

# 2012 NEF CPA Town Hall



A forum to discuss IRC Section 704(b)



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*There is an ancient belief that the gods love the obscure and hate the obvious. Without benefit of divinity, modern men of similar persuasion draft provisions of the Internal Revenue Code.*

~Martin D. Ginsburg

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## Agenda

- Introduction
- Overview of Section 752
- Overview of 704
  - Reg. Section 1.704-1-Determination of distributive share
    - Substantial economic effect
    - Partners interest in the partnership
  - Reg. Section 1.704-2- Allocations attributable to non-recourse liabilities
    - Minimum gain rules
- Examples/Issues/Discussion
- Investor Issues
  - Current Cures – What's being done to correct these issues?
  - Proactive steps to avoid future problems

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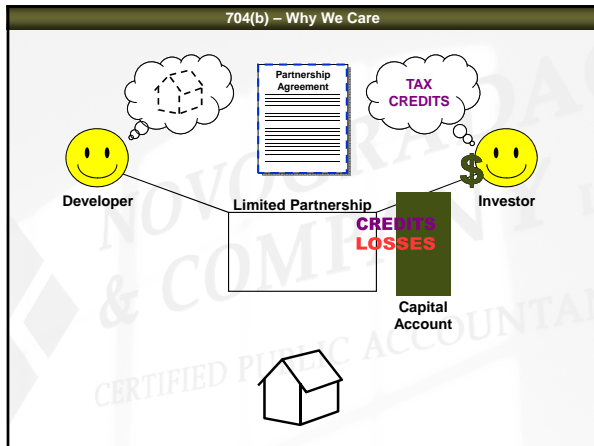
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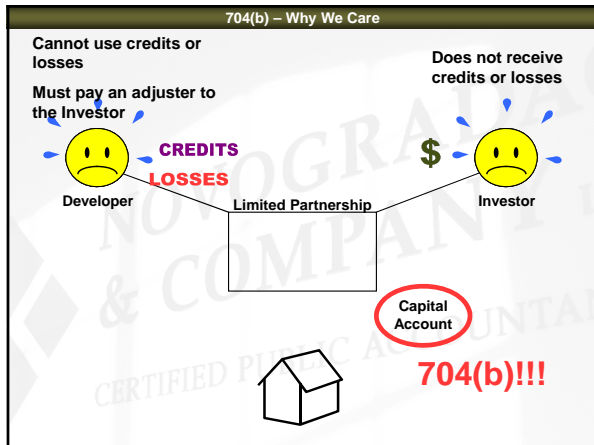
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**Overview of Section 752**

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## Allocations of Liabilities Section 752 Regulations

- Recourse Liabilities – Reg. § 1.752-1(a)(1)
  - Partner or related person bears the “economic risk of loss”
- Non-Recourse Liabilities – Reg. § 1.752-1 (a)(2)
  - No partner or related person bears the “economic risk of loss”

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## Allocations of Liabilities Section 752 Regulations

- Section 752 regulations govern the tax treatment of partnership liabilities
  - Economic risk of loss
- Partner's Share of Recourse Liabilities - Reg. § 1.752-2
  - Obligation to make a payment - Reg. Section 1.752-2(b)
  - Constructive liquidation
- Partner Loans - Reg. § 1.752-2 (c)
  - Partner bears the “economic risk of loss” if the Partner makes a non-recourse loan to the partnership and the “economic risk of loss” is not borne by another partner

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## §752 – Partnership Liabilities

### Non-recourse Determination:

- Constructive liquidation- “He who gets loss, gets liability”.
- Recourse liabilities - Reg. § 1.752-2
  - Partner obligated to make a payment upon liquidation
  - Partner non-recourse loans
- Situations with respect to which the partner protects the lender against the loss through guarantees, stop-loss agreements, or other similar arrangements

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## §752 – Partnership Liabilities

- De-minimus exceptions- Reg. § 1.752-2(d)
  - Partner as lender
    - 10% or less partner makes loan
    - Loan must be "Qualified Non-Recourse Debt" as defined in Section 465(b)(6)
- Partners share of Non-Recourse Liabilities Reg. Section 1.752-3
  - Partner's Share is equal to the sum of:
    - Partners share of partnership minimum gain
    - Partners share of potential Section 704© gain
    - Partner's share of excess non-recourse liabilities (use profit %)

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## §752 – Partnership Liabilities

- Related Person Definition – Reg. Section 1.752-4(b)
  - A person is related to a partner if:
    - They have a relationship described in Section 267(b) or Section 707(b)(1)
      - Substitute 80% ownership for 50%
      - Excluded brothers and sisters from relationships
      - Section 267(e)(1) and Section 267(f)(1)(a) ignored

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## Overview of Section 704

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## Reg. Sections 1.704-1 and 1.704-2

- Reg. Sections 1.704-1
  - Determinations of partner's distributive share
  - Substantial economic effect
  - The "dash 1 regs."
- Reg. Sections 1.704-2
  - Allocations attributable to Non-Recourse Liabilities
  - These allocations cannot by definition have substantial economic effect
  - Minimum gain concept
  - The "dash 2 regs."

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## Flexibility of allocations under §704(b)

- Partnership provisions in the IRC and regulations provide for *special allocations* of items and provide a system whereby those allocations will be respected.
- Contrast with treatment of S Corp allocations
  - *S-Corp allocations must be "straight up"*

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## Regulation Section 1.704-1

- The "dash 1 regs."
- Partner's share of income, gain, loss, deduction, or credit generally determined by the Partnership Agreement.

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## Regulation Section 1.704-1

- Partner's share of income, gain, loss, deduction or credit generally determined in accordance with the *partner's interest in the partnership* ("PIP") if:
  - Partnership agreement does not provide allocations, OR
  - An allocation does not have *substantial economic effect*.

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## Regulation Section 1.704-1

- If the partnership agreement provides for allocations there are 3 ways the allocation will be respected:
  - 1- Substantial economic effect ;
  - 2- Allocation is in accordance with the *partner's interest in the partnership* Use the "comparative liquidation test"
    - Referred to as "the objective standard"
  - 3- Allocation is in accordance with the *partner's interest in the partnership* taking into account all of the facts and circumstances
    - The "subjective standard"
- See Reg. Section 1.704-1(b)(3)(i) and (ii)

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## Substantial Economic Effect 2 part analysis

"Economic Effect" - Reg. Section 1.704-1(b)(2)(ii)

Generally the partner must receive the benefit or bear the burden of the allocation

- Maintenance of capital accounts
- Liquidating distributions made in accordance with positive capital accounts
- Capital account deficits must be restored
  - » or alternatively the partnership agreement must contain a "qualified income offset"

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## Substantial Economic Effect 2 part analysis

2- Economic effect must be “*substantial*”

- Must affect the economic consequences between the partners, independent of the tax consequences.
- Complicated set of rules to determine this test.
- Allocation is not *substantial* if after-tax economic consequences of one partner may, in present value terms, be enhanced and no other partner’s economic consequences likely will be, in present value terms, diminished substantially
- Reg. Section 1.704-1(b)(2)(iii)

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## Regulation Section 1.704-1

Q. Can future capital contributions create 704(b) basis for a partner?

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## Regulation Section 1.704-1

Q. Can future capital contributions create 704(b) basis for a partner?

A. Sometimes

- Must be an unconditional obligation to make subsequent capital contributions
- Tax credit adjustor provisions make obligation conditional? Would appear so.
- Use of limited Deficit Restoration Obligation
- See Reg. Section 1.704-1(b)(2)(ii)(c)(2)

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### Regulation Section 1.704-1

- Q. Does one get 704(b) basis attributable to a Section 754 step-up?

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### Regulation Section 1.704-1

A. No

- Section 754 Election – Basis Step Ups
  - Step-up in basis under Section 743(b) only
  - Section 743(b) asset belongs to applicable partner
  - No step-up in basis for other partners for Section 704(b) capital account purposes
  - 704(b) “book-up” achieves desired result?
  - Reg. Section 1.704-1(b)(2)(iv)(m)

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### Regulation Section 1.704-1

- Revaluations of Partnership Property
  - 704(b) “book – ups”
  - 5 general requirements
  - Book-up must be made “principally for a non-tax business purpose”
    - e.g. Significant contribution of money for a partnership interest etc.
  - Reg. Section 1.704-1(b)(2)(iv)(f)

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## Regulation Section 1.704-1

Capital Accounts for Section 704(b) purposes must be decreased by the partner's share of the following:

- Non-deductible partnership items (Section 705(a)(2)(B) expenditures-Disallowed M&E expense etc)
- Syndication costs
- Disallowed losses under related party rules
- Basis adjustments to property (historic credits/energy credits)
  - Capital account decreased ratably over recapture period for 704(b) purposes only
- See Reg. Section 1.704-1(b)(2)(iv)(i)(1-3) and (j)

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## Regulation Section 1.704-1

- Allocations of Section 42 Low-Income Housing Tax Credits - See Reg. Section 1.704-1(b)(4)(ii)
  - Partners interest in the partnership with respect to “other credits” (i.e. the LIHCT) shall be in the same proportion of the partner's distributive share of the of the loss or deduction giving rise to the credit
  - **Allocations of LIHTC credits follow allocations of depreciation deductions**

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## Regulation Section 1.704-2 Allocations Attributable to Non- Recourse Liabilities The “Dash 2 Regs.”

- Non-recourse deductions cannot have economic effect by definition
  - Creditor alone bears the economic risk of loss
- Allocations must be allocated in accordance with the partner's interest in the partnership
  - Minimum Gain Chargeback test

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## Regulation Section 1.704-2 Minimum Gain Rules

What is minimum gain?

- Gain the partnership would realize if it disposed of the property subject to the non-recourse liability for no consideration other than full satisfaction of the non-recourse liability or.....
- Gain that would be realized by the partnership if it sold its property for nothing more than the relief of non-recourse debt Reg. § 1.704-2(d)
- Essentially a foreclosure sale**

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## Regulation Section 1.704-2 Minimum Gain Rules

What is minimum gain?

- Minimum Gain is allocated to liabilities in the reverse order of payment priority (e.g. first to a second mortgage and then to a first mortgage).
- See Reg. § 1.704-2(d)

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## Section 1.704-2 Minimum Gain Rules

Why is minimum gain important?

- Allows an investor to be allocated depreciation deductions and LIHTCs
- Allows the investor's capital account to go negative
  - Investor's share of minimum gain sustains the investor's negative capital account
  - Investor's share of minimum gain is generally equal to the investor's share of gain from a hypothetical foreclosure sale of the property

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## Minimum Gain Rules

### Why is minimum gain important?

- Investor's share of minimum gain must generally be equal to or greater than the investor's negative capital account
  - To allow current year loss allocations
  - To avoid a reallocation of losses in current year
- Investor's share of minimum gain generally must always bring negative capital account back to zero upon hypothetical liquidation

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## Minimum Gain Rules

- Limited Partners adjusted §704 (b) capital account calculation
  - LPs share of cumulative minimum gain
  - + LPs ending tax capital
  - Syndication Costs
  - Limited Partners adjusted § 704 (b) capital account

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## Minimum Gain Rules

- "Non-Recourse Deductions" – for each year equal the net increase in partnership minimum gain
  - Depreciation is considered the first item of non-recourse deductions
- If no minimum gain is present, all deductions are recourse deductions by definition
  - Allocations of recourse deductions are governed by the "Dash 1 Regs."

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## Minimum Gain Rules

How is minimum gain computed?

- Nonrecourse Debt
  - Adjusted Tax Basis of Secured Assets
  - Cumulative minimum gain
  - x LP ownership %
  - LPs share of cumulative minimum gain

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## Minimum Gain Rules

Net Increase or Decrease in Minimum Gain

- Calculated by taking the minimum gain from the last day of the prior year and comparing it to the minimum gain from the last day of the current year

Minimum Gain – Current Year

Less

Minimum Gain – Prior Year

Equals

Increase or decrease in Minimum Gain

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## Minimum Gain Rules

- "Minimum Gain Chargeback"
  - Income allocation to partner as a result net decrease in partnership minimum gain for the year.
  - Negative capital account relying on existing minimum gain

Chargeback (income allocation) essentially adjusts capital account back to supportable level

- "Kicks capital account back into the middle of the road" (i.e. allows the capital account to remain negative only to the extent it is supported by the partner's remaining share of minimum gain).

- See Reg. § 1.704-2(f)

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**Minimum Gain  
(example 1)**

Cash	\$ 15,000
Building	5,000,000
Land Improvements	500,000
FF&E	300,000
Accum. Depreciation	(2,700,000)
Perm Loan Fee (Net)	30,000
Syndication Costs	<u>10,000</u>
Total Assets	<u>\$ 3,155,000</u>
Non-Recourse Debt	\$ 3,390,000
Recourse Liabilities	15,000
Partners Capital	<u>(250,000)</u>
Total Debt & Equity	<u>\$ 3,155,000</u>

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**Minimum Gain  
(example 1)**

Non-Recourse Debt	<u>\$ 3,390,000</u>
Fixed Assets	5,800,000
less Accum. Depreciation	<u>(2,700,000)</u>
Property's Adj. Tax Basis	<u>3,100,000</u>
Minimum Gain	<u>\$ 290,000</u>

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**Minimum Gain  
(example 1)**

Partner's Capital	(250,000)
Syndication Costs	<u>(10,000)</u>
Partner's Capital Account	(260,000)
Minimum Gain	<u>290,000</u>
Excess Minimum Gain	30,000*

\*No shift in losses, depreciation or tax credits

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## Minimum Gain (example 2)

### Balance Sheet

Cash	\$ 5,000	Mortgage Loan	\$ 3,900,000
Land	200,000		
Building	5,250,000	Deferred Developer Fee	650,000
Land Improvements	800,000	Operating Deficit Loan	130,000
Personal Property	300,000	General Partner Loan	625,000
Accum. Depreciation	(1,700,000)	Accrued Interest	30,000
Perm Loan Fees (Net)	15,000	General Partner's Capital	(12,000)
Syndication Costs	10,000	Limited Partner's Capital	(443,000)
<b>Total Assets</b>	<b>\$ 4,880,000</b>	<b>Total Debt &amp; Capital</b>	<b>\$ 4,880,000</b>

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## Minimum Gain (example 2)

### Partnership Minimum Gain

Non-recourse Debt	\$ 3,900,000	
Property's Adjusted Tax Basis	4,850,000	
<b>Partnership Minimum Gain</b>	<b>\$ 0</b>	

#### \$704(b) Limited Partner's Capital

2011 Ending Capital	\$ (443,000)
Syndication Costs	(10,000)
Share of Min Gain (99%)	0
<b>\$704(b) Capital</b>	<b>\$ (453,000)*</b>

\*\$453,000 of losses/deductions will shift to G.P.; may avoid tax credits being reallocated to G.P.

#### \$704(b) General Partner's Capital & Liabilities

2011 Ending Capital	\$ (12,000)
Share of Min Gain (1%)	0
Deferred Developer Fee	650,000
Operating Deficit Loan	130,000
General Partner Loan	625,000
Accrued Interest	30,000
<b>\$704(b) Capital &amp; Liabs.</b>	<b>\$ 1,423,000</b>

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## Minimum Gain (example 3)

### Year 1

Losses	Minimum Gain
\$100,000	\$100,000

Now, assume that in year 2  
minimum gain is \$75,000

\$25,000 INCOME!

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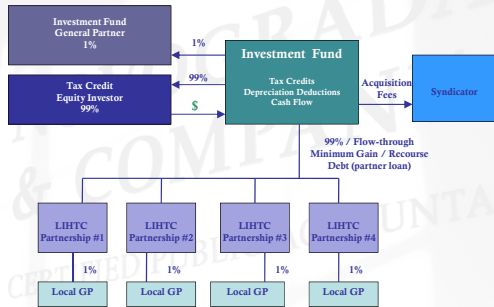
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### Minimum Gain Flow Through Tiered Partnership Structure




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### Minimum Gain Flow Through Tiered Partnership Structure

- Flow-through minimum gain from operating partnerships to the Fund
- Partner non-recourse debt allocable to the Fund under Section 752 flows through to the Fund
  - Flow-through of minimum gain and partner non-recourse debt create Section 704(b) basis at the Fund level
- See Reg. § 1.704-2(k)

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### Minimum Gain Flow Through Tiered Partnership Structure

- Partner level determination of Section 704(b) basis then applied at the Fund level
- Typically the investor will have more 704(b) basis at the fund level
  - Basis attributable to acquisition fees paid to the syndicator

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## Investor Issues

### Current Issues/Problems

#### What are some common reasons for minimum gain issues/problems?

- Deductions for various fees were not specially allocated to the partner receiving the fee
  - The deduction was allocated to the L.P.
- Fees accrued to a related party cash basis taxpayer were incorrectly deducted by the partnership and allocated to L.P.
  - Related party loss suspension rule not followed
  - See IRC Section 267(a)(2)

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## Investor Issues

### Investor Concerns Current Issues/Problems

#### What are some common reasons for minimum gain issues/problems?

- Troubled deals - Operating deficits were not specially allocated to the partner that funded the expenses via an ODL
- General Partner non-recourse debt
  - Interest on developer fee notes not specially allocated to the G.P./developer
  - Creates 704(b) basis for the G.P. not the investor

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## Investor Issues

### Current Cures

#### What are some potential cures to fixing a minimum gain issue?

- Limited Deficit Restoration Obligation
  - Allows investor capital account to go further negative
- Reversal of deductions incorrectly taken-267(a)(2)
  - Accrual basis partnership/cash basis related party payee
  - Amend returns or one year catch up?
- One time fix
  - No technical support for this cure

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## Investor Issues

### Current Cures

- Potential cures for past sins - Be careful
  - One time fix –
    - Special gross income allocation to L.P. (may work if other investors have positive adjusted capital accounts)
    - Special loss allocation to G.P.
    - Special allocations of items of non-depreciation deductions
    - Debt restructuring to create minimum gain
  - Arguments
    - Qualified income offset
    - Restoration of economic arrangement between the partners
    - Beware!-No technical support for many of these positions
      - Consideration of tax risk/Filing positions etc.

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## Investor Issues

### Current Cures

**What are some additional potential cures to fixing a minimum gain issue?**

- Slow down depreciation deductions
  1. Beware! Generally cannot change methods/lives midstream
  2. Elect depreciable life in the year the property is PIS
  3. Upfront projections critical
- Convert partner non-recourse debt to non-recourse
  1. May increase minimum gain
  2. Non-recourse debt must be secured by the property
  3. See Reg. § 1.704-2(g)(3)
- Preserve the Investor's capital account basis
  1. Slow down deductions for incentive management fees, etc.
  2. Specially allocate deductions to partner bearing the economic burden (e.g. allocate operating deficit expenses to the G.P. that funded them)
  3. Specially allocate items of non-depreciation deductions

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## Investor Issues

### Current Cures Deferred Developer Fees

- Disaffiliation – A way to create minimum gain
  1. A way to convert partner non-recourse debt to non-recourse debt ("good 704(b) debt")
  2. Disaffiliation generally works if the G.P./Developer is not a related party to the Partnership
  3. Generally the same person must own less than 80% of the Developer and the General Partner to not be a related party

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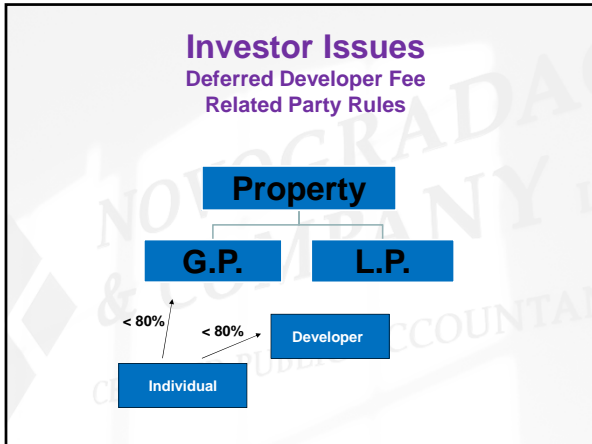
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**Investor Issues**  
Steps to avoid future problems

If a capital account goes negative it must be sustained

1. Minimum gain
2. Partner non-recourse debt
3. Partner recourse debt

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**Investor Issues**  
Steps to avoid future problems

Partnership Agreement provision

1. If G.P. funds an operating deficit .....
2. Those funded expenses get allocated to the G.P.
3. Special allocations of items of non-depreciation deductions and some cash expenses

Limited deficit restoration provision (DRO)

Review of initial projections

1. May want to choose longer depreciation recovery periods
2. Other front-end fixes
3. Structure of debt- De-minimus exception-Section 752

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## Deficit restoration obligations

- ❑ Background – DROs an important part of determining §704(b) minimum gain
- ❑ Minimum gain regulations cover what to consider when the partnership agreement does not have an unlimited obligation to restore
  1. See Reg. § 1.704-1(b)(2)(ii)(d) for discussion of “alternate test”, OR
  2. Reg. § 1.704-1(b)(3) for DRO aspects to “PIP” rules (Partner’s interest in the partnership)

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## Requirements for DROs

- ❑ Obligation to restore cannot be contingent or only a remote possibility
- ❑ Can be a note if payable in year of liquidation or 90 days later
- ❑ Can be an obligation to contribute additional capital, but must be “unconditional”
  1. Must be legally enforceable
  2. All conditions must have been met
  3. Any and all side agreements, written or oral, are considered

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