Mastering Partnership Minimum Gain Chargeback Provisions for the Tax Professional

THURSDAY, JULY 11, 2019, 1:00-2:50 pm Eastern

IMPORTANT INFORMATION FOR THE LIVE PROGRAM

This program is approved for 2 CPE credit hours. To earn credit you must:

- Participate in the program on your own computer connection (no sharing) – if you need to register additional people, please call customer service at 1-800-926-7926 ext. 1 (or 404-881-1141 ext. 1). Strafford accepts American Express, Visa, MasterCard, Discover.
- **Listen on-line** via your computer speakers.
- **Respond to five prompts during the program plus a single verification code.**
- To earn full credit, you must remain connected for the entire program.

WHO TO CONTACT DURING THE LIVE PROGRAM

For Additional Registrations:
-Call Strafford Customer Service 1-800-926-7926 x1 (or 404-881-1141 x1)

For Assistance During the Live Program:
-On the web, use the chat box at the bottom left of the screen

If you get disconnected during the program, you can simply log in using your original instructions and PIN.

Tips for Optimal Quality

FOR LIVE PROGRAM ONLY

Sound Quality

When listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, please e-mail sound@straffordpub.com immediately so we can address the problem.

Mastering Partnership Minimum Gain Chargeback Provisions for the Tax Professional

July 11, 2019

Bradley T. Borden
Professor of Law, Brooklyn Law School
Special Counsel, Duval & Stachenfeld LLP
bborden@dsllp.com

Notice

ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY THE SPEAKERS' FIRMS TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.

You (and your employees, representatives, or agents) may disclose to any and all persons, without limitation, the tax treatment or tax structure, or both, of any transaction described in the associated materials we provide to you, including, but not limited to, any tax opinions, memoranda, or other tax analyses contained in those materials.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

Agenda

- Overview of partnership allocations
  - General tax rules
  - Substantial economic effect
  - Partners' interest in the partnership
- General allocation structures
  - Allocation-driven structures
  - Distribution-driven structures
- Nonrecourse Deductions and Minimum Gain Chargeback

OVERVIEW OF PARTNERSHIP ALLOCATIONS

In general

- Under Subchapter K, the income and loss of a partnership is determined at the entity level, but no entity-level tax is imposed on the partnership.
  - Rather, the partners pay tax on their distributive shares of the partnership's income and loss.
- Question is how to divide the partnership's income and loss among the partners.
- In the absence of an overriding rule, the partners have great flexibility to allocate the income and loss of the partnership among themselves.

Contrasting basis with capital accounts

Outside tax basis	Section 704(b) book capital accounts	Tax capital accounts
Increased by: • Tax basis of contributions • Share of taxable income • Increase in share of partnership liabilities	Increased by: • FMV of contributions • Share of book income • Partnership liabilities actually assumed by the partner	Increased by: • Tax basis of contributions • Share of taxable income
Decreased by: • Tax basis of distributions • Share of taxable loss • Decrease in share of partnership liabilities	Decreased by: • FMV of distributions • Share of book loss • Partner liabilities actually assumed by the partnership	Decreased by: • Tax basis of distributions • Share of taxable loss

Section 704 overview

- Section 704(a): A partner's distributive share of tax items is determined by partnership agreement.
- Section 704(b): Ensures that book allocations of partnership items match economics of deal (i.e., ensures each partner receives economic benefit or bears economic burden associated with allocations of income and deduction).
- Section 704(c): Governs allocations of tax items related to property that has a tax basis different from its section 704(b) book value.
- Section 704(d): Partner is entitled to deduct allocated tax losses only to extent of partner's basis in his or her partnership interest at end of year.

Section 704(b) allocations overview

- Substantial economic effect:
  - Economic effect test requirements must be satisfied.
  - Economic effect of allocations must be substantial.
- Partners' interest in the partnership (PIP).
- Deemed to be in accordance with PIP (e.g., nonrecourse deductions, tax credits).
- Note: An allocation respected under section 704(b) may nevertheless be reallocated under another provision of the Code (e.g., section 482).

Substantial economic effect safe harbor

- Economic effect
  - See Treas. Reg. section 1.704-1(b)(2)(ii).
  - Capital accounts are maintained in accordance with Treas. Reg. section 1.704-1(b)(2)(iv).
  - Liquidation in accordance with positive capital account balances.
  - Unconditional obligation to restore deficit capital accounts.
    - Alternate test for economic effect: If partnership agreement contains a "qualified income offset" provision, allocations will be considered to have economic effect to the extent the allocation does not create or increase a capital account deficit.
- Economic effect equivalence
  - Liquidation would produce the same economic results to the partners as if the above test for economic effect had been satisfied. Treas. Reg. section 1.704-1(b)(2)(ii)(i).

Substantial economic effect safe harbor (cont.)

- Substantiality
  - See Treas. Reg. section 1.704-1(b)(2)(iii).
  - General rule is that there must be a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.
  - Insubstantial allocation schemes
    - Shifting tax consequences. See Treas. Reg. section 1.704-1(b)(2)(iii)(b).
    - Transitory tax consequences. See Treas. Reg. section 1.704-1(b)(2)(iii)(c).
    - Overall tax effect: The economic effect of an allocation is not substantial if (a) allocations improve the after-tax economic position of one partner and (b) there is a strong likelihood in present value terms, that the after-tax economic consequences to no partners will be substantially diminished. Treas. Reg. section 1.704-1(b)(2)(iii)(a).

Outside of the substantial economic effect safe harbor

- If allocations lack "substantial economic effect," they will nevertheless be given effect for tax purposes if:
  - Allocations are in accordance with the partners' interests in the partnership, taking into account all facts and circumstances. Treas. Reg. section 1.704-1(b)(3); OR
  - Allocations are deemed to be in accordance with the partners' interests in the partnership pursuant to special rules set forth in Treas. Reg. sections 1.704-1(b)(4) and -2. Treas. Reg. section 1.704-1(b)(4).

GENERAL ALLOCATION STRUCTURES

Drafting allocation provisions

- Two basic approaches:
  - "Allocation-driven" ("layer cake" or "regular" allocations): Allocations determine distribution rights.
  - "Distribution-driven" ("targeted" or "forced" allocations): Distribution rights determine allocations.
- Approach is reflected in liquidation provision of the partnership agreement.
  - Allocation-driven: Distribute in accordance with positive capital account balances.
  - Distribution-driven: Distribute in accordance with distribution waterfall.

Allocation-driven vs. distribution-driven

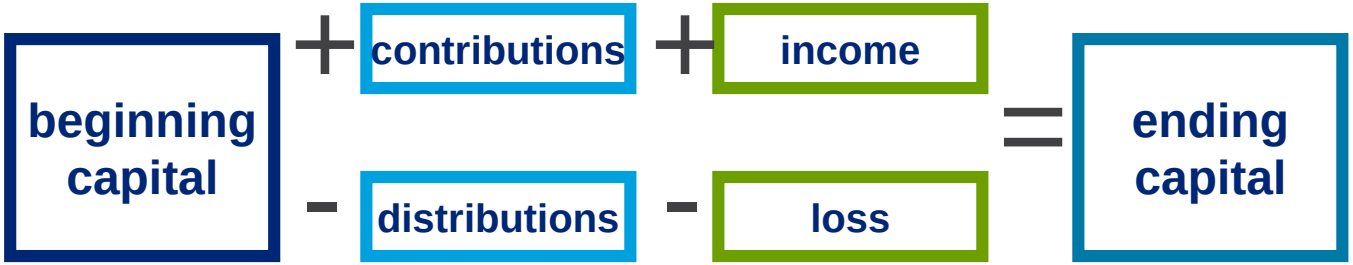
Allocation-driven approach	Distribution-driven approach
Explicitly provides how income and loss are allocated to the partners.	Income/loss are allocated so that, to the extent possible, capital accounts equal the amounts distributable on a fictional liquidation under a distribution waterfall.
May be easier for accountants.	Trust that accountants will get it right.
Clients see individual income/loss allocations.	Clients focus on distribution waterfall.
Because allocations/distributions are not linked, drafter must ensure that allocations match the economic deal (i.e., "get it right twice").	Linkage between allocations and distribution waterfall minimizes risk of a difference between the two (i.e., "get it right once").
Easier to incorporate special allocations. May pose greater risk of substantiality problems.	More difficult to incorporate special allocations; thus, may provide less flexibility in the allocations.
If properly drafted, allocations will have substantial economic effect.	Allocations may not satisfy section 704(b) "economic effect" requirements (because not liquidating in accordance with positive capital account balances).

Layer-cake allocations

- Capital accounts are key.
- Allocations have effect because they change capital accounts.
- Liquidation is based on what is in each partner's ending capital account.

Layer-cake allocations: execution and justification

- Traditional "waterfall" allocation formula
- Historically, in an agreement satisfying the economic effect safe harbor, a partnership would liquidate based on positive capital accounts in accordance with the following formula:



Targeted allocations

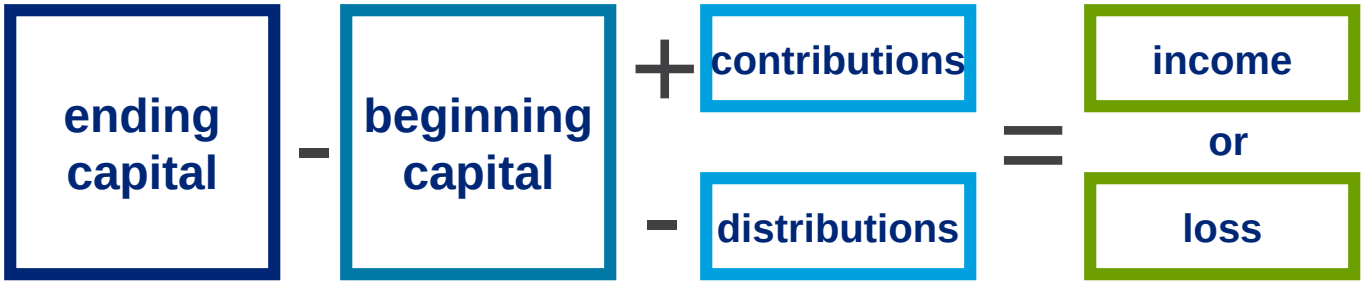
- Targeted allocations are distribution-driven allocations that have the following characteristics:
  - Liquidation in accordance with distribution provision.
  - “Plug” income so that capital accounts equal what a partner would receive upon a hypothetical liquidation if the assets of the partnership were sold for their “Section 704(b) book value.”

Do targeted allocations have economic effect?

- Neither basic test nor alternate test for economic effect will be satisfied because agreement will not provide that the partnership will liquidate in accordance with positive capital account balances.
- Economic effect equivalence? Allocations are deemed to have economic effect if, at the end of each year, a liquidation would produce the same economic effect as if the safe harbor had been satisfied, regardless of the economic performance of the partnership.
- PIP: facts and circumstances test. If allocation fails substantial economic effect safe harbor, partners' distributive shares of partnership items determined in accordance with PIP.
- Note that if allocations do not satisfy section 704(b) economic effect requirement:
  - Risk nonrecourse deduction allocations not respected. *See* Treas. Reg. section 1.704-2(e)(1).
  - Risk "fractions rule" requirements not satisfied. *See* section 514(c)(9)(E)(II).

Targeted allocations: execution and justification

- Targeted allocation formula
- Targeted allocations plug income under the following formula:



Targeted allocations: six-step process

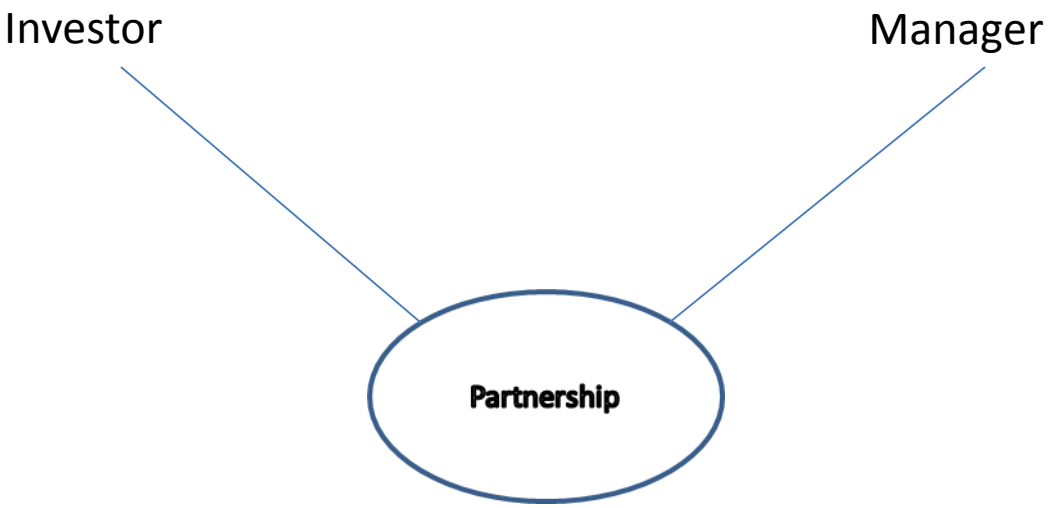
- Targeted allocations are computed under a six-step process:
  - Step 1: Determine beginning capital for each partner.
  - Step 2: Determine contributions and distributions for each partner.
  - Step 3: Add Steps 1 and 2 to determine adjusted capital account for each partner.
  - Step 4: Determine aggregate ending capital (total for all partners).
  - Step 5: Allocate aggregate ending capital to the partners in accordance with the distribution provisions.
  - Step 6: Subtract Step 3 from Step 5 to determine income for each partner.

NONRECOURSE DEDUCTIONS AND MINIMUM GAIN

Definition of Minimum Gain

- The amount of partnership minimum gain is determined by first 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 full satisfaction of the liability, and then aggregating the separately computed gains.
- For any partnership taxable year, the net increase or decrease in partnership minimum gain is determined by comparing the partnership minimum gain on the last day of the immediately preceding taxable year with the partnership minimum gain on the last day of the current taxable year.

Minimum Gain Base Case



- Investor and manager contribute $90x and $10x, respectively.
- Partnership uses $100 contributions and $900 nonrecourse mortgage debt to acquire Property for $1,000.
- After return of capital plus 8% preferred return, distributions split 70% / 30%.

Minimum Gain Base Case

	704(b)Basis	Mortgage	Minimum Gain
Initial	$1,000	$900	$0
Year 1	$950	$900	$0
Year 2	$900	$900	$0
Year 3	$850	$900	$50

- Because depreciation of Property has caused 704(b) basis of Property to be less than the outstanding nonrecourse debt on the property, there is an increase in minimum gain of $50 in Year 3.

Allocations of Nonrecourse Deductions

- A partner's share of any increase or decrease in minimum gain depends upon the partner's share of nonrecourse deductions.
- Partnership allocations must mirror economic entitlement of income to the partners ("substantial economic effect" safe harbor or "partners' interest in the partnership").
- Because NR deductions are not economically borne by any partner and are instead borne by lender, NR deductions cannot have substantial economic effect.

Allocations of Nonrecourse Deductions

- 1.704-2(e) – safe harbor for allocations of NR deductions.
- Through full term of partnership after year of NR borrowing;
- Partnership has minimum gain chargeback provision; and
- Partnership agreement allocates NR deductions "in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities."

Definition of Nonrecourse Liability

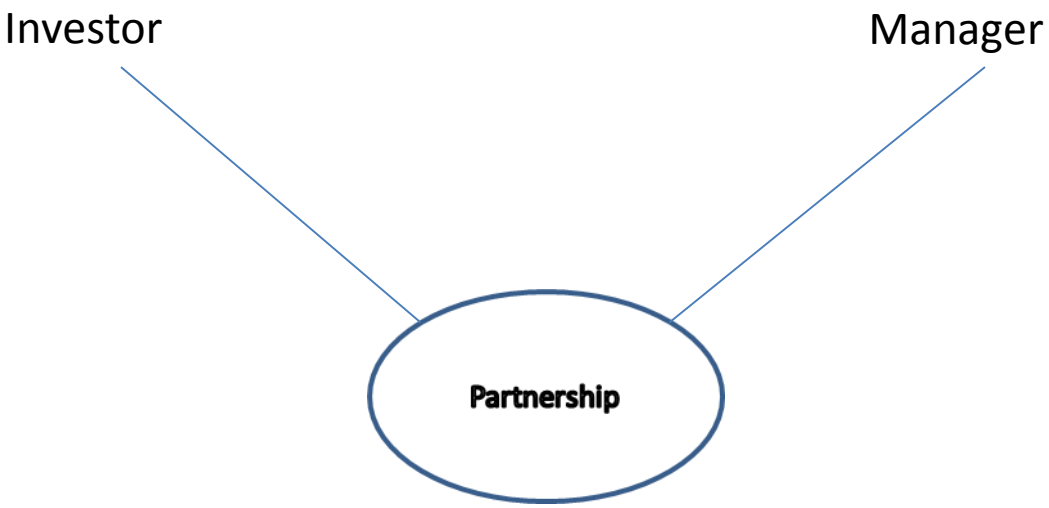
- "Nonrecourse liability" means a nonrecourse liability as defined in §1.752-1(a)(2) (or a §1.752-7 liability assumed by the partnership from a partner on or after June 24, 2003). Reg. §1.704-2(b)(3).
- "Partner nonrecourse liability" means any partnership liability to the extent the liability is nonrecourse for purposes of §1.1001-2, and a partner or related person (within the meaning of §1.752-4(b)) bears the economic risk of loss under §1.752-2 because, for example, the partner or related person is the creditor or a guarantor. Reg. §1.704-2(b)(4).

Definition of Nonrecourse Debt

- Recourse debt. A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss ("EROL") for that liability under Treas. Reg. §1.752-2. Treas. Reg. §1.752-1(a)(1).
- Nonrecourse debt. A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the EROL for that liability under Treas. Reg. §1.752-2. Treas. Reg. §1.752-1(a)(2).

Example

- Continuing example from above:



- Investor and manager contribute $90x and $10x, respectively.
- Partnership uses $100 contributions and $900 nonrecourse mortgage debt to acquire Property for $1,000.
- After return of capital, distributions split 70% / 30%.
- Allocations are made using target capital account method with NR deductions made based on "percentage interests."
- Neither Investor nor Manager guarantees mortgage.

- Years 1-2, income equals interest payment on mortgage, therefore only net allocation is $50 depreciation per year.

	Investor	Manager
Contribution	$90	$10
Distributions	$0	$0
Income/(Loss)	($90)	($10)
Ending Yr 2	$0	$0

- Year 3 there is an additional ($50) depreciation.
- Because no partner bears EROL, this $50 is a NR deduction.
- Allocation under agreement is $35 Investor, $15 Manager.
- Note, this is due to allocations being made based on “percentage interests” but could also presumably be made 90% / 10% in accordance with capital percentages.

- Allocations of NR deductions resulting in minimum gain Year 3:

Year 2 Ending	$0	$0
Contribution	$0	$0
Distribution	$0	$0
Income/(Loss)	($35)	($15)
Ending Yr 3	($35)	($15)

Minimum Gain Chargeback

- On 1/1 Year 5, Property is sold for its original cost of $1,000 and $900 used to repay mortgage.
- Year 4 allocations:

Year 3 Ending	($35)	($15)
Contribution	$0	$0
Distribution	$0	$0
Income/(Loss)	($35)	($15)
Ending Yr 4	($70)	($30)

- Partners' historic share of minimum gain:
  - Investor - $70
  - Manager - $30
- Gain on sale of Property: $200 ($1,000 amount realized less $800 remaining tax basis).
- Minimum gain chargeback:
  - Investor - $70
  - Manager - $30
- $100 cash proceeds distributed $90 to Investor and $10 to Manager, therefore under target capital account remaining $100 of gain is allocated $90 / $10.

Partner Minimum Gain

- Unlike partnership NR deductions, partner NR deductions are allocated solely to the partner or partners who bear the EROL.
- When the property is disposed of or the debt producing such deductions is forgiven, the partner receiving allocations of partner NR deductions will receive chargeback allocations.

Partner Nonrecourse Deduction Example

- Same facts as previous example except that Manager guarantees mortgage.
- Years 1-2, income equals interest payment on mortgage, therefore only net allocation is $50 depreciation per year.

	Investor	Manager
Contribution	$90	$10
Distributions	$0	$0
Income/(Loss)	($90)	($10)
Ending Yr 2	$0	$0

Partner Nonrecourse deduction Example

- Years 3-4, partner nonrecourse deductions allocated solely to Manager because Manager bears EROL:

	Investor	Manager
Year 2 Ending	$0	$0
Contribution	$0	$0
Distributions	$0	$0
Income/(Loss)	$0	($100)
Ending Yr 2	$0	($100)

Partner Minimum Gain Chargeback

- On 1/1 Year 5, Property is sold for its original cost of $1,000 and $900 used to repay mortgage.
- Partners' historic share of minimum gain:
  - Investor - $0
  - Manager - $100
- Gain on sale of Property: $200 ($1,000 amount realized less $800 remaining tax basis).
- Minimum gain chargeback:
  - Investor - $0
  - Manager - $100
- $100 cash proceeds distributed $90 to Investor and $10 to Manager, therefore under target capital account allocation remaining $100 of gain is allocated $90 / $10.

Change in Recourse Nature of Debt

- Any reduction of partnership NR liability due to the conversion of liabilities to partner NR liability (e.g. through a guarantee) will cause minimum gain chargeback, due to decrease in partnership minimum gain.
- An exception to the above rule, however, exists with respect to any partner who guarantees a liability causing the decrease in minimum gain.

Conversion of Character of Liability Example

- Assume first example, such that Investor and Manager contribute $90 and $10 respectively, and Partnership purchases Property for $1,000 subject to $900 mortgage (with no guarantee).
- In years 1-2, Property is depreciated $100 with $90 and $10 allocated to Investor and Manager, respectively.
- In years 3-4, Property is depreciated an additional $100 with such nonrecourse deductions allocated $70 to the Investor and $30 to the Manager.

Minimum Gain Chargeback on Conversion of Character of Liability

	Investor	Manager
Contribution	$90	$10
Distribution	$0	$0
Income / (Loss)	($160)	($40)
Ending Yr 4	($70)	($30)

- In year 5, Property further depreciated $50 (allocated $35 to Investor and $15 to Manager).
- At end of year 5, lender requires Manager to personally guarantee mortgage, converting $900 liability to partner NR liability. Partnership minimum gain is therefore decreased by $150.

- Decrease in partnership minimum gain results in minimum gain chargeback of $150, $105 to Investor and $45 to Manager.
- The partnership minimum gain chargeback, however does not apply to Manager because Manager's $45 of partnership minimum gain is converted to partner minimum gain.
- Investor must be allocated first $105 of Partnership gain or income in year 6 and succeeding years.
- Manager has no current chargeback, however, it has $45 of partner minimum gain.

Acceleration of Income to One of the Partners Example

- Pick up previous example after end of year 5.

Partnership Yr 5				**Property Yr 5 End**	
	Investor	**Manager**		Outstanding Mortgage	$900
Cap Acct Yr 4 End	$(70)	$(30)		Basis	$750
Distribution	$0	$0			
Income / (Loss)	$(35)	$(15)		P'ship Min Gain	$0
Cap Acct Yr 5 End	$(105)	$(45)		Partner Min Gain	$45
P'ship Min Gain Share	$0	$0		P'ship Min Gain Chargeback Requirement	$105
P'ship Min Gain Chargeback Requirement	$105	$0			
Partner Min Gain Share	$0	$45			

Acceleration of Income to One of the Partners Example

- Through year 5, partnership had a total of $150 of "partnership nonrecourse deductions" allocated $105 to Investor and $45 to Manager, creating "partnership minimum gain" of $150.
- At end of year 5, Manager was forced to guarantee mortgage, making the entire $900 liability which was previously a "nonrecourse liability" to become a "partner nonrecourse liability" and resulting in a decrease in "partnership minimum gain" of $150.

Acceleration of Income to One of the Partners Example

- Investor's $105 share of the decrease in "partnership minimum gain" creates a minimum gain chargeback requirement with respect to investor.
- Manager's $45 share of the decrease in "partnership minimum gain" becomes "partner nonrecourse debt minimum gain" with respect to Manager and does not create a chargeback requirement currently.

Acceleration of Income to One of the Partners Example

- Assume that in year 6, Partnership generates $100 of operating income by leasing Property. How will it be allocated?
  - Although one might think that, because the $150 in nonrecourse deductions previously taken were allocated $105 to Investor and $45 to Manager, the $100 of operating income would be allocated in the same proportion (i.e., $70 to Investor and $30 to Manager), because the Partnership has no other income, all $100 of operating income will be allocated to Investor to satisfy its $105 minimum gain chargeback requirement and the Investor will have another $5 of income that must be allocated to him in subsequent years pursuant to the minimum gain chargeback requirement.

Acceleration of Income to One of the Partners Example

- Because the mortgage is now treated as a "partner nonrecourse liability," the $50 of depreciation deductions generated in year 6 will be entirely allocated to the Manager and increase the "partner minimum gain" of the Manager.

Acceleration of Income to One of the Partners Example

Partnership Yr 6				**Property Yr 6 End**	
	Investor	**Manager**		Outstanding Mortgage	$900
Cap Acct Yr 6 End	$(105)	$(45)		Basis	$700
Distribution	$0	$0			
Income / (Loss)	$100	$(50)		P'ship Min Gain	$0
Cap Acct Yr 5 End	$(5)	$(95)		Partner Min Gain	$95
P'ship Min Gain Share	$0	$0		P'ship Min Gain Chargeback Requirement	$5
P'ship Min Gain Chargeback Requirement	$5	$0			
Partner Min Gain Share	$0	$95			

Different Liabilities Encumbering One Property and Partner Contribution to Satisfy Debt

- Investor and Manager contribute $90 and $10 respectively, and Partnership purchases Property for $1,000 subject to $900 mortgage.
- Manager guarantees $500 of mortgage ("top dollar" guarantee). Therefore, $400 of mortgage is treated as "nonrecourse liability" and $500 guaranteed by Manager is treated as "partner nonrecourse liability."
- After return of capital, distributions split 70% to Investor and 30% to Manager.

- Assume no operating income.
- In years 1-2, Property is depreciated $100 with $90 and $10 allocated to Investor and Manager respectively, in proportion to their contributed capital.

Partnership Yrs 1 & 2				**Property Yr 2 End**	
	Investor	**Manager**		Outstanding Mortgage	$900
Contribution	$90	$10		Basis	$900
Distribution	$0	$0			
Income / (Loss)	($90)	($10)		P'ship Min Gain	$0
Cap Acct Yr 2 End	$0	$0		Partner Min Gain	$0
P'ship Min Gain Share	$0	$0			
Partner Min Gain Share	$0	$0			

- In years 3-12, Property is depreciated an additional $500.
- Is the $500 in minimum gain created as a result "partnership minimum gain" or "partner nonrecourse debt minimum gain"?
  - See Treas. Reg. § 1.704-2(d)(2): if more than one liability secures Property, the liability with the highest priority is allocated the first dollars of the Property's basis (i.e., from $0 to the amount of the liability), followed by the other liabilities in the order of their priority, and finally the equity-funded portion of the basis.

- Here, because the Manager's guarantee is a "top dollar" guarantee (i.e., the Manager guarantees any unpaid portion of the mortgage up to $500), the unguaranteed $400 (i.e., the "nonrecourse liability") is treated as having a higher priority because it will be "paid" first out of any proceeds from the sale of the property, given the guarantee of the remaining $500 by the Manager.
- Therefore, the first $400 (i.e., dollars 0 through 400) of the Property's basis is allocated to the "nonrecourse liability" and the next $500 (i.e., dollars 401 through 900) are allocated to the "partner nonrecourse liability").

- Therefore, the $500 of minimum gain created in years 3-10 is "partner nonrecourse debt minimum gain" and the $500 in depreciation deductions are "partner nonrecourse deductions" entirely allocated to Manager.

Partnership Yrs 3 -12				**Property Yr 12 End**	
	Investor	**Manager**		Outstanding Mortgage	$900
Cap Acct Yr 2 End	$0	$0		Basis	$400
Distribution	$0	$0			
Income / (Loss)	$0	($500)		P'ship Min Gain	$0
Cap Acct Yr 12 End	$0	($500)		Partner Min Gain	$500
P'ship Min Gain Share	$0	$0			
Partner Min Gain Share	$0	$500			

- In years 13-16 Property is depreciated an additional $200.
- The additional $200 in minimum gain created is “partnership minimum gain” and the $200 in deductions are “nonrecourse deductions” allocated 90% to Investor and 10% to Manager, in proportion to their contributed capital.

Partnership Yrs 13 -16				**Property Yr 16 End**	
	Investor	**Manager**		Outstanding Mortgage	$900
Cap Acct Yr 12 End	$0	$(500)		Basis	$200
Distribution	$0	$0			
Income / (Loss)	$(180)	($20)		P'ship Min Gain	$200
Cap Acct Yr 16 End	$(180)	($520)		Partner Min Gain	$500
P'ship Min Gain Share	$180	$20			
Partner Min Gain Share	$0	$500			

- At the end of year 16, Property is sold for $600.
- Gain on sale of $400.
- $600 of proceeds goes to satisfy $600 of mortgage but Manager must contribute $300 to pay off remainder of mortgage pursuant to guarantee.

- What is the net decrease in minimum gain requiring a chargeback?
  - Appears to be $700 because the mortgage has been fully satisfied, but because Manager had to contribute $300 to pay off the mortgage, the chargeback requirement is only $400.
  - See Treas. Reg. § 1.704-2(d)(2): partner is not subject to the minimum gain chargeback requirement to the extent the partner contributes capital to the partnership that is used to repay the nonrecourse liability or is used to increase the basis of the property subject to the nonrecourse liability, and the partner's share of the net decrease in partnership minimum gain results from the repayment or the increase to the property's basis.

- Manager contributed $300 to repay part of the “partner nonrecourse liability,” therefore Manager’s share of “partner nonrecourse debt minimum gain” that is subject to the chargeback requirement is $200 ($500 decrease less $300 contribution).
- Decrease in “partnership minimum gain” subject to the chargeback requirement is the full $200.
- Pursuant to chargeback requirement, $400 of gain on sale is allocated $180 to Investor (share of its decrease in “partnership minimum gain”) and $220 to Manager ($20 share of its decrease in “partnership minimum gain” and $200 share of its decrease in “partner nonrecourse debt minimum gain”).

Partnership After Sale of Property		
	Investor	**Manager**
Cap Acct Yr 16 End	$(180)	$(520)
Contribution	$0	$300
Income / (Loss)	$180	$220
Cap Acct After Sale	$0	$0
P'ship Min Gain Share	$0	$0
Partner Min Gain Share	$0	$0

- $300 of "partner nonrecourse deductions" allocated to Manager have not been offset by the minimum gain chargeback, but Manager bore the economic loss associated with the decrease in the Property's value that generated those deductions.

Netting Across Multiple Properties

- Assume two partners contribute $150 each.
- Partnership obtains nonrecourse financing of $1,500 and uses proceeds to acquire 3 properties for $1,800.
- Debt is secured only by those properties.

Netting Across Multiple Properties

- Partnership net income / loss for years 1-3 is $0 aside from depreciation deductions on properties.

	Prop 1	Prop 2	Prop 3
Initial basis	$720	$540	$540
Depreciation	$180	$135	$135
NR Debt	$600	$450	$450
Minimum gain	$60	$45	$45

- Therefore, at the end of year 3, there is a total minimum gain of $150.

Netting Across Multiple Properties

- In Yr 4, the partnership sells Prop 1 for $835 and uses the proceeds to pay off $600 of the mortgage.
- Remaining balance on mortgage is $900 at end of Yr 4.
- Partnership recognizes gain of $295 on sale ($835 less $540 remaining basis).
- Prop 2 and 3 each are depreciated additional $45 in Yr 4.

Netting Across Multiple Properties

- After Yr 4, remaining properties have aggregate $180 minimum gain.

	Prop 2	Prop 3
Initial basis	$540	$540
Depreciation	$180	$180
NR Debt	$450	$450
Minimum gain	$90	$90

- Therefore, even though Prop 1 produced $60 of NR deductions, sale does not trigger minimum gain chargeback because of overall net increase in minimum gain.

Potential Distortion of Allocations

- In certain situations, allocations of operating income prior to the triggering of a minimum gain chargeback can cause the allocations to not follow the intended economics of the partnership.
- In these cases, a ruling can be requested from the IRS to waive the minimum gain chargeback.

Distortion Example

- Investor contributes $90 / Manager contributes $10.
- Partnership acquires property for $300 subject to mortgage of $200.
- Economic deal is distributions are to be made to return capital and thereafter 50% / 50%.
- Partnership agreement provides nonrecourse deductions are made 90% to Investor / 10% to Manager.

- Property is depreciated $100 per year such that at the end of year 3 it is fully depreciated.

	Investor	Manager
Contribution	$90	$10
Distribution	$0	$0
Income / (Loss)	($270)	($30)
Ending Yr. 3	($180)	($20)

- Year 4 – Partnership generates $400 of operating income.
- Income is allocated to reflect economics such that first $300 restores $300 of losses, and remaining $100 is allocated $50 / $50.
- Partnership distributes $200 of cash $90 / $10 to return capital and $50 / $50 of profit.

- After Year 4, capital accounts are $0.

	Investor	Manager
Ending Yr. 3	($180)	($20)
Contribution	$0	$0
Distribution	$140	$60
Income	$320	$80
Ending Yr. 4	$0	$0

- Because Property still held and subject to mortgage, there has been no decrease of partnership minimum gain and therefore no minimum gain chargeback has been triggered.

- In Year 5, Partnership sells Property for $300, generating $300 of gain.
- Partnership uses $200 to repay mortgage and intends to distribute the remainder $150 / $150 ($200 operating income from Year 4 plus $100 net gain from Year 5).
- Sale of the Property, however, causes elimination of $200 partnership minimum gain, and triggers minimum gain chargeback.

- If minimum gain chargeback were required, ending capital accounts would not equal economic distribution entitlements.

	Investor	Manager
Ending Yr. 4	$0	$0
Contribution	$0	$0
Distribution	$150	$150
Income	$230	$70
Ending Yr. 5	$80	($80)

- Instead, because previous operating income had effectively already reversed NR deductions, minimum gain chargeback should be waived and final allocation should be made $150 / $150 to correspond to economic arrangement.
- Regulations, however, note that IRS must grant ruling waiving minimum gain chargeback for this allocation to be respected.

Exculpatory Liabilities

- Minimum gain rules conceptually easy to understand in traditional LP arrangement where §752 recourse / nonrecourse mirror normal §1001 concepts of recourse / nonrecourse.
- Therefore, if partnership obtains mortgage secured only by real property, that is obviously nonrecourse.
- If loan to partnership is not secured by specific property and general recourse debt of partnership, it would be recourse to GP of partnership under §752 principles.

Exculpatory Liabilities

- With advent of LLCs this is rarely the case today.
- Absent a guarantee, general recourse debt of an LLC is recourse under §1001 principles but nonrecourse under §752 principles because no partner bears EROL (an "exculpatory liability").

Exculpatory Liability / COD

- Because of the differing treatment under §752 and §1001, chargeback of exculpatory liabilities can take the form of part gain / part COD income.
- Assume Investor contributes $90 and Manager contributes $10.
- LLC borrows $900 on a recourse basis and purchases depreciable property.
- Property is depreciated $100 / yr and nonrecourse deductions are allocated on a 90% / 10% basis.

Exculpatory Liability / COD

- At the end of yr 4:

	Investor	Manager
Contribution	$90	$10
Distribution	$0	$0
Income / (Loss)	($360)	($40)
Ending Yr 4	($270)	($30)

- At the end of yr 4, LLC surrenders the property to the lender when outstanding debt is still $900.
- Tax basis of property at end of yr 4 is $600 and FMV of property is $800.

Exculpatory Liability / COD

- At the end of Yr 4 the minimum gain is $300 ($900 § 752 nonrecourse debt less $600 remaining tax basis).
- Net decrease in minimum gain therefore in Yr 4 is $300.
- Under §1001 rules debt is recourse and therefore LLC recognizes $200 gain ($800 amount realized less $600 tax basis).
- In addition, LLC recognizes $100 COD income ($900 liability less $800 FMV).

Exculpatory Liability / COD

- Therefore, in Yr 4, there is a minimum gain chargeback triggered of $300, but only $200 of gain on disposition of property, so additional LLC items of income / gain must be allocated to satisfy remaining $100 of chargeback (in this case $100 of COD).