Section 704.—Partner's Distributive Share

26 CFR 1.704–1: Determination of partner's distributive share.
(Also § 752; 1.752–2.)

Calculation of a partner's limited deficit restoration obligation. This rul-

ing holds that the amount of a partner's limited deficit restoration obligation is the amount of money that the partner would be required to contribute to the partnership to satisfy partnership liabilities if all partnership property were sold for the amount of the partnership's book basis in the property.

Rev. Rul. 97–38

ISSUE

If a partner is treated as having a limited deficit restoration obligation under § 1.704–1(b)(2)(ii)(*c*) of the Income Tax Regulations by reason of the partner's liability to the partnership's creditors, how is the amount of that obligation calculated?

FACTS

In year 1, *GP* and *LP,* general partner and limited partner, each contribute $100*x* to form limited partnership *LPRS*. In general, *GP* and *LP* share *LPRS*'s income and loss 50 percent each. However, *LPRS* allocates to *GP* all depreciation deductions and gain from the sale of depreciable assets up to the amount of those deductions. *LPRS* maintains capital accounts according to the rules set forth in § 1.704– 1(b)-(2)(iv), and the partners agree to liquidate according to positive capital account balances under the rules of§ 1.704–1(b)(2)-(ii)(*b*)(*2*).

Under applicable state law, *GP* is liable to creditors for all partnership recourse liabilities, but *LP* has no personal liability. *GP* and *LP* do not agree to unconditional deficit restoration obligations as described in § 1.704–1(b)(2)(ii)(*b*)(*3*) (in general, a deficit restoration obligation requires a partner to restore any deficit capital account balance following the liquidation of the partner's interest in the partnership); *GP* is obligated to restore a deficit capital account only to the extent necessary to pay creditors. Thus, if *LPRS* were to liquidate after paying all creditors and *LP* had a positive capital account balance, *GP* would not be required to restore *GP*'s deficit capital account to permit a liquidating distribution to *LP*. In addition, *GP* and *LP* agree to a qualified income offset, thus satisfying the requirements of the alternate test for economic effect of § 1.704–1(b)(2)(ii)(*d*). *GP* and *LP* also agree that no allocation will be made that causes or increases a deficit

balance in any partner's capital account in excess of the partner's obligation to restore the deficit.

LPRS purchases depreciable property for $1,000*x* from an unrelated seller, paying $200*x* in cash and borrowing the $800*x* balance from an unrelated bank that is not the seller of the property. The note is recourse to *LPRS*. The principal of the loan is due in 6 years; interest is payable semi-annually at the applicable federal rate. *GP* bears the entire economic risk of loss for *LPRS*'s recourse liability, and *GP*'s basis in *LPRS* (outside basis) is increased by $800*x*. *See* § 1.752–2.

In each of years 1 through 5, the property generates $200*x* of depreciation. All other partnership deductions and losses exactly equal income, so that in each of years 1 through 5 *LPRS* has a net loss of $200*x*.

LAW AND ANALYSIS

Under § 704(b) of the Internal Revenue Code and the regulations thereunder, a partnership's allocations of income, gain, loss, deduction, or credit set forth in the partnership agreement are respected if they have substantial economic effect. If allocations under the partnership agreement would not have substantial economic effect, the partnership's allocations are determined according to the partners' interests in the partnership. The fundamental principles for establishing economic effect require an allocation to be consistent with the partners' underlying economic arrangement. A partner allocated a share of income should enjoy any corresponding economic benefit, and a partner allocated a share of losses or deductions should bear any corresponding economic burden. *See* § 1.704–1(b)-(2)(ii)(*a*).

To come within the safe harbor for establishing economic effect in § 1.704–1(b)(2)(ii), partners must agree to maintain capital accounts under the rules of § 1.704–1(b)(2)(iv), liquidate according to positive capital account balances, and agree to an unconditional deficit restoration obligation for any partner with a deficit in that partner's capital account, as described in § 1.704–1(b)(2)(ii)(*b*)(*3*). Alternatively, the partnership may satisfy the requirements of the alternate test for economic effect provided in § 1.704–1(b)(2)(ii)(*d*). *LPRS*'s partnership agreement complies with the alternate test for economic effect.

The alternate test for economic effect requires the partners to agree to a qualified income offset in lieu of an unconditional deficit restoration obligation. If the partners so agree, allocations will have economic effect to the extent that they do not create a deficit capital account for any partner (in excess of any limited deficit restoration obligation of that partner) as of the end of the partnership taxable year to which the allocation relates. Section 1.704–1(b)(2)(ii)(*d*)(*3*) (flush language).

A partner is treated as having a limited deficit restoration obligation to the extent of: (1) the outstanding principal balance of any promissory note contributed to the partnership by the partner, and (2) the amount of any unconditional obligation of the partner (whether imposed by the partnership agreement or by state or local law) to make subsequent contributions to the partnership. Section 1.704–1(b)(2)-(ii)(*c*).

LP has no obligation under the partnership agreement or state or local law to make additional contributions to the partnership and, therefore, has no deficit restoration obligation. Under applicable state law, *GP* may have to make additional contributions to the partnership to pay creditors. However, *GP*'s obligation only arises to the extent that the amount of *LPRS*'s liabilities exceeds the value of *LPRS*'s assets available to satisfy the liabilities. Thus, the amount of *GP*'s limited deficit restoration obligation each year is equal to the difference between the amount of the partnership's recourse liabilities at the end of the year and the value of the partnership's assets available to satisfy the liabilities at the end of the year.

To ensure consistency with the other requirements of the regulations under § 704(b), where a partner's obligation to make additional contributions to the partnership is dependent on the value of the partnership's assets, the partner's deficit restoration obligation must be computed by reference to the rules for determining the value of partnership property contained in the regulations under § 704(b). Consequently, in computing *GP*'s limited deficit restoration obligation, the value of the partnership's assets is conclusively presumed to equal the book basis of those assets under the capital account maintenance rules of § 1.704–1(b)(2)(iv). *See* § 1.704–1(b)(2)(ii)(d)(value equals basis presumption applies for purposes of determining expected allocations and distributions under the alternate test for economic effect); § 1.704–1(b)(2)(iii)(value equals basis presumption applies for purposes of the substantiality test); § 1.704–1(b)(3)(iii) (value equals basis presumption applies for purposes of the partner's interest in the partnership test); § 1.704–2(d) (value equals basis presumption applies in computing partnership minimum gain).

The *LPRS* agreement allocates all depreciation deductions and gain on the sale of depreciable property to the extent of those deductions to *GP*. Because *LPRS*'s partnership agreement satisfies the alternate test for economic effect, the allocations of depreciation deductions to *GP* will have economic effect to the extent that they do not create a deficit capital account for *GP* in excess of *GP*'s obligation to restore the deficit balance. At the end of year 1, the basis of the depreciable property has been reduced to $800*x*. If *LPRS* liquidated at the beginning of year 2, selling its depreciable property for its basis of $800*x*, the proceeds would be used to repay the $800*x* principal on *LPRS*'s recourse liability. All of *LPRS*'s creditors would be satisfied and *GP* would have no obligation to contribute to pay them. Thus, at the end of year 1, *GP* has no obligation to restore a deficit in its capital account.

Because *GP* has no obligation to restore a deficit balance in its capital account at the end of year 1, an allocation that reduces *GP*'s capital account below $0 is not permitted under the partnership agreement and would not satisfy the alternate test for economic effect. An allocation of $200*x* of depreciation deductions to *GP* would reduce *GP*'s capital account to negative $100*x*. Because the allocation would result in a deficit capital account balance in excess of *GP*'s obligation to restore, the allocation is not permitted under the partnership agreement, and would not satisfy the safe harbor under the alternate test for economic effect. Therefore, the deductions for year 1 must be allocated

$100*x* each to *GP* and *LP* (which is in accordance with their interests in the partnership).

The allocation of depreciation of $200*x* to *GP* in year 2 has economic effect. Although the allocation reduces *GP*'s capital account to negative $200*x*, while *LP*'s capital account remains $0, the allocation to *GP* does not create a deficit capital account in excess of *GP*'s limited deficit restoration obligation. If *LPRS* liquidated at the beginning of year 3, selling the depreciable property for its basis of $600*x*, the proceeds would be applied toward the $800*x* *LPRS* liability. Because *GP* is obligated to restore a deficit capital account to the extent necessary to pay creditors, *GP* would be required to contribute $200*x* to *LPRS* to satisfy the outstanding liability. Thus, at the end of year 2, *GP* has a deficit restoration obligation of $200*x*, and the allocation of depreciation to *GP* does not reduce *GP*'s capital account below its obligation to restore a deficit capital account.

This analysis also applies to the allocation of $200*x* of depreciation to *GP* in years 3 through 5. At the beginning of year 6, when the property is fully depreciated, the $800*x* principal amount of the partnership liability is due. The partners' capital accounts at the beginning of year 6 will equal negative $800*x* and $0, respectively, for *GP* and *LP*. Because value is conclusively presumed to equal basis, the depreciable property would be worthless and could not be used to satisfy *LPRS*'s $800*x* liability. As a result, *GP* is deemed to be required to contribute $800*x* to *LPRS*. A contribution by *GP* to satisfy this limited deficit restoration obligation would increase *GP*'s capital account balance to $0.

HOLDING

When a partner is treated as having a limited deficit restoration obligation by reason of the partner's liability to the partnership's creditors, the amount of that obligation is the amount of money that the partner would be required to contribute to the partnership to satisfy partnership liabilities if all partnership property were sold for the amount of the partnership's book basis in the property.

DRAFTING INFORMATION

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