

Partnership and LLC Agreements: Learning to Read and Write Again

By Steven R. Schneider and Brian J. O'Connor

Steven R. Schneider is a director at Goulston & Storrs PC in Washington. Brian J. O'Connor is a partner at Venable LLP in Baltimore and Washington. Schneider and O'Connor are adjunct professors in the LLM tax program at Georgetown University Law Center, where they teach the class "Drafting Partnership and LLC Agreements." The authors frequently remind their students that they had to learn the same material through the school of hard knocks — a nonaccredited institution of learning designed by the same people who walked two miles in the snow to school each day, uphill both ways. The authors would like to thank their students, who have unwittingly served as test cases for the teachings in this report. The authors would like to thank all those who provided comments on earlier drafts of this report, including Monte Jackel, Julia Livingston, Kelly Bissinger, and Robert Honigman.

Learning how to read and write partnership and limited liability company agreements is a never-ending process, constantly evolving with corresponding changes in business and legal requirements. This report is designed to provide an overview of those agreements for lawyers, accountants, and business professionals, emphasizing tax-related provisions. Starting with an overview of a typical partnership agreement structure, the report provides an essential background of the partnership tax rules and ends with a detailed analysis of what the tax boilerplate actually means.

A partnership agreement is typically broken down into various articles or sections and will typically include one or more exhibits and schedules. The primary sections include general provisions, capital contributions, tax allocations, distributions, management, books and records, transfers of interests, and dissolution. Professionals who fully understand what these sections are intended to accomplish should be more than able to read and write sophisticated partnership and LLC agreements for many years to come.

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I. Introduction

Learning how to read and write partnership and limited liability company¹ agreements is a never-ending process, constantly evolving with corresponding changes in business and legal requirements. This report is designed to provide an overview of those agreements for lawyers, accountants, and business professionals, with an emphasis on tax-related provisions. Starting with an overview of a typical partnership agreement structure, the report then provides an essential background of the

¹This report will generally use the term "partnership agreement" to cover agreements for all entities treated as partnerships for federal income tax purposes, including LLCs taxed as partnerships.

partnership tax rules and ends with a detailed analysis of what the tax “boilerplate” actually means, including an appendix explaining the tax boilerplate in a common partnership agreement format.

II. Structure of a Typical Partnership Agreement

A partnership agreement typically is broken down into various articles or sections and will include one or more exhibits and schedules. The following explanation describes typical sections of most partnership agreements in the order commonly found in agreements. Many partnership agreements will contain additional sections covering specialized deal considerations such as compliance with regulatory restrictions that may be unique to that type of partnership agreement.

A. Prefatory Language

The typical agreement begins with prefatory language such as an effective date, a preamble, recitals, “whereas” clauses, or explanatory statements that put the agreement into context. This section will explain fundamental questions such as when the agreement becomes effective, who the partners are, whether it is a new or amended partnership agreement, and the purpose of the partnership (for example, to own a particular property or business). Often these provisions also outline a history of the agreement and any amendments.

B. General Provisions

This section will include general information such as the name of the partnership, the principal and registered offices, the term, and the general purpose and powers (for example, buying real estate, borrowing or lending money, the ability to operate in a particular manner or through particular types of entities). Either this section or a section at the end of the agreement will typically include a lengthy alphabetical list of definitions. Many definitions will simply be a cross-reference to the section in which a term is defined in the main body of the agreement. Many of the definitions relate to federal income tax terminology a partnership must use if it intends to satisfy the tax allocation safe harbors found under the tax code. If these safe harbors are satisfied, the IRS will respect the income or loss allocations among the partners.

C. Capital Contributions

The capital contribution section is short but very important. It answers questions such as what the partners are contributing and when the contributions are being made. Capital contributions are typically broken down into original contributions of cash or property and subsequent contributions, including additional capital contributions a partnership may be able to require from the partners (capital calls). Whether a capital contribution is required may be determined by reference to the penalties and remedies provided in this section to deal with situations in which capital is called and not provided. This section will also dictate whether a partner has the option to make an in-kind contribution (to contribute property in lieu of cash), whether a partner has the right to withdraw its capital before liquidation of the partnership (a lockup), and whether a partner is entitled to interest on its capital account. Finally, this section typi-

cally requires that a partnership maintain capital accounts for each partner, consistent with the regulatory safe harbors for income and loss allocations. The definition of a capital account is included either in this section or in the general definition section.² In essence, a partner’s capital account is the fair market value (FMV) of partner contributions (net of any related debt assumed by the partnership), increased or decreased by the partner’s share of income or loss and decreased by the FMV of partner distributions (net of any related debt assumed by the partner). For this purpose, income and loss refers to the economic or book definitions under the tax rules of section 704(b). It may not be the same as income or loss determined for income tax or for generally accepted accounting principles.

Interest on capital is unusual and is generally classified as a guaranteed payment for federal tax purposes.³ A guaranteed payment is used for some preferred partners that wish to be treated more akin to lenders. This goal is often satisfied with a preferred allocation of partnership income in lieu of stated interest or a guaranteed payment. A preferred return allows some of the advantages of a debtlike investment without putting undue economic obligations on the partnership to pay even if there is no income to support the payment. A preferred return also has the advantage of carrying out the tax character of the underlying income used to satisfy the payment, potentially allowing the recipient the benefit of capital gains tax rates.⁴

Example 1: Capital account basics. A contributes Building with \$100 gross FMV, subject to \$30 of debt. In year 1 the partnership allocates \$10 of section 704(b) book income to A and distributes \$4 of cash to A. A’s ending capital account is \$76, computed as follows:

	Effect on Capital Account	Ending Capital Account
Increase by net FMV of property contributed	+\$70	\$70
Increase by income allocation	+\$10	\$80
Decrease by distributions	-\$4	\$76

D. Tax Allocations — Section 704(b) and (c)

This section of the agreement describes how taxable income and loss should be shared among the partners. Most of the allocation language relates to the economic/book allocations, and in general the taxable income will

²In some cases an agreement may avoid the detailed definition of a capital account and simply state that the partnership must maintain capital accounts in accordance with the specified tax regulations.

³A guaranteed payment is a payment to a partner that is determined without regard to the income of the partnership and in many ways is treated similarly to an interest payment. See generally section 707(c) and reg. section 1.707-1(c).

⁴See generally Todd D. Golub et al., “Economic, Tax, and Drafting Considerations for Preferred Partnership Interests,” 33 *Real Est. Tax’n* 156 (2006).

follow these book allocations.⁵ However, if a partner contributed an asset with built-in appreciation or depreciation, special rules require that the built-in tax gain or loss be allocated back to the contributing partner.⁶ Note that the term “allocation” is a tax-only term and should not be confused with “distribution,” which is an economic term. These two terms interrelate because if a partnership liquidates in accordance with the book capital accounts, the income or loss allocations will directly affect each partner’s share of distributions. For example, an allocation of income increases a partner’s capital account, which means that the partner is entitled to more distributions because of the larger capital account.

Partnership agreements typically break the book allocations down into two sections. The primary allocation section describes the general business deal, such as allocating profits in accordance with relative capital or profit percentages (percentage interests). The second section overrides the first section and is designed to comply with the book income tax regulatory safe harbors to dictate things like making sure partners generally do not receive deductions in excess of their capital accounts and how to allocate deductions funded by nonrecourse debt.⁷ This second section is often called the “boilerplate” or “regulatory allocations” section. The typical agreement first allocates income and loss under the regulatory allocation provisions, if applicable, and then allocates any remaining book income or loss (usually defined as profit and loss in the agreement) in the primary allocation section.

The book allocations section is important because it describes how the taxable income and loss are allocated among the partners. Further, if the partnership liquidates in accordance with capital accounts, those allocations drive the economics of the deal. If the partnership does not liquidate in accordance with capital accounts but instead liquidates according to a defined ordering of cash or property distributions (i.e., a cash or liquidation waterfall), the book allocations have no effect on the economics and relate solely to tax. Because liquidating in accordance with capital accounts means that the complicated regulatory allocations can have a meaningful effect on the business deal, agreements often liquidate with a

waterfall and avoid the need for the business persons to understand the tax boilerplate.⁸

The tax allocations will not be respected if the agreement liquidates with a waterfall and the partners’ economic rights under the waterfall are different from the rights based on their capital accounts. In that case, the taxable income or loss will be reallocated so that the capital accounts and the waterfall rights are consistent. For example, assume the tax allocations send all \$100 of section 704(b) income to Partner A and none to Partner B, causing A’s capital account to increase by all \$100 and B’s capital account to remain constant. If the waterfall provides that the cash corresponding to that profit is shared \$50 each by A and B, the IRS will not respect the tax allocation and will reallocate \$50 of income to B. To avoid inconsistencies between the tax allocations and the partners’ rights under the waterfall, many partnership agreements simply use a target/fill-up allocation under which the agreement allocates book income or loss among the partners using a formula that causes the partners’ capital accounts to equal the amounts the partners would receive under the waterfall.⁹

Example 2: Target allocations. Limited partner, LP, and general partner, GP, contribute \$90 and \$10, respectively, to the partnership and set beginning capital accounts in the same amount. The distribution waterfall provides that cash is paid first to return contributed capital plus a 10 percent annual preferred return and is then paid 80-20 to LP and GP.¹⁰ The partnership earns \$20 of income in year 1, and under the waterfall the \$120 of total partnership cash would be distributed as follows:

	LP	GP	Total
Return of capital	90	10	100
Preferred return	9	1	10
Residual return	8	2	10
Total	107	13	120

A typical target allocation provision would allocate the \$20 of year 1 earnings to fill up the LP and GP opening capital accounts¹¹ (\$90 and \$10, respectively) to

⁵For example, \$100 of net book income may be composed of \$120 of gross capital gain and \$20 of depreciation deductions. An equal allocation of this \$100 of income between two partners results in each partner receiving \$60 of capital gain and \$10 of depreciation deductions for net taxable income of \$50 each. However, if \$30 of the gross income were tax exempt, the net taxable income to each partner would be only \$35 (\$45 of capital gain, \$15 of tax-exempt income, and \$10 of depreciation deductions). See reg. section 1.704-1(b)(1)(vii) (net book allocations carry out a proportionate share of underlying tax items).

⁶Section 704(c).

⁷A partner can receive deductions in excess of its capital account if the partner is at risk for the negative amount (that is, the partner has to fund deficit capital accounts) or if the partner is deemed at risk for the amount (that is, the negative amount is funded from nonrecourse debt that the partner is actually or deemed to be at risk for).

⁸For a more complete discussion of whether to liquidate with capital accounts or with a waterfall, see Brian J. O’Connor and Steven R. Schneider, “Capital-Account-Based Liquidations: Gone With the Wind or Here to Stay?” 102 *J. Tax’n* 21 (2005).

⁹See generally Todd D. Golub, “How to Hit Your Mark Using Target Allocations in a Real Estate Partnership,” 50 *Tax Mgmt. Memo.* 403 (Sept. 28, 2009).

¹⁰Typically the general partner would receive the 20 percent residual profit sharing for its services plus a share of the 80 percent return based on its relative capital contribution. However, for simplicity, the example shows the general partner as receiving only a 20 percent residual profit sharing after the preferred return.

¹¹If the partners had other contributions or distributions during the year, the partnership should adjust the beginning-of-the-year capital accounts to reflect this. Partnership agreements frequently use the term “partially adjusted capital account” to refer to the beginning-of-the-year capital accounts adjusted for intrayear contributions and distributions.

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equal their target rights under the waterfall (\$107 and \$13, respectively). Thus, the \$20 of income is allocated \$17 to LP and \$3 to GP.

For a partnership in which there will be contributions of appreciated or depreciated property, the section allocating those items to the contributing partner should be covered in some detail (section 704(c)). Partnership agreements typically include only a single paragraph to cover section 704(c) allocations and often simply repeat the general statutory requirement that tax allocations take into account a partner's potential built-in tax gain or loss on contributed property. However, for many partnerships, including many real estate partnerships, the section 704(c) provision is highly negotiated and includes much more detail relating to which of several alternative methods is chosen to allocate noneconomic taxable income or loss.¹²

Example 3: Section 704(c). Partner A contributes property with a tax basis of \$20 and a value of \$100, and the partnership later sells the property for \$110. The partnership must allocate the first \$80 of tax gain to Partner A because that represents the inherent built-in gain A had in the property when it contributed the property to the partnership. The remaining \$10 of postcontribution economic gain is allocated according to the section 704(b) book allocation provisions in the agreement. Further, when the built-in gain property is depreciated, the partnership must first allocate tax depreciation on the property to the noncontributing partner up to the amount of its book depreciation, with any residual tax depreciation going to the contributing partner. This ensures that the tax basis shortfall is first borne by the contributing partner through both dispositions and depreciation. However, to the extent there is insufficient tax basis for the noncontributing partner to receive its full share of book depreciation, there may still be a tax shortfall to the noncontributing partner depending on the section 704(c) method chosen.

E. Distributions

The distribution section describes the partners' rights to cash or property distributions. These distribution rights are typically subject to the partners' overall distribution rights on liquidation, which may appear in a later section of the agreement. Sometimes the two distribution sections are referred to as the current distribution section and the liquidation distribution section. Often in a partnership that liquidates with a cash waterfall, the liquidation distribution section simply refers to the partners' rights under the current distribution section (after specified reserves).¹³ For partnerships that follow the book

allocation safe harbor tests, the liquidation section will simply liquidate in accordance with positive section 704(b) book capital accounts after all allocations have been made to partner capital accounts.

The distribution section typically addresses important details such as when distributions are made and in what amount. For example, an agreement may provide that there will be quarterly distributions of operating income and larger distributions of capital on defined capital transactions or capital events (such as significant asset sales or refinancings). Most agreements limit operating income distributions to a defined net cash flow to ensure that the partnership has sufficient cash remaining for operations and necessary reserves.

This section will often specifically address taxes. Many agreements provide for minimum distributions to a partner (so-called tax distributions) to ensure that each partner has sufficient funds to satisfy its personal tax obligations on its share of partnership income. Tax distributions are generally documented as an advance on the partner's rights under the more general distribution provisions. Sometimes the distributions are treated as a loan to the partner. Further, taxes paid by the partnership on behalf of a partner are typically treated as a deemed distribution to the partner whose income is requiring the withholding. This is common when the partnership is required to withhold on distributions to a foreign partner.

F. Management

Partnerships will typically designate a board or a single partner as the managing partner. If the partnership designates a single partner as managing partner, this is usually the person classified under state law as the manager of an LLC or the general partner of a limited partnership. The agreement typically vests significant discretion and control in the board or the managing partner, often allowing the passive partners to vote only on more major matters such as acts in contravention of the agreement, the filing of bankruptcy, the admission of additional members not contemplated by the original agreement, and merger or sale of substantially all the partnership assets. The level of detail in the management section varies greatly among partnership agreements. This section also articulates when a partner has liability to the partnership or other partners, and any related indemnifications. This section will also often refer to any related affiliate service agreements, such as a property or asset management agreement with an affiliate of the managing partner.

G. Accounting, Books, and Records

This section covers the more mundane information about keeping books and records and providing tax statements to partners. Items usually described in this section include (1) annual and quarterly reporting of financial information to the partners; (2) who prepares the tax returns and the deadline for providing this information to the partners; (3) who will serve as the tax matters partner (TMP) and represent the partnership in an IRS audit; and (4) what tax decision-making power the TMP will have, such as the ability to extend the statute of limitations, elect in or out of the special unified partnership audit rules, or make other tax elections. Although the identity and authority of the TMP may sound boring,

¹²See Section IV.C. of this report for a more detailed discussion of section 704(c) methods and considerations.

¹³It is also common to see the operating income waterfall differ from the liquidation waterfall. For example, if the partnership has an entrepreneurial partner and an investor partner, the operating income waterfall may make current cash distributions to both partners, but on liquidation (or some capital events) the liquidating or capital event waterfall will first use funds to repay the investor partner's contributions (that is, return of capital) before making distributions to both partners.

they are often critical questions when controversy later arises. These details are often overlooked in the drafting process.

H. Transfers of Partnership Interests

This section will dictate when a partner can or must transfer its partnership interest. Typically, partnership interest transfers are strictly regulated in the agreement and often have no ready market even if a partner wanted to sell its interest. If a partner is allowed to transfer its interest, the agreement will usually allow the partnership or existing partners to have a right of first offer or right of first refusal to acquire the interest or an option to acquire the interest subject to preagreed pricing formulations. There is typically an exception for some transfers (so-called permitted transfers) that often include estate planning transfers to family trusts or family partnerships. If the parties anticipate a potential sale of partnership interests by some or all of the partners, the agreement may include a right by a majority of the partners to force minority partners to also sell (a drag-along right) or a right by the minority partners to join in a sale by the majority partners (a tag-along right).

If a sale occurs midyear, the agreement will commonly include a provision explaining how the taxable income or loss for the year is allocated between the buying and selling partners. Many agreements simply allow the managing partner discretion on how to reasonably allocate income, while others are much more specific and may require a first-of-the-month convention or a closing of the books for significant items and a proration for smaller items like operating income.¹⁴

I. Dissolution and Winding Up

This section describes when and how a partnership will be wound up and whether there will be any reserves retained for potential obligations. As noted above, from a tax perspective this section may be the key to learning whether the agreement intends to follow the regulatory book allocation safe harbors. The agreement likely intends to follow the safe harbors if, after paying creditors and setting up reserves, the agreement distributes the remaining proceeds according to the partners' section 704(b) book capital accounts. Although there are other requirements to satisfy the safe harbors, this is the primary requirement that puts an agreement either in or out of those safe harbors. If the agreement instead liquidates with a cash waterfall, the agreement must rely on a more limited tax safe harbor for comfort that the IRS will respect the income and loss allocations. That safe harbor applies only if, in all events, the partners would receive the same economic distributions had they liquidated in accordance with each partner's section 704(b) capital account. This would occur, for example, in a simple 50-50 partnership in which all capital is contributed equally and all profits, losses, and distributions are shared equally.

¹⁴The IRS recently proposed regulations that would provide further limits on the partnership's flexibility in allocating tax items in this context. See prop. reg. section 1.706-1 and -4, and REG-144689-04, Doc 2009-8357, 2009 TNT 69-18.

J. Miscellaneous

Finally, the miscellaneous section is a repository for items that do not readily fit within the other sections. This includes things like delivery of notices to the partners or partnership, application of the agreement to successors or assigns, waiver of jury trial, restrictions on disclosure of terms, and representations and warranties.

III. Overview of Tax Rules for Partnerships

A basic understanding of partnership tax rules is essential to understanding a partnership agreement.¹⁵ The key concepts are described below.

A. Section 704(b) Versus Section 704(c)

Partnership taxable income or loss is separated into section 704(b) allocations of book income or loss and section 704(c) allocations of tax-only income, gain, loss, or deduction. Section 704(b) income or loss tracks economic income and loss that occurs while assets are held in the partnership. The partnership then allocates these amounts based on the business arrangement. It tracks each partner's share by maintaining individual partner section 704(b) book capital accounts. In contrast, section 704(c) tracks differences between book and tax capital. This rule is designed to prevent a person from contributing property with a built-in tax gain or loss into a partnership and shifting that gain or loss to another partner.

Unrealized asset appreciation or depreciation is booked into the capital accounts and run through the section 704(b) income statement only on specific triggering events. For example, if a partnership buys an asset for \$100 and later sells it for \$150, the \$50 of previously unrealized book gain is triggered and allocated to the partners. Similarly, there is a book-up or -down event when there is a significant change in the way the partners share economics, such as when the partnership issues a new profits interest to a partner or there is a disproportionate partner contribution or redemption. The rules allow the partnership to book the pre-event unrealized amounts according to the pre-event sharing ratios. For example, if the partnership were owned 50-50 by A and B, and C later joined for a one-third interest, the partnership would be able to book the pre-C appreciation into A and B's capital accounts based on the prior 50-50 ratio.

Although the tax regulations state that book-ups and -downs are optional, many partnerships use these events to revalue the partnership assets and ensure that there is no inappropriate economic or tax shifting of the pre-book-up or -down appreciation or depreciation among

¹⁵For additional background on tax and nontax aspects of drafting partnership and LLC agreements, see Terence Floyd Cuff, "Some Basic Issues in Drafting Real Estate Partnership and Limited Liability Company Agreements," 65 *N.Y.U. Ann. Instit. on Fed. Tax'n* (2007); and Terence Floyd Cuff and Richard A. Shaw, "Drafting Partnership Allocations," 5 *Bus. Entities* 2 (Mar./Apr. 2003).

the partners.¹⁶ Because the book-up or -down preserves the built-in tax gain or loss in the asset (that is, it is a nontaxable book-up or -down), the regulations dictate that the partnership use section 704(c) principles to ensure that the later recognition of the gain or loss is allocated to the partners who received the book-up or -down adjustment. This is commonly referred to as “reverse section 704(c)” to distinguish it from “forward section 704(c)” for contributed property.

Example 4: Section 704(b) basics. A and B each contribute \$100 of cash to form a 50-50 partnership. The partnership uses the cash to immediately buy Land, which it rents on a net basis. During the first year, the partnership earns \$20 of taxable net rental income and benefits from \$50 of unrealized appreciation in Land. The partnership retains \$10 of the rental income and distributes the remaining \$10 equally between A and B. The effects of these transactions on the allocations and capital accounts are shown on the next page. Note that the \$20 of rental income was allocated 50 percent to each of A and B for tax and section 704(b) book purposes, which increased their tax and book capital accounts accordingly. The \$50 of unrealized appreciation was not reflected in the partners’ capital accounts because there has not been a section 704(b) realization (book-up) event to lock in that value change.¹⁷

Opening Balance Sheet					
	Tax	Book		Tax	Book
Assets			Liabilities	\$0	\$0
Land	\$200	\$200			
			Partner equity		
			A	\$100	\$100
			B	\$100	\$100
Total	\$200	\$200	Total	\$200	\$200

Effect of Income Allocations and Distributions				
	Tax	Book	Partner A	Partner B
Beginning capital	\$200	\$200	\$100	\$100
Rent income	+\$20	+\$20	+\$10	+\$10
Distributions	-\$10	-\$10	-\$5	-\$5
Ending capital	\$210	\$210	\$105	\$105

¹⁶See reg. section 1.704-1(b)(2)(iv)(f) for the optional nature of a book-up of unrealized amounts. *But see* reg. section 1.704-1(b)(1)(iv) for a discussion of other potential tax effects that may result even if an allocation satisfies the literal requirements of the section 704(b) regulations.

¹⁷Note that if a new partner later joined the partnership, there would be a book-up event that would allow the partnership to revalue the land and allocate the \$50 of unrealized appreciation into A’s and B’s capital accounts solely for section 704(b) purposes. Thus, if C is admitted to the partnership and the partnership later sells Land for \$250, the \$50 of tax gain in Land is allocated equally to A and B using section 704(c) principles.

Ending Balance Sheet					
	Tax	Book		Tax	Book
Assets			Liabilities	\$0	\$0
Land	\$200	\$200			
Cash	\$10	\$10	Partner equity		
			A	\$105	\$105
			B	\$105	\$105
Total	\$210	\$210	Total	\$210	\$210

Example 5: Section 704(c) basics. A contributes Land A, and B contributes \$100 of cash to form a 50-50 partnership. Land A has a value of \$100, but a tax basis of only \$20. The partnership uses cash to buy Land B. Partnership rents both parcels on a net basis. During the first year, Partnership earns \$20 of taxable net rental income and sells Land A at the end of the year for \$100. The partnership retains all of the rental income and sales proceeds. As in example 4, the \$20 of rental income is allocated 50 percent to each of A and B for tax and section 704(b) book purposes. However, all \$80 of the tax gain from Land A is allocated to A as is required under section 704(c).

Opening Balance Sheet					
	Tax	Book		Tax	Book
Assets			Liabilities	\$0	\$0
Land A	\$20	\$100			
Land B	\$100	\$100	Partner Equity		
			A	\$20	\$100
			B	\$100	\$100
Total	\$120	\$200	Total	\$120	\$200

Effect of Income Allocations				
	Tax	Book	Partner A	Partner B
Beginning capital	\$120	\$200	\$20	\$100
Rent income	+\$20	+\$20	+\$10	+\$10
Land A sale	+\$80	\$0	+\$80	\$0
Ending capital	\$220	\$220	\$110	\$110

Ending Balance Sheet					
	Tax	Book		Tax	Book
Assets			Liabilities	\$0	\$0
Land B	\$100	\$100			
Cash	\$120	\$120	Partner equity		
			A	\$110	\$110
			B	\$110	\$110
Total	\$220	\$220	Total	\$220	\$220

B. Substantial Economic Effect

One of the fundamental requirements of the section 704(b) rules is that the IRS generally will respect the tax effect of partnership allocations of book income or loss

Economic Effect Safe Harbor Overview					
	Maintain Capital Accounts	Liquidate According to Positive Capital Accounts	Full Negative Capital Deficit Restoration Obligation	No DRO but Qualified Income Offset And Limits on Loss Allocations	Will IRS Respect Economic Allocations Under Safe Harbor?
Primary test	Required	Required	Required	N/A	Yes
Alternate test	Required	Required	N/A	Required	Yes
Economic equivalence	N/A	N/A	N/A	N/A	Only if economic results always same as under other two tests

only if those allocations have substantial economic effect. This is a two-part test that requires both that allocations economically affect the dollars the partners receive from the partnership and that the effect be substantial after taking into account tax consequences.¹⁸

Economic effect means that the section 704(b) allocations must be consistent with the underlying economics. The regulations allow partnerships to satisfy a safe harbor to ensure that the IRS will respect the economic effect of the allocations. The regulations include three independent ways to meet the safe harbor, referred to as the primary, alternate, and economic equivalence tests. The first two are very similar and are discussed herein as variations of the same rule. The third, the economic equivalence test, is a limited safe harbor that deems the allocations to have economic effect if the economics could never differ from the case in which the agreement followed one of the first two safe harbors. Although some characterize the economic equivalence test as the “dumb but lucky” rule, it is still widely relied on in many partnership agreements that liquidate with a specified cash waterfall in lieu of liquidating in accordance with partnership capital accounts.¹⁹

Under the primary or alternate economic effect safe harbors, the partnership must follow detailed rules to maintain partner capital accounts and at a minimum liquidate in accordance with positive partner capital accounts. For example, if the AB partnership allocates \$100 of income to A and allocates no income to B such that A’s capital account is increased by the entire \$100, the partnership must distribute that entire \$100 to A on liquidation in accordance with A’s positive capital account (assuming no subsequent losses or distributions offset the income allocation).

¹⁸The substantiality aspect of this test is beyond the scope of this report. An example of a potential substantiality problem is when a partnership contains both tax-exempt and taxable partners and the partnership specially allocates disproportionate taxable income to the tax-exempt partner and then allocates disproportionate tax-exempt income to the taxable partner to have the two special allocations generally offset economically but lower the overall taxes paid by the partners in the aggregate. See, e.g., reg. section 1.704-1(b)(5), Example 5.

¹⁹See William S. McKee et al., *Federal Taxation of Partnerships & Partners*, para. 11.02 (4th ed.) for characterization of this rule as the “dumb but lucky” rule. See generally O’Connor and Schneider, *supra* note 8.

The only difference between the primary and alternate safe harbors is how they account for the economics of negative partner capital accounts resulting from losses or excess distributions. To satisfy the primary safe harbor, the partnership must require that each partner be personally responsible for repayment of its entire negative capital account (referred to as a full deficit restoration obligation (DRO)). More commonly, partnerships follow the alternate safe harbor under which the partnership agreement does not include a full DRO but does include provisions to avoid the partner having a negative adjusted capital account.²⁰ These requirements are (i) the partnership cannot allocate losses to cause the partner’s capital account to be lower than what the partner is actually or deemed²¹ obligated to repay (that excess is referred to as a deficit-adjusted capital account); and (ii) if there is an unexpected event that causes a deficit in the adjusted capital account, the partnership must allocate gross income to eliminate that deficit as quickly as possible (referred to as a qualified income offset (QIO)).

C. Nonrecourse Debt-Sourced Deductions

The partnership tax provisions create an elaborate set of rules to address the allocation of partnership deductions funded by nonrecourse debt. Absent a special rule, these allocations could not have economic effect because it is the lender and not a particular partner who is at risk for the debt-funded loss. For example, if A and B each contributed \$100 to Partnership and Partnership borrowed \$800 on a nonrecourse basis to buy Building, once Building was depreciated from \$900 to \$800, A and B’s capital accounts would be zero and any further allocations of depreciation would drive their capital accounts impermissibly negative but for the special nonrecourse deduction rules.

The regulations create a concept called partnership minimum gain to track deductions in which a nonpartner lender is at risk for a partnership liability. Minimum gain

²⁰The capital account can be negative in some circumstances, such as when an allocation of nonrecourse deductions to the partner is supported by a future minimum gain charge-back or a limited partner DRO.

²¹A partner is deemed obligated to repay its share of partnership or partner “minimum gain.” This is the amount tracked to a partner from its share of deductions funded from partnership or partner nonrecourse debt. For more information on this concept, see Section III.C. of this report.

Computation of Minimum Gain				
	Adjustment	Section 704(b) Value	Nonrecourse Debt	Minimum Gain
Purchase date		\$1,000	\$800	\$0
Year 1 depreciation	(\$100)	\$900	\$800	\$0
Year 2 depreciation	(\$100)	\$800	\$800	\$0
Year 3 depreciation	(\$100)	\$700	\$800	\$100

Capital Accounts, Minimum Gain, and Adjusted Capital Accounts						
	A Capital	A Minimum Gain	A's Adjusted Capital Account	B Capital	B Minimum Gain	B's Adjusted Capital Account
Initial	\$100	\$0	\$100	\$100	\$0	\$100
Year 1	\$50	\$0	\$50	\$50	\$0	\$50
Year 2	\$0	\$0	\$0	\$0	\$0	\$0
Year 3	(\$50)	\$50	\$0	(\$50)	\$50	\$0

is the amount by which the nonrecourse debt exceeds the section 704(b) basis in the property secured by the debt. The concept is that a nonrecourse deduction can be allocated to a partner to cause its capital account to be negative, even without a partner obligation to restore that negative capital account. The regulations permit this because the IRS is protected; the negative capital account will later be offset and made positive (or at least returned to zero) with a later allocation of income whenever there is a decrease in this minimum gain. This is referred to as a partnership minimum gain charge-back. The regulations create a parallel concept for nonrecourse debt lent or guaranteed by a partner (partner nonrecourse debt), except that those deductions and the related charge-back must be allocated to the lender/guarantor partner because that partner is indirectly at risk due to also being the lender/guarantor. In that case, the regulations use the terms "partner minimum gain" and "partner minimum gain charge-back" to have similar meanings to partnership minimum gain and partnership minimum gain charge-back.

Example 6: Partnership nonrecourse deductions. A and B each contribute \$100 to a 50-50 partnership and have no obligation to restore negative capital accounts. The partnership borrows \$800 from an unrelated lender on a nonrecourse basis using an interest-only loan and buys Building for \$1,000. The partnership depreciates Building by \$100 a year. After the third year, the partnership has depreciated the initial \$1,000 of section 704(b) basis in Building to \$700. At the beginning of year 3, A and B have each received depreciation deductions that caused their section 704(b) capital accounts to be zero. Allocating the year 3 depreciation equally to A and B would cause their capital accounts to be negative by \$50 each. Although the general rule is that A and B are not allowed to have negative capital accounts absent a DRO, there is an exception in this case because the deduction is a nonrecourse deduction that creates minimum gain (\$800 nonrecourse debt less \$700 book basis in Building). An allocation of the \$50 deduction to each of A and B creates an allowable \$50 deficit in each partner's capital account because that deficit is supported by \$50 each of minimum gain that the partnership agreement provides the partnership will charge back if there is a later

reduction in that minimum gain.²² For example, if the partnership disposes of Building the next year for an amount equal to the \$800 nonrecourse debt, the entire minimum gain would be triggered (there is no longer any nonrecourse debt to support the minimum gain), and A and B would each be required to report \$50 of taxable income. The partnership has sufficient income to allocate because it has \$100 of section 704(b) book income from the sale of Building.

D. Elections and Audits

Partnership agreements typically address how the partnership deals with partnership-level tax elections and audits. The two main elections unique to partnerships relate to section 754 inside basis adjustments²³ and section 704(c) allocations of built-in gains or losses among the partners. The section 754 election is less

²²Although each partner's section 704(b) capital account is negative, it is not impermissibly negative because the \$50 deduction creating the negative capital account is sourced to a nonrecourse debt deduction. Because a nonrecourse debt deduction gives rise to an equal amount of minimum gain, A and B have minimum gain to offset their negative capital account, which will eventually bring their capital accounts to zero. For purposes of testing whether a capital account is impermissibly negative, minimum gain is added back to the negative capital account to determine whether the adjusted capital account is impermissibly negative. For a more detailed explanation of this concept, see Section IV.B. of this report.

²³Absent a section 754 election, events such as a sale of a partnership interest at a gain or a loss generally would not cause that gain or loss to be reflected in the inside basis of the partnership assets. A partnership has the option to make a section 754 election on such a sale or exchange (or on some distributions). The election locks the partnership into making those adjustments for the electing year and future years. Thus, an election in the year of an inside basis increase could risk a required inside basis decrease in a future year if there is a sale of a partnership interest at a loss. However, beginning in late 2004, downward inside basis adjustments became mandatory in all but some de minimis cases. This effectively removes the major risk of making a section 754 election, with the primary remaining downside being administrative costs to maintain the adjustment.

controversial and frequently is left at the discretion of the managing partner, although sometimes it is required at the reasonable request of an affected partner.²⁴ However, because of what is referred to as the ceiling rule limitation, the section 704(c) method is often subject to more negotiation.

Although section 704(c) always mandates that taxable gain or taxable loss be first allocated to the partner contributing the built-in gain or built-in loss property, if there is insufficient gain or tax basis, the noncontributing partner can frequently bear the burden of built-in gain. For example, assume A and B contribute Property A and Property B, respectively. Both properties are five-year depreciable property valued at \$100 each. However, A's property has zero tax basis and B's property has \$100 of tax basis. Each year B will receive \$10 of book depreciation on Property A with no corresponding tax depreciation if the partnership uses the baseline "traditional" method. However, if B negotiated the "curative" method, B could receive an extra \$10 of tax depreciation from Property B, curing the shortfall. Alternatively, if the partnership didn't have another depreciable property to cure the shortfall, B could receive the same extra \$10 of depreciation per year under the "remedial" method. The cost to A of the remedial method is that every extra notional dollar of depreciation allocated to B is offset by a dollar of notional income to A.

The partnership audit provisions are subject to much less debate. However, they are important because each partner is subject to personal tax adjustments even though the audit is conducted at the partnership level under the 1982 Tax Equity and Fiscal Responsibility Act rules.²⁵ The main audit issues in the agreement relate to which partner will serve as the administrative head of the audit (the TMP), how the audit costs will be funded, and what powers are granted to the TMP, such as the ability to extend the statute of limitations with or without partner consent. If no TMP is named, the tax regulations provide conventions that may result in an inappropriate partner being the TMP.

IV. What Does the Tax Boilerplate Actually Mean?

Perhaps no section of a partnership agreement interests our clients less than the section containing the tax boilerplate provisions. These provisions therefore often receive little or no client review. However, the provisions

are extremely important and, if drafted incorrectly, could lead to surprisingly negative tax and economic consequences. For these reasons, tax practitioners should always review the tax boilerplate provisions carefully and ensure that the client fully understands how those provisions can affect the tax consequences and economics of the partners.

A. Boilerplate Provisions — Capital Accounts

As discussed in Section III.B. above, partnerships must maintain capital accounts for their partners to satisfy the substantial economic effect safe harbor under section 704(b). Accordingly, most partnership agreements include at least some discussion related to maintaining partner capital accounts. As part of that discussion, many partnership agreements may include capital account definitions that resemble the following:

"Capital Account" shall mean, with respect to any Partner, the capital account on the books of the Partnership, which shall initially be zero and which shall be maintained in accordance with the following provisions:

(a) To each Partner's Capital Account there shall be credited the aggregate amount of cash and initial Gross Asset Value of any property contributed by such Partner to the Partnership, such Partner's distributive share of Profits and any items in the nature of income or gain which are specially allocated pursuant to Article ____ and the amount of any Partnership liabilities assumed by such Partner or which are secured by any Partnership property distributed to such Partner.

(b) To each Partner's Capital Account there shall be debited the amount of cash and the Gross Asset Value of any Partnership property distributed to such Partner pursuant to any provision of this Agreement or deemed distributed pursuant to Section ____, such Partner's distributive share of Losses and any items in the nature of expenses or losses which are specially allocated pursuant to Article ____, and the amount of any liabilities of such Partner assumed by the Partnership or which are secured by any property contributed by such Partner to the Partnership.

(c) If any interest in the Partnership is transferred in accordance with the terms of this Agreement, the transferee shall succeed to the Capital Account of the transferor to the extent it relates to the transferred interest.

(d) In determining the amount of any liability for purposes of determining Capital Account balances hereof, there shall be taken into account Section 752(c) of the Code and any other applicable provisions of the Code and Regulations.

The foregoing provisions and the other provisions of this Agreement relating to the maintenance of Capital Accounts are intended to comply with Section 1.704-1(b) of the Regulations, and shall be

²⁴One question on a section 754 election is whether the costs of computing and tracking the corresponding basis adjustment should be paid solely by the affected partners.

²⁵A unique partnership election available to small partnerships is the ability to elect out of the TEFRA rules. Under TEFRA, a partnership-level audit can decide the tax fate of the partners regarding their share of partnership income or loss, as opposed to having separate partner-level audits. Importantly, if a partner has a partner-level penalty defense to a TEFRA audit penalty, the partner can assert that defense only after paying the penalty and applying for a refund. Reg. section 301.6221-1(d). The ability of a small partnership to elect out of TEFRA is limited to partnerships with 10 or fewer partners that meet specific requirements (such as no passthrough partners). See generally section 6231(a)(2)(B).

interpreted and applied in a manner consistent with the Regulations. If the General Partner shall determine that it is prudent to modify the manner in which the Capital Accounts, or any debits or credits thereto, are computed in order to comply with the Regulations, the General Partner may make such modification provided that it is not likely to have a material effect on the amounts that would be distributable to any Partner.²⁶

The above definition of capital account mirrors the rules for determining partner capital accounts described in reg. section 1.704-1(b)(2)(iv). For those partnerships liquidating according to partner capital accounts, this definition will govern the economic relationship among the partners by determining partner entitlements on a liquidation of the partnership. To achieve this result, the liquidation sections of partnership agreements governing liquidations based on capital accounts generally will refer to a capital account definition at the bottom of the liquidation distribution waterfall. Further, for many partnerships not liquidating according to capital accounts, the capital account definition still serves a very important purpose because partner capital accounts typically act as the starting point for determining the taxable income or loss allocable to partners under a targeted allocation regime. In other words, because a typical targeted capital account regime seeks to allocate partnership income or loss to close the difference between beginning or partially adjusted capital accounts and ending or targeted capital accounts, even a targeted capital account approach simply cannot be applied without at least some definition of capital account.

Example 7: Capital accounts with layer cake allocations. Assume Partner A and Partner B form a 50-50 partnership that, under the terms of the partnership agreement, liquidates according to capital accounts and includes a capital account definition similar to the one provided above. Partner A contributes nondepreciable property with a value of \$100 and a tax basis of \$20 to the partnership while Partner B contributes \$100 in cash. After leasing the property contributed by Partner A for several years, generating total rental income of \$60 and incurring total expenses of \$50, the partnership sells that property for \$110 and liquidates. Based on the capital account definition above, each partner will start with a capital account of \$100, increase its capital account by its 50 percent share of the \$60 in income, and decrease its capital account by its 50 percent share of the \$50 in expenses. Each partner will then have a capital account of \$105. Later, when the partnership sells the property, the two partners will equally divide the \$10 gain from the sale, increase their capital accounts from \$105 to \$110, and walk away with \$110 in cash proceeds when the partnership liquidates, leaving their final capital accounts at zero.

Example 8: Capital accounts with targeted allocations. Assume the same facts as in example 7 above except that, under the terms of the partnership agreement, the partnership liquidates 50-50 and includes a targeted allocation provision that effectively matches partner capital accounts with anticipated partner liquidation proceeds. Under the partnership agreement, the partnership will allocate its aggregate net income (\$20) in the manner necessary to match partner capital accounts (which begin at \$100 each) with anticipated partner liquidation proceeds (\$110 each). Based on these facts, the partnership will allocate \$10 to Partner A and \$10 to Partner B. Accordingly, even though the partnership does not liquidate according to capital accounts, the definition of capital account still becomes relevant in determining the income and loss allocations of the partners.

By using nondepreciable property in the examples relating to the above definition of capital account, it was unnecessary to take into account the effect of depreciation on partner capital accounts. To address those matters, partnerships holding depreciable property will often include a provision similar to the following in their partnership agreements:

“Depreciation” shall mean, for each Partnership Year, an amount equal to the depreciation, amortization or other cost recovery deduction allowable with respect to an asset for such year, except that if the Gross Asset Value of an asset differs from its adjusted basis for federal income tax purposes at the beginning of such year, Depreciation shall be an amount which bears the same ratio to such beginning Gross Asset Value as the federal income tax depreciation, amortization or other cost recovery deduction for such year bears to such beginning adjusted tax basis; provided, however, that if the adjusted tax basis of such property is zero, Depreciation shall be determined with reference to such beginning Gross Asset Value using any reasonable method selected by the General Partner.

The provisions of the partnership agreement calculating net profit or loss for book purposes often include a definition of depreciation. The definition therefore directly affects both the income and loss shares and the capital accounts of the partners. In determining net profit or loss for book purposes, partnerships will depreciate the book values of depreciable properties separately from the tax basis of those properties. If no disparities exist between book basis and tax basis for depreciable property, book depreciation should always equal tax depreciation. However, if book-tax disparities exist for depreciable property as a result of forward or reverse section 704(c) implications, book depreciation and tax depreciation will differ each year.

The above definition of depreciation amortizes book depreciation in the same ratio as tax depreciation and thereby causes partnerships to fully recover both the book depreciation and the tax depreciation of a depreciable asset simultaneously. This means that, under the definition of depreciation, the book depreciation and the tax depreciation for depreciable assets generally will reach zero at the same time. One significant exception to this general rule applies when depreciable property has a

²⁶The agreement language used throughout this report is of common use and is based on language used in Robert L. Whitmire et al., *Structuring and Drafting Partnership Agreements* (3d ed. 2003).

positive book basis but a zero tax basis. In that case, the partnership may use any reasonable method to calculate book depreciation (usually a newly placed-in-service life).

Example 9: Depreciation calculation. Partner A contributes two depreciable properties to a partnership. The first is newly purchased property with a seven-year recovery period, a value of \$700, and a tax basis of \$700. The second is five-year recovery property purchased two years ago having a current value of \$600 and a remaining tax basis of \$300. Under the definition of depreciation above, both the book depreciation and the tax depreciation for the first property will equal \$100 each year because the book depreciation will simply follow the tax depreciation. On the second property, however, book depreciation and tax depreciation will differ because the book value of \$600 at the time of contribution differs from the tax basis of \$300 at that time. Further, because the partnership will fully recover through depreciation both the book basis and the tax basis of the asset at the same rate each year, book depreciation each year will bear the same ratio to the book basis as the tax depreciation each year bears to the tax basis. With three years remaining to depreciate the second property for tax purposes, tax depreciation will equal one-third of the remaining tax basis for each of the next three years (or \$100 each year). Book depreciation, therefore, also will equal one-third of the book basis for each of the next three years (or \$200 each year). As a result, at the end of three years of book and tax depreciation, both the book basis and the tax basis of the second property will equal zero.

The above definition of depreciation relies on the definition of gross asset value. A gross asset value definition often will resemble the following:

“Gross Asset Value” shall mean, with respect to any asset, the asset’s adjusted basis for federal income tax purposes, except as follows:

(a) the initial Gross Asset Value of any asset contributed by a Partner to the Partnership shall be the gross fair market value of such asset at the time of such contribution as determined in good faith by the General Partner;

(b) the Gross Asset Values of all Partnership assets may, in the sole discretion of the General Partner, be adjusted to equal their respective gross fair market values, as reasonably determined by the General Partner, as of the following times: (i) the acquisition of an additional interest in the Partnership by any new or existing Partner in exchange for more than a de minimis Capital Contribution; (ii) the distribution by the Partnership to a Partner of more than a de minimis amount of Partnership property as consideration for an interest in the Partnership; and (iii) the liquidation of the Partnership within the meaning of Section 1.704-1(b)(2)(ii)(g) of the Regulations or as otherwise provided in the Regulations;

(c) the Gross Asset Value of any Partnership asset distributed to any Partner shall be the

gross fair market value of such asset on the date of distribution, as reasonably determined by the General Partner; and

(d) the Gross Asset Values of Partnership assets shall be increased (or decreased) to reflect any adjustments to the adjusted basis of such assets pursuant to Section 734(b) or 743(b) of the Code, but only to the extent that such adjustments are taken into account in determining Capital Accounts pursuant to Section 1.704-1(b)(2)(iv)(m) of the Regulations and Article ____; provided, however, that Gross Asset Values shall not be adjusted pursuant to this clause (d) to the extent the General Partner determines that an adjustment pursuant to clause (b) above is necessary or appropriate in connection with a transaction that would otherwise result in an adjustment pursuant to this clause (d).

If the Gross Asset Value of an asset has been determined or adjusted pursuant to clause (a), (b) or (d) above, such Gross Asset Value shall thereafter be adjusted by the Depreciation taken into account with respect to such asset for purposes of computing Profits and Losses.

Under this definition, the gross asset value of a particular asset generally equals its adjusted book value under the section 704(b) regulations. For example, the section 704(b) book value assigned to an asset on its contribution becomes its gross asset value. Similarly, if the partnership adjusts, books up, or books down assets under the provisions of reg. section 1.704-1(b)(2)(iv)(e), (iv)(f), or (iv)(m), the adjusted book values of the assets become their gross asset values. Finally, once the gross asset values of partnership assets have been established, those values are adjusted by depreciation using a depreciation definition similar to the one described above. Under this approach, the gross asset values of partnership assets should always match their section 704(b) book values as partnerships depreciate their assets over time for book purposes.

When partnerships increase or decrease the gross asset values of their assets, they are treated as if they actually sold the assets solely for book purposes (see, for example, clause (c) of the definition of “Profits” and “Losses” below). Thus, as with any actual sale, items of profit or loss for book purposes inevitably will arise. Partnerships adjusting gross asset values will then take these items of profit or loss into account in determining the overall profit and loss allocations to the capital accounts of the partners.

Example 10: Gross asset value. Partner A contributes nondepreciable property with an FMV of \$500 and a tax basis of \$200 to a partnership. Under these facts, the initial gross asset value of the contributed property will equal \$500. When the property has increased in value to \$800, the partnership books up its assets under reg. section 1.704-1(b)(2)(iv)(f). As a result of the book-up, the partnership is treated as if it sold the contributed asset for an amount equal to its FMV (\$800) at the time of the book-up. The resulting \$300 in book gain (\$800 new gross

asset value minus \$500 initial gross asset value) is treated as an item of profit in determining overall partnership profit or loss. The property will remain on the books of the partnership with an \$800 book value until it is adjusted again or disposed of. If the property was depreciable, the partnership would reduce its gross asset value of \$800 by book depreciation taken on the asset under a depreciation definition included in the partnership agreement.

Depreciation and gains or losses from adjustments to gross asset values are just two of the many items that partnerships must take into account in determining their net profit or loss. To capture as many of these items as possible, partnerships will often include a profit and loss definition similar to the following:

“Profits” and “Losses” shall mean, for each Partnership year (or portion thereof), an amount equal to the Partnership’s taxable income or loss for such year (or portion thereof), determined in accordance with Section 703(a) of the Code (for this purpose, all items of income, gain, loss or deduction required to be stated separately pursuant to Section 703(a)(1) of the Code shall be included in taxable income or loss), with the following adjustments:

a. any income of the Partnership that is exempt from federal income tax and not otherwise taken into account in computing taxable income or loss shall be added to such taxable income or loss;

b. any expenditures of the Partnership described in Section 705(a)(2)(B) of the Code or treated as such expenditures pursuant to Section 1.704-1(b)(2)(iv)(i) of the Regulations, and not otherwise taken into account in computing Profits or Losses shall be subtracted from such taxable income or loss;

c. if the Gross Asset Value of any Partnership asset is adjusted pursuant to clause (b) or clause (d) of the definition of Gross Asset Value herein, the amount of such adjustment shall be taken into account as gain or loss from the disposition of such asset for purposes of computing Profits or Losses;

d. gain or loss resulting from any disposition of Partnership property with respect to which gain or loss is recognized for federal income tax purposes shall be computed by reference to the Gross Asset Value of the property disposed of, notwithstanding that the adjusted tax basis of such property differs from its Gross Asset Value;

e. in lieu of the depreciation, amortization and other cost recovery deductions taken into account in computing such taxable income or loss, there shall be taken into account Depreciation for such Partnership Year or other period, computed in accordance with the definition of Depreciation herein; and

f. notwithstanding any other provisions hereof, any items of income, gain, loss or deduction which are specially allocated pursuant to Section ___ shall not be taken into account in computing Profits or Losses.

This profit and loss definition essentially seeks to convert partnership taxable income or loss into section 704(b) book income or loss. To accomplish this, the definition begins with taxable income or loss, then (i) adds back tax-exempt income that would not otherwise be taken into account and (ii) deducts nondeductible expenses that have not already been taken into account. These additions and subtractions are important because both tax-exempt income and nondeductible expenses have economic consequences (despite their lack of tax effect) that partnerships need to reflect in the capital accounts of their partners. As a result, the net profit or loss allocable to the partners simply must include these items even though they are excluded from taxable income or loss.

The profit and loss definition also (i) adds back or deducts adjustments to the gross asset values of partnership assets from book-ups, book-downs, and other adjustment events; (ii) determines gains or losses from asset sales by reference to the gross asset values of the assets sold as opposed to their adjusted tax basis; and (iii) computes depreciation of partnership assets as provided in the depreciation definition. By applying these approaches, the profit and loss definition exclusively uses section 704(b) book numbers and concepts in determining partnership net profit or loss. Section 704(c), however, is largely ignored for this purpose. As a result, as discussed above, book-ups, book-downs, and other capital account adjustment events that have no direct income tax effect still may produce gains or losses for book purposes that will flow to the partners’ capital accounts through the definition of profits and losses. Similarly, asset dispositions resulting in tax gains or losses will not affect profit or loss unless they also result in gains or losses by reference to gross asset values. Finally, depreciation will be calculated for book purposes by reference to the defined term “depreciation,” as opposed to using tax depreciation for the year.

The last provision of the profits and losses definition excludes all specially allocated items from the calculation of net profit or loss. This provision is necessary to ensure that special allocations and allocations that are subject to regulatory allocation provisions are targeted to the partners that are intended or required to receive those allocations. Stated differently, if the profits and losses definition included special allocations and regulatory allocations, all partners would share those allocations in the same way that general partnership items are shared (for example, by percentages or according to a specified waterfall arrangement). Specific targeting would therefore not occur. Accordingly, to remove special allocations and regulatory allocations from the general sharing provisions of the partnership agreement and to allocate those items in an independent and separate manner, the definition of profits and losses excludes those items.

B. Boilerplate Provisions — Regulatory Allocations

As discussed in Section III.B., partnerships more commonly try to satisfy the section 704(b) substantial economic effect safe harbor by qualifying under the alternate economic effect test rather than the primary economic effect test. Further, to qualify under the alternate economic effect test, (i) the partnership cannot allocate losses

to cause a partner to have a deficit-adjusted capital account (a deficit capital account that exceeds amounts the partner is obligated to restore or is deemed obligated to restore); and (ii) if a partner unexpectedly receives a distribution or allocation that creates or increases a deficit-adjusted capital account, the partnership must allocate gross income to the partner to eliminate that deficit as quickly as possible through a QIO.

Because a loss limitation provision and a QIO are so essential to qualifying under the alternate economic effect test, those provisions are often among the first provisions in the regulatory allocations portion of the tax boilerplate. In most cases, the loss limitation will read similar to the following:

Loss Limitation. Notwithstanding anything to the contrary in this Section ____, the amount of items of Partnership expense and loss allocated pursuant to this Section ____ to any Partner shall not exceed the maximum amount of such items that can be so allocated without causing such Partner to have an Adjusted Capital Account Deficit (or increasing such a deficit) at the end of any Partnership Year (as determined taking into account the expected items described in Section 1.704-1(b)(2)(ii)(d) of the Regulations). All such items in excess of the limitation set forth in this section shall be allocated first to Partners who would not have an Adjusted Capital Account Deficit, pro rata, until no Partner would be entitled to any further allocation, and thereafter to the General Partner.

The loss limitation provision above is intended to prevent partners from receiving loss allocations that reduce their negative capital accounts beyond the amounts they are obligated or deemed obligated to restore. Stated differently, the provision seeks to prevent partners from having capital accounts that are impermissibly negative. To accomplish this, the loss limitation provision clearly states that loss allocations cannot cause partners to have adjusted capital account deficits. Further, the provision often provides that if a loss allocation would cause a partner to have an adjusted capital account deficit (or increase such a deficit), the partnership will allocate the loss away from the partner to other partners who can absorb the loss without having adjusted capital account deficits.

Example 11: Loss limitation provision. Partner A contributes \$100 to a real estate partnership while Partner B contributes \$10. The partners agree to divide losses equally, and the partnership incurs a \$30 loss in the first year. The partnership has no liabilities, and the partnership agreement does not contain a DRO for either partner. Under these facts, the partnership can allocate only \$10 (instead of \$15) of the \$30 loss to Partner B because of the loss limitation provision. The \$5 that cannot be allocated to Partner B must instead be allocated to Partner A.

Obviously, the key phrase in the loss limitation provision is “adjusted capital account deficit.” That critical phrase is typically defined similarly to the following:

“Adjusted Capital Account Deficit” shall mean, with respect to any Partner, the deficit balance, if any, in such Partner’s Capital Account, as of the end

of the relevant Partnership Year, after giving effect to the following adjustments: (a) credit to such Capital Account any amounts which such Partner is obligated to restore pursuant to any provision of this Agreement or is deemed to be obligated to restore pursuant to the penultimate sentences of Sections 1.704-2(g)(1) and (i)(5) of the Regulations; and (b) debit to such Capital Account the items described in Sections 1.704-1(b)(2)(ii)(d)(4), (5) and (6) of the Regulations. The foregoing definition of “Adjusted Capital Account Deficit” is intended to comply with the provisions of Section 1.704-1(b)(2)(ii)(d) of the Regulations and shall be interpreted consistently therewith.

In short, the adjusted capital account deficit starts with a partner’s capital account balance and then increases that balance by (i) amounts that the partner has agreed to contribute to the partnership through a DRO or otherwise; and (ii) amounts the partner is deemed obligated to contribute as a result of having a share of either partnership minimum gain (that is, the reference in the adjusted capital account deficit definition to reg. section 1.704-2(g)(1)) or partnership nonrecourse debt minimum gain (that is, the reference in the definition to reg. section 1.704-2(i)(5)).

The sum derived from the above calculation is then reduced by the three categories of items described in reg. section 1.704-1(b)(2)(ii)(d) (the regulation section governing the QIO). Reductions are made for (i) adjustments that, as of the end of the year, are reasonably expected to be made to partners under reg. section 1.704-1(b)(2)(iv)(k) for depletion allowances on oil and gas properties; (ii) allocations of loss and deduction that, as of the end of that year, are reasonably expected to be made to partners under section 704(e)(2), section 706(d), or reg. section 1.751-1(b)(1)(ii); and (iii) distributions that, as of the end of the year, are reasonably expected to be made to partners in excess of offsetting items increasing partner capital accounts that are reasonably expected to occur during (or before) the partnership tax years in which those distributions are reasonably expected to be made (subject to some exceptions).

Stated simply, the adjusted capital account deficit definition effectively is used to determine the maximum amount of losses that the partnership can allocate to each of the partners by looking not only at partner capital accounts, but also at the extent to which partners could have impermissible negative capital negative capital accounts after taking into account minimum gain shares and some expected future events. Indeed, because partners may have negative capital accounts as long as those accounts do not exceed their shares of partnership minimum gain and partnership nonrecourse debt minimum gain, the adjusted capital account deficit provision adds both partnership minimum gain shares and partnership nonrecourse debt minimum gain shares to partner capital accounts to determine the maximum amount of loss allocable to each partner. Then, to the extent that the maximum amount of loss allocable to a partner is reasonably expected to be used up by depletion deductions,

other loss allocations, or distributions in excess of matching income allocations, that maximum loss allocation amount is reduced to take into account those expected events.

Example 12: Adjusted capital account deficit. Assume that Partner A and Partner B each contribute \$50 to a 50-50 partnership that borrows an additional \$900 on a nonrecourse basis to acquire a building. After several years of operations, the partners have collectively received losses of \$500, \$400 of which qualify as nonrecourse deductions carrying with them shares of minimum gain. Under these facts, both Partner A and Partner B will have negative capital accounts of (\$200) (\$50 in initial capital less \$250 in allocated losses). Their adjusted capital accounts for purposes of the adjusted capital account deficit definition, however, will each equal \$0 (negative capital account of \$200 plus \$200 share of minimum gain). As a result, even though both partners will have negative capital accounts, none of the \$250 in losses allocated to each of them will create adjusted capital account deficits.

What if a partner somehow develops an adjusted capital account deficit without triggering the QIO? Technically, this may be possible. QIOs typically provide that partners who unexpectedly receive some adjustments or distributions creating adjusted capital account deficits must receive income allocations (including allocations of gross income) to eliminate their adjusted capital account deficits as quickly as possible. While these provisions presumably will apply to nearly all situations involving impermissible negative capital accounts, partners with impermissible negative capital accounts resulting from events other than unexpected adjustments or distributions technically may fall outside of the reach of the QIO. To address the possibility that the QIO by itself may not eliminate all impermissible negative capital accounts, many partnership agreements will contain a “belts and suspenders” provision similar to the following:

Gross Income Allocation. In the event a Member has a deficit Capital Account at the end of any Allocation Year which is in excess of the sum of: (i) the amount such Member is obligated to restore pursuant to the penultimate sentences of Regulations Sections 1.704-2(g)(1) and 1.704-2(i)(5), each such Member shall be specially allocated items of income and gain in the amount of such excess as quickly as possible, provided that an allocation pursuant to this section shall be made only if and to the extent that such Member would have a deficit Capital Account in excess of such sum after all other allocations provided for in this Article have been made as if this section was not in the Agreement.

Under the gross income allocation provision above, partners with impermissible negative capital accounts who are not subject to the QIO will still receive income allocations (including gross income allocations) to eliminate their impermissible negative capital accounts as quickly as possible. This will happen even though the definition does not reference the adjusted capital account deficit definition. This is because the gross income allocation provision, if triggered, will allocate income items

(including gross income) to all partners with deficit capital accounts in excess of their actual or deemed obligations to restore deficits in their capital accounts. As a result, it will effectively reduce or eliminate all adjusted capital account deficits. However, to the extent that impermissible negative capital accounts will not exist after the partnership has made all other allocations to partners required under the partnership agreement, the gross income allocation by its terms will not apply. The allocation provision, therefore, represents the last line of defense against partners having impermissible negative capital accounts.

In addition to including provisions relating to loss limitation and the QIO, most regulatory allocation sections will include a partnership minimum gain charge-back, a partner nonrecourse debt minimum charge-back, and one or more provisions relating to the allocation of nonrecourse deductions. Those provisions and their accompanying definitions often resemble the following:

Definitions.

“Nonrecourse Liability” shall have the meaning set forth in Section 1.704-2(b)(3) of the Regulations.

“Partner Nonrecourse Debt” shall have the meaning set forth for the term “partner nonrecourse debt” in Section 1.704-2(b)(4) of the Regulations.

“Partner Nonrecourse Debt Minimum Gain” shall have the meaning set forth for the term “partner nonrecourse debt minimum gain” in Section 1.704-2(i)(2) of the Regulations.

“Partnership Minimum Gain” shall have the meaning set forth for the term “partnership minimum gain” in Section 1.704-2(b)(2) of the Regulations.

Regulatory Allocations.

(a) **Partnership Minimum Gain Chargeback.** Notwithstanding anything in this article to the contrary, if there is a net decrease in Partnership Minimum Gain during any Partnership Year, except as otherwise permitted by Sections 1.704-2(f)(2), (3), (4) and (5) of the Regulations, items of Partnership income and gain for such year (and subsequent years, if necessary) in the order provided in Section 1.704-2(a)(2)(i) of the Regulations shall be allocated among all Partners whose shares of Partnership Minimum Gain decreased during such year in proportion to and to the extent of such Partner’s share of the net decrease in Partnership Minimum Gain during such year. The allocation contained in this section is intended to be a minimum gain chargeback within the meaning of Section 1.704-2(f) of the Regulations, and it shall be interpreted consistently therewith.

(b) **Partner Nonrecourse Debt Minimum Gain Chargeback.** Notwithstanding anything in this article to the contrary, if there is a net decrease in Partner Nonrecourse Debt Minimum Gain during any Partnership Year, except as provided in Section 1.704-2(i) of the Regulations, items of Partnership income and gain for such year (and subsequent years, if necessary) in the order provided in Section 1.704-2(6)(j)(ii) of the Regulations shall be allocated

among all Partners whose share of Partner Nonrecourse Debt Minimum Gain decreased during such year in proportion to and to the extent of such Partner's share of the net decrease in Partner Nonrecourse Debt Minimum Gain during such year. This section is intended to comply with the minimum gain chargeback requirement in Section 1.704-2 of the Regulations, and shall be interpreted consistently therewith.

(c) Partner Nonrecourse Deductions. In accordance with Section 1.704-2(i)(1) of the Regulations, any item of Partnership loss or deduction which is attributable to Partner Nonrecourse Debt for which a Partner bears the economic risk of loss (such as a nonrecourse loan made by a Partner to the Partnership or an otherwise nonrecourse loan to the Partnership that has been guaranteed by a Partner) shall be allocated to that Partner to the extent of its economic risk of loss.

The definitions above establish which debts are subject to the special allocation and charge-back rules for nonrecourse deductions. "Nonrecourse liability" and "partnership minimum gain" refer to the amount of general pure nonrecourse debt (debt in which no partner has any risk of loss) and the related amount of minimum gain that partnerships must allocate to partners that receive deductions funded by that debt (nonrecourse deductions). "Partner nonrecourse debt" and "partner nonrecourse debt minimum gain" refer to the same concepts as above except that they cover debt that is nominally nonrecourse but for which a partner bears the risk of loss (as a result of being the lender or a guarantor) and the deductions funded by that debt (partner nonrecourse deductions).

Partnerships generally have some flexibility in allocating deductions and losses funded by nonrecourse liabilities as long as they allocate those items in a manner that is consistent with allocations of other significant items having substantial economic effect.²⁷ Consistent with this general rule, many agreements state that those deductions are allocated in accordance with percentage interests or otherwise. Losses funded by partner nonrecourse debt, however, must be allocated to the partner who is the guarantor/lender because that partner bears the economic risk of loss.²⁸ These loss allocations and the related minimum gain are tracked similarly to nonrecourse liability and partnership minimum gain.

To the extent that a deduction reduces the book basis of property secured by the nonrecourse or partner nonrecourse debt to below the amount of the debt, the difference is either partnership minimum gain (in the case of a pure nonrecourse debt) or partner nonrecourse debt minimum gain (in the case of a partner nonrecourse debt). Further, if there is a subsequent reduction in partnership minimum gain or partner nonrecourse debt minimum gain, the partnership minimum gain chargeback or partner nonrecourse debt minimum gain charge-

back provisions above will be triggered and will allocate income or gain (including gross income) to those partners whose shares of partnership minimum gain or partner nonrecourse debt minimum gain have decreased as a result of the reduction. The charge backs, in effect, balance the books of the partners by allocating income and gain from reductions in nonrecourse or partner nonrecourse debt to those partners that received deductions based on the nonrecourse debts in prior tax years.

Example 13: Partnership minimum gain charge back.

Assume that Partner A and Partner B each contribute \$50,000 to a 50-50 partnership that borrows an additional \$900,000 on a nonrecourse basis to acquire a \$1 million building. After several years of operations during which no principal payments are made on the debt, the partners collectively receive depreciation deductions of \$500,000 (\$250,000 each) from the building and each reduce their capital accounts from \$50,000 to -\$200,000. Of the \$500,000 in depreciation deductions, the first \$100,000 are attributable to partner equity while the remaining \$400,000 qualify as nonrecourse deductions attributable to partnership nonrecourse debt. Under these facts, the partnership will have \$400,000 of partnership minimum gain (\$900,000 nonrecourse debt less \$500,000 book basis equals \$400,000 minimum gain). As for the partners, both Partner A and Partner B will have received \$200,000 in nonrecourse deductions, which will cause them to have minimum gain shares of \$200,000 each. These minimum gain shares support their negative capital accounts of (\$200,000) and prevent them from having adjusted capital account deficits. However, if the partnership sells or otherwise disposes of the building, or if the creditor of the nonrecourse loan forgives all or a portion of the loan, both partnership minimum gain and the partners' minimum gain shares will decrease. This decrease will trigger the minimum gain charge back provision described above and thereby force allocations of income and gain (including gross income) to both Partner A and Partner B.

Example 14: Partner nonrecourse debt minimum gain charge back.

Assume the same facts as in example 13, except that Partner A guarantees the \$900,000 nonrecourse debt and thereby causes the debt to become partner nonrecourse debt for tax purposes. Under these facts, the partnership must allocate the \$400,000 in nonrecourse deductions (now partner nonrecourse deductions) solely to Partner A because Partner A alone bears the economic risk of loss on the debt funding the deductions. The \$50,000 equity-based deduction and the \$400,000 in partner nonrecourse deductions allocated to Partner A will decrease Partner A's capital account from \$50,000 to (\$400,000). Similarly, the partnership will have \$400,000 of partnership nonrecourse debt minimum gain (\$900,000 partner nonrecourse debt less \$500,000 building book basis). Partner A will have a partnership nonrecourse debt minimum gain share of \$400,000 supporting Partner A's negative capital account of (\$400,000) and preventing Partner A from having an adjusted capital accounts deficit. Further, if the partnership sells or otherwise disposes of the building, or if the creditor of the nonrecourse loan forgives all or a portion of the loan, both partnership nonrecourse debt minimum gain and the partner nonrecourse debt minimum gain share of

²⁷Reg. section 1.704-2(e)(2).

²⁸Reg. section 1.704-2(i).

Partner A will decrease. That decrease will trigger the partner nonrecourse debt minimum gain charge back provision described above and force allocations of income and gain (including gross income) to Partner A.

What if a partnership triggers one of the regulatory allocation provisions and, as a result, some partners receive income allocations that are inconsistent with the overall economic arrangement of the partners? For partnerships liquidating based on positive capital account balances, this possibility may present a very real business concern. For example, if a regulatory allocation provision kicks in and increases the capital accounts of some partners in a manner that is inconsistent with the overall economic arrangement, the regulatory allocation provision could distort the economic deal of the partners absent some type of cure or reversal provision in the partnership agreement. To address this economic concern, many partnership agreements will include a provision similar to the following:

Curative Allocations. The allocations set forth in Sections ____ hereof (the "Regulatory Allocations") are intended to comply with certain requirements of the Regulations. It is the intent of the Members that, to the extent possible, all Regulatory Allocations shall be offset either with other Regulatory Allocations or with special allocations of other items of Company income, gain, loss or deduction pursuant to this section. Therefore, notwithstanding any other provision of this Section ____ (other than the Regulatory Allocations) to the contrary, the Manager shall make such offsetting special allocations of income, gain, loss or deduction in whatever manner it determines appropriate so that, after such offsetting allocations are made, each Member's Capital Account balance is, to the extent possible, equal to the Capital Account balance such Member would have had if the Regulatory Allocations were not part of the Agreement and all Company items were allocated pursuant to the general allocation provisions.

A curative allocation paragraph similar to the one provided above is not to be confused with the section 704(c) traditional method with curative allocations. Indeed, a curative allocation paragraph reverses mandatory section 704(b) regulatory allocations to the greatest extent possible to maintain partners' economic arrangements while the traditional method with curative allocations is a section 704(c) tax allocation approach that seeks to correct ceiling rule issues on section 704(c) property. To avoid confusion, some agreements use the term "subsequent" allocations in lieu of "curative" allocations. Examples of how a curative or subsequent allocation provision can apply are provided below:

Example 15: Curative/subsequent allocations no. 1. Partner A contributes \$100 and Partner B contributes \$20 to a new partnership. The partnership agreement includes a loss limitation provision and a QIO. Further, the agreement provides that the partners will share profits and losses equally and liquidate according to positive capital account balances. The partnership incurs a loss of \$50 in its first year. In light of the loss limitation provision and Partner B having only a \$20 initial capital account,

Partner B can receive only \$20 of the \$50 loss (instead of \$25). Partner A, however, will receive its full \$25 share of the \$50 overall loss plus the \$5 portion of Partner B's loss share that Partner B could not receive because of the loss limitation provision. As a result, Partner A's capital account will fall from \$100 to \$70, while Partner B's capital account falls from \$20 to \$0. In its second year, the partnership generates a profit of \$30 and, under the partnership agreement, divides the profit equally between both partners. Thus, Partner A's capital account increases from \$70 to \$85, while Partner B's capital account increases from \$0 to \$15. After its second year, the partnership liquidates and distributes its remaining \$100 according to the capital accounts of the partners (\$85 to Partner A and \$15 to Partner B). Taking the two partnership years together, the partnership experienced a \$20 net loss and divided the loss \$15 to Partner A and \$5 to Partner B because of a regulatory allocation provision. Accordingly, even though the partners agreed to share losses equally, the regulatory allocation provisions undermined their overall 50-50 economic arrangement by effectively assigning overall losses 75 percent to Partner A and 25 percent to Partner B.

Example 16: Curative/subsequent allocations no. 2. Assume the same facts as in example 15, except that the partnership agreement contains a subsequent allocation provision similar to the one described above. Under these revised facts, the capital accounts of Partner A and Partner B after the first year would still equal the numbers used in example 15 (\$70 for Partner A and \$0 for Partner B). However, instead of allocating the \$30 profit equally in the partnership's second year, the subsequent allocation provision would override the general sharing ratios of the partners and assign the \$30 profit in a manner that would reverse the effect of the regulatory allocation provision in year 1. As a result, the partnership would assign \$20 of the \$30 profit to Partner A and increase Partner A's capital account from \$70 to \$90. Similarly, the partnership would assign only \$10 of the \$30 profit to Partner B to increase Partner B's capital account from \$0 to \$10. Under this revised approach, subsequent liquidation distributions of \$90 to Partner A and \$10 to Partner B would correspond to the partners' overall economic arrangement because each partner would effectively bear 50 percent of the partnership's net loss of \$20 for the combined two years of operations.

C. Boilerplate Provisions Related to Section 704(c)

In addition to all the boilerplate provisions addressing issues under section 704(b), most partnership agreements will include at least one provision relating to section 704(c) in their tax boilerplate. Section 704(c) boilerplate provisions may take several forms, but many will resemble the following:

Section 704(c) Allocations. In accordance with Section 704(c) of the Code and the Regulations thereunder, income, gain, loss and deduction with respect to any property contributed to the capital of the Partnership shall, solely for tax purposes, be allocated among the Partners under any reasonable method selected by the General Partner so as to take account of any variation between the adjusted basis of such property to the Partnership for federal

income tax purposes and its initial Gross Asset Value. If the Gross Asset Value of any Partnership asset is adjusted pursuant to clause (c) or (d) of the definition thereof, subsequent allocations of income, gain, loss and deduction with respect to such asset shall take account of any variation between the adjusted basis of such asset for federal income tax purposes and its Gross Asset Value in the same manner as under Section 704(c) of the Code and the Regulations thereunder. Any elections or other decisions relating to such allocations shall be made by the General Partner in a manner that reasonably reflects the purpose and intention of this Agreement. Allocations pursuant to this section are solely for purposes of federal, state and local taxes and shall not affect, or in any way be taken into account in computing, any Partner's Capital Account or share of Profits, Losses, other items or distributions pursuant to any provision of this Agreement.

The section 704(c) paragraph above essentially provides that if there are differences between the book and tax basis of property (either as a result of contributions of built-in gain or loss property to the partnership under section 704(c) (forward section 704(c)) or through partnership revaluations of assets under section 704(b) (reverse section 704(c))), future tax allocations will take that variation into account. To "take that variation into account" effectively means allocating built-in gain and built-in loss items back to contributing partners, in accordance with section 704(c) principles, thereby preventing the shifting of built-in gain or built-in loss away from contributing partners.

In short, the section 704(c) paragraph above mirrors the statutory and regulatory requirements under section 704(c).²⁹ Moreover, this paragraph allows the general partner to decide how to make section 704(c) allocations that are consistent with the intent of the agreement. In contrast, many agreements provide for the method under the regulations for taking the book-tax difference into account (for example, the traditional method under reg. section 1.704-3(b), the traditional with curative allocations method under reg. section 1.704-3(c), or the remedial method under reg. section 1.704-3(d)).

Insisting that a partnership agreement identify the particular section 704(c) method that will apply to built-in gain or loss property clearly makes sense when one does not represent the person with the authority to select section 704(c) methods or when a method issue may create significant controversy among the partners. In general, partners contributing built-in gain property will prefer the traditional method while partners contributing built-in loss property will prefer either the traditional method with curative allocations or the remedial method. Conversely, partners who contribute neither built-in gain nor built-in loss property (noncontributing partners) generally will prefer the traditional method with curative allocations or the remedial method when other partners

contribute built-in gain property, and they will prefer the traditional method when other partners contribute built-in loss property. One advantage of the traditional method with curative allocations method is that there is more flexibility on when and how to cure a shortfall. For example, if there is a depreciation shortfall, there can be a special allocation of gain on sale to cure the shortfall without resorting to the notional income items that the remedial method requires.³⁰

D. Other Boilerplate Provisions

The tax boilerplate provisions discussed above certainly do not represent an exhaustive list of all of the boilerplate provisions included in partnership agreements. For example, many partnership agreements will include provisions addressing how to adjust capital accounts, when elections are made under section 754, how to allocate profit or loss when the interests of partners vary during the year, how to allocate excess nonrecourse liabilities for basis purposes, or other tax boilerplate provisions in addition to those discussed above. Nevertheless, tax practitioners who adequately understand both the tax and economic consequences that can arise with the boilerplate provisions discussed in this article should be well positioned to more than adequately represent their clients who are entering into partnership arrangements.

V. Conclusion

As mentioned in the introduction to this report, professionals who expect to regularly read and write partnership and LLC agreements must be prepared to continually adapt to almost never-ending changes in both the business environment and in the law for partnerships and LLCs. But even as partnership and LLC agreements expand or contract to address new business and legal issues, the structure, organization, and many of the provisions of those agreements are likely to remain largely the same. Professionals who fully understand the points raised and discussed in this report should therefore be more than able to read and write sophisticated partnership and LLC agreements for many years to come.

²⁹The regulations require this whether it is in the agreement or not — all the provision does is give the general partner the right to select the method.

³⁰See reg. section 1.704-3(c)(3)(iii)(B).

VI. Appendix — Tax Boilerplate in Context of LLC Agreement
OPERATING AGREEMENT OF COMPANY, LLC
 Explanatory Statement
 SECTION 1
 THE COMPANY

1.10 Definitions.

Additional Capital Contributions	The section 704(b) value of post-formation capital contributed.
Adjusted Capital Account Deficit	The amount the section 704(b) capital account is impermissibly negative (i.e., negative after adjusting for certain expected events and after adding back the amount a partner is obligated to contribute or is deemed obligated to contribute due to partner's share of nonrecourse debt "Minimum Gain").
Allocation Year	The definition of the fiscal tax year for allocating Profits and Losses based on tax year rules under section 706. This is usually a calendar year but is based on the tax years the partners use.
Capital Account	The economic capital account of a partner based on section 704(b) asset values (not necessarily FMVs). The value starts with the net section 704(b) "Gross Asset Value" (or "book value") of contributions, adjusted up or down for the partner's share of Profits and Losses, and adjusted up or down for net partner contributions or distributions. The accounts are typically reset to FMV on certain "book up" events such as non-de minimis contributions, distributions, or issuances of profits interests to service partners.
Capital Contributions	The section 704(b) value of net contributions at formation or through Additional Capital Contributions.
Company Minimum Gain	This is the LLC equivalent of Partnership Minimum Gain, which is the cumulative amount of unrecaptured deductions allocated to partners funded by nonrecourse debt.
Depreciation	This is the annual section 704(b) depreciation of property based on the book values of property. The annual book depreciation rate parallels the tax depreciation rate so both book and tax depreciation end up at zero at the same time. Thus, if the book value is \$100 and the tax basis is \$40 on four-year straight line property, there is \$10 of tax depreciation and \$25 of book Depreciation each year.
Gross Asset Value	This is the section 704(b) value of property, often referred to as "book value." The book value of a property starts at the FMV of the property at the acquisition date, and is adjusted downward for the annual Depreciation and is also adjusted up or down to FMV if there is a book-up or book-down event.
Member Nonrecourse Debt	This is the LLC equivalent of Partner Nonrecourse Debt, which is debt that is nominally nonrecourse, but for which a partner has personal liability such as through a partner guarantee or if the partner or a related person is at risk as the maker of the loan.
Member Nonrecourse Debt Minimum Gain	This is the parallel to Company/Partnership Minimum Gain except it applies to Member/Partner Nonrecourse Debt as opposed to Company/Partnership Nonrecourse Debt.
Member Nonrecourse Deductions	This is the parallel to Company/Partnership Nonrecourse Deductions except it applies to Member/Partner Nonrecourse Debt as opposed to Company/Partnership Nonrecourse Debt.
Nonrecourse Deductions	These are the deductions funded from nonrecourse debt. For example, if a \$100 property is purchased with \$30 of equity and \$70 of nonrecourse debt, these are the depreciation deductions after the first \$30 of equity-sourced deductions.
Nonrecourse Liability	This is debt where the partnership's obligation to pay is limited to the value of specified partnership assets.
Percentage Interest	This is the percentage that the partners agree to share profits and losses and is generally set forth in an exhibit at the back of the agreement although is sometimes set forth in the Profits and Losses allocation section.
Profits and Losses	This is the definition of section 704(b) book profits and losses that are allocated to the partners each year. The computation starts with the tax profits and losses and adjusts for differences such as (1) adding back tax-exempt income; (2) subtracting nondeductible noncapitalizable expenses; (3) adjusting for book-up gains or book-down losses; (4) adjusting the amount of gains or losses from property sales to measure the amount by reference to book values and not tax basis; and (5) adjusting the amount of annual depreciation to use book Depreciation instead of tax depreciation. The definition of Profits and Losses also specifically excludes any book items that are specially allocated such as through the Regulatory Allocations.
Regulatory Allocations	This is a definitional reference to the Regulatory Allocations for purposes of the later Curative/Subsequent Allocation provision to minimize the risk of the Regulatory Allocations unintentionally affecting the general economics of the LLC agreement. The Regulatory Allocations dictate the allocations relating to Nonrecourse Debt and include an overall loss limitation as is required to meet the alternative economic effect safe harbor under the section 704(b) regulations.
Tax Matters Member	This is the person designated to represent the partnership in tax audits and make certain other tax decisions.

SECTION 2
MEMBERS' CAPITAL CONTRIBUTIONS
SECTION 3
ALLOCATIONS

3.1 Profits.

[This includes the scheme for allocating profits after special allocations.]

3.2 Losses.

[This includes the scheme for allocating losses after special allocations.]

3.3 Special Allocations. The following special allocations shall be made in the following order:

(a) **Minimum Gain Chargeback.** [Allocate minimum gain chargeback to the partner who received the prior company/partnership nonrecourse deductions. There is a chargeback when there is a decrease in minimum gain such as a repayment of debt that has supported prior company/partnership nonrecourse deductions. For example, assume a partnership bought a property using \$70 of nonrecourse debt and depreciated the property to \$50 to create \$20 of minimum gain. If the partnership later repays \$15 of debt, the minimum gain decreases to \$5 (\$55 debt less \$50 of book value) and the partnership must allocate the \$15 of minimum gain chargeback to the partners who received the prior nonrecourse deductions.]

(b) **Member Minimum Gain Chargeback.** [Allocate gain to the partner who received the prior member/partner nonrecourse deductions when there is a decrease in member/partner minimum gain. This is the equivalent of a partnership minimum gain chargeback, except that it relates to a decrease in member/partner minimum gain as opposed to a decrease in company/partnership minimum gain.]

(c) **Qualified Income Offset.** [Allocate gross income items to restore a partner's impermissibly negative capital account from unexpected distributions to the extent there is an adjusted capital account deficit (that is, the negative capital account exceeds what the partner is actually or deemed obligated to restore from deficit restoration obligations or from its share of company/partnership or member/partner minimum gain). Note that the loss limitation is designed to avoid impermissibly negative capital accounts from loss allocations, so it should not give rise to a QIO.]

(d) **Gross Income Allocation.** [This is effectively a backstop to the QIO since the former provision is limited to unexpected distributions creating an adjusted capital account deficit. This provision provides a similar gross income allocation to offset an impermissible capital account deficit that may otherwise occur, such as from "expected" distributions that create an impermissible adjusted capital account deficit.]

(e) **Nonrecourse Deductions.** [This provision specially allocates company/partnership nonrecourse deductions. Because no partner is at risk for these deductions, the tax rules limit the ability to specially allocate them to be consistent with some other significant allocation that has economic effect. Frequently these deductions are allocated in accordance with residual profit- and loss-sharing ratios (percentage interests).]

(f) **Member Nonrecourse Deductions.** [This provision specially allocates member partner nonrecourse deduc-

tions. The regulations mandate that these deductions be allocated to the partner who is at risk for these deductions (the partner-lender or partner-guarantor of the nonrecourse debt).]

(g) **Section 754 Adjustments.** [This provision complies with technical details of the section 704(b) regulations to take into account some adjustments under section 734(b) or section 743(b), such as how to allocate the increase in book value of a property when a section 734(b) adjustment causes the tax basis of a property to exceed its prior book value.]

3.4 Curative Allocations.

[This curative/subsequent allocation paragraph is designed to reverse any unintended long-term effect of the tax boilerplate regulatory allocations (sections 3.3 and 3.5 of this agreement). For example, if the loss limitation provision redirected losses differently from the normal loss-sharing ratios, this provision will reallocate future profits in reverse order so that the partner who received the excess losses also receives offsetting excess profits.]

3.5 Loss Limitation.

[This paragraph prevents the allocation of losses to a partner that would cause that partner's capital account to be impermissibly negative and otherwise cause an adjusted capital account deficit. This paragraph is designed to work in combination with the QIO to satisfy the alternate test for economic effect under the section 704(b) regulations.]

3.6 Other Allocation Rules.

[This section includes allocation housekeeping provisions such as requiring that the partnership follow the rules under section 706 for allocating profit and loss items within a single year when there have been changes in partners' interests during the year.]

3.7 Tax Allocations: Code Section 704(c).

[This provision requires that the partnership follow the mandatory rules under section 704(c) relating to the tracking of built-in tax gain or loss on contributed property or the parallel rules for built-in tax gain or loss that is caused by a postformation book-up or book-down of partnership assets. Typically this provision will pick a specific method among the methods allowed in the regulations for allocating the built-in tax gain or loss. The section 704(c) method is often a significantly negotiated item because there can be significant differences in the tax results, particularly with low-basis depreciable property.]

SECTION 4
DISTRIBUTIONS
SECTION 5
MANAGEMENT
SECTION 6
ROLE OF MEMBERS
SECTION 7

ACCOUNTING, BOOKS AND RECORDS

7.2 Reports.

[This provision will often dictate when the Schedule K-1s are due to the partners.]

7.3 Tax Matters.

(a) **Tax Elections.** [This provision explains who has authority to make tax elections and other tax decisions. It often details the more important decisions, such as who has authority to file a section 754 election, who has

authority to extend the statute of limitations for the partnership, and who serves as the TMP in the case of an IRS audit.]

(c) Tax Classification.

[Sometimes a partnership will specify that elections be made to treat it as a partnership for federal or state tax purposes.]

SECTION 8
AMENDMENTS

SECTION 9
TRANSFERS

SECTION 10

DISSOLUTION AND WINDING UP

10.1 Dissolution Events.

10.2 Winding Up.

[This provision specifies the procedures for winding up, including how proceeds are distributed on liquidation after reserves are provided for creditors. For a partnership that seeks to comply with the primary or alternative section 704(b) safe harbors, the agreement will distribute proceeds based on the partners' positive capital accounts. In these safe harbor agreements, the section

704(b) allocation language will directly affect the way the partners shared the economics because the allocations drive the amount of the partners' capital accounts. Many agreements will instead liquidate with a specified distribution scheme, often referred to as a cash waterfall, out of concern that an error in the tax allocations could unintentionally affect the economics of the deal (that is, "cash is king").]

10.3 Compliance With Certain Requirements of Regulations; Deficit Capital Accounts.

[This provision specifies any partner obligations to restore negative capital accounts (DROs). Although a full DRO is unusual because creditors of the partnership can enforce the DRO, sometimes a partner will have a partial DRO.]

SECTION 11
POWER OF ATTORNEY
SECTION 12
MISCELLANEOUS
APPENDIX A

[This section lists the capital contributions and percentage interests of the partners.]