Allocating Income

The partnership agreement controls how income is allocated.
- No agreement exists
- The agreement lacks “substantial economic effect”

Note: Substantial economic effect is really a two-part test. Allocations must have
1. economic effect (objective) and
2. be substantial (subjective).

The PIP Rule

• Facts and Circumstances Test
• The PIP rule examines:
  - Relative contributions of partners
  - Relative interests in distributions upon liquidation
  - Relative interests in cash flow
  - Relative interests in economic profit and loss sharing ratios

  Treas. Reg. §1.704-1(b)(3)

Partner's Interest In The Partnership

When the partnership agreement does not control, each partners’ distributive share of income, gain, loss, deduction, and credit is determined by each partners’ “interest in the partnership” --- The PIP rule.

PIP Question

Stephen King (SK) and Steven Thompson (ST) form a partnership. SK and ST share partnership profits 50-50 but ST originally contributed $70 partnership while SK contributed $30. Upon liquidation, SK and ST will received assets in proportion to their ending capital accounts. SK withdrew $100 from the partnership during the year. ST only withdrew $50.

What are the partners’ interest in the partnership?
Stanley Orrisch
Predecessor to the Regs.

S.O.  L

$100        $100
<30>        <30>
  +10        +10
$ 80        $110

to each

to S.O.

Bldg: $500
Cash     200
Mortg  300

Income $ 80
Expenses  -60
Net Inc.  20
Depr  -30

Orrisch Capital Accts.

S.O.  L

$100        $100
<30>        <30>
  +10        +10
$ 80        $110

Sell Bldg For $470

Sales Price: $ 470
Less Basis: -470
Gain on Sale: 0
No Gain Chg-back 0
(To Orrisch)
Balance: 0
(Split 50 / 50)

Income $ 80
Expenses  -60
Net Inc.  20
Depr  -30

NBV = $470

Sale $ 470 - Payoff $ 300
+ N. I. $ 20 = $ 190 cash

Orrisch Loss Acct.

S.O.  L

$100        $100
<30>        <30>
  +10        +10
$ 80        $110

Sell Bldg For $350

Sales Price: $ 350
Less Basis: -470
Loss on Sale: -120
No Gain Chg-back -0
(All to Orrisch)
Balance: <120>

Income $ 80
Expenses  -60
Net Inc.  20
Depr  -30

NBV = $470

Sale $ 350 - Payoff $ 300
+ N. I. $ 20 = $ 70 cash

Stanley Orrisch Result

S.O.  L

$100        $100
<30>        <30>
  +10        +10
$ 80        $110

Sell Bldg For $530

Sales Price: $ 530
Less Basis: -470
Gain on Sale: 80
Gain Chg-back 30
(To Orrisch)
Balance: 30
(Split 50 / 50)

Income $ 80
Expenses  -60
Net Inc.  20
Depr  30

NBV = $470

Sale $ 530 - Payoff $ 300
+ N. I. $ 20 = $ 250 cash

STANLEY ORRISCH
Predecessor to the Regs.

S.O.  L

$100        $100
<30>        <30>
  +10        +10
$ 80        $110

Bldg: $500
Cash     200
Mortg  300

Income $ 80
Expenses  -60
Net Inc.  20
Depr  -30

Depr  -30

to S.O.

Sell Bldg For $530

Sales Price: $ 530
Less Basis: -470
Gain on Sale: 80
Gain Chg-back 30
(To Orrisch)
Balance: 30
(Split 50 / 50)

Income $ 80
Expenses  -60
Net Inc.  20
Depr  30

NBV = $470

Sale $ 530 - Payoff $ 300
+ N. I. $ 20 = $ 250 cash

STANLEY ORRISCH
Result
Eco. Effect—Primary Test

- Capital account maintenance
- Liquidation proceeds distributed in accordance with capital accounts
- Deficit capital accounts must be restored

Treas. Reg. §1.704-1(b)(2)(ii)

Deficit Restoration

- In partnership agreement
- State law
- Promissory notes
- Unconditional obligation to contribute
- Ultimate payor on partnership recourse debt

Question

Can a limited partner who doesn’t want to be liable for additional contributions (i.e., a DRO) be eligible for a special allocation under the economic effect test? If so, how?

- Yes, just do it.
- No, deficit capital accounts must be restored.
- Yes, recognize income.
- No, available only to general partners.

Eco. Effect—Alternate Test

- Capital account maintenance
- Liquidate in accordance with positive capital accounts
- Qualified Income Offset (QIO)

Treas. Reg. §1.704-1(b)(2)(ii)(d)
Qualified Income Offset

- Partner agrees to restore any deficit capital account caused by *unexpected* distributions to the partner
- Income or gain is allocated to the partner
- It is only necessary to restore the partner’s deficit capital account to a deficit balance that can be justified under the regulations

Economic Equivalence Test

- This is also known as the “*dumb-but-lucky*” rule.
- An allocation will still have economic effect if the partnership agreement ensures that a liquidation of the partnership, as of the end of each partnership year, would produce the same economic results that would occur if the three requirements had been met.

Treas. Reg. §1.704-1(b)(2)(ii)

§704(b) Regs.

Substantiality

Treas. Reg. §1.704-1(b)(2)(iii) provides that

“... an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.”
Substantial

**Subjective tests**
- Allocations within a year (Shifting)
- Allocations between years (Transitory)

The AB Partnership invests money which produces both taxable and tax-exempt interest. Throughout the life of the partnership, A and B have shared all items equally. A is in a 39% marginal tax bracket currently, while B, because of losses sustained in other activities, will not pay any tax this year.

Near year-end, the partnership agreement is amended to provide that the first $10,000 of tax-exempt interest be allocated to A while the first $10,000 of taxable interest received be allocated to B. All other partnership items are allocated equally. There is a strong likelihood that at least $10,000 of both taxable and exempt interest will be earned by the partnership in the current year.

Will the allocation of the $10,000 be substantial?

**Section 704(c) Logic**

<table>
<thead>
<tr>
<th>Land</th>
<th>$50,000 FMV</th>
<th>$10,000 Basis</th>
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</thead>
<tbody>
<tr>
<td>50% A</td>
<td>Cash &lt;br&gt;$50,000</td>
<td>AB &lt;br&gt;$20,000</td>
</tr>
<tr>
<td>50% B</td>
<td></td>
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</tr>
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</table>

Sales price of Land $50,000
Less basis 10,000
Gain recognized $40,000

A <br> $20,000 <br> B <br> $20,000

**Section 704(c)(1)(A) General Rule**

§704(c)(1)(A):

...income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution, ...
Ceiling Rule - Shortage

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<th>Land</th>
<th>FMV</th>
<th>Basis</th>
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<tr>
<td>50% B</td>
<td>Cash</td>
<td>$50,000</td>
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Sales price of Land $42,000
Less basis 10,000
Gain recognized $32,000

Treas. Reg. §1.704-3

- Apply to contributions of built-in gain and built-in loss property

De minimis rule
- 15% rule
- Contributed property < $20,000

- Partnership must make allocations for built-in gain or loss property using a reasonable method of allocation
- Anti abuse rule

Possible Reasonable Methods

- Traditional method (Treas. Reg. §1.704-3(b))
- Traditional method with curative allocations (Treas. Reg. §1.704-3(c))
- Remedial allocation method (Treas. Reg. §1.704-3(d))
- Other reasonable method

No safe harbor

Traditional Method

Treas. Reg. §1.704-3(b)

- Allocates built-in gain or loss to contributing partner.
- Allocate depreciation and amortization first to noncontributing partner.
- Ceiling rule limits allocation to tax attributes.
Traditional Method With Curative

Treas. Reg. §1.704-3(c)
• Allows traditional method calculations to be “cured” by an allocation of other items.

Curative allocations
• Limited to amount necessary to offset effect of ceiling rule.
• Must be expected to have substantially the same effect on each partners’ tax liability as the tax item distorted by ceiling rule.

Remedial Allocation Method

Treas. Reg. §1.704-3(d)
• Allows partnership to create remedial allocations to offset effect of ceiling rule
• Requires two-tier calculation for book cost recovery
• Remedial allocations are generally less than curative allocations in the first several years after the contribution of cost recovery property

Depreciation – Traditional Method

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<tr>
<th>Machine – 10 yr life remaining</th>
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<td>$ 4,000 Basis</td>
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<td>50% B</td>
<td>Cash $10,000</td>
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A |

-0- Depreciation

B |

400 Depreciation

20 yr. Asset with 10 years remaining.
Tax depreciation for AB partnership is $400 (10% of $4,000). B is entitled to $500 of depreciation ½ of the (10% of $10,000).

Because partnership depreciation is less than what B is entitled to take, a ceiling rule application exists.

Depreciation – Curative Method

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<th>Machine – 10 yr life remaining</th>
<th>$10,000 FMV</th>
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<td>50% B</td>
<td>Cash $10,000</td>
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</table>

A |

-0- Depreciation

B |

400 Depreciation

Situation 1. If the partnership has ordinary income of $500 which is normally to be split 50/50, it can make a “curative allocation.” Thus Partner B would get all of the $400 depreciation and Partner A would be allocated the first $100 of ordinary income to “cure” the depreciation inequity to partner B.

Situation 2. If the partnership had ordinary income of $50 and a capital gain of $350, it can only make a partial curative allocation. Partner B would get $400 of the depreciation and Partner A would be allocated the $50 of ordinary income. None of the capital can be allocated to A because it is not of the same character as the depreciation.
Depreciation – Remedial Method

Machine – 10 yr life remaining
$10,000 FMV
$ 4,000 Basis

50% A

$10,000

50% B

Cash

AB

A

-0-

Depreciation

B

400

Depreciation

Book Depreciation

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Tax Depreciation Allocation

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Ab

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Depreciation

B

400

Depreciation