5

Allocations Having Substantial Economic Effect

Section 704(b)

Form 1065 K-1

L Partner's capital account analysis:

Beginning capital account	$
Capital contributed during the year	$
Current year increase (decrease) .	$
Withdrawals & distributions . . .	$ ( )
Ending capital account	$

☐ Tax basis ☐ GAAP ☐ Section 704(b) book

☐ Other (explain)

5

Importance of the Partnership Agreement

“A partner's distributive share of any item or class of items of income, gain, loss, deduction, or credit of the partnership shall be determined by the partnership agreement, unless otherwise provided by section 704....”

5

(Reg. 1.704-1(a))

Partnership Agreement Defined

5

"[A]ll arrangements among partners, or between one or more partners and the partnership relating to the partnership, direct and indirect, including puts, options, and other buy-sell agreements, ..."

"In addition, the partnership agreement includes provisions of Federal, State, or local law that govern the affairs of the partnership or are considered under such law to be a part of the partnership agreement ...."

5

(Reg. 1.704-1(b)(2)(ii)(h))

6

Observation: The partnership agreement includes "modifications made prior to, or at, the time prescribed for filing a partnership return (not including extensions)…."

6

The allocation in the partnership agreement must:

6

1) Have substantial economic effect

OR

6

2) “be determined in accordance with such partner's interest in the partnership [PIP]”

(Reg. 1.704-1(a))

(same if no agreement)

Primary Test For Economic Effect (PTEE)

Three Requirements

The partnership agreement must provide that:

1) Capital accounts be determined and maintained according to the rules of §1.704-1(b)(2)(iv);

2) Upon liquidation of a partner’s interest, liquidating distributions are made in accordance with the partners’ positive capital account balances; and

3) The partner must be unconditionally obligated to restore the deficit balance in the partner’s capital account following the liquidation of the partner’s partnership interest.

Agreement Lanquage Meeting First Requirement of the Primary Test (maintain capital accounts)

A separate Capital Account will be maintained for each Partner. Each Partner's Capital Account will be increased by

(i) the amount of money contributed by such Partner to the Partnership;

(ii) the fair market value of the property contributed by such Partner to the Partnership...;

(iii) allocations to such Partner of Net Profits; and

(iv) allocations to such Partner of income described in Code Section 705(a)(1)(B) [tax exempt income].

Each Partner's Capital Account will be decreased by

(A) the amount of money distributed to such Partner by the Partnership;

(B) the fair market value of property distributed to such Partner by the Partnership...;

Form 1065 K-1

L Partner's capital account analysis:

Beginning capital account . . .	$
Capital contributed during the year	$
Current year increase (decrease) .	$
Withdrawals & distributions . .	$ ( )
Ending capital account	$

☐ Tax basis ☐ GAAP ☐ Section 704(b) book

☐ Other (explain)

Partnership Agreement Lanquage Meeting Second Primary Test

(liquidate per positive capital account balances)

Distributions in liquidation of the partnership (or any partner's interest) are to be made in accordance with the partners' positive capital account balances throughout the term of the partnership as set forth in Treasury Reg. 1.704-1(b)(2)(ii)(b)(2).

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Partnership Agreement Lanquage Meeting

Third Primary Test

(Deficit Restoration Obligation)

Any partner with a deficit balance in the partner's capital account following the liquidation of the partner's interest must restore that deficit to the partnership as set forth in Treasury Reg. 1.704(b)(2)(ii)(b)(3).

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Won't see this with LLCs or for Ltd. Partners

Distinguish:

1) Partnership ‘book”
profits or losses, from

2) A partner's
“distributive share”

9

Partnership “Book” Net Income or Net Loss

Sample P&L in a Partnership Agreement

9

Net Income and Net Loss. ***"Net Income" and "Net Loss" mean, for each Fiscal Year … an amount equal to the Partnership's taxable income or taxable loss, … but with the following adjustments:***

Federal Tax Accounting Principles

Reg. 1.704-1(b)(2)(iv)(q)

(b) any expenditures of the Partnership described in Code Section 705(a)(2)(B) [not deductible and not capitalized] including any items treated under Treasury Regulations Section 1.704-1(b)(2)(iv)(I) as items described in Code Section 705(a)(2)(B), shall be subtracted from such taxable income or taxable loss,

Reg. 1.704-1(b)(2)(iv)(I) treats the following as 705(a)(2)(B) expenditures:

- Sec. 709 organization or promotion costs except organization costs deducted or amortized with a sec. 709(b) election.

- Losses “incurred in connection with the sale or exchange of partnership property [that] is disallowed to the partnership under section 267(a)(1) or section 707(b)”

c) ***any 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 so disposed, notwithstanding that the adjusted tax basis of such property differs from its Book Value;***

(d) any items of depreciation, amortization and other cost recovery deductions with respect to Partnership property having a Book Value that differs from its adjusted tax basis shall be computed by reference to the property's Book Value (as adjusted for Book Depreciation) in accordance with Treasury Regulations Section 1.704-1(b)(2)(iv)(g);

"Book Depreciation" *means, with respect to any [PSP] asset … the [PSP's] depreciation, amortization, … determined for federal income tax purposes, except that if the Book Value of an asset differs from its adjusted tax basis at the beginning of such …Year, Book Depreciation shall be an amount which bears the same ratio to such beginning Book Value as the federal income tax depreciation, amortization, …or such Fiscal Year bears to such beginning adjusted tax basis; provided….*

d) the Book Value of each Partnership asset shall be increased or decreased, as the case may be, to reflect any adjustments to the adjusted tax basis of such Partnership asset pursuant to Code Section 734(b) or Code Section 743(b), but only to the extent that such adjustments are taken into account in determining Capital Account balances pursuant to Treasury Regulations Section 1.704-1(b)(2)(iv)(m);

provided, that Book Values shall not be adjusted pursuant to this paragraph (d) to the extent that an adjustment pursuant to paragraph (c) [optional revaluation] above is made in conjunction with a transaction that would otherwise result in an adjustment pursuant to this paragraph (d); and

Observation: Optional revaluation adjustments eliminate the Reg. 1.704-1(b)(2)(iv)(m) section 734 or 743 adjustments (detail below).

The definition of book income or loss will be the same whether the PSP uses the Treasury Method or the Target Method of allocating distributive shares

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Example 1
PTEE

- Hal and Lori each contribute $50,000.
- PSP borrows $900,000 (recourse debt).
- The partnership purchases a building for $1,000,000.
- All items 50-50 except depreciation of 100% to Hal.

- Interest only on debt.
- Depreciation $50K per year.
- All gross income is equally offset by gross expenses (net zero) except for depreciation.

Upon Formation (In Thousands)

Building	1,000	Recourse Debt	900
		Capital – Hal	50
		Capital – Lori	50
Assets	1,000	Debt + Capital	1,000

1) *The partners' capital accounts will be determined and maintained in accordance with Treasury Reg. 1.704-1(b)(2)(iv).*
2) *Distributions in liquidation of the partnership (or any partner's interest) are to be made in accordance with the partners' positive capital account balances throughout the term of the partnership as set forth in Treasury Reg. 1.704-1(b)(2)(ii)(b)(2).*
3) *Any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership as set forth in Treasury Reg. 1.704(b)(2)(ii)(b)(3).*

Year 1

	Tax and Book Capital Accts	
	Hal	Lori
Formation	50,000	50,000
Yr. 1 Loss	-50,000	0
End of Yr. 1	0	50,000

Primary Test Met

End of Year 1 (In Thousands)

Building	950	Recourse Debt	900
		Capital – Hal	0
		Capital – Lori	50
Assets	950	Debt + Capital	950

Year 2

	Tax and Book Capital Accts	
	Hal	Lori
Formation	50,000	50,000
Yr. 1 Loss	-50,000	0
End of Yr. 1	0	50,000
Yr. 2 Loss	-50,000	0
Ending Cap.	<50,000>	50,000

Primary Test Met

Hal has a DRO

End of Year 2 (In Thousands)

Building	900	Recourse Debt	900
		Capital – Hal	<50>
		Capital – Lori	50
Assets	900	Debt + Capital	900

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Example 2
Sale in Yr. 3

- Sold for $1,100,000 (and the $900,000 debt paid).
- $200,000 of tax and book gain ($1,100,000 amount realized minus $900,000 adjusted basis) is allocated 50/50.

	Tax and Book Capital Accts	
	Hal	Lori
Yr. 3 Beg.	<50,000>	50,000
Sale Gain +	100,000	100,000
Ending =	50,000	150,000

Primary Test Met

Following Sale for $1,100K and $900K Debt Pyt. (In Thousands)

Cash	200	Recourse Debt	0
		Capital – Hal	50
		Capital – Lori	150
Assets	200	Debt + Capital	200

- Likely, Hal would insist on a gain chargeback to the extent of his prior depreciation expense.

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Example 3

Gain Chargeback

Gain Chargeback. *In the event of a sale of the building resulting in a gain, prior to any other allocations of income, gain, loss or deduction; HAL will receive an allocation of realized gain on the building sale equal to the Excess Depreciation Hal has been allocated up to the date of sale, … Any remaining income, gain, loss or deduction will be allocated 50-50.*

Excess Depreciation is the amount of depreciation allocated to one partner in excess of that allocated to each other partner.

	Tax and Book Capital Accts	
	Hal	**Lori**
Yr. 3 Beg.	**<50,000>**	**50,000**
Sale Gain +	**150,000**	**50,000**
Ending =	**100,000**	**100,000**

Primary Test Met

But does the gain chargeback provision cause the special allocation of depreciation to fail the substantiality test?

General Rule For Substantiality

"a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences."

Reg. Sec. 1.704- 1(b)(2)(iii)(a).

Can IRS argue that appreciation of the building was a strong likelihood so that the tax motivated depreciation allocations to Hal lacked substantiality?

NO

Value Equals Basis Rule

FMV is presumed to equal adjusted book basis.

The value equals basis rule protects Hal from failing the substantiality test.

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Example 4
Loss on Sale at Beginning of Year 3

- Sold for $800K (used to pay down the debt of $900K).

- <$100K> loss ($800K (A.R.) - $900K (A.B.) allocated 50/50.

	Tax and Book Capital Accts	
	Hal	Lori
Yr. 3 Beg.	<50,000>	50,000
Sale Loss	-50,000	-50,000
Ending	<100,000>	0

Primary Test Met

Hal Must Restore the Deficit Upon Liquidation (to pay lender)

Following Sale for $800K (used to pay debt)

Cash	0	Recourse Debt	100,000
		Capital – Hal	<100,000>
		Capital – Lori	0
Assets	0	Debt + Capital	0

Lori may or may not agree to a special loss allocation to the extent of Hal's excess depreciation.

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Example 5 Special Allocation of Loss to Lori

Same facts as Example 4 (Yr. 3 sale for $800K) except for a special allocation of loss to Lori.

Special Allocation. *In the event of a sale of the building resulting in a gain …. In the event of a sale of the building at a loss, prior to any other allocations of income, gain, loss or deduction, Lori will be allocated loss on the building sale equal to the Excess Depreciation HAL was previously allocated up to the date of sale but not in excess of realized loss on the sale of the building. Any remaining income, gain, loss or deduction will be allocated 50-50.*

	Tax and Book Capital Accts	
	Hal	Lori
Beg. Yr. 3	<50,000>	50,000
Sale Loss	0	-100,000
End. Yr. 3	<50,000>	<$50,000>

Primary Test Met

Both Hal and Lori Must Restore the Deficit

Upon Liquidation (to pay lender)

Following Sale for $800K (used to pay debt)

Cash	0	Recourse Debt	100,000
		Capital – Hal	<50,000>
		Capital – Lori	<50,000>
Assets	0	Debt + Capital	0

Again, the value equals basis rule protects Hal (and Lori) from failing the substantiality test.

Observation: If sold for A.B. of $900K, then zero gain or loss so Hal must pay $50K (to Lori).

Following Sale for $900K (used to pay-off debt)

	Tax and Book Capital Accts	
	Hal	Lori
Beginning	<50,000>	50,000
Sale Gain/Loss	0	0
Ending	<50,000>	50,000

Following Sale for $900K (used to pay-off debt)

Cash	0	Recourse Debt	0
		Capital – Hal	<50,000>
		Capital – Lori	50,000
Assets	0	Debt + Capital	0

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Alternate Test For Economic Effect (ATEE)

Aimed at limited partners and LLC members who do not agree to an unlimited DRO.

Typical LLC Language

"No Member shall be required to pay to the LLC or to any other Member the amount of any negative balance which may exist from time to time in such Member's Capital Account."

ATEE

The partnership agreement satisfies the first two PTEE tests:

(1) Capital account maintenance.

(2) Liquidate in accordance with positive capital account balances.

~~(3) Unlimited deficit restoration obligation~~.

A loss allocation still has economic effect if:

1) the loss is charged to the properly maintained capital account; and

2) the loss does not reduce the capital account below zero or in excess of a limited DRO;

AND

The partnership agreement contains a “qualified income offset” (QIO)

Qualified Income Offset

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Requires that, in the event of any unexpected event creating a capital account deficit, that an allocation of income and gain must be made to eliminate the resulting capital account deficit "as quickly as possible."

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Example 6
ATEE

- Alice and Bill each contribute $50,000 to the AB Limited PSP.
- Bill is the general partner.
- Alice is the limited partner.

- The partnership purchases a building for $1,000,000.
- All income and expenses are allocated 50-50 (including depreciation of $100K per year).

First two years: rental income equals operating expenses, but a loss due to annual depreciation of <$100K>.

Opening Balance Sheet (In Thousands)

Building	1,000	Recourse Debt	900
		Cap. – Alice (LP)	50
		Cap. – Bill (GP)	50
Assets	1,000	Debt + Capital	1,000

The PSP agreement contains all three of the primary test requirements for Bill but Ltd. Ptr. Alice does not agree to restore capital account deficits.

Qualified Income Offset. *In the event any Limited Partner* ***unexpectedly*** 17 *receives any adjustments, allocations or distributions…, items of Partnership* ***income and gain will be specially allocated to each such Partner*** *in an amount and manner sufficient to* ***eliminate****…****the Adjusted Capital Account Deficit*** *of such Member as quickly as possible, ….*

Adjusted Capital Account Deficit *shall mean with respect to any Partner, the deficit balance, if any, in such Partner's Capital Account … after giving effect to the following adjustments:*
(i) Credit to such Capital Account any amount which such Partner is obligated to restore pursuant to Treasury Regulations 1.704-1(b)(2)(ii)(c) (a limited deficit restoration obligation), §1.704-2(g)(1)(Partners share of partnership minimum gain) and § 1.704-2(i)(5); (Partners share of nonrecourse debt minimum gain) ***and***

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(ii) ***Debit to such Capital Account the items described in Treasury Regulations §1.704-1(b)(2)(ii)(d)(4), (5) and (6) [reasonably expected depletion, losses, or distributions].***

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The Year 1 loss is allocated 50-50.

	Tax and Book Capital Accts	
	Alice Ltd. Ptr.	Bill G.P.
Contributions	50,000	50,000
Yr. 1 Loss	-50,000	-50,000
End of Yr. 1	0	0

Alice meets the ATEE

Bill meets the PTEE

Year 1 Ending Balance Sheet

Building	900	Recourse Debt	900
		Cap. – Alice (LP)	0
		Cap. – Bill (GP)	0
Assets	900	Debt + Capital	900

18

- The Year 2 loss is allocated 100% to Bill per the regulatory provisions in the PSP agreement.

	Tax and Book Capital Accts	
	Alice	Bill
Yr. 2 Beg.	0	0
Yr. 2 Loss	0	-100,000
End of Yr. 2	0	<100,000>

Alice fails the ATEE with any loss allocation.

Bill meets the PTEE

Year 2 Ending Balance Sheet

Building	800	Recourse Debt	900
		Cap. – Alice (LP)	0
		Cap. – Bill (GP)	<100>
Assets	800	Debt + Capital	800

The allocation of the entire loss to Bill in Year 2 distorts the intention of the partners to allocate all items 50-50.

A "curative allocation" can, with sufficient income in later years, fix the distortion caused by the regulatory limitation.

Curative Allocation. …. *Notwithstanding the 50-50 allocation…, the Regulatory Allocations shall be taken into account in allocating other items of income, gain, loss and deduction among the Members so that, to the extent possible, the net amount of such allocations of other items and the Regulatory Allocations to each Member* ***shall be equal to the net amount that would have been allocated to each such Member if the Regulatory Allocations had not occurred.***

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In Year 3, the company earns a profit of $100K (after depreciation).

Without Curative Allocation:

	Tax and Book Capital Accts	
	Alice (LP)	Bill (GP)
Yr. 3 Beg.	0	<100,000>
Yr. 3 Income	50,000	50,000
Ending Cap.	50,000	<50,000>

With Curative Allocation:

	Tax and Book Capital Accts	
	Alice	Bill
Yr. 3 Beg.	0	<100,000>
Yr. 3 Income	0	100,000
Ending Cap.	0	0

The "curative allocation" causes the same result as if the income/loss for the first three years were allocated 50/50

(each partner loses <$50,000> of capital)

Year 3 Ending Balance Sheet With Curative Allocation

Cash	200	Recourse Debt	900
Building	700	Cap. – Alice (LP)	0
		Cap. – Bill (GP)	0
Assets	900	Debt + Capital	900

Assume no curative allocation in Year 3

As a result of failing to cure the distortion in Yr. 3, it is permanently embedded in the capital accounts

In Year 4, the company again earns a profit of $100K (after depreciation).

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(assume no curative allocation in Year 3)

	Tax and Book Capital Accts	
	Alice (LP)	Bill (GP)
Yr. 4 Beg.	50,000	<50,000>
Yr. 4 Income	50,000	50,000
Ending Cap.	100,000	0

Year 4 Ending Balance Sheet

Cash	400	Recourse Debt	900
Building	600	Cap. – Alice (LP)	100
		Cap. – Bill (GP)	0
Assets	1,000	Debt + Capital	1,000

If the partnership were liquidated Alice would receive the entire $100,000. The partners intended it be $50,000/$50,000.

Same facts but if the Target Method is used, the distortion in Year 2 is self-corrected in Year 3 (see Example 4 on Page 68 of text, discussed below)

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Economic Effect Equivalence Test (EEET)

111

“Allocations made to a partner that do not otherwise have economic effect ... shall nevertheless be deemed to have economic effect, provided ... a liquidation of the [PSP] at the end of such year ... would produce the same economic results to the partners [as if all three requirements of the primary test were met]” (Reg. 1.704-1(b)(2)(ii)(i))

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21

Example 7

EEET

Same facts as Example 6 in Years 1 and 2 except the agreement does not contain a qualified income offset.

What is the likely outcome?

21

The Same as Ex. 6! Per the EEET

First two years: rental income equals operating expenses, but a loss due to annual depreciation of <$100K>.

	Tax and Book Capital Accts	
	Alice (LP)	Bill (GP)
Contributions	50,000	50,000
Yr. 1 Loss	-50,000	-50,000
End of Yr. 1	0	0

Alice meets EEET Test

Bill meets the PTEE

	Tax and Book Capital Accts	
	Alice (LP)	Bill (GP)
Yr. 2 Beg.	0	0
Yr. 2 Loss	0	-100,000
End of Yr. 2	0	<100,000>

Alice fails the EEET test with any loss allocation

Bill meets the PTEE

22

Partner's Interest in the Partnership (PIP) Test

If the partnership agreement lacks "substantial economic effect" (or is silent) , then a "partner's distributive share ... shall be determined in accordance with the partner's interest in the partnership [PIP] (determined by taking into account all facts and circumstances)" (§704(b))

Factors Considered Include:

22

(a) Relative contributions to the PSP

(b) The interests of the partners in economic P&L (if different than that taxable income or loss),

(c) Interests of the partners in cash flow and other non-liquidating distributions, and

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(d) The rights of the partners to distributions of capital upon liquidation. (Reg. 1.704(b)(3))

Comparative Liquidation PIP Test (CLPIP)

22

(Alternative to F&CPIP)

CLPIP

The partnership agreement satisfies the first two PTEE tests:

(1) Capital account maintenance.

(2) Liquidate in accordance with positive capital account balances.

~~(3) Unlimited deficit restoration obligation~~.

Determine the allocation "by comparing the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the taxable year to which the allocation relates

with the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately [at the beginning of the tax year]".

(Reg. 1.704(b)(3)(iii))

Comparative Liquidation Test

Distribution to or contribution by PTR if liquidation of PSP at book value at year end

−

Distribution to or contribution by PTR if liquidation of PSP at book value at beginning of year

=

Income

or

Loss

23

Deemed PIP Test for Partnership Nonrecourse Deductions

(no SEE)

Deemed PIP Tests Also Apply to Tax Credits
(no SEE)

Nonrecourse deductions are deductions attributed to nonrecourse debt

Unique because:

(1) No True Partner Economic Risk of Loss, and

(1) Capital Account Deficits are Permitted. Deemed DRO for minimum gain.

Safe Harbor Tests

PIP Test Deemed Met for Nonrecourse Deductions If:

1) Throughout the partnership's term of existence, capital accounts are maintained for each partner in accordance with the capital account maintenance rules of reg. sec. (First primary test.)

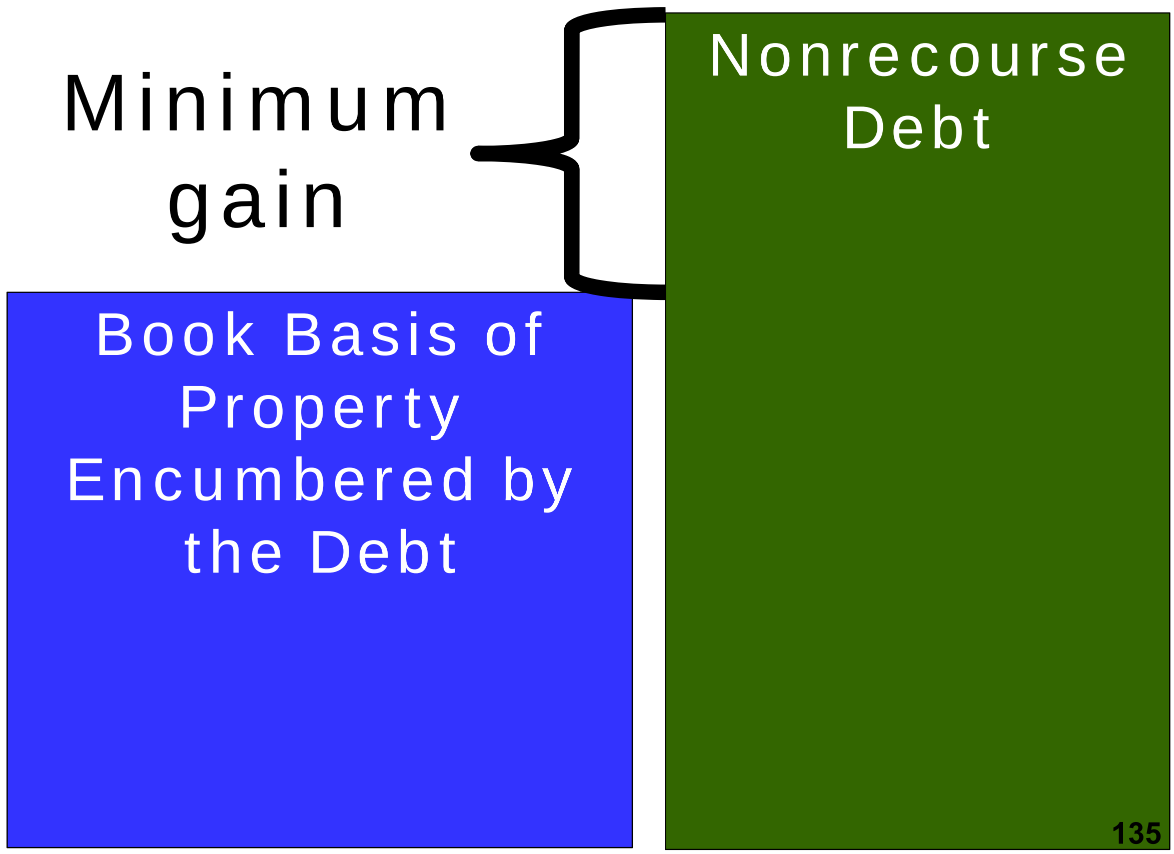
2) Any liquidating distributions are made according to the positive capital account balances of the partners whose interests are liquidated. (Second primary test.)

3) The partnership agreement contains either an unconditional deficit restoration obligation or a qualified income offset provision. (Meets PTEE or ATEE)

4) The partnership agreement allocates nonrecourse deductions in a way that is reasonably consistent with another significant partnership item that is attributable to the property collateralizing the nonrecourse liability, and that allocation has substantial economic effect.

5) The partnership agreement has a minimum gain chargeback provision.

6) All other adjustments have substantial economic effect.



"Nonrecourse Deductions"

Deductions that relate to a net increase in minimum gain

Depreciation will commonly cause a net increase in minimum gain. If so, the depreciation is a nonrecourse deduction.

Debt repayment reduces minimum gain.

Minimum Gain Chargeback

Requires that if a net decrease in minimum gain for the tax year, each partner must be allocated income equal to the partner's share of the net decrease.

Apollo Global Mgt.

"Minimum Gain Chargeback. If there is a net decrease in Partnership Minimum Gain or Partner Nonrecourse Debt Minimum Gain ...during any Partnership taxable year, the Partners shall be specially allocated items of Partnership income and gain for such year (and, if necessary, subsequent years) in an amount equal to their respective shares of such net decrease during such year, determined pursuant to Treasury Regulations Sections 1.704-2(g) and 1.704-2(i)(5)....."

Example 8

27

- Abbey and Baker form the AB LLC
- Each contribute $50,000 and the partnership borrows $900,000, nonrecourse.
- The LLC purchases a building for $1,000,000 and the debt is secured by the building.

- The debt satisfies the definition of qualified nonrecourse financing.
- For simplicity, no principal is paid on the debt and the building is depreciated over 10 years ($100,000 per year).
- The agreement meets the ATEE (has a QIO) and has a minimum gain chargeback

- Except for depreciation of <$100,000>, all rental income and expenses are equal.

- All items of income, loss, depreciation, etc. are allocated 50-50.

- The LLC agreement specifies that loss allocations cannot generate an “Adjusted Capital Account Deficit”.

The LLC/ PSP meets the Deemed PIP Test for nonrecourse deductions.

Year 1 – AB LLC

	Tax and Book Capital Accts	
	Abbey	Baker
Contributions	50,000	50,000
Yr. 1 Loss	-50,000	-50,000
End of Yr. 1	0	0

Abbey and Baker both meet ATEE

No Nonrecourse Deductions Yet

(Debt 900K – A.B. $900K)

Year 1 Ending Balance Sheet

Building	900	Nonrecourse Debt	900
		Cap. – Abbey	0
		Cap. – Baker	0
Assets	900	Debt + Capital	900

Year 2 – AB LLC

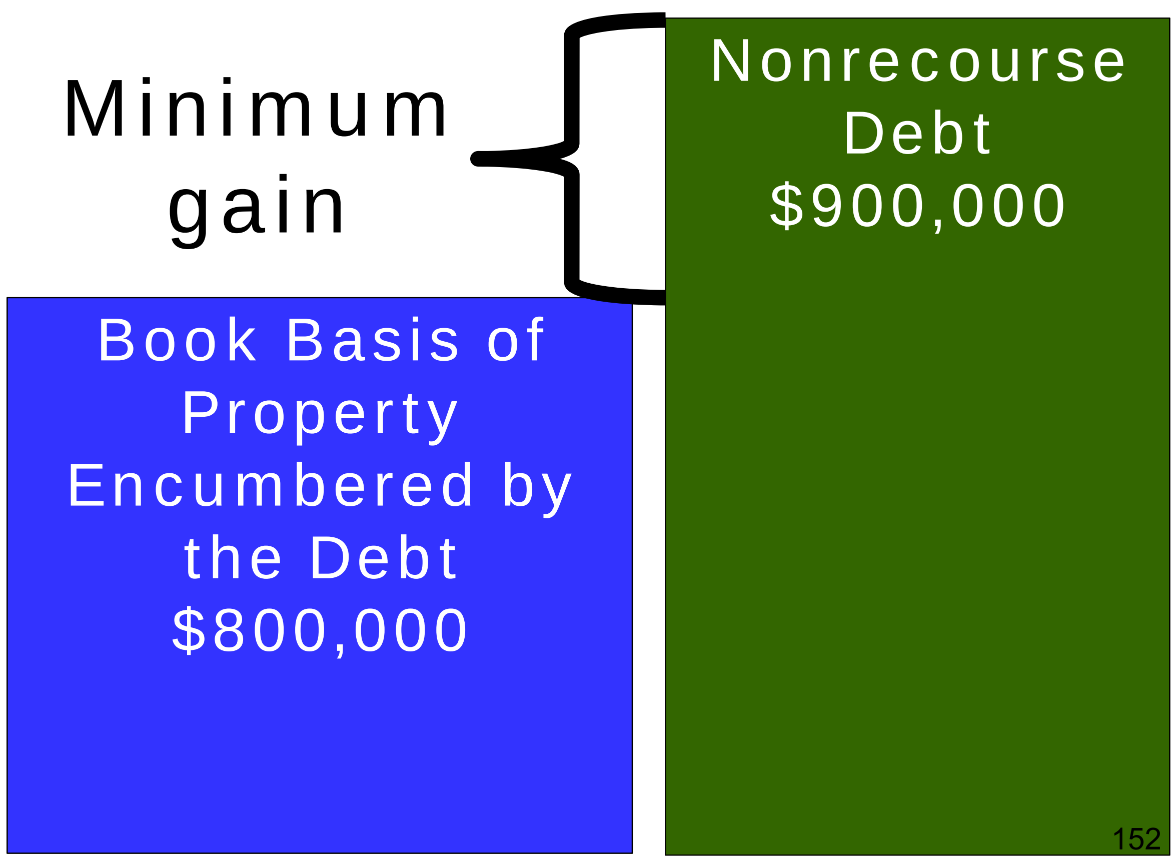
	Tax and Book Capital Accts	
	Abbey	Baker
Beg. of Yr. 2	0	0
Yr. 2 Loss	-50,000	-50,000
End of Yr. 2	<50,000>	< 50,000>

Year 2 Ending Balance Sheet

Building	800	Nonrecourse Debt	900
		Cap. – Abbey	<50>
		Cap. – Baker	<50>
Assets	800	Debt + Capital	800

Nonrecourse Deductions of $100,000

(e) Nonrecourse Deductions. *Nonrecourse Deductions for any Fiscal Year or other period will be allocated to the Members in accordance with the Sharing Ratios (50-50).*



The partnership agreement contains a minimum gain chargeback

(the safe harbor is met)

Abbey and Baker each have a deemed deficit restoration obligation (DRO) of $50,000*

*50% x $100,000 of minimum gain

Neither Partner has an *"Adjusted Capital Account Deficit"* under the partnership agreement.

Adjusted Capital Account Deficit *shall mean with respect to any Partner, the* ***deficit balance,*** *if any, in such Partner's Capital Account … after giving effect to the following adjustments:*

*(i) Credit to such Capital Account any amount which such Partner is obligated to restore pursuant to Treasury Regulations 1.704-1(b)(2)(ii)(c) (a limited deficit restoration obligation), §1.704-2(g)(1)(****Partners share of partnership minimum gain)*** *and § 1.704-2(i)(5); (Partners share of nonrecourse debt minimum gain) and ….*

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K-1s

K Partner's share of liabilities at year end:

Nonrecourse	$
Qualified nonrecourse financing .	$ 450,000
Recourse	$

Nonrecourse Debt share is first allocated based upon each partner's share of minimum gain. (Section 752 Regs.)

Year 3 Foreclosure

31

FMV of the Building Equals its Adjusted Basis of $800K – deemed sale for $900K per section 7701(g) (lender loss of $100K)

$900K Amt. Realized

\- $800K Adjusted Basis

= $100K Recognized Gain

The minimum gain chargeback forces $50K gain to each partner.

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Partner Nonrecourse Deductions

Unique for two reasons:

1) The debt is "nonrecourse" under section 704(b)* but "recourse" per section 752.

*Clearly if secured by one LLC asset, but perhaps even if lender can pursue all LLC assets; see discussion of CCA 201525010 on page 34

2) Must be allocated to PTR who bears the economic risk of loss (EROL).

(despite the PSP agreement saying 50-50)

Example 9

35

Same as Example 8 except the lender insists that LLC member Abbey guarantees the debt of $900,000

Beginning Balance Sheet

Building	1,000	Nonrecourse Debt	900
		Cap. – Abbey	50
		Cap. – Baker	50
Assets	1,000	Debt + Capital	1,000

Abbey's K-1

K Partner's share of liabilities at year end:

Nonrecourse	$
Qualified nonrecourse financing .	$
Recourse	$ 900,000

The partnership agreement contains the following added regulatory provisions:

- member (partner) nonrecourse debt minimum gain chargeback
- member (partner) nonrecourse deductions are allocated to the member/partner who bears the economic risk of loss for the debt.

(f) Member Nonrecourse Deductions. *Member Nonrecourse Deductions for any Fiscal Year or other period* ***will be allocated to the Member who bears the economic risk of loss with respect to the Member Nonrecourse Debt*** *to which such Member Nonrecourse Deductions are attributable in accordance with Treasury Regulations §1.704-2(i)(1).*

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Year 1

Loss of <$100,000>

Year 1

	Tax and Book Capital Accts	
	Abbey	Baker
Contributions	50,000	50,000
Yr. 1 Loss	-50,000	-50,000
End of Yr. 1	0	0

Abbey and Baker both meet ATEE

No Member Nonrecourse Deductions Yet

(Debt 900K – A.B. $900K)

Year 1 Ending Balance Sheet

Building	900	Nonrecourse Debt	900
		Cap. – Abbey	0
		Cap. – Baker	0
Assets	900	Debt + Capital	900

Year 2
Loss of <$100,000>

Member Nonrecourse Deductions of $100,000

(Debt 800K – A.B. $900K)

(f) Member Nonrecourse Deductions. *Member Nonrecourse Deductions for any Fiscal Year or other period* ***will be allocated to the Member who bears the economic risk of loss with respect to the Member Nonrecourse Debt*** *to which such Member Nonrecourse Deductions are attributable in accordance with Treasury Regulations §1.704-2(i)(1).*

Year 2 Ending Balance Sheet

Building	800	Nonrecourse Debt	900
		Cap. – Abbey	<100>
		Cap. – Baker	0
Assets	800	Debt + Capital	800

Abbey does not have an *"Adjusted Capital Account Deficit"* under the partnership agreement.

(despite her actual capital account deficit of <$100K>)

***Adjusted Capital Account Deficit** shall mean with respect to any Partner, the deficit balance, if any, in such Partner's Capital Account … after giving effect to the following adjustments:*

(i) Credit to such Capital Account any amount which such Partner is obligated to restore pursuant to Treasury Regulations 1.704-1(b)(2)(ii)(c) (a limited deficit restoration obligation), §1.704-2(g)(1)(Partners share of partnership minimum gain) and § 1.704-2(i)(5); ***(Partners share of nonrecourse debt minimum gain) and ….***

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Year 3 Foreclosure when building is worth $800K (debt $900K)

Does she have COD income or deemed sale gain of $100,000?

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Sale gain says CCA 201525010-- nonrecourse for purposes of section 108

Abbey's K-1

K Partner's share of liabilities at year end:

Nonrecourse	$	
Qualified nonrecourse financing .	$	
Recourse	$	900,000

The member minimum gain chargeback forces all $100K of the deemed sale gain to Abbey.

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***(e) Member Nonrecourse Debt Minimum Gain Chargeback.** … if there is **a net decrease in Member Nonrecourse Debt Minimum Gain** … each Member …. will be specially **allocated items of Partnership income and gain** for such year (and, if necessary, subsequent years) in an amount **equal to such Member's share of the net decrease in Member Nonrecourse Debt Minimum Gain** determined in accordance with Treasury Regulations §1.704-2(i)(4).*

Example 10

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- Same as Example 9 except LLC/PSP net income is $200,000 in Year 2.

- The intent is that all items are allocated 50-50.

Year 1

Loss of <$100,000>

Year 1

	Tax and Book Capital Accts	
	Abbey	Baker
Contributions	50,000	50,000
Yr. 1 Loss	-50,000	-50,000
End of Yr. 1	0	0

Abbey and Baker both meet ATEE

Year 1 Ending Balance Sheet

Building	900	Nonrecourse Debt	900
		Cap. – Abbey	0
		Cap. – Baker	0
Assets	900	Debt + Capital	900

Year 2

Net Income of

$200,000

(after depreciation)

The Year 2 nonrecourse deduction for $100K of depreciation must be allocated 100% to Abbey

(even though neither partner has capital account deficits)

Allocation absent a curative allocation:

Abbey: $50,000 ($150,000 ($300,000 x 50%) - $100,000 depreciation).

Baker: $150,000 ($300,000 x 50%).

Year 2 Ending Balance Sheet Without Curative Allocation

Cash	300	Nonrecourse Debt	900
Building	800	Cap. – Abbey	50
		Cap. – Baker	150
Assets	1,100	Debt + Capital	1,100

Curative Allocations. …. … *Therefore, notwithstanding any other provision of this Article … the Manager* ***will make such offsetting special allocations of Company 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 this Agreement …***

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So the LLC manager might allocate 50K more income to Abbey (away from Baker) as a curative allocation.

Year 2 Ending Balance Sheet With Curative Allocation

Cash	300	Nonrecourse Debt	900
Building	800	Cap. – Abbey	100
		Cap. – Baker	100
Assets	1,100	Debt + Capital	1,100

But the member minimum gain chargeback must be considered. It could eventually offset the disparity.

Curative Allocations. …. In exercising its discretion under this Section ___, the Manager will take into account future Regulatory Allocations under Sections X (a) and (b) [minimum gain chargeback and member nonrecourse debt minimum gain chargeback] that, although not yet made, are likely to offset other Regulatory Allocations previously made under Sections 7.02(f) [nonrecourse deductions] and (g) [member nonrecourse deductions].

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Observation #1: Can some conditional guarantees be ignored thus preventing partner nonrecourse deductions?

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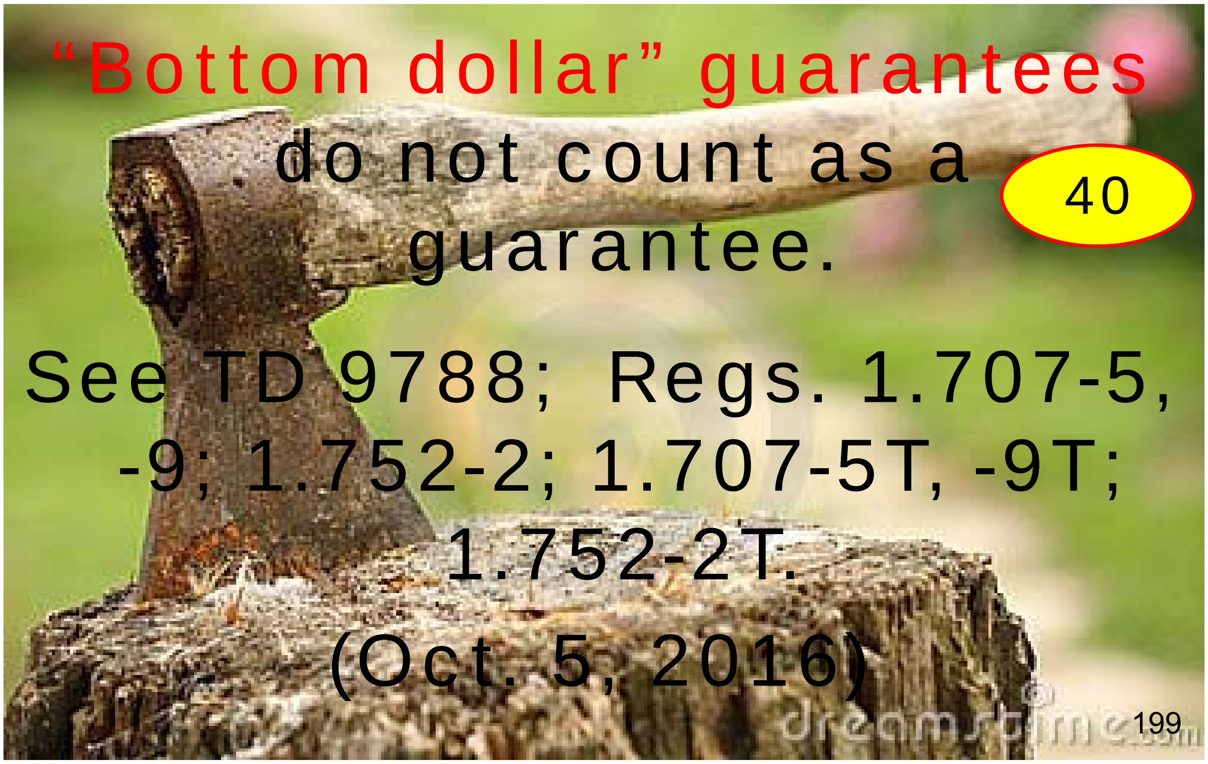
Yes. Conditional loan guarantees known as "Bad Boy" guarantees.

See Chief Counsel Memorandum AM 2016-001 (released 4/15/2016)

Observation #2:



"Bottom dollar" guarantees do not count as a guarantee.

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See TD 9788; Regs. 1.707-5, -9; 1.752-2; 1.707-5T, -9T; 1.752-2T.

(Oct. 5, 2016)

Substantiality Test

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Important, but not normally addressed in the partnership agreement

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Treasury v. Target Methods (and hybrids)

45

Treasury Method

Beg. Book Capital + Contribs. + Income − Distribs. − Loss = Ending Book Capital

Target Method

Target Ending Book Capital − [Beg. Book Capital + Contribs. − Distribs.] = Income **or** Loss

Example 1A

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Treasury Method With Profits

- A and B form the AB LLC taxed as a partnership.
- A contributes $20,000; B contributes $80,000
- The partnership borrows $900,000, nonrecourse, and purchases a building on leased land for $1,000,000.
- The debt is secured by the Bldg.

Beginning Balance Sheet

Assets:		**NR Debt:**	**900**
Cash	**0**	**Capital:**	
Building	**1,000**	**A**	**20**
		B	**80**
		Total Cap.	**100**
Total Assets	**1,000**	**Debt + Cap.**	**1,000**

The partnership agreement contains all of the boilerplate provisions in Example (8) above, necessary to assure that the allocations have economic effect under the ATEE or the Deemed PIP test for nonrecourse deductions.

Section 6.2. Allocations

*1. …(a) **Profits** for any Allocation Year shall be allocated …:*

*(i) **First, 20% to A and 80% to B** in amounts equal to the excess, if any, of* 48

(A) the cumulative Losses allocated pursuant to Paragraph 1(b)(i) for all prior Allocation Years over

(B) the cumulative Profits allocated pursuant to this Paragraph 1(a)(i) for all prior Allocation Years; and

*(ii) **The balance**, if any, **50% to A and 50% to B.***

Year 1 Book Income:

$800K Gross Rents

-200K Operating Exp.

-100K Depreciation

= 500K Net Income (Yr. 1)

(allocated 50-50)

Year 1 Ending Balance Sheet

Assets:		**NR Debt:**	**900**
Cash	**600**	**Capital:**	
Building	**900**	**A 270**	
		B 330	
		Total Cap.	**600**
Total Assets	**1,500**	**Debt + Cap.**	**1,500**

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Section 6.3 Distributions. Distributions shall be made in the following order and priority (at such time or times as may be determined by the managing member):

(A) First, to all members, pro-rata [20% to A and 80% to B], in proportion to the Unreturned Capital (defined herein) of each member at such time, until the Unreturned Capital of all members is reduced to zero ($0), and

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(B) Thereafter, to all members, pro rata, in proportion to their respective Percentage Interests (defined herein—50/50).

"Unreturned Capital" is the aggregate net capital contributions made by a Member, less the amount of any distributions made to the Member under clause (A).

"Percentage Interests" represents the percentage of the residual gains and profits that each Member is entitled to (50/50 here).

Year 1 Ending Balance Sheet

Assets:		**NR Debt:**	**900**
Cash	**600**	**Capital:**	
Building	**900**	**A**	**270**
		B	**330**
		Total Cap.	**600**
Total Assets	**1,500**	**Debt + Cap.**	**1,500**

So, if liquidated for book value at the end of year 2:

A receives $270K ($20K + $250K)

B receives $330 ($80K + $250K)

Example 1B

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Target Method With Profits

- Same facts and same distribution provision but with the Target Method.
- The allocation provision (below) contains a formula rather than a direct statement of how income or losses are allocated.

All of the same regulatory provisions except the statement that liquidation proceeds follow book capital accounts.

The allocation outcome is the same as with the Treasury Method!

While the Agreement does not state that liquidation proceeds match capital accounts, it but does "provide" for that outcome (Reg. 1.704(b)(ii)(a))

	(In Thousands)	A	B	Total
1:	Beginning Capital	20	80	100
2:	Contributions/Distribs.	0	0	
3:	Adjusted Beg. Capital	20	80	100
4:	Ending Total Capital			600
	Book Income (Step 4 – 3)			500

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Section 6.2 Allocations.

A. Except as otherwise provided in Section 6.3 [provisions that comply with the regulatory requirements in the Treasury Regulations], Net Income and Net Loss (and, if necessary, individual items of gross income or loss) for the year shall be allocated among the Members in a manner such that, to the extent possible, the Capital Account balance of each Member at the end of such taxable year, including short taxable years, shall be equal to the excess (which may be negative) of:

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(1)   the amount that would be distributed to such Member if (a) the Company were to sell the assets of the Company for their Gross Asset Values (defined in Section 8), (b) all Company liabilities were settled in cash according to their terms (limited, with respect to each Nonrecourse Liability, to the Gross Asset Values of the assets securing such liability), and [$600K] ***(c) the net proceeds thereof were distributed in full pursuant to Section 7.1,***

$270K to A and $330K to B

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over

(2) the sum of (a) the amount, if any, without duplication, that such Member would be obligated to contribute to the capital of the Company, (b) such Member's share of Company Minimum Gain and (c) such Member's share of Member Minimum Gain determined pursuant to Regulations Section 1.704-2(i)(5), all computed as of the date of the hypothetical sale described in (1) above.

[zero here]

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Section 7.1 Distributions. Distributions shall be made in the following order and priority (at such time or times as may be determined by the managing member):

(A) First, to all members, pro-rata [20% to A and 80% to B], in proportion to the Unreturned Capital (defined herein) of each member at such time, until the Unreturned Capital of all members is reduced to zero ($0), and

	(In Thousands)	A	B	Total
1:	Beginning Capital	20	80	100
2:	Contributions/Distribs.	0	0	
3:	Adjusted Beg. Capital	20	80	100
4:	Ending Total Capital			600
	Book Income (Step 4 – 3)			500
5:	$600,000 Fictional Cash:			
	1st 100K 20%/80% to B	+20	+80	

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(B) Thereafter, to all members, pro rata, in proportion to their respective Percentage Interests (defined herein—50/50).

"Unreturned Capital" is the aggregate net capital contributions made by a Member, less the amount of any distributions made to the Member under clause (A).

"Percentage Interests" represents the percentage of the residual gains and profits that each Member is entitled to (50/50 here).

	(In Thousands)	A	B	Total
1:	Beginning Capital	20	80	100
2:	Contributions/Distribs.	0	0	
3:	Adjusted Beg. Capital	20	80	100
4:	Ending Total Capital			600
	Book Income (Step 4 – 3)			500
5:	$600,000 Fictional Cash:			
	1st 100K 20/80	+20	+80	
	2nd 500K 50/50	+250	+250	
	Target Cap (Yr. End)*	=270	=330	

	If 100K were Distributed	A	B	Total
1:	Beginning Capital	20	80	100
2:	Contributions/Distribs.	-20	-80	
3:	Adjusted Beg. Capital	0	0	0
4:	Ending Total Capital			500
	Book Income (Step 4 – 3)			500
5:	$500,000 Fictional Cash:			
	1st $0 20/80	+0	+0	
	2nd 500: 50/50	+250	+250	
	Target Cap (Yr. End)*	=250	=250	
6:	Allocation (Step 5 – 3)	250	250	500

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Examples 2A and 2B show how, with losses, you reach the same result with the Treasury and Target Methods

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Example 3A and 3B illustrated a potential distortion caused by a mimimum gain

Example 4 illustrates how the Target Method can self-correct a disparity caused by the loss limit rules shown in Ex. 6 above

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Example 6 Review Of Facts

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- Alice and Bill each contribute $50,000 to the AB Limited PSP.
- Bill is the general partner with unlimited deficit restoration obligation (DRO)
- Alice is the limited partner with no DRO.

- The partnership borrows $900K—recourse debt— and purchases a building for $1 mil.

- All items are 50-50 (including depreciation of $100K).

First two years: rental income equals operating expenses, but a loss due to annual depreciation of <$100K>.

Opening Balance Sheet (In Thousands)

Building	1,000	Recourse Debt	900
		Cap. – Alice (LP)	50
		Cap. – Bill (GP)	50
Assets	1,000	Debt + Capital	1,000

Treasury Method Year 1 (Example 6)

16

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The Year 1 loss is allocated 50-50.

	Tax and Book Capital Accts	
	Alice	**Bill**
Contributions	**50,000**	**50,000**
Yr. 1 Loss	**-50,000**	**-50,000**
End of Yr. 1	**0**	**0**

Alice meets the ATEE

Bill meets the PTEE

Year 1 Ending Balance Sheet

Building	900	Recourse Debt	900
		Cap. – Alice (LP)	0
		Cap. – Bill (GP)	0
Assets	900	Debt + Capital	900

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Target Method
Year 1
(same result)

Year 1 Target Method

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	In Thousands	A	B	Total
1:	Beginning Capital	50	50	100

Year 1 Target Method

71

	In Thousands	A	B	Total
1:	Beginning Capital	50	50	100
2:	Contributions/Distribs.	0	0	
3:	Adjusted Beg. Capital	50	50	100
4:	Ending Total Capital			0
	Book Income (Step 4 – 3)			<100>

Section 6.2 Allocations. 69

A. Except as otherwise provided in Section 6.3 [provisions that comply with the regulatory requirements in the Treasury Regulations], Net Income and Net Loss (and, if necessary, individual items of gross income or loss) for the year shall be allocated among the Members in a manner such that, to the extent possible, the Capital Account balance of each Member at the end of such taxable year, including short taxable years, shall be equal to the excess (which may be negative) of:

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(1) the amount that would be distributed to such Member if (a) the Company were to sell the assets of the Company for their Gross Asset Values (defined in Section 8), (b) all Company liabilities were settled in cash according to their terms (limited, with respect to each Nonrecourse Liability, to the Gross Asset Values of the assets securing such liability), and [zero] ***(c) the net proceeds thereof were distributed in full pursuant to Section 7.1,***

[Per Sec. 7.1 distributions are 50-50 or zero/zero here] *over,*

(2) the sum of (a) the amount, if any, without duplication, that such Member would be obligated to contribute to the capital of the Company, (b) such Member's share of Company Minimum Gain and (c) such Member's share of Member Minimum Gain determined pursuant to Regulations Section 1.704-2(i)(5), all computed as of the date of the hypothetical sale described in (1) above.

[Zero here – no deficit]

Year 1 Target Method

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	In Thousands	A	B	Total
1:	Beginning Capital	50	50	100
2:	Contributions/Distribs.	0	0	
3:	Adjusted Beg. Capital	50	50	100
4:	Ending Total Capital			0
	Book Income (Step 4 – 3)			<100>
5:	Fictional Dist. 50/50	+0	+0	
	Target Cap. (Year End)*	=0	=0	

Year 1 Target Method

71

	In Thousands	A	B	Total
1:	Beginning Capital	50	50	100
2:	Contributions/Distribs.	0	0	
3:	Adjusted Beg. Capital	50	50	100
4:	Ending Total Capital			0
	Book Income (Step 4 – 3)			<100>
5:	Fictional Dist. 50/50	+0	+0	
	Target Cap. (Year End)*	=0	=0	
6:	Allocation (Step 5 – 3)	<50>	<50>	<100>

Treasury Method Year 2

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The Year 2 loss is allocated 100% to GP Bill per the regulatory provisions in the PSP agreement.

(only Bill has a DRO)

	Tax and Book Capital Accts	
	Alice	Bill
Yr. 2 Beg.	0	0
Yr. 2 Loss	0	-100,000
End of Yr. 2	0	<100,000>

Alice fails the ATEE and EEET with any loss allocation.

Bill meets the PTEE

Year 2 Ending Balance Sheet

Building	800	Recourse Debt	900
		Cap. – Alice (LP)	0
		Cap. – Bill (GP)	<100>
Assets	800	Debt + Capital	800

The allocation of the entire loss to Bill in Year 2 distorts the intention of the partners to allocate all items 50-50.

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Target Method Year 2 (same result)

Year 2 Target Method

71

	In Thousands	A	B	Total
1:	Beginning Capital	0	0	0

Year 2 Target Method

71

	In Thousands	A	B	Total
1:	Beginning Capital	0	0	0
2:	Contributions/Distrib.	0	0	
3:	Adjusted Beg. Capital	0	0	0
4:	Ending Total Capital			<100>
	Book Income (Step 4 – 3)			<100>

- How do you distribute negative capital? (distributions are 50-50)

- What pushes Bills capital account to negative <$100K>?

Section 6.2 Allocations. 69

A. Except as otherwise provided in Section 6.3 [provisions that comply with the regulatory requirements in the Treasury Regulations], Net Income and Net Loss (and, if necessary, individual items of gross income or loss) for the year shall be allocated among the Members in a manner such that, to the extent possible, the Capital Account balance of each Member at the end of such taxable year, including short taxable years, shall be equal to the excess (which may be negative) of:

69

(1) the amount that would be distributed to such Member if (a) the Company were to sell the assets of the Company for their Gross Asset Values (defined in Section 8), (b) all Company liabilities were settled in cash according to their terms (limited, with respect to each Nonrecourse Liability, to the Gross Asset Values of the assets securing such liability), and [zero] *(c) the net proceeds thereof were distributed in full pursuant to Section 7.1,*

[Per Sec. 7.1 distributions are 50-50 or zero/zero here]

69

over, (2) the sum of

(a) the amount, if any, without duplication, that such Member would be obligated to contribute to the capital of the Company, [Bill must contribute $100,000 here]

(b) such Member's share of Company Minimum Gain and

(c) such Member's share of Member Minimum Gain determined pursuant to Regulations Section 1.704-2(i)(5), all computed as of the date of the hypothetical sale described in (1) above,

Year 2 Target Method

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	In Thousands	A	B	Total
1:	Beginning Capital	0	0	0
2:	Contributions/Distrib.	0	0	
3:	Adjusted Beg. Capital	0	0	0
4:	Ending Total Capital			<100>
	Book Income (Step 4 – 3)			<100>
5:	Distribution 50/50	+0	-100	
	Target Cap. (Year End)*	=0	=<100>	

Year 2 Target Method

71

	In Thousands	A	B	Total
1:	Beginning Capital	0	0	0
2:	Contributions/Distrib.	0	0	
3:	Adjusted Beg. Capital	0	0	0
4:	Ending Total Capital			<100>
	Book Income (Step 4 – 3)			<100>
5:	Distribution 50/50	+0	-100	
	Target Cap. (Year End)*	=0	=<100>	
6:	Allocation (Step 5 – 3)	0	<100>	<100>

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In Year 3, the company earns a profit of $100K (after depreciation).

Treasury Method

Year 3

(Without a Curative Allocation a different result from Target Method)

Without Curative Allocation: Treasury Method

	Tax and Book Capital Accts	
	Alice	Bill
Yr. 3 Beg.	0	<100,000>
Yr. 3 Income	50,000	50,000
Ending Cap.	50,000	<50,000>

If liquidated, not the intent of the partners

With Curative Allocation Treasury Method

	Tax and Book Capital Accts	
	Alice	Bill
Yr. 3 Beg.	0	<100,000>
Yr. 3 Income	0	100,000
Ending Cap.	0	0

Target Method

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Year 3

(observe self-correction without curative allocation)

Without Curative Allocation Target Method

	In Thousands	A	B	Total
1:	Beginning Capital	0	<100>	<100>

Without Curative Allocation Target Method

	In Thousands	A	B	Total
1:	Beginning Capital	0	<100>	<100>
2:	Contributions/Distributions	0	0	
3:	Adjusted Beg. Capital	0	<100>	<100>
4:	Ending Total Capital			0
	Book Income (Step 4 – 3)			100

If the assets were sold for book value ($0), then zero would be available to distribute to each partner

(after the debt is paid)

Without Curative Allocation Target Method

	In Thousands	A	B	Total
1:	Beginning Capital	0	<100>	<100>
2:	Contributions/Distributions	0	0	
3:	Adjusted Beg. Capital	0	<100>	<100>
4:	Ending Total Capital			0
	Book Income (Step 4 – 3)			100
5:	Distribution 50/50	+0	+0	
	Target Cap. (Year End)*	=0	=0	

Without Curative Allocation Target Method

	In Thousands	A	B	Total
1:	Beginning Capital	0	<100>	<100>
2:	Contributions/Distributions	0	0	
3:	Adjusted Beg. Capital	0	<100>	<100>
4:	Ending Total Capital			0
	Book Income (Step 4 – 3)			100
5:	Distribution 50/50	+0	+0	
	Target Cap. (Year End)*	=0	=0	
6:	Allocation (Step 5 – 3)	0	100	100

Year 3 Ending Balance Sheet With Target Method

Cash	200	Recourse Debt	900
Building	700	Cap. – Alice (LP)	0
		Cap. – Bill (GP)	0
Assets	900	Debt + Capital	900

The Target Method automatically corrects the distortion from Year 2

(no need for curative allocation here)

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Example 5A illustrates the potential capital shift issue caused by Target Allocations

- A and B each contribute $100K to the AB PSP

Yr 1:

$10x gross income
- $10x gross loss
= $0 Net Income

At the end of Yr 1, the book value of AB is $200x

How distributed in a fictional distribution?

Section 7.1 Distributions. Distributions shall be made in the following order and priority (at such time or times as may be determined by the managing member):

(A) First, to A in proportion to A's Unreturned Capital (defined herein) at such time, until the Unreturned Capital of A is reduced to zero ($0), [$100x to A]

(B) Second, a 5% per year (no compounding) return on A's contributed capital. [$5x]

(C) Third, to B in proportion to B's Unreturned Capital (defined herein) at such time, until the Unreturned Capital of B is reduced to zero ($0), [95x]

(D) Thereafter, to A and B 50-50.

****

Target (Ending) Capital Accounts:

$105 for A

<$95> for B

Target Allocation result:

$5x income to A

<$5x> loss to B

- But PSP net income is zero?

Section 6.2 Target Allocations.

A. Except as otherwise provided in Section 6.3 (Regulatory), Net Income and Net Loss** (and, if necessary, individual items of gross income or loss) **for the year shall be allocated among the Members in a manner such that, to the extent possible, the Capital Account balance of each Member at the end of such taxable ….

($10x gross income to A and zero gross income to B; gross loss $5x each)

Ending Capital Accounts:

$105 for A

<$95> for B

What if the agreement does not allow for line item allocations?

Section 6.2 Target Allocations.

A. Except as otherwise provided in Section 6.3 [provisions that comply with the regulatory requirements in the Treasury Regulations], Net Income and Net Loss ~~(and, if necessary, individual items of gross income or loss)~~ for the year shall be allocated among the Members in a manner such that, to the extent possible, the Capital Account balance of each Member at the end of such taxable year, including short taxable years, shall be equal to the excess (which may be negative) of:

A likely taxable capital shift from B to A.

(Lehman, 19 T.C. 659 (1953))

(IRS guidance is needed)

$5x guaranteed payment to A

(fictionally distributed and contributed)

which causes <$5x> loss to B.

Example 5B

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Shows how the Target Method corrects the Yr. 1 distortion in Yr. 2, if sufficient income.