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THE ALLOCATION OF PARTNERSHIP INCOME AND LOSS UNDER §704

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I. Introduction

A. The Statute and Regulations. Section 704(b) provides, inter alia, that a partner’s distributive share of income and loss shall be determined in accordance with the partner’s interest in the partnership if (i) the partnership agreement does not provide as to the partner’s distributive share or (ii) the allocation to a partner under the agreement does not have substantial economic effect.

1. Section 704(b) is effective for partnership taxable years beginning after December 31, 1975.

2. Regulations were proposed on March 9, 1983 and were finalized on December 31, 1985.

3. The final regulations reserved §1.704-1(b)(4)(iv) to deal with deductions attributable to nonrecourse debt. Regulations dealing with this subject, as well as making certain clarifying amendments to the December 31, 1985 regulations, were published on September 9, 1986. T.D. 8099 (Sept. 9, 1986).

B. Theory of Regulations. If a partner benefits economically from an item of income or gain, the item, and thus the corresponding tax burden, must be allocated to him; conversely, if a partner suffers the economic burden of an item of loss or deduction, the item, and thus the corresponding tax benefit, must be allocated to him. In short, tax must follow economics.

II. The Three Tests of the Regulations

A. Generally. An allocation will be valid if it satisfies the requirements of any one of three tests:

1. The allocation has "substantial economic effect";
2. The allocation is in accordance with the partners' interests in the partnership; or

3. The allocation is deemed to be in accordance with the partners' interests in the partnership. Reg. §1.704-1(b)(1)(i).

B. Relationship of Tests. The "substantial economic effect" and the "partners' interests in the partnership" tests share the same premise—that is, items of income or deduction should be allocated to the partners who will bear the corresponding economic benefits or burdens. Application of the two tests will thus generally yield the same result, and they can appropriately be viewed as restatements of each other with the partners' interests in the partnership test to be applied only if the substantial economic effect test is not satisfied in the first instance. The "deemed interest" test, however, performs a function different from the other two in that it provides rules for allocating tax items that have no economic corollary and which, therefore, cannot be allocated in accordance with the basic principle that tax must follow economics. The deemed interest test is particularly significant in three areas:

1. When property is properly reflected in the partners' capital accounts and on the partnership books at a book value different from its tax basis (e.g., because the property has been contributed to the partnership or properly revalued under Reg. §§1.704-1(b)(2)(iv)(d) or 1.704-1(b)(2)(iv)(f)) such that capital accounts are thereafter adjusted for book rather than tax items;

2. The allocation of credits, percentage depletion with respect to zero basis property, and percentage and cost depletion with respect to oil and gas properties;

3. The allocation of deductions attributable to nonrecourse debt.

C. Effective Dates

1. The regulations are effective for partnership taxable years beginning on or after May 1, 1986 (January 1, 1987 for allocations of nonrecourse deductions). Reg. §1.704-1(b)(1)(ii). A pre-May 1, 1986 partnership that has not properly
maintained capital accounts in accordance with the regulations since inception can secure the benefit of the substantial economic effect safe harbor in post-May 1, 1986 years only if (i) partners' capital accounts are adjusted, effective as of the first taxable year for which the regulations are effective, to reflect the fair market value of partnership property as of the first day of such year, or (ii) the difference between the partners' capital account balances and the balances if such capital accounts had been properly maintained are not significant (for example, a failure to have properly accounted for §705(a)(2)(B) expenditures or for §754 elections), and capital accounts are adjusted to conform with the regulations no later than the end of the first partnership taxable year beginning after April 30, 1986. Reg. §1.704-1(b)(2)(iv)(r). Otherwise, the validity of such a partnership's allocations in post-May 1, 1986 years will be determined by reference to the partners' interests in the partnership. Reg. §1.704-1(b)(1)(i). In effect, then, calendar year partnerships will have until April 15, 1988 (the due date for 1987 returns) to decide whether to restate and to reach an agreement regarding the value of the partnership's property as of January 1, 1987.

2. For taxable years beginning before May 1, 1986 and after December 31, 1975, an allocation is valid if it satisfies the regulations or either has "substantial economic effect" or is in accordance with the "partners' interests in the partnership" as such terms have been interpreted by the case law, the legislative history of the Tax Reform Act of 1976, and the regulations in effect before May 1, 1986.

III. Substantial Economic Effect

A. Overview. An allocation has substantial economic effect test if it (i) has economic effect and (ii) such economic effect is substantial. Reg. §1 704-1(b)(2)(i).

B. Economic Effect

1. Generally. An allocation has economic effect if the partnership satisfies the following three requirements:
a. Capital accounts are maintained in accordance with the regulations;

b. Upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions will be made to the partners in accordance with their positive capital account balances; and

c. Partners are required to restore the negative balance of their capital accounts to the partnership upon the liquidation of their interests in the partnership. Reg. §1.704-1(b)(2)(ii)(b).

2. Liquidation. The regulations ignore state law in determining when a partnership or a partner's interest is liquidated. Instead, a liquidation occurs upon the earlier of the date on which a partnership terminates under §708(b)(1)(B) or the date on which the partnership ceases to be a going concern (even though it may continue for purposes of winding up its affairs). Reg. §1.704-1(b)(2)(ii)(g).

a. A determination of whether there has been a liquidation of a partner's interest will generally be made in accordance with Reg. §1.761-1(d) which provides that a person remains a partner as long as the partnership is making liquidating distributions to him. Id.

b. If a liquidation is delayed after a partnership ceases to engage in its primary business activity (i.e., by continuing to engage in a small amount of business activity) for a principal purpose of deferring any liquidating distributions to a partner or deferring a partner's deficit restoration obligation, requirements (2) and (3) of the economic effect test will not be satisfied. Id.

c. The deficit restoration obligation must be satisfied, and liquidating distributions must be made, by the end of the partnership's taxable year in which liquidation occurs or, if later, 90 days after the liquidation. Reg. §1.704-1(b)(2)(ii)(b).
3. Miscellaneous Notes

a. The deficit restoration requirement need not be contained in the partnership agreement if it is imposed by state law. Reg. §§1.704-1(b)(2)(ii)(c)(2); 1.704-1(b)(5), Ex. (4)(ii). But note that the definition of capital account for state law purposes may not be the same as the regulations' definition. It may thus be dangerous to rely on state law to satisfy this requirement.

b. If the first and third requirements of the economic effect test are satisfied but the partnership agreement does not provide for liquidating distributions to be made in accordance with capital accounts, it would seem that the economic effect test will have been satisfied, since the deficit restoration requirement will generally produce a net result identical to distributions in accordance with capital accounts. Reg. §1.704-1(b)(2)(ii)(i).

c. Requirement (2) and (3) of the economic effect test will not be violated if a partner's interest is purchased (other than in connection with the liquidation of the partnership) by the partnership or by one or more partners pursuant to an arm's length agreement between parties with adverse interests so long as a principal purpose of such purchase is not to avoid the underlying principle that "tax follows economics." Reg. §1.704-1(b)(2)(ii)(b).

d. Requirement (2) of the economic effect test will not be violated if, upon the liquidation of a partnership, the partners' capital accounts are increased or decreased as of the date of liquidation to reflect the then fair market value of the partnership's assets (see III.C.4., infra), and the partnership makes liquidating distributions in accordance with the restated capital accounts except for reasonable reserves for liabilities and installment obligations owed to the partnership, so long as such withheld amounts are distributed as soon as practicable and in
the ratios of the partners’ positive capital account balances. Id.

4. **Limited Deficit Makeups--The Alternate Test.** An allocation to a partner will have economic effect absent an unlimited deficit restoration obligation if (i) the first two requirements of the economic effect test are satisfied, (ii) the agreement contains a "qualified income offset," and (iii) the allocation does not reduce the partner’s capital account to a deficit amount greater than his deficit restoration obligation. Reg. §1.704-1(b)(2)(ii)(d).

   a. **Partner’s Share of Minimum Gain.** For purposes of the alternate economic effect test, the amount of a partner’s share of minimum gain (see V.C., infra) is treated as an amount that the partner is obligated to restore to the partnership with respect to a deficit balance in his capital account. Reg. §1.704-1(b)(4)(iv)(f).

   b. **Reasonably Expected Adjustments.** In applying this alternate economic effect test, a partner’s capital account must be reduced by (i) all future "reasonably expected" depletion allowances with respect to partnership oil and gas properties, (ii) all reasonably expected future allocations to him of items of deductions that are required by §§704(e)(2), 706(d) and Reg. §1.751-1(b)(2)(ii), and (iii) all reasonably expected distributions to the extent they will exceed offsetting increases (other than increases pursuant to a minimum gain chargeback) that are reasonably expected to occur during (or prior to) the partnership taxable years in which the distributions are expected to be made. Reg. §1.704-1(b)(2)(ii)(d)(4), (5) and (6). For purposes of determining the amount of expected distributions and expected capital account increases, the "value equal basis" rule of Reg. §1.704-1(b)(2)(iii)(c) applies. As a result, anticipated future cash distributions cannot be offset by the anticipated realization of unrealized gain in the partnership’s assets. See Reg. §1.704-1(b)(5), Ex. 1(vi). It is unclear, however, to what extent the value equals basis rule
should also be taken into account in computing offsetting capital account increases due to projected operating income (as opposed to sale gain). Example (2) of the final regulations indicates that zero-basis property can produce taxable income, although this is clearly inconsistent with the notion (expressly adopted by the regulations) that property with a book value of zero is valueless. Similarly, it is not clear to what extent the value equals basis rule applies in determining reasonably expected distributions.

c. Qualified Income Offset. In order to satisfy the alternate economic effect test, the partnership agreement must contain a "qualified income offset" which assures that, in the event of any unexpected distribution, adjustment or allocation, there will be an allocation of income and gain (consisting of a pro rata portion of each item of income and gain) to the partner that eliminates any resulting capital account deficit "as quickly as possible." Reg. §1.704-1(b)(2)(ii)(d).

(1) An allocation of "bottom line" income or gain is probably not sufficient, for this purpose. Instead, an allocation of partnership gross income and gain appears to be required. Id.

(2) Because the amount of a partner's share of minimum gain is treated as a limited deficit restoration obligation, the qualified income offset need only reduce the deficit balance of the partner's capital account to an amount equal to the sum of (i) his share of minimum gain plus (ii) the amount of any actual deficit restoration obligation imposed on him by the partnership agreement.

5. Notes and Contribution Obligations. A partner who has no deficit restoration obligation is treated as having a limited obligation to restore a deficit to the extent of the principal balance of any promissory note that he contributes to the partnership and any unconditional obligation to make subsequent contributions to the partnership. Reg. §1.704-1(b)(2)(ii)(c).
a. The note or other obligation must require satisfaction by the end of the partnership’s taxable year in which the partner’s interest is liquidated or, if later, within 90 days after the date of liquidation. Id.

b. If the note is negotiable, its principal balance may be treated as a limited restoration obligation even if the note does not provide for acceleration at the time of liquidation if the maker is obligated under the agreement to contribute, on liquidation, the difference between the fair market value of the note and its principal balance. Id. A negotiable note is deemed to have a fair market value at least equal to its principal balance if it bears interest at a rate no less than the applicable federal rate at the time of valuation. Reg. §1.704-1(b)(2)(iv)(d)(2).

c. Notes that are readily tradable on established securities markets are credited to a partner’s capital account at the time of contribution and are not, therefore, taken into account in determining whether a partner has a limited deficit restoration obligation. Id.

d. Note: If a partner has an unlimited deficit restoration obligation, the treatment of notes and fixed contribution obligations is irrelevant to the economic effect test. In the absence of an unlimited deficit restoration obligation, however, notes and fixed contribution obligations may create a limited deficit restoration obligation that will enable losses to be allocated to a partner in excess of his actual contributions if the alternate test for economic effect is satisfied.

C. Maintenance of Capital Accounts. The core of the §704 regulations are the capital account maintenance rules. Both “economic effect” and the “partners’ interests in the partnership” are determined by reference to a capital account analysis.

1. Basic Rules. A partner’s capital account must be credited with the following:
a. The amount of money contributed to the partner;
b. The fair market value of property contributed to the partnership (net of liabilities encumbering the contributed property); and
c. The partner’s distributive share of partnership income and gain (or items thereof), including tax exempt income. Reg. §1.704-1(b)(2)(iv)(b).

A partner’s capital account must be debited with the following:

a. The amount of money distributed to the partner;
b. The fair market value of property distributed to the partner (net of liabilities encumbering the distributed property); and
c. The partner’s distributive share of partnership loss and deduction (or item thereof) and §705(a)(2)(B) items. Id.

There are certain refinements to these rules that should be noted.

a. Money contributed by a partner includes a partner’s assumption of partnership liabilities, and money distributed to a partner includes a partnership’s assumption of a partner’s liabilities, but neither includes changes in a partner’s share of partnership liabilities that result in constructive contributions and distributions under §752(a) and (b). Reg. §1.704-1(b)(2)(iv)(c). Liabilities are “assumed” for this purpose only if the assuming party is subjected to primary and personal liability, the obligee is aware of the assumption and can directly enforce the obligation, and as between the assuming party and the party from whom the liability is assumed, the assuming party is ultimately liable. Id.

b. Section 707(c) guaranteed payments affect capital accounts only to the extent that they affect the partners’ distributive shares of
the partnership's deductions or losses. Reg. §1.704-1(b)(2)(iv)(o).

c. A partner with more than one interest in a partnership has only a single capital account that reflects all such interests, regardless of the class of interest (e.g., general or limited) and regardless of the time or manner in which the interests were acquired. Reg. §1.704-1(b)(2)(iv)(b).

d. Minor good faith errors made by the partnership in maintaining capital accounts will not invalidate allocations. Reg. §1.704-1(b)(2)(iv)(p).

2. Promissory Notes. Unless a promissory note is readily tradable on an established securities market, a contribution of the note to a partnership will not increase the contributing partner's capital account until the partnership makes a taxable disposition of the note or the partner makes principal payments on the note. Reg. §1.704-1(b)(2)(iv)(d)(2). Similarly, except in the case of a liquidation of a partner's interests, the distribution of a partnership's promissory note will not reduce the distributee partner's capital account until there is a taxable disposition of the note by the partner or the partnership makes principal payments on the note. Reg. §1.704-1(b)(2)(iv)(e)(2).

a. If the distribution of the note is made in liquidation of the distributee partner's interest, the partner's capital account will be reduced by the fair market value of the note distributed to him (or by the unsatisfied portion of a note previously distributed to him). Id.

b. The fair market value of a distributed note is deemed to be no less than its outstanding principal balance if it bears interest at a rate no less than the applicable federal rate at the time of valuation. Id.

3. Contributions and Distributions of Property. Under the basic rules (see III.C.1., supra), a partner's capital account must be increased or decreased, as the case may be, by the fair market value of
property contributed by, or distributed to, him. Reg. §1.704-1(b)(2)(iv)(b), (d)(1) and (e)(1).

a. In the case of a distribution of property, the capital accounts of all partners must first be adjusted to reflect the manner in which the unrealized income, gain, loss and deduction with respect to such property (not previously reflected in capital accounts) would be allocated among the partners if there had been a taxable disposition of the property for its fair market value on the date of distribution. Reg. §1.704-1(b)(2)(iv)(e)(1).

b. Section 7701(g) (which provides generally that property encumbered by nonrecourse debt has a value at least equal to the amount of the debt) is applicable in determining the unrealized gain or loss with respect to distributed property for purposes of adjusting the partners' capital accounts prior to the distribution. Id. Section 7701(g) is not applicable, however, for purposes of determining the appropriate capital account adjustments resulting from the distribution of property by, or the contribution of property to, a partnership. Reg. §1.704-1(b)(2)(iv)(d)(1) and (e)(1). See §752(c).

4. Revaluations of Partnership Property. Partners' capital accounts may be adjusted to reflect the revaluation of partnership property (including intangible assets such as goodwill) if the adjustments are made principally for a substantial nontax business purpose either --

a. in connection with the liquidation of the partnership or a contribution or distribution of money or other property as consideration for the requisition or relinquishment of an interest in the partnership; or

b. under generally accepted industry accounting practices if substantially all of the partnership’s property (excluding money) consists of stock, securities, commodities, options, warrants, futures or similar instruments that are readily tradeable on an established securities market. Reg. §1.704-1(b)(2)(iv)(f).
Mechanically, the following steps are required in adjusting capital accounts to reflect a revaluation of property --

a. The adjustments must be based on the fair market value of the partnership's property (taking §7701(g) into account) and must reflect the manner in which unrealized income, gain, loss or deduction with respect to the property would be allocated among the partners if there were a taxable disposition of the property at its fair market value;

b. The partners' capital accounts must be subsequently adjusted for book depreciation, depletion, amortization, gain and loss with respect to the property; and

c. The partners' distributive share of tax items with respect to the property must be determined so as to take into account the resulting book/tax disparities in accordance with the rules of §704(c). Id.

The regulations note that a failure to restate capital accounts or to achieve a similar result through special allocations upon the acquisition or relinquishment of a partnership interest could have substantial adverse tax consequences. Id. This warning is presumably a reference to the capital shift that may result from the failure and the corresponding tax consequences if the shift is attributable to the performance of services or the transfer of property. The regulations also provide that the fair market value assigned to contributed, distributed or revalued property will be regarded as correct if it is reasonably agreed to among partners in arm's-length negotiations and if the partners have sufficient adverse interests. Reg. §1.704-1(b)(2)(iv)(h). If the value is overstated or understated by more than an insignificant amount, the partnership's capital accounts will not be deemed to have been maintained in accordance with the regulations, and its allocation scheme will not have economic effect. Id.

5. Accounting for Book/Tax Disparities. In any case in which there is a book/tax disparity in the basis of partnership property, the principles of §704(c)
govern the partners' distributive shares of tax items with respect to the property, while §704(b) governs the partners' distributive shares of book items. Indeed, the principles of §704(c) are applied to eliminate book/tax disparities without regard to how the disparity arises, including those not within the scope of §704(c) itself, and in such cases, the application of §704(c) principles is a condition to the "safe-harbor" of the §704(b) regulations. Reg. §1.704-1(b)(2)(iv)(g).

a. Book depreciation, depletion or amortization with respect to partnership property with a book/tax disparity in basis must be the amount that bears the same relationship to the book value of the property as the depreciation (or cost recovery deduction), depletion or amortization computed for tax purposes bears to the tax basis of the property. If the property's tax basis is zero, the book depreciation, depletion or amortization may be determined under any reasonable method selected by the partnership. Reg. §1.704-1(b)(2)(iv)(g)(3).

b. Example. A and B form an equal partnership. A contributes $100 cash and B contributes property that has a value of $100 and a tax basis of $50. The property has a 10-year remaining tax life and is being depreciated for tax purposes at a straight-line rate of $5 per year. The partnership has gross income of $10 per year and no deductions other than a depreciation deduction with respect to the contributed property. Under the final (but not the proposed) regulations, the property is required to be recorded on the partnership's books at its fair market value and B receives a corresponding credit to his capital account for such amount. For book purposes, the §704(b) regulations require the partnership to depreciate the asset at the same rate used for tax purposes, i.e., $100 book value divided by 10 year life = $10 annual book depreciation. Under §704(c), however, A, the cash contributing partner, is required, subject to the ceiling rule limitation, to be allocated tax depreciation equal to his share of book depreciation ($5). Thus, A must be allocated all of the tax depreciation, leaving his net
distributive share of taxable income at $0, while B reports $5 of income with no depreciation offset. Thus, although the partnership’s book income is $0, §704(c) effectively forces B to amortize the $50 book/tax disparity over the depreciable life of the property by recognizing $5 of taxable gain annually. If, instead, the property were sold for its book value immediately after the formation of the partnership, §704(c) would eliminate the book/tax disparity by allocating the precontribution gain solely to B.

6. Transfers and Terminations. Upon a sale or exchange of a partnership interest, the capital account of the transferor partner attributable to the transferred interest generally carries over to the transferee. Reg. §1.704-1(b)(2)(iv)(l).

a. If the transfer causes a termination of the partnership under §708(b)(1)(B), the partners’ capital accounts must be adjusted by applying the constructive distribution and contribution rules of Reg. §1.704-1(b)(1)(iv). Thus, the capital account adjustments must reflect the manner in which the unrealized income, gain, loss and deduction with respect to partnership property (not previously reflected in capital accounts) would be allocated among the partners on a taxable disposition of the property for its fair market value at the time of termination. Reg. §1.704-1(b)(2)(iv)(e)(1). The assets of the terminated partnership are then deemed to be distributed to the partners in accordance with their adjusted capital accounts, and a new partnership is deemed to be formed by a constructive contribution of the assets. Reg. §1.704-1(b)(2)(iv)(l); Reg. §1.704-1(b)(5) Ex. (13)(ii) and (iv).

b. Note the probable application of §704(c) to the hypothetical contribution of assets to the new partnership because of the likely difference between the tax basis and book value of the contributed assets.

-14-
7. Optional Basis Adjustments

a. **Section 743(b) Adjustments.** A basis adjustment for a transferee partner under §743(b) has no effect on the capital account of the transferee. Reg. §1.704-1(b)(2)(iv)(m)(2). The same is true with respect to basis adjustments under §732(d). Reg. §1.704-1(b)(2)(iv)(m)(3).

b. **Section 734 Adjustments.** In the case of a distribution of property in liquidation of a partner's interest which results in a §734 basis adjustment, the partner receiving the distribution must receive a corresponding adjustment to his capital account. Reg. §1.704-1(b)(2)(iv)(m)(4). If the distribution is not made in liquidation of a partner's interest, the capital accounts of all partners must be adjusted by their respective shares of the unrealized income or loss that is displaced by the §734 basis adjustment. Id.

(1) The capital account adjustment to reflect a §734 basis adjustment is made only to the extent the basis adjustment can be allocated to one or more items of partnership property under §755. Reg. §1.704-1(b)(2)(iv)(m)(5).

(2) The capital account adjustment can be made only if the §734 basis adjustment results in an increase or decrease in the amount at which property is carried on the partnership's books. Id. Thus, if the book value of partnership property exceeds its tax basis, a basis adjustment to the property may be reflected in the partners' capital accounts only to the extent that the adjustment exceeds the book/tax disparity in the property before the adjustment.

8. **Section 705(a)(2)(B) Expenditures.** Expenditures described in §705(a)(2)(B) must be allocated among the partners and must reduce their capital accounts in the proportion that they bear the economic burden of the expenditures. Reg. §1.704-1(b)(2)(iv)(i)(1). Certain items are specifically
treated as §705(a)(2)(B) expenditures for this purpose:

a. §709 organization and syndication expenses, other than amounts with respect to which 60-month amortization is elected under §709(b), Reg. §1.704-1(b)(2)(iv)(i)(2); and

b. Losses disallowed in connection with the sale or exchange of partnership property under §§267(a)(1) or 707(b). Reg. §1.704-1(b)(2)(iv)(i)(3).

9. Basis Adjustment to §38 Property. Capital accounts must be adjusted by the partners' shares of any upward or downward basis adjustments to partnership property under §48(q)(1) or (q)(3). Reg. §1.704-1(b)(2)(iv)(j).

a. The basis adjustment is shared by the partners in the same proportion as the basis of investment credit property is allocated among them under Reg. §1.46-3(f) or Reg. §1.48-8(a)(4)(iv). Id.

10. Depletion of Oil and Gas Properties. Because of §613A(c)(7)(D), under which depletion and gain or loss with respect to oil and gas properties is calculated at the partner level, "simulated" depletion and gain or loss with respect to such property must be calculated at the partnership level and must be taken into account in computing capital accounts. Reg. §1.704-1(b)(2)(iv)(k)(2).

In this way, the economic effect of the allocation of the basis of partnership property under §613A(c)(7)(D) is tested.

a. In calculating simulated depletion deductions, the partnership may use cost or percentage depletion without regard to restrictions on the use of these methods that may be applicable to particular partners. The method is chosen on a property-by-property basis and, once chosen, is binding for all subsequent taxable years.

b. The partnership's simulated adjusted basis in an oil and gas property cannot be reduced below zero. Id.
c. When an oil and gas property is sold, the partnership's simulated loss is allocated among the partners in proportion to their shares of the amount realized from the property which represents a recovery of the partnership's simulated adjusted basis. Any simulated gain on sale is allocated in proportion to the partners' shares of the amount realized which exceeds the partnership's simulated adjusted basis in the property.

d. Alternatively, the partnership may elect to adjust partners' capital accounts by reference to the actual depletion allowance allocable to each partner. Reg. §1.704-1(b)(2)(iv)(k)(3).

(1) The partnership must determine each partner's depletion allowance for the partner's taxable year that ends with or within the partnership's taxable year. Each partner's capital account is then adjusted by his actual depletion allowance until the total depletion allowance allocable to the partner equals the basis of the property allocated to him. Id.

(2) Upon sale of a property, each partner's capital account is adjusted upward or downward by the difference between his allocable share of the amount realized and his remaining basis in the property.

D. Substantiality

1. Overview. An allocation, to be valid, must have "substantial" economic effect. The regulations articulate the substantiality concept by stating a general rule as to when an allocation will be considered substantial, and providing three specific rules that delineate circumstances under which an allocation will be deemed to be insubstantial even though the general rule might otherwise be satisfied.

2. General Rule. Except as otherwise provided in the substantiality regulations, the economic effect of an allocation is considered 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. Reg. §1.704-1(b)(2)(iii)(a).

3. Shifting Allocations. The economic effect of an allocation of items within a taxable year is not substantial if, at the time the allocation becomes a part of the partnership agreement, there is a strong likelihood that --

a. 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 or decreases that would be recorded if the allocations were not provided for, and

b. The total tax liability of the partners will be less than if the allocations had not been provided for (taking into account the partners' nonpartnership tax attributes). Reg. §1.704-1(b)(2)(iii)(b).

If the consequences described above actually occur, there is a rebuttable presumption that there was a strong likelihood that they would occur. Id.

4. Transitory Allocations. The economic effect of an allocation that will be offset by an allocation in a later year is transitory, and if such allocations reduce the total tax liability of the partners, their economic effect will not be substantial. Reg. §1.704-1(b)(2)(iii)(c).

a. Allocations of losses that may be offset by future allocations of gain from the sale of assets are generally not transitory under the "value equals basis" rule which mandates that the value of partnership property is assumed to be its basis or book value. Id.

b. Loss allocations that will be offset by future income allocations are nevertheless substantial if there is a strong likelihood when the original allocation was made that the offsetting income allocations will not, in large part, occur within five years of the original loss allocations (determined on a first-in, first-out basis). Id. A clarifying
amendment made by T.D. 8099 (Sept. 9, 1986) makes it clear that allocations which are protected from "transitory" status because of the five-year rule will also be presumed to satisfy the general rule set out in paragraph 2 above. Thus, even though the partners may be all but certain that the offsetting income allocations will occur, it is presumed that the original and offsetting allocations will have a reasonable possibility of affecting the dollar amounts to be received by the partners from the partnership. As noted below, however, it is not clear whether the five-year rule also insures compliance with the overall tax effect rule.

5. Overall Tax Effect. The economic effect of an allocation is not substantial if (i) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced, and (ii) there is a strong likelihood that the after-tax consequences of no partner will, in present value terms, be substantially diminished (taking into account the partners' nonpartnership tax attributes). Reg. §1.704-1(b)(2)(iii)(a).

a. Under this rule, the economic effect of an allocation scheme is not substantial even if it significantly affects capital accounts if, after taxes, no partner's situation is worse than it would be in the absence of the allocation. For this rule to be applicable, it would seem, therefore, that the partners must have significantly different nonpartnership tax attributes.

b. The "value equals basis" rule applies for purposes of the overall tax effect rule (as it does to all aspects of the substantiability test), and it should thus protect most gain chargeback allocations Reg. §1.704-1(b)(2)(iii)(c).

c. Whether an allocation scheme that employs a nontransitory five-year operating income chargeback will be similarly protected from the overall tax effect rule is unclear because the clarifying change made by the September 9 amendments purports only to bless such allocations under the general rule of
substantiality, and does not expressly advert to the overall tax effect rule. It is difficult to conceive, however, that Treasury would create a presumption that such allocations offer a reasonable possibility of affecting the dollar amounts to be received by the partners and yet discard the presumption for purposes of the overall tax effect rule.

IV. Partner's Interest in Partnership

A. Generally. If an allocation lacks substantial economic effect, the item in question must be reallocated among the partners in accordance with their interests in the partnership. Reg. §1.704-1(b)(3)(i). The partners' interests are determined on the basis of the manner in which they share the economic benefits and burdens (if any) corresponding to the item being allocated, taking into account all facts and circumstances relating to the partners' economic arrangement. Id.

1. There is a rebuttable presumption that each partner has an equal interest in the partnership at all times. Id.

2. A partner's interest is determined item by item. Thus, a partner with a 50% overall interest in the partnership may have a 90% interest in a particular item of income or deduction. Id.

B. Relevant Factors. The following four facts and circumstances may be relevant to the determination of the partners' interests in a partnership:

1. The partners' relative contributions to the partnership;

2. The partners' interests in economic profits and losses (if different from their interests in taxable income or loss);

3. The partners' interests in cash flow and other nonliquidating distributions; and


C. Special Rule. If a reallocation is caused by the partnership agreement's failure to provide for an unlimited negative capital account restoration
obligation, the partners’ interests in the partnership are determined by comparing (i) the manner in which distributions or contributions would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the taxable year with (ii) the manner in which distributions or contributions would be made on the same sale and liquidation assumption at the end of the prior taxable year. The result is then adjusted to satisfy the requirements of the alternate test for economic effect. Reg. §1.704-1(b)(3)(iii).

V. Nonrecourse Debt

A. Definitions

1. **Nonrecourse Deductions.** The amount of nonrecourse deductions for a partnership taxable year equals the net increase, if any, in the partnership minimum gain during the year. Reg. §1.704-1(b)(4)(iv)(a).

   a. If the partners’ capital accounts are increased under Reg. §1.704-1(b)(2)(iv)(f) to reflect a revaluation of partnership property subject to nonrecourse debt, any decrease in the partnership’s minimum gain attributable to such revaluation is added back to the net increase or decrease otherwise determined. Reg. §1.704-1(b)(4)(iv)(b).

   b. Nonrecourse deductions consist first of depreciation or cost recovery deductions with respect to items of partnership property subject to nonrecourse debt to the extent of the increase in minimum gain attributable to such nonrecourse debt, with the remainder of such nonrecourse deductions, if any, consisting of a pro rata portion of the partnership’s other items of deduction, loss and §705(a)(2)(B) expenditures. If the depreciation and cost recovery deductions exceed the net increase in minimum gain, a proportionate share of each such deduction shall constitute a nonrecourse deduction. And if the increase in minimum gain exceeds the total amount of partnership deductions and §705(a)(2)(B) expenditures, then an amount of such deductions and expenditures equal to such excess constitutes nonrecourse deductions in
succeeding years as if there had been an increase in partnership minimum gain in such succeeding years equal to such excess. Id.

2. Partnership Minimum Gain. Partnership minimum gain is determined by computing, with respect to each nonrecourse liability of the partnership, the amount of gain (of whatever character), if any, that would be realized by the partnership if it disposed of the property subject to the nonrecourse debt in full satisfaction of the debt, and by then aggregating the amounts so computed. Reg. §1.704-1(b)(iv)(c).

a. For this purpose, the adjusted basis of partnership property is allocated among all liabilities (both recourse and nonrecourse) secured by the property in proportion to their outstanding balances after first taking into account the relative priorities of the liabilities. Only the portion of the basis allocated to nonrecourse liabilities is used in computing minimum gain. Id.

b. If partnership property subject to a nonrecourse debt is properly reflected at a book value different from its tax basis, the determination of minimum gain is made with reference to the partnership’s book value. Id.

B. Allocation of Nonrecourse Deductions

1. Requirements. Allocations of nonrecourse deductions are deemed to have been made in accordance with the partners’ interests in the partnership if:

a. The first two requirements of the “substantial economic effect” test are satisfied (i.e., proper maintenance of capital accounts and liquidating distributions in accordance with capital accounts);

b. The partnership agreement provides for the allocation of nonrecourse deductions in a manner that is reasonably consistent with allocations, which have substantial economic effect, of some other significant partnership
item (other than minimum gain) attributable to the property securing the nonrecourse debt;

c. Either the partners are required to restore negative capital accounts or the partnership agreement contains a "minimum gain chargeback"; and

d. All other material allocations and capital account adjustments are recognized under the regulations. Reg. §1 704-1(b)(iv)(d).

2. Consistency Rule.

a. One major departure from the proposed regulations is the "consistency rule" described above. Under the proposed regulations, an allocation of deductions attributable to nonrecourse debt did not have to conform with the allocation of other partnership items. Commentators questioned whether, as a matter of tax policy, partners ought to be permitted to allocate nonrecourse deductions in a manner that was entirely different from their overall interest in other partnership items. and Treasury responded by requiring, as a condition to the availability of the "deemed interest" exception, that nonrecourse deductions be allocated in a manner reasonably consistent with some other significant item attributable to the property securing the debt.

b. The regulations provide some indication of the scope of the consistency rule in Examples (20)(ii) and (iii). In this example, partners A and B agree to share nonrecourse deductions attributable to a building equally, and to share all other income and deductions in a 90/10 ratio until the partnership has recognized income and gain equal to the items of loss and deduction (other than nonrecourse deductions) previously claimed. Thereafter, all partnership items (including nonrecourse deductions) are allocated equally. Under the facts of the example, there is a reasonable likelihood that the partnership will recognize income and gain significantly in excess of the amounts of loss and deduction (other than nonrecourse deductions). The example
concludes that the equal allocation of nonrecourse deductions has substantial economic effect because it is consistent with allocations of other significant partnership items attributable to the building.

c. The example also states that any allocation scheme for nonrecourse deductions ranging from 90% to A and 10% to B, down to 50% to A and 50% to B, would satisfy the consistency requirement, but that a 99%/1% allocation would not. Thus, the example establishes a permissible "consistency zone" by reference to the varying allocation schemes employed by the partners for two other classes of significant partnership items (the first class being income and deductions recognized prior to the flip-flop, which are allocated 90%/10%, and the second class being those items recognized after the flip-flop, which are allocated 50%/50%). By concluding that a 99%/1% allocation is not reasonably consistent with a 90%/10% allocation, the example suggests that only minor variations in the allocation of nonrecourse deductions from the allocation of other significant items will be tolerated. On the other hand, it is likely that a 90%/10% allocation of nonrecourse deductions would not satisfy the consistency requirement if all other partnership items are shared 80%/20% throughout the life of the partnership. Accordingly, the only way to ensure compliance with the consistency requirement is to conform the allocation of nonrecourse deductions precisely to the allocation of other significant partnership items attributable to the property securing the debt.

3. Minimum Gain Chargeback. A partnership agreement contains a minimum gain chargeback if it provides, in the case of a net decrease in minimum gain during a partnership taxable year, that all partners with deficit capital account balances at the end of such year (excluding any negative restoration obligation and any addition to capital accounts resulting from a revaluation of partnership property) will be allocated, before any other allocation is made under §704(b), items of income and gain in the amount and proportions
necessary to eliminate such deficits as quickly as possible. Reg. §1.704-1(b)(iv)(e).

a. For this purpose, the same adjustments must be made to a partner's capital account that are required in applying of the alternate economic effect test. Id, see III.B.4.b., supra.

b. Allocations made pursuant to a minimum gain chargeback are deemed to consist first of gain recognized from the disposition of property subject to nonrecourse debt to the extent of the decrease in minimum gain attributable to such disposition, with the remainder of such minimum gain chargeback, if any, consisting of a pro rata portion of the partnership's other items of income and gain. Id.

C. Partner's Share of Minimum Gain

1. A partner's share of partnership minimum gain at the end of any partnership taxable year equals the aggregate nonrecourse deductions that have been allocated to such partner less such partner's share of the net decrease in partnership minimum gain up to that time. Reg. §1.704-1(b)(iv)(f).

a. A partner's share of the net decrease in minimum gain during a partnership taxable year equals an amount that bears the same relation to the net decrease as such partner's share of partnership minimum gain at the end of the prior taxable year (or, if later, at the time immediately following the last time that capital accounts are increased to reflect a revaluation of partnership property) bears to the amount of partnership minimum gain at the end of such prior taxable year (or such later date). Id.

b. For purposes of the alternate economic effect test, the amount of a partner's share of minimum gain shall be added to the limited dollar amount, if any, that such partner is obligated to restore with respect to any deficit balance in his capital account. Id.
D. Nonrecourse Loans Made by Partners

1. A nonrecourse liability is one with respect to which none of the partners has any economic risk of loss other than through their interests in the partnership assets subject to the liability. Accordingly, deductions attributable to nonrecourse liabilities with respect to which a partner bears the economic risk corresponding to the loss or deduction attributable to such liabilities (e.g., a nonrecourse loan made by a partner) are not governed by the special rules relating to nonrecourse deductions. Instead, such losses and deductions must be allocated in accordance with the partner's interests in the partnership which will require the allocation of such losses and deductions to the partner who bears the economic risk of such losses and deductions (e.g., the lending partner). Reg. §1.704-1(b)(iv)(g).

2. The regulations reserve the treatment of losses and deductions attributable to nonrecourse loans made by a person related to a partner. Reg. §1.704-1(b)(iv)(h).