

Tax Provisions of Partnership and LLC Agreements: Learning to Read and Write Again

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Introduction

- Understand the partners and their tax characteristics.
- Learn the general economics/business deal (e.g., capital commitments, preferred versus common interests, compensatory interests, distributions (including tax distributions), special partners, etc.).
- Create an everyday working relationship, therefore needs to be cooperative in addition to adversarial.

Review the Cash Flow and Allocations

- Terms of preferred interests.
- Operating versus liquidating distributions.
- Other:
 - Tax distributions.
 - Capital calls and partner loans.

Types of Preferred Interests

- Distribution-based preferred.
 - Liquidate with cash waterfall.
 - Preferred return typically paid even if there is no net profit.
- Section 704(b) allocation-based preferred.
 - Liquidate with section 704(b) capital accounts.
- Guaranteed payments.
 - Not part of profit and loss allocation section.
 - Separate section generally referencing section 707(c) and providing specific interest like return to preferred partner.

Tax Distributions

- Many agreements contain minimum distributions to a partner to ensure that it has sufficient funds to satisfy taxes relating to its share of partnership income.
- Typically documented as an advance on the partner's rights under the more general distribution provisions. Sometimes distributions are treated as a loan to the partner.
- Generally equal to share of net income multiplied by maximum applicable rate for type of income.
 - Variables: Actual versus assumed rates, partners subject to different tax rates, losses followed by profits, quarterly versus annual distributions.

Liquidation Alternatives

- This section may be the key to learning whether the agreement intends to follow the regulatory book allocation safe harbors.
- An agreement likely follows safe harbors if, after paying creditors and setting up reserves, the agreement distributes the remaining proceeds according to the partners' positive capital accounts.
- If the agreement instead liquidates with a cash waterfall, then the agreement must rely on a more limited tax safe harbor to get comfort that the IRS will respect the income and loss allocations (the partners would receive the same economic distributions as had they liquidated in accordance with each partner's capital account).
 - This would occur, for example, in a simple 50-50 partnership where all capital is contributed equally and all profits, losses, and distributions are shared equally.

Be Aware of the Tax Ramifications of Entry and Operations

- If built-in gain or loss property is contributed, understand and evaluate.
 - Disguised sale potential.
 - Built-in gain/loss allocations.
- Will special allocations be respected for tax purposes?
- Will income cause problems for certain partners?
 - Unrelated business taxable income for tax-exempt partners?
 - Effectively connected income or FIRPTA ramifications for foreign partners?

Elections and Audits

- **Elections:** Agreement should address how partnership-level tax elections are made. The two main elections unique to partnerships relate to section 754 inside basis adjustments and section 704(c) allocations of built-in gains or losses among the partners.
- **Audits:** Tax Matters Partner (TMP) generally represents the partnership before the IRS and in federal civil tax litigation and is required to keep the other partners informed. Generally, the TMP must be a manager and member.
 - Although the identity and authority of the TMP may sound boring, it is often a critical question when later controversy arises and the details are often overlooked in the drafting process.

Accounting, Books, and Records

- Typical items included in this section are:
 - annual and quarterly reporting of financial information to the partners,
 - who prepares the tax returns and what is the deadline for providing this information to the partners, and
 - who will serve as the TMP, and its specific authority.

Special Partners

- REITs
- Tax-Exempts
- Foreign Partners

REIT Partners

- Where one of the members is a REIT, it will seek to impose the following types of restrictions on the joint venture's operations in order to ensure compliance with the REIT requirements:
 - Real estate asset holding and income limitations;
 - No prohibited transactions (e.g., condo sales);
 - Limitations on loans (mezz debt or secured by real property);
 - Limitations on leases (related party and personal property restrictions); and
 - Arm's-length transactions with REIT owners.

Tax-Exempt Partners

- Tax-exempt entities are generally subject to the unrelated business income tax for investment returns funded with “acquisition debt.” However, there is a Real Estate Financing Exception for “qualified organizations” that use specific types of debt to acquire or improve real property.
- To meet the Real Estate Financing Exception, qualified organizations who invest through a partnership must meet the Fractions Rule.
- To be Fractions Rule compliant, partnership allocations must satisfy the following two requirements on actual and prospective basis:
 - **Safe harbor allocations:** The most significant economic factor in satisfying these rules is that the partnership liquidate with positive capital accounts in lieu of a cash waterfall.
 - **Disproportionate allocation rule:** A qualified organization’s share of overall income for any year cannot exceed its lowest share of overall loss for any year.

Foreign Partners

- Partnerships are required to withhold taxes on a foreign investor's share of real estate income because special "FIRPTA" rules treat the partner's income from real estate as subject to U.S. taxation even if the income is not otherwise subject to U.S. tax.
- A partnership agreement typically treats this withholding as a partner distribution or loan.
- Certain partners may be subject to reduced withholding, but the partnership should require the partner to provide specific documentation to the partnership to receive the reduced rate.

Example 1: Capital Account Basics

Section 704(b)

Property contribution; income allocation; distribution

- Facts: A contributes Building with \$100 gross fair market value, subject to \$30 of debt. In year one the partnership allocates \$10 of section 704(b) book income to A and distributes \$4 of cash to A.

	Effect on Capital Account	Ending Capital Account
Increase by net FMV of property contributed	+\$70	\$70
Increase by income allocation	+\$10	\$80
Decrease by distributions	-\$4	\$76

Tax Allocations – sections 704(b) and 704(c)

- How taxable income and loss are shared among the partners.
- Most of the allocation language relates to the economic/book allocations and in general taxable income will follow these book allocations.
- If a partner contributed an asset with built-in appreciation or depreciation, special rules require that such built-in tax gain or loss is allocated back to the contributing partner.

Tax Allocations – section 704(b)

- Partnership agreements typically break the book allocations down into two sections.
- The primary allocation section describes the general business deal, such as allocating profits in accordance with relative capital or profit percentages (i.e., “Percentage Interests”).
- The second section (regulatory allocations) overrides the first section and is designed to comply with the book income tax regulatory safe harbors.

Tax Allocations – section 704(b)

- The tax allocations will not be respected if the agreement liquidates with a waterfall and the partners' economic rights under the waterfall are different from their rights based on their capital accounts.
 - The taxable income or loss will be re-allocated so that the capital accounts and the waterfall rights are consistent.
- Example - tax allocations send all \$100 of section 704(b) income to Partner A and none to Partner B. A's capital account increases by all \$100 and B's capital account remains constant. If the waterfall provides that the cash corresponding to that profit is shared \$50 each by A and B, then the IRS will not respect the tax allocation and will reallocate \$50 of income to B.
- To avoid inconsistencies between tax allocations and the partners' rights under the waterfall, many partnership agreements simply use a Target allocation (allocates book income or loss among the partners using a formula that causes the partners' capital accounts to equal the amounts the partners would receive under the waterfall).

Tax Allocations – section 704(c)

- “Section 704(c)” generally requires the partnership to allocate built-in gain or loss back to the contributing partner.
- Partnership agreements typically include only a single paragraph to cover these allocations and often simply repeat the general statutory requirement that tax allocations take into account a partner’s potential built-in tax gain or loss on contributed property.
- For many partnerships (including many real estate partnerships), this provision is highly negotiated and includes much more detail relating to which of several alternative methods is chosen to allocate non-economic taxable income or loss.

Example 2: Target Allocations

Section 704(b)

Basic Facts

- LP and GP contribute \$90 and \$10, respectively.
- The distribution waterfall
 - Cash is paid first to return contributed capital plus a 10% annual preferred return
 - Cash paid 80:20 to LP and GP, respectively.
- The partnership earns \$20 of income in year one.

Waterfall & Target Allocation

	LP	GP	Total
Return of capital	90	10	100
Preferred return	9	1	10
Residual return	8	2	10
Total	107	13	120

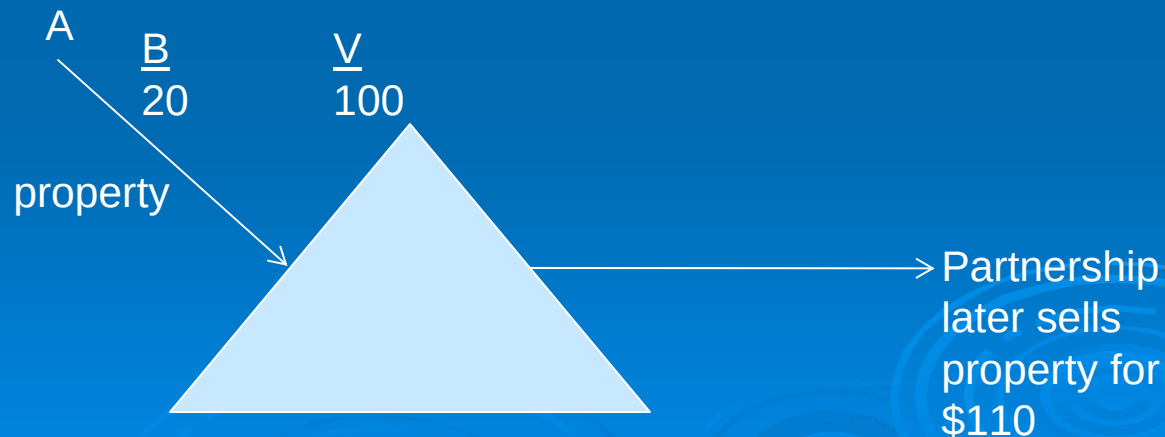
A typical target allocation provision would allocate the \$20 of year one earnings to “fill up” the LP and GP opening capital accounts (\$90 and \$10, respectively) to equal their Target rights under the Waterfall (\$107 and \$13, respectively).

	LP	GP	Total
Beginning	90	10	100
Ending	107	13	120
Target	17	3	20

Example 3: 704(c) Basics

Facts: Partner A contributes property with a tax basis of \$20 and a value of \$100 and the partnership sells the property for \$110.

- 704(c) effect: The partnership must allocate the first \$80 of tax gain to Partner A because that represents the inherent built-in gain.



Built-in Gain/Loss Boilerplate

- **Section 704(c) Allocations.** In accordance with Section 704(c) of the Code and the Regulations thereunder, income, gain, loss and deduction with respect to any property contributed to the capital of the Partnership shall, solely for tax purposes, be allocated among the Partners under any reasonable method selected by the General Partner so as to take account of any variation between the adjusted basis of such property to the Partnership for federal income tax purposes and its initial Book Value. If the Book Value of any Partnership asset is adjusted pursuant to clause (c) or (d) of the definition thereof, subsequent allocations of income, gain, loss and deduction with respect to such asset shall take account of any variation between the adjusted basis of such asset for federal income tax purposes and its Book Value in the same manner as under Section 704(c) of the Code and the Regulations thereunder. Any elections or other decisions relating to such allocations shall be made by the General Partner in a manner that reasonably reflects the purpose and intention of this Agreement. Allocations pursuant to this section are solely for purposes of federal, state and local taxes and shall not affect, or in any way be taken into account in computing, any Partner's Capital Account or share of Profits, Losses, other items or distributions pursuant to any provision of this Agreement.

Example 4: Partnership Nonrecourse Deductions

- A and B each contribute \$100 to a 50-50 partnership and have no obligation to restore negative capital accounts. The partnership borrows \$800 from an unrelated lender on a nonrecourse basis using an interest-only loan and buys Building for \$1,000. The partnership depreciates Building by \$100 a year. After the third year, the partnership has depreciated the initial \$1,000 of section 704(b) basis in Building down to \$700.

Computation of Minimum Gain

	Adjustment	Section 704(b) Value	Nonrecourse debt	Minimum gain
Purchase date		\$1,000	\$800	\$0
Year 1 depreciation	(\$100)	\$900	\$800	\$0
Year 2 depreciation	(\$100)	\$800	\$800	\$0
Year 3 depreciation	(\$100)	\$700	\$800	\$100

Capital Accounts, Minimum Gain, and Adjusted Capital Accounts

	A capital	A minimum gain	A's Adjusted Capital Account	B capital	B minimum gain	B's Adjusted Capital Account
Initial	\$100	\$0	\$100	\$100	\$0	\$100
Year 1	\$50	\$0	\$50	\$50	\$0	\$50
Year 2	\$0	\$0	\$0	\$0	\$0	\$0
Year 3	(\$50)	\$50	\$0	(\$50)	\$50	\$0

What Does The Tax Boilerplate Actually Mean?

- A. Boilerplate Provisions – Capital Accounts
 - Capital Accounts
 - Depreciation
 - Book Value
 - Profit and loss

Capital Accounts

“**Capital Account**” shall mean, with respect to any Partner, the capital account on the books of the Partnership which shall initially be zero and which shall be maintained in accordance with the following provisions:

(a) To each Partner’s Capital Account there shall be credited the aggregate amount of cash and initial Book Value of any property contributed by such Partner to the Partnership, such Partner’s distributive share of Profits and any items in the nature of income or gain which are specially allocated pursuant to Article ____ and the amount of any Partnership liabilities assumed by such Partner or which are secured by any Partnership property distributed to such Partner.

(b) To each Partner’s Capital Account there shall be debited the amount of cash and the Book Value of any Partnership property distributed to such Partner pursuant to any provision of this Agreement or deemed distributed pursuant to Section ____, such Partner’s distributive share of Losses and any items in the nature of expenses or losses which are specially allocated pursuant to Article ____, and the amount of any liabilities of such Partner assumed by the Partnership or which are secured by any property contributed by such Partner to the Partnership.

Capital Accounts

- (c) If any interest in the Partnership is transferred in accordance with the terms of this Agreement, the transferee shall succeed to the Capital Account of the transferor to the extent it relates to the transferred interest.
- (d) In determining the amount of any liability for purposes of determining Capital Account balances hereof, there shall be taken into account Section 752(c) of the Code and any other applicable provisions of the Code and Regulations.
- The foregoing provisions and the other provisions of this Agreement relating to the maintenance of Capital Accounts are intended to comply with Section 1.704-1(b) of the Regulations, and shall be interpreted and applied in a manner consistent with the Regulations.

Depreciation

- **“Depreciation”** shall mean, for each Partnership Year, an amount equal to the depreciation, amortization or other cost recovery deduction allowable with respect to an asset for such year, except that if the Book Value of an asset differs from its adjusted basis for federal income tax purposes at the beginning of such year, **Depreciation shall be an amount which bears the same ratio to such beginning Book Value as the federal income tax depreciation, amortization or other cost recovery deduction for such year bears to such beginning adjusted tax basis;** provided, however, that if the adjusted tax basis of such property is zero, Depreciation shall be determined with reference to such beginning Book Value using any reasonable method selected by the General Partner.

Example 5: Depreciation Calculation

- **Facts:** Partner A contributes a depreciable property to partnership. The property is five-year recovery property purchased two years ago having a current value of \$600 and a remaining tax basis of \$300.
- **Results:** Book depreciation and tax depreciation will differ because the book value of \$600 at the time of contribution differs from the tax basis of \$300 at that time.

Depreciation: Results

- With three years remaining to depreciate the second property for tax purposes, tax depreciation will equal $\frac{1}{3}$ of the remaining tax basis for each of the next three years (or \$100 each year). Book depreciation, therefore, also will equal $\frac{1}{3}$ of the book basis for each of the next three years (or \$200 each year).

	Tax	Book
Total tax	300	
Remaining Tax Life	3	
Tax/year	100	
Total book		600
Remaining tax life		3
Book/year		200

Book Value

- **“Book Value”** shall mean, with respect to any asset, the asset’s adjusted basis for federal income tax purposes, except as follows:
 - (a) the initial Book Value of any asset contributed by a Partner to the Partnership shall be the gross fair market value of such asset at the time of such contribution as determined in good faith by the General Partner;
 - (b) the Book Values of all Partnership assets may, in the sole discretion of the General Partner, be adjusted to equal their respective gross fair market values, as reasonably determined by the General Partner, as of the following times: (i) the acquisition of an additional interest in the Partnership by any new or existing Partner in exchange for more than a de minimis Capital Contribution; (ii) the distribution by the Partnership to a Partner of more than a de minimis amount of Partnership property as consideration for an interest in the Partnership; and (iii) the liquidation of the Partnership within the meaning of Section 1.704-1(b)(2)(ii)(g) of the Regulations or as otherwise provided in the Regulations;

Book Value - Continued

- (c) the Book Value of any Partnership asset distributed to any Partner shall be the gross fair market value of such asset on the date of distribution, as reasonably determined by the General Partner; and
- (d) the Book Values of Partnership assets shall be increased (or decreased) to reflect any adjustments to the adjusted basis of such assets pursuant to Section 734(b) or 743(b) of the Code, but only to the extent that such adjustments are taken into account in determining Capital Accounts pursuant to Section 1.704-1(b)(2)(iv)(m) of the Regulations and Article ____; provided, however, that Book Values shall not be adjusted pursuant to this clause (d) to the extent the General Partner determines that an adjustment pursuant to clause (b) above is necessary or appropriate in connection with a transaction that would otherwise result in an adjustment pursuant to this clause (d).
- If the Book Value of an asset has been determined or adjusted pursuant to clause (a), (b) or (d) above, such Book Value shall thereafter be adjusted by the Depreciation taken into account with respect to such asset for purposes of computing Profits and Losses.

Example 6: Book Value Calculation

FACTS:

- Partner A contributes nondepreciable property with a fair market value of \$500 and a tax basis of \$200 to a partnership. Under these facts, the initial Book Value of the contributed property will equal \$500.
- At a time when the property has increased in value to \$800, the partnership “books-up” its assets pursuant to Regulations Section 1.704-1(b)(2)(iv)(f).

Book Value: Results

- The partnership is treated as if it sold the contributed asset for an amount equal to its fair market value (that is, \$800) at the time of the book-up. The resulting \$300 in book gain (\$800 new Book Value minus \$500 initial Book Value) is treated as an item of profit in determining overall partnership profit or loss.
- Going forward, the property will remain on the books of the partnership with an \$800 book value until it is adjusted again or disposed of. If the property is depreciable, the partnership would reduce its Book Value of \$800 by book depreciation taken on the asset pursuant to a Depreciation definition included in the partnership agreement.

Profit and Loss

- “Profits” and “Losses” shall mean, for each Partnership year (or portion thereof), **an amount equal to the Partnership’s taxable income or loss** for such year (or portion thereof), determined in accordance with Section 703(a) of the Code (for this purpose, all items of income, gain, loss or deduction required to be stated separately pursuant to Section 703(a)(1) of the Code shall be included in taxable income or loss), **with the following adjustments**:
 - (a) **any income of the Partnership that is exempt** from federal income tax and not otherwise taken into account in computing taxable income or loss shall be added to such taxable income or loss;
 - (b) any **expenditures of the Partnership described in Section 705(a)(2)(B)** of the Code or treated as such expenditures pursuant to Section 1.704-1(b)(2)(iv)(i) of the Regulations, and not otherwise taken into account in computing Profits or Losses shall be subtracted from such taxable income or loss;
 - (c) if the Book Value of any Partnership asset is adjusted pursuant to clause (b) or clause (d) of the definition of Book Value herein, the amount of such adjustment shall be taken into account as gain or loss from the disposition of such asset for purposes of computing Profits or Losses;

Profit and Loss - Continued

- (d) gain or loss resulting from any disposition of Partnership property with respect to which gain or loss is recognized for federal income tax purposes shall be computed by reference to the Book Value of the property disposed of, notwithstanding that the adjusted tax basis of such property differs from its Book Value;
- (e) in lieu of the depreciation, amortization and other cost recovery deductions taken into account in computing such taxable income or loss, there shall be taken into account Depreciation for such Partnership Year or other period, computed in accordance with the definition of Depreciation herein; and
- (f) notwithstanding any other provisions hereof, any items of income, gain, loss or deduction which are specially allocated pursuant to Section _____ shall not be taken into account in computing Profits or Losses.

What Does the Tax Boilerplate Actually Mean?

➤ B. Boilerplate Provisions – Regulatory Allocations

- Loss Limitation Provision
- Adjusted Capital Account Deficit
- Gross Income Allocation
- Nonrecourse Debt Definitions
- Partnership Minimum Gain Chargeback
- Partner Minimum Gain Chargeback
- Partner Nonrecourse Deductions
- Curative/Subsequent Allocations
- Built-in gain or loss boilerplate

Loss Limitation Provision

- **Loss Limitation.** Notwithstanding anything to the contrary in this Section ____, the amount of items of Partnership expense and loss allocated pursuant to this Section ____ to any Partner **shall not exceed** the maximum amount of such items that can be so allocated **without causing such Partner to have an Adjusted Capital Account Deficit** (or increasing such a deficit) at the end of any Partnership Year (as determined taking into account the expected items described in Section 1.704-1(b)(2)(ii)(d) of the Regulations). All such items in excess of the limitation set forth in this section shall be allocated first to Partners who would not have an Adjusted Capital Account Deficit, pro rata, until no Partner would be entitled to any further allocation, and thereafter to the General Partner.

Example 7: Loss Limitation Provision

FACTS:

- Partner A contributes \$100 to a real estate partnership while Partner B contributes \$10. The partners agree to divide losses on an equal basis, and the partnership incurs a \$30 loss in the first year. The partnership has no liabilities, and the partnership agreement does not contain a DRO for either partner.

Loss Limitation Provision: Results

- The partnership can allocate only \$10 (instead of \$15) of the \$30 loss to Partner B because of the loss limitation provision. The \$5 that cannot be allocated to Partner B must instead be allocated to Partner A.

	A	B
Initial Capital	100	10
Original Allocation	(15)	(15)
Before Loss Limit	(85)	(5)
Loss Limit	(20)	(10)
Net Capital	80	0

Adjusted Capital Account Deficit

- **“Adjusted Capital Account Deficit”** shall mean, with respect to any Partner, the deficit balance, if any, in such Partner’s Capital Account, as of the end of the relevant Partnership Year, after giving effect to the following adjustments: (a) credit to such Capital Account any amounts which such Partner is obligated to restore pursuant to any provision of this Agreement or is deemed to be obligated to restore pursuant to the penultimate sentences of Sections 1.704-2(g)(1) and (i)(5) of the Regulations; and (b) debit to such Capital Account the items described in Sections 1.704-1(b)(2)(ii)(d)(4), (5) and (6) of the Regulations. The foregoing definition of “Adjusted Capital Account Deficit” is intended to comply with the provisions of Section 1.704-1(b)(2)(ii)(d) of the Regulations and shall be interpreted consistently therewith.

Example 8: Adjusted Capital Account Deficit

FACTS:

- Partner A and Partner B each contribute \$50 to a 50-50 partnership that borrows an additional \$900 on a nonrecourse basis to acquire a building. After a number of years of operations, the partners have collectively received losses of \$500, \$400 of which qualifies as nonrecourse deductions carrying with them shares of minimum gain.

Adjusted Capital Account Deficit Results

- Both Partner A and Partner B will have negative capital accounts of (\$200) (\$50 in initial capital less \$250 in allocated losses). Their “adjusted” capital accounts for purposes of the Adjusted Capital Account Deficit definition, however, will each equal \$0 (negative capital account of (\$200) plus \$200 share of minimum gain). As a result, even though both partners will have negative capital accounts, none of the \$250 in losses allocated to each of them will create Adjusted Capital Account Deficits.

	A	B
Initial Capital	50	50
Deductions	(250)	(250)
Net capital	(200)	(200)
Minimum gain	200	200
Adjusted Capital	0	0

Gross Income Allocation

- **Gross Income Allocation.** In the event a Member has a deficit Capital Account at the end of any Allocation Year which is in excess of the sum of: (i) the amount such Member is obligated to restore pursuant to the penultimate sentences of Regulations Sections 1.704-2(g)(1) and 1.704-2(i)(5), each such Member shall be specially allocated items of income and gain in the amount of such excess as quickly as possible, provided that an allocation pursuant to this section shall be made only if and to the extent that such Member would have a deficit Capital Account in excess of such sum after all other allocations provided for in this Article have been made as if this section was not in the Agreement.

Nonrecourse debt definitions

- **“Nonrecourse Liability”** shall have the meaning set forth in Section 1.704-2(b)(3) of the Regulations.
- **“Partner Nonrecourse Debt”** shall have the meaning set forth for the term “partner nonrecourse debt” in Section 1.704-2(b)(4) of the Regulations.
- **“Partner Nonrecourse Debt Minimum Gain”** shall have the meaning set forth for the term “partner nonrecourse debt minimum gain” in Section 1.704-2(i)(2) of the Regulations.
- **“Partnership Minimum Gain”** shall have the meaning set forth for the term “partnership minimum gain” in Section 1.704-2(b)(2) of the Regulations.

Partnership Minimum Gain Chargeback

- **Partnership Minimum Gain Chargeback.** Notwithstanding anything in this article to the contrary, if there is a net decrease in Partnership Minimum Gain during any Partnership Year, except as otherwise permitted by Sections 1.704-2(f)(2), (3), (4) and (5) of the Regulations, items of Partnership income and gain for such year (and subsequent years, if necessary) in the order provided in Section 1.704-2(j)(2) of the Regulations shall be allocated among all Partners whose shares of Partnership Minimum Gain decreased during such year in proportion to and to the extent of such Partner's share of the net decrease in Partnership Minimum Gain during such year. The allocation contained in this section is intended to be a minimum gain chargeback within the meaning of Section 1.704-2(f) of the Regulations, and it shall be interpreted consistently therewith.

Partner Minimum Gain Chargeback

- **Partner Nonrecourse Debt Minimum Gain Chargeback.**
Notwithstanding anything in this article to the contrary, if there is a net decrease in Partner Nonrecourse Debt Minimum Gain during any Partnership Year, except as provided in Section 1.704-2(i) of the Regulations, items of Partnership income and gain for such year (and subsequent years, if necessary) in the order provided in Section 1.704-2(j)(2)(ii) of the Regulations shall be allocated among all Partners whose share of Partner Nonrecourse Debt Minimum Gain decreased during such year in proportion to and to the extent of such Partner's share of the net decrease in Partner Nonrecourse Debt Minimum Gain during such year. This section is intended to comply with the minimum gain chargeback requirement in Section 1.704-2 of the Regulations, and shall be interpreted consistently therewith.

Partner Nonrecourse Deductions

- **Partner Nonrecourse Deductions.** In accordance with Section 1.704-2(i)(1) of the Regulations, any item of Partnership loss or deduction which is attributable to Partner Nonrecourse Debt for which a Partner bears the economic risk of loss (such as a nonrecourse loan made by a Partner to the Partnership or an otherwise nonrecourse loan to the Partnership that has been guaranteed by a Partner) shall be allocated to that Partner to the extent of its economic risk of loss.

Example 9: Partnership Nonrecourse Debt Minimum Gain Chargeback

Facts:

- Partner A and Partner B each contribute \$50,000 to a 50-50 partnership that borrows an additional \$900,000 on a nonrecourse basis to acquire a \$1,000,000 building. Over time, the partners collectively receive depreciation deductions of \$500,000 (\$250,000 each) from the building and reduce their capital accounts from \$50,000 to (\$200,000).

	A	B
Initial Capital	50	50
Deductions	(250)	(250)
Net capital	(200)	(200)
Minimum gain	200	200
Adjusted Capital	0	0

Partnership Nonrecourse Debt

Minimum Gain Chargeback: Results

- The partnership will have \$400,000 of partnership minimum gain (\$900,000 nonrecourse debt less \$500,000 book basis equals \$400,000 minimum gain). As for the partners, both Partner A and Partner B will have received \$200,000 in nonrecourse deductions which will cause them to have minimum gain shares of \$200,000 each. These minimum gain shares will support their negative capital accounts of (\$200,000) and prevent them from having Adjusted Capital Accounts Deficits.
- If the partnership sells or otherwise disposes of the building, or if the creditor of the nonrecourse loan forgives all or a portion of the loan, both partnership minimum gain and the minimum gain shares of the partners will decrease. This will force an allocation of gross income in a minimum gain chargeback.

Example 10: Partner Nonrecourse Debt Minimum Gain Chargeback

Facts:

- Same facts as in Example 9 above except that Partner A guarantees the \$900,000 nonrecourse debt and thereby causes the debt to become partner nonrecourse debt for tax purposes.

	A	B
Initial Capital	50	50
Deductions	(450)	(50)
Net Capital	(400)	0
Minimum Gain	400	0
Adjusted Capital	0	0

Curative/Subsequent Allocations

- **Curative Allocations.** The allocations set forth in Sections _____ hereof (the “Regulatory Allocations”) are intended to comply with certain requirements of the Regulations. It is the intent of the Members that, to the extent possible, all Regulatory Allocations shall be offset either with other Regulatory Allocations or with special allocations of other items of Company income, gain, loss or deduction pursuant to this section. Therefore, notwithstanding any other provision of this Section ____ (other than the Regulatory Allocations) to the contrary, the Manager shall make such offsetting special allocations of income, gain, loss or deduction in whatever manner he determines appropriate so that, after such offsetting allocations are made, each Member’s Capital Account balance is, to the extent possible, equal to the Capital Account balance such Member would have had if the Regulatory Allocations were not part of the Agreement and all Company items were allocated pursuant to the general allocation provisions.

Example 11: Loss Limitation

Facts – Year 1:

- Partner A contributes \$100 and Partner B contributes \$20 to a new partnership. The partnership agreement includes a loss limitation provision and a QIO. Further, the agreement provides that the partners will share profits and losses equally and liquidate according to positive capital account balances. The partnership incurs a loss of \$50 in its first year.

Loss Limitation: Results

- In light of the loss limitation provision and Partner B having only a \$20 initial capital account, Partner B can receive only \$20 of the \$50 loss (instead of \$25). Partner A, on the other hand, will receive its full \$25 share of the \$50 overall loss plus the \$5 portion of Partner B's loss share that Partner B could not receive due to the loss limitation provision.

	A	B
Initial Capital	100	20
Intended Loss Allocation	(25)	(25)
After Loss Reallocation	(30)	(20)
Ending Capital	70	0

Subsequent Profit Allocations

- In year 2, the partnership generates a profit of \$30 and, pursuant to the partnership agreement, divides the profit equally between both partners. Taking the two partnership years together, the partnership experienced a \$20 net loss and divided the loss \$15 to Partner A and \$5 to Partner B because of a regulatory allocation provision.

	A	B
Initial Capital	100	20
Ending Year 1 Capital	70	0
Year 2 Profit	15	15
Ending Year 2 Capital	85	15
Net Year 1 & 2 Allocations	(15)	(5)

Example 12: Curative/Subsequent Allocations

- The same facts as in Example 11 above, except that the partnership agreement contains a “Curative” or “Subsequent Allocation” provision.

	A	B	Total
Initial Capital	100	20	120
Year 1 Losses	(30)	(20)	(50)
Year 2 Profit			30

Curative/Subsequent Allocations Results

- Instead of allocating the \$30 profit equally in the partnership's second year, the "Subsequent Allocation" provision would override the general sharing ratios of the partners and assign the \$30 profit in a manner that would reverse the effect of the regulatory allocation provision in year one.

	A	B	Total
Initial Capital	100	20	120
Year 1 Losses	(30)	(20)	(50)
Year 2 Profit			30
Curative Allocation	10		
50:50 profit	10	10	
Net year 1 & 2	(10)	(10)	(20)

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PARTNERSHIP AND LLC AGREEMENTS - LEARNING TO READ AND WRITE AGAIN

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I. Introduction.

Learning how to read and write partnership and LLC² agreements is a never-ending process, constantly changing with corresponding changes in business and legal requirements. This article is designed to provide an overview of such agreements for lawyers, accountants, and business professionals, emphasizing tax-related provisions. Starting with an overview of a typical partnership agreement structure, the article then provides an essential background of the partnership tax rules and ends with a detailed analysis of what the tax boilerplate actually means, including an appendix explaining the tax boilerplate using a common partnership agreement format.

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² This article will generally use the term "partnership agreement" to cover agreements for all entities treated as partnerships for federal income tax purposes including LLCs taxed as partnerships.

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II. Structure of a typical partnership agreement.

A partnership agreement is typically broken down into various Articles or Sections, and will typically include one or more Exhibits and Schedules. The following explanation describes typical sections of most partnership agreements, covered in the order commonly found in agreements. Many partnership agreements will contain additional sections covering specialized deal considerations such as compliance with regulatory restrictions that may be unique to that type of partnership agreement.

Prefatory language. The typical agreement begins with prefatory language such as an effective date, a Preamble, Recitals, Whereas Clauses or Explanatory Statements which put the agreement into context. This section will explain fundamental questions like when the agreement becomes effective, who the partners are, whether it is a new or amended partnership agreement, and the purpose of the partnership (e.g., to own a particular property or business). These provisions often also outline a history of the agreement and any amendments.

General Provisions. This section will include general information such as the name of the partnership, the principal and registered offices, the term, and the general purpose and powers (e.g., buying real estate, borrowing or lending money, the ability to operate in a particular manner or through particular types of entities). Either this section or a section at the end of the agreement will typically include a lengthy alphabetical list of definitions. Many definitions will simply be a cross reference to the section where a particular term is defined in the main body of the agreement. A disproportionately large number of the definitions relate to federal income tax terminology required if a partnership intends to satisfy the tax allocation safe harbors found under the tax code. If these safe harbors are satisfied, then the IRS will respect the income or loss allocations among the partners.

Capital Contributions. The capital contribution section is short, but very important. It answers questions such as what the partners are contributing and when the contributions are being made. Capital contributions are typically broken down into original contributions of cash or property and subsequent contributions including whether the partnership has the ability to require the partners to make additional capital contributions (i.e., a Capital Call). Whether a capital contribution is or is not required may be determined by reference to the penalties and remedies provided in this section to deal with situations in which capital is called and not provided. This section will also dictate whether a partner has the option to make a contribution “in-kind” (i.e., contribute property in lieu of cash), whether a partner has the right to withdraw its capital prior to liquidation of the partnership (i.e., a Lock Up), and whether a partner is entitled to interest on its capital account. Finally, this section typically requires that a partnership maintain capital accounts for each partner, consistent with the regulatory safe harbors for income and loss allocations. The definition of a capital account is included either in this section or in the general definition section.³ In essence a partner’s capital account is the fair market value (FMV) of partner contributions (net of any related debt assumed by the partnership) increased or decreased by the partner’s share of income or loss and decreased by the fair market value of partner distributions (net of any related debt assumed by the partner). For this purpose, income and loss

³ In certain cases an agreement may avoid the detailed definition of a capital account and simply state that partnership must maintain capital accounts in accordance with the specified tax regulations.

refers to the economic or “book” definitions under the tax rules under section 704(b) and may not be the same as income or loss determined for income tax or for Generally Accepted Accounting Principles (GAAP).

Interest on capital is unusual and is generally classified as a “guaranteed payment” for federal tax purposes.⁴ A guaranteed payment is used in the case of certain preferred partners that wish to be treated more akin to lenders. Often a preferred allocation of partnership income is used to satisfy this goal in lieu of stated interest or a guaranteed payment. A preferred return allows some of the advantages of a debt-like investment without putting undue economic obligations on the partnership to pay even if there is no income to support it. A preferred return also has the advantage of carrying out the tax character of the underlying income used to satisfy the payment, potentially allowing the recipient the benefit of capital gains tax rates.⁵

Example 1 - capital account basics:

A contributes Building with \$100 gross fair market value, subject to \$30 of debt. In year one the partnership allocates \$10 of section 704(b) book income to A and distributes \$4 of cash to A. A’s ending capital account is \$76 computed as follows:

	Effect on Capital Account	Ending Capital Account
Increase by net FMV of property contributed	+\$70	\$70
Increase by income allocation	+\$10	\$80
Decrease by distributions	-\$4	\$76

Tax Allocations – sections 704(b) and 704(c).

This section of the agreement describes how taxable income and loss should be shared among the partners. Most of the allocation language relates to the economic/book allocations and in general the taxable income will follow these book allocations.⁶ However, if a partner contributed an asset with built-in appreciation or depreciation, special rules require that such built-in tax gain or loss is allocated back to the contributing partner.⁷ Note that the term “allocation” is a tax-only term and should not be confused with the term “distribution”, which is

⁴ A guaranteed payment is a payment to a partner that is determined without regard to the income of the partnership and is treated in many ways similar to an interest payment. See generally section 707(c) and Reg. § 1.707-1(c).

⁵ See generally, Golub et. al, Economic, Tax, and Drafting Considerations For Preferred Partnership Interests, Real Estate Taxation, Volume 33, Number 04 (2006.)

⁶ For example, a \$100 of net book income may be comprised of \$120 of gross capital gain and \$20 of depreciation deductions. An allocation of this \$100 of income equally between two partners results in each partner receiving \$60 of capital gain and \$10 of depreciation deductions for net taxable income of \$50 each. However, if \$30 of the gross income were tax-exempt, then the net taxable income to each partner would only be \$35 (\$45 of capital gain, \$15 of tax-exempt income, and \$10 of depreciation deductions). See Reg. § 1.704-1(b)(1)(vii) (net book allocations carry out a proportionate share of underlying tax items).

⁷ Section 704(c).

an economic term. These two terms interrelate because if a partnership liquidates in accordance with the book capital accounts, the income or loss allocations will directly affect each partner's share of distributions. For example, an allocation of income increases a partner's capital account, which means that the partner is entitled to more distributions due to the larger capital account.

Partnership agreements typically break the book allocations down into two sections. The primary allocation section describes the general business deal, such as allocating profits in accordance with relative capital or profit percentages (i.e., "Percentage Interests"). The second section overrides the first section and is designed to comply with the book income tax regulatory safe harbors to dictate things like making sure partners generally do not receive deductions in excess of their capital accounts and how to allocate deductions funded by nonrecourse debt.⁸ This second section is often called the "boilerplate" or "regulatory allocations." The typical agreement first allocates income and loss under the regulatory allocation provisions, if applicable, and thereafter allocates any remaining book income or loss (usually defined as "Profit" and "Loss" in the agreement) in the primary allocation section.

The book allocations section is important because it describes how the taxable income and loss are allocated among the partners. Further, if the partnership liquidates in accordance with capital accounts, such allocations drive the economics of the deal. If the partnership does not liquidate in accordance with capital accounts but instead liquidates according to a defined ordering of cash or property distributions (i.e., a Cash or Liquidation Waterfall or simply the "Waterfall") then the book allocations have no effect on the economics and relate solely to tax. Because liquidating in accordance with capital accounts means that the complicated regulatory allocations can have a meaningful effect on the business deal, agreements often liquidate with a Waterfall and avoid the need for the business persons to understand the tax boilerplate.⁹

The tax allocations will not be respected if the agreement liquidates with a Waterfall and the partners' economic rights under the Waterfall are different from their rights based on their capital accounts. In such a case, the taxable income or loss will be re-allocated so that the capital accounts and the Waterfall rights are consistent. For example, assume the tax allocations send all \$100 of section 704(b) income to Partner A and none to Partner B, causing A's capital account to increase by all \$100 and B's capital account to remain constant. If the Waterfall provides that the cash corresponding to that profit is shared \$50 each by A and B, then the IRS will not respect the tax allocation and will reallocate \$50 of income to B. To avoid inconsistencies between the tax allocations and the partners' rights under the Waterfall, many partnership agreements simply use a Target/Fill Up allocation under which the agreement

⁸ A partner can receive deductions in excess of their capital account if the partner is at risk for the negative amount (i.e., the partner has to fund deficit capital accounts) or if the partner is deemed at risk for the amount (i.e., the negative amount is funded from nonrecourse debt that the partner is actually or deemed to be at risk for).

⁹ For a more complete discussion of the issue of whether to liquidate with capital accounts or with a Waterfall see O'Connor and Schneider, Capital-Account-Based Liquidations: Gone With the Wind or Here to Stay? *Journal of Taxation*, Vol. 102, No. 1 (January 2005).

allocates book income or loss among the partners using a formula that causes the partners' capital accounts to equal the amounts the partners would receive under the Waterfall.¹⁰

Example 2 - target allocations:

LP and GP contribute \$90 and \$10, respectively, to the partnership and set beginning capital accounts in the same amount. The distribution Waterfall provides that cash is paid first to return contributed capital plus a 10% annual preferred return and then is paid 80:20 to LP and GP, respectively.¹¹ The partnership earns \$20 of income in year one and under the Waterfall the \$120 of total partnership cash would be distributed as follows:

	LP	GP	Total
Return of capital	90	10	100
Preferred return	9	1	10
Residual return	8	2	10
Total	107	13	120

A typical target allocation provision would allocate the \$20 of year one earnings to “fill up” the LP and GP opening capital accounts¹² (\$90 and \$10, respectively) to equal their Target rights under the Waterfall (\$107 and \$13, respectively). Thus, the \$20 of income is allocated \$17 to LP and \$3 to GP.

For a partnership where there will be contributions of appreciated or depreciated property, the section allocating such items to the contributing partner should be covered in some detail. This is referred to as “section 704(c)” after the tax code section that generally requires the partnership to allocate such tax items back to the contributing partner. Partnership agreements typically include only a single paragraph to cover section 704(c) allocations and often simply repeat the general statutory requirement that tax allocations take into account a partner’s potential built-in tax gain or loss on contributed property. However, for many partnerships, including many real estate partnerships, the section 704(c) provision is highly negotiated and includes much more detail relating to which of several alternative methods is chosen to allocate non-economic taxable income or loss.¹³

Example 3 - section 704(c):

Partner A contributes property with a tax basis of \$20 and a value of \$100 and the partnership thereafter sells the property for \$110. The partnership must allocate the first

¹⁰ See generally, Golub, How to Hit Your Mark Using Target Allocations in a Real Estate Partnership, Tax Management Memorandum, Vol. 50 No. 20, (September 28, 2009).

¹¹ Typically the GP would receive the 20% residual profit sharing for its services plus a share of the 80% return based on its relative capital contribution. However, for simplicity, the example shows the GP as only receiving a 20% residual profit sharing after the preferred return.

¹² If the partners had other contributions or distributions during the year, the partnership should adjust the beginning of the year capital accounts to reflect this. Partnership agreements frequently use the term “Partially Adjusted Capital Account” to refer to the beginning of the year capital accounts adjusted for intra-year contributions and distributions.

¹³ See Section IV.C. of this article for a more detailed discussion of section 704(c) methods and considerations.

\$80 of tax gain to Partner A because that represents the inherent built-in gain A had in the property when it contributed the property to the partnership. The remaining \$10 of post-contribution economic gain is allocated according to the section 704(b) book allocation provisions in the agreement. Further, when the built-in gain property is depreciated, the partnership must first allocate tax depreciation on the property to the non-contributing partner up to the amount of its book depreciation, with any residual tax depreciation going to the contributing partner. This ensures that the tax-basis shortfall is first born by the contributing partner through both dispositions and depreciation. However, to the extent that there is insufficient tax basis for the non-contributing partner to receive its full share of book depreciation, there may still be a tax shortfall to the non-contributing partner depending on the section 704(c) method chosen.

Distributions. The distribution section describes the partners' rights to cash or property distributions. These distribution rights are typically subject to the partners' overall distribution rights on liquidation, which may appear in a later section of the agreement. Sometimes the two distribution sections are referred to as the "current" distribution section and the "liquidation" distribution section. Often in a partnership that liquidates with a cash Waterfall, the liquidation distribution section simply refers to the partners' rights under the current distribution section (after certain reserves).¹⁴ For partnerships that follow the book allocation safe harbor tests, the liquidation section will simply liquidate in accordance with positive section 704(b) book capital accounts after all allocations have been made to partner capital accounts.

The distribution section typically addresses important details such as when distributions are made and in what amount. For example, an agreement may provide that there will be quarterly distributions of operating income and larger distributions of capital upon specifically defined Capital Transactions or Capital Events (such as significant asset sales or refinancings). Most agreements limit operating income distributions to a specifically defined Net Cash Flow so as to ensure that the partnership has sufficient cash remaining for operations and necessary reserves.

This section will often specifically address taxes. Many agreements contain minimum distributions to a partner to ensure that each partner has sufficient funds to satisfy its tax obligations relating to its share of partnership income (so called "Tax Distributions"). Tax Distributions are generally documented as an advance on the partner's rights under the more general distribution provisions. Sometimes the distributions are treated as a loan to the partner. Further, taxes paid by the partnership on behalf of a partner are typically treated as a deemed distribution to the partner whose income is requiring the withholding. This is common when the partnership is required to withhold on distributions to a foreign or out of state partner.

Management. Partnerships will typically designate a board or a single partner as the managing partner. If the partnership designates a single partner as managing partner, this is typically the person classified under state law as the "Manager" of an LLC or the "General Partner" of a Limited Partnership. The agreement typically vests significant discretion and control in the

¹⁴ It is also common to see the operating income Waterfall differ from the liquidation Waterfall. For example, if the partnership has an entrepreneurial partner and an investor partner, the operating income Waterfall may make current cash distributions to both partners, but on liquidation (or certain capital events) the liquidating/capital-event Waterfall will first use funds to repay the investor partner's contributions (i.e., return of capital) before making distributions to both partners.

board or the managing partner, often allowing the passive partners to vote only on more major matters such as acts in contravention of the agreement, the filing of bankruptcy, admitting additional members not contemplated in the original agreement, and merging or selling substantially all of the partnership assets. The level of detail in the management section varies greatly among partnership agreements. This section also articulates when a partner has liability to the partnership or other partners and any related indemnifications. This section will also typically reference any related affiliate service agreements, such as a property or asset management agreement with an affiliate of the managing partner.

Accounting, Books, and Records. This section covers the more mundane information about keeping books and records and providing tax statements to partners. Typical items included in this section are: (1) annual and quarterly reporting of financial information to the partners, (2) who prepares the tax returns and what is the deadline for providing this information to the partners, (3) who will serve as the Tax Matters Partner and represent the partnership in an IRS audit, and (4) what tax decision making power the Tax Matters Partner will have, such as the ability to extend the statute of limitations, elect in or out of the special unified partnership audit rules, or make certain other tax elections. Although the identity and authority of the Tax Matters Partner may sound boring, it is often a critical question when later controversy arises and the details are often overlooked in the drafting process.

Transfers of Partnership Interests. This section will dictate when a partner can or must transfer its partnership interest. Typically partnership interest transfers are strictly regulated in the agreement and often have no ready market even if someone wanted to sell their interest. If a partner is allowed to transfer its interest, the agreement will typically allow the partnership or existing partners to have a Right of First Offer (i.e., a “ROFO”) or Right Of First Refusal (i.e., a “ROFR”) to acquire the interest or an option to acquire the interest subject to specific pre-agreed pricing formulations. There is usually an exception for certain transfers, so called Permitted Transfers, which often include estate planning transfers to family trusts or family partnerships. If the parties anticipate a potential sale of partnership interests by some or all of the partners, the agreement may include a right by a majority of the partners to force minority partners to also sell (a “Drag Along” right) or a right by the minority partners to join in a sale by the majority partners (a “Tag Along” right).

If a sale occurs mid-year, the agreement will typically include a provision explaining how the taxable income or loss for the year is allocated between the buying and selling partners. Many agreements simply allow the managing partner discretion on how to reasonably allocate income, while others are much more specific and may specify a first of the month convention or require a “closing of the books” for significant items and a pro ration for smaller items like operating income.¹⁵

Dissolution and Winding Up. This section describes when and how a partnership will be wound up and whether there will be any reserves kept behind for potential obligations. As noted above, from a tax perspective, this section may be the key to learning whether the agreement intends to follow the regulatory book allocation safe harbors. The agreement likely intends to

¹⁵ The IRS recently proposed regulations that would provide further limits on the partnership’s flexibility in allocating tax items in this context. See Prop. Reg. §1.706-1, -4, and REG-144689-04 (April 13, 2009).

follow the safe harbors if, after paying creditors and setting up reserves, the agreement distributes the remaining proceeds according to the partners' section 704(b) book capital accounts. Although there are other requirements to satisfy the safe harbors, this is the primary requirement that either puts an agreement in or out of such safe harbors. If the agreement instead liquidates with a cash Waterfall, then the agreement must rely on a more limited tax safe harbor to get comfort that the IRS will respect the income and loss allocations. That safe harbor applies only if, in all events, the partners would receive the same economic distributions as had they liquidated in accordance with each partner's section 704(b) capital account. This would occur, for example, in a simple 50-50 partnership where all capital is contributed equally and all profits, losses, and distributions are shared equally.

Miscellaneous. Finally, the miscellaneous section is a repository for items that do not readily fit within the other sections. This includes things like (1) delivery of notices to the partners or partnership, (2) application to successors or assigns, (3) waiver of jury trial, (4) restrictions on disclosure of terms, (5) provisions for how or under what circumstances the partnership agreement may be amended, and (6) representations and warranties.

III. Overview of Tax Rules for Partnerships.

A basic understanding of partnership tax rules is essential to understanding a partnership agreement.¹⁶ The key concepts are described below.

A. Section 704(b) vs. Section 704(c).

Partnership taxable income or loss is separated into section 704(b) allocations of book income or loss and section 704(c) allocations of tax-only income, gain, loss or deduction. Section 704(b) income or loss tracks economic income and loss that occurs while assets are held in the partnership and the partnership then allocates these amounts based on the business arrangement. The partnership then tracks each partner's share through maintaining individual partner section 704(b) book capital accounts. In contrast, section 704(c) tracks differences between book and tax capital. This rule is designed to prevent a person from contributing property with a built-in tax gain or loss into a partnership and shifting that gain or loss to another partner.

Unrealized asset appreciation or depreciation is only "booked" into the capital accounts and run through the section 704(b) income statement upon certain triggering events. For example, if a partnership buys an asset for \$100 and later sells it for \$150, the \$50 of previously unrealized book gain is triggered and allocated to the partners. Similarly there is a book-up/down event when there is a significant change in the way the partners share economics. This can occur when the partnership issues a new profits interest to a partner or there is a disproportionate partner contribution or redemption. In such cases, the rules allow the partnership to book the pre-event unrealized amounts according to the pre-event sharing ratios. For instance, if the partnership were owned 50-50 by A and B and C later joined for a one-third interest, the partnership would

¹⁶ For additional background on tax and non-tax aspects of drafting partnership and LLC agreements see Cuff, Some Basic Issues in Drafting Real Estate Partnership and Limited Liability Company Agreements, 65 NYU INSTITUTE ON FED. TAX'N (2007); and Cuff and Shaw, Drafting Partnership Allocations, 5 Business Entities 2 (March/April 2003).

be able to book the pre-C appreciation into A and B's capital accounts based on the prior 50-50 ratio.

Although the tax regulations state that book-ups/downs are optional, many partnerships use these events to revalue the partnership assets and ensure that there is no inappropriate economic or tax shifting of the pre book-up/down appreciation or depreciation among the partners.¹⁷ The regulations dictate that, since the book-up/down preserves the built-in tax gain or loss in the asset (i.e., it is a non-taxable book-up/down) the partnership must use section 704(c) principles to make sure the later recognition of the gain or loss is allocated to the partners who received the book-up/down adjustment. This is commonly referred to as "reverse section 704(c)" to distinguish it from "forward section 704(c)" for contributed property.

Example 4 - Section 704(b) basics:

A and B each contribute \$100 of cash to form a 50-50 partnership. The partnership uses the cash to immediately buy Land, which it rents on a net basis. During the first year, the partnership earns \$20 of taxable net rental income and benefits from unrealized appreciation in Land of \$50. The partnership retains \$10 of the rental income and distributes the remaining \$10 equally between A and B. The effects of these transactions on the allocations and capital accounts are shown below. Note that the \$20 of rental income was allocated 50% to each of A and B for tax and section 704(b) book purposes, which increased their tax and book capital accounts accordingly. The \$50 of unrealized appreciation was not reflected in the partners' capital accounts because there has not been a section 704(b) realization (book-up) event to lock in that value change.¹⁸

Opening Balance Sheet					
	Tax	Book		Tax	Book
Assets			Liabilities	\$0	\$0
Land	\$200	\$200			
			Partner Equity		
			A	\$100	\$100
			B	\$100	\$100
Total	\$200	\$200	Total	\$200	\$200

Effect of Income Allocations and Distributions				
	Tax	Book	Partner A	Partner B
Beginning capital	\$200	\$200	\$100	\$100
Rent Income	+\$20	+\$20	+\$10	+\$10

¹⁷ See Reg. § 1.704-1(b)(2)(iv)(f) for the optional nature of a book-up of unrealized amounts. *But see* Reg. § 1.704-1(b)(1)(iv) for a discussion of potential other tax effects that may result even if an allocation satisfies the literal requirements of the section 704(b) regulations.

¹⁸ Note, if a new partner subsequently joined the partnership, there would be a book-up event that would allow the partnership to revalue the land and allocate the \$50 of unrealized appreciation into A's and B's capital accounts solely for section 704(b) purposes. Thus, if C is admitted to the partnership and the partnership thereafter sells Land for \$250, the \$50 of tax gain in Land is allocated equally to A and B using section 704(c) principles.

Distributions	-\$10	-\$10	-\$5	-\$5
Ending capital	\$210	\$210	\$105	\$105

Ending Balance Sheet					
	Tax	Book		Tax	Book
Assets			Liabilities	\$0	\$0
Land	\$200	\$200			
Cash	\$10	\$10	Partner Equity		
			A	\$105	\$105
			B	\$105	\$105
Total	\$210	\$210	Total	\$210	\$210

Example 5 - Section 704(c) basics:

A contributes Land-A and B contributes \$100 of cash to form a 50-50 partnership. Land-A has a value of \$100, but a tax basis of only \$20. The partnership uses the \$100 cash to buy Land-B. Partnership rents both parcels of land on a net basis. During the first year, Partnership earns \$20 of taxable net rental income and sells Land-A at the end of the year for \$100. The partnership retains all of the rental income and sales proceeds. As in Example 4, the \$20 of rental income is allocated 50% to each of A and B for tax and section 704(b) book purposes. However, all \$80 of the tax gain from Land-A is allocated to A as is required under section 704(c).

Opening Balance Sheet					
	Tax	Book		Tax	Book
Assets			Liabilities	\$0	\$0
Land-A	\$20	\$100			
Land-B	\$100	\$100	Partner Equity		
			A	\$20	\$100
			B	\$100	\$100
Total	\$120	\$200	Total	\$120	\$200

Effect of Income Allocations				
	Tax	Book	Partner A	Partner B
Beginning capital	\$120	\$200	\$20	\$100
Rent Income	+\$20	+\$20	+\$10	+\$10
Land-A sale	+\$80	\$0	+\$80	\$0
Ending capital	\$220	\$220	\$110	\$110

Ending Balance Sheet					
	Tax	Book		Tax	Book

Assets			Liabilities	\$0	\$0
Land-B	\$100	\$100			
Cash	\$120	\$120	Partner Equity		
			A	\$110	\$110
			B	\$110	\$110
Total	\$220	\$220	Total	\$220	\$220

B. Substantial Economic Effect.

One of the fundamental requirements of the section 704(b) rules is that the IRS generally will only respect the tax effect of partnership allocations of book income or loss if those allocations have “substantial economic effect.” This is a two-part test that requires both that allocations economically affect the dollars the partners receive from the partnership and that such effect be substantial after taking into account tax consequences.¹⁹

Economic effect means that the section 704(b) allocations must be consistent with the underlying economics. The regulations allow partnerships to satisfy a safe harbor to ensure that the IRS will respect the economic effect of the allocations. The regulations include three independent ways to meet the safe harbor, referred to as the “primary”, “alternate”, and “economic equivalence” tests. The first two are very similar and discussed herein as variations of the same rule. The third, the economic equivalence test, is a limited safe harbor that deems the allocations to have economic effect if the economics could never differ from the case where the agreement followed one of the first two safe harbors. Although some characterize the economic equivalence test as the “dumb but lucky” rule, it is still widely relied upon in many partnership agreements that liquidate with a specified cash Waterfall in lieu of liquidating in accordance with partnership capital accounts.²⁰

Under the primary or alternate economic effect safe harbors, the partnership must follow detailed rules to maintain partner capital accounts and at a minimum liquidate in accordance with positive partner capital accounts. For example, if the AB partnership allocates \$100 of income to A and allocates no income to B such that A’s capital account is increased by the entire \$100, the partnership must distribute that entire \$100 to A upon liquidation in accordance with A’s positive capital account (assuming no subsequent losses or distributions offset the income allocation).

The only difference between the primary and alternate safe harbors is how they account for the economics of negative partner capital accounts resulting from losses or excess distributions. To satisfy the primary safe harbor, the partnership must require each partner to be personally

¹⁹ The “substantiality” aspect of this test is beyond the scope of this article. An example of a potential “substantiality” problem is when a partnership contains both tax-exempt and taxable partners and the partnership specially allocates disproportionate taxable income to the tax-exempt partner and then allocates disproportionate tax-exempt income to the taxable partner in order to have the two special allocations generally offset economically but lower the overall taxes paid by the partners in the aggregate. See, e.g., Reg. §1.704-1(b)(5) Example 5.

²⁰ See paragraph 11.02 of McKee, Nelson & Whitmire: Federal Taxation of Partnerships & Partners (WG&L 4th edition) for characterization of this rule as the “dumb but lucky” rule. See generally O’Connor & Schneider, Liquidating with Capital Accounts: Gone with the Wind or Here to Stay?, Journal of Taxation, Vol. 102, No. 1 (January 2005).

responsible to repay its entire negative capital account (referred to as a full deficit restoration obligation, or “DRO”). More commonly, partnerships follow the alternate safe harbor under which the partnership agreement does not include a full DRO but does include provisions in the partnership agreement to avoid the situation where a partner will have a negative adjusted capital account.²¹ These requirements are (i) the partnership cannot allocate losses to cause the partner’s capital account to be lower than what the partner is actually or deemed²² obligated to repay (such excess is referred to as a “deficit adjusted capital account”), and (ii) if there is an unexpected event that causes such a deficit in the adjusted capital account, then the partnership must allocate gross income to eliminate that deficit as quickly as possible (referred to as a “qualified income offset” or “QIO”).

Economic Effect Safe Harbor Overview					
	Maintain Capital Accounts	Liquidate according to Positive Capital Accounts	Full Negative Capital Deficit Restoration Obligation	No DRO but Qualified Income Offset and limits on loss allocations	Will IRS Respect Economic Allocations under Safe Harbor?
Primary Test	Required	Required	Required	NA	Yes
Alternate Test	Required	Required	NA	Required	Yes
Economic Equivalence	NA	NA	NA	NA	Only if economic results always same as under other two tests

C. Nonrecourse Debt-Sourced Deductions.

The partnership tax rules create an elaborate set of rules to address the allocation of partnership deductions funded by nonrecourse debt. Absent a special rule, these allocations could not have economic effect because it is the lender and not a particular partner who is at risk for the debt-funded loss. For example, if A and B each contributed \$100 to Partnership and Partnership borrowed \$800 on a nonrecourse basis to buy Building, once Building was depreciated down from \$900 to \$800, A’s and B’s capital accounts would be zero and any further allocations of depreciation would drive their capital accounts impermissibly negative but for the special nonrecourse deduction rules.

The regulations create a concept called “partnership minimum gain” to track deductions where a non-partner lender is at risk for a partnership liability. Minimum gain is the amount by which the nonrecourse debt exceeds the section 704(b) basis in the property secured by the debt. The concept is that a nonrecourse deduction can be allocated to a partner to cause its capital account

²¹ The capital account can be negative in certain circumstances, such as an allocation of nonrecourse deductions to the partner supported by a future minimum gain chargeback or a limited partner deficit restoration obligation.

²² A partner is deemed obligated to repay its share of partnership or partner “minimum gain”. This is the amount tracked to a partner from its share of deductions funded from partnership or partner nonrecourse debt. See Section III.C. of this article for more information on this concept.

to be negative, even without a partner obligation to restore such negative capital account. The regulations permit this because the IRS is protected since the negative capital account will later be offset and made positive (or at least returned to zero) with a later allocation of income whenever there is a decrease in this minimum gain. This is referred to as a “partnership minimum gain chargeback.” The regulations create a parallel concept for nonrecourse debt loaned or guaranteed by a partner (i.e., “partner nonrecourse debt”) except that those deductions and the related chargeback must be allocated to the lender/guarantor partner because that partner is indirectly at risk due to also being the lender/guarantor. In that case, the regulations use the terms “partner minimum gain” and “partner minimum gain chargeback” to have similar meanings to partnership minimum gain and partnership minimum gain chargeback.

Example 6 - partnership nonrecourse deductions:

A and B each contribute \$100 to a 50-50 partnership and have no obligation to restore negative capital accounts. The partnership borrows \$800 from an unrelated lender on a nonrecourse basis using an interest-only loan and buys Building for \$1,000. The partnership depreciates Building by \$100 a year. After the third year, the partnership has depreciated the initial \$1,000 of section 704(b) basis in Building down to \$700. At the beginning of Year 3, A and B have each received depreciation deductions that caused their section 704(b) capital accounts to be zero. An allocation of the year 3 depreciation equally to A and B would cause their capital accounts to be negative by \$50 each. Although the general rule is that A and B are not allowed to bring their capital accounts negative absent a DRO, there is an exception in this case because the deduction is a nonrecourse deduction that creates minimum gain (\$800 nonrecourse debt less \$700 book basis in Building). An allocation of the \$50 deduction to each of A and B creates an allowable \$50 deficit in each partner’s capital account because that deficit is supported by \$50 each of minimum gain that the partnership agreement provides it will charge back if there is a later reduction in that minimum gain.²³ For example, if the partnership disposes of Building the next year for an amount equal to the \$800 nonrecourse debt, the entire minimum gain would be triggered (no longer any nonrecourse debt to support the minimum gain) and A and B would be required to report \$50 of taxable income each. The partnership has sufficient income to allocate since it has \$100 of section 704(b) book income from the sale of Building.

Computation of Minimum Gain				
	Adjustment	Section 704(b) Value	Nonrecourse debt	Minimum gain
Purchase date		\$1,000	\$800	\$0
Year 1 depreciation	(\$100)	\$900	\$800	\$0

²³ Although each partner’s section 704(b) capital account is negative, it is not impermissibly negative because the \$50 deduction creating the negative capital account is sourced to a nonrecourse debt deduction. Because a nonrecourse debt deduction gives rise to an equal amount of minimum gain, A and B have minimum gain to offset their negative capital account, which will eventually bring their Capital Accounts to zero. For purposes of testing whether a capital account is impermissibly negative, minimum gain is added back to the negative capital account to determine whether the “Adjusted Capital Account” is impermissibly negative. See section IV.B. of this article for a more detailed explanation of this concept.

Year 2 depreciation	(\$100)	\$800	\$800	\$0
Year 3 depreciation	(\$100)	\$700	\$800	\$100

Capital Accounts, Minimum Gain, and Adjusted Capital Accounts						
	A capital	A minimum gain	A's Adjusted Capital Account	B capital	B minimum gain	B's Adjusted Capital Account
Initial	\$100	\$0	\$100	\$100	\$0	\$100
Year 1	\$50	\$0	\$50	\$50	\$0	\$50
Year 2	\$0	\$0	\$0	\$0	\$0	\$0
Year 3	(\$50)	\$50	\$0	(\$50)	\$50	\$0

D. Elections and Audits.

Partnership agreements typically address how the partnership deals with partnership-level tax elections and audits. The two main elections unique to partnerships relate to section 754 inside basis adjustments²⁴ and section 704(c) allocations of built-in gains or losses among the partners. The section 754 election is less controversial and frequently is left at the discretion of the managing partner, although sometimes is required at the reasonable request of an affected partner.²⁵ However, due to what is referred to as the “ceiling rule” limitation, the section 704(c) method is often subject to more negotiation.

Although section 704(c) always mandates that taxable gain or taxable loss is first allocated to the partner contributing the built-in gain or built-in loss property, if there is insufficient gain or tax basis, the non-contributing partner can frequently bear the burden of built-in gain. For example, assume A and B contribute Property-A and Property-B, respectively. Both properties are 5-year depreciable property valued at \$100 each. However, A’s property has zero tax basis and B’s property has \$100 of tax basis. Each year B will receive \$10 of book depreciation on Property-A with no corresponding tax depreciation if the partnership uses the base-line “Traditional” method. However, if B negotiated the “Curative” method, B could receive an extra \$10 of tax depreciation from Property-B, curing the shortfall. Alternatively, if the partnership didn’t have another depreciable property to cure the shortfall, B could receive the same extra \$10 of

²⁴ Generally, absent a section 754 election, events such as a sale of a partnership interest at a gain or a loss would not cause such gain or loss to be reflected in the inside basis of the partnership assets. A partnership has the option to make a section 754 election upon such a sale or exchange (or upon certain distributions). The election locks the partnership into making such adjustments for the electing year and future years. Thus an election in a year of an inside basis increase could create the risk of a required inside basis decrease in a future year if there is a sale of a partnership interest at a loss. However, beginning in late 2004, downward inside basis adjustments became mandatory in all but certain de minimis cases. This effectively takes away the major risk with making a section 754 election, with the primary remaining downside being administrative costs to maintain the adjustment.

²⁵ One question on a section 754 election is whether the costs of computing and tracking the corresponding basis adjustment should be paid solely by the partners who are affected.

depreciation per year under the “Remedial” method. The cost to A of the Remedial method is that every extra notional dollar of depreciation allocated to B is offset by a dollar of notional income to A.

The partnership audit provisions are frequently subject to much less debate. However, they are important because each partner is subject to personal tax adjustments even though the audit is conducted at the partnership level under the so-called “TEFRA” rules.²⁶ The main audit issues in the agreement relate to which partner will serve as the administrative head of the audit (the so-called “tax matters partner” or “TMP”), how the audit costs will be funded, and what powers are granted to the TMP, such as the ability to extend the statute of limitations with or without partner consent. If no TMP is named, the tax regulations provide conventions which may result in a partner being the TMP who is not the right person for the job.

IV. So What Does the Tax Boilerplate Actually Mean?

Perhaps no section of a partnership agreement interests our clients less than the section containing the tax boilerplate provisions. These provisions, therefore often receive little or no client review. However, the provisions are extremely important and, if drafted incorrectly, could lead to surprisingly negative tax and economic consequences. For these reasons, tax practitioners should always review the tax boilerplate provisions carefully and make certain that they fully understand how those provisions can affect the tax consequences and the economics of the partners.

A. Boilerplate Provisions - Capital Accounts.

As discussed in III.B above, partnerships must maintain capital accounts for their partners in order to satisfy the substantial economic effect safe harbor under section 704(b). In light of this, most partnership agreements include at least some discussion related to maintaining partner capital accounts. As part of such a discussion, many partnership agreements may include capital account definitions that resemble the following:

“Capital Account” shall mean, with respect to any Partner, the capital account on the books of the Partnership which shall initially be zero and which shall be maintained in accordance with the following provisions:

- (a) To each Partner’s Capital Account there shall be credited the aggregate amount of cash and initial Gross Asset Value of any property contributed by such Partner to the Partnership, such Partner’s distributive share of Profits and any items in the nature of income or gain which are specially allocated pursuant to

²⁶ A unique partnership election is whether a “small partnership” should elect out of the special partnership audit rules referred to as “TEFRA” (after the name of the legislation that enacted the rules in 1982). Under TEFRA, a partnership-level audit can decide the tax fate of the partners with respect to their share of partnership income or loss, as opposed to having separate partner level audits. An important point here is that if a partner has a partner-level penalty defense to a TEFRA audit penalty, the partner can only assert such defense after paying the penalty and applying for a refund. Reg. § 301.6221-1(d). The ability of a small partnership to elect out of TEFRA is limited to partnerships with 10 or fewer partners that meet certain requirements (such as no pass-through partners). See *generally* section 6231(a)(2)(B).

Article ____ and the amount of any Partnership liabilities assumed by such Partner or which are secured by any Partnership property distributed to such Partner.

(b) To each Partner's Capital Account there shall be debited the amount of cash and the Gross Asset Value of any Partnership property distributed to such Partner pursuant to any provision of this Agreement or deemed distributed pursuant to Section ____, such Partner's distributive share of Losses and any items in the nature of expenses or losses which are specially allocated pursuant to Article ____, and the amount of any liabilities of such Partner assumed by the Partnership or which are secured by any property contributed by such Partner to the Partnership.

(c) If any interest in the Partnership is transferred in accordance with the terms of this Agreement, the transferee shall succeed to the Capital Account of the transferor to the extent it relates to the transferred interest.

(d) In determining the amount of any liability for purposes of determining Capital Account balances hereof, there shall be taken into account Section 752(c) of the Code and any other applicable provisions of the Code and Regulations.²⁷

The foregoing provisions and the other provisions of this Agreement relating to the maintenance of Capital Accounts are intended to comply with Section 1.704-1(b) of the Regulations, and shall be interpreted and applied in a manner consistent with the Regulations. If the General Partner shall determine that it is prudent to modify the manner in which the Capital Accounts, or any debits or credits thereto, are computed in order to comply with the Regulations, the General Partner may make such modification provided that it is not likely to have a material effect on the amounts that would be distributable to any Partner.

The definition of "Capital Account" above mirrors the rules for determining partner capital accounts described in Regulation Section 1.704-1(b)(2)(iv). For those partnerships liquidating according to partner capital accounts, this definition will govern the economic relationship among the partners by determining partner entitlements upon a liquidation of the partnership. To accomplish this result, the liquidation sections of partnership agreements governing partnerships liquidating based on capital accounts generally will refer to a Capital Account definition at the very bottom of the liquidation distribution Waterfall. Further, for many partnerships not liquidating according to capital accounts, the Capital Account definition still serves a very important purpose because partner capital accounts typically act as the starting point for determining the taxable income or loss allocable to partners under a "targeted" allocation regime. In other words, because a typical targeted capital account regime seeks to allocate partnership income or loss to close the difference between beginning or "partially adjusted" capital accounts and ending or "targeted" capital accounts, even a targeted capital account approach simply cannot be applied without at least some definition of "Capital Account".

²⁷ The agreement language used throughout this article is of common use and is based on language used in Whitmire, Nelson, McKee, Kuller, Hallmark, and Garcia, *Structuring and Drafting Partnership Agreements*, 3rd Edition (2003).

Example 7 - Capital Accounts with Layer Cake Allocations:

Assume that Partner A and Partner B form a 50-50 partnership that, under the terms of the partnership agreement, liquidates according to capital accounts and includes a capital account definition similar to the one provided above. Partner A contributes nondepreciable property with a value of \$100 and tax basis of \$20 to the partnership while Partner B contributes \$100 in cash. After leasing the property contributed by Partner A for a number of years, generating total rental income of \$60 and incurring total expenses of \$50, the partnership sells the property contributed by Partner A for \$110 and liquidates. Based on the capital account definition above, each partner will start with a capital account of \$100, increase its capital account by its 50% share of the \$60 in income and decrease its capital account by its 50% share of the \$50 in expenses. After these events, each partner will have a capital account of \$105. Then, when the partnership sells the property, the two partners will equally divide the \$10 gain from the sale, increase their capital accounts from \$105 to \$110 and walk away with \$110 in cash proceeds when the partnership liquidates, leaving their final capital accounts at zero.

Example 8 - Capital Accounts with Targeted Allocations:

Assume the same facts as in Example 7 above except that, under the terms of the partnership agreement, the partnership liquidates 50-50 and includes a targeted allocation provision that effectively matches partner capital accounts with anticipated partner liquidation proceeds. Under the partnership agreement, the partnership will allocate its aggregate net income (that is, \$20) in the manner necessary to match partner capital accounts (which begin at \$100 each) with anticipated partner liquidation proceeds (\$110 each). Based on these facts, the partnership will allocate \$10 to Partner A and \$10 to Partner B. Accordingly, even though the partnership does not liquidate according to capital accounts, the definition of Capital Account still becomes very relevant in determining the income and loss allocations of the partners.

By using nondepreciable property in the examples relating to the definition of “Capital Account” above, it was not necessary to take into account the impact of depreciation on partner capital accounts. To address such matters, partnerships holding depreciable property often will include a provision similar to the following in their partnership agreements:

“Depreciation” shall mean, for each Partnership Year, an amount equal to the depreciation, amortization or other cost recovery deduction allowable with respect to an asset for such year, except that if the Gross Asset Value of an asset differs from its adjusted basis for federal income tax purposes at the beginning of such year, Depreciation shall be an amount which bears the same ratio to such beginning Gross Asset Value as the federal income tax depreciation, amortization or other cost recovery deduction for such year bears to such beginning adjusted tax basis; provided, however, that if the adjusted tax basis of such property is zero, Depreciation shall be determined with reference to such beginning Gross Asset Value using any reasonable method selected by the General Partner.

The provisions of the partnership agreement calculating net profit or loss for book purposes often include a definition of “Depreciation.” The definition, therefore, directly affects both the income and loss shares and the capital accounts of the partners. In determining net profit or loss for book purposes, partnerships will depreciate the book values of depreciable properties separately from the tax basis of those properties. If no disparities exist between book basis and tax basis for depreciable property, book depreciation should always equal tax depreciation. On the other hand, if “book-tax” disparities exist for depreciable property as a result of “forward” or “reverse” section 704(c) implications, book depreciation and tax depreciation will differ each year.

The definition of “Depreciation” above amortizes book depreciation in the same ratio as tax depreciation and thereby causes partnerships to fully recover both the book depreciation and the tax depreciation of a depreciable asset at the same time. This means that, under the definition of “Depreciation”, the book depreciation and the tax depreciation for depreciable assets generally will reach zero at the same time. One significant exception to this general rule applies when depreciable property has a positive book basis but has a zero tax basis. In that case, the partnership may use any reasonable method to calculate book depreciation (usually a newly placed in service life).

Example 9 - Depreciation Calculation:

Partner A contributes two depreciable properties to a partnership. The first property is newly purchased property with a seven-year recovery period, a value of \$700 and a tax basis of \$700. The second property is five-year recovery property purchased two years ago having a current value of \$600 and a remaining tax basis of \$300. Under the definition of Depreciation above, both the book depreciation and the tax depreciation for the first property will equal \$100 each year because the book depreciation will simply follow the tax depreciation. On the second property, however, book depreciation and tax depreciation will differ because the book value of \$600 at the time of contribution differs from the tax basis of \$300 at that time. Further, because the partnership will fully recover through depreciation both the book basis and the tax basis of the asset at the same rate each year, book depreciation each year will bear the same ratio to the book basis as the tax depreciation each year bears to the tax basis. With three years remaining to depreciate the second property for tax purposes, tax depreciation will equal 1/3 of the remaining tax basis for each of the next three years (or \$100 each year). Book depreciation, therefore, also will equal 1/3 of the book basis for each of the next three years (or \$200 each year). As a result, at the end of three years of book and tax depreciation, both the book basis and the tax basis of the second property will equal zero.

The definition of “Depreciation” above relies upon the definition of “Gross Asset Value”. A Gross Asset Value definition often will resemble the following:

“Gross Asset Value” shall mean, with respect to any asset, the asset’s adjusted basis for federal income tax purposes, except as follows:

- (a) the initial Gross Asset Value of any asset contributed by a Partner to the Partnership shall be the gross fair market value of such asset at the time of such contribution as determined in good faith by the General Partner;

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existing Partner in exchange for more than a de minimis Capital Contribution; (ii) the distribution by the Partnership to a Partner of more than a de minimis amount of Partnership property as consideration for an interest in the Partnership; and (iii) the liquidation of the Partnership within the meaning of Section 1.704-1(b)(2)(ii)(g) of the Regulations or as otherwise provided in the Regulations;

(c) the Gross Asset Value of any Partnership asset distributed to any Partner shall be the gross fair market value of such asset on the date of distribution, as reasonably determined by the General Partner; and

(d) the Gross Asset Values of Partnership assets shall be increased (or decreased) to reflect any adjustments to the adjusted basis of such assets pursuant to Section 734(b) or 743(b) of the Code, but only to the extent that such adjustments are taken into account in determining Capital Accounts pursuant to Section 1.704-1(b)(2)(iv)(m) of the Regulations and Article ____; provided, however, that Gross Asset Values shall not be adjusted pursuant to this clause (d) to the extent the General Partner determines that an adjustment pursuant to clause (b) above is necessary or appropriate in connection with a transaction that would otherwise result in an adjustment pursuant to this clause (d).

If the Gross Asset Value of an asset has been determined or adjusted pursuant to clause (a), (b) or (d) above, such Gross Asset Value shall thereafter be adjusted by the Depreciation taken into account with respect to such asset for purposes of computing Profits and Losses.

Under this definition above, the Gross Asset Value of a particular asset generally equals its adjusted book value under the section 704(b) regulations. For example, the section 704(b) book value assigned to an asset upon its contribution becomes its Gross Asset Value. Similarly, if the partnership adjusts or “books-up” or “books-down” assets pursuant to the provisions of Regulations Sections 1.704-1(b)(2)(iv)(e), 1.704-1(b)(2)(iv)(f) or 1.704-1(b)(2)(iv)(m), the adjusted book values of the assets become their Gross Asset Values. Finally, once the Gross Asset Values of partnership assets have been established, such values are adjusted by “Depreciation” using a “Depreciation” definition similar to the one described above. Under this approach, the Gross Asset Values of partnership assets should always match their section 704(b) book values as partnerships depreciate their assets over time for book purposes.

When partnerships increase or decrease the Gross Asset Values of their assets, they are treated as if they actually sold the assets solely for book purposes (see, for example, clause (c) of the definition of “Profits” and “Losses” below). Thus, as with any actual sale, items of profit or loss for book purposes inevitably will arise. Partnerships adjusting Gross Asset Values will then take these items of profit or loss into account in determining the overall profit and loss allocations to the capital accounts of the partners.

Example 10 - Gross Asset Value:

Partner A contributes nondepreciable property with a fair market value of \$500 and a tax basis of \$200 to a partnership. Under these facts, the initial Gross Asset Value of the contributed property will equal \$500. At a time when the property has increased in value to \$800, the partnership “books-up” its assets pursuant to Regulations Section 1.704-1(b)(2)(iv)(f). As a result of the book-up, the partnership is treated as if it sold the contributed asset for an amount equal to its fair market value (that is, \$800) at the time of the book-up. The resulting \$300 in book gain (\$800 new Gross Asset Value minus \$500 initial Gross Asset Value) is treated as an item of profit in determining overall partnership profit or loss. Going forward, the property will remain on the books of the partnership with an \$800 book value until it is adjusted again or disposed of. If the property was depreciable, the partnership would reduce its Gross Asset Value of \$800 by book depreciation taken on the asset pursuant to a Depreciation definition included in the partnership agreement.

Depreciation and gains or losses from adjustments to Gross Asset Values are just two of the many items that partnerships must take into account in determining their net profit or net loss. To capture as many of these items as possible, partnership agreements will often include a profit and loss definition similar to the following:

“Profits” and “Losses” shall mean, for each Partnership year (or portion thereof), an amount equal to the Partnership’s taxable income or loss for such year (or portion thereof), determined in accordance with Section 703(a) of the Code (for this purpose, all items of income, gain, loss or deduction required to be stated separately pursuant to Section 703(a)(1) of the Code shall be included in taxable income or loss), with the following adjustments:

- (a) any income of the Partnership that is exempt from federal income tax and not otherwise taken into account in computing taxable income or loss shall be added to such taxable income or loss;
- (b) any expenditures of the Partnership described in Section 705(a)(2)(B) of the Code or treated as such expenditures pursuant to Section 1.704-1(b)(2)(iv)(i) of the Regulations, and not otherwise taken into account in computing Profits or Losses shall be subtracted from such taxable income or loss;
- (c) if the Gross Asset Value of any Partnership asset is adjusted pursuant to clause (b) or clause (d) of the definition of Gross Asset Value herein, the amount of such adjustment shall be taken into account as gain or loss from the disposition of such asset for purposes of computing Profits or Losses;
- (d) gain or loss resulting from any disposition of Partnership property with respect to which gain or loss is recognized for federal income tax purposes shall be computed by reference to the Gross Asset Value of the property disposed of, notwithstanding that the adjusted tax basis of such property differs from its Gross Asset Value;

(e) in lieu of the depreciation, amortization and other cost recovery deductions taken into account in computing such taxable income or loss, there shall be taken into account Depreciation for such Partnership Year or other period, computed in accordance with the definition of Depreciation herein; and

(f) notwithstanding any other provisions hereof, any items of income, gain, loss or deduction which are specially allocated pursuant to Section ____ shall not be taken into account in computing Profits or Losses.

This definition of “Profits” and “Losses” essentially seeks to convert partnership taxable income or loss into section 704(b) book income or loss. To accomplish this, the definition begins with taxable income or loss and then (i) adds back tax-exempt income that would not otherwise be taken into account; and (ii) deducts nondeductible expenses that have not already been taken into account. These particular additions and subtractions are important because both tax-exempt income and nondeductible expenses have economic consequences (notwithstanding their lack of tax effect) that partnerships need to reflect in the capital accounts of their partners. As a result, the net profit or loss allocable to the partners simply must include these items even though they are excluded from taxable income or loss.

The “Profits” and “Losses” definition also (i) adds back or deducts adjustments to the Gross Asset Values of partnership assets from book-ups, book-downs and other adjustment events; (ii) determines gains or losses from asset sales by reference to the Gross Asset Values of the assets sold as opposed to their adjusted tax basis; and (iii) computes depreciation of partnership assets as provided in the Depreciation definition. By applying these approaches, the “Profits” and “Losses” definition uses exclusively section 704(b) book numbers and concepts in determining partnership net profit or net loss. Section 704(c), on the other hand, is largely ignored for this purpose. As a result, as discussed above, book-ups, book-downs and other capital account adjustment events which have no direct income tax effect still may produce gains or losses for book purposes that will flow through to the capital accounts of the partners via the definition of “Profits” and “Losses”. Similarly, asset dispositions resulting in tax gains or losses will not affect “Profit” or “Loss” unless they also result in gains or losses by reference to “Gross Asset Values”. Finally, depreciation will be calculated for book purposes by reference to the defined term “Depreciation” as opposed to using tax depreciation for the year.

The last provision of the “Profits” and “Losses” definition excludes all specially allocated items from the calculation of net profit or loss. This provision is necessary to ensure that special allocations and allocations subject to regulatory allocation provisions are targeted to the partners that are intended or required to receive those allocations. Stated differently, if the “Profits” and “Losses” definition included special allocations and regulatory allocations, then all partners would share those allocations in the same way that “general” partnership items are shared (for example, by percentages or according to a specified Waterfall arrangement). Specific targeting, therefore, would not occur. Accordingly, to remove special allocations and regulatory allocations from the general sharing provisions of the partnership agreement and allocate those items in a totally independent and separate manner, the definition of “Profits” and “Losses” excludes those items.

B. Boilerplate Provisions Related to the Regulatory Allocations.

As discussed in Part III.B. above, partnerships more commonly seek to satisfy the section 704(b) substantial economic effect safe harbor by qualifying under the alternate economic effect test as opposed to qualifying under the primary economic effect test. Further, to qualify under the alternate economic effect test, (i) the partnership cannot allocate losses to cause a partner to have a deficit adjusted capital account (that is, a deficit capital account that exceeds amounts the partner is obligated to restore or deemed obligated to restore); and (ii) if a partner unexpectedly receives a distribution or allocation that creates or increases a deficit adjusted capital account, the partnership must allocate gross income to the partner to eliminate that deficit as quickly as possible through a qualified income offset or QIO.

Because a loss limitation provision and a QIO are so essential to qualifying under the alternate economic effect test, those provisions often are among the first provisions provided for in the portion of the tax boilerplate that includes the regulatory allocations. In most cases, the loss limitation will read similar to the following:

Loss Limitation. Notwithstanding anything to the contrary in this Section ____, the amount of items of Partnership expense and loss allocated pursuant to this Section ____ to any Partner shall not exceed the maximum amount of such items that can be so allocated without causing such Partner to have an Adjusted Capital Account Deficit (or increasing such a deficit) at the end of any Partnership Year (as determined taking into account the expected items described in Section 1.704-1(b)(2)(ii)(d) of the Regulations). All such items in excess of the limitation set forth in this section shall be allocated first to Partners who would not have an Adjusted Capital Account Deficit, pro rata, until no Partner would be entitled to any further allocation, and thereafter to the General Partner.

The loss limitation provision above is intended to prevent partners from receiving loss allocations that reduce their negative capital accounts beyond the amounts they are obligated or deemed obligated to restore. Stated differently, the provision seeks to prevent partners from having capital accounts that are “impermissibly negative.” To accomplish this goal, the loss limitation provision clearly states that loss allocations cannot cause partners to have “Adjusted Capital Account Deficits.” Further, the provision often provides that if a loss allocation would cause a partner to have an Adjusted Capital Account Deficit (or increase such a deficit); the partnership will allocate the loss away from the partner to other partners who can absorb the loss without having Adjusted Capital Account Deficits.

Example 11 - Loss Limitation Provision:

Partner A contributes \$100 to a real estate partnership while Partner B contributes \$10. The partners agree to divide losses on an equal basis, and the partnership incurs a \$30 loss in the first year. The partnership has no liabilities, and the partnership agreement does not contain a DRO for either partner. Under these facts, the partnership can allocate only \$10 (instead of \$15) of the \$30 loss to Partner B because of the loss limitation provision. The \$5 that cannot be allocated to Partner B must instead be allocated to Partner A.

Obviously, the key phrase in the loss limitation provision is “Adjusted Capital Account Deficit.” That critical phrase is typically defined similar to the following:

“Adjusted Capital Account Deficit” shall mean, with respect to any Partner, the deficit balance, if any, in such Partner’s Capital Account, as of the end of the relevant Partnership Year, after giving effect to the following adjustments: (a) credit to such Capital Account any amounts which such Partner is obligated to restore pursuant to any provision of this Agreement or is deemed to be obligated to restore pursuant to the penultimate sentences of Sections 1.704-2(g)(1) and (i)(5) of the Regulations; and (b) debit to such Capital Account the items described in Sections 1.704-1(b)(2)(ii)(d)(4), (5) and (6) of the Regulations. The foregoing definition of “Adjusted Capital Account Deficit” is intended to comply with the provisions of Section 1.704-1(b)(2)(ii)(d) of the Regulations and shall be interpreted consistently therewith.

In short, the Adjusted Capital Account Deficit starts with a partner’s capital account balance and then increases that balance by (i) amounts that the partner has agreed to contribute to the partnership through a DRO or otherwise; and (ii) amounts the partner is deemed obligated to contribute as a result of having a share of either partnership minimum gain (that is, the reference in the Adjusted Capital Account Deficit definition to Regulations Section 1.704-2(g)(1)) or partnership nonrecourse debt minimum gain (that is, the reference in the definition to Regulations Section 1.704-2(i)(5)).

The sum derived from the calculation above is then reduced by the three categories of items described in Regulation Section 1.704-1(b)(2)(ii)(d) (that is, the regulation section governing the QIO). Specifically, reductions are made for (i) adjustments that, as of the end of the year, reasonably are expected to be made to partners under Regulations Section 1.704-1(b)(2)(iv)(k) for depletion allowances on oil and gas properties; (ii) allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to partners under section 704(e)(2), section 706(d) or Regulations Section 1.751-1(b)(1)(ii); and (iii) distributions that, as of the end of the year, reasonably are expected to be made to partners in excess of offsetting items increasing partner capital accounts that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made (subject to certain exceptions).

Stated simply, the Adjusted Capital Account Deficit definition effectively is used to determine the maximum amount of losses that the partnership can allocate to each of the partners by looking not only at partner capital accounts but also the extent to which partners could have impermissible negative capital accounts after taking into account minimum gain shares and certain expected future events. Indeed, because partners may have negative capital accounts as long as those negative capital accounts do not exceed their shares of partnership minimum gain and partnership nonrecourse debt minimum gain, the Adjusted Capital Account Deficit provision adds both partnership minimum gain shares and partnership nonrecourse debt minimum gain shares to partner capital accounts to determine the maximum amount of loss allocable to each partner. Then, to the extent that the maximum amount of loss allocable to a partner is reasonably expected to be “used up” by depletion deductions, other loss allocations or distributions in excess of matching income allocations, that maximum loss allocation amount is reduced to take into account those expected events.

Example 12 - Adjusted Capital Account Deficit:

Assume that Partner A and Partner B each contribute \$50 to a 50-50 partnership that borrows an additional \$900 on a nonrecourse basis to acquire a building. After a number of years of operations, the partners have collectively received losses of \$500, \$400 of which qualify as nonrecourse deductions carrying with them shares of minimum gain. Under these facts, both Partner A and Partner B will have negative capital accounts of (\$200) (\$50 in initial capital less \$250 in allocated losses). Their “adjusted” capital accounts for purposes of the Adjusted Capital Account Deficit definition, however, will each equal \$0 (negative capital account of (\$200) plus \$200 share of minimum gain). As a result, even though both partners will have negative capital accounts, none of the \$250 in losses allocated to each of them will create Adjusted Capital Account Deficits.

What if a partner somehow develops an Adjusted Capital Account Deficit without triggering the QIO? Technically, this may be possible. QIOs typically provide that partners who unexpectedly receive certain adjustments or distributions creating Adjusted Capital Account Deficits must receive income allocations (including allocations of gross income) to eliminate their Adjusted Capital Account Deficits as quickly as possible. While these provisions presumably will apply to nearly all situations involving impermissible negative capital accounts, partners with impermissible negative capital accounts resulting from events other than unexpected adjustments or distributions technically may fall outside of the reach of the QIO. To address the possibility that the QIO, by itself, may not eliminate all impermissible negative capital accounts, many partnership agreements will contain a “belts and suspenders” provision similar to the following:

Gross Income Allocation. In the event a Member has a deficit Capital Account at the end of any Allocation Year which is in excess of the sum of: (i) the amount such Member is obligated to restore pursuant to the penultimate sentences of Regulations Sections 1.704 2(g)(1) and 1.704 2(i)(5), each such Member shall be specially allocated items of income and gain in the amount of such excess as quickly as possible, provided that an allocation pursuant to this section shall be made only if and to the extent that such Member would have a deficit Capital Account in excess of such sum after all other allocations provided for in this Article have been made as if this section was not in the Agreement.

Under the “Gross Income Allocation” provision above, partners with impermissible negative capital accounts who are not subject to the QIO still will receive income allocations (including gross income allocations) to eliminate their impermissible negative capital accounts as quickly as possible. This result will take place even though the definition does not reference the Adjusted Capital Account Deficit definition. This is because the “Gross Income Allocation” provision, if triggered, will allocate income items (including gross income) to all partners with deficit capital accounts in excess of their actual or deemed obligations to restore deficits in their capital accounts. As a result, it effectively will work to reduce or eliminate all Adjusted Capital Account Deficits. However, to the extent that impermissible negative capital accounts will not exist after the partnership has made all other allocations to partners required under the partnership agreement, the “Gross Income Allocation” by its terms will not apply. The allocation provision, therefore, represents the “last line of defense” against partners having impermissible negative capital accounts.

In addition to including provisions relating to loss limitation and the QIO, most regulatory allocation sections will include a partnership minimum gain chargeback, a partner nonrecourse debt minimum chargeback and one or more provisions relating to the allocation of nonrecourse deductions. Those provisions and their accompanying definitions often resemble the following:

Definitions.

“Nonrecourse Liability” shall have the meaning set forth in Section 1.704-2(b)(3) of the Regulations.

“Partner Nonrecourse Debt” shall have the meaning set forth for the term “partner nonrecourse debt” in Section 1.704-2(b)(4) of the Regulations.

“Partner Nonrecourse Debt Minimum Gain” shall have the meaning set forth for the term “partner nonrecourse debt minimum gain” in Section 1.704-2(i)(2) of the Regulations.

“Partnership Minimum Gain” shall have the meaning set forth for the term “partnership minimum gain” in Section 1.704-2(b)(2) of the Regulations.

Regulatory Allocations.

(a) Partnership Minimum Gain Chargeback. Notwithstanding anything in this article to the contrary, if there is a net decrease in Partnership Minimum Gain during any Partnership Year, except as otherwise permitted by Sections 1.704-2(f)(2), (3), (4) and (5) of the Regulations, items of Partnership income and gain for such year (and subsequent years, if necessary) in the order provided in Section 1.704-2(j)(2) of the Regulations shall be allocated among all Partners whose shares of Partnership Minimum Gain decreased during such year in proportion to and to the extent of such Partner’s share of the net decrease in Partnership Minimum Gain during such year. The allocation contained in this section is intended to be a minimum gain chargeback within the meaning of Section 1.704-2(f) of the Regulations, and it shall be interpreted consistently therewith.

(b) Partner Nonrecourse Debt Minimum Gain Chargeback. Notwithstanding anything in this article to the contrary, if there is a net decrease in Partner Nonrecourse Debt Minimum Gain during any Partnership Year, except as provided in Section 1.704-2(i) of the Regulations, items of Partnership income and gain for such year (and subsequent years, if necessary) in the order provided in Section 1.704-2(j)(2)(ii) of the Regulations shall be allocated among all Partners whose share of Partner Nonrecourse Debt Minimum Gain decreased during such year in proportion to and to the extent of such Partner’s share of the net decrease in Partner Nonrecourse Debt Minimum Gain during such year. This section is intended to comply with the minimum gain chargeback requirement in Section 1.704-2 of the Regulations, and shall be interpreted consistently therewith.

(c) Partner Nonrecourse Deductions. In accordance with Section 1.704-2(i)(1) of the Regulations, any item of Partnership loss or deduction which is attributable to Partner Nonrecourse Debt for which a Partner bears the economic risk of loss (such as a

nonrecourse loan made by a Partner to the Partnership or an otherwise nonrecourse loan to the Partnership that has been guaranteed by a Partner) shall be allocated to that Partner to the extent of its economic risk of loss.

The definitions above define which debts are subject to the special allocation and chargeback rules for nonrecourse deductions. “Nonrecourse Liability” and “Partnership Minimum Gain” refer to the amount of general “pure” nonrecourse debt (that is, debt where no partner has any risk of loss) and the related amount of minimum gain that partnerships must allocate to partners who receive deductions funded by such debt (so-called “nonrecourse deductions”). “Partner Nonrecourse Debt” and “Partner Nonrecourse Debt Minimum Gain” refer to the same concepts as above except that they cover debt that is nominally nonrecourse but for which a partner bears the risk of loss (as a result of being the lender or a guarantor) and the deductions funded by such debt (so-called “partner nonrecourse deductions”).

Partnerships generally have some flexibility in allocating deductions and losses funded by Nonrecourse Liabilities as long as they allocate such items in a manner that is consistent with allocations of certain other significant items having substantial economic effect.²⁸ Consistent with this general rule, many agreements specifically state that such deductions are allocated in accordance with percentage interests or otherwise. Losses funded by Partner Nonrecourse Debt, on the other hand, must be allocated to the partner who is the guarantor/lender because that partner bears the economic risk of loss.²⁹ These loss allocations and the related minimum gain are tracked in a manner similar to that of a Nonrecourse Liability and Partnership Minimum Gain.

To the extent that a deduction reduces the book basis of property secured by the nonrecourse or partner nonrecourse debt to below the amount of the debt, the difference is either “Partnership Minimum Gain” (in the case of a pure nonrecourse debt) or “Partner Nonrecourse Debt Minimum Gain” (in the case of a partner nonrecourse debt). Further, if there is a subsequent reduction in “Partnership Minimum Gain” or “Partner Nonrecourse Debt Minimum Gain,” the “Partnership Minimum Gain Chargeback” or “Partner Nonrecourse Debt Minimum Gain Chargeback” provisions above will be triggered and specially allocate income or gain (including gross income) to those partners whose shares of such Partnership Minimum Gain or Partner Nonrecourse Debt Minimum Gain have decreased as a result of the reduction. The chargebacks, in effect, balance the books of the partners by allocating income and gain from reductions in nonrecourse or partner nonrecourse debt to those partners who received deductions based on the nonrecourse debts in prior tax years.

Example 13 - Partnership Minimum Gain Chargeback:

Assume that Partner A and Partner B each contribute \$50,000 to a 50-50 partnership that borrows an additional \$900,000 on a nonrecourse basis to acquire a \$1,000,000 building. After a number of years of operations during which no principal payments are made on the debt, the partners collectively receive depreciation deductions of \$500,000 (\$250,000 each) from the building and reduce their capital accounts from \$50,000 to (\$200,000). Of

²⁸ Reg. § 1.704-2(e)(2).

²⁹ Reg. § 1.704-2(i).

the \$500,000 in depreciation deductions, the first \$100,000 are attributable to partner equity while the remaining \$400,000 qualify as nonrecourse deductions attributable to partnership nonrecourse debt. Under these facts, the partnership will have \$400,000 of partnership minimum gain (\$900,000 nonrecourse debt less \$500,000 book basis equals \$400,000 minimum gain). As for the partners, both Partner A and Partner B will have received \$200,000 in nonrecourse deductions which will cause them to have minimum gain shares of \$200,000 each. These minimum gain shares support their negative capital accounts of (\$200,000) and prevent them from having Adjusted Capital Accounts Deficits. However, if the partnership sells or otherwise disposes of the building, or if the creditor of the nonrecourse loan forgives all or a portion of the loan, both partnership minimum gain and the minimum gain shares of the partners will decrease. This decrease will trigger the minimum gain chargeback provision described above and thereby force allocations of income and gain (including gross income) to both Partner A and Partner B.

Example 14 - Partner Nonrecourse Debt Minimum Gain Chargeback:

Assume the same facts as in Example 13 above except that Partner A guarantees the \$900,000 nonrecourse debt and thereby causes the debt to become partner nonrecourse debt for tax purposes. Under these facts, the partnership must allocate the \$400,000 in nonrecourse deductions (now partner nonrecourse deductions) solely to Partner A because Partner A alone bears the economic risk of loss on the debt funding the deductions. The \$50,000 equity based deduction and the \$400,000 in partner nonrecourse deductions allocated to Partner A will decrease Partner A's capital account from \$50,000 to (\$400,000). Similarly, the partnership will have \$400,000 of partnership nonrecourse debt minimum gain (\$900,000 partner nonrecourse debt less \$500,000 building book basis). Partner A will have a partnership nonrecourse debt minimum gain share of \$400,000 supporting Partner A's negative capital account of (\$400,000) and preventing Partner A from having an Adjusted Capital Accounts Deficit. Further, if the partnership sells or otherwise disposes of the building, or if the creditor of the nonrecourse loan forgives all or a portion of the loan, both partnership nonrecourse debt minimum gain and the partner nonrecourse debt minimum gain share of Partner A will decrease. Such a decrease will trigger the partner nonrecourse debt minimum gain chargeback provision described above and force allocations of income and gain (including gross income) to Partner A.

What if a partnership triggers one of the regulatory allocation provisions and, as a result, some partners receive income allocations that are not consistent with the overall economic arrangement of the partners? For partnerships liquidating based on positive capital account balances, this possibility may present a very real business concern. For example, if a regulatory allocation provision kicks in and increases the capital accounts of some partners in a manner that is not consistent with the overall economic arrangement, the regulatory allocation provision could distort the economic deal of the partners absent some type of cure or reversal provision in the partnership agreement. To address this potential economic concern, many partnership agreements will include a provision similar to the following:

Curative Allocations. The allocations set forth in Sections ____ hereof (the “Regulatory Allocations”) are intended to comply with certain requirements of the Regulations. It is

the intent of the Members that, to the extent possible, all Regulatory Allocations shall be offset either with other Regulatory Allocations or with special allocations of other items of Company income, gain, loss or deduction pursuant to this section. Therefore, notwithstanding any other provision of this Section ___ (other than the Regulatory Allocations) to the contrary, the Manager shall make such offsetting special allocations of income, gain, loss or deduction in whatever manner it determines appropriate so that, after such offsetting allocations are made, each Member's Capital Account balance is, to the extent possible, equal to the Capital Account balance such Member would have had if the Regulatory Allocations were not part of the Agreement and all Company items were allocated pursuant to the general allocation provisions.

A curative allocation paragraph similar to the one provided above is not to be confused with the section 704(c) "traditional method with curative allocations." Indeed, a curative allocation paragraph reverses mandatory section 704(b) regulatory allocations, to the greatest extent possible, in order to maintain partner economic arrangements while the traditional method with curative allocations is a section 704(c) tax allocation approach that seeks to correct ceiling rule issues on section 704(c) property. To avoid confusion, some agreements use the term "subsequent" allocations in lieu of "curative" allocations. Examples of how a "curative" or "subsequent" allocation provision can apply are provided below:

Example 15 - Curative/Subsequent Allocations #1:

Partner A contributes \$100 and Partner B contributes \$20 to a new partnership. The partnership agreement includes a loss limitation provision and a QIO. Further, the agreement provides that the partners will share profits and losses equally and liquidate according to positive capital account balances. The partnership incurs a loss of \$50 in its first year. In light of the loss limitation provision and Partner B having only a \$20 initial capital account, Partner B can receive only \$20 of the \$50 loss (instead of \$25). Partner A, on the other hand, will receive its full \$25 share of the \$50 overall loss plus the \$5 portion of Partner B's loss share that Partner B could not receive due to the loss limitation provision. As a result, Partner A's capital account will fall from \$100 to \$70, while Partner B's capital account falls from \$20 to \$0. In its second year, the partnership generates a profit of \$30 and, pursuant to the partnership agreement, divides the profit equally between both partners. Thus, Partner A's capital account increases from \$70 to \$85, while Partner B's capital account increases from \$0 to \$15. After its second year, the partnership liquidates and distributes its remaining \$100 according to the capital accounts of the partners (that is, \$85 to Partner A and \$15 to Partner B). Taking the two partnership years together, the partnership experienced a \$20 net loss and divided the loss \$15 to Partner A and \$5 to Partner B because of a regulatory allocation provision. Accordingly, even though the partners agreed to share losses equally, the regulatory allocation provisions undermined their overall 50-50 economic arrangement by effectively assigning overall losses 75% to Partner A and 25% to Partner B.

Example 16 - Curative/Subsequent Allocations #2.

Assume the same facts as in Example 15 above, except that the partnership agreement contains a "Subsequent Allocation" provision similar to the one provided above. Under

these revised facts, the capital accounts of Partner A and Partner B after the first year would still equal the numbers used in Example 15 (that is, \$70 for Partner A and \$0 for Partner B). However, instead of allocating the \$30 profit equally in the partnership's second year, the "Subsequent Allocation" provision would override the general sharing ratios of the partners and assign the \$30 profit in a manner that would reverse the effect of the regulatory allocation provision in year one. As a result, the partnership would assign \$20 of the \$30 profit to Partner A and increase Partner A's capital account from \$70 to \$90. Similarly, the partnership would assign only \$10 of the \$30 profit to Partner B to increase Partner B's capital account from \$0 to \$10. Under this revised approach, subsequent liquidation distributions of \$90 to Partner A and \$10 to Partner B would correspond to the overall economic arrangement of the partners because each partner would effectively bear 50% of the partnership's net loss of \$20 for the combined two years of operations.

C. Boilerplate Provisions Related to Section 704(c).

In addition to all of the boilerplate provisions above addressing issues under section 704(b), most partnership agreements will include at least one provision relating to section 704(c) in their tax boilerplate. Section 704(c) boilerplate provisions may take many forms, but many will resemble the following:

Section 704(c) Allocations. In accordance with Section 704(c) of the Code and the Regulations thereunder, income, gain, loss and deduction with respect to any property contributed to the capital of the Partnership shall, solely for tax purposes, be allocated among the Partners under any reasonable method selected by the General Partner so as to take account of any variation between the adjusted basis of such property to the Partnership for federal income tax purposes and its initial Gross Asset Value. If the Gross Asset Value of any Partnership asset is adjusted pursuant to clause (c) or (d) of the definition thereof, subsequent allocations of income, gain, loss and deduction with respect to such asset shall take account of any variation between the adjusted basis of such asset for federal income tax purposes and its Gross Asset Value in the same manner as under Section 704(c) of the Code and the Regulations thereunder. Any elections or other decisions relating to such allocations shall be made by the General Partner in a manner that reasonably reflects the purpose and intention of this Agreement. Allocations pursuant to this section are solely for purposes of federal, state and local taxes and shall not affect, or in any way be taken into account in computing, any Partner's Capital Account or share of Profits, Losses, other items or distributions pursuant to any provision of this Agreement.

The section 704(c) paragraph above essentially provides that if there are differences between the book and tax basis of property (either as a result of contributions of built-in gain or loss property to the partnership under section 704(c) (that is, "forward section 704(c)") or through partnership revaluations of assets under section 704(b) (that is, "reverse section 704(c)")), then future tax allocations shall "take that variation into account." To "take that variation into account" effectively means allocating built-in gain and built-in loss items in accordance with section 704(c) principles back to contributing partners and thereby preventing shifting of built-in gain or built-in loss away from contributing partners.

In short, the section 704(c) paragraph above mirrors the statutory and regulatory requirements under section 704(c).³⁰ This paragraph, moreover, allows the General Partner to decide how to make section 704(c) allocations that are consistent with the intent of the agreement. In contrast, many agreements specifically provide for the method under the regulations for taking such difference into account (for example, the “Traditional,” the “Traditional with Curative Allocations,” or the “Remedial” method under Regulations section 1.704-3(b), (c), or (d), respectively).

Insisting that a partnership agreement specifically identify the particular section 704(c) method that will apply to built-in gain or loss property clearly makes sense when one does not represent the person with the authority to select section 704(c) methods or when such a method issue may create significant controversy among the partners. In general, partners contributing built-in gain property will prefer the Traditional Method while partners contributing built-in loss property will prefer either the Traditional Method with Curative Allocations or the Remedial Method. Conversely, partners who contribute neither built-in gain nor built-in loss property (so-called “noncontributing partners”) generally will prefer the Traditional Method with Curative Allocations or the Remedial Method when other partners contribute built-in gain property and the Traditional Method when other partners contribute built-in loss property. One advantage of the Traditional Method with Curative Allocations is that there is more flexibility in when and how to cure a shortfall. For example, if there is a depreciation shortfall, the tax cure can be through a special allocation of gain on sale to cure the shortfall without resorting to the notional income items that the Remedial Method requires.³¹

D. Other Boilerplate Provisions.

The tax boilerplate provisions discussed above certainly do not represent an exhaustive list of all of the tax boilerplate provisions included in partnership agreements. Many partnership agreements, for example, will include provisions addressing how to adjust capital accounts when elections are made under section 754, how to allocate profit or loss when the interests of partners vary during the year, how to allocate “excess nonrecourse liabilities” for basis purposes or other tax boilerplate provisions in addition to the provisions discussed in above. Nevertheless, tax practitioners who adequately understand both the tax and economic consequences that can arise with the boilerplate provisions discussed in this article should be well positioned to more than adequately represent their clients who are entering into partnership arrangements.

V. Conclusion.

As mentioned in the Introduction to this article, professionals who expect to regularly read and write partnership and LLC agreements must be prepared to continually adapt to almost never ending changes in both the business environment and the law for partnerships and LLCs. However, even as partnership and LLC agreements expand or contract to address new business and legal issues, the structure, organization and many of the provisions of such agreements are likely to largely remain the same. Professionals who fully understand the points raised and

³⁰ The regulations require this whether it is in the agreement or not – all the provision does is give the General Partner the right to select the method.

³¹ See Reg. § 1.704-3(c)(3)(iii)(B).

discussed in this article, therefore, should be more than able to read and write sophisticated partnership and LLC agreements for many years to come.

VI. Appendix – Tax Boilerplate In Context of LLC Agreement

OPERATING AGREEMENT OF COMPANY, LLC

Explanatory Statement

SECTION 1 THE COMPANY

1.10 Definitions.

Additional Capital Contributions	The section 704(b) value of post-formation capital contributed.
Adjusted Capital Account Deficit	The amount the section 704(b) capital account is impermissibly negative (i.e., negative after adjusting for certain expected events and after adding back the amount a partner is obligated to contribute or is deemed obligated to contribute due to partner's share of nonrecourse debt "Minimum Gain").
Allocation Year	The definition of the fiscal tax year for allocating Profits and Losses based on tax year rules under section 706. This is usually a calendar year but is based on the tax years the partners use.
Capital Account	The economic capital account of a partner based on section 704(b) asset values (not necessarily fair market values). The value starts with the net section 704(b) "Gross Asset Value" (or "book value") of contributions, adjusted up or down for the partner's share of Profits and Losses, and adjusted up or down for net partner contributions or distributions. The accounts are typically reset to fair market value on certain "book-up" events such as non-de minimis contributions, distributions, or issuances of profits interests to service partners.
Capital Contributions	The section 704(b) value of net contributions at formation or through Additional Capital Contributions.
Company Minimum Gain	This is the LLC equivalent of Partnership Minimum Gain, which is the cumulative amount of unrecaptured deductions allocated to partners funded by nonrecourse debt.
Depreciation	This is the annual section 704(b) depreciation of property based on the book values of property. The annual book depreciation rate parallels the tax depreciation rate so both book and tax depreciation end up at zero at the same time. Thus, if the book value is \$100 and the tax basis is \$40 on 4-year straight line property, there is \$10 of tax depreciation and \$25 of book Depreciation each year.

Gross Asset Value	This is the section 704(b) value of property, often referred to as “book value”. The book value of a property starts at the fair market value of the property at the acquisition date, and is adjusted downward for the annual Depreciation and is also adjusted up or down to fair market value if there is a book-up or book-down event.
Member Nonrecourse Debt	This is the LLC equivalent of Partner Nonrecourse Debt, which is debt that is nominally nonrecourse, but for which a partner has personal liability such as through a partner guarantee or if the partner or a related person is at risk as the maker of the loan.
Member Nonrecourse Debt Minimum Gain	This is the parallel to Company/Partnership Minimum Gain except it applies to Member/Partner Nonrecourse Debt as opposed to Company/Partnership Nonrecourse Debt.
Member Nonrecourse Deductions	This is the parallel to Company/Partnership Nonrecourse Deductions except it applies to Member/Partner Nonrecourse Debt as opposed to Company/Partnership Nonrecourse Debt.
Nonrecourse Deductions	These are the deductions funded from nonrecourse debt. For example, if a \$100 property is purchased with \$30 of equity and \$70 of nonrecourse debt, these are the depreciation deductions after the first \$30 of equity-sourced deductions.
Nonrecourse Liability	This is debt where the partnership’s obligation to pay is limited to the value of specified partnership assets.
Percentage Interest	This is the percentage that the partners agree to share profits and losses and is generally set forth in an exhibit at the back of the agreement although is sometimes set forth in the Profit and Loss allocation section.
Profits and Losses	This is the definition of section 704(b) book profits and losses that are allocated to the partners each year. The computation starts with the tax profits and losses and adjusts for differences such as (1) adding back tax-exempt income; (2) subtracting non-deductible non-capitalizable expenses; (3) adjusting for book-up gains or book down losses; (4) adjusting the amount of gains or losses from property sales to measure the amount by reference to book values and not tax basis; and (5) adjusting the amount of annual depreciation to use book Depreciation instead of tax depreciation. The definition of Profit and Losses also specifically excludes any book items that are specially allocated such as through the Regulatory Allocations.
Regulatory Allocations	This is a definitional reference to the Regulatory Allocations for purposes of the later Curative/Subsequent Allocation provision to minimize the risk of the Regulatory Allocations unintentionally affecting the general economics of the LLC agreement. The Regulatory Allocations dictate the allocations relating to Nonrecourse Debt and include an overall loss limitation as is required to meet the alternative economic effect safe harbor under the section 704(b) regulations.
Tax Matters Member	This is the person designated to represent the partnership in tax audits and make certain other tax decisions.

SECTION 2 MEMBERS' CAPITAL CONTRIBUTIONS

SECTION 3 ALLOCATIONS

3.1 Profits

[This includes the scheme for allocating Profits after special allocations.]

3.2 Losses.

[This includes the scheme for allocating Losses after special allocations.]

3.3 Special Allocations. The following special allocations shall be made in the following order:

(a) **Minimum Gain Chargeback.** [Allocate Minimum Gain Chargeback to the partner who received the prior Company/Partnership Nonrecourse Deductions. There is a chargeback when there is a decrease in Minimum Gain such as a repayment of debt that has supported prior Company/Partnership Nonrecourse Deductions. For example, assume a partnership bought a property using \$70 of Nonrecourse Debt and depreciated the property to \$50 to create \$20 of Minimum Gain. If the partnership later repays \$15 of debt, the Minimum Gain decreases to \$5 (\$55 debt less \$50 of book value) and the partnership must allocate the \$15 of Minimum Gain Chargeback to the partners who received the prior Nonrecourse Deductions.]

(b) **Member Minimum Gain Chargeback.** [Allocate gain to the partner who received the prior Member/Partner Nonrecourse Deductions when there is a decrease in Member/Partner Minimum Gain. This is the equivalent of a partnership Minimum Gain Chargeback except that it relates to a decrease in Member/Partner Minimum Gain as opposed to a decrease in Company/Partnership Minimum Gain.]

(c) **Qualified Income Offset.** [Allocate gross income items to restore a partner's impermissibly negative capital account from unexpected distributions to the extent there is an Adjusted Capital Account Deficit (i.e., the negative capital account exceeds what the partner is actually or deemed obligated to restore from deficit restoration obligations or from its share of Company/Partnership or Member/Partner Minimum Gain. Note that the Loss Limitation is designed to avoid impermissibly negative capital accounts from loss allocations and so should not give rise to a Qualified Income Offset.)]

(d) **Gross Income Allocation.** [This is effectively a back-stop to the Qualified Income Offset since the former provision is limited to "unexpected distributions" creating an Adjusted Capital Account Deficit. This provision provides a similar gross income allocation to offset an impermissible capital account deficit that may otherwise occur, such as from "expected" distributions that create an impermissible Adjusted Capital Account Deficit.]

(e) **Nonrecourse Deductions.** [This provision specially allocates Company/Partnership Nonrecourse Deductions. Since no partner is at risk for these deductions,

the tax rules limit the ability to specially allocate these deductions to be consistent with some other significant allocation that has economic effect. Frequently these deductions are allocated in accordance with residual profit and loss sharing ratios (i.e., Percentage Interests).]

(f) **Member Nonrecourse Deductions.** [This provision specially allocates Member/Partner Nonrecourse Deductions. The regulations mandate that these deductions be allocated to the partner who is at risk for these deductions (i.e., the partner-lender or partner-guarantor of the Nonrecourse Debt).]

(g) **Section 754 Adjustments.** [This provision complies with technical details of the §704(b) regulations to take into account certain adjustments under the §734(b) or §743(b), such as how to allocate the increase in book value of a property when §734(b) adjustment causes the tax basis of a property to exceed its prior book value.]

3.4 Curative Allocations

[This curative/subsequent allocation paragraph is designed to reverse any unintended long-term effect of the tax boilerplate Regulatory Allocations (§§3.3 and 3.5). For example, if the Loss Limitation provision redirected losses differently than the normal Loss sharing ratios, this provision will reallocate future profits in reverse order so that the partner who received the excess losses also receives offsetting excess Profits.]

3.5 Loss Limitation

[This paragraph prevents the allocation of losses to a partner that would cause that partner's capital account to be impermissibly negative and otherwise cause an Adjusted Capital Account Deficit. This paragraph is designed to work in combination with the Qualified Income Offset to satisfy the Alternate test for Economic Effect under the section 704(b) regulations.]

3.6 Other Allocation Rules

[This section includes allocation housekeeping provisions such as requiring that the partnership follow the rules under section 706 for allocating Profit and Loss items within a single year when there have been changes in partners' interests during the year.]

3.7 Tax Allocations: Code Section 704(c)

[This provision requires that the partnership follow the mandatory rules under section 704(c) relating to the tracking of built-in tax gain or loss on contributed property or the parallel rules for built-in tax gain or loss that is caused by a post-formation book-up or book-down of partnership assets. Typically this provision will pick a specific method among the methods allowed in the regulations for allocating such built-in tax gain or loss. The section 704(c) method is often a significantly negotiated item as there can be significant differences in the tax results, particularly with low-basis depreciable property.]

SECTION 4 DISTRIBUTIONS

SECTION 5 MANAGEMENT

SECTION 6 ROLE OF MEMBERS

SECTION 7 ACCOUNTING, BOOKS AND RECORDS

7.2 Reports.

[This provision will often dictate when the K-1s are due to the partners.]

7.3 Tax Matters.

(a) Tax Elections. [This provision explains who has authority to make certain tax elections and other tax decisions. This often specifies the more important decisions such as who has authority to file a section 754 election, extend the statute of limitations for the partnership, and who serves as the Tax Matters Partner in the case of an IRS audit.]

(c) Tax Classification.

[Sometimes a partnership will specify the making of certain tax elections to treat it as a partnership for federal or state purposes.]

SECTION 8 AMENDMENTS

SECTION 9 TRANSFERS

SECTION 10 DISSOLUTION AND WINDING UP

10.1 Dissolution Events

10.2 Winding Up

[This provision specifies the procedures for winding up including how proceeds are distributed upon liquidation after reserves are provided for creditors. For a partnership that seeks to comply with the primary or alternative section 704(b) safe harbors, the agreement will distribute proceeds based on the partners' positive capital accounts. In these safe harbor agreements, the section 704(b) allocation language will directly affect the way the partners shared the economics because the allocations drive the amount of the partners' capital accounts. Many agreements will instead liquidate with a specified distribution scheme, often referred to as a cash Waterfall, out of concern that an error in the tax allocations could unintentionally affect the economics of the deal (i.e., "cash is king").]

10.3 Compliance With Certain Requirements of Regulations; Deficit Capital Accounts

[This provision specifies any partner obligations to restore negative capital accounts. This is typically referred to as a Deficit Restoration Obligation, or DRO. Although a full DRO is unusual because creditors of the partnership can enforce the DRO, sometimes a partner will have a partial DRO.]

SECTION 11 POWER OF ATTORNEY

SECTION 12 MISCELLANEOUS

APPENDIX A

[This section lists the Capital Contributions and Percentage Interests of the partners.]