Nonrecourse Deductions and Minimum Gain Chargebacks

To illustrate how a minimum gain chargeback provision in a partnership agreement works, let's take the facts of the problem on page 161 and tweak them a little, to read like this:

G and L form a limited partnership. G, the general partner, contributes $80,000 and L, the limited partner, contributes $320,000. Each partner is assigned an initial capital account equal to the partner's cash contribution. The partnership purchases commercial real estate, a building on leased land, paying $400,000 cash and borrowing $1,600,000 on a nonrecourse basis from a bank. The terms of the loan require payment of interest only for the first five years.

The GL partnership agreement allocates all income, gain, loss and deductions 50% to G and 50% to L, except that all of the depreciation deductions attributable to the building, and two other significant items relating to the building, are allocated to L. The partnership agreement requires that all allocations are to be reflected in appropriate adjustments to the partners' capital accounts, and liquidation proceeds are to be distributed in accordance with positive capital account balances. Only G is required to restore a capital account deficit. The partnership agreement contains a qualified income offset for L and a minimum gain chargeback provision. The partnership depreciates its property using the straight-line method over a valid (you may assume) 10-year recovery period. The partnership makes no distributions to partners in the first five years of its existence.

Specifically, what does the minimum gain chargeback provision in the partnership agreement say? From Reg. § 1.704-2(f)(1): "If there is a net decrease in partnership minimum gain for a partnership taxable year, the minimum gain chargeback requirement applies and each partner must be allocated items of partnership income and gain for that year equal to that partner's share of the net decrease in partnership minimum gain (within the meaning of paragraph (g)(2))." And Reg. § 1.704-2(g)(2) tells us: "A partner's share of the net decrease in partnership minimum gain is the amount of the total net decrease multiplied by the partner's percentage share of the partnership's minimum gain at the end of the immediately preceding taxable year." The GL partnership agreement contains all of that.

More facts: In year 1, the partnership's gross income and all of its deductions other than depreciation just happen to offset each other exactly. Not only that, but the two significant other items allocated all to L also just happen to offset each other exactly. Thus, the partnership has a net operating loss of $200,000 in year 1.

Does the partnership agreement's allocation of all the year 1 depreciation deduction ($200,000) to L hold up? Yes. Under the general Section 704 regulations, it doesn't result in a negative capital account for L, and there's a qualified income offset in the partnership agreement. See Reg. § 1.704-1(b)(2)(ii)(d) ("alternate test for economic effect"). At the end of year 1, assuming that the partnership has no assets other than the building (with a book value now reduced to $1.8 million – book values also reflect depreciation) and no liabilities other than the mortgage (with a book value of $1.6 million), the partners' capital accounts are:

G	$80,000
L	$120,000

On to year 2. Let's say that once again, the partnership's gross income and all of its deductions other than depreciation just happen to offset each other exactly. Not only that, but the two significant other items allocated all to L also just happen to offset each other exactly. Does the partnership agreement's allocation of all the depreciation deduction ($200,000) to L hold up? No. Under the general Section 704 regulations, Reg. § 1.704-1, we can't take L's capital account negative because L hasn't agreed to restore it. Therefore, all the facts and circumstances determine distributive shares, but under any sensible reading of the facts, only $120,000 of the year 2 depreciation passes through to L; the other $80,000 passes through to G. At the end of year 2, assuming that the partnership has no assets other than the building and no liabilities other than the mortgage, the partners' capital accounts are:

G	-0-
L	-0-

Note that the relaxed rules of Reg. § 1.704-2 have not yet kicked in, because in year 2, the partnership has no "minimum gain." Minimum gain is any gain the partnership would realize under *Crane* and *Tufts* if it walked away from the nonrecourse debt. See Reg. § 1.704-2(d)(1). Here, the debt remains at $1.6 million, the partnership's adjusted basis in the building is not less than that (it's exactly $1.6 million at the end of year 2), and so there is no such gain. In year 2, we are still governed by Reg. § 1.704-1. That's why L doesn't get all the depreciation that year.

However, in year 3, when depreciation takes the basis of the building down to $1.4 million, with $1.6 million of nonrecourse debt still encumbering the property, now there is "minimum gain," and therefore now there are "nonrecourse deductions" that can be allocated under the relaxed rules of Reg. § 1.704-2. Because the partnership agreement contains the minimum gain chargeback, all of the year 3 depreciation deduction can be allocated to L. *See* Reg. § 1.704-2(e).

Let's say that in year 3, once again, the partnership's gross income and all of its deductions other than depreciation just happen to offset each other exactly. Not only that, but the two significant other items allocated all to L also just happen to offset each other exactly. Does the partnership agreement's allocation of all the depreciation deduction to L hold up? Now, yes. At the end of year 3, assuming that the partnership has no assets other than the building and no liabilities other than the mortgage, the partners' capital accounts are:

G	-0-
L	($200,000)

Now (finally) let's get a look at how the minimum gain chargeback provision in the partnership agreement works. Let's say that on the first day of year 4, the partnership sells the building to an unrelated buyer, who agrees to pay the partnership $300,000 cash and take the building (and the underlying land lease) subject to the $1.6 million. The partnership recognizes a $500,000 gain under *Crane* and *Tufts*:

Amount realized	$300,000 + $1,600,000
Less adjusted basis	(1,400,000)
Recognized gain	$500,000

Assume that this gain is the partnership's only item of gross income or deduction for all of year 4.

How is the gain divvied up as between G and L? The partnership agreement says that generally, everything is equal, but the minimum gain chargeback provision in the agreement overrides that. At the end of year 3, there was $200,000 of minimum gain, and it had all been allocated to L (that is, L had taken all the depreciation deductions). By virtue of the sale, partnership minimum gain is being reduced to zero. Therefore, the decrease in minimum gain is 100 percent allocable to L. And so the first $200,000 of the gain must be allocated to L. The other $300,000 of the gain is split equally between G and L under the partnership agreement. Reg. § 1.704-1. At the end of year 4, assuming that the partnership has no assets other than the buyer's cash and no liabilities, the partners' capital accounts are:

G	$150,000
L	$150,000

As I mentioned in class, minimum gain can also decrease, triggering the chargeback provision, as the result of the partnership repaying principal on the debt. In that case, under the chargeback provision, a partner such as L, who got all the depreciation, would be allocated all the partnership's income up to the decrease in the minimum gain for the year.

For example, say that instead of selling the building at the start of year 4, the partnership keeps it. In that year, the partnership takes another $200,000 of depreciation but voluntarily pays back $500,000 of principal on the loan. That would mean that for the year, minimum gain decreases by $300,000 (the $500,000 repayment minus the year 4 depreciation). Under the chargeback provision, the first $300,000 of partnership income for year 4 would pass through to L.