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The Negative Capital Account Maze

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In this report, Schwidetzky provides an integrated discussion of the tax and nontax ramifications of partners' negative capital accounts.

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I. Introduction

Capital accounts play a central role in partnership taxation. Under some circumstances, partners are permitted to have negative capital accounts. Outside *Hubert I*[1] and *Hubert II*,[2] there has been little discussion of negative capital accounts in the tax context and almost no discussion in the nontax context. Nontax law, however, is critically important. This report provides an integrated discussion of the application of tax and nontax law to negative capital accounts.

One of the challenges in writing this report is that it requires a discussion of both the at-risk rules of section 465 and the debt allocation rules of section 752. Complex issues involving sections 465 and 752 and their interaction are worthy of their own articles. Indeed, others have written those articles.[3] In this report, I endeavor to stay focused on the negative capital account issues. So although I am forced to make forays into sections 465 and 752, I try to keep them restrained.

Partnerships for federal tax purposes normally include state law partnerships and limited liability companies with two or more members.[4] Any discussion of LLCs in this report assumes they are classified as partnerships and that their members are classified as partners for federal tax purposes. Further, in my discussion of section 465, I do not cite or consider the 1979 section 465 proposed regulations. (It is hard to see why proposed regulations from over 35 years ago should be given any credence. They often conflict with case law;[5] even the IRS reasons differently from them;[6] and other

[1]*Hubert Enterprises v. Commissioner*, 125 T.C. 72 (2005), *aff'd in part, vacated in part, and remanded*, 230 Fed. Appx. 526 (6th Cir. 2007).

[2]*Hubert Enterprises Inc. v. Commissioner*, T.C. Memo. 2008-46 (remand decision).

[3]*See, e.g.*, Karen C. Burke, "Illusory DROs: At Risk Lessons From *Hubert*," *Tax Notes*, Jan. 21, 2008, p. 405 (Burke 2008); and Susan Kalinka, "Hubert Enterprises: LLC Members, Partners, Deficit Restoration Obligations, and the At-Risk Rules," *Tax Notes*, July 10, 2006, p. 137. *See also* Ajay Gupta, "Who's at Risk? Abbott and Costello Take on Section 465," 17 *U. Miami Bus. L. Rev*. 47 (2008) (a 109-page behemoth that looks at a variety of associated issues).

[4]*See* reg. section 301.7701-2. An LLC can elect to be taxed as a C corporation or an S corporation. Reg. section 301.7701-3(g). Under section 7704, most publicly traded limited partnerships are taxed as C corporations.

[5]*Compare* prop. reg. section 1.465-22(a), *with Melvin v. Commissioner*, 88 T.C. 63, 75 (1987), *aff'd*, 894 F.2d 1072 (9th Cir. 1990).

[6]*Compare* prop. reg. section 1.465-6(d), *with* ILM 201308028.

writers often pay them little heed.[7]) Finally, unless otherwise indicated, when I discuss a capital account deficit restoration obligation (DRO), an actual DRO is meant. As explained in the primer (the Appendix), in the nonrecourse debt context, it is possible to have a deemed DRO that does not involve an obligation of a partner to make a financial contribution to the partnership.

II. *Hubert* Confusion

A. The Basics

In *Hubert I*, the Tax Court concluded that the DRO of an LLC member (who was a partner for tax purposes) did not increase the member's amount at risk under section 465.[8] That decision was vacated by the Sixth Circuit because the Tax Court failed to apply the ''payer of last resort'' standard (discussed below). The Tax Court in *Hubert II*, on remand, purported to apply the Sixth Circuit standard and came to the same conclusion.[9] Sadly, the case misunderstands important areas of law. (At times I will refer to both cases together as *Hubert*.)

Section 465 is a disallowance provision. It denies taxpayers loss deductions that other code sections otherwise permit. To simplify a bit, section 465 was enacted to prevent taxpayers from taking loss deductions attributable to specific nonrecourse debt.[10] Generally, section 465(a) provides that individuals and some closely held corporations are allowed to take a loss deduction from an activity only to the extent of the taxpayer's amount at risk for the tax year in that activity, with any disallowed loss carried forward until a sufficient amount at risk is developed.[11] The amount at risk includes money contributed by the taxpayer; the basis of property contributed by the taxpayer; and amounts borrowed for use in the activity for which the taxpayer has unprotected personal liability or, alternatively, for which the taxpayer has provided property as security if the property is not used in the activity.[12] Thus, nonrecourse debt generally does not increase the amount at risk.[13] As the Tax Court has noted, the critical inquiry is who is the obligor of last resort when the partnership fails.[14] Thus, for example, a taxpayer is not at risk under the above rules if she agrees to be liable on recourse debt but is entitled to reimbursement from someone else should she be required to pay on the debt.[15] But if she has unprotected exposure, she can be at risk to that extent. Note that the rules for calculating a partner's basis in the partnership interest or capital account are not keyed to the at-risk rules. So even if the at-risk rules deny a tax deduction to a partner, the deduction still reduces the partner's basis in the partnership interest and the partner's capital account.

In the Sixth Circuit, in whose jurisdiction the *Hubert* taxpayers resided, the question is ''whether, in a worst case scenario, the individual taxpayer will suffer any personal, out-of-pocket expenses.''[16] Thus, in the Sixth Circuit, it does not have to be probable, for example, that a partner will end up

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[7] *See* Burke 2008, *supra* note 3, and Kalinka, *supra* note 3, in which the proposed regulations get only the odd mention.

[8] I do not focus on the original Tax Court decision given that it was vacated, but the court's reasoning regarding DROs was vacuous. In concluding that the taxpayer was not at risk under section 465, the court stated: ''As observed by respondent, [the LLC agreement] contains a condition that must be met before the deficit capital account restoration obligation arises. In accordance with that condition, an [LLC] member must first liquidate its interest in [the LLC] before the member has any obligation to the entity. Neither [of the taxpayers] liquidated its interest in [the LLC] during the relevant years.'' *Hubert I*, 125 T.C. at 106. To be at risk under section 465, the taxpayer needs personal liability in the current year; she does not need to make payment in the current year. *See* section 465(b)(2). As I discuss below, there may need to be a realistic possibility of payment, but the mere fact that there is a condition precedent, such as a liquidation of a member's interest, does not prevent liability from arising. There is always some sort of condition precedent to payment, *e.g.*, default by the LLC or demand by the creditor. That the Sixth Circuit vacated the decision suggests that it, too, was unimpressed by the Tax Court's reasoning. *See* Richard M. Lipton, ''At-Risk Rules and DROs: Did the Tax Court Err in *Hubert Enterprises*?'' 103 *J. Tax'n* 325 (2005).

[9] For a more detailed discussion of the case, see Steven Kline and Stephen Looney, ''*Hubert II Enterprises* Revisited,'' *Bus. Entities* (May/June 2008); and Blake Rubin, Andrea Whiteway, and Jon Finkelstein, ''Tax Court Sticks to Its Guns and Sticks It to the Taxpayers in *Hubert II* Case,'' ALI-CLE course materials (Sept. 26-27, 2013). *See also* Lipton and Todd Golub, ''*Hubert Enterprises* Part II: We Can 'Guarantee' a Better Result,'' 109 *J. Tax'n* 14 (2008); Rubin, Whiteway, and Finkelstein, ''*Hubert II Enterprises, Inc.*: Does a Capital Account Deficit Restoration Obligation Increase a Partner's At-Risk Amount on Share of Liabilities,'' 9 *J. Passthrough Entities* ___ (2006); and Rubin, Whiteway, and Finkelstein, ''Sixth Circuit Reverses Controversial Hubert Case Dealing With Partner's Amount at Risk,'' 10 *J. Passthrough Entities* 9 (July-Aug. 2007).

[10] *See* Boris I. Bittker, Martin J. McMahon, and Lawrence A. Zelenak, *Federal Income Taxation of Individuals*, para. 19 (2002).

[11] Section 465(a).

[12] Section 465(b). Generally, amounts borrowed are not considered at risk if borrowed from a person with an interest in the activity or from a person related to a person (other than the taxpayer) with an interest in the activity. *See Pritchett v. Commissioner*, 827 F.2d 644 (9th Cir. 1987); *Gefen v. Commissioner*, 87 T.C. 1471 (1986); and *Abramson v. Commissioner*, 86 T.C. 360 (1986).

[13] There is an exception for qualified nonrecourse financing, which is mostly nonrecourse debt secured by real property and borrowed from a commercial lender. *See* section 465(b)(6).

[14] *Melvin v. Commissioner*, 88 T.C. 63, 75 (1987), *aff'd*, 894 F.2d 1072 (9th Cir. 1990).

[15] Section 465(b)(4).

[16] *Pledger v. United States*, 236 F.3d 315, 319 (6th Cir. 2000). *See Emershaw v. Commissioner*, 949 F.2d 841 (6th Cir. 1991).

having to pay on a partnership debt. She will be at risk to the extent she has unprotected personal liability on the debt in a worst-case scenario. Several other circuits and the Tax Court apply a ''realistic possibility'' test, discussed below.[17]

Hubert involved an equipment leasing LLC (LCL) formed in Wyoming in 1998.[18] LCL was treated as a partnership for tax purposes. Its two members, HBW Inc. and Hubert Commerce Center Inc., were part of a group of affiliated corporations whose common parent was owned by a family trust. As closely held corporations, the members were subject to the at-risk rules. LCL purchased equipment with promissory notes, some of which were nonrecourse and others of which were partially recourse. Under these facts, only the recourse portion of the notes could give rise to an at-risk amount. But the members of the LLC did not sign or guarantee the notes. Because LLC members are not liable for the obligations of the LLC,[19] without more, the members had no liability on the LLC's recourse indebtedness and thus no amount at risk.[20]

But there was more. The LLC agreement was amended to add the following standard-issue DRO:

> Deficit Capital Account Restoration. If any Partner has a deficit Capital Account following the liquidation of his, her or its interest in the partnership, then he, she or it shall 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, for payment to creditors or distribution to Partners with positive capital account balances.[21]

For years postdating the amendment, the court had to address whether the DRO could create an amount at risk. The taxpayer's argument was essentially that in a worst-case scenario, the taxpayer would have to restore a negative capital account (potentially created by the loss allocations generated by the recourse portions of the debt) and that those amounts could be used to pay creditors. Thus, the taxpayer argued that it was at risk on the recourse indebtedness to the extent of the DRO.

B. The Tax Court's Erroneous Reasoning

In *Hubert II*, the Tax Court gave two main reasons why the DRO did not create an amount at risk. The first was that a creditor cannot force the LLC to liquidate. Wyo. Stat. Ann. section 17-15-123, applicable to the case but now repealed, governed when an LLC was dissolved. It is true that the statute did not give creditors the right to cause a dissolution of an LLC. However, the court went so far as to state that ''LCL could not be made to liquidate by a creditor in any circumstance, not even by a creditor that forced LCL into receivership or bankruptcy.'' That is simply wrong. As the Supreme Court recently observed, state law cannot trump federal bankruptcy law.[22] Indeed, federal bankruptcy preemption is one of the few enumerated powers granted to Congress by the Constitution.[23] Creditors can force an LLC into a chapter 7 bankruptcy, and the LLC can be liquidated by the bankruptcy trustee, thereby potentially triggering member DROs.[24] And the potential for this to happen is well short of the Sixth Circuit's worst-case scenario; three or more creditors (or a single creditor if there are fewer than 12 creditors overall) holding at least

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[17]*See Levy v. Commissioner*, 91 T.C. 838 (1988); and *Wag-a-Bag Inc. v. Commissioner*, T.C. Memo. 1992-581. The following are circuit court decisions that apply an economic reality test and deny that a taxpayer is at risk if a transaction is structured so that it removes any realistic possibility that the taxpayer will suffer an economic loss: *Waters v. Commissioner*, 978 F.2d 1310, 1316-1317 (2d Cir. 1992); *Young v. Commissioner*, 926 F.2d 1083, 1089 (11th Cir. 1991); *Moser v. Commissioner*, 914 F.2d 1040, 1048 n.21 (8th Cir. 1990); and *American Principals Leasing Corp. v. United States*, 904 F.2d 477, 482-483 (9th Cir. 1990). *See also Kingston v. Commissioner*, T.C. Memo. 1997-512.

[18]Interestingly, it was formed under the original Wyoming LLC act, which ultimately gave rise to the LLC revolution. *See* Susan Hamill, ''The Origins Behind the Limited Liability Company,'' 59 *Ohio State L.J.* 1459 (1998).

[19]At the time, the relevant rule was in Wyo. Stat. Ann. section 17-15-113 (2007). *See* Carter Bishop and Daniel Kleinberger, ''Limited Liability Companies,'' *Tax and Business Law*, para. 1.01.

[20]Those types of liabilities, recourse to the LLC but not to the members, are sometimes called exculpatory liabilities if they are unsecured. They raise several complex issues. *See* Burke, ''Exculpatory Liabilities and Partnership Nonrecourse Allocations,'' 57 *Tax Law*. 33 (2003) (Burke 2003).

[21]*Hubert II*, T.C. Memo. 2008-46, at *6.

[22]*See Puerto Rico v. Franklin California Tax-Free Trust*, 136 S. Ct. 1938 (2016).

[23]Article I, section 8, clause 4 states that Congress shall have the power to pass ''uniform Laws on the subject of Bankruptcies.'' In my 30-plus years of teaching and scholarship, this may be the first time I have made a citation to the Constitution that was not to the 16th Amendment. The credit for this unique opportunity goes to professor Scott Ehrlich of California Western School of Law, who teaches bankruptcy law and schooled me on the relevant provisions. In Burke 2008, *supra* note 3, at the text accompanying note 104 of that article, Burke states that ''the remote possibility that a bankruptcy trustee might be permitted to enforce the members' DROs should not suffice to render the obligation unconditional for purposes of sections 704(b) and 752,'' and she cites reg. section 1.752-2(b)(3), although reg. section 1.752-2(b)(4) is actually meant, which disregards contingent obligations that are unlikely to be discharged until a future event occurs. As much as I respect Burke as a scholar, the possibility of a bankruptcy trustee enforcing a DRO strikes me, more often than not, as a probability. I think it would be a virtual certainty in many fact patterns.

[24]*See* Bankruptcy Code section 303; *see also* Peter J. Lahny IV, 4-41 *Debtor Creditor Law*, section 41.02.

$15,000 in debt can file an involuntary petition if the debtor is generally not paying debts as they come due.[25]

Further, it is not clear from the LLC agreement whether the DRO was triggered by a state law liquidation or tax liquidation. Many tax professionals likely would assume the latter. As discussed in the primer, the whole idea of a DRO provision principally comes from tax law — that is, the regulations under section 704(b), which address when allocations of partnership items of income and deduction are allowed.[26] Under section 708 and its regulations, a liquidation occurs when a partnership ceases to be a going concern.[27] Thus, even putting aside bankruptcy law, if tax liquidation was meant in the *Hubert* DRO provision, LCL and its members did not have complete control over whether liquidation occurred. If LCL failed or ceased operations for other reasons, it could be deemed liquidated and the DROs could be triggered. Although it would not be creditors forcing the liquidation in that scenario, it still means that forces beyond the control of LCL or its members could trigger a liquidation and the DROs. This undermines the reasoning of the court.[28]

The second reason the *Hubert II* court gave for its conclusions was that a DRO need not match a member's unpaid share of the recourse indebtedness. Although the math can sometimes get tricky, assuming no distributions, it is often the existence of debt that allows a partner to develop a negative capital account. As discussed in the primer, any money or property contributed by the partner gives rise to a positive capital account balance and a positive outside basis. Debt increases the outside basis but not the capital account. And under section 704(d), a partner may not deduct losses exceeding her outside basis.[29] In what is likely the most typical case, for a capital account to be negative, recourse or nonrecourse debt must be generating deductions. That is when the Sixth Circuit's worst-case scenario comes into play. In the abstract, it is indeed difficult to predict why a given partner's capital account might be negative. Perhaps she got a disproportionate share of loss allocations, perhaps it was because of deductions attributable to nonrecourse debt, or perhaps she received a distribution. But in a worst-case scenario, it is of course possible (and often probable) that the recourse debt would force the capital account to go negative and enforcement of the DRO would provide the funds necessary to pay the recourse debt. Indeed, before *Hubert II*, tax practitioners widely assumed that a DRO created an at-risk amount for this very reason. Thus, the Tax Court's analysis appears to contradict the Sixth Circuit standard, which it was supposed to apply.

The Tax Court also reasoned that the DRO by its terms does not require that the amount contributed be paid to creditors because it could be paid to partners with positive capital account balances. That is again wrong, at least if the LLC does not want to violate debtor-creditor law. An LLC cannot prefer a member to a creditor. It must pay its creditors before its members if it is insolvent or if a distribution to a member would render it insolvent.[30]

But it gets better. The court also stated:

> If a member of a limited liability company is automatically "at risk" for repayment of the company's recourse debt simply by inserting a DRO in the operating agreement in order to meet the requirements of section 704(b), then

[25]*See* Bankruptcy Code section 303(b) and (h).

[26]*See* reg. section 1.704-1(b)(2)(ii); and Rubin, Whiteway, and Finkelstein, "Tax Court Sticks," *supra* note 9, which also discusses this issue.

[27]Reg. section 1.708-1(b)(1) provides that "a partnership shall terminate when the operations of the partnership are discontinued and 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."

[28]*See* Rubin, Whiteway, and Finkelstein, "Tax Court Sticks," *supra* note 9, which also discusses this issue.

[29]*See infra* notes 118-123 and accompanying text.

[30]The Revised Uniform Limited Liability Company Act (RULLCA) section 405 provides limitations on distributions, and RULLCA section 406 sets forth the liability of members and managers for making an improper distribution. RULLCA section 405(a) states that a distribution may not be made if it renders the LLC insolvent. The tougher question is who may enforce the liability under RULLCA section 406, because the liability is to the LLC and presumably the errant members or managers are not going to enforce it against themselves. So a creditor may need to seek to have a receiver appointed for the LLC who can then claw back the improper distributions to the LLC or place the LLC into an involuntary bankruptcy and get the trustee to do the clawback.

Further, a distribution while the LLC is insolvent or that would render it insolvent is an "avoidable transaction" (the new term for a "fraudulent transfer") under the Uniform Voidable Transactions Act (UVTA), aka the 2014 revisions to the Uniform Fraudulent Transfer Act. If the distribution was intended to defeat the LLC's creditors, it is an avoidable transaction under UVTA section 4(a). If the LLC was rendered insolvent, it is an avoidable transaction under UVTA section 5(a). The Wyoming law that applied when the case arose is mostly consistent with the above. *See* Wyo. Stat. Ann. section 17-15-121(d) (1977) (now repealed); and Wyo. Stat. Ann. sections 34-14-205 and 34-14-206 (1977). *See* Harvey Gelb, "Liabilities of Members and Managers of Wyoming Limited Liability Companies," 31 *Land & Water L. Rev*. 133 (1996). *See also* Dale W. Cottam et al., "The 2010 Wyoming Limited Liability Company Act: A Uniform Recipe With Wyoming 'Home Cooking,'" 11 *Wyo. L. Rev*. 49 (2011). Many thanks to Jay Adkisson, who knows more about debtor-creditor law than I could ever hope to (or want to) and helped me write this footnote.

> the at-risk rules of section 465 have little purpose in that seemingly every member of a limited liability company is at risk for the repayment of the company's recourse debt.[31]

Here the court demonstrates a fundamental lack of understanding of partnership tax law. Partners do not lightly agree to DROs. Attorneys often do not want their clients to agree to them precisely because of the underlying liability exposure.[32] The regulations provide their rules on DROs precisely so an allocation to a partner can have economic effect (that is, have a real economic impact).[33] As discussed below, I agree that in some circumstances the mere existence of a DRO might not give rise to an at-risk amount, but the court seems to treat DROs as some sort of superfluous boilerplate. DROs are far from that and far from routine.

Would it make a difference if instead of a worst-case scenario standard, a more rigorous test were applied? The Tax Court and most circuits have held that there must be a ''realistic possibility'' that a taxpayer will be liable on recourse debt in order to be at risk.[34] The cases that concluded that a taxpayer was not at risk on recourse debt under the realistic possibility test involved complex circular leasing structures with underlying nonrecourse debt and other protections, making it indeed unlikely that the taxpayer would have to pay on the recourse debt. None of those cases discussed DROs, and they are a far cry from the *Hubert* position that the existence of a DRO by definition cannot create an amount at risk. A realistic possibility cannot mean probability or else only businesses likely to fail would have at-risk amounts under section 465.

Hubert involved both nonrecourse and recourse notes. In general, if an LLC owns properties secured by recourse and nonrecourse debt, it is not at all unlikely that if the LLC's business fails, the creditors would foreclose on the properties to ''collect'' on the nonrecourse indebtedness and sue on the recourse debt (possibly without foreclosure if foreclosure on the nonrecourse debt exhausted the available collateral). In a failed business scenario, it is not only possible but probable that the LLC would be forced to liquidate through a voluntary or involuntary bankruptcy proceeding. And upon liquidation, members would be called on to restore their deficit capital accounts, with the amounts contributed used to pay the outstanding recourse indebtedness. Thus, it could have been a very realistic possibility in *Hubert* that the amounts paid by the members under their DROs would be used to pay the recourse indebtedness.

A more detailed look: In the LLC setting, what counts as recourse debt and nonrecourse debt gets tricky because debt can be recourse to the LLC but be nonrecourse to the members, who, in their capacity as members, have no liability on LLC recourse debt (often called exculpatory debt[35]). Others have addressed this area, and I will not revisit it in detail here, but baseline classification of debt as recourse or nonrecourse is important.[36] Although I will discuss the section 752 regulations below, for now it is important to note that it is possible under those regulations for a debt to be recourse to the extent of obligations under DROs.[37]

The next part of this discussion assumes that the nominal LLC recourse debt in fact counts as recourse debt under section 752 to the extent of DROs and that any LLC nonrecourse debt is secured by property.[38] Keeping those assumptions in mind, recall that both nonrecourse and recourse debt can cause a capital account to go negative.[39] If the business fails, foreclosure of the property securing the nonrecourse debt will generate gain if the amount of the nonrecourse debt exceeds the basis of the property, as often will be the case and almost certainly will be the case if nonrecourse debt caused the capital account to go negative.[40] To oversimplify somewhat, that gain will commonly eliminate the deficit in the capital account attributable to the nonrecourse debt.[41] Assuming no distributions — unlikely to be made if a business is failing — any negative capital account remaining will necessarily be attributable to the recourse debt, and when the members restore the deficit capital account, the amount paid must be used to pay the recourse creditors. This is true both under debtor-creditor law and under the *Hubert* DRO language, which by

[31]*Hubert II*, T.C. Memo. 2008-46, at *18.

[32]*See* Kline and Looney, *supra* note 9; all my coauthors of Richard M. Lipton et al., *Partnership Taxation* (2012), tell me they avoid DROs.

[33]*See infra* notes 118-121 and accompanying text.

[34]*Waters*, 978 F.2d at 1316-1317; *Young*, 926 F.2d at 1089; *Moser*, 914 F.2d at 1048 n.21; and *American Principals Leasing Corp.*, 904 F.2d at 482-483.

[35]*See* Burke 2003, *supra* note 20.

[36]*Id.*; Burke 2008, *supra* note 3. *See also* Michael A. Oberst, ''The Disappearing Limited Deficit Restoration Obligation,'' 56 *Tax Law*. 485 (2003).

[37]*See infra* notes 53-59 and accompanying text.

[38]For ''true'' nonrecourse debt, partners normally do not have a DRO but are allowed to have negative capital accounts to the extent of their share of minimum gain. *See infra* notes 133-149 and accompanying text.

[39]*See infra* notes 118-149 and accompanying text.

[40]*Tufts v. Commissioner*, 461 U.S. 300 (1983).

[41]I am resisting the temptation to bury the reader in the details of the regulations on the allocation of nonrecourse deductions in reg. section 1.704-2. But note that the regulations focus on book gain, which need not be identical to tax gain. *See* Lipton et al., *supra* note 32, at para. 5.07.

its terms specifically allowed contributed funds to be used to pay creditors. This sequence of events, while complex, need not be at all unrealistic or a stretch. Thus, even under the more rigorous realistic possibility test, the taxpayers' DROs could have created an amount at risk.

That said, when recourse debt, secured nonrecourse debt, and perhaps exculpatory debt are involved, the analysis can get very complicated. The exact terms of the relevant promissory notes need to be analyzed, as do the tax consequences of any deemed liquidation of the partnership. My analysis assumes that because of the DROs, some debt will be classified as recourse. That will often be true, particularly because creditors can force a partnership into bankruptcy and thus trigger the DROs. But it is not an inevitability. If nominal recourse debt has priority as to partnership assets over nonrecourse debt, the assets may be sufficient to pay the recourse debt. In that case, there may be nothing left for the nonrecourse creditors to receive, making the cancellation of the nonrecourse debt cancellation of indebtedness (COD) income.[42] A true nonrecourse creditor should not be able to enforce a DRO because that would have the effect of making nonrecourse debt recourse. Thus, there are indeed scenarios in which DROs may not be meaningful. To resolve the at-risk question, one has to run the numbers assuming a failed business and determine whether creditors can enforce the DRO, and, if so, how payment on the DRO would be used. Without that effort, it is impossible to calculate the at-risk amount. Alas, the Tax Court in *Hubert* did not make that effort.[43]

The fundamental problem with *Hubert* is that the Tax Court made what amounted to a categorical decision that a DRO per se cannot lead to an amount at risk. That conclusion conflicts with section 465 and associated case law, which focus on bottom-line economic exposure. There is no doubt that there are many fact patterns in which a DRO can create near-term, legitimate economic exposure on recourse debt and other fact patterns in which this is not the case. The issue is not whether there is a DRO but whether under all the facts and circumstances there is, in the Sixth Circuit, a worst-case possibility of economic risk and, outside the Sixth Circuit, a realistic possibility of economic risk. The focus should be on all the facts and circumstances, not on DROs.

[42]*See* Burke 2008, *supra* note 3, for an excellent discussion of these issues.

[43]*See* Kalinka, *supra* note 3, and Burke 2008, *supra* note 3, in which the authors offer some possible calculations.

C. Timing

Does a capital account actually have to be negative for a DRO to give rise to an at-risk amount? In *Hubert I*, the Tax Court mentioned in passing that the partners' capital accounts were not negative.[44] The court did not discuss the matter further, and under the facts of the case, it does not appear that this could literally have been true. LCL incurred losses significantly in excess of the members' capital account balances in the relevant tax years.[45] Under section 465(a), the at-risk determination is made annually.[46] In other words, the taxpayer must be at risk in the current tax year before section 465 will permit a deduction. Accordingly, if the sole basis for being at risk is a DRO, a partner is at risk in a given tax year only to the extent that her capital account is actually negative.

It is quite possible for a capital account to exceed a partner's outside basis before taking into account partnership debt. Consider, for example, an LLC taxed as a partnership to which the member's sole contribution is property with a tax basis of $1,000 and a fair market value of $10,000. The member's outside basis is $1,000,[47] but his capital account is $10,000.[48] Under section 704(d), the tax losses that he is allowed to deduct are limited to $1,000. His at-risk amount is also $1,000.[49] If, however, the member is allocated $5,000 of recourse debt under section 752, that debt increases his outside basis to $6,000.[50] Now the member is allowed to deduct $6,000 of losses under section 704(d), which in turn reduces his capital account to $4,000. However, section 465 disallows the loss deduction unless the member is at risk on his share of the debt. If the sole basis for making the member at risk is a DRO, the member could not be at risk in this example because the capital account is not negative. Even after he fully "uses up" his outside basis, he would still have a positive capital account and no real way of going negative. If, however, the recourse debt allocated to the member is $20,000, his outside basis increases to $21,000, with the capital account remaining at $10,000. If he is allocated losses of $21,000, his capital account becomes a negative $11,000. Under those facts, a DRO of at least $11,000

[44]*Hubert I*, 125 T.C. at 84.

[45]*See* Kalinka, *supra* note 3, in which Kalinka suggests that the court might have meant basis rather than true capital accounts, and she also calculates possible negative capital account balances.

[46]In contrast, section 752 includes liabilities in basis regardless of whether they are needed to permit a loss deduction.

[47]Section 722.

[48]*See infra* notes 118-121 and accompanying text.

[49]Section 465(b)(1).

[50]*See* sections 752(a) and 722.

should (*Hubert* notwithstanding) increase the taxpayer's at-risk amount by $11,000 (to a total of $12,000 counting the basis of the contributed property). Thus, $12,000 of losses allocated to the member are potentially deductible under the at-risk rules.[51] But because the at-risk determination must be made annually, the member would have to have a negative capital account for the at-risk rules to be relevant. The member will be unable to deduct the first $9,000 of losses if he does not have some independent basis for being at risk, because those losses would not cause his capital account to go negative.

D. Indefensible Decision?

So were the *Hubert* courts' decisions wholly indefensible? Perhaps not quite, although the courts seemed mostly unaware of their best arguments. In *Hubert II*, the Tax Court noted that the LLC agreement contained the following additional (often-seen) language:

> Nothing express or implied in this Agreement is intended or shall be construed to confer upon or to give any person or entity, other than the parties or their successors-in-interest in accordance with the provision of this Agreement, any rights or remedies hereunder or by reason hereof.

This language should prevent creditors from being third-party beneficiaries of any DRO. In yet another example of sloppy opinion writing, the *Hubert II* court introduced the language with the statement that the ''agreement contains a provision concerning potential third-party beneficiaries.'' But the court did not further address the third-party beneficiary issue with any specificity. It did restate the quoted language, almost in passing, in its conclusion, but the court primarily based its holding on the other issues I discussed earlier. However, the third-party beneficiary issue is highly important, and I dedicate a later section of this report to it. As I will explain, had the court grounded its decision in the fact that the creditors were not third-party beneficiaries of the DROs, it would have had a stronger basis for its holding, although perhaps still not a completely persuasive one. But without that focus, the third-party beneficiary language in the *Hubert II* decision contributes little, if anything, to the court's reasoning.

[51]Sections 704(d) and 465 operate in parallel. *See* Lipton et al., *supra* note 32, at para. 4.07.

E. *Hubert* v. Section 752 Regulations[52]

Section 752(a) provides that an increase in a partner's share of partnership liabilities is treated as a contribution of money by the partner to the partnership and thus increases the partner's basis in the partnership interest under section 722. This ability of entity-level debt to increase partner-level basis is unique to partnerships and often makes them the preferred vehicle. Because a partner may not deduct partnership losses exceeding her basis in the partnership interest under section 704(d), in a sense, more partnership debt means more possible loss deductions for partners.

The rules for allocating recourse and nonrecourse debt to partners are different. Here I will focus on the rules for recourse debt, since nonrecourse debt under the facts of *Hubert* could not have given rise to an at-risk amount. Generally, a partner is allocated recourse debt based on that partner's economic risk of loss on the debt.

Reg. section 1.752-2(b)(1) allocates recourse debt based on a constructive liquidation of the partnership in which the partnership assets are sold for no consideration other than the release of nonrecourse debt. A partner or related person bears the economic risk of loss on a recourse liability if after the constructive liquidation (1) the partner or related person would be obligated to make a payment to any person because the liability became due and payable, and (2) the partner or related person would not be entitled to reimbursement from another partner or a related person to another partner.

All the facts and circumstances are considered in determining the extent to which a partner has an obligation to make a payment on a recourse liability.[53] The regulations specifically list a DRO as a relevant fact.[54] In determining whether a person has a payment obligation, it is assumed that all partners and related persons who have obligations to make payment actually perform those obligations, regardless of their net worth, unless there is a plan to ''circumvent or avoid the obligation.''[55]

The economic risk of loss rules and the at-risk rules are not mirror images of each another, and they sometimes apply differently.[56] But in this context, the economic risk of loss rules address the same issue as the at-risk rules: bottom-line economic exposure on recourse debt, taking all the facts and circumstances into account. It is clear that a DRO can generate economic risk of loss under the

[52]In this discussion, I borrow liberally from Lipton et al., *supra* note 32, at ch. 3.

[53]Reg. section 1.752-2(b)(3).

[54]Reg. section 1.752-2(b)(3)(ii).

[55]Reg. section 1.752-2(b)(6).

[56]*See* Kalinka, *supra* note 3.

section 752 regulations, and there is no apparent reason why it categorically should not also be able to generate an amount at risk under the at-risk rules. Indeed, the IRS has previously acknowledged that a DRO can increase both economic risk of loss and the at-risk amount.[57] The IRS would have been wise to stay with its original thinking.[58]

Because all facts and circumstances are considered under the economic risk of loss rules, an unduly remote possibility of actually having to fulfill a DRO might not provide an economic risk of loss. And if a DRO cannot provide for economic risk of loss, it is difficult to argue that it should provide an at-risk amount. To what extent should time alone make a DRO unduly remote? There is certainly a cogent argument that if the DRO most likely will not have to be met until the distant future, the obligation is unduly remote. However, it is difficult to create a coherent rule for time, given the current rules for including debt in basis inside and outside the partnership context. As long as a bona fide debtor-creditor relationship exists, there are no limitations on how long the debt repayment obligation may run. Indeed, everyday homeowners typically carry a 30-year mortgage, with little paid on principal for much of the loan term. It is hard to make the case that a DRO that might not need to be fulfilled for a similar length of time should be given a lesser status. Thus, although the time concern is a fair one, addressing it coherently would require an overarching change in the way we treat debt generally.[59]

[57]*See* FSA 0293 (Dec. 15, 2003) (concluding that DROs increased limited partners' bases in their partnership interests under section 752(a) and their at-risk amounts under section 465); *see also* Rubin, Whiteway, and Finkelstein, "Tax Court Sticks," *supra* note 9.

[58]Although on appeal the IRS took a more nuanced approach than the Tax Court ultimately did. *See* Burke 2003, *supra* note 3.

[59]The section 752 regulations address this issue modestly. If a partner has an economic risk of loss on a debt because of a contribution obligation, that contribution must be made within 90 days of the liquidation of the partnership interest to be taken into account at full value. Otherwise, it is taken into account at present value, unless the partner is required to pay interest at no less than the applicable federal rate from the date of liquidation. Reg. section 1.752-2(g). The at-risk rules do not contain a similar provision. *See Follender v. Commissioner*, 89 T.C. 943 (1987); and *Pritchett v. Commissioner*, T.C. Memo. 1989-21.

III. Creditor: Third-Party Beneficiary of a DRO?

A. Generally

I will focus on the widely accepted Restatement (Second) of Contracts for (curiously non-sequential) guidance.[60] Section 304 of the Restatement provides:

> A promise in a contract creates a duty in the promisor to any intended beneficiary to perform the promise, and the intended beneficiary may enforce the duty.

Section 302 of the Restatement provides:

> 1. Unless otherwise agreed between promisor and promisee, a beneficiary of a promise is an intended beneficiary if recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties and either
>
> a. the performance of the promise will satisfy an obligation of the promisee to pay money to the beneficiary; or
>
> b. the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance.
>
> 2. An incidental beneficiary is a beneficiary who is not an intended beneficiary.

Importantly, section 308 of the Restatement provides:

> It is not essential to the creation of a right in an intended beneficiary that he be identified when a contract containing the promise is made.

Section 310 of the Restatement provides:

> 1. Where an intended beneficiary has an enforceable claim against the promisee, he can obtain a judgment or judgments against either the promisee or the promisor or both based on their respective duties to him. Satisfaction in whole or in part of either of these duties, or of a judgment thereon, satisfies to that extent the other duty or judgment, subject to the promisee's right of subrogation.

[60]*See* Gregory Maggs, "The Restatement (Second) of Contracts and the Modern Development of Contract Law," 66 *Geo. Wash. L. Rev*. 508 (1998); Kellye Y. Testy, "Whose Deal Is It?: Teaching About Structural Inequality by Teaching Contracts Transactionally," 34 *U. Tol. L. Rev*. 699 (2003); and Stephen J. Leacock, "Fingerprints of Equitable Estoppel and Promissory Estoppel on the Statute of Frauds in Contract Law," 2 *Wm. & Mary Bus. L. Rev*. 73 (2011).

2. To the extent that the claim of an intended beneficiary is satisfied from assets of the promisee, the promisee has a right of reimbursement from the promisor, which may be enforced directly and also, if the beneficiary's claim is fully satisfied, by subrogation to the claim of the beneficiary against the promisor, and to any judgment thereon and to any security therefor.

Section 311 of the Restatement provides:

1. Discharge or modification of a duty to an intended beneficiary by conduct of the promisee or by a subsequent agreement between promisor and promisee is ineffective if a term of the promise creating the duty so provides.

2. In the absence of such a term, the promisor and promisee retain power to discharge or modify the duty by subsequent agreement.

3. Such a power terminates when the beneficiary, before he receives notification of the discharge or modification, materially changes his position in justifiable reliance on the promise or brings suit on it or manifests assent to it at the request of the promisor or promisee.

4. If the promisee receives consideration for an attempted discharge or modification of the promisor's duty which is ineffective against the beneficiary, the beneficiary can assert a right to the consideration so received. The promisor's duty is discharged to the extent of the amount received by the beneficiary.

For purposes of this discussion, I am assuming the partnership or LLC operating agreement has a standard DRO, such as the one in *Hubert*, in which the proceeds of the DRO can be used to pay creditors. If, for example, partners were obligated to restore a deficit capital account to enable the partnership to pay the positive capital account balances of other partners but not to pay creditors, the creditors could not be third-party beneficiaries of the DRO.

Normally, partners do not have DROs to the extent the deficit capital account is created by nonrecourse debt.[61] But even if a partner did have a DRO in this scenario as a result of bad lawyering, a creditor should be unable to be a third-party beneficiary of the DRO because that ability would have the unintended effect of making a nonrecourse debt recourse. Thus, the rest of this discussion focuses on deficit capital accounts generated by recourse debt.

Assume the following scenario: An LLC taxed as a partnership borrows $100,000 on a recourse basis. The LLC has two equal members, A and B, who do not guarantee the debt but who each contribute $25,000 to the LLC. The LLC complies with the substantial economic effect rules, and A and B have DROs sufficient to enable them under the section 752 regulations to each be allocated $50,000 of the recourse debt.[62] The LLC buys depreciable equipment for $150,000, paying for it with the debt proceeds and the cash A and B contributed. Assume the LLC breaks even except for depreciation deductions in all relevant years. A and B each start with a positive capital account of $25,000. By the time the equipment is fully depreciated, A and B will each have a negative capital account of $50,000 and, of course, a DRO of $50,000. Following the language of the Restatement, regarding the DROs, A and B are the promisors and the LLC is the promisee. Obviously, under these facts, the only way the LLC will be able to pay the recourse creditor is if A and B fulfill their contractual obligations and pay the LLC the negative balances in their capital accounts. Under Restatement sections 304 and 302, it seems inescapable that the creditor is the intended beneficiary of A's and B's DROs (that is, the creditor is a third-party beneficiary of A and B's promise to the LLC). The LLC has no other way to pay the debt (meeting the requirements of Restatement section 302(1)(a)). Further, under Restatement section 310, the creditor may sue A and B directly. Note that section 752 permits the recourse debt to be allocated to A and B under these circumstances precisely because they are effectively liable on the debt.[63]

Of course, the facts are usually not that simple. There may be many properties, many ways losses are generated, sales and purchases of properties, and creditors who come and go. But under Restatement section 308, the creditor need not be known when the DRO is established. As long as an allocation of recourse debt to a partner is what enables the partner to have a negative capital account balance, the creditors should be the third-party beneficiaries of the DRO because the partnership ultimately depends on the DRO to be able to satisfy the creditor, at least when the business fails.

I could find no cases that address the third-party beneficiary issue in the DRO context. Although there are undoubtedly countless partnership agreements with some kind of DRO, there may not yet have been a critical mass of unpaid creditors of insolvent partnerships with solvent partners who refused to meet their DROs. That said, courts have found creditors to be third-party beneficiaries of

[61]*See infra* notes 133-149 and accompanying text.

[62]*See supra* notes 52-59 and accompanying text.

[63]*Id.*

limited partners' promises to make additional capital contributions to the limited partnership.[64] Because there is no real, substantive difference between a DRO and a fixed obligation to make a capital contribution, those cases are highly persuasive in the DRO area for courts that do not want to rely on the Restatement alone.

B. Eliminating Third-Party Beneficiary Status

Can the partners prevent a creditor from being a third-party beneficiary? Yes. Restatement section 302 provides for third-party beneficiary treatment "unless otherwise agreed."[65] Indeed, the agreement in *Hubert* had language effectively denying creditors third-party beneficiary status, although the court did not meaningfully address the third-party beneficiary issue.[66] I am aware of no data on this, but my sense is that anti-third-party-beneficiary language like that in *Hubert* is fairly common. However, one may question whether it is wise for partners to prevent a creditor from being a third-party beneficiary. If creditors are unpaid, in the typical case there would be no incentive for the partners to cause the partnership to liquidate to trigger the DROs because any funds paid would go to the creditors.[67] Under debtor-creditor law, the partnership would have to use the contributed funds first to pay the creditors, and it could not distribute them to other partners.[68] That would in turn suggest that partners with deficit capital accounts would not have ultimate liability to the creditor despite their DROs. This fact should eliminate the partners' economic risk of loss for section 752 purposes and (for courts not convinced by *Hubert*) the at-risk amount under section 465. Less economic risk of loss means less outside basis, and a lower at-risk amount means, well, a lower amount at risk, which together equate to reduced loss deductions. But the partners most likely would not have agreed to DROs to begin with if they did not want to be able to deduct allocable losses. Thus, preventing creditors from being third-party beneficiaries of DROs may be too clever by half. Had the court in *Hubert* focused on this issue, it might have reached a more defensible holding.

What keeps this line of reasoning from being completely convincing is bankruptcy law. Recall that both the economic risk of loss rules and the at-risk rules look at bottom-line risk when things go sour. Typically, the partnership will be insolvent, its creditors can readily force it into a chapter 7 bankruptcy, and the partnership can be liquidated by the bankruptcy trustee.[69] That in turn will trigger the partners' DROs. So perhaps negating third-party beneficiary status does not prevent a partner from having economic risk of loss or (despite *Hubert*) an at-risk amount after all. But denying creditors third-party beneficiary status makes it at least somewhat less likely that the DRO will be enforced. Not all failed businesses are forced into bankruptcy. In an uncomplicated partnership with simple allocation regimes, the bankruptcy card is likely still sufficient to give the partners with DROs economic risk of loss and an at-risk amount. But in complex deals with varying allocations and many tiered partnerships, denying third-party beneficiary status to creditors may be the fact that tips the balance and makes the possibility of having to fulfill a DRO too remote to justify an allocation of economic risk of loss for section 752 purposes. Recall that the section 752 regulations look at all the facts and circumstances.[70] By the same token, in circuits that follow the realistic possibility test, the partners may be denied an amount at risk (although the lack of a debt allocation under section 752 probably moots the at-risk rules). Complexity also creates proof problems, as I discuss below.

C. Recourse-Generated Losses

Assuming the creditor is not denied third-party beneficiary status, it should be able to be a third-party beneficiary only of a negative capital account attributable to recourse-debt-generated losses. If the capital account is negative for some other reason, there would be no intent to benefit the creditor. For example, in the above example, assume C contributes $20,000 to become a partner and the partnership makes a distribution of $10,000 each to A and B. A's and B's negative capital accounts increase from a negative $50,000 to a negative $60,000. But under the Restatement, the creditor could be seen as a third-party beneficiary only of the first $50,000. The additional $10,000 deficit creates contractual rights and obligations among the partners and the

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[64] *See International Investors v. Business Park Fund*, 991 P.2d 219 (Alaska 1999). *See also Racing Investment Fund 2000 LLC v. Clay Ward Agency Inc.*, 320 S.W.3d 654 (Ky. 2010); *Continental Waste Systems Inc. v. Zoso Partners*, 727 F. Supp. 1143, 1149-1150 (N.D. Ill. 1989); and *Builders Steel Co. v. Hycore Inc.*, 877 P.2d 1168 (Okla. App. 1994).

[65] *See Murray on Contracts*, section 131[B][2].

[66] *See* discussion under Section II.D.

[67] I am assuming the partnership is an LLP or an LLC where there is no direct owner liability to the creditors.

[68] *See supra* note 30. Of course, if the DROs exceeded the debt owed to creditors, partners with positive capital account balances would have an incentive to liquidate.

[69] *See supra* notes 23-25 and accompanying text.

[70] *See supra* notes 52-59 and accompanying text.

partnership, but nothing in the Restatement suggests there is a way the creditor could be seen as an intended beneficiary.

The difficulty for creditors may not be in arguing that the third-party beneficiary doctrine can apply but rather proving that a negative capital account is attributable to recourse-debt-based loss allocations. The examples I gave above are very simple. And indeed, life is not always complex; there are partnerships in operation not so different from my examples. But as the complexity increases, proving cause and effect becomes a major challenge. There may be many classes of partners, each with different allocation regimes and different distribution rights. The partnerships may be tiered. The partnerships may own many different businesses with many different assets, with both nonrecourse and recourse debt, and with some debt having both nonrecourse and recourse elements. Tracking what caused a capital account to go negative may be no easy feat. Perhaps the proof challenges explain why there are no cases dealing with DROs and third-party beneficiary rights.

D. Deleting DROs?

Can the partnership and its partners agree to change the DRO, perhaps eliminating it? The answer will often be no. If the creditor lent money to the partnership in reliance on the DRO, Restatement section 311(3) should prohibit a change to the terms of the DRO, although in many fact patterns the creditor might find it difficult to prove reliance. But of course, the creditor has no enforcement rights if the DRO prohibited it from having third-party beneficiary status.[71]

Because the DROs in *Hubert* indeed prevented creditors from being third-party beneficiaries, the members could have amended the operating agreement to eliminate the DROs. As Professor Susan Kalinka has noted, this ability in turn could prevent the members from being at risk on the DRO (assuming it survives the other attacks under the at-risk rules discussed above).[72] There is no case on point in the DRO area, but there is a relevant limited partnership case. In *Callahan*,[73] each limited partner had the right to opt out of an obligation to make an additional capital contribution if doing so would not harm creditors. The Tax Court concluded that the opt-out clause prevented the limited partners from being at risk. Although there was no opt-out clause in *Hubert*, the two members of LCL were controlled by the same entity, making an amendment to the operating agreement virtually hurdle free. Under the facts of *Hubert*, this effective opt-out ability might, at least at first blush, have provided a reasonable basis for the Tax Court to conclude that the taxpayers were not at risk on their DROs.[74] But there are problems with that argument.

As a preliminary matter, the argument holds only under facts in which, as in *Hubert*, the amendment is easily achieved. It does not hold if the partners have little or no practical ability to agree to remove DROs. That is likely the more typical scenario. For example, if the partners are unrelated, have conflicting interests, and are relatively numerous, they will likely be unable to agree to remove a DRO. Or if one solvent partner has independently guaranteed partnership debt, he will almost never agree to let other, unrelated partners off the hook on their DROs.

Further, there is an important difference between a DRO and the obligation in *Callahan*: The latter was effectively never fixed until the capital call was made, whereas a DRO represents an already fixed obligation. There are many reasons a limited partner in a similar situation to *Callahan* might opt out. She might have personal financial difficulties; the partnership might be in financial trouble; or she just might prefer a different investment. But because removing a DRO would likely involve adverse tax consequences, it will typically occur when the partnership is in financial trouble. And then bankruptcy law again presents hurdles.

The adverse tax consequences are the following: As I will discuss below, removing a DRO might create COD income. Also, if a partner is allocated recourse debt based on the DRO,[75] reducing the DRO also reduces the recourse debt that had previously been allocated to the partner. That reduction constitutes a deemed distribution of money to the partner under section 752(b), causing the partner to

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[71]Of course, other partners may be less than enthusiastic about a DRO being reduced, assuming that would put more of the onus for paying the debt on them.

[72]*See* Kalinka, *supra* note 3; *see also* 9A Kalinka, Jeffrey W. Koonce, and Philip T. Hackney, *Louisiana Limited Liability Companies and Partnerships: A Guide to Business and Tax Planning*, section 6:7 (2015). This ability to remove the DRO could conceivably prevent the DRO from generating an economic risk of loss. Reg. section 1.752-2(b)(4) provides that a payment obligation is disregarded if, taking into account all the facts and circumstances, the obligation is subject to contingencies that make it unlikely that it will ever be discharged. *See* Kalinka, *supra* note 3.

[73]*Callahan v. Commissioner*, 98 T.C. 276 (1992).

[74]Note that if the argument holds, this ability likely would also prevent the members from having economic risk of loss on the DROs under section 752. As discussed above, although a DRO can be a basis for creating an economic risk of loss, the regulations consider all the facts and circumstances. The ability to amend away a DRO is, of course, a highly relevant fact. *See supra* notes 52-59 and accompanying text; and reg. section 1.752-2(b)(4).

[75]*See supra* notes 52-59 and accompanying text.

recognize gain under section 731 if the deemed distribution exceeds the partner's basis in his partnership interest. If, *Hubert* notwithstanding, a DRO increases the at-risk amount, section 465(e) may join the party. If as a result of removing the DRO, the partner's at-risk amount drops below zero, section 465(e) requires the partner to include the negative amount in income.

The bankruptcy law hurdles are the following: Once a bankruptcy petition has been filed, the automatic stay in Bankruptcy Code section 362(a) prevents any act to try to alter the relative rights of creditors against the debtor. Thus, after a bankruptcy filing, it would be impossible to remove a DRO. Further, section 547 of the Bankruptcy Code permits the bankruptcy trustee to avoid a transfer that causes creditors to receive more than they would otherwise receive. The transfer must occur within 90 days before bankruptcy generally and for one year prior for insiders. Section 101(31) of the Bankruptcy Code defines insiders to include general partners. Although section 101(31) does not contemplate LLCs and their members, that does not seem to present the hurdle it does in the tax code. The definitions of insider in section 101(31) have been held to be "illustrative rather than exhaustive,"[76] and a bankruptcy court and the Seventh Circuit have concluded that an LLC member with management responsibility is an insider.[77] Section 101(54) of the Bankruptcy Code defines transfer very broadly and covers almost any act that diminishes the value of the debtor vis-à-vis unsecured creditors. Thus, removing a DRO could be seen as a transfer. Because removing a DRO would re-trigger debt obligations, possibly causing some creditors to receive more than they would otherwise receive, it could well trigger section 547. Further, often the one-year period would apply, making section 547 difficult to plan around, particularly when one considers that a debtor can be forced into bankruptcy. And, of course, well-informed creditors will have an incentive to force a debtor into bankruptcy if they know the clock is ticking on a deleted DRO.[78]

Section 548 of the Bankruptcy Code might pose an even larger hurdle. It permits the bankruptcy trustee to avoid fraudulent transfers. Section 548 applies to transfers made within two years of bankruptcy "with the intent to hinder, delay or defraud" creditors. Of course, the whole point of removing a DRO would be to alter the obligation to creditors, likely triggering section 548. And the two-year time frame would be difficult to plan around.

Thus, bankruptcy law would commonly prevent the partners from removing the DROs. In the Sixth Circuit, which applies the at-risk rules using a worst-case supposition, it is hard to see how one gets around these bankruptcy provisions. Bankruptcy is the quintessential worst case. Further, the conclusion could be the same in jurisdictions that require the taxpayer to have a realistic possibility of being at risk. Going bankrupt is hardly beyond the realm of the realistically possible, particularly for a partnership in financial trouble. And again, it is when the partnership is in financial trouble that partners would be inclined to remove a DRO.

Although I think Kalinka's argument has merit in facts such as those involved in *Hubert*, it would be difficult to convert it into a bright-line rule that has much consistent cogency. First of all, scenarios in which the partners can be expected to agree easily to remove DROs, as in *Hubert*, are probably the exception. And even then, bankruptcy law commonly prevents the partners from removing the DROs. I have never been a fan of creating a rule to deal with a rare event. But if there is going to be a rule, it should be the same as the one for determining economic risk of loss in the section 752 regulations.[79] In each case, all the facts and circumstances must be considered. A partner's real, practical ability to delete a DRO is surely a relevant fact, but not itself determinative.

IV. Transfers When Negative

When a partner sells or gifts a partnership interest, the transferee inherits the transferor's capital account.[80] This raises several questions.

Example: A partner contributes $20,000 to the partnership and is allocated $30,000 of partnership recourse debt under section 752. Her outside basis is $50,000, but her capital account is $20,000. Under section 704(d), she may be allocated losses up to her basis, that is, $50,000.[81] Assuming for now that she has an unlimited DRO, a $50,000 loss allocation gives her a $30,000 deficit in her capital account and a zero tax basis. Now assume the partner sells the partnership interest for $10,000 plus the assumption

[76] *In re Krehl*, 86 F.3d 737, 741 (7th Cir. 1996).

[77] *Longview Aluminum LLC v. Brandt*, 431 B.R. 193 (N.D. Ill. 2010), *aff'd*, 657 F.3d 507 (7th Cir. 2011). *See also Kapila v. Clark*, 431 B.R. 263 (Bankr. S.D. Fla. 2010); *United States v. Forbes*, 740 F. Supp.2d 326 (D. Conn. 2010); and *Sergeant v. G.R.D. Investments LLC*, 331 B.R. 401 (2005).

[78] In Kalinka, *supra* note 3, at n.86, the author, while acknowledging that a bankruptcy trustee could enforce a DRO, observes that the members may retract the DROs before filing for bankruptcy. As the text notes, this may not be feasible.

[79] Reg. section 1.752-2(b)(4).

[80] Reg. section 1.704-1(b)(2)(iv)(l).

[81] Subject to the at-risk rules of section 465 and the passive loss rules of section 469.

of her share of partnership liabilities, which remain unchanged (Scenario 1). Section 752(d) requires the liabilities to be included in the amount realized, making the total gain recognized under section 1001 equal to $40,000 - $0 = $40,000.[82] The buyer's outside basis is $40,000, but the capital account stays at a negative $30,000. Because the buyer is willing to pay the seller $10,000 in cash and assume the debt, there should be equity in the partnership assets, of which the buyer's share is $10,000 (ignoring possible discounts for lack of marketability and lack of control). Given the $30,000 of debt, the buyer's share of the gain in partnership assets is $40,000. As the partnership sells its assets, it recognizes book and tax gain (which I am assuming are the same).[83] If the values do not change, and ignoring post-purchase partnership income or loss, the buyer eventually has a $10,000 capital account, that is, a capital account equal to what he paid for the partnership interest. Under these facts, there is no particular reason why the existence of the negative capital account at the time of the sale should trigger any special additional consequences for the selling partner.

The answer should not change if the debt is nonrecourse instead of recourse and if, instead of an actual DRO, there is a deemed $30,000 DRO to the extent of the partner's share of minimum gain.[84] As in Scenario 1, what allows the selling partner to have a negative capital account is the nonrecourse debt, and on the sale, section 752(d) will set everything right. Further, minimum gain itself should not trigger a special consequence for the selling partner any more than any other gain inherent in partnership property because it is not fundamentally different.[85]

Returning now to the recourse debt version of Scenario 1, what if, before the sale, the partnership distributes to the selling partner property with a tax basis and FMV of $10,000. Further assume that the distribution falls within the tax-free distribution rules of section 731.[86] The selling partner's capital account is now negative $40,000 (-$30,000 - $10,000), his outside basis remains zero, and he takes a zero basis in the distributed property under section 732. If the values in the example are otherwise the same, the buyer would be willing to assume the seller's debt but pay no cash for the partnership interest (Scenario 2). In other words, the extra negative $10,000 capital account offsets the $10,000 in equity that existed in Scenario 1. If everything else is held constant, when the partnership disposes of its assets, the buyer's capital account gets back to zero because the buyer paid no cash and assumed the seller's share of partnership debt. How should tax law now treat the selling partner? Should the ''extra'' $10,000 of negative capital account be treated as an additional liability of the selling partner that the buyer assumes, generating $10,000 of additional gain? This seems to be the correct answer because the extra $10,000 of negative capital account means an extra $10,000 of DRO, which is a real liability for the seller that the buyer accepts. Indeed, it appears to fall within section 752(d), which states:

> In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

Nothing limits the application of section 752(d) to a partner's share of partnership liabilities; it speaks to liabilities generally. The regulations, however, although not free from doubt, suggest only partnership liabilities are meant.[87] But even if section 752(d) does not bring the extra $10,000 DRO into the fold, the regulations under section 1001 would. They provide that liabilities assumed by a buyer in any transaction are added to the amount realized.[88] Note that in Scenario 1 the selling partner's negative capital account and the share of partnership liabilities match, so the negative capital account did not trigger any additional tax consequences. But in Scenario 2, the negative capital

[82]The sale can trigger a host of other provisions, including sections 751(a), 754, 755, and 743(b). I will spare you the details.

[83]On a distribution of property to a partner, tax gain may not be recognized under section 731, but book gain is still recognized for capital account purposes. Reg. section 1.704-1(b)(2)(iv)(e)(1).

[84]*See infra* notes 131-147 and accompanying text.

[85]Implicit support for this position can be found in the section 704(c) regulations. In its simplest version, section 704(c) allocates gain or loss inherent in contributed property at the time of the contribution to the contributing partner when the partnership later sells the contributed property. The regulations provide that if a partner transfers his partnership interest by sale or gift, the transferee inherits the transferor's section 704(c) amount. Reg. section 1.704-3(a)(7). There is no conceptual reason the answer should be any different for ''untriggered'' minimum gain of the transferring partner. Thanks to professor James Maule of Villanova University School of Law for alerting me to this issue.

[86]I am assuming no application of section 707(a)(2)(B), 704(c)(1)(B), or 737. Also, the regulations require that any book gain or loss inherent in distributed property be recognized upon the distribution, with appropriate adjustments to the partners' capital accounts. In the example, there is no book gain or loss. *See* reg. section 1.704-1(b)(2)(iv)(e)(1).

[87]Reg. section 1.752-1(a)(4).

[88]Reg. section 1001-2(a).

account exceeds the selling partner's share of partnership liabilities by $10,000, hence the need to bring that $10,000 within either section 752(d) or section 1001.[89]

What if the selling partner has only a $30,000 DRO but because of the distribution has a $40,000 negative capital account? Or alternatively, what if the seller has no actual DRO, but the partnership debt is nonrecourse instead of recourse, still allowing the seller to have a $30,000 deficit capital account before the property distribution,[90] which again increases the deficit capital account to $40,000 (Scenario 3)? In either case, the property distribution reduces the partner's capital account below the allowed deficit. If the partnership complies with the regulations' substantial economic effect test, in either case the partnership is obligated to allocate income to the partner to offset that extra $10,000 deficit (that is, make a qualified income offset).[91]

But what if the partnership has not yet earned the income with which to make the qualified income offset allocation at the time of the sale? The liability rules are no longer any help because there is no additional liability of the partnership or the selling partner at issue. Note that while section 706(d) provides rules for allocating income when partners' interests in the partnership change, section 706(c)(2) provides that the tax year for the partner who sells his entire interest closes with the sale, meaning that income earned by the partnership after the sale cannot be allocated under section 706 to the selling partner. Nonetheless, the selling partner has shifted income he was ''due'' to the buyer as part of a sale. It undermines the principles underlying the qualified income offset rules to allow the selling partner to avoid that income. The whole point of the qualified income offset rules is to ''fix'' the fact that a partner has a capital account that is more negative than allowed — that the partner took more out of the partnership than he was obligated to repay. Under some circumstances, the sales price agreed to by the buyer and seller may take into account the extra taxes the seller would have to pay on the income, but there is no assurance that will occur. Further, that may change the character of the income to the seller. And in a fundamental way, the as-of-yet-unallocated income is personal to the seller.[92]

Assignment of income principles provide the answer. The partner has effectively sold an income ''right'' along with the partnership interest. There is no case on point in the partnership context. In non-partnership settings, courts have not achieved consensus on how to treat the sale of a future right to income.[93] Commonly, a taxpayer wants to sell a future right to income to increase income in the current year (and reduce it in a future year). Increasing income in the current year may enable the taxpayer to take a tax deduction that might otherwise be unavailable, such as an expiring net operating loss. The Sixth Circuit, the highest court to address this issue, blessed the strategy in *Estate of Stranahan*,[94] concluding that selling a future right to ordinary income generated ordinary income to the seller in the year the consideration was received. Other courts have rejected this treatment, finding that the transaction lacked substance, and have denied the increased deduction. Those courts typically treat the funds received in the current year as a loan to be repaid in a future year.[95]

In Scenario 3, however, no manipulation of the tax code is involved. One searches simply for the proper tax treatment. The seller is terminating his partnership interest, and the date of the sale is the logical time to bring closure to all income recognition. In this setting, *Estate of Stranahan* provides a logical way to proceed. Thus, whatever portion of the sales price is attributable to that income right (in Scenario 3, $10,000 without discounts) should be income to the seller in the year of the sale.

What should the character of the income be? In principle, it should be the same character as that of

[89]Although this analysis gives the correct result on the sale, it does cause the selling partner to ultimately recognize ''extra'' tax gain. The tax gain on the sale is $40,000 - $0 = $40,000. The partner takes a zero basis in the distributed property under section 732(a)(2). If the values do not change, he will recognize $10,000 of gain when he sells the property, for a total of $50,000 of gain. But this problem is less the consequence of applying section 752 or 1001 than that of applying section 732(a)(2). Whenever a partner takes a lesser basis in a distributed property than what the partnership had, more gain will be recognized on the sale of that property than would have been recognized if the partnership had sold it. A section 754 election and section 734(b) adjustment are designed to provide some relief in that case.

[90]*See infra* notes 133-149 and accompanying text.

[91]The extra $10,000 deficit triggers a qualified income offset even if the debt is nonrecourse and the partner has a deemed DRO. It does not trigger a minimum gain chargeback, which arises only when a partner's share of minimum gain drops. *See infra* notes 133-149 and accompanying text.

[92]The income would not appear to fall within the definition of an unrealized receivable that could trigger section 751(a).

[93]*See Estate of Stranahan v. Commissioner*, 472 F.2d 867 (6th Cir. 1973); and *Principal Life Insurance Co. v. United States*, 116 Fed. Cl. 82 (2014), which criticized *Estate of Stranahan*. *See also Hort v. Commissioner*, 313 U.S. 28 (1941); *Lucas v. Earl*, 281 U.S. 111 (1930); *Hydrometals Inc. v. Commissioner*, T.C. Memo. 1972-254, *aff'd per curiam*, 485 F.2d 1236 (5th Cir. 1973); *Mapco Inc. v. United States*, 556 F.2d 1107 (Ct. Cl. 1977); and Bittker, McMahon, and Zelenak, *supra* note 10, at para. 34.02.

[94]472 F.2d 867.

[95]*See Principal Life Insurance*, 116 Fed. Cl. 82; *Hydrometals*, T.C. Memo. 1972-254; *Mapco*, 556 F.2d 1107; and Bittker, McMahon, and Zelenak, *supra* note 10, at para. 34.02.

the income that would have been allocated to the seller — typically, ordinary income. But in many scenarios, it will not be knowable what the character of income would have been. Perhaps the partnership earns both ordinary income and capital gains in different amounts in different years. A solution might be to take the relative percentages of types of income that the partnership earned over the preceding three years and apply them to the income earned by the selling partner. Thus, if the partnership over the preceding three years earned 90 percent ordinary income and 10 percent long-term capital gains, the selling partner's income would be characterized the same way. In most cases, the income should be all ordinary, limiting the impact of the problem.[96]

What is the tax treatment to the buyer when the $10,000 of qualified income offset is allocated to her? Applying *Estate of Stranahan* principles shows that the buyer paid for the income right. Thus, the buyer should have income only to the extent that what she paid for the income right is less than the $10,000 of income allocated to her. This treatment will require a special ''off the books'' adjustment for the buyer, because subchapter K does not resolve the question. This adjustment doubtless adds complexity, but the complexity is preferable to allowing the seller to avoid $10,000 of income that was essentially personal to him.

What if instead of a qualified income offset, a minimum gain chargeback has been triggered, for example, because of payment of principal on a nonrecourse loan?[97] But what if the income to implement that minimum gain chargeback has not been earned at the time of the sale? This is conceptually the same situation as the qualified income offset example, and the answer should be the same.

What if the transferor partner instead gifts the partnership interest? Scenarios 1 and 2 should be treated as a part-sale, part-gift transaction.[98] The effective liability assumption would be treated as the amount realized for part-sale purposes. That less the donor's basis (in these facts, zero) would be the donor's gain. The difference between the FMV of the partnership interest and the liability assumed would be the part-gift portion of the transaction.[99] In Scenario 3, however, the $10,000 ''extra'' negative capital account does not represent a liability of the donor but rather an income right of the donor that is being gifted to the donee. When the $10,000 income is recognized by the partnership, it should be allocated to the donee to offset the excess negative capital account. But the assignment of income doctrine generally prevents taxpayers from gifting income to another party.[100]

The assignment of income doctrine does not normally tax gifted income at the time of the gift but rather when it is recognized.[101] It is true that if a taxpayer gifts income-producing property, the income earned after the gift belongs to the donee.[102] But the donor is taxed on income that accrued before the time of the gift, regardless of when paid.[103] Here an event has occurred before the gift, triggering an income allocation to the donor. This would seem to be a form of income accrual. Thus, the relevant income, when allocated to the donee, should be taxed to the donor. I suspect taxpayers do not respect this analysis in real life.

V. DROs When Partnership Fails

What if the partnership business fails while partners have negative capital accounts that they have an obligation to restore? As discussed earlier, if it is partnership debt that allowed the capital accounts to go negative, resolving debt issues with the partnership's creditors will likely restore the capital accounts to zero. For the sake of completeness, I will assume a partnership that has both nonrecourse and recourse debt.

Creditors holding nonrecourse debt will typically foreclose on the securing property or receive a deed in lieu of foreclosure, triggering a minimum gain chargeback and restoring a capital account deficit attributable to nonrecourse deductions.[104] If the nonrecourse debt is exculpatory debt or is junior to the recourse debt, matters get messier. In some

[96]The distributee partner ends up with ''extra'' gain of $10,000 because he both is allocated (undiscounted) $10,000 of income and takes a zero basis in the distributed property, which has an FMV of $10,000. But this is a function of section 732(a)(2), not an inappropriate consequence of the discussed analysis. A section 754 election and a section 734(b) adjustment can provide some relief.

[97]*See infra* notes 133-149 and accompanying text. Note that if the minimum gain chargeback is triggered by a sale of the underlying property, there is income to allocate to the selling partner and the situation would not arise. Section 706 requires partnership income earned up to the time of the sale to be allocated to the selling partner.

[98]Reg. section 1.1015-4(a); *see* Bittker, McMahon, and Zelenak, *supra* note 10, at para. 29.03[4].

[99]*See* reg. section 1.1015-4(a); and Bittker, McMahon, and Zelenak, *supra* note 10, at para. 29.03[4].

[100]*See Helvering v. Horst*, 311 U.S. 112; *Lucas v. Earl*, 281 U.S. 111; and Bittker, McMahon, and Zelenak, *supra* note 10, at para. 34.02.

[101]*Lucas v. Earl*, 281 U.S. 111; *see* Bittker, McMahon, and Zelenak, *supra* note 10, at para. 34.01.

[102]Bittker, McMahon, and Zelenak, *supra* note 10, at para. 34.03[1].

[103]*Id.* at para. 34.03[4].

[104]*See infra* notes 133-149 and accompanying text. As noted above, an actual DRO would not typically exist if the only partnership debt was nonrecourse debt.

cases, the creditors may be able to foreclose on unsecured assets. In other cases, nonrecourse debt may be forgiven, generating COD income. Either process should generally offset deficit capital accounts attributable to nonrecourse debt.

If the debt is recourse to the partners, again, the creditors will typically foreclose on available assets, although if the debt exceeds the FMV of the relevant property, the amount realized will be limited to the FMV.[105] Normally, gain will be generated that can offset at least some portion of the negative capital account.[106] The deficiency (that is, the difference between the recourse debt and the FMV of the partnership property) remains an obligation of the partners liable on the debt. If the deficiency is forgiven, there is possible COD income, which would offset some portion of a negative capital account. But if the debt is not forgiven and the partners can pay the deficiency, they will likely restore the remaining deficits in their capital accounts and have the partnership pay the debt. Even if the partners pay the debt directly to the creditor, it should be seen as a deemed restoration of the deficit capital account because the bottom-line economic consequence is the same. For example, if the partner's negative capital account and DRO are $10,000 but his share of gain from foreclosure is only $8,000 because the recourse debt exceeds the FMV of the property, there will be a negative $2,000 capital account remaining. The partner is liable for this amount to the partnership upon liquidation of the partnership. And the creditors can force liquidation through involuntary bankruptcy.[107] There may be direct liability to the creditor if the creditor is a third-party beneficiary of the DRO or if the partner agreed to be directly liable on the debt.[108] Either way the creditor gets paid, and the capital account consequences should be the same regardless of the payment mechanics.

What if the deficit capital account is attributable not to debt but to a distribution that partners received? If the partnership has failed, what is likely involved is a voidable transfer under debtor-creditor law and the partners would be required to repay the distribution to the partnership, again resolving the deficit capital account.[109] If debtor-creditor law does not save the day and creditors are unpaid, the creditors should still be able to force the partnership into bankruptcy and then into liquidation, triggering the DRO. If neither of those scenarios arises and the DRO is not enforced, it should be seen as forgiven.

VI. Forgiveness of a DRO

What if the partnership and the other partners simply forgive or decide not to enforce a DRO?[110] Or what if the creditors don't enforce their rights as third-party beneficiaries or their rights to force the partnership into bankruptcy? To mostly state the obvious, section 108(d)(1) defines a debt as any indebtedness for which the taxpayer is liable.[111] COD income arises when a creditor either forgives a debt or simply decides not to enforce its rights to collect on the debt.[112] A partner is liable for his DRO, so it seems inescapable that a DRO is a debt. Thus, if the DRO is forgiven or not enforced, it also seems inescapable that the result should be COD income.

I am unaware of any case fully on point, but the issue was addressed in *Bassing*,[113] which involved a procedural issue. The taxpayer was one of two general partners in a Maryland limited partnership that developed real estate, and he also held a limited partnership interest in that partnership. The taxpayer, who was insolvent, had a deficit capital account of $882,871 and a DRO. As part of a general resolution of its indebtedness with its creditors, the partnership forgave the taxpayer's DRO, and he waived specific rights he had under the partnership agreement. The taxpayer initially reported the discharge as a short-term capital gain of $882,871. He then amended his return and applied for a refund. The amended return treated the forgiveness of the DRO as COD income, which, because the taxpayer was insolvent, would have been excluded from income under section 108(a)(1)(B) had the amended

[105]Reg. section 1.1001-2(a)(2).

[106]I am assuming — realistically — that capital accounts were driven negative primarily through allocations of deductions, making it probable that the basis of the partnership assets is fairly low and that there will be gain on foreclosure. If instead a loss on foreclosure occurred, the capital accounts of the partners would be more negative and the obligation of the solvent partners that much greater.

[107]*See supra* notes 23-25 and accompanying text.

[108]*See supra* notes 60-64 and accompanying text.

[109]*See supra* note 30.

[110]As noted above, a deemed DRO should be eliminated through the foreclosure process. *See infra* notes 133-149 and accompanying text.

[111]*See Zarin v. Commissioner*, 92 T.C. 1084 (1989), *rev'd*, 916 F.2d 110 (3d Cir. 1990).

[112]*See* section 61(a)(12); and *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931). *See* Bittker, McMahon, and Zelenak, *supra* note 10, at para. 4.05[4]. If forgiveness of the debt is a gift, no COD income should result. *See id*. at para. 4.05[4][c]. If a debt is canceled as a payment for services, the taxpayer should have income from services rather than COD income. *See id*. at para. 4.05[6]. If the partner is bankrupt, or to the extent the partner is insolvent, COD income can be a good thing because section 108 will exclude it from the partner's income.

[113]*Bassing v. United States*, 563 F.3d 1280 (Fed. Cir. 2009).

return been accepted. The taxpayer also would have been entitled to a refund of the tax paid on the amount reported as short-term capital gain. The Federal Circuit, however, held that the taxpayer's refund action was barred by section 7422(h), which generally prohibits refund actions attributable to partnership items as defined in section 6231(a)(3). The court concluded that forgiveness of the DRO:

> was a partnership item because it represented an amount determined by the partnership under its capital account maintenance rules, which constituted an accounting practice adopted by the partnership and applicable to all the partners. . . . The release of that obligation was also a partnership item because it was necessary to determine whether, under the partnership's capital account maintenance rules, the capital account deficit would be treated as an enforceable obligation, so that the release of that obligation would qualify as a cancellation of debt for the partnership. See Treas. Reg. section 301.6231(a)(3)-1(a)(1).

The taxpayer in *Bassing* lost on procedure, but there is nothing in the case to suggest he would have lost on the merits. At no time did the court object to COD treatment for the forgiven DRO, nor would it have made much sense to do so. The Federal Circuit did note in a footnote that "absent an enforceable restoration obligation, it is likely that a partner's capital account deficit would not qualify as a debt." This is a bit of an odd comment because a DRO is an enforceable restoration obligation. As discussed above, it should qualify as debt.[114] Forgiving a DRO could also cause a reallocation of partnership debt to the partners under section 752.[115]

VII. Conclusion

Deficit capital accounts and DROs involve a host of potential tax and nontax issues. The *Hubert* court gave negative capital accounts a hard look but found itself overmatched. Indeed, the sheer complexity of the associated issues and the fact that both tax and nontax law plays critical roles make this area difficult to master. Some of the complexity is the result of the advent of LLCs. Most relevant tax law predates LLCs and does not contemplate them.[116] For example, tax law generally assumes that some partner will be liable on partnership recourse debt. But that need not be the case with LLCs. Further, although DROs can exist with any tax partnership, the fact that LLCs are so ubiquitous brings matters into focus that previously tended to reside more at the periphery of tax consciousness. The at-risk rules provide a good example.

I hope to have convinced the reader that DROs should permit taxpayers to be at risk on LLC recourse debt in most circumstances. But under the existing at-risk rules, that is a clunky process. The DROs must be tied to LLC recourse debt, and figuring out when an LLC has recourse debt is itself not a simple matter. But in a conventional sense, a member is at risk on her DRO. It represents a real obligation. Why go through a convoluted process of tying it to LLC recourse debt? One may ask whether it would make more sense to just provide that a DRO typically increases the at-risk amount to the extent the capital account is negative and skip all the fancy footwork. Other code sections can then determine what deductions are allocated to a member.

That said, although the at-risk rules present one of the greater technical challenges, they are just one part of the DRO puzzle. There are many other parts that need to be addressed, often irrespective of the advent of LLCs. I hope that this report has helped piece them all together.

Appendix: A Primer[117]

A partnership is a flow-through entity. Income and deductions are passed through to the partners. A mechanism is needed for determining each partner's allocable share of partnership income and deductions. Section 704(b) and its regulations generally allow partners a great deal of flexibility in this regard. The allocations need not necessarily be in proportion to the underlying ownership of the partnership interests (as is the case with S corporations).[118] Someone who is otherwise a 50 percent partner could be allocated 90 percent of depreciation deductions, for example. Or all losses could initially be allocated to the "money partners," with subsequent income allocated to them to the same extent as losses were, and then income allocated 50

[114]In *Buckley v. Commissioner*, T.C. Memo. 1995-35, the court held that a positive capital account balance did not constitute a debt of the partnership and that the failure to pay it did not give rise to a bad debt deduction by the erstwhile partner. In *Curran v. Commissioner*, T.C. Memo. 1984-92, the court held that a deficit capital account did not constitute a debt when there was no specific obligation to restore it. These are obviously horses of a different color. Similarly, see *Turner v. Commissioner*, T.C. Memo. 1960-210.

[115]*See supra* notes 52-59 and accompanying text.

[116]Or limited liability limited partnerships.

[117]In writing this primer, I borrowed liberally from Lipton et al., *supra* note 32, Chpt. 5. I am the primary author of this chapter.

[118]*See* section 1377(a). Because partners can have varying interests in capital and profits, determining what the underlying ownership interest is may not be an easy task.

percent to the money partners and 50 percent to the promoters. This is sometimes called a "flip." Flips are quite common.

Section 704(b) provides that a partner's "distributive share of income, gain, loss, and deduction, or credit . . . shall be determined in accordance with the partner's interest in the partnership" if the partnership agreement does not provide for how a distributive share is allocated or if the allocations do not have substantial economic effect. In subchapter K, the word "distributive" has nothing to do with distributions and is generally synonymous with allocable. Thus, if an allocation does have substantial economic effect, it need not be in accordance with a partner's interest in the partnership. A partner's interest in the partnership is determined under a facts and circumstances test that is anything but certain.[119] The regulations provide detailed and specific rules on when allocations have substantial economic effect. Those substantial economic effect rules provide a structure that is intended to be a safe harbor. If the partnership agreement complies with the rules, the partnership knows the transaction will be safe. Many practitioners will endeavor to comply with them if possible. It used to be that practitioners viewed compliance with the substantial economic effect rules as virtually mandatory, but in recent years practitioners have been increasingly drafting agreements to fall under the partners' "interest in the partnership" facts and circumstances test. Indeed, in large, complex deals, the latter approach is likely the norm.

The partnership allocation rules have been called "a creation of prodigious complexity . . . essentially impenetrable to all but those with the time, talent, and determination to become thoroughly prepared experts on the subject."[120] Unfortunately, that is not an exaggeration.

For an allocation to have substantial economic effect under the safe harbor, the capital accounts must be maintained in accordance with the rules in the regulations. As the name of the substantial economic effect test suggests, an allocation meets the test if it has a genuine after-tax economic effect on the partner to whom the allocation is made. The rules for maintaining the capital accounts help fulfill this task. Because the concern here is with the economic effects rather than tax impacts, the rules for maintaining capital accounts are quite different from the rules for computing a partner's basis in his partnership interest (outside basis).

Under the regulations,[121] a partner's capital account is increased by:

1. the amount of money contributed to the partnership;

2. the FMV of property contributed to the partnership (net of liabilities secured by the property that the partnership is considered to assume or take subject to section 752);[122] and

3. allocations of partnership income and gain, including tax-exempt income.

A partner's capital account is decreased by:

1. the amount of money distributed to the partner;

2. the FMV of property distributed to the partner (net of liabilities secured by the property that the partner is considered to assume or take subject to section 752);

3. allocations of expenditures of the partnership that can be neither capitalized nor deducted in computing taxable income; and

4. allocations of partnership loss and deduction.

The differences between the way a partner's outside basis is calculated and the way his capital account is calculated are as follows: The outside basis is increased for the basis of contributed property, not its FMV as is the case with capital accounts. Further, a partner's capital account does not include the partner's share of partnership liabilities, whereas under section 752, a partner's outside basis does. This disparity exists because, roughly at least, a partner's capital account is designed to measure a partner's net economic investment in the partnership. But a partner's outside basis is meant to reflect his "tax investment" in the partnership, and for tax purposes partnership liabilities can be included in a partner's outside basis under section 752.[123] The bottom line is that if the partnership has liabilities, a partner's outside basis often will exceed his capital account balance.[124] Because a partner may

[119]Reg. section 1.704-1(b)(3).

[120]Lawrence Lokken, "Partnership Allocations," 41 *Tax L. Rev*. 547 (1986).

[121]Reg. section 1.704-1(b)(2)(iv)(a).

[122]The FMV assigned to property will be regarded as correct if (1) that value is reasonably agreed to among the partners in arm's-length negotiations, and (2) the partners have sufficiently adverse interests. *See* reg. section 1.704-1(b)(2)(iv)(h).

[123]Section 752 mirrors the rule that when a taxpayer acquires property with debt, recourse or nonrecourse, that debt is included in the tax basis of the acquired property. *See Crane v. Commissioner*, 331 U.S. 1 (1947).

[124]This is not inevitably the case, however. For example, if the partner contributes property to a partnership with an FMV that greatly exceeds its basis, the capital account may exceed the tax basis of the partnership interest even after factoring in liabilities.

receive loss allocations up to his outside basis,[125] a partner may have a positive tax basis and a negative capital account.

For example, assume a partner contributes $20,000 to a partnership and his share of partnership liabilities under section 752(a) is $10,000. The partner's capital account is $20,000, but the outside basis is $30,000. Section 704(d) permits a partner to deduct losses up to his basis in the partnership interest.[126] If a partner could not have a negative capital account, it would be impossible to deduct losses up to the partner's total tax investment in the partnership. To allow section 704(d) its full reign, the regulations permit partners to have negative capital accounts.

A brief digression: In the capital account context, it is necessary to distinguish between tax gain and book gain and between tax basis and book value. They may be the same but need not be. They will be different if a partner contributes property to a partnership with a tax basis different from FMV. The partnership's tax basis in the partnership is typically a carryover basis under section 723. But the book value is the FMV. In this report, I assume book value and tax basis are the same.

As mentioned above, the regulations' substantial economic effect rules are a safe harbor. An allocation that has substantial economic effect is allowed under section 704(b). There are two parts to the test. First, the allocation must have economic effect. The regulations in most instances provide a mechanical test for determining whether an allocation has economic effect, which I outline below. Second, because it is often possible to manipulate the economic effect test, the regulations also provide that the economic effect of an allocation must be substantial. Generally, the economic effect of an allocation is substantial if on an after-tax, present value basis, a partner's economic investment in the partnership is either enhanced or diminished as a consequence of the allocation, though there are several variations on that theme.[127] Because my focus is on negative capital accounts, which can come into being under the economic effect test, there is no need to delve further into the substantiality test, important though its role is.

Partnerships have three options under the regulations to meet the economic effect test: the regular economic effect test, the alternate economic effect test, and the economic effect equivalence test.[128] I will discuss only the first two of these options since they are the ones most pertinent to negative capital accounts.

The regular test has three parts:

1. The partnership must keep capital accounts in accordance with the rules described above.

2. When an interest of a partner is liquidated, the partner must be paid any positive balance in his capital account.

3. If a partner has a deficit balance in his capital account, he must pay the deficit to the partnership by the end of the tax year in which his partnership interest is liquidated (or, if later, 90 days after liquidation). This last rule is sometimes called a DRO.[129]

This regular economic effect test requires the partner to have an unlimited DRO. An unlimited DRO can mean unlimited liability. I give my partnership tax students the following example: An employee of a limited partnership while on partnership business runs over a neurosurgeon with eight handicapped children. The personal liability judgment far exceeds the partnership's insurance limits and generates a large loss. Under the limited partnership agreement, 99 percent of losses are allocated to the limited partners. If the limited partners have unlimited DROs, the losses can be allocated to them, possibly generating large negative capital accounts. If the partnership liquidates soon thereafter, the limited partners will end up paying for 99 percent of the personal injury judgment, which almost certainly was not contemplated.

Recognizing this business reality, the regulations contain an alternative in reg. section 1.704-1(b)(2)(ii)(d). Under this alternative, partners may have either no DRO or only a limited DRO. The partnership agreement must meet the first two economic effect tests (keep capital accounts according to the rules, and upon liquidation, pay to a partner any positive balance in his capital account). The next requirement is that the partnership agreement have a qualified income offset provision (discussed below). If this alternative test is met, for partners with no DROs, an allocation will be treated as having economic effect if the allocation does not cause the partner to have a deficit capital account balance (taking some adjustments into consideration), or increase an existing deficit capital account balance. For partners with limited DROs, the rules are the same except that the allocation cannot cause the capital account to be negative by more than the limited DRO or increase a negative capital account that already exceeds the limited DRO. If a partner

[125]Section 704(d).

[126]Section 704(d) may be trumped by the at-risk rules of section 465 and the passive loss rules of section 469.

[127]Reg. section 1.704-1(b)(2)(iii)(a).

[128]*See* Lipton et al., *supra* note 32, at section 5.03B.

[129]Reg. section 1.704-1(b)(2)(ii)(a)-(c).

has a negative capital account balance, economically she has taken more out of the partnership than she has put into it, thus the requirement under the regular rules that she restore any deficit upon liquidation of her interest. If the partner is not going to have a DRO (or is going to have only a limited DRO), it makes sense that a current allocation would not be allowed to cause her to have a deficit capital account (or one that exceeds a limited DRO). Indeed, at one time that was almost all there was to the rule. The difficulty with keeping the rule that simple is that a capital account can become negative (or excessively negative) for reasons other than allocations. The partnership could, for example, make a distribution to a partner that would cause a negative capital account balance (or an excessive negative capital account balance). Although the IRS can force a partnership to change the way it makes allocations, it cannot control who the partnership makes distributions to.

The IRS needed a mechanism for eliminating the deficit capital account of a partner who has no obligation to restore it or the excessively negative capital account for a partner with only a limited DRO. That mechanism was to require the partnership to allocate income to the partner to offset any deficit the partner was not obligated to restore. Further, distributions are not the only events the IRS cannot control that can cause a capital account to become negative. Some provisions of subchapter K can require allocations to a partner that might create an excessive deficit capital account, so the IRS needed to account for those events as well. Finally, it is obviously preferable to avoid the deficit capital account to begin with. To this end, the partnership is required to reduce the capital account for specified reasonably expected future events before determining whether the proposed allocation will create a deficit capital account.[130] These rules are of no great import for this report and will not be detailed here.

Thus, the relevant regulations[131] provide that a partner may have either no DRO or only a limited one, if:

1. the first two requirements of the regular rule are satisfied (that is, the requirement to keep capital accounts in accordance with the regulations and pay to a partner upon liquidation of his interest any positive capital account balance);
2. the allocation does not cause or increase a deficit capital account balance beyond any limited DRO; and
3. the partnership agreement contains a qualified income offset provision.

A qualified income offset provision provides that if, despite the above, a partner's capital account goes negative beyond any limited DRO (for example, by a distribution), the partner 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 that year) in an amount and manner sufficient to eliminate the excess deficit balance as quickly as possible.[132]

Assume a partner has a $10,000 capital account and that there are no reasonably expected future events. If the partner has no DRO but the partnership agreement includes a qualified income offset provision, the allocations to him will still be effective as long as they do not cause him to have a negative capital account.[133] In other words, the maximum loss allocation to that partner is $10,000. If, for example, because of a distribution, the partner's capital account does go negative, the partnership is required to abandon its regular allocation regime and first allocate income to the partner with the negative capital account until the capital account is restored to zero.[134]

As indicated above, sometimes partners have limited DROs. They will agree to restore a deficit in their capital account up to a specified amount but not beyond that. A partner might agree to a limited DRO in order to be allocated more losses. In that situation, the partnership will need to comply with the qualified income offset rules, and allocations can be made to a partner that create a negative capital account up to the fixed amount that the partner is obligated to restore. Thus, if a partner has a $5,000 DRO, he could be given allocations that caused him to have up to a $5,000 negative capital account as long as the partnership otherwise complies with the qualified income offset rules.

Because this report is about partners with negative capital accounts, typically the partners in question will have to have some kind of DRO, at least if the partnership has recourse debt. It is conceivable, however, that some of the discussion will apply to a partner with a negative capital account and no DRO if the qualified income offset requirement has not yet been able to fully restore the capital account to zero because of insufficient income, for example.

Alas, there is yet another wrinkle for partnerships with nonrecourse debt. It is not uncommon

[130]*See* Lipton et al., *supra* note 32, at section 5.03B2.

[131]Reg. section 1.704-1(b)(2)(ii)(d).

[132]*Id.*

[133]The allocation could also not increase a negative capital account she already had for some reason.

[134]If multiple partners are in this situation, the income is allocated pro rata. Reg. section 1.704-1(b)(2)(ii)(d).

for partnerships involved in the real estate industry to use nonrecourse financing. The use of nonrecourse financing involves more than just tax planning. Avoiding personal liability is preferable for obvious reasons. Lenders would, of course, prefer recourse lending, but they commonly make nonrecourse loans to stay competitive in the lending market. When enough equity is present, lenders may actually prefer nonrecourse loans because typically the interest rate on nonrecourse debt is higher than that on recourse debt.

However, the use of nonrecourse financing poses a dilemma for partnership allocations. Recall that the cornerstone of the substantial economic effect rules is that allocations have a genuine economic effect on the partners. This poses a problem for deductions generated by nonrecourse debt, which are called "nonrecourse deductions."[135] When a taxpayer, including a partnership, purchases property with debt, recourse or nonrecourse, that debt is included in the basis of the property.[136] As noted above, partnership liabilities are allocated to partners under section 752 and can increase partners' outside bases. Nonrecourse deductions arise when, for example, depreciation deductions are generated a partnership property's basis attributable to nonrecourse debt (which would occur after any equity in the property has been depreciated away).[137] The partners have an economic risk only to the extent of any cash or property invested. To the extent that basis and associated deductions are generated by nonrecourse debt, only the lender is truly at risk. If the venture fails, the partners can walk away without any personal obligation on the debt. If the deductions generated by the nonrecourse debt cause the partners to have negative capital accounts, a DRO may not be very meaningful. If all the partners have negative capital accounts, which commonly eventually occurs when nonrecourse debt is used, none of them will have an incentive to enforce DROs.[138] For that reason, DROs don't normally exist in the nonrecourse context unless the lawyers are not paying attention. The regulations therefore conclude that if property is purchased with nonrecourse debt, only allocations of deductions attributable to the equity invested by the partners can have economic effect.[139] Allocations of nonrecourse deductions cannot have economic effect.[140]

> **Example:** Assume AB Partnership has two equal partners, A and B. A and B invest no funds in the partnership, and the partnership borrows $200,000 on a nonrecourse basis and uses the proceeds to buy an apartment building for $200,000. No principal payments on the debt are due for five years. Capital accounts are not increased for a partner's share of loan proceeds, so the partners' beginning capital accounts are zero. If the property drops in value to $150,000, the partners could simply default on the loan and would not be obligated to make any payment to the lender. The lender bears the risk of loss on the decline in the property's value. Now assume that AB Partnership takes $20,000 in depreciation deductions on the property. If we assume that the partnership breaks even except for depreciation deductions, A and B have negative capital accounts of $10,000 each and the partnership's basis is reduced to $180,000.[141] A and B (as is normally the case) do not have DROs. Thus, neither A nor B has borne the economic burden of the allocations, and those allocations cannot have economic effect.

Because the allocation of nonrecourse deductions cannot have economic effect, the general rule of the regulations is that they must be allocated in accordance with the partners' interests in the partnership.[142] The use of nonrecourse debt is fairly common, and there are legitimate nontax reasons for its use. It was thus incumbent on the IRS to come up with a more definite approach that would permit partners to allocate nonrecourse deductions, and indeed, the regulations provide a safe harbor. The cornerstone of the safe harbor is the fact that when there are nonrecourse deductions, there is also minimum gain. The Supreme Court held in *Tufts*[143] that if a taxpayer sells or disposes of property encumbered by nonrecourse debt, the amount realized includes the amount of that debt. Thus, at a minimum, the taxpayer must recognize taxable gain to the extent that the encumbering nonrecourse debt exceeds the taxpayer's basis in the property.

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[135] Reg. section 1.704-2(b)(1).

[136] *See Crane*, 331 U.S. 1.

[137] *See* reg. section 1.704-2(c).

[138] As I discussed earlier in this report, it may be possible for creditors to be third-party beneficiaries of DROs created by recourse debt. But it is unlikely that a creditor could be a third-party beneficiary of a DRO created by nonrecourse debt because that would have the effect of making a nonrecourse debt recourse.

[139] If recourse debt is also used, deductions attributable to the recourse debt can also have economic effect.

[140] Reg. section 1.704-2(b)(1).

[141] The regulations use book value rather than tax basis if there is a book-tax disparity, but in this example book value and tax basis are the same. *See* reg. section 1.704-2(d)(3).

[142] Reg. section 1.704-1(b)(3).

[143] *Commissioner v. Tufts*, 461 U.S. 300 (1983).

Indeed, on any taxable disposition of property subject to nonrecourse debt, this excess is the minimum gain that a taxpayer will have to recognize. Although A and B may not be required to restore the deficits in their capital accounts, it is still possible to bring their capital accounts back to at least zero. This is done by allocating minimum gain to each partner in an amount at least sufficient to bring the capital account to zero. In the example, if AB Partnership defaults on the loan after the first year, the partnership and its two partners have $20,000 gain on the foreclosure ($200,000 debt minus $180,000 basis). Allocating that gain equally to A and B brings their capital accounts back to zero. Thus, if allocations of nonrecourse deductions are made and the basis of the property is reduced below the amount of the debt, we can commonly be assured that at some point there will be compensating minimum gain. Generally, the regulations allow allocations of nonrecourse deductions to a partner as long as an equal amount of minimum gain is allocated to that partner (this minimum gain is unrecognized but inherent in the property).[144] Further, partners may generally have negative capital accounts, even if they do not have DROs, to the extent of their shares of minimum gain. There can be a genuine economic impact to this minimum gain. If the only gain recognized is the amount of the minimum gain, no cash will be going to the taxpayer, and he will have to reach into his pocket to pay the taxes on the minimum gain (income without cash is sometimes called "phantom income").

Because the allocation of deductions attributable to nonrecourse debt cannot have economic effect, the regulations provide that they must be allocated in accordance with the partners' interests in the partnership.[145] The regulations provide a complex safe harbor that contains several specialized terms. Partnership minimum gain is determined by computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than the full satisfaction of the liability — in other words, the amount by which the nonrecourse liabilities exceed the property's basis.[146]

The amount of nonrecourse deductions for a partnership tax year equals the net increase in partnership minimum gain during that year.[147] In the example above, if the property generates $20,000 of depreciation deductions in the first year and there are no other expenses for the property, the property's basis is reduced by $20,000, meaning that the increase in partnership minimum gain is also $20,000. It went from zero to $20,000. Note that the partnership can have nonrecourse debt without creating nonrecourse deductions. Until there is minimum gain, any deductions are considered to come from the equity in the property.[148] Nonrecourse deductions are created when the partnership generates minimum gain. Nonrecourse deductions and minimum gain are two sides of one coin. Nonrecourse deductions consist first of depreciation deductions for property that is subject to nonrecourse debt and then, generally, of pro rata portions of the partnership's other deductions and section 705(a)(2)(B) expenditures.[149]

Despite the lack of economic effect, the regulations provide a safe harbor under which the allocation of nonrecourse deductions will be allowed[150]:

1. The partnership must comply with the economic effect test discussed earlier. Recall that part 3 of that test requires a partner to either have an unlimited DRO or meet the qualified income offset rules. Also, recall that under the qualified income offset rules, a partner may have a deficit capital account to the extent of any limited DRO. Partnerships using nonrecourse debt commonly do not have DROs. The nonrecourse deduction rules allow for deficit capital accounts despite the lack of a DRO to the extent of a partner's share of minimum gain. The qualified income offset rules provide that partners may have negative capital accounts to the extent of their shares of minimum gain. A partner's share of minimum gain is considered a limited DRO for purposes of the qualified income offset rules.[151]

2. Beginning in the first tax year of the partnership in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, the partnership agreement must provide for allocations of nonrecourse deductions in a manner that is "reasonably consistent" with allocations of some other

[144]Technically, the regulations provide that if the allocation of nonrecourse deductions is in accordance with the regulatory rules, it will also be in accordance with the partner's interest in the partnership. Reg. section 1.704-2(b)(1).

[145]Reg. section 1.704-2(b)(1).

[146]Or book value if different from tax basis. Reg. section 1.704-2(d)(1), (3). Section 704(c) governs book-tax disparities.

[147]Reg. section 1.704-2(c). This is reduced by any distributions of nonrecourse liabilities that are attributable to an increase in minimum gain. Increases in partnership minimum gain resulting from conversions, refinancing, and other changes to the debt instrument do not generate nonrecourse deductions.

[148]Reg. section 1.704-2(c).

[149]Reg. section 1.704-2(j)(1).

[150]Reg. section 1.704-2(e).

[151]Reg. section 1.704-2(g)(1).

significant partnership item attributable to the property securing the nonrecourse liabilities that has substantial economic effect.

3. The partnership must have a minimum gain chargeback provision, discussed below.

4. The partnership must otherwise comply with the regulatory rules for allocations.

Eventually, minimum gain inherent in partnership property will be reduced. The partnership might sell the underlying property (meaning the associated minimum gain drops to zero), or it might pay down some or all of the nonrecourse debt. Of course, the key item that has been driving this whole allocation system is that there is minimum gain available to offset the nonrecourse deductions. What does the partnership do when the minimum gain goes down? The regulations provide that at that time there is a minimum gain chargeback, meaning that the partners must be allocated items of income and gain equal to their shares of the net decrease in minimum gain.[152] Of course, if the partnership sells the underlying property (or has it taken in foreclosure), finding the gain will not be a problem. The gain from the sale or foreclosure will be available for this purpose. Indeed, the regulations provide that any minimum gain chargeback must consist first of gains recognized from the disposition of partnership property subject to partnership nonrecourse liabilities. But if there is no such disposition gain because, for example, the reduction in minimum gain resulted from paying down the debt, the partnership must allocate a pro rata portion of the partnership's other items of income and gain to the partners to offset the drop in minimum gain. If insufficient income and gain are available in the year in which the drop in minimum gain occurs, the allocations continue in future years until the full offset has been made. This minimum gain chargeback allocation is made before any other section 704 allocations.[153]

What is a partner's share of partnership minimum gain? Generally, it is the sum of the nonrecourse deductions allocated to the partner, net of prior minimum gain chargebacks.[154] ■

[152]Reg. section 1.704-2(f)(1).
[153]Reg. section 1.704-2(j).
[154]Reg. section 1.704-2(g)(1).