1000 CAPITAL ACCOUNTS- ALLOCATION OF PARTNERSHIP INCOME AND LOSS

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1010 INTRODUCTION

As a pass-through entity, a partnership computes its income, gain, loss, deduction, and credit at the partnership level and allocates these items among its partners. The partners report their distributive share[1] of these items on their own tax returns. Partners are generally allowed to allocate partnership items of income, gain, loss, deduction, or credit among themselves based on their partnership agreement. However, to be respected for tax purposes, **an allocation of the partnership tax items must be consistent with the underlying economic arrangement among the partners**. If a partner is allocated an item for tax purposes that has no corresponding impact on his economic investment in the partnership, such allocation is disregarded for lack of "substantial economic effect."

To measure the economic value of a partner's investment in a partnership, the partner's capital account is required to be maintained according to IRC § 704 and the regulations promulgated there under. In addition, § 704 regulations also provide special rules regarding allocations attributable to non-recourse liabilities and allocations with respect to contributed property . These subjects are discussed in the following sections:

PTM 1000: Allocation of Partnership Income and Loss/Capital Questions (§§ 1000 – 1650)
PTM 2000: Allocations under IRC § 704(c). (§§ 1000 – 2690)
PTM 3000: Allocations attributable to nonrecourse liability (§§ 3000 – 3500)

Note: Certain provisions related to oil and gas adjustments are not discussed in these sections (§§ 1000 - 3500).

***Observation**: The § 704 regulations are very detailed and complex. They are also flexible since they basically allow allocations as long as the receiving partner bears the burden of such allocation. An understanding of these allocation rules will serve as a foundation for understanding other important areas of partnership tax law.*

[1] It should be noted that the phrase "distributive share" is used in the Code to refer to the portion of the partnership income, loss, etc. which is allocated to a partner. It does not imply actual distributions of partnership cash or property to partners.

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1020 CALIFORNIA CONFORMITY

In general, California has adopted IRC § 704 and the federal regulations promulgated thereunder. [California Revenue and Taxation Code § 17851].Exceptions to the general conformity rules will be discussed in the relevant sections.

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1030 ALLOCATION PRINCIPLE

Like most other investments, an investment in a partnership usually results in *tax consequences* (e.g., distributive share of partnership's income, gain, loss, deduction, etc.) and *after-tax economic consequences* that are measured in terms of dollar amounts (e.g., how much the investor gets back from the investment). Though partners are generally allowed to allocate the *tax consequences* among themselves [IRC § 704(a)], they cannot abuse this allowance by allocating the tax items in a manner different from the allocation of the economic consequences. For example, if a partner is allocated a gain for tax purposes, he must also receive the economic benefit (dollar amount) of such gain. Likewise, if a partner is allocated a partnership tax loss, he must bear an economic risk of loss with regard to such loss. Thus, **the allocation of tax results must follow the allocation of economic results**. [Treas. Reg. § 1.704-1(b)(1)(i)]

Observation*: A partnership agreement usually contains agreements among the partners on how the partnership's taxable income, loss, etc. are allocated to partners (tax allocation), how partnership assets are distributed to partners in both liquidating and non-liquidating distributions (economic benefit allocation), and who is obligated to make additional contributions to satisfy partnership liabilities (economic burden allocation), etc. To guarantee that the allocation of tax items follows the allocation of economic benefit and burden, various complex rules discussed in the following paragraphs are designed by § 704 regulations to make sure that the above allocation principle is applied throughout the full term of a partnership.*

1040 BASIC ALLOCATION RULES

IRC § 704(a) provides that "(A) partner's distributive share of income, gain, loss, deduction or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement." However, the partners' ability to allocate partnership's income or loss is **not** unlimited; Subchapter K was not intended to permit taxpayers to circumvent general principles prohibiting tax avoidance and assignment of income and losses. To be respected for tax purposes, the allocation must meet one of the following three requirements: [Treas. Reg. § 1.704-1(b)(1)(i)]

- The allocation has *substantial economic effect* (See PTM 1100), or
- Taking into account all facts and circumstances, the allocation is in accordance with the *partner's interest in the partnership* (See PTM 1600), or
- The allocation is *deemed* to be in accordance with the partner's interest in the partnership under the *special rules* (See PTM 1640).

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If an allocation under the partnership agreement **does not** meet one of those requirements, the partnership's income, loss, deduction, or credit will be reallocated in accordance with the partner's interest in the partnership. [Treas. Reg. § 1.704-1(b)(1)(i)]

If a partnership agreement **does not** provide for the allocation of income, gain, loss, deduction, or credit to a partner, then the partner's distributive share of such income, gain, loss, deduction, or credit shall be determined in accordance with such partner's interest in the partnership (taking into account all facts and circumstances). [Treas. Reg. § 1.704-1(b)(1)(i)]

1050 EFFECTIVE DATES

- The final regulations under § 704(b) were promulgated in 1991 and are effective *retroactively* to partnership tax years beginning after **December 31, 1975**.
- However, for the taxable years before May 1, 1986, a partnership's allocation will be respected if it has substantial economic effect or is in accordance with the partners' interests in the partnership as those terms have been interpreted under the relevant case law, the legislative history of the 1976 Act, and the old regulations applicable to partnership taxable years beginning before May 1, 1986. [Treas. Reg. § 1.704-1(b)(1)(ii).]
- For partnerships that began operating before May 1, 1986 and continue to operate after April 30, 1986, the partners' capital accounts have to be restated in accordance with the capital account rules. (See PTM 1640)

* *Rules relating to foreign tax expenditures. See Treas. Reg. § 1.704-1(b)(1)(ii)(b).*

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1060 EFFECTS OF OTHER SECTIONS

The regulations under § 704(b) govern the partnership's allocation of its income, loss, deduction, or credit to its partners only. The tax treatments of each partner's distributive share of such income, loss, deduction, or credit are governed by other sections of the law. For instance, an allocation of loss to a partner may be respected under § 704(b) because it has substantial economic effect but may not be deductible by such partner if, for instance, he does not have the requisite motive for economic gain [2]or disallowed under § 706(d) (changes in partners' interests in partnership during the year) and the related assignment of income principles. The allocated loss may also be limited under § 704(d) (due to a lack of basis), § 465 (at-risk rules), and § 469 (passive activity loss limitations). In other words, the regulations under § 704(b) determine the **validity** of a partnership allocation, not the **tax treatment** or tax consequences of such allocation at the partner's level. [Treas. Reg. § 1.704-1(b)(1)(iii) & (iv).]

Observation: *Allocations of partnership items to persons who are not partners, or who are not receiving the allocations in their capacity as partners, are not partner's distributive shares but treated according to their true nature – that is, as compensation, as loan repayments, as rent, etc.*

1070 COORDINATION BETWEEN IRC § 704(B) AND §704(C)

- IRC § 704(b) provides the general principle that allocations of tax items (tax results) must follow the allocations of book items (economic results). The regulations under § 704(b) provide rules for allocations of book items. However, when a partner contributes a property to a partnership and the partner's tax basis in the property differs from its fair market value, the law requires that the allocation of the tax items (e.g., built-in gain, loss, depreciation, etc.) with regard to the contributed property must follow a different set of rules under § 704(c) and § 1.704-3.

- The interaction between § 704(b) and § 704(c) is as follows: Though the regulations under § 704(b) do not directly determine the tax allocation provided under § 704(c), a partner's distributive share of the **tax items** may be determined under § 704(c) and §1.704-3 with reference to the partner's share of the **corresponding book items** under § 704(b). Detailed explanations of § 704(c) are provided in PTM 2100.

- For illustration, see PTM 1510, Example 1. [See also Treas. Reg. § 1.704-1(b)(5), Ex. 13(i).]

[2] See e.g., Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966)

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1080 BOTTOM LINE ALLOCATION

The allocation rules provided under § 704 are applicable to:

- allocations of income, gain, loss, deduction, and credit,
- allocations of specific items of income, gain, loss, deduction, and credit, and
- allocations of partnership net or “bottom line” taxable income or loss. If a share of a partnership’s net or “bottom line” income or loss is allocated to a partner, the partner is treated as sharing in each item of income, gain, loss, and deduction that is taken into account in computing such net or “bottom line” taxable income or loss. [Treas. Reg. § 1.704-1(b)(1)(vii).]

Observation: When a partner’s distributive share of the partnership (bottom line) income or loss is partially disallowed for lack of substantial economic effect, the allowed portion is treated as consisting of a proportionate share of all items that make up that portion. (See Example in PTM 1150)

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1100 SUBSTANTIAL ECONOMIC EFFECT

- A partnership allocation will be respected if it has **substantial economic effect**. The determination of the substantial economic effect involves a two-part analysis made at the end of the partnership taxable year to which the allocation relates. First, the allocation must have **economic effect**.
  Second, the economic effect of the allocation must be **substantial**.
  [Treas. Reg. § 1.704-1(b)(2)(i)]
- Meeting one of the above two requirements is not enough for an allocation to be respected. For instance, if an allocation has economic effect but the economic effect is not substantial, such allocation will be disregarded.
- For discussion of the Economic Effect requirements (or Economic Effect test), see PTM 1110.
- For discussion of the Substantiality test, see PTM 1200.

PTM 1110 Economic Effect
PTM 1120 Economic Effect Requirements
PTM 1130 Obligation to Restore Deficit
PTM 1140 Alternate Test for Economic Effect
PTM 1150 Partial Economic Effect
PTM 1160 Definition of Liquidation
PTM 1170 Definition of Partnership Agreement
PTM 1180 Economic Effect Equivalence

1110 Economic Effect

The fundamental principle: **In order for a tax allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners**. This means that in the event there is an economic benefit or economic burden associated with a tax allocation, the partner to whom the tax allocation is made must also receive such economic benefit or bear such economic burden. [Treas. Reg. § 1.704-1(b)(2)(ii)(a)]

Based on the principles, an allocation of income, gain, loss, or deduction (or item thereof) to a partner will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement includes all of the following provisions regarding:

- The maintenance of partners' capital accounts (See PTM 1130, PTM 1300);
- The liquidating distributions are in accordance with positive capital accounts (See PTM 1120);

- The partners are obligated to restore deficit capital account balances (See PTM 1130)

If a partnership agreement does not include all of the above three requirements (referred to as the Economic Effect test), an allocation may still be respected for tax purpose if it passes the Alternate Economic Effect test (See PTM 1140) or the Economic Equivalence test (See 1180). It should be noted that those three tests are to prove the economic effect of an allocation. The Substantiality applies after an allocation passes one of those three economic effect tests.

Example 1: *Cynthia and Phyllis form a partnership to produce a manual for a state agency. The manual is completed during the year and the partnership receives a fee of $10,000. Cynthia and Phyllis agree that the $10,000 fee will be* ***distributed*** *equally between them, thus they* ***share the economic profit equally****. However,* ***for tax purposes, the gain will be specially allocated $7,500 to Cynthia and $2,500 to Phyllis****. The* ***tax allocation (75/25) is <u>not</u> consistent with the underlying economic arrangement (50/50)*** *between Cynthia and Phyllis. Unless the partnership agreement contains other provisions that meet the allocation requirements (See* PTM 1040*), the tax allocation has no economic effect and has to be reallocated to the partners based on their economic sharing ratio (50/50).*

Example 2*: Al and Kay form a partnership. Al and Kay contribute $1,000 and $99,000 in cash, respectively. Due to Al's expertise in management and his daily participation in the partnership's business, the partnership agreement provides that Al will be allocated 20% of the partnership taxable income and 1% of the partnership loss. Thus, although Al owns only 1% in partnership capital, his profit sharing ratio is 20%. This tax allocation between Al and Kay is respected as long as the distribution of economic benefits between the two is also in the same ratio (i.e., 20% to Al and 80% to Kay).*

Observation*: There has been some misunderstanding that a "special allocation" similar to the one described in Example 2 is an abuse of the tax law. However, the law generally respects such allocations provided the tax allocations correspond to the economic arrangements (See Examples in* PTM 1140*).*

1120 Economic Effect Requirements

An allocation of income, gain, loss, deduction, and credit to a partner will have economic effect if, and only if, <u>throughout the full term of the partnership</u>, **the partnership agreement (either oral or written,** see PTM 1170**) includes the following three requirements** [Treas. Reg. § 1.704-1(b)(2)(ii)(b)] (together: the Economic Effect requirements, sometimes called the Mechanical tests):

1. *The Capital Account Maintenance Requirement*: The partners' capital accounts must be determined and maintained in accordance with the rules provided in § 1.704-1(b)(2)(iv) (See PTM 1300).
2. *The Liquidation Distribution Requirement*: Upon liquidation of the partnership (or any partner's interest in the partnership), **liquidating distributions are required in all cases to be made in accordance with the positive capital account balances** of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs. The liquidating distribution has to be made by the end of such taxable year (or, if later, within 90 days after the date of such liquidation) (See PTM 1160 for definition of liquidation).
3. *The Deficit Restoration Requirement*: If a partner has a deficit in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all the capital account adjustments during the liquidating year, he is **unconditionally obligated to restore the amount of such deficit balance** to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation). The amount will be paid to the creditors of the partnership or distributed to other partners in accordance with their positive capital account balances. For the purpose of this paragraph, the taxable year of a partnership is determined without regard to § 706(c)(2)(A), which provides that the partnership's taxable year is closed with respect to a partner who sells or exchanges his entire interest in the partnership. (If a partnership agreement fails to include this requirement, See PTM 1130 for other requirements).

The above three requirements must be in effect throughout the full term of the partnership. If the partnership agreement is modified after it originally included the above three requirements, see PTM 1650.

Notes:

Unless specified otherwise, the term "capital account(s)" used in this chapter implies that the capital accounts are determined and maintained according to §704(b). This type of capital account is also referred to as "book" or § 704(b) capital account as distinct from tax-basis capital accounts, § 704(c) capital accounts, or financial accounting capital accounts. (See PTM 1300.)

If the partnership does not meet the Economic Effect test (i.e., containing the above three requirements), see the Alternate Economic Effect test discussed in PTM 1140 **and the Economic Equivalence Test discussed in** PTM 1180**.**

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Example 1: *John and Janet form a general partnership. Each makes a cash contribution of $50,000, which is used by the partnership to purchase a piece of land for $100,000. Before the end of the taxable year, the partnership sells the land for $150,000 and recognizes a gain of $50,000. According to the partnership agreement, John and Janet will share equally in partnership taxable losses and cash flow. However, all partnership gains will be allocated 80% to John and 20% to Janet. The partnership agreement also provides that the partners' capital accounts will be determined and maintained in accordance with § 704(b) regulations, but that upon liquidation of the partnership, distribution will be made* ***equally*** *between the partners (regardless of the partners' capital account balances) and* ***no partner is required to restore his deficit capital account****. Assuming at the end of the year, the partnership distributes the sales proceeds ($150,000) equally to the partners and liquidates. The tax allocation and economic allocation will be as follows:*

Capital Accounts	*John*	*Janet*	*Total*
Beginning of the year	*$50,000*	*$50,000*	*$100,000*
Allocation of Taxable Gain	*40,000*	*10,000*	*50,000*
Less: Economic Distribution	*(75,000)*	*(75,000)*	*(150,000)*
Balance at Liquidation	*$15,000*	*($15,000)*	*$0*

As can easily be seen, John is allocated 80% of the gain for tax purposes ($40,000) but receives only 50% of the economic gain, $25,000, while Janet is allocated 20% of the taxable gain ($10,000) but receives 50% of the economic gain, $25,000. The special allocation of taxable gain results in positive capital account for John and negative capital account for Janet after distribution. Since the liquidating distribution is not based on the partners' positive capital accounts and the partner with negative capital account balance is not required to make contribution to the partnership to pay for the partner with positive capital account, the allocation of the taxable gain between John and Janet has no economic effect and therefore has to be reallocated in accordance with their partnership interest, which is 50/50.

Observation*: It is assumed in this example that the partnership agreement does not meet the Alternate Economic Effect test (See* PTM 1140*) and the Economic Equivalent test (See* PTM 1180*)*

Example 2*: Assume the same facts as Example 1 except that the partnership agreement requires that liquidating distributions have to be made in accordance with the partners' positive capital accounts. As a result, John will receive $90,000 and Janet will receive $60,000. Thus, the economic gain of $50,000 is distributed in the ratio of 80/20 to John and Janet, respectively. The tax allocation is now valid since it is consistent with the economic arrangement between the partners.*

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Capital Accounts	***John***	***Janet***	***Total***
Beginning of the year	*$50,000*	*$50,000*	*$100,000*
Allocation of Taxable Gain	*40,000*	*10,000*	*50,000*
Balance Before Distribution	*90,000*	*60,000*	*150,000*
Less: Economic Distribution	*(90,000)*	*(60,000)*	*(150,000)*
Balance at Liquidation	*$0*	*$0*	*$0*

Observation: *In the above example, the partnership agreement does not require the partners to restore the deficit capital account balances but the allocation is still valid since the partners' capital accounts do not become negative as a result of the allocation. Had this been an allocation of partnership loss and the allocated amount of the loss is in excess of the partners' capital accounts, the allocation may not be respected with regard to the excess loss.*

1130 Obligation to Restore Deficit

Generally, in order for an allocation to have economic effect, a partnership agreement must contain the Deficit Restoration Requirement, which requires partners to restore their deficit capital account balances (See PTM 1120). However, if the partnership agreement does not expressly require the partners to restore their deficit capital accounts, a partner nevertheless will be treated as obligated to restore the deficit balance in his capital account to the extent of: [Treas. Reg. § 1.704-1(b)(2)(ii)(c).]

- The outstanding principal balance of any promissory note to the partnership (of which such partner is the maker and provided that the note meets the requirements specified below) and
- The amount of any unconditional obligation such partner make subsequent contribution to the partnership (other than pursuant to a promissory note stated above). The amount of any unconditional obligation may be imposed by the partnership agreement or by State or local law. (See Examples and Observation below)

A contribution of a note or an obligation to make subsequent contribution must meet the following requirements:

- such note or obligation is required to be satisfied at a time no later than the end of the partnership taxable year in which such partner's interest is liquidated or, if later, within 90 days after the date of such liquidation.
  - If such note is negotiable, the time requirement (explained above) is met if the partnership agreement provides that the partnership has to retain such note and the partner has to contribute to the partnership the excess, if any, of the

outstanding principal of such note over its fair market value at the time of liquidation.

However, it should be noted that if such obligation is not legally enforceable or the facts and circumstances otherwise indicate a plan to circumvent such obligation, the partner is not considered to have satisfied the requirement to restore his deficit capital account. [Treas. Reg. § 1.704-1(b)(2)(ii)(c).]

Example 1*: Upon the formation of the partnership, Paul contributes to the partnership his negotiable promissory note with a $10,000 principal balance. The note unconditionally obligates Paul to pay $10,000 to the partnership (1) at the end of the partnership's fifth taxable year or (2) at the end of the year Paul's partnership interest is liquidated. Paul is considered obligated to restore up to $10,000 of his deficit capital account balance to the partnership. (Thus, if the partnership allocates losses that cause a deficit (up to $10,000) in Paul's capital account, such an allocation has substantial economic effect.)*

Example 2*: Same facts as in Example 1 except Paul is only required to pay at the end of the partnership's fifth taxable year regardless of when his partnership interest is liquidated. In this situation, his deficit capital account restoration obligation is still considered satisfied provided that the partnership retains the note and Paul agrees to contribute to the partnership any excess of the outstanding balance of the note over its fair market value.* [*See Treas. Reg. § 1.704-1(b)(5) Example (1)(ix).] (e.g., if the partnership disposes of Paul's personal note for $9,000, Paul has to reimburse the partnership $1,000.)*

Example 3*: Same facts as in Example1 except Paul's obligation to restore his negative capital account is not evidenced by a promissory note. Instead, the partnership agreements imposes upon Paul the obligation to make an additional contribution of $10,000 at the earlier of (1) the end of the partnership fifth taxable year or (2) the end of the partnership taxable year in which Paul's interest in the partnership is liquidated. Paul is considered to have satisfied his deficit capital account restoration obligation up to $10,000. [See Treas. Reg. § 1.704-1(b)(5) Example (1)(x).]*

Observation*: It should be noted that the obligation to make a subsequent contribution is different from the obligation to restore the deficit capital account. When a partner is obligated to make a subsequent contribution, the contribution amount is usually predetermined under the partnership agreement. On the contrary, the obligation to restore the deficit capital account generally requires the partner to contribute the negative balance in his or her capital account. Some limited partnership agreements may not contain the deficit capital account restoration requirement because they are designed to limit the potential economic exposure of limited partners through unlimited*

additional capital contributions under the deficit capital account restoration requirement. In such situations, the regulations provide some relief to these limited partners through the alternate economic effect test and other limited restoration obligations. Thus, if the partnership agreement does not provide for a deficit restoration obligation, allocations of losses may still be respected if they meet the alternative requirements. Again, in examining these requirements, the auditor needs to be aware of potential planning to circumvent or avoid these obligations. For instance, if a promissory note is not legally enforceable (e.g., the partnership cannot enforce a payment under the jurisdiction of the maker's state or country), such note may not be respected.

Another important requirement is that the obligation to restore the negative capital account must be ***expressly*** *provided by the partnership agreement and cannot be relied upon similar requirements under the state or local law. See further explanations in* PTM 2920

1140 Alternate Test for Economic Effect

The primary test for Economic Effect can be satisfied only if a partner has unlimited deficit restoration obligation. If the requirement regarding the restoration of the deficit capital account balance is not provided for in the partnership agreement, or if a partner is required to restore only a limited dollar amount of such deficit balance, **an allocation may still be treated as having economic effect if it meets all of the following requirements under the Alternate Economic Effect Test:** [Treas. Reg. § 1.704-1(b)(2)(ii)(d)]

1. The partnership agreement satisfies the first two requirements of the primary test (i.e. the capital account and liquidation requirements)
2. The partnership agreement contains a "**qualified income offset**" statement. A partnership agreement contains a "qualified income offset" if, and only if, it provides that **a partner who unexpectedly receives an adjustment, allocation, or distribution described in item 4(a), 4(b), or 4(c) below, will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible**.
3. The allocation does not cause or increase a deficit balance in such partner's capital account as of the end of the partnership taxable year to which such allocation relates, and
4. Such partner's capital account must also be reduced by the following "special adjustments": [Treas. Reg. § 1.704-1(b)(2)(ii)(d)] (For illustration of this requirement, see Example 4 below.)

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a) Adjustments that, as of the end of such year, reasonably are expected to be made to such partner's capital account under treasury regulation §1.704(b)(2)(iv)(k) (relates to depletion allowances for oil and gas properties of the partnership),
b) Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to § 704(e)(2) (relates to family partnership rules), § 706(d) (relates to the determination of a partner's distributive share when the partner's interest changes), § 1.751-1(b)(2)(ii) (relates to a distribution of § 751 property to which another partner has a special basis adjustment), and
c) Distributions to the partner that are in excess of the increases to such partner's capital account during or prior to the partnership's taxable years in which such distributions reasonably are expected to be made.

Notes regarding the last bulleted item: The increases mentioned above do not include the increases pursuant to a minimum gain chargeback (See PTM 3340) under § 1.704-1(b)(4)(iv)(e) or under § 1.704-2(f). However, increases to a partner's capital account pursuant to a minimum gain chargeback requirement are taken into account as an offset to a distribution of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain. For purposes of determining the amount of expected distributions and expected capital account increases described above, the rule set out under the Transitory Allocations (See PTM 1220) concerning the presumed value of partnership property shall apply.

Notes: If the partnership does not meet the requirements under the Economic Effect test or the Alternate Economic Effect test, see the Economic Equivalence test discussed in PTM 1180.

Example 1*: Steve and Jerry form a general partnership. Each contributes $50,000, which is used by the partnership to buy depreciable personal property for $100,000. The partnership agreement provides that Steve and Jerry will have an equal share of partnership taxable income and loss (computed without regard to cost recovery deductions (i.e., depreciation deductions)) and that* ***all cost recovery deductions will be allocated to Steve****. The agreement further provides that the partners' capital accounts will be maintained in accordance with § 1.704-1(b)(2)(iv), and that distributions in liquidation will be made in accordance with the partners' positive capital account balances throughout the term of the partnership. (Note that* ***there is no requirement that a partner with a negative capital account has to restore his deficit balance****.) The partnership agreement contains a qualified income offset statement and as of the end of each partnership taxable year, the items described in (a), (b), and (c) above (See* PTM 1140*, item (4)) are not reasonably expected to cause or increase a deficit balance in Steve's capital account.*

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In the partnership's first taxable year, it recognizes operating income equal to its operating expenses and has an additional $30,000 cost recovery deduction which is allocated entirely to Steve.

Capital Accounts	***Steve***	***Jerry***
Beginning of the 1st year	*$50,000*	*$50,000*
Less: Cost Recovery Deduction	*(30,000)*	*0*
End of the 1st year	*$20,000*	*$50,000*

*Under the **alternate economic effect test**, the allocation of the depreciation deduction to Steve has economic effect because (1) the partnership agreement has a qualified income offset, (2) none of the items described in (a), (b), and (c) above are expected at the end of the first year, and (3) the allocation of the depreciation does not cause a deficit in Steve's capital account. [See Treas. Reg. § 1.704-1(b)(5) Example (1)(iii).]*

***Observation**: In the above example, the allocation of depreciation deductions to Steve would have failed under the economic effect because the partnership agreement does not require a capital account deficit restoration. However, **under the alternate economic test, the allocation has economic effect** as explained above.*

***Example 2**: Assume the same facts as in Example 1 and that in year 2, the partnership recognizes operating income equal to its operating expenses and has a $30,000 cost recovery deduction which is allocated entirely to Steve according to the partnership agreement.*

Capital Accounts	***Steve***	***Jerry***
Beginning of the 2nd year	*$20,000*	*$50,000*
Less: Cost Recovery Deduction	*(30,000)*	*0*
End of the 2nd year	*($10,000)*	*$50,000*

*The allocation of the $30,000 depreciation deduction to Steve causes a $10,000 deficit in his capital account. Therefore, the allocation **satisfies the alternate economic test only to the extent of $20,000** and only this portion ($20,000) of the allocation ($30,000) has economic effect. The remaining $10,000 must be reallocated in accordance with the partners' interest in the partnership (which is 50/50). However, under the general principle (See* PTM 1010*) that the partner who is* allocated *a partnership loss must bear the economic burden with regard to the loss, it is necessary to determine who actually bears the economic risk of loss with regard to this $10,000 loss. If the partnership sells the property immediately at the end of the partnership's second taxable year for $40,000 (its adjusted tax basis: total cost of $100,000 less depreciation of $60,000), the entire $40,000 proceeds will be allocated to Jerry pursuant to the partnership agreement (liquidation distribution in accordance to partners' positive*

capital accounts). Since Jerry's total investment is $50,000 and he receives only $40,000 in the hypothetical liquidation distribution, he bears the economic risk of loss of $10,000. Thus, the remaining $10,000 of the $30,000 cost recovery deduction has to be reallocated to Jerry because he bears the economic burden corresponding to such amount. [See Treas. Reg. § 1.704-1(b)(5) Example (1)(iv).]

For reallocation method, see also PTM 1630

***Example 3**: Assume the same facts as in Example 2 except that the cost recovery deduction for the second year is $20,000 instead of $30,000. The allocation of the $20,000 cost recovery deduction to Steve has economic effect under the alternate economic effect test as discussed in Example 1. Assume further that the partnership sells the property for $20,000 immediately following the end of the partnership's second taxable year and the partnership is liquidated. The sale results in $30,000 loss [the partnership's adjusted basis in the property is $50,000 (total cost $100,000 less $50,000 accumulated depreciation taken in year 1 and 2)]. Under the partnership agreement, Steve and Jerry share equally in partnership income and loss. Thus, the $30,000 loss on the sale of the property is allocated equally to Steve and Jerry. However, this allocation has **no** economic effect as shown below:*

Capital Accounts	***Steve***	***Jerry***
Beginning of the 2nd year	*$20,000*	*$50,000*
Less: Cost Recovery Deduction	*20,000*	*0*
End of the 2nd year	*$50,000*	*0*
Less: Loss on sale	*(15,000)*	*(15,000)*
Cap. acct. before Liquidation	*(15,000)*	*$35,000*
Distribution of sales proceeds	*0*	*(20,000)*
Ending Balance	*($15,000)*	*$15,000*

Under the partnership agreement, liquidating distributions are made in accordance with the partners' positive capital accounts. Thus, the sales proceeds ($20,000) is distributed to Jerry. After the distribution, he still has a positive capital account of $15,000 while Steve's capital account is negative. Thus, the allocation of the $30,000 taxable loss on the sale of the property to Steve according to the partnership agreement (50/50) does not have economic effect because Jerry is the one who bears the economic loss (i.e., his capital account shows a positive balance of $15,000 at liquidation). As a result, the $15,000 taxable loss allocated to Steve based on the partnership agreement has to be reallocated to Jerry. [See Treas. Reg. § 1.704-1(b)(5) Example (1)(v).] On their returns filed for year 2, Steve will report $20,000 cost recovery deduction and Jerry will report $30,000 loss from the partnership.

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Capital Accounts	***Steve***	***Jerry***
Beginning of the 2nd year	*$20,000*	*$50,000*
Less: Cost Recovery Deduction	*(20,000)*	*0*
End of the 2nd year	*0*	*$50,000*
Less: Loss on sale	*0*	*(30,000)*
Cap. acct. before Liquidation	*0*	*$20,000*
Distribution of sales proceeds	*0*	*(20,000)*
Ending Balance	*$0*	*$0*

***Observation**: In Examples 1 and 3, from an economic standpoint, Steve's investment of $50,000 results in a cost recovery deduction of $30,000 and $20,000 in year 1 and 2, respectively. Jerry's $50,000 investment results in $0 loss in year 1, $30,000 loss in year 2, plus a distribution of $20,000 from the partnership.*

The special allocation of cost recovery deductions to Steve in year 1 and 2 has economic effect under the alternate economic effect test. However, the $30,000 taxable loss from the sales of the property has to be allocated entirely to Jerry because he bears the economic loss (in spite of their agreement to share equally in partnership loss).

***Examples 4**: Assume the same facts as in Example 2 except that the cost recovery deduction in year 2 is $20,000 and that at the end of year two, it is reasonably expected that during its **third** taxable year the partnership will (1) have operating income equal to its operating expenses and will have no cost recovery deductions and (2) borrow $10,000 (recourse) and distribute the amount equally to Steve and Jerry and (3) thereafter sell the property, repay the $10,000 loan, and liquidate. In determining if the special allocation of the $20,000 cost recovery deduction to Steve in year 2 meets the alternate test, the fair market value of the property is presumed to be equal to its adjusted tax basis, which is $50,000 (total cost of $100,000 less accumulated depreciation of $50,000 taken in year 1 and 2). Thus, there will be no gain on the sale of the property and there can be no reasonable expectation that there will be any increases to Steve's capital account in the third taxable year that will offset the expected $5,000 distribution to Steve. Therefore, the expected distribution of the loan proceeds in year three must be taken into account in determining to what extent the alternate economic test is satisfied.*

Capital Accounts	***Steve***	***Jerry***
Beginning of the 2nd year	*$20,000*	*$50,000*
Less: Expected Distribution	*(5,000)*	*(5,000)*

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Less: Year 2 cost recovery deduction	*(20,000)*	*0*
End of the 2nd year	*($5,000)*	*$45,000*

Upon the sale of the property, the $50,000 sales proceeds will be used to pay off the $10,000 liability and the remaining $40,000 will be distributed to Jerry (in accordance with the partnership agreement.)

Under these circumstances the allocation of $20,000 cost recovery deduction to Steve in year 2 satisfies the alternative economic effect test only to the extent of $15,000. The remaining $5,000 of the cost recovery deduction will be reallocated to Jerry.

The results in this example would be the same as above even if the partnership agreement provides that the gain on the sale of the property would be allocated to Steve to the extent of the cost recovery allocated to him previously and that at the end of the second year the partners are confident that the gain on the sale of the property in year three will be sufficient to offset the expected $5,000 distribution to Steve. [See Treas. Reg. § 1.704-1(b)(5) Example (1)(vi).]

***Observation**: This example illustrates one of the "special adjustments" to capital accounts mentioned earlier in this paragraph. The distribution of the $5,000 loan proceeds expected to occur in year 3 is taken into account in determining Steve's capital account in year 2 and therefore limits the amount of the cost recovery deduction allocated to Steve in year 2. Note that under the alternate economic test, an allocation **cannot** create a deficit balance in a partner's capital account. In this example, though the allocation of $20,000 cost recovery deduction in year 2 does not cause Steve's capital account to be negative, the expected distribution in year 3 will cause Steve's capital account to be negative. Therefore, the allocated cost recovery deduction to Steve in year 2 must be reduced to the extent of the potential deficit amount. (A partner's capital account is reduced by distributions from the partnership to such partner. See* PTM 1400*). The effect of this rule is to prevent the situation where a partner's capital account is increased before year-end to allow him to be allocated losses and immediately reduced the following year through distribution.*

***Example 5**: Assuming the same facts as in Examples 2 except that the partnership agreement provides that any partner with a deficit capital account following the liquidation of his interest must restore the deficit to the partnership. Assume further that the partnership allocates its cost recovery deduction of $30,000 in year 2 to Steve and sells the property for $35,000 at the end of year 2 and liquidates. The sale of the property results in a loss of $5,000 (total cost of $100,000 less accumulated*

depreciation of $60,000 to give the adjusted basis of $40,000). The sales proceeds of $35,000 is distributed to Jerry pursuant to the partnership agreement.

Capital Accounts	***Steve***	***Jerry***
Beginning of the 2nd year	*$20,000*	*$50,000*
Less: Cost Recovery Deduction	*(30,000)*	*0*
Less: Loss on sale of the property	*(2,500)*	*(2,500)*
Less: Distribution of sales proceeds		*(35,000)*
End of the 2nd year	*($12,500)*	*$12,500*

Since the partnership agreement requires any partner with a deficit capital account to restore it, Steve would be obligated to contribute $12,500 (the deficit balance in his capital account) to the partnership, and that $12,500 will be distributed to Jerry. Thus, the allocation of $30,000 cost recovery deduction and $2,500 loss on property sale to Steve in year two has economic effect because the partnership agreement contains all three requirements under the economic effect test. *[See Treas. Reg. § 1.704-1(b)(5)] (See* PTM 1140*).*

Observation*: This example shows that the obligation to restore a deficit capital account is essential in preventing a partner from being allocated losses that he does not bear economically. Assuming the law does not require Steve to restore his deficit capital account nor prevent him from being allocated losses that have no economic effect, Steve would have a total tax loss of $62,500 in two years while his economic outlay is only $50,000.*

Example 6*: Assume the same facts as in Example 5 except that Steve is required to restore the deficit balance in his capital account up to a maximum of $4,000. Thus, the allocation of the $30,000 cost recovery deduction and the $2,500 loss on sale of property to Steve has economic effect under the alternate test up to $24,000. The balance ($8,500) has to be reallocated to Jerry. Also, Steve has to contribute $4,000 to the partnership at the end of year two (when the partnership liquidates) and the partnership distributes that $4,000 to Jerry. [See Treas. Reg. § 1.704-1(b)(5) Example (1)(viii).]*

1150 Partial Economic Effect

If only a portion of an allocation made to a partner with respect to a partnership taxable year has economic effect, both the portion that has economic effect and the portion that is reallocated (due to the lack of economic effect) shall consist of a proportionate share of all items that made up the allocation to such partner for such year. [Treas. Reg. § 1.7041(b)(2)(ii)(e)]

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***Example**: Kim owns a 50% limited interest in a partnership that owns a rental property. The partnership agreement provides that Kim is not obligated to restore her deficit capital account upon liquidation. Her capital account balance at the beginning of the year is $500. During the year, the partnership generates the following items of income and expenses:*

	Partnership	***Kim***
Rent	*$10,000*	*$1,000*
Operating expenses	*(2,000)*	*(200)*
Interest expenses	*(6,000)*	*(600)*
Deprec. Ded.	*(7,000)*	*(700)*
Net Rental loss	*($5,000)*	*($500)*

Kim's share of the net rental loss is $2,500. However, only $500 of the loss allocated to her has economic effect. The remaining loss of $2,000 is allocated to the other partners. The $500 loss allocated to Kim is treated as consisting of a proportionate share (10%) of all items that made up the $500 loss as shown above. [See Treas. Reg. § 1.704-1(b)(5) Example (15)(ii).]

1160 Definition of Liquidation

Liquidation of a partner's interest in the partnership: For purposes of applying the economic effect test, a partner's interest in the partnership is considered liquidated upon the earlier of: [Treas. Reg. §
1.704-1(b)(2)(ii)(g)]

- the date upon which there is a liquidation of the partnership, or
- the date upon which there is a liquidation of the partner's interest in the partnership under treas. reg. § 1. 761-1(d). Section 1.761-1(d) provides that the term "liquidation of a partner's interest" means a termination of a partner's entire interest in a partnership by means of a distribution or a series of distributions, to the partner by the partnership. Where a partner's interest is to be liquidated by a series of distributions (made in one year or more than one year), the interest will not be considered as terminated until the final distribution has been made.

Liquidation of a partnership: The liquidation of a partnership occurs upon the earlier of: [Treas. Reg. § 1.704-1(b)(2)(ii)(g)]

- the date upon which the partnership is terminated under § 708(b)(1), or

- the date upon which the partnership ceases to be a going concern (even though it may continue in existence for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its partners.

IRC § 708(b)(1) provides that a partnership shall be considered terminated only if (A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership or (B) within a 12-month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

Note: IRC § 708(b)(1) was amended by the Tax Cuts and Jobs Act, which eliminated IRC § 708(b)(1)(B) in its entirety. As a result, a sale or exchange of 50 percent or more of the interest in partnership would not cause a technical termination of the partnership. The change was effective for partnership tax years beginning after 12/31/2017. California has not conformed to the changes made by Tax Cuts and Jobs Act.

Potential Abuses: If the liquidation of a partner's interest in a partnership is delayed after the partnership's primary business activities have been terminated (for example, by continuing to engage in a relatively minor amount of business activity), such a delay will be treated as incurred for a principal purpose of deferring any distribution to the partners with positive capital accounts or deferring a partner's obligation to restore a deficit capital account. [Treas. Reg. § 1.704-1(b)(2)(ii)(g)]

1170 Definition of Partnership Agreement

For purposes of applying the economic effect test, a partnership agreement includes all agreements among the partners, or between one or more partners and the partnership, concerning affairs of the partnership and responsibilities of partners, whether **oral** or **written**, and whether or not embodied in a document referred to by the partners as the partnership agreement.

As a result, in determining whether distributions are required to be made in accordance with the partners' positive capital accounts, or the extent to which a partner is required to restore the deficit capital account balance (the third requirement of the economic effect test-deficit restoration requirement. Treas. Reg. § 1.704-1(b)(2)(ii)(b)), it is necessary to consider <u>all arrangements</u> among the partners or between one or more partners and the partnership, direct or indirect, including puts, options, buy-sell agreements, and any other stop-loss arrangements as parts of the partnership agreement.

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An agreement with a partner or a partnership also includes an agreement with a related person within the meaning of IRC §267(b) (without modification by IRC § 267(e)(1)) or IRC § 707(b)(1), to such partner or partnership.

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 part of the partnership agreement. Treasury regulation § 1.761-1(c) provides that if the partnership agreement, or any modification thereof, is silent with regard to any matter, the provisions of local law shall be considered a part of the agreement. [Treas. Reg. § 1.704-1(b)(2)(ii)(h)]

1180 Economic Effect Equivalence

The economic effect rules (See PTM 1120) require that (1) partners' capital accounts be maintained in accordance with the § 704(b) regulations, (2) liquidation distributions be made in accordance with the partners' positive capital account balances, and (3) partners with deficit capital accounts have to restore the deficit balances. However, if a partnership agreement does not contain any of these requirements, allocations made to partners nevertheless are deemed to have economic effect if a liquidation of the partnership at the end of a taxable year (or of any future year) would produce the same economic results as under the three requirements above. [Treas. Reg. § 1.704-1(b)(2)(ii)(i)]

***Example 1**: Susan and Lori contribute $9,000 and $1,000, respectively, to form a general partnership. The partnership agreement provides that all income, gain, loss, and deductions will be allocated **equally** between the partners, that the partners' capital accounts will be determined and maintained in accordance with the regulations, but that all partnership distributions, regardless of capital account balances, will be made 90% to Susan and 10% to Lori. The partners are not required to restore their deficit capital account balances at liquidation. Thus, the tax allocations (50/50) in the partnership agreement do not have economic effect. If contributions to partnership are made in the 90/10 ratio, and the partnership agreement provides that all partnership's economic profits and losses are to be shared in the 90/10 ratio (i.e., liquidating distributions to be made in the 90/10 ratio), the allocations of all partnership income, loss, gain, and deductions must also be in the same ratio of 90/10. Such allocations are respected under the economic effect equivalence test. [See Treas. Reg. § 1.704-1(b)(5) Example (4)(i).]*

***Example 2:** Same facts as in Example 1 except that the partnership does not maintain capital accounts and the partnership agreement provides that all income, gain, loss, deductions will be allocated 90% to Susan and 10% to Lori.*

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Susan and Lori are ultimately liable (under a State law right of contribution) for 90% and 10%, respectively, of any debts of a partnership. Although the allocations do not satisfy the capital account maintenance requirement under § 704(b)(2)(ii)(b), the allocations have economic effect under the economic effect equivalence test as discussed above. To illustrate, assume further that during the year, the partnership borrows $20,000 from a bank on a recourse basis. Both Susan and Lori, as general partners, are personally liable for repayment of the loan. The partnership uses all its $30,000 cash to invest in stock of a corporation which becomes totally worthless at the end of the year. Susan and Lori make additional contribution of $18,000 and $2,000 to the partnership to pay off the $20,000 loan to the bank.

Capital Accounts	*Susan*	*Lori*
Beginning of the year	*$ 9,000*	*$1,000*
Less: Stock Loss	*(27,000)*	*(3,000)*
Additional Contribution	*$18,000*	*$2,000*
Ending Capital	*0*	*0*

Thus, although the partnership agreement does not meet the requirements under the economic effect test, the allocation of the tax loss to Susan and Lori has the same economic effect as if all three requirements under the economic effect test are satisfied and the allocation is deemed to have economic effect. [See Treas. Reg. § 1.704-1(b)(5) Example (4)(ii).] (Or, respected under the economic effect equivalence test.)

***Observation**: The situation in Example 2 above probably reflects a large number of partnerships the auditor may encounter. Many of these partnership agreements may not contain all or some of the general requirements under the substantial economic effect. However, an absence of these requirements has no material bearing on the allocations of partnership taxable income or loss because the allocations are generally based on the partners' capital interests in the partnership. Note that the principal purpose of the substantial economic effect tests is to prevent abuses regarding special allocations of certain partnership items of income or deduction. If the allocations are not "special", then whether or not the requirements under the economic effect are contained in the partnership agreement does not make any difference.*

1200 SUBSTANTIALITY

In order for an allocation to be respected, it must have **economic effect** (See PTM 1120) and the economic effect must be **substantial**. If an allocation has economic effect but the economic effect is not substantial, such allocation will be disregarded. [Treas. Reg. § 1.704-1(b)(2)(iii).]

The regulations adopt both a pre-tax and after-tax test for substantiality.

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The general rule is a pre-tax test, and it requires that there be a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent from the tax consequences. [Treas. Reg. § 1.704-1(b)(2)(iii)(a)] In other words, under this rule, if the only effect of an allocation is to reduce taxes without substantially affecting the partners' pre-tax distributive shares, the economic effect of the allocation will not be substantial.

Merely satisfying this general rule is not sufficient to establish substantiality. The regulations provide an "after-tax exception" which focuses on the after-tax consequences to the partners. Under this exception, the allocation will not be substantial if the after-tax effect of an allocation is to enhance the economic consequences of one or more partners without adversely affecting any other partner. See Treasury Reg. § 1.704-1(b)(2)(iii)(a) for more information.

For illustration, see Examples in PTM 1210 and PTM 1220.

There are two common types of allocations that are **not** substantial:

- The “shifting tax consequences” which relates to allocations that occur within a single tax year (See PTM 1210), and
- The “transitory tax consequences” which relates to allocations that occur over two or more tax years (See PTM 1220).

PTM 1210 Shifting Tax Consequences
PTM 1220 Transitory Allocations

1210 Shifting Tax Consequences

The economic effect of an allocation in a partnership taxable year is **not** substantial if at the time the allocation becomes part of the partnership agreement, there is a strong likelihood that:

- (First condition) the net increases and decreases in the partners’ capital accounts for such taxable year will not differ substantially from the net increases or decreases in such partners’ capital account if the allocations were not contained in the partnership agreement, [Treas. Reg. § 1.704-1(b)(2)(iii)(b)(1)] and
- (Second condition) the total tax liability of the partners for the taxable years in which the allocations are taken into account will be **less** than if the allocations were not contained in the partnership agreement. It is necessary to take into

account the tax consequences that result from the interaction of the allocations with partner tax attributes that are unrelated to the partnership. [Treas. Reg. § 1.704-1(b)(2)(iii)(b)(2)]

At the end of the taxable year, if these two results come to pass, the regulations presume (rebuttable) that at the time the allocation was originally agreed to there was a strong likelihood that they would occur.[Treas. Reg. § 1.704-1(b)(2)(iii)(b)(2)]

***Example**: A and B are **equa**l partners in a partnership. The partnership agreement contains all requirements regarding the maintenance of the capital accounts in accordance with the § 704(b) rules, the liquidation distribution according to partners' positive capital account and the deficit capital account restoration obligation. During the year, the partnership generates passive income (from rental real estate) of $5,000 and capital gain of $5,000. A has $7,000 in passive losses from investments in other rental real estate unrelated to the partnership. B has $11,000 in capital loss carryovers from previous years. A and B agree that the entire passive income will be allocated to A and the entire capital gain will be allocated to B. Assume both partners are in the 28% tax bracket. The after-tax economic consequences under the special allocation will be as follows:*

	A	***B***	***Total***
Passive Income	*$5,000*	*0*	*$5,000*
Capital Gain	*0*	*$5,000*	*$5,000*
Less: Taxes on income(*)	*0*	*0*	*0*
Net Cash after tax	*$5,000*	*$5,000*	*$10,000*

(*) The taxes on income are zero since A offsets the passive income of $5,000 against passive losses from other investments and B offset the $5,000 capital gain against the capital loss carryover.

*The after-tax economic consequences **without** special allocation will be as follows:*

	A	***B***	***Total***
Passive Income	*$2,500*	*$2,500*	*$5,000*
Capital Gain	*2,500*	*$2,500*	*$5,000*
Less: Taxes on income (*)	*(700)*	*(700)*	*(1,400)*
Net Cash after tax	*$4,300*	*$4,300*	*$8,600*

(*) A's passive income of $2,500 will be offset by the passive losses from other investments. However, A will have to pay $700 in taxes on the capital gain ($2,500 x

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28%). B's capital gain of $2,500 will be offset by the capital loss carryover but B will have to pay $700 taxes on the $2,500 passive income. (For simplicity, ignoring other minor allowances for deductions regarding capital losses or passive losses.)

*Based on the above analysis of the after-tax consequences, the allocation meets the first condition that the net increases in the partners' capital accounts do not differ substantially (i.e., with or without the special allocation, each partner's capital account is increased by the same $5,000 in income) and the second condition that the total tax liability under the special allocation is **less** than the tax liability if there is no special allocation (i.e., both partners are better off after taxes.) Therefore**, it will be presumed that at the time the allocation became part of such partnership agreement, there was a strong likelihood that these results would occur. As a result, the special allocation is insubstantial** and the passive income and the capital gain have to be reallocated equally between A and B.*

The above presumption may be overcome by a showing of facts and circumstances that prove otherwise. [Treas. Reg. § 1.704-1(b)(2)(iii)(b)(2)] For instance, assume the same facts as above except that at the time when A and B entered into the agreement to specially allocate the passive income and the capital gain, they had no expectation of deriving such individual tax benefits from such allocation (i.e., A did not know he would have passive losses from other investments and B did not know he would have capital loss carryover), then the allocation may be considered substantial.

***Observation**: The above example illustrates the purpose of the substantiality test: it is designed to prevent special allocations based on the **character** of the partnership income or deductions but have no effect on the dollar value of the partner's interest. The test is based on the after-tax economic consequences of the allocation. To be substantial, if the after-tax economic consequence of one partner is **enhanced** due to the allocation, the after-tax economic consequences of other partners must be **diminished** due to such allocation. In other words, an allocation that causes after-tax benefit to a partner must also cause a significant after-tax cost to any other partner. In the above example, the allocation causes after-tax benefits to both A and B and does **not** diminish any partner's after-tax consequences, thus the allocation is **not** substantial.*

1220 Transitory Allocations

If a partnership agreement provides for the possibility that one or more allocations (the "original allocations") will be largely offset by one or more allocations (the "offsetting allocations"), and at the time the allocations become part of the partnership agreement, there is a strong likelihood that:

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- (First condition) the net increases or decreases in the partners' capital ac;counts will **not** differ substantially if the original allocation(s) and offsetting allocation(s) were not contained in the partnership agreement, and [Treas. Reg. § 1.704-1(b)(2)(iii)(c)(1)]

- (Second condition) the total tax liability of partners will be **less** than if the allocations were not contained in the partnership agreement. [Treas. Reg. § 1.704-1(b)(2)(iii)(c)(2)]

If the above two conditions occur, **there is a presumption that the allocation is not substantial**. The presumption can be overcome by a showing of facts and circumstances that prove otherwise. [Treas. Reg. § 1.704-1(b)(2)(iii)(c)]

The Transitory allocation test is similar to the Shifting Tax Consequences allocation test (PTM 1210) except it covers allocations that occur over more than one year.

An allocation will be presumed to not be transitory if there is a strong likelihood that the offsetting allocation will **not** be made within 5 years after the original allocation is made (determined on a first-in, first-out basis).

Example 1*: Bob and Marion form a general partnership to acquire and lease 5 year-recovery property (under § 168). Each contributes $10,000 and the partnership borrows $80,000 to purchase the property. The partnership agreement contains all requirements regarding the maintenance of partners' capital accounts, the liquidation distribution pursuant to the partners' positive capital account balances, and the deficit capital account restoration obligation in accordance with § 704(b) regulations. In addition, the partnership agreement also provides that:*

1. *The partnership's net taxable loss will be allocated 90% to Bob and 10% to Marion until the partnership has net taxable income,*
2. *The partnership's net taxable income will be allocated 90% to Bob and 10% to Marion until Bob's allocated taxable income is equal to his previously allocated net taxable loss,*
3. *All partnership's net taxable income or loss will be allocated equally between Bob and Marion thereafter, and*
4. *Distributions of operating cash flow will be made equally to the two partners.*

The partnership entered into a 12-year lease with a corporation. The partnership's expected income and loss for the life of the lease is as follows:

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- *Net taxable loss from year 1 through 5: ($10,000), ($9,000), ($8,000), ($7,000), and ($6,000), respectively.*
- *Net taxable income from year 6 through 12: $4,000, $5,000, $6,000, $7,000, $8,000, $9,000, and $10,000, respectively.*

*Even though there is a strong likelihood that the allocation of losses in years 1 through 5 will be offset by the income in years 6 through 12 and even if it is assumed that the total tax liability of Bob and Marion in years 1 through 12 will be less than if there are no such allocations, the economic effect of these special allocations is presumed to be substantial under the above rule. This is because at the time such allocations became part of the partnership agreement, there was a strong likelihood that the allocation of losses in year 1 through 5 would not be offset by allocations of income **within 5 years**, determined on a first-in, first-out method. The year 1 allocation of $10,000 loss will not be offset until years 6, 7, and 8 ($4,000 in year 6, $5,000 in year 7, and $1,000 in year 8) and the year 2 allocation of $9,000 loss will not be offset until years 8 and 9 ($5,000 in year 8 and $4,000 in year 9), etc. [See Treas. Reg. § 1.704-1(b)(5) Example (2).]*

***Example 2**: Cynthia and Larry are equal partners in CL partnership, which is engaged in producing tax research for a state agency. Cynthia and Larry share equally in all of the partnership's income, loss, and deduction. The partnership agreement contains all the requirements regarding capital account maintenance, liquidating distribution, and deficit capital account restoration as provided by the § 704(b) regulations. In 1995, Cynthia and Larry decided to invest $50,000 in tax exempt bonds and another $50,000 in corporate stock for the next three years. Cynthia and Larry are expected to be in the 31% and 15% tax brackets, respectively, during these three years. At the time the investment decision is made, Cynthia and Larry agree that during the 3-year period, the income and loss from these investments will be allocated as follows:*

	Cynthia	***Larry***
Interest on tax-exempt bonds	*90%*	*10%*
Gain/loss on sale of bonds	*90%*	*10%*
Dividend from corporate stock	*10%*	*90%*
Gain/loss on sale of stock	*10%*	*90%*

*Also, at the time the allocations concerning these investments become part of the partnership agreement, there is **not** a strong likelihood that the gain or loss from the sale of the corporate stock will be **substantially equal** to the gain or loss on the sale of the tax-exempt bonds. However, there is a strong likelihood that the tax-exempt interest and the stock dividends for the next three years will not differ substantially.*

Do these allocations have economic effect? Yes, because the partnership agreement contains all the economic effect requirements under § 704(b) regulation.

*Do the allocations of gain or loss on the **sale** of bonds and stock have **substantial** economic effect? Yes, since at the time the allocation decision becomes part of the partnership agreement, there is **not** a strong likelihood that the gain or loss on sale of the bonds will be substantially equal to the gain or loss on the sale of stock. Thus, the increases or decreases in the partners' capital accounts will differ substantially with the special allocation. For instance, assuming the gain on the sale of the bonds is $5,000 and the gain on the sale of the stock is $15,000. Cynthia's and Larry's capital accounts based on the special allocations will be increased by the following:*

	Cynthia	Larry	Total
Bonds (90/10 to Cynthia/Larry)	$4,500	$500	$ 5,000
Stock (10/90 to Cynthia/Larry)	1,500	13,500	15,000
Total Increases	$6,000	$14,000	$20,000

Without the special allocation, Cynthia's and Larry's capital account increases will be as follows:

	Cynthia	Larry	Total
Bonds (50/50 to Cynthia/Larry)	$2,500	$2,500	$5,000
Stock (50/50 to Cynthia/Larry)	7,500	7,500	15,000
Total Increases	$10,000	$10,000	20,000

It should be noted that the purpose of the substantial effect test is to prevent allocations that cause different after-tax economic consequences without causing any substantial differences in the capital accounts. (See Example in PTM 1210*). In this example, Cynthia's and Larry's capital accounts are substantially different under the special allocation. Thus, the allocations of the gain on the sale of the bonds and stock are substantial.*

*Do the allocations of the tax-exempt interest and the dividends have substantial effect? There is a strong likelihood that the tax-exempt interest and the stock dividend for the next three years will **not** differ substantially. Thus, assuming the total interest income equal the dividend, which is $10,000. The capital accounts of the partners under the special allocation will be as follows:*

	Cynthia	Larry	Total

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Bonds (90/10 to Cynthia/Larry)	*$9,000*	*$1,000*	*$10,000*
Stock (10/90 to Cynthia/Larry)	*1,000*	*9,000*	*10,000*
Total Increases	*$10,000*	*$10,000*	*$20,000*

Without the special allocation, Cynthia and Larry will share equally in the $10,000 tax-exempt interest income and $10,000 dividend. Thus, their capital account will be increased by the same amount: $10,000. As a result, the first condition of the transitory test is met: the increases in the partners' capital account are the same with or without the allocation. The second condition of the test is whether the total tax liability under the special allocation is less than the total tax liability with no special allocation.

With the special allocation, Cynthia's tax liability on the $1,000 dividend will be $310 ($1,000 x 31%) and Larry's tax liability on the dividend will be $1,350 ($9,000 x 15%) to give a total of $1,660. Without the special allocation, Cynthia's tax liability on the $5,000 dividend will be $1,550 ($5,000 x 31%) and Larry's tax liability on the dividend will be $750 ($5,000 x 15%) to give a total tax liability of $2,300. Thus, the total tax liability under the special allocation ($1,660) is much less than the total tax liability without the special allocation ($2,300). As a result, the special allocation does not have substantial effect because (1) it causes no substantial differences in the partners' capital accounts and (2) the total tax liability is substantially less than without the special allocation. [See Treas. Reg. § 1.704-1(b)(5) Example (7)(i).]

***Observation**: Note that the transitory test applies to the three year period while the shifting of income test applies to one year only. However, the underlying principle of the substantial effect is the same: if an allocation causes no difference in the partners' capital account but the total partners' tax liability is less than the total tax liability if there is no special allocation, such special allocation has no substantial effect.*

1300 MAINTENANCE OF CAPITAL ACCOUNTS

In general, a partner's capital account reflects his equity (economic) interest in the partnership.

- If a partner's capital account has a positive balance, it usually indicates the proceeds the partner will receive if his partnership interest is liquidated.
- If a partner's capital account has a negative balance, it may indicate that the partner has to make an additional contribution to the partnership if his partnership interest is liquidated.

Based on how they are prepared, there are several "types" of capital accounts:

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Tax basis capital accounts (See PTM 1310), IRC § 704(b) capital accounts (See PTM 1320), IRC § 704(c) capital accounts (See PTM 1330), and financial capital accounts based on generally accepted accounting principles (GAAP) (See PTM 1340).

PTM 1310 Tax-Basis Capital Accounts
PTM 1320 IRC § 704(b) Capital Accounts
PTM 1330 Other – IRC § 704(c)
PTM 1340 Financial Capital Accounts

1310 Tax-Basis Capital Accounts:

In general, tax basis capital accounts are prepared based on the "tax" basis amounts (as opposed to "book" amounts or fair market values). The adjustments to tax-basis capital accounts are based on the **tax-basis amounts** determined under **tax law**.

Initial tax basis capital account includes:

- Cash contributed to the partnership or used to acquire the partnership interest.
- If a property is contributed to the partnership, the partner's tax basis capital account is increased by the partner's **adjusted tax basis** in the property, less any encumbered liability assumed by the partnership. (The fair market value of the contributed property has no bearing on the tax basis capital account.)

A partner's initial tax basis capital account is increased by:

- Any additional contributions to the partnership by the partner of cash and the tax basis of property(net of liabilities),
- the partner's distributive share of taxable income and tax-exempt income, including the income from a cancellation of debt (COD) regardless of whether or not the COD income is excluded by the partner under various provisions of IRC §108.

A partner's tax basis capital account is decreased by:

- the amount of cash and the tax basis of property(net of liabilities)distributed from the partnership to the partner,
- the partner's distributive share of taxable losses and the partnership's nondeductible expenses (e.g., political contributions, premium payment on partners' life insurance, etc.)

In many ways, the computation of a partner's tax basis capital account is similar to the computation of the partner's basis in his partnership interest (see PTM 5000). The

primary difference is that a partner's tax basis capital account does not include his share of partnership's liabilities.

When a partner's interest in a partnership is liquidated, his negative tax basis capital account immediately after the liquidating distribution usually indicates the amount of gain he will recognize from the liquidation. The gain could be ordinary or capital.

Example 1*: Paul and Kathy form a general partnership. Paul contributes $30,000 cash and Kathy contributes rental property with a fair market value of $35,000 and an adjusted basis of $20,000. The property is encumbered by a mortgage of $5,000. During the first year, the partnership generates a rental loss of ($1,000) and tax-exempt interest income of $3,000. The partnership also makes a distribution of $4,000 to each partner. The* ***tax basis*** *capital accounts and Paul's and Kathy's outside basis are as follows:*

	Paul		*Kathy*	
	Tax Cap. Acct.	*Basis*	*Tax Cap. Acct.*	*Basis*
Cash Contribution	*$30,000*	*$30,000*	*0*	*0*
Property Contribution	*0*	*0*	*$20,000*	*$20,000*
Less: Relieved Liability	*0*	*0*	*(5,000)*	*(5,000)*
Add: Assumed Liability	*0*	*2,500*	*0*	*2,500*
Interest Income	*1,500*	*1,500*	*1,500*	*1,500*
Rental Loss	*(500)*	*(500)*	*(500)*	*(500)*
Distributions	*(4,000)*	*(4,000)*	*(4,000)*	*(4,000)*
Year End Balances	*$27,000*	*$29,500*	*$12,000*	*$14,500*

Note that the sole difference between the partners' tax capital accounts and their partnership bases is the liability of $2,500. This liability comes from the $5,000 mortgage on the rental property and assumed by the partnership, and Paul and Kathy share the liability equally.

Kathy's initial tax capital account is her adjusted basis in the contributed property, $20,000, less the liability assumed by the partnership, $5,000.

Example 2*: Assume the same facts as in Example 1 except that at the beginning of year two, Paul sells his interest in the partnership to Sam for $30,000 cash. Paul's gain on the sale of his interest is as follows:*

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Amount Realized:	
Cash:	*$30,000*
Add: Liability assumed by buyer	*2,500*
Less: Basis in partnership interest	*(29,500)*
Gain:	*$3,000*

Sam's "outside basis" in the partnership:

Cash paid	*$30,000*
Liability Assumed	*2,500*
Initial Outside Basis	*$32,500*

Sam's "inside basis" in the partnership, however, equals Paul's basis in the partnership, which is $29,500. Thus, if the partnership has § 754 election in effect, Sam's inside basis may be adjusted to equal his outside basis.

***Observation**: Another shortcut to computing potential gain or loss on a disposition of a partnership interest is by subtracting the partner's tax basis capital account from the cash received. In the above example, the difference between Paul's tax capital account balance ($27,000) and the cash he receives ($30,000) reflects the gain of $3,000. If Paul's tax capital account were negative, say ($2,000), the gain would be $32,000.*

In general, the partnership is required to report § 704(b) capital accounts on Form 565 and the partners' schedule K-1. **When determining a partner's gain or loss on the liquidation or the disposition of the partner's interest in the partnership, the auditor needs to request a schedule of the partner's basis in the partnership.** (See PTM 5000)

1320 IRC § 704(b) Capital Accounts

Partnerships' allocation of income or loss to their partners must have substantial economic effect, as provided under § 704(b) regulations. To measure the economic effect of partnerships' allocations, partners' capital accounts are required to be maintained in accordance with certain rules prescribed under the § 704(b) regulations to reflect the economic value of the partners' interest. Thus, the main purpose of the § 704(b) capital accounts is to trace the partners' real economic interests in the partnership, rather than their tax bases.

To reflect the real economic value of partners' interests in the partnership, § 704(b) capital accounts are prepared based on the fair market value of the interests. For instance, if a partner contributes a property to the partnership, his § 704(b) capital

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account will be increased by the fair market value of the property, rather than by the partners' adjusted tax basis in the property. (See the maintenance rules regarding § 704(b) capital accounts discussed in PTM 1400.)

Terminology: Since § 704(b) capital accounts are based on the fair market value of the property, they are also referred to as “book” capital accounts in the Regulations. Also, the difference between the tax-basis capital accounts and § 704(b) “book” capital accounts is commonly referred to as the “book/tax” disparity in the Regulations.

It is important to note that the terms “book”, “book value”, ‘book income” and “book loss” used in the Regulations have nothing to do with the partnership’s books of accounts kept for financial accounting purposes or the income or loss computed based on financial accounting principles.

One of the primary differences between § 704(b) “book” capital accounts and the capital accounts prepared for financial accounting purposes is that the adjustments to the § 704(b) capital accounts are based on federal income tax principles (e.g., depreciation deductions based on tax law), **not** financial accounting principles (e.g., depreciation deductions using generally accepted accounting principles).

In §§ 1000 -- §§ 3500, unless specified otherwise, the term “capital account(s)” implies the § 704(b) capital accounts and the term “book” is understood within the context of § 704(b) regulations rather than of the financial accounting principles.

1330 Other - IRC § 704(c)

IRC § 704(c) provides that if at the time a property is contributed to the partnership, its **adjusted tax basis** is different than its fair market value. This difference has to be allocated to the contributing partner if sold within 7 years. As a result, the partnership has to keep track of this pre-contribution gain or loss for allocation purposes.

A detailed discussion of § 704(c) is provided in PTM 2100.

1340 Financial Capital Accounts

Certain partnerships may maintain their partners’ capital accounts based on generally accepted accounting principles[3] (GAAP) for financial accounting purposes (such as publishing their financial statements.) Though GAAP capital

[3] See Accounting Research Bulletin No. 51 and Accounting Principles Board Opinion No. 18

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accounts may be similar to § 704(b) capital accounts (e.g., contributed property recorded at fair market value, revaluation of partnership assets, etc.), they are not the same. Therefore, GAAP capital accounts should not be used for § 704(b) allocation purposes.[4]

1400 BASIC CAPITAL ACCOUNT MAINTENANCE RULES

In general, under the IRC § 704(b) regulations, a partner's capital account is increased by: [Treas. Reg. § 1.704-1(b)(2)(iv)(b)]

- the amount of money contributed to the partnership (See PTM 1410),
- the fair market value or adjusted basis of the property contributed to the partnership depending on capital account maintenance method chosen, net of any encumbering liabilities assumed by the partnership pursuant to IRC § 752 rules (See PTM 1420),
- the partner's distributive share of partnership income and gain, including income exempt from tax,
- the book (not tax) income and gain with respect to property whose adjusted tax basis differs from its fair market value [Treas. Reg. §1.704-1(b)(2)(iv)(g)] (See PTM 1460),
- unrealized income with respect to accounts receivable and other accrued but unpaid items, and

A partner's capital account is decreased by:

- the amount of money distributed to the partner by the partnership (See PTM 1410),
- the fair market value or adjusted basis of property distributed to the partner by the partnership depending on capital account maintenance method chosen, net of any encumbering liabilities assumed by the distributee partner pursuant to IRC § 752 rules (See PTM 1420),
- the partner's distributive share of partnership losses and deductions and the partnership expenditures that are neither deductible by the partnership in computing its taxable income nor properly chargeable to capital accounts described in IRC § 705(a)(2)(B) (such as syndication costs under § 709(b), organization costs not elected by the partnership for amortization and losses recognized by the partnership on sales of its assets but are not deductible due to the related party rules under §§ 267(a)(1) and 707(b)),

[4] See, e.g., W. McKee, W. Nelson, R. White, *Federal Taxation of Partnerships and Partners*, 6.04, (4th Ed. 2007).

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- book (not tax) losses and deductions with respect to property whose adjusted tax basis differs from its fair market (book) value, [Treas. Reg §1.704-1(b)(2)(iv)(g)]
- unrealized deductions with respect to accounts payable and other accrued but unpaid items,
- excess percentage depletion regarding depletable property (not discussed in §§ 1000 – §§ 3500), and

For liabilities assumed before June 24, 2003, references to liabilities in Treas. Reg §1.704-1(b)(2)(iv)(b) shall include only liabilities secured by the contributed or distributed property that are taken into account under IRC § 752(a) and (b).

The above increases and decreases are determined at the partnership level (See PTM 1520).

Single Capital Account: If a partner has more than one interest in the partnership, he will be treated as having a single capital account that reflects all such interests, regardless of the class of the interest (general or limited) and regardless of the time or manner in which such interests are acquired. [Treas. Reg. § 1.704-1(b)(2)(iv)(b)]

Observation*: The above adjustments to capital accounts may be complicated in certain circumstances. Please refer to the reference paragraphs for detailed explanations.*

PTM 1410 Assumption of Liabilities
PTM 1420 Contributions and Distributions of Property
PTM 1425 IRC § 704(c) Considerations
PTM 1430 Contributions of Promissory Notes
PTM 1440 Distribution of Promissory Notes
PTM 1450 Revaluation of Property
PTM 1460 Adjustments to Reflect Book Value
PTM 1470 Determination of Fair Market Value
PTM 1480 IRC § 705(a)(2)(B) Expenditures
PTM 1490 Organization and Syndication Fees (§ 709 Expenses)
PTM 1495 Disallowed Losses

1410 Assumption of Liabilities

- For purposes of § 704(b) capital accounts, a partner's capital account is increased by the amount of money contributed by such partner to the partnership

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and decreased by the amount of money distributed by a partnership to such partner.

- If a partner **personally assumes** a partnership liability, the assumed liability is treated as a cash contribution. If the partnership assumes **a partner's personal liability**, the assumed liability is treated as a cash distribution by the partnership to such partner.

Assumption Rules: For purposes of § 704(b) capital accounts, liabilities are considered assumed only to the extent:

- the assuming party is thereby subject to personal liability with respect to such obligation,
- the creditor is aware of the assumption and can directly enforce the obligation of the assuming party, and
- the assuming party is ultimately liable for the obligation. [Treas. Reg. § 1.704-1(b)(2)(iv)(c)]

Note:
The assumption of liabilities for purposes of § 704(b) is similar to the assumption rules of § 752. [Treas. Reg. § 1.752-1(d)] However, it is important to distinguish between an assumption of liabilities and a share of partnership liabilities under § 752. A partner's share of partnership liabilities under § 752 is treated as a constructive cash contribution by such partner and therefore increases his basis in the partnership interest. However, under § 752, the liabilities remain partnership liabilities (i.e., the partnership continues to make payments on principal and interest of the liability) as opposed to a partner being liable for payments of principal and interest on a liability that the partner personally assumes. The liability is no longer a partnership liability. The increases or decreases in a partner's share of partnership liabilities under § 752 has no effect on the partner's capital account. [*Treas. Reg. § 1.752-1(d)] On the contrary, when a partner personally assumes a partnership liability or when the partnership assumes a partner's liability, his capital account is increased or decreased, respectively, by such liability.*

A true assumption is a novation of the contract where the obligee releases the original obligor and looks solely to the new obligor for satisfaction of the obligation. The auditor must be careful to distinguish between a real "assumption" and a sloppy guarantee.

***Example**: In exchange for a 10% interest in a partnership, Debbie and the partnership incur the following transactions:*

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- *Debbie contributes to the partnership a rental property with an adjusted basis of $30,000 and a market value of $50,000. The property is encumbered by a recourse mortgage of $20,000.*
- *The partnership owes Debbie's father $1,000. Debbie agrees to assume payments on this $1,000 liability.*

Debbie's capital account under §704(b) is as follows:

Market Value of Contributed Property	*$50,000*
Less: Encumbering liabilities assumed by the partnership	*(20,000)*
Add: Personally Assumed Liability	*1,000*
Balance at Contribution	*$31,000*

***Observation**:*

- *Debbie's book capital account is first increased by $50,000, the fair market value of the contributed property (See* PTM 1420*).*
- *The encumbering mortgage of $20,000 is assumed by the partnership and therefore is treated as a cash distribution which decreases Debbie's capital account. (Note that when a property subject to a liability is contributed by a partner to the partnership or distributed by the partnership to a partner, the transferee is treated as having assumed the encumbering liability to the extent that the liability does not exceed the fair market value of the property. [Treas. Reg. § 1.752-1(e)]) After the $20,000 liability becomes a partnership liability, Debbie's share of the liability (10%) under the sharing rules of § 752 only affects her basis in the partnership, not her capital account. (See* PTM 5400*: Partnership Liabilities)*
- *Since Debbie personally assumes the partnership's $1,000 liability, she is treated as making a contribution of $1,000 in cash to the partnership.*
- *In applying the assumption rule of § 704(b), Debbie's assumption of the $1,000 liability can only be treated as a cash contribution if (1) she is personally liable for making payment on the liability, (2) her father (the creditor) is aware of the assumption and can legally enforce the obligation against her and require her to make payments on the liability, and (3) Debbie, not the partnership, is ultimately liable for the $1,000 liability. It should be noted that the key to this assumption of liability is the fact that Debbie personally takes over payments on the liability. If Debbie merely guarantees payments on the liability alone while the partnership continues to make payments, the guarantee is not treated as an assumption under § 704(b) and therefore does not increase Debbie's capital account.*

1420 Contribution and Distribution of Property

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In general, for purposes of § 704(b), a partner's capital account is increased by the **fair market value** of property contributed to the partnership on the date of contribution. [Treas. Reg. § 1.704-1(b)(2)(iv)(d).] A partner's capital account is decreased by the **fair market value** of property distributed by the partnership to such partner, whether in connection with a liquidation or otherwise. [Treas. Reg. § 1.704-1(b)(2)(iv)(e)(1) and (d)(1).]

The use of the fair market value rather than the tax basis is to prevent the shifting of pre-contribution gain or loss to partners other than the contributing partner. For a determination of fair market value, See PTM 1470.

If the contributed or distributed property is subject to nonrecourse liabilities, the requirement under § 7701(g) does **not** apply. [Treas. Reg. § 1.704-1(b)(2)(iv)(e)(1) and (d)(1).] (IRC § 7701(g) requires that for purposes of determining the amount of gain or loss with respect to any property, the fair market value of such property shall be treated as not less than the amount of any nonrecourse indebtedness to which such property is subject.) (See PTM1460)

If a property is distributed to a partner, additional adjustments must first be made to the capital accounts of all partners to reflect the manner in which the unrealized income, gain, loss and deduction inherent in such property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for the fair market value of such property on the date of distribution. These adjustments are made prior to decreasing the recipient partner's capital account. Note that for purposes of this paragraph, the requirement of § 7701(g) mentioned in the immediate paragraph applies. [Treas. Reg. § 1.704-1(b)(2)(iv)(e)(1) and (d)(1).] For illustration, see PTM 1450, Example 5.

1425 IRC § 704(c) Considerations

IRC § 704(c) and §1.704-3 govern the determination of the partners' distributive shares of income, gain, loss, and deduction, as computed for tax purposes, with respect to property contributed to a partnership. In cases where § 704(c) and §1.704-3 apply to partnership property, the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph §1.704-1(b)(2)(iv) unless the partnership agreement requires that the partners' capital accounts be adjusted in accordance with paragraph §1.704-1(b)(2)(iv)(g) for allocations to them of income, gain, loss, and deduction (including depreciation, depletion, amortization, or other cost recovery) as computed for book purposes, with respect to the property. (See PTM 1460)

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1430 Contribution of Promissory Notes

If a promissory note is contributed to a partnership by a partner who is the maker of the note, such partner's capital account will be increased with respect to such note only when:

- there is a taxable disposition of such note by the partnership or
- when the partner makes principal payments on such note.[5]

However, in certain rare situations, if the note is readily tradable on an established securities market, the contributing partner's capital account may be increased immediately by the fair market value of the note. [Treas. Reg. § 1.704-1(b)(2)(iv)(d)(2)]

***Observation**: All notes are negotiable unless explicitly made non-negotiable (i.e., cannot be sold, transferred, hypothecated, pledged as collateral, etc.) With regard to whether a note is readily tradable on an established securities market, it is a non-existent ability. The reason is that the established securities markets, such as NASDAQ, etc., only sells very high quality stuff. The only notes having such qualities are corporate bonds. Thus, if IBM is the partner, it could use its note (bond) and qualify*.

If a partner liquidates his partnership interest and contributes a promissory note to the partnership to satisfy his obligation to restore the deficit capital account balance, he is treated as satisfying the deficit balance to the extent of:

- the fair market value, at the **time of contribution**, of the negotiable note that he contributes to the partnership within the time permitted under the deficit capital account restoration rules (90 days) and
- the fair market value, at the **time of liquidation**, of the unsatisfied portion of any negotiable notes that he *previously* contributed to the partnership.

For purposes of the rules in this paragraph, the fair market value of the note will be no less than the outstanding principal balance of such note, provided such note bears interest at a rate no less than the applicable federal rate at the time of valuation. [Treas. Reg. § 1.704-1(b)(2)(iv)(d)(2)]

1440 Distribution of Promissory Notes

[5] Treas. Reg. § 1.704.1(b)(2)(iv)(d)(2). However, see also PERACCHI v. COMM., 81 AFTR 2d 98-1754 (143 F.3d 487), 4/29/1998 , Code Sec(s) 357.

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If a promissory note is distributed to a partner by the partnership who is the maker of the note, such partner's capital account will be decreased by the amount of such note only when:

- there is a taxable disposition of such note by the partner or
- the partnership makes principal payments on the note. However, if the note is readily tradable on an established securities market, the distributee partner's capital account may be adjusted downward immediately. [Treas. Reg. § 1.704-1(b)(2)(iv)(e)(2)]

If the partner's interest in the partnership is liquidated, his capital account will be reduced to the extent of:

- the fair market value, at the time of distribution, of any negotiable promissory note distributed by the partnership (of which such partnership is the maker) to such partner within the time permitted in the law (§ 1.704-1(b)(2)(ii)(b)(2)), and
- the fair market value, at the time of liquidation, of the unsatisfied portion of any negotiable promissory note that the partnership previously distributed to the partner.

The fair market value of a note will be no less than the outstanding principal balance of such note, provided the note bears interest at a rate no less than the applicable federal rate[6] at the time of valuation. [Treas. Reg. § 1.7041(b)(2)(iv)(e)(2)]

1450 Revaluation of Property

A partnership agreement may provide that, upon the occurrence of certain events, the partners' capital accounts will be adjusted to reflect a revaluation of partnership property (including intangible assets such as goodwill) on the partnership's books if the adjustments are made principally for a substantial **nontax business purpose**. A revaluation may occur:

- In connection with a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership,
- In connection with the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership,

[6] Determined under the original issue discount rules of §§ 1271-1275

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- In connection with the grant of an interest in the partnership (other than a de minimis interest) on or after May 6, 2004, as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner,
- In connection with the issuance by the partnership of a noncompensatory option (other than an option for a de minimis partnership interest), or
- Under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market. [Treas. Reg. § 1.704-1(b)(2)(iv)(f)]

To be in compliance with the maintenance rules of § 1.704-1(b)(2)(iv), the partners' capital accounts must be adjusted in the following manner:

(1) The adjustments are based on the fair market value of partnership property on the date of adjustment (taking § 7701(g) into consideration),
(2) The adjustments reflect the manner in which the unrealized income, gain, loss, or deduction inherent in such property (that has not been reflected in the capital account previously) would be allocated among the partners if there were a taxable disposition of such property for such fair market value on that date,
(3) The partnership agreement requires that the partners' capital accounts be adjusted in accordance with the rules provided in § 1.7041(b)(2)(iv)(g) (See PTM 1460) regarding depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with regard to such property, and
(4) The partnership agreement requires that the partners' distributive shares of depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to such property, be determined so as to take account of the variation between the adjusted tax basis and book value (FMV) of such property in the same manner as under § 704(c) (See PTM 1640).

If the capital accounts of the partners are **not** adjusted to reflect the fair market value of the partnership property when an interest in the partnership is acquired from or relinquished to the partnership, the potential tax consequences should be based on §1.704-1(b)(1)(iii) and (iv) [Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)] (See PTM 1060).

Note: Item (1) above is limited by the provision of § 7701(g) that provides that the fair market value of a property cannot be less than the amount of nonrecourse liability that the property is subject to. Thus, property being re-

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valued cannot be booked down below the outstanding balance of the nonrecourse liability.

Example 1*: Anthony and Ted form a partnership to which each contributes $10,000. The partnership invests the $20,000 in securities of Instant News Inc. (which are not readily tradable on an established securities market). The partnership agreement contains all the provisions regarding maintenance, distribution and restoration of partners' capital accounts as required by § 1.704-1(b)(2)(ii)(b) (*See PTM 1120*). And the partners' capital accounts will be determined and maintained in accordance with § 1.704-1(b)(2)(iv). Assume there is no operating income or expense during the first year. At the beginning of the second year, Vengie, a new partner, makes a cash contribution of $25,000 in exchange for one-third interest in the partnership. At the time of Vengie's admission, the securities of Instant News Inc. have a fair market value of $50,000. Immediately after the admission, the partnership sold the securities for its fair market value that results in a taxable gain of $30,000. Pursuant to the above requirements, the (book) capital accounts of Anthony and Ted must be adjusted to reflect the difference between the fair market value and the adjusted basis of the partnership property at the time of Vengie's admission. After the sale, their capital accounts are also adjusted as follows:*

	Anthony		***Ted***		***Vengie***	
	Tax	*Book*	*Tax*	*Book*	*Tax*	*Book*
Cap. acct. before admission	*$10,000*	*$10,000*	*$10,000*	*$10,000*	*0*	*0*
Book adjustment following adm	*0*	*15,000*	*0*	*15,000*	*$25,000*	*$25,000*
Cap. acct. after admission	*$10,000*	*$25,000*	*$10,000*	*$25,000*	*$25,000*	*$25,000*
Adjustments for taxable gain	*$15,000*	*0*	*$15,000*	*0*	*0*	*0*
Cap. Acct. after sale	*$25,000*	*$25,000*	*$25,000*	*$25,000*	*$25,000*	*$25,000*

Observation*: Anthony's and Ted's § 704(b) "book" capital accounts are adjusted to reflect the fair market value of the partnership assets at the time Vengie is admitted to the partnership. Their tax basis capital accounts are not affected by the book gain (which is computed based on the difference between the adjusted tax basis and the fair market value of the securities).*

*The taxable gain of $30,000 on the sale of the securities is allocated to Anthony and Ted pursuant to § 704(c) (because the gain represents the appreciation of the securities prior to Vengie's admission) (*See PTM 2100*) and adjustments are made to their tax basis capital accounts to reflect the taxable gain.* [*See Treas. Reg. § 1.704-1(b)(5) Example (14)(i).]*

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***Example 2**: Assume the same facts as in Example 1 except that after Vengie's admission to the partnership, the securities appreciate to $77,000 and are sold, resulting in a taxable gain of $57,000 ($77,000 less $20,000 tax basis) and a book gain of $27,000 ($77,000 less $50,000 book basis). This gain includes $30,000 appreciation before Vengie's admission and $27,000 appreciation after her admission. Pursuant to the above requirements and the requirements under § 704(c) Regulations, the $30,000 gain is shared by Anthony and Ted and the $27,000 gain is shared equally by all three partners. Their capital accounts are adjusted as follows:*

	Anthony		Ted		Vengie	
	Tax	Book	Tax	Book	Tax	Book
Cap. acct. before admission	$10,000	$10,000	$10,000	$10,000	0	0
Book adj. Following admission	0	15,000	0	15,000	$25,000	$25,000
Cap. acct. after admission	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Adjustments for tax/book gain	$24,000	9,000	$24,000	9,000	9,000	9,000
Cap. Acct. after sale	$34,000	$34,000	$34,000	$34,000	$34,000	$34,000

***Observation**: The $24,000 tax gain adjustments to Anthony's and Ted's tax basis capital accounts reflects the pre-admission gain of $15,000 and the post admission gain of $9,000. However, their § 704(b) 'book" capital accounts are adjusted twice to reflect the book gain at the admission and the book gain at the sale.* [*See Treas. Reg. § 1.704-1(b)(5) Example (14)(ii).]*

***Example 3**: Assume the same facts as in Example 1 except that after Vengie's admission, the securities depreciated to $38,000 and are sold for the same amount, resulting in a taxable gain of $18,000 and a book loss of $12,000 ($38,000 less $50,000 book basis). The taxable gain of $18,000 is allocated to Anthony and Ted. The book loss of $12,000 is shared equally by the three partners. Their capital accounts are adjusted as follows:*

	Anthony		Ted		Vengie	
	Tax	Book	Tax	Book	Tax	Book
Cap. acct. before admission	$10,000	$10,00	$10,000	$10,000	0	0
Book adjustment following adm.	0	15,000	0	15,000	$25,000	$25,000
Cap. acct. after admission	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000

Adjustments for tax gain	*9,000*	*0*	*9,000*	*0*	*0*	*0*
Adjustments for book loss	*0*	*(4,000)*	*0*	*(4,000)*	*0*	*(4,000)*
Cap. Acct. after sale	*$19,000*	*$21,000*	*$19,000*	*$21,000*	*$25,000*	*$21,000*

***Observation**: In this example, Vengie bears an economic loss of $4,000 without a corresponding taxable loss due to the "ceiling rule" (discussed in* PTM 2010*). [See Treas. Reg. § 1.704-1(b)(5) Example (14)(iii).]*

***Example 4**: Assume the same facts as in Example 2 except that after Vengie's admission to the partnership, the capital accounts of Anthony and Ted are **not** adjusted upward to $25,000 to reflect the appreciation in the securities held by the partnership during the period before Vengie's admission. However, after Vengie's admission, the partnership agreement is amended to provide that the first $30,000 of taxable gain upon the sale of the securities will be allocated equally between Anthony and Ted, and that all other income, gain, loss, and deduction will be allocated equally among the three partners. When the securities are sold for $77,000, the $57,000 of taxable gain is allocated in accordance with the amended partnership agreement. The allocations have substantial economic effect. [See Treas. Reg. § 1.704-1(b)(5) Example (14)(iv).]*

***Example 5**: Assume the same facts as Example 4 except that instead of selling the securities, the partnership makes a distribution of the securities which have a fair market value of $77,000. Assume the distribution does not give rise to a § 707(a)(2)(B) transaction.[7] Pursuant to the requirements under § 1.704-1(b)(2)(iv)(e)(1) (See* PTM 1420*), the partners' capital accounts are adjusted immediately prior to the distribution to reflect how the taxable gain ($57,000) would have been allocated had the securities been sold for their fair market value ($77,000). Thus, the capital accounts of all partners are adjusted with reference to the $77,000 "book-up" value. [See Treas. Reg. § 1.704-1(b)(5) Example(14)(v).]*

	Anthony	***Ted***	***Vengie***
Book Cap. acct. before adjustments	*$10,000*	*$10,000*	*$25,000*
Deemed sale adjustments	*24,000*	*24,000*	*9,000*
Less: Distribution	*(25,667)*	*(25,667)*	*(25,667)*
Cap. Acct. after distribution	*$8,333*	*$8,333*	*$8,333*

[7] Transactions between partners and partnership in which the partners acting other than in their capacity as partners.

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1460 Adjustments to Reflect Book Value

When a property is contributed to a partnership (See PTM 1420), or when the partnership property is re-valued (See PTM 1450), the fair market value (book value) of such property, as recorded on the books of the partnership, may be different from its adjusted tax basis. Thus, the amounts of depreciation, depletion, amortization, and gain or loss computed for books with regard to such property may be different from the amounts computed for tax. In these circumstances, the regulations under § 704(b) and (c) provide that **the capital accounts of the partners have to be adjusted for the allocations to them of depreciation, depletion, amortization, and gain or loss as computed for book purposes** (**not** for tax purposes) with regard to such property. (Note that the same principle applies under the basic capital account maintenance rules (See PTM 1400): when the fair market value of a property differs from its adjusted tax basis, the partners' capital accounts are adjusted by the book income or gain.)

In addition, the partners' capital accounts may **not** be further adjusted by their share of the corresponding items computed for tax purposes (See the Observation in PTM 1460, Example 2).

The allocation of those book items must be in accordance with the following rules:

- In determining whether the economic effect of the allocation of the book items (depreciation, depletion, amortization, gain or loss) is substantial, the partnership should consider the effect of such allocation on the allocation of the corresponding tax items under § 704(c). If the allocation of the book items under the partnership agreement does not have substantial economic effect or is not respected under § 1.704-1(b)(2)(ii) and (b)(2)(iii), these items will be reallocated in accordance with the partners' interests in the partnership, and such reallocation will be the basis upon which the partners' distributive shares of the corresponding tax items are determined under § 704(c) and § 1.704-1(b)(4)(i). [Treas. Reg. § 1.704-1(b)(2)(iv)(g)(1)] (see Example 1, PTM 1460)

- Book and tax depreciation, depletion, amortization, and gain or loss with respect to property that has an adjusted tax basis that differs from book value include, under analogous rules and principles, the unrealized income or deduction with respect to accounts receivable, accounts

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payable, and other accrued but unpaid items. [Treas. Reg. § 1.704-1(b)(2)(iv)(g)(2).]

- Determining the amount of book items: the amount of book depreciation, depletion, or amortization must bear the same relationship to the book value of such property as the depreciation (or cost recovery deduction), depletion, or amortization computed for tax purposes bears to the adjusted tax basis of such property. For example, if the contributed property has an adjusted tax basis of $200 and a fair market value of $500 and is subject to a three-year cost recovery deductions in the amounts of $60 (30%), $100 (50%), and $40 (20%), the corresponding book depreciation deductions are $150, $250, and $100. If the property has a zero adjusted tax basis, the book depreciation, depletion, or amortization may be determined under any reasonable method selected by the partnership. [Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3).]

Example 1*: Stan and Jennifer form a partnership with Stan contributing $10,000 in cash and Jennifer contributing a property with an adjusted tax basis of $8,000 and a fair market value of $10,000. The property has 2 years of cost recovery deductions remaining. The partnership agreement contains all the requirements under the economic effect test of § 1.704-1(b)(2)(ii) and provides that the partners' capital accounts will be determined and maintained in accordance with § 1.704-1(b)(2)(iv) Stan expects to be in a substantially higher tax bracket than Jennifer in the partnership's first taxable year. In the second partnership taxable year, both of them are expected to be in equivalent tax brackets. The partnership agreement provides that all items are allocated equally except that all $5,000 of book depreciation is allocated to Stan in the first partnership taxable year and Jennifer will be allocated all $5,000 of book depreciation in the second partnership taxable year. If the allocation of the book depreciation to Stan in the first year is respected, Stan will be entitled to the entire cost recovery deduction of $4,000 for such year under § 704(c). In the same manner, Jennifer will be allocated the cost recovery deduction of $4,000 in the second year. (Note the general principle of partnership allocations is that tax allocations must follow book allocations. Thus, if the entire book depreciation of $5,000 is allocated to Stan in the first year, he must also be allocated the entire corresponding tax depreciation of $4,000. The same principle applies in year two with regard to Jennifer.)*

The issue is whether those special allocations of book depreciation (and the corresponding tax depreciation) to Stan and Jennifer in the first and second years, respectively, have substantial economic effect.

First, since the partnership agreement contains all three requirements under the economic effect test (See PTM 1120*), the above special allocations have economic effect.*

However, ***the economic effect is not substantial*** *since there is a strong likelihood that at the time such allocations became part of the partnership agreement that, at the end of the two-year period to which such allocations relate, the net increases and decreases to Stan's and Jennifer's capital accounts will be the same with such allocations as they would have been in the absence of such allocations while the total tax liabilities of Stan and Jennifer will be reduced (due to the allocation of cost recovery deductions under § 704(c)) as a result of the allocation of book depreciation (See* PTM 1200*). Thus, the allocations of the book depreciation in the partnership agreement will be disregarded. Stan and Jennifer will be reallocated such book depreciation in accordance with their interests in the partnership (50/50) as provided above. [See Treas. Reg. § 1.704-1(b)(5) Example (17).]*

Observation*: Again, it should be remembered that allocations of tax items must follow allocations of book or economic items. In this example, the allocations of the tax depreciation pursuant to § 704(c) (due to property being contributed to the partnership with an adjusted tax basis different from its fair market value) follow the allocations of book depreciation. Thus, if the book allocation is respected under the rules of § 704(b) (i.e. the substantial economic effect test), the tax allocation (under § 704(c)) will also be respected.*

To test the "substantiality" of an allocation, it is necessary to take into account the tax effects of such allocation with regard to the partners (See PTM 1200*). Since a book allocation cannot have tax affects, the regulations provide that the tax effects of a book allocation are determined based on the corresponding tax allocation that follows such book allocation. In this example, the substantiality test is based on the effect of the allocations of the tax depreciation of $4,000 that follows the allocation of the book depreciation of $5,000. As stated above, since the book allocation fails under the substantiality test, it has to be reallocated equally between Stan and Jennifer. As a result, for book purposes, the $5,000 depreciation will be reallocated equally between Stan and Jennifer in year 1 and year 2. Also, the corresponding tax depreciation of $4,000 will be reallocated in accordance with the book allocation, i.e., equally to Stan and Jennifer.*

Example 2*: Rafael and Don form a brokerage general partnership for investing and trading in securities. Rafael contributes cash of $10,000 and Don contributes securities of M Corporation, which have an adjusted basis of $4,000 and a fair*

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market value of $10,000. The partnership agreement contains all the requirements regarding capital accounts as provided under § 1.704-1(b)(2)(ii), including the obligation to restore the negative capital account balance. The partnership agreement also provides that all partnership distributions, income, gain, losses, deductions, and credits will be shared equally between Rafael and Don, except the taxable gain attributable to the pre-contribution appreciation associated with the securities of M corporation will be allocated to Don in accordance with § 704(c). During the first year, the partnership sells the securities of M corporation for $12,000, resulting in taxable gain of $8,000 ($12,000 less $4,000 adjusted tax basis) and a book gain of $2,000 ($12,000 less $10,000 book basis). The partnership has no other income or gain. The gain from the sale of the securities is allocated as follows:

	Rafael		***Don***	
	Tax	*Book*	*Tax*	*Book*
Cap. acct. upon formation	*$10,000*	*$10,000*	*$4,000*	*$10,000*
Plus: gain	*1,000*	*1,000*	*7,000*	*1,000*
Cap. Acct. at year end	*$11,000*	*$11,000*	*$11,000*	*$11,000*

***Observation**:*

The fair market value of the contributed property (securities of M corporation) is different from its adjusted tax basis. Thus, the adjustments to Rafael's and Don's book capital accounts are based on the gain ($2,000) computed for book purposes. (The inclusion of the tax basis capital accounts above is for reference purposes. The balance sheet and the partners' capital accounts as shown on the partnership information return will reflect the book capital account amounts only.) Also, since the adjusted tax basis of the contributed securities is different from its fair market value, the allocation of pre-contribution gain and the book gain are governed by §704(c) regulations (see PTM 2010*. for detailed explanations). [See Treas. Reg. § 1.704-1(b)(5) Example (13)(i).]*

Don's book capital account is increased by the book gain of $1,000. Thus, his capital account cannot be further increased by the taxable gain of $7,000 as computed for tax purposes. The auditor should be aware of this situation since, if correctly prepared, on his Schedule K-1, Don's capital account (which is book capital account) will show an upward adjustment of $1,000 while the taxable gain is $7,000.

1470 Determination of Fair Market Value

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The fair market value assigned to property contributed to a partnership, property distributed by a partnership, or property otherwise re-valued by a partnership, will be regarded as correct, provided that: (same cite as below)

- such value is reasonably agreed to among the partners in arm's-length negotiations, and
- the partners have sufficiently adverse interests.

If the above conditions are not satisfied and the value assigned to the property is overstated or understated, the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of the § 704(b) regulations. The determination of the fair market value will be on a property-by-property basis, except as permitted otherwise by the regulations under § 704(c). [Treas. Reg. § 1.704-1(b)(2)(iv)(h)]

1480 IRC § 705(a)(2)(B) Expenditures

IRC § 705(a)(2)(B) expenditures are the expenditures of the partnership which are not deductible in computing its taxable income and not properly chargeable to capital account (e.g., certain premium payments on life insurance are not deductible under § 264, meal and entertainment expenses in excess of allowable deduction (§ 274(n), etc.)

A partner's distributive share of these expenditures reduces his basis in the partnership.

Under the capital account rules, an allocation to a partner of § 705(a)(2)(B) expenditures decreases such partner's capital account. If an allocation of these expenditures does not have substantial economic effect, or is not otherwise respected, the expenditures will be reallocated in accordance with the partner's interest in the partnership. [Treas. Reg. § 1.704-1(b)(2)(iv)(i)(1)]

1490 Organization and Syndication Fees (§ 709 Expenses)

Organization and syndication fees (amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) partnership interests) are treated as § 705(a)(2)(B) expenditures that are neither deductible nor capitalized.

As a result, each partner's capital account is reduced by his distributive share of these expenditures. [Treas. Reg. § 1.704-1(b)(2)(iv)(i)(2)]

1495 Disallowed Losses

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If a deduction for a loss incurred in connection with the sale or exchange of partnership property is disallowed to the partnership under § 267(a)(1) (related party transaction) or §707(b) (transactions with respect to controlled partnerships), the disallowed loss will be treated as a § 705(a)(2)(B) expenditure and will reduce the partners' capital accounts. [Treas. Reg. § 1.704-1(b)(2)(iv)(i)(3)]

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1500 TRANSFER OF PARTNERSHIP INTEREST

In general, upon the transfer of all or part of an interest in the partnership, the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner. (See PTM 1510, Example 2.)For the effect of a § 754 election on the partners' capital accounts, see PTM 1510.

If the transfer of an interest in a partnership causes a termination of the partnership under § 708(b)(1)(B) (occurring on or after May 9, 1997), the capital account of the transferee partner and the capital accounts of the other partners of the terminated partnership carry over to the new partnership that is formed under §1.708-1(b)(4) (Predecessor §1.708-1(b)(1)(iv)). Moreover, the deemed contribution of assets and liabilities to the new partnership and the deemed liquidation of the terminated partnership that occur under §1.708-1(b)(4) are **disregarded** for purposes of capital account maintenance rules. [Treas. Reg. § 1.704-1(b)(2)(iv)(l)] (See PTM 1510 Example 5)

Note: IRC § 708(b)(1) was amended by the Tax Cuts and Jobs Act, which eliminated IRC § 708(b)(1)(B) in its entirety. As a result, a sale or exchange of 50 percent or more of the interest in partnership would not cause a technical termination of the partnership. The change was effective for partnership tax years beginning after 12/31/2017. California has not conformed to the changes made by the Tax Cuts and Jobs Act.

PTM 1510 IRC § 754 Elections
PTM 1520 Partnership Level Characterization
PTM 1530 Guaranteed Payments
PTM 1540 Minor Discrepancies
PTM 1550 Adjustments Where Guidance is Lacking
PTM 1560 Restatement of Capital Accounts

1510 IRC § 754 Elections

IRC § 743: In the case of a transfer of all or part of an interest in a partnership that has a § 754 election in effect, or where the partnership has a substantial built-in loss immediately after such transfer, the adjustments to the adjusted tax basis of partnership property under § 743 shall **not** be reflected in the capital account of the transferee partner or on the books of the partnership. In addition, the subsequent

adjustments to the capital account for depreciation, depletion, amortization, and gain or loss will disregard the effect of such basis adjustments. [Treas. Reg. §1.704-1(b)(2)(iv)(m)(2)]

*__Note: Substantial built-in loss.__

In general. For purposes of § 743, a partnership has a substantial built-in loss with respect to a transfer of an interest in a partnership if the partnership's adjusted basis in the partnership property exceeds by more than $250,000 the fair market value of such property (§743(d)).
Alternative rules for electing investment partnerships. For purposes of this section, an electing investment partnership shall not be treated as having a substantial built-in loss with respect to any transfer occurring while the election under paragraph (5)(A) is in effect. (See IRC § 743(e) for further details).

IRC § 732: In certain situations where there is a transfer of an interest in a partnership that does not have a § 754 election in effect but the adjusted tax basis of the partnership property is required to be adjusted under § 732(d), such adjustment has **no** effect on the capital accounts of the partners (in the same manner as § 743 basis adjustments). [Treas. Reg. § 1.704-1(b)(2)(iv)(m)(3)]

IRC § 734 – Liquidating Distribution: In the case of a distribution of property in liquidation of a partner's interest in the partnership, and the partnership has a § 754 election in effect, or has a substantial basis reduction, the partner who receives the distribution that gives rise to the basis adjustment under § 734 shall have a corresponding adjustment to his capital account. However, if the property to which the adjustment relates has already been booked up and the partners' capital accounts have already been adjusted to reflect the book-up, no further adjustment is permitted. [Treas. Reg. § 1.704-1(b)(2)(iv)(m)(4)]

***Note: Substantial Basis Reduction.**

In general. For purposes of § 734, there is a substantial basis reduction with respect to a distribution if the sum of the loss recognized to the distributee partner and the excess of the basis of the distributed property to the distributee over that of the partnership exceeds $250,000. (See IRC § 734 for further details).

IRC § 734 – Non-liquidating Distribution: In the case of a non-liquidating distribution that gives rise to a basis adjustment under § 734 and the partnership has a § 754 election in effect, or has a substantial basis reduction, the capital accounts of all partners are adjusted to reflect the manner in which the gain or loss would have been allocated had

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the property been sold by the partnership for its re-computed adjusted basis. [Treas. Reg. § 1.704-1(b)(2)(iv)(m)(4)]

For limitations on the adjustments to capital accounts with regard to the above rules (§§ 734, 732, and 743), see § 1.704-1(b)(iv)(m)(5).

For illustrations, see PTM 1510, Examples 3 & 4.

Example 1*(similar to PTM 1460 Example 2): Rafael and Don form a brokerage general partnership for investing and trading in securities. Rafael contributes cash of $10,000 and Don contributes securities of M corporation, which has an adjusted basis of $4,000 and a fair market value of $10,000. The partnership agreement contains all the requirements regarding capital accounts as provided under § 1.704-1(b)(2)(ii), including the obligation to restore the negative capital account balance. The partnership agreement also provides that all partnership distribution, income, gain, loss, deduction, and credit will be shared equally between Rafael and Don, except the taxable gain attributable to the precontribution appreciation associated with the securities of M corporation will be allocated to Don in accordance with § 704(c). During the first year, the partnership sells the securities of M corporation for $12,000, resulting in taxable gain of $8,000 ($12,000 less $4,000 adjusted tax basis) and a book gain of $2,000 ($12,000 less $10,000 book basis). The partnership has no other income or gain. The gain from the sale of the securities is allocated as follows:*

	Rafael		***Don***	
	Tax	*Book*	*Tax*	*Book*
Cap. acct. upon formation	*$10,000*	*$10,000*	*$4,000*	*$10,000*
Plus: gain	*1,000*	*1,000*	*7,000*	*1,000*
Cap. Acct. at year end	*$11,000*	*$11,000*	*$11,000*	*$11,000*

Observation*: The book gain of $2,000 allocated equally to Rafael and Don has economic effect. For tax purposes, the taxable gain of $8,000 consists of a built-in gain of $6,000 that is allocated to Don pursuant to § 704(c). The remaining $2,000 gain is allocated equally between Rafael and Don. [See Treas. Reg. § 1.704-1(b)(5) Example (13)(i).]*

Example 2*: Assume the same facts as in Example 1 except that at the beginning of year 2, the partnership invests $22,000 of cash in the securities of Big Buck Corporation. Five months later, the securities of Big Buck Corporation increase in value to $60,000. Rafael decides to sell one-half of his partnership interest (which is*

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25% of the interests in the partnership) to Winston for $15,000. The partnership does not elect § 754 during the year of the sale. Based on § 1.704-1(b)(2)(iv)(l) (See PTM 1500*), Winston inherits 50% of Rafael's capital account balance. Thus, after the sale, Rafael and Winston each have a capital account balance of $5,500 and Don's capital account remains at $11,000. Before the end of the year, the partnership sells the securities for $60,000, which results in a taxable gain of $38,000. The partnership has no other income or loss during the year. Under the partnership agreement, the $38,000 gain is allocated as follows:*

	Rafael	Don	Winston
Cap. Acct. before the sale	$5,500	$11,000	$5,500
Plus gain	9,500	19,000	9,500
Cap. Acct. at year end	$15,000	$30,000	$15,000

The allocation of the $38,000 taxable gain has economic effect. Note that no § 754 is elected by the partnership. Thus, Winston's outside basis (after the sale) is $24,500 (initial cash investment of $15,000 plus distributive share of partnership income of $9,500). However, his inside basis is $15,000 (25% of the partnership total cash of $60,000). [See Treas. Reg. § 1.704-1(b)(5) Example (13)(ii).]

Example 3*: Assume the same facts as in Example 2 except that the partnership has a §754 election in effect for the partnership taxable year in which Rafael sells one-half of his partnership interest to Winston. Accordingly, under § 1.743-1, there is a $9,500 basis increase to the Big Buck corporation securities with respect to Winston. Notwithstanding this basis adjustment, as a result of the sale of the Big Buck corporation securities, Winston's capital account is increased by the $9,500 gain. The fact that Winston does not recognize the gain from such sale due to the § 743 adjustment which increases his basis in the securities by $9,500 for tax purposes is irrelevant for capital accounting purposes since the basis adjustment under § 743 is disregarded in the maintenance and computation of the partners' capital account.* [*See Treas. Reg. § 1.704-1(b)(5) Example (13)(iii).]*

Observation*: As explained at* PTM 6700*, the basis adjustment under §§ 732 and 743 as well as the tax gain on the sale of the securities have no effect on the* ***book capital account*** *of Winston. However, Winston's* ***tax basis capital account*** *may be adjusted to include $9,500 of the adjusted tax basis adjustment if he so desires, provided that the partnership has a § 754 election in effect. (See* PTM 1310*)*

Example 4*: Assume the same facts as in Example 3 except that immediately following Rafael's sale of his partnership interest to Winston, the securities of Big*

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Buck Corporation decrease in value to $52,000 and are sold. The $30,000 taxable gain ($52,000 less $22,000 adjusted tax basis) is allocated as follows:

	Rafael	***Don***	***Winston***
Cap. Acct. before the sale	*$5,500*	*$11,000*	*$5,500*
Plus gain	*7,500*	*15,000*	*7,500*
Cap. Acct. at year end	*$13,000*	*$26,000*	*$13,000*

The fact that Winston recognizes $2,000 taxable loss from the sale (due to his $9,500 basis adjustment under § 743) is irrelevant for capital accounting purposes since the basis adjustment under § 743 is disregarded in the maintenance and computation of the partners' capital accounts. [See Treas. Reg. § 1.704-1(b)(5) Example (13)(iv).] (See PTM 1310*)*

***Example 5**: Assume the same facts as in Example 2 except that Rafael sells all of his interest in the partnership to Winston for $30,000. Under §708(b)(1)(B), the partnership terminates. Under § 1.708-1(b)(4) (Predecessor §1.708-1(b)(1)(iv)), there is a constructive liquidation of the partnership. Immediately before the constructive liquidation, the capital accounts of Don and Winston equal $11,000 each (Winston having inherited Rafael's $11,000 capital account) and the book value of the Big Buck Corp. securities is $22,000 (original purchase price of securities). Under § 1.708-1(b)(2)(iv)(l), the deemed contribution of assets and liabilities by the terminated partnership to the new partnership and the deemed liquidation of the terminated partnership that occur under §1.708-1(b)(4) are disregarded in the maintenance and computation of the partners' capital accounts. As a result, the capital accounts of Don and Winston in the new partnership equal $11,000 each (their capital accounts in the terminated partnership immediately prior to the termination), and the book value of the Big Buck Corp. securities remains $22,000 (its book value immediately prior to the termination).*

	Don	***Winston***
Cap. acct. following sale	*$11,000*	*$11,000*
Cap. Acct. before constructive liquidation	*11,000*	*11,000*
Cap. Acct. after constructive liquidation	*$11,000*	*$11,000*

[See Treas. Reg. § 1.704-1(b)(5) Example (13)(v).]

Note: Example 13(v) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this Example 13(v) to the termination in a consistent manner.

***Example 6**: Patricia, John, and Loraine form a general partnership to which each contributes $10,000. The partnership uses $10,000 to buy securities of Sub-S Inc.*

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During the next three years, the value of the securities appreciates to $40,000. The partnership does not engage in any other investment activities. Thus, all of its assets consist of $20,000 in cash and the securities of the Sub-S Inc. At the end of the third year, Patricia's interest in the partnership is liquidated for $20,000 cash. The partnership has a § 754 election in effect. As a result of the liquidating distribution to Patricia, the § 754 election requires the partnership to increase its basis in the securities by $10,000 (the amount Patricia recognizes upon her partnership liquidation: her cost basis is $10,000 and liquidating distribution is $20,000.) Under the capital account rules (See PTM 1510*, IRC § 734), Patricia's capital account must also be increased by $10,000 and reduced by the $20,000 distribution.*

	John		Loraine		Patricia	
	Tax	Book	Tax	Book	Tax	Book
Cap. acct. before distribution	$10,000	$10,000	$10,000	$10,000	$10,000	$10,000
Plus: basis adjustment	0	0	0	0	$10,000	$10,000
Less: distribution		0		0	(20,000)	(20,000)
Cap. Acct. after liquidation	$10,000	$10,000	$10,000	$10,000	$ 0	$ 0

Note: If Patricia's book capital account had been booked up to $20,000 previously due to some occurrence (e.g., an admission of a new partner), no further adjustment to her capital account would be required at liquidation. Her tax basis capital account, however, is adjusted since the previous book-up does not affect her tax-basis capital account.

1520 Partnership Level Characterization

In general, to be considered as determined and maintained in accordance with the rules of § 704(b) regulations, the adjustments to partners' capital accounts with respect to partnership income, gain, loss and deduction must be made with reference to the Federal tax treatment of such items (and in the case of book items, with reference to the Federal tax treatment of the corresponding tax items) at the partnership level, without regard to any requisite or elective tax treatment of such items at the partner level. [Treas. Reg. § 1.704-1(b)(2)(iv)(n)]

1530 Guaranteed Payments

Guaranteed payments made to a partner for services or the use of capital (under § 707(c)) do not change the recipient partner's capital account except to the extent

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such payments affect the partnership taxable income resulting from deductions for such payments. [Treas. Reg. § 1.704-1(b)(2)(iv)(o)]

Example*: A owns 50% interest in a partnership. A provides personal services to the partnership and receives a guaranteed payment of $50,000 annually. This guaranteed payment does not affect A's capital account. However, since the partnership is allowed to deduct the payment against its operating income, this deduction affects A's distributive share of partnership income and, as a result, A's capital account (an indirect effect).*

1540 Minor Discrepancies

If there are discrepancies between the partners' actual capital accounts and the capital accounts that would have been had they been determined and maintained in accordance with § 1.704-1(b)(2)(iv), these discrepancies will not adversely affect the validity of an allocation, provided the discrepancies are minor and are attributable to good faith error by the partnership. [Treas. Reg. § 1.7041(b)(2)(iv)(p)]

1550 Adjustments Where Guidance is Lacking

If the capital account rules of § 1.704-1(b)(2)(iv) fail to provide guidance on how adjustments to the partners' capital accounts should be made in certain situations, those capital account adjustments will be treated as determined and maintained in accordance with the capital account rules if they are made in a manner that:

- maintains equality between the aggregate governing capital accounts of the partners and the amount of the partnership capital reflected on the partnership's balance sheet, as computed for book purposes.
- is consistent with the underlying economic arrangement of the partners, and
- is based, wherever practicable, on Federal tax accounting principles. [Treas. Reg. § 1.704-1(b)(2)(iv)(q)]

1560 Restatement of Capital Accounts

If a partnership began operating in a taxable year prior to May 1, 1986 and the capital accounts of the partners, since inception, were not determined and maintained in accordance with the capital account rules under § 1.704-1(2)(b)(iv), such capital accounts will be treated as determined and maintained in accordance

with the capital account rules if, for taxable years after April 30, 1986, they meet one of the following two requirements:

1. such capital accounts are adjusted, effective for the first partnership taxable year beginning after April 30, 1986, to reflect the fair market value of partnership property as of the first day of such taxable year and (b) those adjustments are in accordance with the rules of § 1.704-1(2)(b)(iv)(f)(2) , (3) and(4)(See PTM 1450 (2), (3) & (4)) or

2. the differences between the partners' actual capital accounts and the capital accounts that would have been had they been determined and maintained in accordance with the capital account rules are not significant (for instance, if the differences are attributable to a failure to provide for the treatment of § 709 expenses (See PTM 1490) or a failure to adjust capital accounts in accordance with § 754 basis adjustment rule (See PTM 1510)) and the partners' capital accounts are adjusted to bring them into conformity with the capital account rules no later than the end of the first partnership taxable year after April 30, 1986.

   With respect to a partnership that began operating in a taxable year beginning before May 1, 1986, modifications to the partnership agreement adopted on or before November 1, 1988, the capital account adjustments required to comply with the rules of restatement of capital accounts, and otherwise to satisfy the requirements of the rules of restatement of capital accounts, will be treated as if such modifications were included in the partnership agreement before the end of the first partnership taxable year beginning after April 30, 1986. However, compliance with the above restatement rules has no bearing on the validity of allocations that relate to partnership taxable years beginning <u>before</u> May 1, 1986. [Treas. Reg. § 1.704-1(b)(2)(iv)(r)(3)]

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1600 ALLOCATION ACCORDING TO PARTNERS' INTERESTS IN THE PARTNERSHIP

Under the basic allocation rules discussed at PTM 1040, partnership allocations must meet one of the following three requirements:

- The allocation has ***substantial economic effect*** (See PTM 1100),
- The allocation is in accordance with the ***partner's interest in the partnership*** *(*See PTM 1610*)*, or
- The allocation is ***deemed*** to be in accordance with the partner's interest in the partnership under the ***special rules*** (See PTM 1640).

If an allocation does not meet one of the three requirements above, or if a partnership agreement **does not** provide for the allocation of income, gain, loss, deduction, or credit to a partner, then the partnership income, gain, loss, deduction, or credit will be reallocated in accordance with the partners' interest in the partnership. [Treas. Reg. § 1.704-1(b)(1)(i)]

PTM 1610 Definition of a Partner's Interest in the Partnership
PTM 1620 Determining a Partner's Interest in a Partnership
PTM 1630 Reallocation Rule
PTM 1640 Special Rules
PTM 1650 Amendment to Partnership Agreement

1610 Definition of a Partner's Interest in the Partnership

The partners' interests in the partnership are based on "the manner in which the partners have agreed to **share** the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or items thereof) that is allocated." Except for the partnership items that cannot have economic effect (such as nonrecourse deductions of the partnership), the **sharing** arrangement may or may not correspond to the overall economic arrangement of the partners. For instance, a partner who has a 50 percent interest in the partnership may have a 90 percent interest in a particular item of income or deduction. A partner who does not have a deficit make-up obligation unexpectedly receives a downward adjustment to his capital account and the adjustment causes his capital account to be negative. In this case, it may be necessary to allocate a disproportionate amount of gross income of the partnership to such partner (regardless of his percentage of interest in income or profit) for such year so as to bring that partner's capital account back up to zero (See PTM 1140). [Treas. Reg. § 1.704-1(b)(3)(i)]

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1620 Determining a Partner's Interest in a Partnership

The determination of a partner's interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners. The following factors may be relevant in such determination:

- The partner's relative contributions to the partnership, (See PTM 1620, Example)
- The interests of the partners in economic profits and losses (if different from taxable income or loss),
- The interests of the partners in cash flow and other non-liquidating distributions, and
- The rights of the partners to distributions of capital upon liquidation. [Treas. Reg. § 1.704-1(b)(3)(ii).]

Example*: Kevin and Michelle contribute $60,000 and $40,000, respectively, to form a partnership. The partnership agreement provides that all income, gain, loss, and deduction will be allocated* ***equally*** *between the partners, that the partners' capital accounts will be maintained in accordance with the capital account rules (§1.704-1(2)(b)(iv)),* ***except*** *that all partnership distributions will, regardless of the capital account balances, be made 60 percent to Kevin and 40 percent to Michelle and that neither partner is required to restore the deficit capital account balance.*

The (equal) allocations of partnership income, gain, loss, and deduction provided in the partnership agreement have no economic effect (the economic effect test is not met - see PTM 1120*). Since contributions were made in the ratio of 60/40 (factor 1 above), and the partnership agreement provides that all liquidating distributions are to be made in a 60/40 ratio (factor 4 above), partnership income, loss, gain, and deduction will be reallocated 60 percent to Kevin and 40 percent to Michelle.* [*See Treas. Reg. § 1.704-1(b)(5) Example (4)]*

1630 Reallocation Rule

In order for a partnership allocation to have economic effect, § 1.704-1(b)(2)(ii)(b) requires that:

1. the partners' capital accounts must be maintained in accordance with certain rules (*See* PTM 1300),
2. liquidating distributions must be made in accordance with the partners' positive capital account balances, and
3. the partners with negative capital account balances must be required to restore the deficit balances (*See* PTM 1130) unless the partnership agreement contains a qualified income offset provision (*See* PTM 1140).

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As long as a partnership fulfills all three requirements, both IRS and the courts can be assured that the partnership's allocations of income, loss or deduction for tax purposes will be consistent with the economic benefits and the burdens corresponding to those items. If only the first two requirements are met and the partnership allocations lack economic effect because of the absence of the third requirement, the portions of the partnership income, gain, loss, or deduction that have no economic effect are reallocated in the following manner:

Step 1: Compute the difference between (a) the proceeds that the partner would receive (or contribution he would be obligated to make) if, immediately at the end of the year to which the allocation in question relates, all partnership property were sold for its book value and the partnership was then liquidated, and (b) the proceeds that the partner would receive (or the contribution he would be obligated to make) if, immediately at the end of the year ***preceding*** the year to which the allocation in question relates, all partnership property were sold for its book value and the partnership was then liquidated.

Step 2: Determine the partner's portion of the allocation that has economic effect and subtract this amount from the amount computed in Step 1. The remainder represents the partner's interests in the partnership with respect to the portion that has no economic effect. [Treas. Reg. § 1.704-1(b)(3)(iii)(b)]

The amounts computed in the first step above must be adjusted for the items described in (4), (5), and (6) of § 1.704-1(b)(2)(ii)(d) (relating to depletion deductions, expected distributions, etc.) (See PTM 1140)

Note: The reallocation rule explained above only applies if the allocations so determined are substantial within the meaning of § 1.704-1(b)(2)(iii).

Example*: Steve and Jerry form a general partnership. Each contributes $50,000 that is used by the partnership to buy depreciable personal property for $100,000. The partnership agreement provides that Steve and Jerry will have equal shares of partnership taxable income and loss (computed without regard to cost recovery deductions (i.e., depreciation deductions)) and that* ***all cost recovery deductions will be allocated to Steve****. The agreement further provides that the partners' capital accounts will be maintained in accordance with § 1.704-1(b)(2)(iv), and that distributions in liquidation will be made in accordance with the partners' positive capital account balances throughout the term of the partnership. (****There is no requirement that a partner with a negative capital account has to restore his deficit balance****.) The partnership agreement contains a qualified income offset and*

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that as of the end of each partnership taxable year, the items described in 4(a), (b), and (c) of PTM 1140 *are not reasonably expected to cause or increase a deficit balance in Steve's capital account.*

In the partnership's first taxable year, it recognizes operating income equal to its operating expenses and has an additional $30,000 cost recovery deduction that is allocated entirely to Steve.

Capital Accounts	***Steve***	***Jerry***
Beginning of the 1st year	*$50,000*	*$50,000*
Less: Cost Recovery Deduction	*(30,000)*	*0*
End of the 1st year	*$20,000*	*$50,000*

In year 2, the partnership recognizes operating income equal to its operating expenses and has a $30,000 cost recovery deduction that is allocated entirely to Steve according to the partnership agreement.

Capital Accounts	***Steve***	***Jerry***
Beginning of the 2nd year	*$20,000*	*$50,000*
Less: Cost Recovery Deduction	*(30,000)*	*0*
End of the 2nd year	*($10,000)*	*$50,000*

The allocation of $30,000 cost recovery deduction to Steve satisfies the alternative economic effect test under §1.704-1(b)(2)(ii)(d) only to the extent of $20,000. The remaining $10,000 that lacks economic effect must be reallocated according to the above rule:

- *Step 1: If the partnership sold its property at the end of year 2 for $40,000 (its book value and adjusted tax basis: $100,000 cost less depreciation of $60,000 in year 1 and 2), Steve would receive none of the proceeds because his capital account at the end of year 2 is negative. If the partnership sold its property at the end of the year preceding the year the allocation in question relates (which is year 1) for $70,000 (its book value and adjusted tax basis: cost $100,000 less depreciation of $30,000 in year 1), Steve would receive $20,000 based on his positive capital account balance. Thus, the difference between year 1 and 2 is $20,000.*

- *Step 2: Determine the portion that has economic effect: The $30,000 cost recovery deduction allocated to Steve has economic effect up to $20,000 determined based on §1.704-1(b)(2)(ii)(d). When this amount ($20,000, the*

portion that has economic effect) is subtracted from the amount determined in step 1 (which is also $20,000), the remainder is zero. This means that with regard to the $10,000 that has to be reallocated, Steve has no interest in it.

If the above calculation is performed with regard to Jerry, it will show that Jerry has interest in the reallocated $10,000 and this amount is allocated entirely to him.

The above test yields the same result as that of the economic risk of loss test, as illustrated previously in the same example (See PTM 1140*, Example 2): "The allocation of the $30,000 depreciation deduction to Steve* ***satisfies the alternate economic test only to the extent of $20,000****.) Therefore, only $20,000 of the $30,000 allocation has economic effect. The remaining $10,000 must be reallocated in accordance with the partners' interest in the partnership (which is 50/50). However, under the general principle that the partner who is allocated partnership losses must bear the economic risk of loss with regard to the loss, it is necessary to determine who actually bears the economic risk of loss with regard to this $10,000 loss. If the partnership sells the property immediately at the end of the partnership's second taxable year for $40,000 (its adjusted tax basis: total cost of $100,000 less depreciation of $60,000), the entire $40,000 proceeds will be allocated to Jerry pursuant to the partnership agreement (liquidation distribution in accordance to partners' positive capital accounts). Since Jerry's total investment is $50,000 and he receives only $40,000 in the hypothetical liquidation distribution, he bears the economic risk of loss of $10,000. Thus, the remaining $10,000 of the $30,000 cost recovery deduction has to be reallocated to Jerry because he bears the economic burden corresponding to such amount."*

1640 Special Rules

Partnership allocations are respected if:

- the allocations have substantial economic effect (PTM 1100.),
- the allocations are in accordance with the partners' interests in the partnership (PTM 1600.), or
- the allocations are **deemed** to be in accordance with the partners' interests in the partnerships under the **special rules**.

When a property is contributed to the partnership under § 1.704-1(b)(2)(iv)(d) (See PTM 1420), or when the property is re-valued under § 1.704-1(b)(2)(iv)(f) (See PTM 1450), the property is reflected in the capital accounts of the partners and on

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the books of the partnership at a book value that differs from its adjusted tax basis (See PTM 1460). The depreciation, depletion, amortization, and gain or loss, as computed for book purposes, will be greater or less than the depreciation, depletion, amortization, gain or loss, as computed for tax purposes, with respect to such property. In these cases,

- the capital accounts of the partners are required to be adjusted solely for allocations of **book items** to such partners, as provided under § 1.704(b)(2)(iv)(g) (See PTM 1460), and
- the partner's share of the corresponding tax items are **not** reflected by further adjustments to the partners' capital accounts.

Thus, in order for the allocation of the tax items to be respected for tax purposes, the partners' distributive share of such items must (unless governed by § 704(c)) be determined in accordance with the partners' interests in the partnership. These tax items must be shared among the partners in a manner that takes into account the variation between the adjusted tax basis of such property and its book value (in the same manner as variations between the adjusted tax basis and fair market value of property contributed to the partnership are taken into account in determining the partners' shares of tax items under § 704(c)). [Treas. Reg. § 1.704-1(b)(4)(i)]

For a detailed explanation of the § 704(c) regulations, see PTM 2100.

Other special allocation rules regarding tax credits, excess percentage deductions, and oil and gas property are not discussed in this manual. For allocations attributable to non-recourse liabilities, see PTM 3070.

Example 1*: Dan and Connie form a general partnership to which each contributes $50,000. The partnership uses $100,000 to purchase tangible personal property that it leases out. The partnership agreement provides that the partners' capital accounts will be maintained in accordance with the capital accounts rules, including the obligation to restore deficit capital account balances. In addition, the partnership agreement provides that all income, gain, losses, and deductions of the partnership will be allocated equally between the partners, and all non-liquidating distributions of the partnership will be made equally between the partners. Assume that in each of the partnership's taxable years, its operating income is equal to its operating expense, excluding depreciation deductions and gain or loss on the sale of its property. During the first two years, the partnership has $20,000 of depreciation deductions in each year. These items are allocated equally between Dan and Connie in accordance with the partnership agreement. [§ 1.704-1(b)(5) Example (18)(i)]*

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	Dan	Connie
Capital account at formation	*$50,000*	*$50,000*
Less: net loss in years 1 & 2	*(20,000)*	*(20,000)*
Capital account at end of year 2	*$30,000*	*$30,000*

***Example 2**: Assume the same facts as in Example 1 except that Peter is admitted to the partnership at the beginning of the partnership's third taxable year. At the time of his admission, the fair market value of the property is $80,000. Peter contributes $40,000 in exchange for an equal one-third interest in the partnership. The capital accounts of Dan and Connie are adjusted upward to $40,000 each as permitted under § 1.704-1(b)(2)(4)(g) (adjustments to reflect book value, see* PTM 1460*). In addition, the partnership agreement is amended to provide that depreciation and gain or loss, as computed for **tax** purposes, with respect to the property, will be shared equally among the three partners in a manner that takes account of the variation between the property's $60,000 adjusted tax basis ($100,000 cost less $40,000 accumulated depreciation) and its $80,000 book value in accordance with § 1.704-1(b)(2)(iv)(f) (revaluation of property, see* PTM 1450*) and the special rule contained in § 1.704-1(b)(4)(i). Depreciation and gain or loss as computed for **book** purposes, with respect to the property, will be allocated equally among the partners and will be reflected in the partners' capital accounts pursuant to § 1.704-1(b)(2)(iv)(g). Since the requirements of the § 1.704-1(b)(2)(iv)(g) are satisfied, the capital accounts of the partners (as adjusted) continue to be maintained in accordance with the general maintenance rules provided under § 1.704-1(b)(2)(iv) (see* PTM1300.*) [§ 1.704-1(b)(5) Example (18)(ii)]*

***Example 3**: Assuming the same facts as in Example 2 except that immediately after Peter's admission, the property is sold for $80,000, resulting in a taxable gain of $20,000 ($80,000 less $60,000 adjusted tax basis) and no book gain or loss. The partnership is immediately liquidated. Consistent with the special partners' interests in the partnership rule (§ 1.704-1(b)(4)(i), the partnership agreement provides that the $20,000 gain will be shared by Dan and Connie in accordance with § 704(c) rules. The $120,000 of partnership cash (sales proceeds of $80,000 plus $40,000 contributed by Peter) is distributed equally among the three partners in accordance with their adjusted positive capital account balances, which is $40,000 each. [§ 1.704-1(b)(5) Example (18)(iii)]*

	Dan		Connie		Peter	
	Tax	*Book*	*Tax*	*Book*	*Tax*	*Book*
Cap. Acct. at beg. of yr. 3	*$30,000*	*$40,000*	*$30,000*	*$40,000*	*$40,000*	*$40,000*
Plus: gain	*10,000*		*10,000*	*0*	*0*	*0*
Cap. Acct. before liquidation	*$40,000*	*$40,000*	*$40,000*	*$40,000*	*$40,000*	*$40,000*

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***Example 4**: Assume the same facts as in Example 3 except that five months after Peter's admission, the property appreciates and is sold for $95,000, resulting in a taxable gain of $35,000 ($95,000 less $60,000 adjusted tax basis) and a book gain of $15,000 ($95,000 less $80,000 book basis). Under the partnership agreement, the book gain of $15,000 is allocated equally among the three partners and the allocation has substantial economic effect.*

	Dan		Connie		Peter	
	Tax	Book	Tax	Book	Tax	Book
Cap. Acct. at beg. of yr. 3	$30,000	$40,000	$30,000	$40,000	$40,000	$40,000
Plus: gain	15,000	5,000	15,000	5,000	5,000	5,000
Cap. Acct. before liquidation	$45,000	$45,000	$45,000	$45,000	$45,000	$45,000

Consistent with the special partners' interests in the partnership rule (§ 1.704-1(b)(4)(i)) the partnership agreement provides that the $35,000 taxable gain is, in accordance with § 704(c) principles, shared $15,000 to Dan, $15,000 to Connie, and $5,000 to Peter. This ensures that (1) Dan and Connie share equally the $20,000 taxable gain that is attributable to the appreciation in the property that occurs before Peter's admission in the same manner as it was reflected in their capital accounts upon Peter's admission, and (2) Dan, Connie, and Peter share equally the additional $15,000 taxable gain in the same manner as they share the $15,000 book gain. [§ 1.704-1(b)(5) Example (18)(iv)]

***Example 5**: Assume the same facts as in Example 2 except that shortly after Peter's admission, the property depreciates and is sold for $74,000, resulting in a taxable gain of $14,000 ($74,000 less $60,000 adjusted tax basis) and a book loss of $6,000 ($74,000 less $80,000 book value). Under the partnership agreement, these items are allocated as follows:*

	Dan		Connie		Peter	
	Tax	Book	Tax	Book	Tax	Book
Cap. Acct. at beg. of yr. 3	$30,000	$40,000	$30,000	$40,000	$40,000	$40,000
Plus: gain	7,000	0	7,000	0	0	0
Less: Loss	0	(2,000)	0	(2,000)	0	(2,000)
Cap. Acct. before liquidation	$37,000	$38,000	$37,000	$38,000	$40,000	$38,000

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The $6,000 book loss is allocated equally among the three partners and such allocation has economic effect. Consistent with the special partners' interests in the partnership rule (§ 1.704-1(b)(4)(i)) the partnership agreement provides that the $14,000 taxable income is allocated to Dan and Connie pursuant to § 704(c). The fact that Peter bears an economic risk of loss of $2,000 without a corresponding taxable loss is attributable entirely to the "ceiling rule" under § 704(c) (see PTM 2010.*) [§ 1.704-1(b)(5) Example (18)(v)]*

Assume further that the partnership liquidates immediately after selling the property and distributes the $114,000 cash (sales proceeds of $74,000 plus $40,000 contributed by Peter) equally among the three partners in accordance with their adjusted positive capital account balances, which is $38,000 each. Thus, Dan and Connie each will have $1,000 capital gain (adjusted tax basis in the partnership is $37,000) and Peter will have $2,000 capital loss (adjusted tax basis in the partnership is $40,000) upon partnership liquidation. The $2,000 economic risk of loss that Peter was unable to deduct because of the "ceiling rule" is now deductible.

***Example 6**: Assume the same facts as in Examples 2 except that after Peter's admission to the partnership, the property depreciates and is sold for $54,000, resulting in a $6,000 taxable loss ($54,000 less $60,000 adjusted tax basis) and a book loss of $26,000 ($54,000 less $80,000 book value). The book loss is allocated equally among the partners ($8,666 each) and has substantial economic effect. Consistent with the special partners' interests in the partnership rule (§ 1.704-1(b)(4)(i)) the partnership agreement provides that the entire $6,000 taxable loss is, in accordance with § 704(c) principles, included in Peter's distributive share. [§ 1.704-1(b)(5) Example (18)(vi)]*

	Dan		Connie		Peter	
	Tax	Book	Tax	Book	Tax	Book
Cap. Acct. at beg. of yr. 3	$30,000	$40,000	$30,000	$40,000	$40,000	$40,000
Less: Loss	0	(8,666)	0	(8,666)	(6,000)	(8,667)
Cap. Acct. before liquidation	$30,000	$31,334	$30,000	$31,334	$34,000	$31,333

***Example 7**: Assume the same facts as in Example 2 except that the partnership has an additional $2,000 depreciation deduction for tax and $26,667 book depreciation attributable to the property. The $26,667 book depreciation deduction*

is allocated equally among the three partners, and that allocation has substantial economic effect. Consistent with the special partners' interests in the partnership rule, the partnership agreement provides that the entire $2,000 cost recovery deduction for the partnership third taxable year is allocated to Peter. This is because under the § 704 regulations, Peter is required to include the cost recovery deduction for such property in his distributive share up to the amount of the book depreciation deduction for such property allocated to him. (See PTM 2010) for detailed explanations of § 704(c)) [§ 1.704-1(b)(5) Example (18)(vii)]

	Dan		***Connie***		***Peter***	
	Tax	*Book*	*Tax*	*Book*	*Tax*	*Book*
Cap. Acct. at beg. of yr. 3	*$30,000*	*$40,000*	*$30,000*	*$40,000*	*$40,000*	*$40,000*
Less: depreciation in yr.3	*0*	*(8,889)*		*(8,889)*	*(2,000)*	*(8,889)*
Cap. Acct. before liquidation	*$30,000*	*$31,334*	*$30,000*	*$31,334*	*$38,000*	*$31,333*

1650 Amendment to Partnership Agreement

If an allocation has substantial economic effect or is deemed to be made in accordance with the partners' interests in the partnership based on the partnership agreement that is effective for the taxable year to which such allocation relates, and such partnership agreement thereafter is modified, both the tax consequences of the modification and the facts and circumstances surrounding the modification will be closely scrutinized to determine whether the purported modification was part of the original agreement.

If it is determined that the purported modification was part of the original agreement, prior allocations may be reallocated in a manner consistent with the modified terms of the agreement, and subsequent allocations may be reallocated to take account of such modified terms. For example, if a partner is obligated by the partnership (original) agreement to restore the deficit balance in his capital account and thereafter, such obligation is eliminated, reduced (other than as provided in § 1.704-1(b)(2)(ii)(f)), or is not complied with in a timely manner, such elimination, reduction, or noncompliance may be treated as if **it always were part of the partnership agreement** for purposes of making any reallocations and determine the appropriate limitations period. [Treas. Reg. § 1.704-1(b)(4)(vi)]

The information provided in this manual does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.