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Partnership Tax Allocations: The Basics

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Partnership Tax Allocations: The Basics

by Walter Schwidetzky

This article discusses the basic rules for partnership tax allocations and identifies when practitioners should consult with experts in this area.

This article endeavors to help practitioners who are not partnership tax allocation experts identify when they should consult with those that have that expertise. The partnership-allocation Treasury Regulations 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.” This article is written for those, to date at least, without that time and determination. At the same time, the article provides an introduction to the partnership tax allocation rules for those contemplating making the requisite investment of time and determination.

The term “partnership,” for purposes of this article, means a tax partnership. A tax partnership typically includes state law partnerships and limited liability companies (LLCs) with two or more members. The term “partner” may also refer to an LLC member.

Regarding tax law generally, there is almost no rule without an exception. Accordingly, half the sentences in this article could begin with the words “typically” or “generally,” generally, they don’t.

The Partnership Entity

A partnership is a flow-through entity, meaning that the entity is not taxed. Rather, income and deductions are passed through to the partners. Thus, a mechanism needs to exist for determining each partner’s allocable share of partnership income and deductions. IRC § 704(b) and the Treasury Regulations generally allow partners a great deal of flexibility in this regard. The allocations do not necessarily have to be proportional to the underlying ownership of the partnership interests. For example, someone who is otherwise a 50% partner could be allocated 90% of depreciation deductions. Or all losses could initially be allocated to the “money partners,” with subsequent income allocated to them to the same extent as losses; subsequently income is allocated 50% to the money partners and 50% to the promoters. (This is sometimes called a “flip”; flips are quite common.)

As discussed in more detail below, if all of the partners’ interests in the partnership do not change and their shares of recourse and nonrecourse debt match their partnership interests, a practitioner can often forgo consulting an expert and inserting complex allocation language into the partnership agreement. To illustrate, in LLC ABC, the members’ interests are, and always will be, A 40%, B 35%, and C 25%, and their shares of LLC debt, recourse or nonrecourse, match those interests. Thus, if the members guarantee an LLC debt (making the debt recourse to them), they guarantee it in such a way that their bottom-line liability (assuming everyone is reasonably expected to fulfill his or her obligation) matches their LLC interests.

Note that it is preferable if all partners contribute cash. If they contribute appreciated or depreciated property, that does not in and of itself create a risk of violating the IRC § 704(b) Treasury Regulations, but it does trigger IRC § 704(c) and its Treasury Regulations. IRC § 704(c) and its Treasury Regulations are complex. An important feature is that, generally, tax gain or loss inherent in contributed property must be allocated to the contributing partner. If the agreement is silent on IRC § 704(c), the partners default into the “traditional method,” which may not be preferable.

The overwhelming majority of the provisions in the Treasury Regulations are meant to address circumstances other than the one described in the example. The Treasury Regulations endeavor to permit partners to vary allocations for legitimate business reasons, while disallowing allocations that primarily have a tax-avoidance motive. That is a difficult line to draw and makes for complex Treasury Regulations. Many of the IRC’s partnership provisions were created before most of the people reading this article were born, at a

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time when partnerships were usually vehicles for small businesses. Businesses of any size were typically either C corporations or S corporations. C corporations are subject to two levels of tax, one on corporate taxable income and a second on dividends. Tax rates in the 1960s on C corporations could be over 50%, and top tax rates on dividends paid to individuals varied from around 90% in 1960 to around 70% in 1970, making double taxation a big problem. An S corporation has one level of tax, at the shareholder level, but there is no (or at least no sufficient) means of varying allocations among shareholders.\(^7\)

But taxpayers often wanted flexibility in their business arrangements. Starting in the 1960s, non-publicly traded businesses increasingly moved to limited partnerships, which afford taxpayers both one level of tax at the partner level and the ability to vary allocations. Most “tax shelters” from this era were limited partnerships. In some ways, Congress and the IRS have been playing catch-up ever since. Had Congress seen this coming, it might have constructed the partnership tax rules differently. But it did not. From time to time, commentators have proposed ways of getting the genie back into the bottle and radically changing the partnership tax rules to make them less flexible, less subject to abuse, and often more S corporation-like. But those efforts, to date, have always come to naught.\(^8\) Numerous anti-abuse rules, however, have been added to the Code and Treasury Regulations, making partnership taxation one of the most complex areas in all of taxation (no mean feat). But the fundamental structure of partnership taxation has not changed.

This article takes a “gentle” look at the Treasury Regulations to provide a basic understanding of the derivation of the complex tax provisions sometimes seen in partnership agreements. Often these provisions cannot be avoided, and practitioners need to consult a tax professional to ensure an agreement says what it needs to say. But complex tax provisions can sometimes be avoided, as discussed below.

**Substantial Economic Effect Rules**

To oversimplify a bit, under IRC § 704(b), allocations must either be “in accordance with the partner’s interest in the partnership” or have “substantial economic effect.”\(^9\) The Treasury Regulations contain detailed rules on when an allocation has substantial economic effect, and say little about when an allocation is in accordance with a partner’s interest in the partnership. As the name suggests, an allocation has substantial economic effect if it has a genuine after-tax, economic effect on the partner to whom the allocation is made. Given the detailed provisions in the Treasury Regulations, the substantial economic effect rules constitute what tax professionals call a “safe harbor,” meaning taxpayers know they are safe if they comply with these rules. If they do not, they cannot know with confidence that their allocation regimen will pass muster (though sometimes they can be confident it will not).

One might assume this reality would force taxpayers to comply with the safe harbor provisions, and often it does. But in larger deals it is probably the norm that tax professionals consciously choose to not comply with the safe harbor, hoping that either the
IRS or a court can be persuaded that the allocations are in accordance with the partners’ interests in the partnership, notwithstanding the lack of a clear definition in this regard. (There are often good reasons for this choice, which are beyond the scope of this article.) This choice likely will not have to be defended, however, because the odds of being audited are low, and there have been a relatively small number of cases on this issue, some won and some lost by taxpayers. The more the allocation is primarily about saving taxes and the less it is driven by genuine business considerations, the more likely it is that the taxpayer will lose.  

**Capital Accounts**

Given that the Regulations focus on economic effect, a method is needed to measure a partner’s economic investment in the partnership. “Capital accounts” perform this function. Partnerships that wish to formally comply with the substantial economic effect rules must have a provision in the partnership agreement that requires the partnership to keep capital accounts in accordance with the Treasury Regulations. Because the concern here is with economic rather than tax impacts, the rules for keeping capital accounts are quite different from the rules for computing partners’ tax bases in their partnership interests.

Under the Treasury Regulations, a partner’s capital account is increased by (1) the amount of money contributed to the partnership; (2) the fair market value of property contributed to the partnership (net of liabilities secured by the property); 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 fair market value of property distributed to the partner (net of liabilities secured by the property); and (3) allocations of partnership losses and deductions.

Note that a partner’s capital account does not include that partner’s share of partnership liabilities. But under IRC § 752, the partner’s tax basis in his partnership interest can include his share of those liabilities (a full explanation of which would require a separate article). If the partnership has liabilities, a partner’s basis in his partnership interest often will exceed his capital account balance. Because, subject to the at-risk and passive activity loss rules (explaining them would require yet another article), a partner may receive loss allocations up to his basis in the partnership interest under IRC § 704(d), a partner may have a positive tax basis and a negative capital account. Partners are allowed to have negative capital accounts under some circumstances, and defining these circumstances makes for a lot of complexity in the Treasury Regulations.

To comply with the Treasury Regulations, a partnership maintains “book” accounts for the properties it holds. For example, if a partner contributes property with a tax basis of $7,000 and a fair market value of $10,000, the partnership’s tax basis in that property under IRC § 723 is $7,000. However, the partnership’s “book value” (sometimes called “book basis” by tax professors) is the full fair market value of $10,000. Book value, like the capital account, focuses on the economic value of contributed property. If a partnership makes a distribution of property for which the fair market value differs from its book value, for capital account purposes, the partnership recognizes the inherent book gain or loss and allocates that gain or loss to the partners’ capital accounts. There probably will not be any corresponding taxable gain or loss, and thus no effect on the partners’ bases in their partnership interests, as distributions are commonly not taxable events to the partnership or the partners.  

For example, assume a partnership has two equal partners, A and B, and holds a property with a fair market value of $20,000 and a book value of $15,000 (ignore the tax basis and any possible tax consequences). It distributes the property to A. Recall that A’s capital account is reduced for the full fair market value of the property, that is, $20,000. To enable capital accounts to properly do their job, which is to reflect the economics of the partners’ investments, the partners’ capital accounts must be adjusted for the gain inherent in the distributed property. Accordingly, for capital account purposes, the partnership recognizes the $5,000 of gain inherent in the property and allocates $2,500 of the gain to each partner’s capital account, increasing each capital account by that amount.

There are two parts to the substantial economic effect test. First, the allocation must have economic effect, and second, the economic effect must be substantial.

**Economic Effect Test**

Partnerships have three options under the Treasury Regulations to satisfy the “economic effect” test: the “regular” economic effect test, the “alternative” economic effect test (touched on here only briefly), and the “economic effect equivalence” test (which can spare “straight-up” deals a lot of complex language in the agreement).

**“Regular” Rules**

Under the regular test, (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 her capital account; and (3) if a partner has a deficit balance in her capital account, she must pay the deficit to the partnership by the end of the tax year in which her partnership interest is liquidated (or, if later, 90 days after liquidation). The first two parts of the test are self-explanatory. The third rule is sometimes called a deficit restoration obligation (DRO).

A DRO should rarely be unlimited. For example: Assume the partners form a limited partnership and all partners have unlimited DROs. An employee of the partnership, while conducting partnership business, runs over and kills a neurosurgeon with eight children, all with some type of disability. A large tort liability, in excess of insurance limits, results. The general partner is the only one liable under state partnership law, and he contributes sufficient funds to the partnership to enable it to pay the liability, thus increasing the general partner’s capital account. The payment results in a large tax loss to the partnership that, depending on the allocation provisions in the partnership agreement, may be primarily allocated to the limited partners. The allocation causes the limited partners to have substantial negative capital accounts. If they have to restore those deficit capital accounts (as might happen if the general partner decided to take this opportunity moment to cause the partnership to liquidate), they would in effect be paying the tort liability, which was something that likely was not contemplated when they entered into the partnership agreement. The bottomless risk that an unlimited DRO poses makes it untenable for most partners, even those with management responsibilities. Note
that unless a DRO provision is carefully drafted, a creditor can become a third-party beneficiary of the DRO and enforce it. Further, regardless of how well the DRO is drafted, a trustee in bankruptcy can likely enforce it.\textsuperscript{13} In response to these realities, the Treasury Regulations, under some circumstances, permit a partner to have no DRO or only a limited DRO. Most advisors probably counsel their clients to avoid DROs altogether, if possible.

To understand the role of DROs, assume the partners have unlimited DROs. For example: On January 1 of year 1, A and B each invest $10,000 in the AB partnership. The partnership purchases equipment for $20,000. The tax basis of the equipment is, of course, $20,000, and that is also its book value. The Treasury Regulations in this context focus on the adjustments to book value.\textsuperscript{16} Assume that book depreciation deductions are $5,000 per year and the partnership has no debt.\textsuperscript{17} Further, assume the partnership breaks even on its operations except for depreciation deductions, and thus the partnership operates at a $5,000 book loss per year for the first three years. The partnership agreement complies with the regular economic effect rules and allocates all of the depreciation deductions to A (perfectly permissible). After three years of allocations, A's capital account is reduced to a negative ($5,000); B's capital account remains at $10,000; and the book value of the equipment is reduced for the depreciation to $5,000. Importantly, the Treasury Regulations commonly assume that a property has a fair market value equal to its book value.\textsuperscript{18} If the partnership were to liquidate at the end of the third year, the partnership (it is assumed) could sell the equipment for $5,000. For B to receive the $10,000 balance in her capital account, A must restore the negative ($5,000) balance in his capital account. The sale proceeds coupled with the contribution by A will provide the partnership with the $10,000 needed to pay B her positive capital account balance. As A's capital account is now zero, the partnership has no obligation to make a payment to A. In the parlance of the Treasury Regulations, all of the depreciation allocations have "an economic effect" on A: A's capital account is taken from a positive $10,000 to a negative ($5,000), and A has a DRO. Thus, we have not just allocated tax attributes to A. The adjustments to A's capital account coupled with the DRO mean that there is a real economic impact on A as well. Note also that if the partnership is in compliance with the economic effect rules, after liquidation of a partner's interest, the partners' capital accounts will be zero.

**Alternative Economic Effect Rules**

As noted above, the difficulty with the regular economic effect rules is that partners are required to have unlimited DROs. That is likely unwise for any owner, but especially for passive investors.

Recognizing this business reality, Treas. Reg. § 1.704-1(b)(2)(ii)(d) provides an alternative. Under this alternative, an allocation must meet the first two economic effect tests (keep capital accounts according to the rules and, upon liquidation, pay a partner any positive balance in his capital account). But instead of having to meet the third economic effect test by having an unlimited DRO, the partnership agreement contains a qualified income offset (QIO) provision (discussed below). Assuming there is no DRO, if this alternative test is met, an allocation will be treated as having economic effect if the allocation does not cause the partner to have a deficit capital account balance or increase an already-existing deficit capital account balance. If a partner has a negative capital account balance, economically she has taken more out of the partnership than she put into it (hence the requirement under the regular rules that she restore any deficit on liquidation of her interest). If the partner does not have a DRO, it makes sense that a current allocation that would cause her to have a deficit capital account not be allowed. 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 for reasons other than allocations. The partnership could, for example, make a distribution to a partner that would cause a deficit capital account balance. While the IRS can force a partnership to change the way it makes allocations, it cannot control to whom a partnership makes distributions.\textsuperscript{19}

The IRS mechanism for eliminating the deficit capital account of a partner who has no obligation to restore it is the Treasury Reg. § 1.704-1(b)(2)(ii)(d) requirement that the partnership allocate income to the partner to offset any such deficit: This is the QIO. If a QIO is triggered, the partnership must put aside its normal allocation regimen and allocate income, including gross income, to the relevant partners, before making any other allocations. If all of the partners become proportionately negative in their capital accounts, the QIO may yield the same results as the normal allocation regimen. But if some are negative and some not, triggering a QIO can wreak near-term allocation havoc. Typically, partnership agreements provide that if a QIO is triggered, the partnership will adjust allocations later to return the partners back to where they would have been had the QIO not been triggered.

A partner can agree to a limited DRO, which is likely the only kind of DRO to which a well-advised partner will agree. A partner might agree to a limited DRO to be allocated more losses. In this circumstance, the partnership must comply with the QIO 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 $10,000 DRO, she could be given allocations that caused her to have up to a ($10,000) negative capital account as long as the partnership otherwise complies with the qualified income offset rules.

As is doubtless obvious, the QIO rules require complex provisions in the partnership agreement. Attorneys should consult someone with the relevant partnership tax expertise to understand the implications of each agreement that has QIO provisions.

Most attorneys will not want to comply with the regular rules, which are already fairly complex and require unlimited DROs. The QIO rules are even more complex. Is there a way out for the non-partnership tax specialist? Can an LLC agreement comply with the Treasury Regulations without having complex tax provisions? Thankfully, the answer is yes.

**Economic Effect Equivalence**

Allocations made to a partner that do not otherwise have economic effect under the rules discussed above can nevertheless be deemed to have economic effect under a third alternative, the "economic effect equivalence test," also referred to in this article as "straight-up allocations." If a partnership liquidation at the end of a given year or at the end of any future year would produce the same economic results to the partners as would occur if the regular economic effect test were met, regardless of the economic performance of the partnership, the economic equivalence test is met.\textsuperscript{20}

The Treasury Regulations offer this example: Assume A and B contribute $75,000 and $25,000, respectively, to the AB partnership. Assume further that the partnership maintains no capital
accounts, the partnership agreement has no “tax provisions,” but the partnership agreement does provide that all income, gain, loss, deduction, and credit will be allocated 75% to A and 25% to B. A and B are ultimately liable (under a state law right of contribution) for 75% and 25%, respectively, of any debts of the partnership. Although the allocations do not satisfy the requirements of the regular or alternative economic effect rules discussed above because of the lack of the relevant provisions in the partnership agreement, the allocations have economic effect under the economic effect equivalence test. Further, most partnership tax practitioners would say the allocation is also in accordance with the “partners’ interest in the partnership” (the “backstop” IRC § 704(b)) test. Thus, in a sense this allocation regimen is doubly safe. It would be wise to state in the operating agreement that “the relevant percentages are the partners’ interest in the partnership,” to take full advantage of the statute.

In more complex situations, such as when the partners have varying interests over time or varying interests in different items, it may be difficult or even impossible to prove that a liquidation of the partnership at the end of a given year or at the end of any future year would produce the same economic results to the partners as would occur if the regular economic effect test were met, regardless of the economic performance of the partnership. Accordingly, practitioners can only be confident that they will be in compliance with the economic effect equivalent test (which typically means also being in compliance with the partners’ interests in the partnership test) if the partners’ interests in all tax items are always the same and their liability for partnership debts matches their partnership interests (as in the example from the Treasury Regulations).

Straying from these limitations without partnership tax expertise invites peril, but there may be a little wiggle room for liabilities. As just noted, for attorneys who want to avoid complex tax provisions, it is generally recommended that the sharing of liabilities match allocations and the partners’ partnership interests. Recall that a partner’s share of partnership liabilities gives the partner more basis in the partnership interest, and more basis can lead to more deductions. That said, if everything else is held constant, and one partner has a proportionately larger share of liabilities than other partners, it may simply mean that he runs out of basis later and can take a greater share of his deductions currently.

For example, assume that in the equal AB LLC, each of the two members contributed $100 to the LLC and owns a 50% interest. They agree to split everything 50/50. The LLC has $200 of debt, which A has personally guaranteed, without a right of contribution from B. Under IRC § 752, the debt is classified as recourse debt and is allocated entirely to A. Under these facts, A’s basis in his LLC interest is $300 and B’s is $100. Putting aside the at-risk and passive activity loss rules, if the LLC operates at a loss, A may be able to use his 50% share of losses more quickly than B, given A’s higher basis. Assume, for example, that the LLC has a net loss in the first year of $400, $200 of which is preliminarily allocated to each member. A can deduct his entire $200 share, but B can deduct only $100, because under IRC § 704(d), a member’s loss deductions are limited to the member’s basis in the partnership interest (for an LLC classified as a partnership). For B, the other $100 of loss is carried forward to a future year when B has more basis in the LLC interest. In this simple example, it might well be possible for the partners to meet the economic effect equivalence test, notwithstanding the fact
that they do not share partnership debt in the same proportions as their general ownership interests. But the rules for sharing liabilities, recourse and nonrecourse, get very complicated, very quickly. And those rules interact with the economic effect rules. So while there may be situations where partners can share liabilities disproportionately and still meet the economic effect equivalence test, it would be wiser, nonetheless, to consult with a partnership tax professional in these circumstances.

Substantiability

Note that the entire name of the regulatory safe harbor is the substantiable economic effect test. For all of their complexity, the economic effect rules are not enough to get the job done. They are, for the most part, mechanical rules, and like all mechanical rules can be inappropriately manipulated. Accordingly, the Treasury Regulations provide that the allocation must have economic effect and that the economic effect must be substantial. The Treasury Regulations provide four independent tests of whether the economic effect of an allocation is substantial, the details of which are, frankly, too much detail.

The underlying concern is that the allocation system might be used to change tax consequences without bottom-line economic consequences. It is almost impossible to trigger a substantiaility issue if straight-up allocations are made. But to impart a feel for the area, the baseline rule (as I like to tell my students) is that the economic effect of an allocation is not substantial if, on a present-value, after-tax basis, there is a strong likelihood that someone is better off and no one is worse off than would be the case if the allocation were not present. Under these circumstances, it means that the allocation had a tax effect, but no economic effect (on a present value basis). For there to be substantial economic effect, if someone is better off, someone else has to be worse off.

A commonly used example of an allocation that does not have substantial economic effect involves a “net operating loss.” Over-simplified, a net operating loss or “NOL” is a net loss from business operations. Under IRC § 172, an NOL may be carried back 2 years and forward 20 years. Thus, for example, a taxpayer may offset an NOL in one year against income in a subsequent year. Assume now that AB partnership has two equal partners, A and B. The partnership also has reliable, fairly constant net income from year to year. Partner A has substantial NOLs unrelated to the partnership that would otherwise expire unused. To allow A to fully use her NOLs, the partnership allocates all of the net partnership income to A in year 1, all of the net partnership income to B in year 2, and thereafter returns to a 50/50 allocation. Note that how the partnership distributes money does not have to track how it allocates income. When the two years are viewed together, both A and B are better off than if the usual 50/50 allocations had been made for both years. A got to take more advantage of her NOL and B got to avoid tax on income for year 1. If there is a strong likelihood of this outcome, the economic effect of the allocation is not substantial, and under the Treasury Regulations the IRS will require the partnership to make a 50/50 allocation of the net partnership income in years 1 and 2.

Allocations of Nonrecourse Deductions

Allocating nonrecourse deductions becomes remarkably complex, even by partnership tax standards. LLCs add another layer of complexity: It is possible in the LLC context to have debt that counts as recourse debt under one Code section and nonrecourse debt under another Code section. Without delving into too much detail, the basic problem as well as the basics of the solution can be illustrated by a non-partnership example. Assume a taxpayer buys depreciable property for $1,000, paying $200 in cash and borrowing the balance of $800 on a nonrecourse basis with the property securing the nonrecourse loan. The first $200 of depreciation will come out of the equity in the property (the $200 paid for with cash). The allocation of that depreciation falls within the substantial economic effect rules. The other $800 of depreciation, the portion that is attributable to the nonrecourse debt, does not. The reason is that its allocation cannot truly be said to have economic effect, because the creditor, not the taxpayer, is the one truly taking the risk.

In regulatory parlance, deductions attributable to nonrecourse debt are called nonrecourse deductions. Simply disallowing all nonrecourse deductions is not a viable option, so the IRS created a parallel allocation regime. A cornerstone of that regime is based on Commissioner v. Tufts, in which the U.S. Supreme Court held that the minimum amount realized upon the disposition of property subject to nonrecourse debt is the amount of that debt. Thus, using the above example, assume the taxpayer depreciated the tax basis of the property down to zero but makes no principal payments on the debt. If the creditor later forecloses on the property, the taxpayer's amount realized is (ignoring foreclosure costs) $800; his basis is zero, resulting in $800 of recognized gain. That $800 of gain, then, is the "minimum gain" that the taxpayer can recognize.
Minimum gain is the foundation on which the Treasury Regulations for allocating partnership nonrecourse deductions rest.27 The good news is that by using straight-up allocations, these Treasury Regulations normally will not pose a problem.28

Conclusion

Because LLCs are the favored entity in the United States, and LLCs with two or more members typically are taxed as partnerships, partnership taxation far and away is the most important area of tax for closely held, domestic businesses.

In a double-spaced Word document, it took about 110 pages to cover in detail the topics discussed in this article.29 Obviously, this is very complicated material, and this article simply highlights basic issues. But lawyers without expertise in partnership taxation who form LLCs need to have a feel for the core issues, if for no other reason than to avoid wandering inadvertently into a partnership taxation black hole.

Thanks to Adam M. Cohen for his assistance with this article and also to Thomas E. Rutledge not only for his help with this article, but with many other projects over the years.

Notes

2. This article borrows heavily from Lipton et al., Partnership Taxation, Chapter 5 (4th ed. Carolina Academic Press 2017). I am the primary author of Chapter 5. (The book has not yet been published; it is expected to be available this summer.)
4. Because partners can have varying interests in capital and profits, determining what the underlying ownership interest is may not be easy. Contrast partnerships with S corporations, where income and deductions must be allocated to shareholders based on stock ownership under IRC § 1377.
5. In regulatory parlance, this arrangement meets the “economic effect equivalence” test as well as the partners’ interest in the partnership test, discussed below. See Treas. Reg. § 1.704-1(b)(2)(i)(i) and Treas. Reg. § 1.704-1(b)(5), example 4(i).
7. See IRC § 1377, which requires that income and deductions be allocated based on stock ownership. In some cases, there may be a modest ability to plan around IRC § 1377 through, for example, salary bonuses, stock options, and debt instruments.
9. The actual rule under IRC § 704(b) is that allocations must be in accordance with the partner’s interest in the partnership if the partnership agreement does not provide for allocations or if the allocation does not have substantial economic effect.
10. One of the most famous lines of cases, referred to as the “Castle Harbour cases,” is TIFD III-E Inc. v. United States, 342 F. Supp. 2d 94 (Conn. Dist. Ct. 2004), rev’d on other grounds, 459 F.3d 220 (2d Cir. 2006), on remand, 660 F. Supp. 2d 367 (D.C. Conn. 2009), rev’d, 666 F.3d 836 (2d Cir. 2012). The taxpayer mostly won at trial and lost, repeatedly, on appeal. These cases led to a change in the Code, to end-run the trial judge’s reading of IRC § 704(e) in the second round. The trial judge did a good job of explaining the allocation Treasury Regulations, but lost the forest for the trees.
12. Note that book value may differ from financial values under generally accepted accounting principles.
13. This is so except to the extent that the money distributed exceeds the partner’s basis in his partnership interest. See IRC § 731.
16. If a book and tax basis vary, as would occur upon the contribution of property with a tax basis that is different from its fair market value, a number of important rules can apply, including those of IRC § 704(c). The discussion of these issues would involve yet another article.
17. I made this number up, and it completely ignores the actual IRC § 168 depreciation rules, including the mid-year convention and IRC § 179.
18. The assumption applies to the substantiality rules, for certain purposes of the alternative economic effect rules, and for determining the partners’ interests in the partnership. I am assuming it applies in this context as well. See Treas. Reg. § 1.704-1(b)(2)(ii).  
19. Further, distributions are not the only events that the IRS cannot control that can cause a capital account to become negative. Certain provisions of Subchapter K can require allocations to a partner that might create a deficit capital account, so the IRS had to account for these 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 certain reasonably expected future events before determining whether the proposed allocation will create a deficit capital account. These adjustments are only for purposes of testing whether a current allocation causes a partner to have a negative capital account. Once this testing has been done, the adjustments for future events are reversed. I will not burden you with these rules. They often do not have much real-world impact and require a detailed explanation about partnership taxation. That said, these rules can be significant in oil and gas deals, where special rules apply and the advice of a tax professional is mandatory.
21. This example is based on Treas. Reg. § 1.704-1(b)(5), example 4(i)
22. See IRC §§ 721 and 752.
24. This example is based on Treas. Reg. § 1.704-1(b)(f), example 8(ii).
25. IRC § 752 and its Treasury Regulations look at the liability of owners. Arguably, IRC § 1001 and its Treasury Regulations look at the liability of the entity. Thus, if the owners have no liability on an LLC debt, under the IRC § 752 Treasury Regulations, the debt is nonrecourse. But if the creditor has full access to all of the assets of the LLC to collect the debt, the debt may be recourse for IRC § 1001 purposes. A lot of the heavy lifting in this area was done by Prof. Karen Burke and well-known partnership tax practitioner Terrence Cuff. See, e.g., Burke, “Illusory DROs: At-Risk Lessons from Hubert,” 118 Tax Notes 405 (2008); Burke, “Exculpatory Liabilities and Partnership Nonrecourse Allocations,” 57 Tax Law. 33 (2003); Cuff, “Indebtedness of a Disregarded Entity,” 81 Taxes 303 (2003).
28. These can still apply, but it is unlikely to run afoot of them.
29. See note 2, supra.
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