2006

Partnership Tax Allocation Provisions

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Section 704

Section 704(a)\(^1\) provides that a partner's share of income, gain, loss, deduction or credit shall, except as otherwise provided, be determined by the partnership agreement.\(^2\) Under §704(b), however, the Internal Revenue Service will respect allocations of partnership tax items of income, gain, deduction and loss only so long as (i) they have "substantial economic effect", or (ii) taking into account all facts and circumstances, they are in accordance with the "partner's interest in the partnership" ("PIP").\(^3\)

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\(^1\) All section references, unless otherwise indicated, are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder.

\(^2\) For purposes of this outline, the term "partnerships" shall include general partnerships, limited partnerships, limited liability partnerships, limited liability companies and all other entities classified as partnerships for tax purposes under §301.7701-3 of the Treasury Regulations.

\(^3\) Treas. Reg. §1.704-1(b)(i)(iii), however, reminds us that allocations respected under §704(b) nevertheless may be reallocated under other provisions such as §§482, 704(e)(2) and 706(d).
The §704(b) Safe Harbor

To have substantial economic effect, allocations must have “economic effect” and that economic effect must be “substantial”. To have “economic effect” under the primary economic effect test, (i) the partnership making the allocations must maintain capital accounts according to the provisions in the Treasury Regulations; (ii) the partnership must liquidate according to those capital accounts; and (iii) if a partner has a deficit capital account balance upon liquidation, the partner must be obligated to restore its deficit balance or the partnership must satisfy an alternate test described below. This economic effect test is designed to result in tax allocations that are consistent with the underlying economic arrangement of the partners.

Example 1. A and B form AB Partnership. A contributes $90x to AB Partnership and B contributes $10x to AB Partnership. Under the AB Partnership Agreement, A and B agree to divide profits and share losses equally. The AB Partnership Agreement also provides for (i) the maintenance of partner capital accounts consistent with the Treasury Regulations; (ii) liquidating distributions to partners according to positive partner capital account balances; and (iii) deficit capital account restorations by all partners upon partnership liquidation.

In the first year of the partnership, the partnership experiences a $20x loss. Under the primary test for economic effect described above, the allocation of this loss $10x to A and $10x to B should be respected for tax purposes. In the partnership’s second year, AB Partnership once again experiences a $20x loss. Once again, this time particularly

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because of the deficit capital account restoration provision in the AB Partnership Agreement, the equal allocation of this loss between A and B should be respected for tax purposes notwithstanding the creation of a negative capital account for B. If the AB Partnership Agreement did not contain a deficit capital account restoration provision, however, the allocation of any additional loss to B after the partnership's first year will not have economic effect and therefore will not be respected. Indeed, because B will not bear the economic burden of additional losses after AB Partnership's first year, the entire second year loss must be allocated to A under PIP.

Example 2. The facts are the same as in Example 1 above, except that A and B agree that losses will be allocated entirely to B notwithstanding B's relatively small capital contributions. As a result of this arrangement, the loss of $20x in AB Partnership's first year will be allocated entirely to B under the AB Partnership Agreement. Because B is subject to a deficit capital account restoration provision upon the liquidation of B's interest in AB Partnership, this allocation will have economic effect and should be respected for tax purposes. As a result of the allocation, B's capital account will be reduced from $10x at the beginning of AB Partnership's first year to ($10x) at the end of AB Partnership's first year. Further, because of the deficit capital account restoration provision, B will have to contribute an additional $10x to AB to restore B's deficit capital account if A and B liquidated AB Partnership at the end of AB Partnership's first year.

Example 3. The facts are the same as in Example 1, except that A and B agree that all AB Partnership depreciation will be allocated to B notwithstanding B's relatively small capital contribution. Thus, unlike Example 2 above, A and B agree to specially allocate an item of expense as opposed to a "bottom-line" loss amount. Nevertheless, because the AB Partnership Agreement requires capital account maintenance, liquidation according to positive partner capital account balances and deficit capital account restoration upon liquidation, the allocation of all AB Partnership depreciation to B will have economic effect. On the other hand, if the AB Partnership Agreement did not contain the provisions described above, the allocation of all AB Partnership depreciation to B would be reallocated between A and B based on PIP.
Under an alternate test for economic effect, allocations will be respected if (i) the allocations satisfy the first two requirements of the economic effect test described above; (ii) no allocation is permitted to decrease a deficit balance in a partner’s capital account below the amount the partner is obligated to restore (or is deemed obligated to restore) upon a liquidation of the partnership or upon a liquidation of the partner’s interest in the partnership; and (iii) the applicable partnership agreement contains a “qualified income offset”.

For purposes of this alternate test, a partnership agreement contains a “qualified income offset” if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation or distribution that drives the deficit balance of its capital account below the amount the partner is obligated to restore (or deemed obligated to restore) will be allocated items of income and gain (including gross income) in an amount and in a manner sufficient to eliminate such excess deficit balance as quickly as possible. Because partners generally do not wish to expose themselves to the economic risk of having to restore a deficit capital account upon liquidation, most partnerships seeking to satisfy the substantial economic effect safe harbor attempt to satisfy the alternate test (that is, the test without the deficit capital

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7 Id.
account restoration obligation) as opposed to the primary test (the test with the deficit capital account restoration obligation).

**Example 4.** The facts are the same in Example 1 above, except that instead of having a deficit capital account restoration provision in the AB Partnership Agreement, A and B install (i) a provision limiting the ability of either partner to receive loss allocations that would result in a negative capital account in excess of a partner's actual or deemed obligation to restore a negative capital account; and (ii) a "qualified income offset" requiring AB Partnership to make gross income allocations to any partner who unexpectedly receives loss allocations or distributions that result in a negative capital account in excess of its actual or deemed deficit capital account restoration obligations. Under these facts, the AB Partnership Agreement can satisfy the alternate test for economic effect described above. As a result, the loss allocations to A and B in AB Partnership's first year will have economic effect and should be respected. The loss allocations in year 2 can also be respected. However, the reason why the allocations in the second year can be respected is that the AB Partnership Agreement will allocate those losses entirely to A pursuant to the loss limitation provision described in (i) above.

Allocations failing to satisfy the primary or alternate economic effect tests described above may still satisfy the substantial economic effect safe harbor if they have "economic effect equivalence." Allocations have economic effect equivalence to the extent that they would result each year in the partners receiving the same amounts upon a liquidation of the partnership as they would receive if the partnership actually satisfied the primary or alternate economic effect test. In other words, if the otherwise non-qualifying allocations would not result in a different...

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9 Id.
outcome upon a liquidation of the partnership, there is a no harm, no foul exception for taxpayers. This exception, however, has been referred to by leading commentators as the “dumb but lucky rule” and should not be relied upon outside of extraordinary circumstances.¹⁰

Example 5. A and B form AB Partnership and agree to divide profits and share losses equally. A and B each contribute $50x to AB Partnership. In AB Partnership’s first year, the partnership incurs a loss of $20x and allocates that loss $10x to A and $10x to B. AB’s Partnership Agreement, however, does not provide for the maintenance of capital accounts, liquidations based on positive partner capital accounts, deficit capital account restorations upon partnership liquidation or a qualified income offset. Nevertheless, because AB Partnership’s $20x loss would have been allocated equally between A and B if AB Partnership had actually satisfied either the primary or alternate economic effect test described above, the equal allocation of AB Partnership’s $20x loss between A and B will have economic effect equivalence and, therefore, should be respected.

As stated above, the second part of the substantial economic effect test is the so-called “substantiality requirement”. Under the substantiality requirement, an allocation will be respected as substantial if there is a reasonable possibility that the allocation will offset substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.¹¹ Nevertheless, an allocation will not qualify as substantial if, at the time the allocation becomes part of the partnership agreement, (i) the after-tax economic consequences


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of at least one partner may, in present value terms, be enhanced compared to the consequences if the allocation was not contained in the partnership agreement; and (ii) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to the consequences if the allocation was not contained in the partnership agreement.\textsuperscript{12} In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with the partner's tax attributes that are unrelated to the partnership are taken into account.\textsuperscript{13}

In addition to the general overall substantiality requirement described above, the regulations governing the substantiality requirement set forth two examples of transactions that fail the substantiality test. First, the regulations describe transactions that are referred to as "shifting allocations".\textsuperscript{14} Secondly, the regulations describe a separate set of transactions referred to as "transitory allocations".\textsuperscript{15}

As to shifting allocations, the regulations state that allocations will fail the substantiality test if, at the time they become part of the partnership agreement, there is a strong likelihood that (i) the net increases and decreases that will be

\textsuperscript{12} Id.
\textsuperscript{13} Id.
\textsuperscript{14} Treas. Reg. §1.704-1(b)(2)(iii)(b).
\textsuperscript{15} Treas. Reg. §1.704-1(b)(2)(iii)(c).
recorded in the partners' respective capital accounts for such taxable year will not differ substantially from the net increases and decreases that would be recorded in the partners' respective capital accounts if the partnership agreement did not contain the allocations, and (ii) the total tax liability of the partners (for their respective taxable years in which the allocations apply) is less than if the partnership agreement did not contain the allocations. If, at the end of a partnership taxable year to which an allocation relates, the net increases and decreases that are recorded in the partners' respective capital accounts do not differ substantially from the net increases and decreases that would have been recorded in such partners' respective capital accounts had the partnership agreement not contained the allocation, and the total tax liability of the partners is less that it would have been had the partnership agreement not contained the allocation, it is presumed that, at the time the allocation became part of such partnership agreement, there was a strong likelihood that these results would occur.\footnote{Treas. Reg. §1.704-1 (b)(2)(iii)(b).} This presumption may be overcome by a showing of facts and circumstance that prove otherwise.\footnote{Id.}

**Example 6.** A, an entity that is a tax-exempt under Section 501(c)(3), and B, a taxable entity, form AB Partnership and agree to be equal partners. Based on AB Partnership's investments, A and B are certain that AB Partnership will generate equal amounts of both tax-exempt interest income and taxable interest income. A and B, therefore, agree to allocate all of the tax-exempt interest to B (the taxable entity) and all

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\footnote{Treas. Reg. §1.704-1(b)(2)(iii)(b).} \footnote{Id.}
of the taxable interest to A (the tax-exempt entity). Under the AB Partnership Agreement, (i) AB Partnership will maintain partner capital accounts; (ii) AB Partnership will liquidate according to positive capital accounts; and (iii) AB Partnership will be subject to a loss limitation provision and a qualified income offset.

Because the AB Partnership Agreement contains the economic effect safe harbor provisions described above, AB Partnership's allocations of its tax-exempt and taxable interest will have economic effect. However, because (i) the economic consequences to A and B with the special allocations of tax-exempt and taxable interest in the AB Partnership Agreement will not differ from the economic consequences to the partners if the agreement did not contain the allocations; and (ii) the total tax liability of the partners will be less with the allocations in than agreement than it would be if the agreement did not contain the allocations, the allocations will fall within the description of "shifting allocations" and, therefore, will fail the substantiality requirement. As a result, the amounts will be reallocated between the partners based on the PIP test. Under PIP, each partner will presumably receive equal allocations of both AB Partnership's tax-exempt interest and taxable interest.

As to transitory allocations, if a partnership agreement provides for the possibility that an allocation will be largely offset by another allocation, and, at the time the allocations become part of the partnership agreement, there is a strong likelihood that (i) the net increases and decreases that will be recorded in the partners' respective capital accounts for the taxable years to which the allocations relate will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such years if the partnership agreement did not contain the original allocation and offsetting allocation, and (ii) the total tax liability of the partners (for their respective taxable years in which
the allocations will be taken into account) is less than if the partnership agreement did not contain the allocations; the economic effect of the original allocation and offsetting allocation will not be substantial.\textsuperscript{18} If, at the end of a partnership taxable year to which an offsetting allocation relates, the net increases and decreases recorded in the partners' respective capital accounts do not differ substantially from the net increases and decreases that would have been recorded in such partners' respective capital accounts had the partnership agreement not contained the original allocation and the offsetting allocation, and the total tax liability of the partners is less than it would have been had the partnership agreement not contained such allocations, it will be presumed that, at the time the allocations became part of the partnership agreement, there was a strong likelihood that these results would occur.\textsuperscript{19} Similar to the shifting allocation presumption described above, this presumption may be overcome by a showing of facts and circumstances proving otherwise.\textsuperscript{20}

**Example 7.** A, a corporate entity with an expiring net operating loss, and B, an individual, form AB Partnership. To allow A to take advantage of its net operating loss before it expires, A and B agree to specially allocate an amount of first-year income equal to the expiring net operating loss to A. Further, in AB Partnership's second year, A and B agree that AB Partnership will make a comparable special allocation to income to B to offset the effect of the first year special allocation.

\textsuperscript{18} Treas. Reg. §1.704-1(b)(2)(iii)(c).

\textsuperscript{19} Id.

\textsuperscript{20} Id.
allocation to A. To ensure that neither partner will be economically harmed, AB Partnership invests in assets that will generate sufficient amounts of income in each of AB Partnership's first two years to satisfy both special allocation amounts described above.

Under the AB Partnership Agreement, (i) AB Partnership will maintain partner capital accounts; (ii) AB Partnership will liquidate based on positive capital accounts; and (iii) the partners of AB Partnership will be subject to a loss limitation provision and a qualified income offset. Because the AB Partnership Agreement contains these economic effect safe harbor provisions, the special allocations of income to A and B will have economic effect. Nevertheless, (i) because the economic consequences to A and B with the allocations (taking both years into account) in the AB Partnership Agreement will not differ from the economic consequences to the partners if the agreement did not contain the allocations (again, taking both years into account); and (ii) the total tax liability of the partners will be less with the allocations than it would be without the allocations, the allocations will fall within the description of “transitory allocations” and, therefore, will fail the substantiality requirement. As a result, the amounts will be reallocated between the partners based on PIP. Under PIP, each partner's special allocation presumably will be ignored.

Notwithstanding the discussion above, the original allocation will not be insubstantial (and therefore it will be presumed that there is a reasonable possibility that the allocations will affect substantially the dollar amounts to be received by the partners) if, at the time the allocations become part of the partnership agreement, there is a strong likelihood that the offsetting allocation will not, in large part, be made within five years after the original allocation is made.²¹

For purposes of applying these provisions, the adjusted tax basis of partnership property (or, if partnership property is properly reflected on the books of the

²¹ Id.
partnership at a book value differing from its adjusted tax basis, the book value of such property) will be presumed to be the fair market value of such property. This final provision is often referred to as the "value equals basis" rule.\textsuperscript{22}

\textbf{The PIP Test}

If allocations of items fail to satisfy the substantial economic effect test, the government will reallocate the items to the extent necessary to correspond with PIP. Under the PIP test, tax items are shared among partners based on their overall economic arrangement, taking into account all facts and circumstances.\textsuperscript{23} PIP provides very few bright line rules. Nevertheless, if partnership allocations satisfy the first two prongs of the economic effect test but fail to satisfy the third prong of that test (relating to deficit capital accounts), the PIP test generally will determine a partner's interest by comparing (a) the manner in which the partnership would make distributions and receive contributions if it sold all of its property and immediately liquidated following the end of the year with (b) the manner in which the partnership would have made distributions and received contributions if it sold all of its property

\textsuperscript{22} Id.

\textsuperscript{23} Treas. Reg. §1.704-1(b)(3)(i). The PIP test begins with a presumption that all partner interests are equal on a per capita basis. However, taxpayers or the government may rebut this presumption by establishing facts and circumstances showing that a different result is appropriate. Note that recently proposed regulations propose removing this presumption altogether.
and immediately liquidated following the end of the prior year, after making certain adjustments. 24

Both the substantial economic effect test and the PIP test are intended to match allocations of income and loss with economic benefits and burdens. Thus, because both tests have the same ultimate objective, the PIP test will often place the taxpayer in the same position it would have been in had it satisfied the substantial economic effect test in the first place. The substantial economic effect test, however, provides taxpayers with the certainty of a safe harbor as well as the accompanying benefits of other favorable rules. The PIP test, on the other hand, exposes taxpayers to the unpredictability of a facts and circumstances test that very few tax experts are comfortable applying. Based on the principles described above, many taxpayers seek to satisfy the substantial economic effect test if they can. For the reasons discussed immediately below, however, a growing percentage of taxpayers do not concern themselves with satisfying the substantial economic effect test.

Indeed, although the substantial economic effect safe harbor clearly provides taxpayers with the benefits of certainty, it often concerns taxpayers for at least three major reasons. First of all, many taxpayers simply do not understand capital accounts or the significance of income and loss allocations. Without this understanding, they often have great difficulty signing documents overflowing with

references to capital accounts and citations to the §704 regulations. In these situations, taxpayers are likely to walk away from their transactions less than fully satisfied, even if their transactions go forward.

Secondly, although taxpayers often do not understand capital accounts, they often are comfortable with common corporate provisions. As a result, they often prefer including the equivalent of corporation distribution provisions in their partnership agreements. The substantial economic effect test does not have a corporate equivalent. Many taxpayers, therefore, may resist including language in their agreements necessary to meet the test. Instead, they will often lobby for distribution provisions similar to those commonly found in corporate documents.

Finally, taxpayers typically do not want mistakes or unexpected interpretations of the §704(b) regulations to alter their economic arrangement. If capital accounts and allocations ultimately govern distributions, a mistake in making allocations can have serious business repercussions. Further, if an unexpected interpretation of the allocation regulations ultimately can affect the overall business arrangement, partners seeking the benefit of the safe harbor effectively will permit those with authority over interpreting those regulations (that is, the government or the courts) to disturb their business deal.

In response to these concerns (as well as others), many partnership agreements have adopted approaches allowing distributions of cash and property to
determine allocations of income and loss. These alternative approaches often will not satisfy the substantial economic effect safe harbor and, therefore, will be subject to the PIP test. Nevertheless, the approaches allow taxpayers to focus solely on the distribution provisions of their agreements; provisions that they generally believe they understand very well. Further, these approaches often mirror common provisions found in corporate documents. Finally, taxpayers often feel comfortable that, under these alternative approaches, mistakes in making allocations or unexpected interpretations of the allocation regulations ultimately will not affect their economic results.

**Nonrecourse Deductions**

Special rules apply to losses and deductions attributable to partnership nonrecourse liabilities (so-called “nonrecourse deductions”). Under the regulations, allocations of nonrecourse deductions cannot have economic effect because the nonrecourse creditor bears the economic burden that corresponds to such allocations.\(^{25}\) Nonrecourse deductions, therefore, must be allocated according to PIP.\(^{26}\) However, allocations of nonrecourse deductions will be deemed to be in accordance with PIP if they satisfy a special safe harbor test. Otherwise, they will be

\(^{25}\) Treas. Reg. §1.704-2(b)(1).

\(^{26}\) Id.
reallocated to conform to the uncertainties of the PIP test based on all of the applicable facts and circumstances.

The applicable safe harbor for nonrecourse deductions is contained in Treasury Regulation §1.704-2(e). Under that regulation, allocations of nonrecourse deductions will be deemed to be in accordance with PIP only if (i) throughout the full term of the partnership, the partnership satisfies the first three requirements of the economic effect test (that is, maintaining capital accounts, liquidating according to positive capital accounts, and partners with deficit capital accounts agree to an unconditional deficit restoration obligation or a qualified income offset); (ii) beginning in the first taxable year of the partnership in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, the partnership agreement provides for allocations of nonrecourse deductions in a manner that is reasonably consistent with allocations having substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities; (iii) beginning in the first taxable year the partnership has nonrecourse deductions, and thereafter throughout the full term of the partnership, the partnership agreement contains a minimum gain chargeback (described below); and (iv) all other material allocations and capital account adjustments under the partnership agreement are recognized under the Treasury Regulations.
For purposes of this requirement, partnership minimum gain equals the aggregation of all partnership gain that the partnership will realize if it disposed of all of its properties subject to nonrecourse liabilities. Further, for any partnership taxable year, the net increase or decrease in partnership minimum gain is determined by comparing partnership minimum gain on the last day of the immediately preceding taxable year with partnership minimum gain on the last day of the current taxable year.

**Example 8.** A and B form AB Partnership as equal partners to purchase an office building for rent. A and B each contribute $10x to AB Partnership and AB Partnership borrows an additional $80x from an unrelated bank on a nonrecourse basis to purchase a $100x office building. For the sake of simplicity, assume (i) that the office building is depreciable over 40 years; (ii) AB Partnership generates income each year equal to all of its expenses other than depreciation; and (iii) AB Partnership makes no principal payments on the nonrecourse debt. Based on these assumptions, AB Partnership incurs a net loss in each year equal to its depreciation amount (that is, $2.5x per year).

During AB Partnership's first 8 years, its depreciation deductions (which total $20x) will not qualify as nonrecourse deductions because they will not reduce the basis of the office building (which is initially $100x), below the nonrecourse debt which encumbers the building (that is, $80x). In year 9, however, the basis of the office building will be reduced from $80x to $77.5x while the nonrecourse debt encumbering the office building remains at $80x. AB Partnership's depreciation deduction in year 9, therefore, will be attributable to AB Partnership's nonrecourse borrowing and will qualify as a nonrecourse deduction. AB Partnership's minimum gain at the end of year 9, moreover, will equal $2.5x (the minimum amount of gain AB Partnership

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28 Id.
Partnership would recognize if the partnership sold or otherwise transferred the office building in a taxable transaction).

As described above, AB Partnership’s depreciation deduction in year 9 cannot have economic effect because the nonrecourse lender ultimately bears the risk that the value of office building will not be sufficient to satisfy the lender’s debt amount. Nevertheless, if AB Partnership satisfies the nonrecourse deduction safe harbor described above, its allocations of nonrecourse deductions to A and B will be deemed to be in accordance with PIP. Alternatively, if AB Partnership does not satisfy the nonrecourse deduction safe harbor described above, its allocations of nonrecourse deductions to A and B will be subject to the uncertainties of the PIP test.

For most practitioners, the most significant element of the nonrecourse deduction safe harbor is the minimum gain chargeback requirement. To satisfy the minimum chargeback requirement, if there is a net decrease in partnership minimum gain for a partnership taxable year, each partner must be allocated items of partnership income and gain (including gross income) for that year equal to that partner’s share of the net decrease in partnership minimum gain. This minimum gain chargeback provision has the effect of making partners very sensitive to reductions in partnership nonrecourse debt.

**Partnership Nonrecourse Deductions**

Separate special rules also apply to losses and deductions attributable to otherwise nonrecourse partnership liabilities (“partner nonrecourse liabilities”) for which a particular partner of the partnership bears the economic risk of loss (so-
called “partner nonrecourse deductions”). Common circumstances which often give rise to partner nonrecourse deductions include guarantees by partners of otherwise nonrecourse partnership debt and cases where a partner itself makes an otherwise nonrecourse loan to the partnership.

Under the regulations, partner nonrecourse deductions must be allocated entirely to the partner that bears the economic risk of loss for a partner nonrecourse liability. Further, if more than one partner bears the economic risk of loss on a partner nonrecourse liability, any partner nonrecourse deductions attributable to that liability must be allocated among the partners according to the ratio in which they bear the economic risk of loss. For this purpose, if partners bear the economic risk of loss for different portions of a liability, each different portion is treated as a separate partner nonrecourse liability.

For any partnership taxable year, the amount of partner nonrecourse deductions generally equals the net increase during the year in minimum gain attributable to the partner nonrecourse debt (“partner nonrecourse debt minimum gain”). In determining partner nonrecourse debt minimum gain and the net gain, see Treas. Reg. §1.704-2(f).

Id.
Id.
increases or decreases in such minimum gain, rules similar to the rules described above for "regular" partnership minimum gain will apply.\textsuperscript{34} Further, a comparable minimum gain chargeback automatically applies.\textsuperscript{35} As a result, if during a partnership taxable year there is a net decrease in partner nonrecourse debt minimum gain, any partner with a share of that partner nonrecourse debt minimum gain as of the beginning of the year must be allocated items of income and gain (including gross income) for the year (and, if necessary, for succeeding years) equal to that partner's share of the decrease in the partner nonrecourse debt minimum gain.\textsuperscript{36}

**Example 9.** The facts are the same as in Example 8 above, except that A personally guarantees the $80x nonrecourse debt encumbering the office building. Under these facts, AB Partnership's $2.5x depreciation deduction in year 9 will qualify as a partner nonrecourse deduction because it is attributable to an otherwise nonrecourse liability for which a partner (in this case, A) bears the economic risk of loss. The $2.5x depreciation deduction, therefore, must be allocated entirely to A. Partnership nonrecourse debt minimum gain at the end of year 9, moreover, will equal $2.5x (the minimum amount of gain AB Partnership would recognize if the partnership sold or otherwise transferred the office building in a taxable transaction). Under the partner nonrecourse debt minimum gain chargeback provision described above, AB Partnership will be required to allocate this minimum gain amount back to A upon a taxable disposition of the office building.

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\textsuperscript{34} Treas. Reg. §1.704-2(i)(3).
\textsuperscript{35} Treas. Reg. §1.704-2(i)(4).
\textsuperscript{36} Id.
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