonrecourse Debt

- **Three-tier rule under Reg. §1.752-3:**
  1. **Share of §704(b) minimum gain**
  2. **Share of §704(c) minimum gain**
  3. **Share of excess nonrecourse debt**
- **§704(b) minimum gain** = nonrecourse debt > §704(b) book basis (FMV initially).
  Created as property is depreciated below debt.
- **§704(c) minimum gain** = gain that would be allocated if K distributed property in exchange for no consideration other than nonrecourse debt on property.
- **Excess nonrecourse debt** = any debt left.

§752 Nonrecourse Debt

- **Rationale:** Lenders, not partners, bear the economic risk associated with nonrecourse liabilities. However, partners do indeed receive tax benefits (enhanced deductions such as depreciation or credits) as a result of nonrecourse debt.
- Thus, the debt is allocated based on **future gain** that is likely to occur upon satisfaction of the nonrecourse debt (Tier 1 & 2) or in the absence of such a direct link, based on the allocation of overall profits (Tier 3).
- The basis attributable to this debt should inure to partners in the same manner those partners will be allocated profits!

§704(b) Minimum Gain Chargeback

- Allocations of nonrecourse deductions (basically depreciation) **cannot have substantial economic effect** because the creditor alone bears any economic loss attributable to those deductions.
- For allocations of nonrecourse deductions to be respected, additional requirements must be met (past the 3 rules of §704(b)).
- Regs provide a way around this problem with the MGC.
- Nonrecourse deductions must be allocated in accordance with the members' interests in the LLC.

Reg. §1.704-2

§704(b) Minimum Gain Chargeback

- Minimum gain = amount of gain that would be realized if partnership disposed of property subject to nonrecourse debt in satisfaction of the debt only. Gain = Nonrecourse liability > book basis of property, as if foreclosure.
- Nonrecourse deductions are allowed every year to the extent of the net increase in a partner's share of minimum gain.
- If the partner's share of minimum gain **decreases** in a year, the minimum gain chargeback kicks in! **Items of income or gain must be allocated to that partner to cover that net decrease.**

§704(b) Minimum Gain Chargeback

- **Theory: although partners are not personally liable for nonrecourse liabilities, a partner who receives an allocation of a nonrecourse deduction will ultimately be required to recognize a corresponding amount of gain.**