
3000 CAPITAL ACCOUNTS- ALLOCATIONS OF NON-RECOURSE DEDUCTIONS

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| PTM 3010 | Allocation Attributable to Non-recourse Liabilities |
| PTM 3020 | General Allocation Principles |
| PTM 3030 | Requirements for Allocation of Non-recourse Deductions |
| PTM 3040 | Definition of Non-recourse Liabilities |
| PTM 3050 | Definition of Partnership Minimum Gain |
| PTM 3060 | Computation of Partnership Minimum Gain |
| PTM 3070 | Computation of Non-recourse Deductions |
| PTM 3071 | Property Subject to More Than One Liability |
| PTM 3072 | Partnership Minimum Gain if Book/Tax Disparity |
| PTM 3073 | Special Rule for Year of Revaluation |
| PTM 3100 | Shares of Partnership Minimum Gain |
| PTM 3200 | Partner Non-recourse Liability |
| PTM 3300 | Ordering Rules |
| PTM 3400 | Tiered Partnerships |
| PTM 3500 | Effective Dates |

3010 ALLOCATION ATTRIBUTABLE TO NON-RECOURSE LIABILITIES

Under the general allocation principle of §704(b) Regulations (discussed in PTM 1000), an allocation of a partnership's taxable income or loss to its partners must have substantial economic effect. For instance, a partner who is allocated a partnership's taxable loss has to bear the economic burden with regard to such allocation. However, this principle is not applicable when a partnership borrows money on a non-recourse basis to finance its operating expenses (deductions) because the economic burden is borne by the creditors, not the partners. Thus, deductions attributable to non-recourse liabilities (referred to as "*non-recourse deductions*") are allocated based on a different set of rules under § 704(b) Regulations. [Treas. Reg. § 1.704-2(b)(1)]

The allocation rules are based on several concepts:

To determine the amount of *non-recourse deductions* (i.e., which of the partnership's deductions are attributable to non-recourse liabilities), it must first determine the amount of *partnership minimum gain*. An increase in partnership minimum gain during a taxable year causes the partnership to have non-recourse deductions. An increase in partnership minimum gain is caused by a decrease in the tax basis of property encumbered by a nonrecourse liability below the amount of that liability (i.e. due to cost recovery deductions) and by a nonrecourse borrowing that exceeds the tax basis of the property encumbered by the borrowing. (See PTM 3070.)

The non-recourse deductions are then allocated to partners based on certain rules discussed at PTM 3020. The allocation of non-recourse deductions to a partner increases his share of partnership minimum gain.

Under the *minimum gain chargeback* rules, if there is a "net decrease in *partnership minimum gain*" the partner who shares in the partnership's minimum gain has to be allocated the partnership's income or gain in an amount equal to his share of the net decrease. (See PTM 3340)

Observation: *Though the above concepts are simple, the applicable rules may be complicated in certain situations. It may be useful for the auditor to remember the relationship among these concepts when following the discussion of the applicable rules.*

3020 GENERAL ALLOCATION PRINCIPLES

When a partnership realizes losses, deductions, or IRC § 705(a)(2)(B) expenses (See PTM 1480 – PTM 1495) that are funded by non-recourse borrowing, the allocation of these items (referred to as *non-recourse deductions*) cannot be based on the partners' share of economic risk of loss because the creditor alone bears any economic burden corresponding to those allocations. Thus, nonrecourse deductions must be allocated in accordance with the partners' interest in the partnership. [Treas. Reg. § 1.704-2(b)(1)]

In order for allocations of non-recourse deductions to be **deemed** in accordance with the partners' interests in the partnership, they have to meet a set of requirements provided in § 1.704-2 (e). (See PTM 3030)

If those requirements are not satisfied, the partners' distributive shares of nonrecourse deductions will be determined in accordance with the partners' overall economic interests in the partnership provided under § 1.704-1(b)(3) (See PTM 1600) [Treas. Reg. § 1.704-2(b)(1)]

Special rules apply for allocations of deductions attributable to nonrecourse liabilities for which a partner bears the economic risk of loss (see PTM 3200). [Treas. Reg. §§ 1.704-2(b)(4) and 1.704-2(i)]

For definitions of non-recourse liabilities, partner non-recourse liabilities, partnership minimum gain, and minimum gain chargeback, see PTM 3030 through PTM 3050, and PTM 3200.

3030 REQUIREMENTS FOR ALLOCATION OF NON-RECOURSE DEDUCTIONS

Allocations of non-recourse deductions are **deemed** to be in accordance with the partners' interests in the partnership only if **all** of the following requirements are satisfied [Treas. Reg. § 1.704-2(e)]:

1. Throughout the full term of the partnership, the economic effect requirements (See PTM 1120) under § 1.704-1(b)(2)(ii)(b) are satisfied (i.e., the partners' capital accounts are maintained in accordance with IRC § 704(b) rules; liquidating distributions are made in accordance with the partners' positive capital account balances; and partners with deficit capital accounts have an unconditional obligation to restore the deficit balances or agree to a qualified income offset);
2. Beginning in the first taxable year of the partnership in which there are **nonrecourse deductions**, and thereafter throughout the full term of the partnership, the partnership agreement provides that allocations of nonrecourse deductions must be made in a manner that is "reasonably consistent" with the allocations of some other "significant partnership items". These "significant partnership items" are items that have substantial economic effect and are attributable to the property securing the non-recourse liabilities;
3. Beginning in the first taxable year that the partnership has non-recourse deductions or makes a distribution of proceeds of a non-recourse liability that are allocable to an increase in **partnership minimum gain** and thereafter throughout the full term of the partnership, the partnership agreement contains the **minimum gain chargeback** requirement under Treas. Reg. § 1.704-2(f) (See PTM 3150)
4. All other material allocations and capital account adjustments are recognized under § 1.704-1(b) (i.e., partnership's allocations and capital accounts are in accordance with the rules discussed in PTM 1000 through PTM 3500.

In essence, the above requirements provide that if a partnership has nonrecourse deductions (determined based on partnership minimum gain), these non-recourse deductions must be allocated in accordance with the allocations of other significant items attributable to the property securing the non-recourse liabilities, and the partners who are allocated these non-recourse deductions must be subject to the minimum gain chargeback rules.

3040 DEFINITION OF NON-RECOURSE LIABILITIES

- A non-recourse liability, as defined under § 1.752-1(a)(2), is a liability for which **no partner** or a related person bears the economic risk of loss, or a § 1.752-7 liability (as defined in § 1.752-7(b)(3)(i)) assumed by the partnership from a partner on or after 6/24/03. [Treas. Reg. § 1.704-2(b)(3)] In simple terms, if a partnership fails to repay a nonrecourse liability, the lender has no recourse against any partners except to foreclose on the assets used to secure the non-recourse loan.
- For further discussion of non-recourse liabilities, (See PTM 5490)
- For determination of the economic risk of loss, (See PTM 5510)
- If the non-recourse liabilities are made or guaranteed by a partner or a related person, and the partner or related person bears the economic risk of loss, the non-recourse debt is treated as a “partner non-recourse debt”. (See PTM 3200.) [Treas. Reg. § 1.704-2(b)(4)]

3050 DEFINITION OF PARTNERSHIP MINIMUM GAIN

Partnership minimum gain is the excess of the non-recourse liability over the adjusted tax basis of the partnership property that it encumbers. [Treas. Reg. § 1.704-2(b)(1)] It is the minimum amount of gain that the partnership would realize upon a disposition of the property because the amount realized from such disposition cannot be less than the nonrecourse liability secured by the property, regardless of the value of the property at that time. *Commissioner v. Tufts* 461 U.S. 300 (1983).

Non-recourse liability - Adjusted tax basis = Partnership Minimum Gain

Important: If the adjusted tax basis of the property is different from its book basis, the minimum gain is computed based on book basis. This rule applies to all computations of minimum gain or increases in minimum gain. (See PTM 3072) [Treas. Reg § 1.704-2(d)(3)]

If the adjusted tax basis of the property decreases (e.g., due to depreciation), or if the partnership borrows additional non-recourse debts encumbered by the same property, the partnership minimum gain will increase.

If the non-recourse liability is reduced (e.g., through payments by the partnership), the partnership minimum gain will decrease. [Treas. Reg. § 1.704-2(b)(2)]

For computation of increases and decreases in partnership minimum gain, See PTM 3060.

Example: *Brian and Larry form a partnership with each contributing \$1,000 to the partnership. The partnership obtains a non-recourse loan of \$8,000 from an unrelated party and purchases a depreciable property for \$10,000. The partnership generates \$2,000 of depreciation in each of the first five years.*

At the end of year 3, the outstanding balance of the non-recourse liability is \$7,000 and the adjusted tax basis of the property is \$4,000 (\$10,000 cost basis less \$6,000 accumulated depreciation for three years). The partnership minimum gain at the end of year 3 is \$3,000 (\$7,000 non-recourse liability less \$4,000 adjusted tax basis).

Assuming in year 4, the property appreciates in value to \$15,000. The partnership borrows a second non-recourse liability of \$3,000 and distributes the proceeds to Brian and Larry. No principal payments are made on the first nonrecourse liability during year

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4. *The partnership minimum gain at the end of year 4 is computed as follows:*

| | | |
|--|---------------------------|---------------------|
| <i>Total non-recourse liabilities:</i> | <i>(\$ 7,000 + 3,000)</i> | <i>\$10,000</i> |
| <i>Adjusted tax basis(*)</i> | | <i><u>2,000</u></i> |
| <i>Partnership minimum gain</i> | | <i>\$ 8,000</i> |

(*) *\$10,000 cost basis less \$8,000 accumulated depreciation for four years.*

3060 COMPUTATION OF PARTNERSHIP MINIMUM GAIN

The computation of the amount of partnership minimum gain and the net increases or decreases in partnership minimum gain during a partnership taxable year is important since it determines how much of the partnership deductions are attributable to non-recourse liabilities (referred to as non-recourse deductions, See PTM 3070).

The amount of partnership minimum gain is determined by first computing for each partnership non-recourse liability any gain the partnership would realize if it disposes of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains. [Treas. Reg. § 1.704-2(d)(1)]

- See PTM 3050 for how to determine partnership minimum gain.
- If a property is subject to more than one non-recourse liability, See PTM 3071.

The amount of partnership minimum gain also includes minimum gain arising from a conversion, refinancing, or other change to a debt instrument as described in Treas. Reg. § 1.704-2(g)(3) only to the extent the partner is allocated a share of that minimum gain. Detailed computation is provided at PTM 3500.

The net increase or decrease in partnership minimum gain in any partnership taxable year is determined by comparing the partnership minimum gain on the last day of the current taxable year with the partnership minimum gain on the last day of the immediately preceding taxable year. [Treas. Reg. § 1.704-2(d)(1)]

For illustration of the computation of the amount of partnership minimum gain, see Example in PTM 3070.

3070 COMPUTATION OF NON-RECOURSE DEDUCTIONS

Once the amount of partnership minimum gain is computed (See PTM 3060), the next step is to determine the amount of partnership non-recourse deductions. The purpose of determining which deductions generated at the partnership level are attributable to non-recourse liabilities is to determine how they (the nonrecourse deductions) are allocated to partners. The amount of non-recourse deductions may be less than, equal to, or more than the partnership taxable loss. (Note that the partner who is allocated non-recourse deductions is subject to the minimum gain chargeback.)

The amount of non-recourse deductions for a partnership tax year equals:

- the net increase in partnership minimum gain during the year (determined under Treas. Reg. § 1.704-2 (d), see PTM 3060), and
- reduced (but not below zero) by the aggregate distributions made during the year of proceeds of a non-recourse liability that are allocated to an increase in partnership minimum gain (determined under Treas. Reg. § 1.704-2 (h); see PTM 3140).
[Treas. Reg. § 1.704-2(c)]

Increases in partnership minimum gain resulting from conversions, re-financings, or other changes to a debt instrument (See PTM 3130) **do not** generate nonrecourse deductions. [Treas. Reg. § 1.704-2(c)]

Generally, non-recourse deductions consist first of certain depreciation deductions or cost recovery deductions and then, if necessary, a pro-rata portion of other partnership losses, deductions, and IRC § 705(a)(2)(B) expenditures for that year. [Treas. Reg. § 1.704-2(c)] (For the ordering rules, see PTM 3300.) Thus, the non-recourse deductions may be less than, equal to, or more than the partnership's taxable loss during the year.

If the non-recourse deductions exceed the partnership losses during the year, the excess amount is carried over to the succeeding partnership taxable year. [Treas. Reg. § 1.704-2(c)] (See PTM 3330)

Example: Laurie and Gary form a limited partnership to own and operate a rental property. Laurie, the limited partner, contributes \$18,000 and Gary, the general partner, contributes \$2,000. The partnership obtains a \$80,000 nonrecourse loan to purchase the property (on leased land) for \$100,000. The loan is secured by the property and no principal payments are due for 5 years. The partnership agreement provides that Gary has to restore his negative capital account balance following his partnership interest's liquidation. Laurie, the limited partner, however, is not required to restore her deficit capital account balance. The partnership agreement also contains the following

CALIFORNIA FRANCHISE TAX BOARD

requirements (discussed at PTM 3030): partners' capital accounts maintained in accordance with the rules under Treas. Reg. § 1.704-1(b)(2)(ii)(b)(1), liquidating distributions made in accordance with the partners' positive capital accounts, a qualified income offset, and a minimum gain chargeback. The partnership agreement also provides that unless required by the qualified income offset and the minimum gain chargeback provisions, all partnership items are allocated 90% to Laurie and 10% to Gary until the first time when the partnership has recognized items of income and gain that exceed the items of loss and deduction it has recognized over its life. Thereafter, all partnership items will be allocated equally between Laurie and Gary. Finally, the partnership agreement also provides that all partnership distributions, other than liquidating distributions, will be made 90% to Laurie and 10% to Gary until a total of \$20,000 has been distributed (the \$20,000 is their initial capital contributions). Thereafter, all distributions will be made equally between Laurie and Gary.

In each of the first two years, the partnership generates the following items: rental income of \$9,500, operating expenses of \$1,000, interest expense of \$8,000 and depreciation deduction of \$9,000, resulting in a net taxable loss of \$8,500 in each of those years. The allocations of these losses to Laurie (90%) and Gary (10%) have substantial economic effect. Their capital accounts are as follows:

| | Laurie | Gary |
|----------------------------------|-----------------|----------------|
| Capital account on formation | \$18,000 | \$2,000 |
| Less: net loss in year 1&2 | <u>(15,300)</u> | <u>(1,700)</u> |
| Capital account at end of year 2 | \$ 2,700 | \$ 300 |

In the partnership's third taxable year, it generates the same items of income and expenses as in the first two years. No distributions were made by the partnership.

In general, the determination of how to allocate the partnership taxable loss is done in the following order:

- (1) Determine if the partnership has minimum gain (if there is no minimum gain, there is no non-recourse deductions, the taxable loss is allocated in accordance with the principles discussed in PTM 1000);
- (2) If there is minimum gain, determine the amount of non-recourse deductions based on the increase in minimum gain during the year (note that all or a portion of the partnership taxable loss may be attributable to non-recourse deductions, as computed below in this example);
- (3) Once the amount of non-recourse deductions is determined, it is allocated to the partners in accordance with the rules discussed in PTM 3100. (Losses which are not attributable to non-recourse deductions are also allocated to partners in accordance with the rules discussed in PTM 1000 – PTM 1495,

CALIFORNIA FRANCHISE TAX BOARD

i.e., substantial economic effect rules, as computed below in this example.)

The allocation of the partnership taxable loss in year 3 to Laurie and Gary based on the above order is as follows:

- Calculation of partnership minimum gain (See PTM 3060): *If the partnership were to dispose of the rental property at the end of year 3 in full satisfaction of the non-recourse liability of \$80,000, it would realize a gain of \$7,000 (\$80,000 amount realized less adjusted tax basis of \$73,000 which is computed at \$100,000 cost basis less accumulated depreciation of \$27,000). This \$7,000 gain is the partnership minimum gain (i.e., the excess of nonrecourse liability over the adjusted tax basis). Using the same hypothetical sale, the partnership minimum gain at the end of year 2 is zero (\$80,000 recourse liability less \$82,000 adjusted tax basis). Thus, the net increase in partnership minimum gain during year 3 is \$7,000.)*
- Calculation of non-recourse deductions (See PTM 3070): *The partnership total taxable loss in year 3 is \$8,500 (included in the loss is the depreciation deduction of \$9,000). Since the amount of non-recourse deductions equals the net increase in partnership minimum gain during the year, the partnership non-recourse deductions for year 3 is \$7,000 (out of the total loss of \$8,500).*
- Allocation of non-recourse deductions: *The partnership's total taxable loss of \$8,500 includes \$7,000 of non-recourse deductions and \$1,500 of loss (without non-recourse deduction). The taxable loss of \$1,500 is allocated 90% to Laurie and 10% to Gary in accordance with the partnership agreement and this allocation has substantial economic effect (because the partnership agreement contains all the economic effect requirement (See PTM 1120). With regard to the \$7,000 non-recourse deductions, they are also allocated in the ratio of 90/10 to Laurie and Gary, respectively. This allocation satisfies the requirement 2 at PTM 3030 since it is consistent with the allocation of "other significant partnership items attributable to the property that have substantial economic effect" (which, in this example, are the taxable loss of \$1,500). Also, the other requirements 1, 3 and 4 at PTM 3030 are satisfied. Thus, the allocation of non-recourse deductions to Laurie and Gary in year 3 is deemed to be in accordance with the partners' interests in the partnership.*

| | Laurie | Gary |
|--|----------------|--------------|
| Capital account at end of yr. 2 | \$2,700 | \$300 |
| Less: net loss in year 3 (without non-recourse deductions) | (1,350) | (150) |
| Less: yr. 3 Non-recourse deductions | <u>(6,300)</u> | <u>(700)</u> |
| Capital accounts at end of yr. 3 | (\$4,950) | (\$550) |

CALIFORNIA FRANCHISE TAX BOARD

At the end of the partnership third taxable year, Laurie and Gary's shares of partnership minimum gain are \$6,300 and \$700, respectively. [See Treas. Reg. § 1.704-2(m), Ex. (1)(i).]

Under the minimum gain chargeback rules (See PTM 3150), if the partnership were to dispose of the property in full satisfaction of the non-recourse liability at the end of year 3, the partnership minimum gain will be decreased from \$7,000 to zero and the gain from that disposition will be allocated \$6,300 to Laurie and \$700 to Gary.

PTM 3071 Property Subject to More Than One Liability

PTM 3072 Partnership Minimum Gain if Book/Tax Disparity

PTM 3073 Special Rule for Year of Revaluation

3071 PROPERTY SUBJECT TO MORE THAN ONE LIABILITY

If a property is subject to more than one liability, only the portion of the property's adjusted tax basis allocated to a non-recourse liability (as explained below) is used to compute minimum gain. [Treas. Reg. § 1.704-2(d)(2)(i)]

- If a property is subject to two or more liabilities of *equal priority*, the property's adjusted tax basis is allocated among the liabilities in proportion to their outstanding balances. [Treas. Reg. § 1.704-2(d)(2)(ii)]
- If a property is subject to liabilities of *unequal priority*, the adjusted tax basis is first allocated to the liability of the highest priority to the extent of its outstanding balance and then to each liability in descending order of priority to the extent of its outstanding balance, until fully allocated. [Treas. Reg. § 1.704-2(d)(2)(ii)]

Example: *Rainbow Partnership acquires a commercial building for \$1,000,000 that is financed by an \$800,000 non-recourse loan and a \$200,000 recourse loan subordinate to the non-recourse loan. Assume at the end of year 3, the balance of the non-recourse loan is \$800,000 and the balance of the recourse loan is \$150,000. The partnership's adjusted tax basis in the property is \$850,000. Since the non-recourse loan has higher priority, the \$850,000 adjusted tax basis of the property has to be allocated to the non-recourse loan to the extent of its outstanding balance, which is \$800,000. Thus, there is no minimum gain at the end of year 3 since the allocated portion of adjusted tax basis (\$800,000) is equal to the balance of the non-recourse loan. (Note: the remaining balance of the adjusted tax basis of \$50,000 is allocated to the recourse loan. There is no minimum gain since the loan is recourse.)*

If the non-recourse loan were subordinate in priority to the recourse loan, the adjusted tax basis of \$850,000 is first allocated to the balance of the recourse loan, which is \$150,000. The remaining adjusted tax basis of \$700,000 is allocated to the \$800,000 non-recourse loan. Thus, the partnership minimum gain at the end of year 3 is \$100,000 (\$800,000 - 700,000). [See Treas. Reg. § 1.704-2(m), Ex. (1)(v)]

3072 PARTNERSHIP MINIMUM GAIN IF BOOK/TAX DISPARITY

If partnership property subject to one or more non-recourse liabilities is reflected on the books of the partnership at a value that differs from its adjusted tax basis, the determination of partnership minimum gain is based on the property's book value.

[Treas. Reg. § 1.704-2(d)(3)]

The disparity between tax/book is due to property being contributed to the partnership (See PTM 1420), being re-valued (See PTM 1450), or a restatement of capital accounts (See PTM 1560).

See Example at PTM 3120 for an illustration.

3073 SPECIAL RULE FOR YEAR OF REVALUATION

If the partners' capital accounts are increased pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(d), (f), or (r) (property contributed to the partnership (See PTM 1420), revalued property (See PTM 1450), or a restatement of capital accounts (See PTM 1560), respectively), to reflect a revaluation of partnership property subject to a non-recourse liability, the net increase or decrease in partnership minimum gain for the partnership taxable year of revaluation is determined by:

1. First, calculating the net decrease or increase in partnership minimum gain using the current year's book values and the prior year's partnership minimum gain amount; and
2. Then adding back any decrease in minimum gain arising solely from the revaluation. [Treas. Reg. § 1.704-2(d)(4)]

See Example at PTM 3120.

If the partners' capital accounts are decreased to reflect a revaluation, the net decrease or increase in partnership minimum gain are determined in the same manner as in the year before the revaluation, but by using book values rather than adjusted tax bases. The re-valued property cannot be booked down below the outstanding non-recourse liability secured by such property. (See PTM 1450)

3100 SHARES OF PARTNERSHIP MINIMUM GAIN

- PTM 3110 General Rule
- PTM 3120 Share of Net Decrease
- PTM 3130 Conversion of Debt into Non-recourse Debt
- PTM 3140 Distribution of Non-recourse Liability Proceeds
- PTM 3141 Distribution Allocable to Non-recourse Liability Proceeds
- PTM 3142 Obligation to Restore
- PTM 3143 Carryover
- PTM 3150 Minimum Gain Chargeback Requirement
- PTM 3151 Allocation of Minimum Gain Chargeback
- PTM 3152 Exception for Certain Conversion and Refinancing
- PTM 3153 Exception for Certain Capital Contributions
- PTM 3154 Waiver for Certain Income Allocations
- PTM 3155 Items Subject to Minimum Gain Chargeback Requirement

3110 General Rule

A partner's share of partnership minimum gain at the end of any taxable year equals:

The sum of

- non-recourse deductions allocated to that partner (and to that partner's predecessors in interest) up to that time and
 - the distributions made to that partner (and to that partner's predecessors in interest) up to that time *of proceeds of a non-recourse liability allocable to an increase in partnership minimum gain* (See PTM 3120);
- Minus the sum of
- that partner's (and to that partner's predecessors in interest) aggregate share of the net decreases in partnership minimum gain plus
 - their aggregate share of decreases resulting from revaluation of partnership property subject to one or more partnership non-recourse liabilities. [Treas. Reg. § 1.704-2(g)(1)]

See examples at Treas. Reg. § 1.704-2(m)(1)(i) and (3)(i).

Important Rule: For purposes of § 1.704-1(b)(2)(ii)(d) (Alternative economic effect requirements, see PTM 1140), a partner's share of partnership minimum gain is added to the limited dollar amount, if any, of the deficit balance in the partner's capital account that the partner is obligated to restore. [Treas. Reg. § 1.704-2(g)(1)(ii)]

Example: See Example at PTM 3070 and the following additional discussion:

The allocation of the non-recourse deductions in year 3 causes Laurie and Gary's capital accounts to be negative as follows:

| | Laurie | Gary |
|---|----------------|--------------|
| <i>Capital account at end of yr. 2</i> | \$2,700 | \$300 |
| <i>Less: net loss in year 3 (without non-recourse deductions)</i> | (1,350) | (150) |
| <i>Less: yr. 3 Non-recourse deductions</i> | <u>(6,300)</u> | <u>(700)</u> |
| <i>Capital accounts at end of yr. 3</i> | (\$4,950) | (\$550) |

The allocation of \$6,300 in non-recourse deductions to Laurie increases her share of partnership minimum gain by \$6,300. Under the rule discussed immediately above, (a partner's share of partnership minimum gain is added to the limited dollar amount, if any, of the deficit balance in the partner's capital account that the partner is obligated to restore) Laurie is treated as obligated to restore a deficit capital account balance up to \$6,300, her share of the partnership minimum gain.

*Why is the above requirement necessary? Note that pursuant to the partnership agreement, Laurie, a limited partner, is **not** required to restore her deficit capital account. Thus, under the economic effect test, the above allocation that reduces her capital account negative does not have economic effect. Though the partnership agreement contains a qualified income offset statement under the alternative economic effect test (See PTM 1140), an allocation cannot increase a deficit balance in Laurie's capital account. Thus, the only way for the allocation of \$6,300 in non-recourse deductions (which causes Laurie's capital account to be negative) to have economic effect is that Laurie has to be obligated to restore a limited dollar amount up to such allocation. As a result, the allocation is considered to have economic effect under the alternative economic effect test contained in Treas. Reg. § 1.704-1(b)(2)(ii)(d). [See Treas. Reg. § 1.704-2(m), Ex. (1)(i).]*

From an economic standpoint, this rule makes sense since if Laurie benefits from a tax deduction of \$6,300, she should bear the economic burden of such deduction through the deficit restoration obligation.

*Also, since Laurie is required to restore a deficit capital account balance up to \$6,300 while her actual capital account balance at the end of year 3 is only \$4,950, she may be allocated up to an additional \$1,350 of partnership deductions and losses that are **not** non-recourse deductions in year 4.*

3120 Share of Net Decrease

A partner's share of the net decrease in partnership minimum gain is the amount of the total net decrease multiplied by the partner's percentage share of the partnership minimum gain at the end of the immediately preceding taxable year.

If there is a revaluation of the partnership property, a partner's share of any decrease in partnership minimum gain equals the increase in partner's capital account attributable to the revaluation to the extent the reduction in minimum gain is caused by the revaluation. [Treas. Reg. § 1.704-2(g)(2)]

Example 1: *Linda and George form a limited partnership to acquire and lease a 5-year recovery property. Linda, the limited partner, and George, the general partner, contribute \$10,000 each to the partnership. The partnership obtains an \$80,000 non-recourse loan and purchases a machine for \$100,000. The nonrecourse liability is secured by the machine. Payments on principal of the loan are made \$5,000 in each of the partnership first five years and the remaining balance of \$55,000 is paid on the first day of year 6. The partnership agreement contains all the requirements discussed at PTM 3030 and except to satisfy the qualified income offset and minimum gain*

CALIFORNIA FRANCHISE TAX BOARD

chargeback provisions, all partnership items will be allocated equally between Linda and George, all distributions, except liquidating distribution, will be made equally between the two.

In the partnership first taxable year, it generates rental income of \$13,000, interest expense of \$8,000, and a depreciation deduction of \$15,000, resulting in a taxable loss of \$10,000. In addition, the partnership repays \$5,000 of the \$80,000 debt. The allocation of the \$10,000 loss equally between Linda and George has substantial economic effect. Their capital accounts at the end of the first year are as follows:

| | Linda | George |
|---|----------------|----------------|
| <i>Capital account on formation</i> | \$10,000 | \$10,000 |
| <i>Less: net loss in year 1</i> | <u>(5,000)</u> | <u>(5,000)</u> |
| <i>Capital account at end of year 2</i> | \$ 5,000 | \$ 5,000 |

Note: There is no partnership minimum gain at the end of year 1 since the balance of the loan \$75,000 (\$80,000 original balance less payment of \$5,000) does not exceed the property's adjusted tax basis \$85,000 (\$100,000 original basis less depreciation of \$15,000). Thus, there is no non-recourse deduction.

In the second year, the partnership generates rental income of \$13,000, interest expense of \$7,500, and depreciation of \$22,000, resulting in a taxable loss of \$16,500. In addition, the partnership repays \$5,000 of the loan, and distributes \$250 of cash to each partner. If the partnership were to dispose of the machinery in full satisfaction of the non-recourse loan at the end of that year, it would realize \$7,000 gain (\$70,000 outstanding loan balance less \$63,000 adjusted tax basis). Thus, the amount of partnership minimum gain at the end of year two is \$7,000, which is also the amount of non-recourse deductions for the year. As a result, the total partnership loss for the year (\$16,500) consists of \$7,000 of non-recourse deductions and \$9,500 of loss without non-recourse deductions. The allocation of these items is as follows:

| | Linda | George |
|---|--------------|---------------|
| <i>Capital account at end of year 1</i> | \$5,000 | \$5,000 |
| <i>Less: net loss in year 2 (without non-recourse deductions)</i> | (4,750) | (4,750) |
| <i>Less: non-recourse deductions</i> | (3,500) | (3,500) |
| <i>Less: distribution</i> | <u>(250)</u> | <u>(250)</u> |
| <i>Capital account at end of year 2</i> | (\$3,500) | (\$3,500) |

The allocation of \$9,500 net loss (without non-recourse deductions) equally between the two partners has substantial economic effect. The allocation of the \$3,500 non-recourse deductions is deemed to be in accordance with the partners' interests in the

CALIFORNIA FRANCHISE TAX BOARD

partnership because the requirements of Treas. Reg. § 1.704-2(e) (See PTM 3030) are satisfied. Each partner's share of partnership minimum gain is \$3,500 and is obligated to restore their deficit capital account balances up to that amount pursuant to Treas. Reg. § 1.704-2(g)(2) (See PTM 3110).

If the partnership were to dispose of the property at the beginning of the third year in full satisfaction of the non-recourse loan, and assuming there is no other economic activity in that year, the partnership minimum gain would be decreased from \$7,000 to zero. Linda and George's share of the decrease in minimum gain would be \$3,500 each. Upon that disposition, the minimum gain chargeback would require that Linda and George each be allocated \$3,500 of that gain before any other allocation is made under IRC § 704(b). [See Treas. Reg. § 1.704-2(m), Ex. (3)(i)]

Observation: *Thus, from an audit standpoint, the purposes of the determination of the non-recourse deductions are (1) to verify if the non-recourse deductions are allocated correctly pursuant to the requirements (discussed at PTM 3030) and (2) to make sure that the partners who are allocated these deductions are also allocated gains under the minimum gain chargeback rules (See PTM 3150). If the disposition of the property does not generate enough income to allocate under the minimum gain chargeback rules, a pro rata portion of the partnership's other items of income and gains for that year must be allocated to the partners (see ordering rules at PTM 3300, PTM 3340). Therefore, it appears the allocations under the minimum gain chargeback rules precede the IRC § 704(b) allocations.*

Example 2: *Assume the same facts as in Example 1 except Carol is admitted to the partnership at the beginning of year three. At the time of Carol's admission, the fair market value of the machinery is \$90,000 (the adjusted tax basis is \$63,000). Carol contributes \$10,000 cash in exchange for one-third interest in the partnership. The partnership purchases a piece of undeveloped land for \$9,500 and holds the remaining \$500 cash. Due to Carol's admission, the partnership revalues its property. The machinery's fair market value of \$90,000 is reflected on the partnership's books. Pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(f) (See PTM 1450), the capital accounts of Linda and George are adjusted upward by \$13,500 each to reflect the revaluation of the property. The adjustment reflects the manner the gain of \$27,000 (\$90,000 fair market value less \$63,000 adjusted tax basis) would be shared between Linda and George if the machine were sold for its fair market value immediately prior to Carol's admission.*

| | Linda | George |
|--|---------------|---------------|
| Capital account at end of year 2 | (\$3,500) | (\$3,500) |
| Deemed sale adjustment | <u>13,500</u> | <u>13,500</u> |
| Capital accounts after Carol's admission | \$10,000 | \$10,000 |

Note that prior to Carol's admission, there is no difference between Linda's and George's tax-basis capital accounts and book-basis capital accounts. After Carol's admission, Linda's and George's tax basis capital accounts remain the same as prior to the admission but their book basis capital accounts are adjusted upward to \$10,000. (The book capital accounts are frequently shown on the partnership tax return.)

As a result of Carol's admission, the partnership agreement is modified to provide that except as otherwise required by its qualified income offset and minimum gain chargeback provisions, partnership income, gain, loss, and deductions, as computed for book purposes, are allocated equally among the partners, and those allocations are reflected in the partners' capital accounts. The partnership agreement also is modified to provide that depreciation and gain or loss, as computed for tax purposes, with regard to the machinery, will be shared among the partners in a manner that takes account for the variation between the property's \$63,000 adjusted tax basis and its \$90,000 book value, pursuant to Treas. Reg. §§ 1.704-1(b)(2)(iv)(f) and 1.704-1(b)(4)(i) (See PTM 1450).

Effects of the revaluation: Due to the valuation of the machine upward by \$27,000, the partnership minimum gain in year three is zero. (Note that since the book value of the machine is \$90,000, there is no minimum gain because the balance of the loan is \$70,000. Note also that if the property's adjusted tax basis is different from its book basis, the book basis is to be used to compute the partnership minimum gain. See PTM 3072) Under the rule for computation of the partnership minimum gain in the year of revaluation (See PTM 3073), the net increase or decrease in partnership minimum gain in year three regarding the revaluation is computed as follows:

First, calculating the net increase or decrease in partnership minimum gain using the current year book value and the prior year partnership minimum gain: the current year minimum gain is zero; the prior year minimum gain is \$7,000. Thus there is a net decrease in partnership minimum gain of \$7,000.

Second, adding back any decrease in minimum gain arising solely from the revaluation. In this example, the decrease caused by the revaluation is \$7,000. Thus, by adding back the \$7,000 decrease in minimum gain arising solely from the revaluation, there is no net increase or decrease solely on account of the revaluation. (In other words, the partnership minimum gain is immediately reduced to zero after such revaluation and is immediately increased from zero to \$7,000.) Thus, no minimum gain chargeback is triggered (See PTM 3150).

All future non-recourse deductions will be computed based on the book value of the machinery and allocated to all three partners in accordance with the partnership agreement. Linda's and George's share of the decrease in minimum gain is \$3,500

CALIFORNIA FRANCHISE TAX BOARD

each. However, under the principles of IRC § 704(c) (see PTM 1300), the tax basis capital accounts of Linda and George will eventually be charged \$3,500 each (due to the operation of IRC § 704(c)), reflecting their 50 percent share of the decrease in partnership minimum gain, as illustrated in Example 3.

Example 3: Assume the same facts as in Example 2 except during the partnership’s third taxable year, the partnership generates rental income of \$13,000, interest expense of \$7,000, tax depreciation of \$21,000, and book depreciation of \$30,000. As a result, the partnership has a taxable loss of \$15,000 and a book loss of \$24,000. In addition, the partnership repays \$5,000 of the non-recourse debt (after the date of Carol’s admission). Thus, the balance of the non-recourse debt is \$65,000. The partnership also distributes \$500 cash to each partner.

Allocations: If the partnership were to dispose of the property in full satisfaction of the non-recourse debt at the end of the year, the book gain would be \$5,000 (\$65,000 amount realized less \$60,000 book basis). Thus, the partnership minimum gain is \$5,000, which represents the decrease in partnership minimum gain of \$2,000 (from \$7,000 in year two). However, as discussed in Example 2, pursuant to the special rule for the year of revaluation, the net increase in partnership minimum gain in year three is determined by adding back the \$7,000 decrease in minimum gain attributable to the revaluation of the machinery to the \$2,000 net decrease in partnership minimum gain during the year. Thus, instead of a \$2,000 decrease in minimum gain, there is a \$5,000 increase (\$7,000 - 2,000) in minimum gain in year three. Thus, the non-recourse deductions in year three are \$5,000. Pursuant to the partnership agreement, all partnership items comprising of the book loss of \$24,000, including the \$5,000 non-recourse deduction, are allocated equally among the three partners. The allocation of these items, other than the non-recourse deductions, has substantial economic effect. With regard to the \$21,000 depreciation for tax purposes, it is allocated in accordance with the principles of IRC § 704(c): Linda and George are allocated \$5,500 each; Carol is allocated \$10,000. Their tax and book capital accounts are as follows:

| | Linda/George | | Carol | |
|-----------------------------------|---------------------|--------------|--------------|--------------|
| | <u>Tax</u> | <u>Book</u> | <u>Tax</u> | <u>Book</u> |
| Capital account - yr. 3 | (\$3,500) | \$10,000 | \$10,000 | \$10,000 |
| Less: Non-recourse deduction | (916) | (1,666) | (1,666) | (1,666) |
| Less: Items other n/r deductions. | (2,584) | (6,334) | (6,334) | (6,334) |
| Less: Distribution | <u>(500)</u> | <u>(500)</u> | <u>(500)</u> | <u>(500)</u> |
| Capital accounts - end of the yr. | (\$7,500) | \$1,500 | \$1,500 | \$1,500 |

The capital accounts of Linda and George are similar. Their tax and book capital accounts are different due to the difference between the book value and the adjusted tax basis of the partnership property when Carol is admitted into the partnership. The computation of the above amounts is as follows:

Allocation of Book Loss: *The partnership’s book loss is \$24,000. Under the partnership agreement, the book loss is share equally among the partners. Thus, each is allocated \$8,000 of the book loss.*

Allocation of tax loss: *The partnership’s tax loss is \$15,000. Included in this tax loss is tax depreciation of \$21,000. Thus, the operating income without depreciation is \$6,000. Under the general rule of IRC § 704(b), allocations of tax loss follow allocation of book loss, which, in this example, is also allocated equally among the three partners. However, when Carol is admitted into the partnership, the property’s adjusted tax basis (\$63,000) is different from its book value (\$90,000). Thus, under the principles of IRC § 704(c) regulations, the book/tax variation must be taken into consideration in allocating partnership taxable income, gain, loss, and deduction (See PTM 2130). Under the traditional method of allocation (See PTM 2200), tax allocation of depreciation must equal book allocation, subject to the ceiling rule. In this example, Carol, the “noncontributing partner”¹³ is allocated one third of the total book depreciation, which is \$10,000. Thus, for tax purposes, she must also be allocated \$10,000 of tax depreciation. As a result, Linda and George are allocated the remaining tax depreciation of \$11,000 (\$21,000 total tax depreciation less \$10,000 allocated to Carol). The partnership’s income before tax depreciation is \$6,000 and this income is allocated equally among the three partners (note that the IRC § 704(c) allocation applies to IRC § 704(c) property only). Each partner’s share of the partnership’s taxable loss in year 3 is as follows:*

| | Linda | George | Carol |
|----------------------------|----------------|----------------|-----------------|
| <i>Income before depr.</i> | \$2,000 | \$2,000 | \$2,000 |
| <i>Less; depreciation</i> | <u>(5,500)</u> | <u>(5,500)</u> | <u>(10,000)</u> |
| <i>Taxable Loss</i> | (\$3,500) | (\$3,500) | (\$8,000) |

Allocation of Non-recourse Deductions: *the total non-recourse deduction for year three is \$5,000 that is allocated equally among the three partners (\$1,666 to each). This allocation is deemed to be in accordance with the partners’ interest in the partnership. (See PTM 3030). For purposes of the tax capital accounts, the amount of tax non-recourse deduction is computed by multiplying the total tax depreciation by the*

¹³ Though Carol is admitted into the partnership, she is a non-contributing partner with regard to the property. In other words, Linda and George were treated as contributing the property and Carol contributes \$10,000 cash to form a new partnership.

ratio of the book non-recourse deductions (\$5,000) to the total book depreciation (\$30,000)¹⁴ Thus, the tax non-recourse deduction is

\$3,500 ($\$21,000 \times (5,000 \div 30,000)$). For tax purposes, Carol is allocated an amount of non-recourse deduction equal to the book amount (\$1,666). The balance of \$1,834 ($\$3,500 - 1,666$) is shared equally between Linda and George. The amount of “items without non-recourse deduction” is computed by subtracting the non-recourse deduction from the total taxable loss (i.e., \$2,584 for Linda and George and \$6,334 for Carol).

Observation: This example illustrates the coordination between the principles of the non-recourse deduction allocation and of IRC § 704(c), and the general principle of IRC § 704(b) that tax allocations must follow economic arrangement (or book allocations). Though the computation may appear complicated, the auditor should take time to redo the example to understand how these amounts are computed. Also, the examples provided in the regulations are good illustrations of the application of these allocation principles.[See §1.704-2(m), Ex. (3)(iv) & (v).]

¹⁴ The Regulations did not provide a method for computation of the non-recourse deductions for tax capital accounts. The method suggested here is based on the example provided in Treas. Reg. § 1.704-2(m) Ex. (3)(iii). It should be noted that even in this example, there was no explanation of how these amounts were computed.

3130 Conversion of Debt into Non-recourse Debt

A **recourse** liability or **partner non-recourse** liability may become partially or wholly **non-recourse** due to refinancing, the lapse of a guarantee, or other change to a debt instrument.

If a recourse liability becomes a non-recourse liability, a partner has a share of the partnership minimum gain that results from the conversion equal to the partner's deficit capital account (determined under Treas. Reg. § 1.704-1(b)(2)(iv)) to the extent the partner no longer bears the economic burden for the entire deficit capital account as a result of the conversion. For purposes of determining the extent to which a partner bears the economic burden for a deficit capital account, see the rule described in Treas. Reg. § 1.704-1(b)(2)(iii)(c). [Treas. Reg. § 1.704-2(g)(3)]¹⁵

If a *partner non-recourse debt* becomes a *non-recourse debt*, the partner's share of the partnership minimum gain is increased to the extent the partner is not subject to the minimum gain chargeback requirement under Treas. Reg. § 1.704-2(i)(4) (See PTM 3150)

For definition of partner non-recourse debt, See PTM 3210.

3140 Distribution of Non-recourse Liability Proceeds

General Rules: If during its taxable year, a partnership makes a distribution to the partners which is allocable to the proceeds of a non-recourse liability, the distribution is allocable to an increase in partnership minimum gain to the extent the increase results from encumbering partnership property with aggregate nonrecourse liabilities that exceed the property's adjusted tax basis. If the net increase in partnership minimum gain for a partnership taxable year is allocable to more than one non-recourse liability, the net increase is allocated among the liabilities in proportion to the amount each liability contributed to the increase in minimum gain. [Treas. Reg. § 1.704-2(h)(1)]

For illustration, see Treas. Reg. § 1.704-2(m), Ex. 1(vi).

PTM 3141 Distribution Allocable to Non-recourse Liability Proceeds

PTM 3142 Obligation to Restore

PTM 3143 Carryover

¹⁵ Although Treas. Reg. § 1.704-2(g)(3) references Treas. Reg. § 1.704-1(b)(2)(iii)(c), the rules with regard to a partner's obligation to restore a deficit capital account balance are found in Treas. Reg. § 1.704(b)(2)(ii)(c).

3141 Distribution Allocable to Non-recourse Liability Proceeds

A partnership may use any reasonable method to determine whether a distribution by the partnership to one or more partners is allocable to proceeds of a non-recourse liability. For instance, the rules prescribed under Treas. Reg. § 1.163-8T for allocating debt proceeds among expenditures constitute a reasonable method. [Treas. Reg. § 1.704-2(h)(2)]

3142 Obligation to Restore

A partnership may treat any distribution to a partner of the proceeds of a nonrecourse liability (that would otherwise be allocable to an increase in partnership minimum gain) as a distribution that is not allocable to an increase in partnership minimum gain to the extent the distribution does not cause or increase a deficit balance in the partner's capital account that exceeds the amount the partner is otherwise obligated to restore (within the meaning of § 1.704-1(b)(2)(ii)(c)) as of the end of the partnership taxable year in which the distribution occurs. [Treas. Reg. § 1.704-2(h)(3)]

3143 Carryover

The carryover rule applies if the net increase in partnership minimum gain for a partnership taxable year that is allocable to a non-recourse liability exceeds the distributions allocable to proceeds of the liability ("excess allocable amount"), and all or part of the net increase in partnership minimum gain for the year is carried over as an increase in partnership minimum gain for the immediately succeeding taxable year. The excess allocable amount is treated in the succeeding taxable year as an increase in partnership minimum gain that arose in that year as a result of incurring the non-recourse liability to which the excess allocable amount is attributable. [Treas. Reg. § 1.704-2(h)(4)]

For illustration, see Treas. Reg. § 1.704-2(m), Ex. 1(vi).

3150 Minimum Gain Chargeback Requirement

General rule: If there is a net decrease in partnership minimum gain for a partnership taxable year, the minimum gain chargeback requirement applies and each partner must be allocated items of partnership income and gain for that year equal to that partner's share of the net decrease in partnership minimum gain as computed in PTM 3120. [Treas. Reg. § 1.704-2(f)(1)]

PTM 3151 Allocation of Minimum Gain Chargeback

PTM 3152 Exception for Conversion and Refinancing

PTM 3153 Exception for Capital Contributions

PTM 3154 Waiver for Income Allocations

PTM 3155 Items Subject to Minimum Gain Chargeback Requirement

3151 Allocation of Minimum Gain Chargeback

Allocation of gain attributable to a decrease in partnership minimum gain (referred to a “minimum gain chargeback”, see PTM 3100) must be made to the partners that either were allocated non-recourse deductions or received distributions of proceeds attributable to a non-recourse borrowing. [Treas. Reg. § 1.704-2(f)(1)]

3152 Exception for Conversion and Refinancing

A partner is **not** subject to the minimum gain chargeback requirement to the extent (1) the partner’s share of the net decrease in partnership minimum gain is caused by a recharacterization of nonrecourse partnership debt as partially or wholly recourse debt or partner non-recourse debt, and (2) the partner bears the economic risk of loss (within the meaning of Treas. Reg. § 1.752-2) for the liability. [Treas. Reg. § 1.704-2(f)(2)]

Example: *Tony and Jenny form a partnership, each contributes \$2,500 to the partnership and agree to share all losses and profit equally. Neither of the partners is required to restore their deficit capital account balances. All the requirements regarding allocations of non-recourse liabilities are met (See PTM 3030). The partnership obtains a \$10,000 non-recourse loan from an unrelated party and purchases two assets: stocks for \$5,000 and depreciable property for \$10,000. The non-recourse loan is secured by the depreciable property. The partnership generates \$2,000 of depreciation in each of its first 5 years and that is its only tax item. These deductions are properly treated as non-recourse deductions and the allocation of these deductions is deemed to be in accordance with the partners’ interests in the partnership. At the end of year 5, each partner has a deficit capital account of \$2,500 and a \$5,000 share of the partnership minimum gain. In the beginning of year 6, due to the lender’s request, Tony guarantees the entire non-recourse liability. Pursuant to Treas. Reg. § 1.704-2(d)(1) (discussed at PTM 3060), the conversion of the non-recourse liability into partner non-recourse liability causes a net decrease in minimum gain of \$10,000 and under Treas. Reg. § 1.704-2(g)(2) (See PTM 3130), Tony and Jenny’s share of that net decrease are \$5,000 each. Under the minimum gain chargeback requirement, Jenny is subject to \$5,000 minimum gain chargeback. Because the partnership does not have income in year 6, the entire \$5,000 is carried over to succeeding taxable years until there is enough income to cover the minimum gain chargeback requirement. Under the exception discussed above, Tony is not subject to a minimum gain chargeback because he bears*

the economic risk of loss for the liability. Tony's share of "partner non-recourse debt minimum gain" is \$5,000 under Treas. Reg. § 1.704-2(i)(3).

In year 7, the partnership earns \$10,000 of net operating income and uses the money to repay the entire non-recourse liability that Tony guaranteed. Under § 1.704-2(i)(3), the partnership has a net decrease in partner non-recourse debt minimum gain of \$5,000. Jenny must be allocated \$5,000 of the operating income pursuant to the carried over minimum gain chargeback requirement. Under § 1.704-2(i)(4), Tony is allocated the other \$5,000 of operating income as a partner non-recourse minimum gain chargeback. (See PTM 3150)

3153 Exception for Capital Contributions

A partner is not subject to the minimum gain chargeback requirement to the extent the partner contributes capital to the partnership that is used to repay the non-recourse liability or is used to increase the basis of the property subject to the non-recourse liability, and the partner's share of the net decrease in partnership minimum gain results from the repayment or the increase to the property's basis. [Treas. Reg. § 1.704-2(f)(3)]

3154 Waiver for Income Allocations

In any taxable year that a partnership has a net decrease in partnership minimum gain, if the minimum gain chargeback requirement would cause a distortion in the economic arrangement among the partners and it is **not** expected that the partnership will have sufficient other income to correct that distortion, the Commissioner has the discretion, if requested by the partnership, to waive the minimum gain chargeback requirement. The conditions for such a waiver request is provided in § 1.704-2(f)(4). The Commissioner may also provide additional exceptions through revenue rulings. [Treas. Reg. § 1.704-2(f)(4) & (5)]

Example: *Partnership LG consists of two partners: limited partner L, and general partner G. L contributes \$9,000 and G contributes \$1,000 to the partnership. The partnership agreement has a minimum gain chargeback provision and provides that except as otherwise required by § 704(c), all losses will be allocated 90 percent to L and 10 percent to G; and that all income will be allocated first to restore previous losses and thereafter shared equally between L and G. Distributions are made first to return initial capital to the partners and then shared equally between the two partners. Final distributions are made in accordance with the partners' capital account balances. The partnership borrows \$20,000 on a non-recourse basis from an unrelated party and purchases an asset for \$30,000. The partnership's only tax item for each of the first three taxable years is \$10,000 of depreciation on the asset. L's and G's share of minimum gain (for computation, see PTM 3072) and deficit capital account balances are*

CALIFORNIA FRANCHISE TAX BOARD

\$18,000 and \$2,000 respectively at the end of the third taxable year. In the fourth year, the partnership earns \$40,000 of net operating income and allocates the first \$30,000 to restore the previous losses (\$27,000 to L and \$3,000 to G); the last \$10,000 is allocated equally between L and G. The partnership also distributes \$20,000 of available cash the same year. The first \$10,000 is to return the partners' initial capital (\$9,000 to L and \$1,000 to G). The last \$10,000 is distributed equally between L and G to reflect their ratio for sharing profit. Their capital accounts are as follows:

| | L | G |
|--|-----------------|----------------|
| <i>Capital account on formation</i> | \$9,000 | \$1,000 |
| <i>Less: net losses in yr. 1 - 3</i> | <u>(27,000)</u> | <u>(3,000)</u> |
| <i>Capital accounts at end of yr. 3</i> | <u>(18,000)</u> | <u>(2,000)</u> |
| <i>Allocation of income to restore non-recourse deductions</i> | \$18,000 | \$2,000 |
| | | |
| <i>Allocation of operating income to restore cap. Contr.</i> | 9,000 | 1,000 |
| <i>Allocation of operating income to reflect profit</i> | <u>5,000</u> | <u>5,000</u> |
| <i>Capital accounts after allocations of income</i> | \$14,000 | \$6,000 |
| <i>Distribution reflecting capital contribution</i> | (9,000) | (1,000) |
| <i>Distribution in profit sharing ratio (50/50)</i> | <u>(5,000)</u> | <u>(5,000)</u> |
| <i>Capital account after distributions</i> | \$0 | \$0 |

In the fifth year, the partnership sells the property for \$30,000 and realizes \$30,000 gain. The proceeds are used to pay off the \$20,000 non-recourse debt. The partnership has total cash of \$30,000 (\$20,000 cash left from year 4 after distribution of \$20,000 of its total income of \$40,000) to distribute and the partners expect to share it equally. However, without a waiver discussed above, the minimum gain chargeback would require the partnership to allocate the first \$20,000 of the gain \$18,000 to L and \$2,000 to G, which would distort their economic arrangement. This allocation, together with the allocation of the remaining \$10,000 profit \$5,000 to each, would result in L having a positive capital account balance of \$23,000 and G having a positive capital account balance of \$7,000. In effect, the allocation of \$40,000 income in year 4 anticipated the minimum gain chargeback that did not occur until year 5. Assuming the partnership does not have sufficient other income to correct the distortion that would otherwise result, the partnership may request that the Commissioner exercise her discretion to waive the minimum gain chargeback requirement and recognize allocation that would allow L and G to share equally the \$30,000 gain on the sale of the property. This allocation may be permitted by the Commissioner as discussed above.

Observation: *Note that in this example, the application of the minimum gain chargeback requirement in year 5 becomes a distortion because the partnership already allocated the \$40,000 income in year 4 in a manner that reduces the deficit balances caused by the allocation of non-recourse deductions in the previous three years. Thus,*

the \$30,000 income realized by the partnership in year 5 should be allocated equally between the two partners as they agreed to share the economic benefit equally after all prior losses are offset and initial capital is returned through distribution. Assuming there was no income in year 4, the gain in year 5 would have to be allocated pursuant to the minimum gain chargeback requirement.

3155 Items Subject to Minimum Gain Chargeback Requirement

Any minimum gain chargeback required for a partnership taxable year consists first a pro rata portion of certain gains recognized from the disposition of partnership property subject to one or more partnership non-recourse liabilities and income from the discharge of debt relating to one or more partnership nonrecourse liabilities to which partnership property is subject, and then if necessary consists of a pro rata portion of the partnership’s other items of income and gain for that year. If the amount of the minimum gain chargeback requirement exceeds the partnership’s income and gains for the taxable year, the excess carries over. [Treas. Reg. § 1.704-2(f)(6)]

3200 PARTNER NON-RECOURSE LIABILITIES

A non-recourse liability is defined as a liability for which no partner or related person bears the economic risk of loss, or a § 1.752-7 liability (as defined in § 1.752-7(b)(3)(i)) assumed by the partnership from a partner on or after 6/24/03. [Treas. Reg. § 1.704-2(b)(3)]. (See PTM3040). However, if a partner or related person bears the economic risk of loss with respect to the liability (i.e. the partner or related person is the creditor or guarantor), the non-recourse liability is treated as a partner non-recourse liability. (See PTM 3220) [Treas. Reg. § 1.704-2(b)(4)]

In general, since none of the partners bears the economic risk of loss regarding non-recourse liabilities, the regulations provide rules for allocating deductions attributable to these liabilities based on the concepts of minimum gain, minimum gain chargeback, etc. However, when one or more partners bear the economic risk of loss with regard to a non-recourse liability, the non-recourse liability becomes those partners' non-recourse liability and the allocation rules regarding non-recourse liability generally apply to the partners who bear the economic risk of loss.

- PTM 3210 Definitions of Partner Non-recourse Liabilities
- PTM 3220 Non-recourse Deductions and Economic Risk of Loss
- PTM 3230 Determination of Partner Non-recourse Deductions

3210 Definition

A “partner non-recourse liability” means any partnership liability:

- to the extent the liability is non-recourse for purposes of Treasury Regulations §1.1001-2 and
- a partner or related person bears the economic risk of loss because the partner or the related person is the creditor or the guarantor. [Treas. Reg. § 1.704-2(b)(4)]

Treasury Regulation § 1.1001-2 does not provide a definition of non-recourse liability, but its examples refer to a non-recourse liability as the liability for which the borrower is “**not** personally liable on the note...” and in the event of default the creditor’s “only recourse is to the asset”. [Treas. Reg. § 1.1001-2(c), Ex. (2)]

3220 Non-recourse Deductions and Economic Risk of Loss

In general, partnership losses, deductions, or IRC § 705(2)(a)(B) expenditures that are attributable to a particular partner non-recourse liability (referred to as “partner non-recourse deduction”) must be allocated to the partner that bears the economic risk of loss for the liability.

If more than one partner bears the economic risk of loss for a partner nonrecourse liability, the partner non-recourse deductions must be allocated among the partners according to the ratio in which they bear the economic risk of loss.

If partners bear the economic risk of loss for different portions of a liability, each portion is treated as a separate partner non-recourse liability. [Treas. Reg. § 1.704-2(i)(1)]

3230 Determination of Partner Non-recourse Deductions

For any partnership taxable year, the amount of partner non-recourse deductions with respect to a partner non-recourse debt equals:

- the net increase during the year in minimum gain attributable to the partner non-recourse debt (referred to as “partner non-recourse debt minimum gain”),
- reduced (but not below zero) by proceeds of the liability distributed during the year to the partner bearing the economic risk of loss for the liability that are both attributable to the liability and allocable to an increase in the partner non-recourse debt minimum gain. [Treas. Reg. § 1.704-2(i)(2)]

The determination of the following items with respect to the partner non-recourse liability are similar to the determination of the corresponding items with respect to the non-recourse liability:

- Partnership items constituting the partner non-recourse deductions (see PTM 3070) [Treas. Reg. § 1.704-2(i)(2)]
- Partner non-recourse debt minimum gain and the share of this minimum gain (See PTM 3060) [Treas. Reg. § 1.704-2(i)(3)]
- Chargeback of partner non-recourse debt minimum gain (See PTM 3150) [Treas. Reg. § 1.704-2(i)(4)]
- Partner’s share of partner non-recourse debt minimum gain (See PTM 3100) [Treas. Reg. § 1.704-2(i)(5)]
- Distribution of partner non-recourse debt proceeds allocable to an increase in partner non-recourse debt minimum gain (See PTM 3140, PTM 3141) [Treas. Reg. § 1.704-2(i)(6)]

3300 ORDERING RULES

Allocations of partner non-recourse deductions, non-recourse deductions, and minimum gain chargebacks are made before any other allocations. [Treas. Reg. 1.704-2(j)]

The following ordering rules are for allocations of:

- partner non-recourse deductions (PTM 3310),
- partnership non-recourse deductions (PTM 3320), and
- the minimum gain chargeback (PTM 3340).

Note: To help understand these rules, the auditor should bear in mind that many rules regarding partner non-recourse debt are similar to the corresponding rules regarding partnership non-recourse debt. For distinction between partner nonrecourse debt and partnership non-recourse debt, see PTM 3040 & PTM 3220.

- PTM 3310 Partner Non-recourse Deductions
- PTM 3320 Partnership Non-recourse Deductions
- PTM 3330 Carryover
- PTM 3340 Minimum Gain Chargeback

3310 Partner Non-recourse Deductions

Partnership losses, deductions, and IRC § 705(a)(2)(B) expenditures are treated as partner non-recourse deductions in the following order:

1. First, depreciation or cost recovery deductions with respect to property that is subject to partner non-recourse debt;
2. Then, if necessary, a pro rata portion of the partnership’s other deductions, losses, and IRC § 705(a)(2)(B) expenditures.

Depreciation or cost recovery deductions with respect to property that is subject to a partnership non-recourse liability is treated a partnership non-recourse deduction and any excess is treated as a partner non-recourse deduction. [Treas. Reg. § 1.704-2(j)(1)(i)]

3320 Partnership Non-recourse Deductions

The ordering rules are similar to the partner non-recourse deductions rules above.

Partnership losses, deductions, and IRC § 705(a)(2)(B) expenditures are treated as partnership non-recourse deductions in the following order:

1. First, depreciation or cost recovery deductions with respect to property that is subject to partnership non-recourse debt;
2. Then, if necessary, a pro rata portion of the partnership's other deductions, losses, and IRC § 705(a)(2)(B) expenditures.

Depreciation or cost recovery deductions with respect to property that is subject to a partner non-recourse liability is first treated as partner non-recourse deduction and any excess is treated as a partnership non-recourse deduction. Any other item that is treated as a partner nonrecourse deduction will in no event be treated as a partnership nonrecourse deduction. [Treas. Reg. § 1.704-2(j)(1)(ii)]

3330 Carryover

If the amount of non-recourse deductions or partner non-recourse deductions exceeds the partnership losses, deductions, and IRC § 705(a)(2)(B) expenditures for the taxable year, the excess is treated as an increase in the partnership minimum gain or the partner non-recourse minimum gain in the immediately succeeding partnership taxable year. [Treas. Reg. § 1.704-2(j)(1)(iii)]

For illustration, see treasury regulation § 1.704-2(m), Ex. 1(vi).

Observation: *For a number of reasons, the cost recovery deductions of a partnership may be less than the increase in partnership minimum gain. For example, the increase in partnership minimum gain may be attributable to secondary borrowing and the proceeds are distributed in the subsequent years or retained to pay partnership expenses. In the absence of secondary borrowing, there will always be sufficient cost recovery deductions because those deductions will have been responsible for the increase in partnership minimum gain.*

3340 Minimum Gain Chargeback

Items of partnership income and gain equal to the minimum gain chargeback requirement (See PTM 3150) are allocated as a minimum gain chargeback in the following order:

- First, a pro rata portion of gain from the disposition of property subject to partnership nonrecourse liabilities and COD income relating to partnership nonrecourse liabilities to which property is subject;
- Then, if necessary, a pro rata portion of the partnership's other items of income and gains for that year;

Similarly, items of partnership income and gain equal to the partner nonrecourse debt minimum gain chargeback are allocated to satisfy a partner nonrecourse debt minimum gain chargeback requirement in the following order:

- First, a pro rata portion of gain from the disposition of property subject to partner nonrecourse debt and COD income relating to partner nonrecourse debt to which property is subject;
- Then, if necessary, a pro rata portion of the partnership's other items of income and gain for that year.

Gain from the disposition of property subject to partnership non-recourse debt is allocated to satisfy the partnership minimum gain chargeback requirement first. The excess is allocated to the partner non-recourse debt minimum gain chargeback.

Gain from the disposition of property subject to partner non-recourse debt is allocated to satisfy the partner minimum gain chargeback requirement first. The excess is allocated to the partnership non-recourse debt minimum gain chargeback. [Treas. Reg. § 1.704-2(j)(2)(i) and (ii)]

If a minimum gain chargeback requirement exceeds partnership's income and gains for the taxable year, the excess is treated as a minimum gain chargeback requirement in the following partnership taxable years until fully charged back. [Treas. Reg. § 1.704-2(j)(2)(iii)]

3400 TIERED PARTNERSHIPS

When a partnership ("upper tier partnership") is a partner in another partnership ("lower tier partnership"), the following rules apply:

- Increases in upper tier partnership's minimum gain: The sum of non-recourse deductions that the lower tier partnership allocates to the upper tier partnership for any taxable year of the upper tier partnership, and the distributions (of non-recourse debt proceeds) from the lower tier partnership to the upper tier partnership that are allocable to an increase in the lower tier partnership's minimum gain, is treated as an increase in the upper tier partnership's minimum gain. (The rule applies as if the upper tier partnership were an individual partner.) [Treas. Reg. § 1.704-2(k)(1)]
- Decreases in upper tier partnership's minimum gain: An upper tier partnership's share of the lower tier partnership's net decrease in minimum gain is treated as a decrease in the upper tier partnership's minimum gain. [Treas. Reg. § 1.704-2(k)(2)]
- Non-recourse Debt proceeds distributed from the lower tier partnership to upper tier partnership are treated as proceeds of a non-recourse debt of the upper tier partnership (provided that the non-recourse liability proceeds are allocable to an increase in the lower tier partnership's minimum gain.) [Treas. Reg. § 1.704-2(k)(3)]
- All non-recourse deductions of lower tier partnership are treated as depreciation by upper tier partnership. [Treas. Reg. § 1.704-2(k)(4)]
- Coordination with partner non-recourse debt rules: The lower tier partnership's liabilities that are treated as the upper tier partnership's liabilities under Treas. Reg. § 1.752-4(a) are treated as the upper tier partnership's liabilities for purposes of applying the rules regarding partner non-recourse loans. [Treas. Reg. § 1.704-2(k)(5)]

3500 EFFECTIVE DATES

- In general, the rules discussed throughout the PTM 3000 series apply for partnership taxable years beginning on or after December 28, 1991. [Treas. Reg. § 1.704-2(l)(1)]
- A partnership may elect to apply the provisions of this section (i.e., the rules discussed throughout PTM 3000) to the first taxable year of the partnership ending on or after December 28, 1991 by attaching a written statement to the partnership return filed for the first taxable year ending on or after December 28, 1991. [Treas. Reg. § 1.704-2(l)(4)]
- For the rules applicable to partnership taxable years beginning after December 29, 1988, and before December 29, 1991, see former § 1.704-1T(b)(4)(iv). [Treas. Reg. § 1.704-2(l)(1)]

CALIFORNIA FRANCHISE TAX BOARD

- For the rules applicable to taxable years beginning on or before December 28, 1988, see former § 1.704-1(b)(4)(iv). [Treas. Reg. § 1.704-2(l)(1)]
- For special rule applicable to pre-January 30, 1989 regarding related party of non-recourse debt, see § 1.704-2(l)(2).
- For transition rule for pre-March 1, 1984 regarding partner non-recourse debt, see § 1.704-2(l)(3).