Partnership Income & Loss Allocations: Why Accuracy Matters

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Partnership allocation errors can lead to many seemingly unrelated consequences.

One of the allures of structuring a business venture as a partnership is the significant flexibility afforded to the partners in creating their economic arrangement. Section 704(a) provides taxpayers seemingly limitless flexibility in defining how the partners will share income and loss generated by the partnership.[1] However, Section 704(b) creates uncertain boundaries to this universe of possibilities by requiring allocations described in the partnership agreement to simply have substantial economic effect. If allocations defined in the partnership agreement do not have substantial economic effect, the partnership will allocate income and loss based on the partner's interest in the partnership (the "PIP Rules"). While Treasury regulations go to great lengths to describe when an allocation will have substantial economic effect, there is a dearth of guidance describing the PIP Rules.

Setting the Stage

In practice, partnership allocation provisions meeting the requirements of substantial economic effect have given way to allocations heavily dependent on determining the partner's liquidating distribution rights ("LDR Agreements"). These LDR Agreements come complete with a dizzying array of variations that must be considered in determining each partner's distributive share of partnership income and loss. LDR Agreements typically do not include allocations that have substantial economic effect and are therefore subject to the PIP Rules.

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EXHIBIT 1

	Partner A				Partner B			
	704(b) Basis	**Outside Tax Basis**	**Ceiling Limitation**	**Inside Tax Basis**	**704(b) Basis**	**Outside Tax Basis**	**Ceiling Limitation**	**Inside Tax Basis**
Contribution	$1,000	$1,000	$0	$1,000	$1,000	$100	$0	$100
Cost Recovery Deductions	(500)	(100)	(400)	(500)	(500)	-	400	400
Subtotal	$500	$900	($400)	$500	$500	$100	$400	$500
Liquidating Distribution	(500)	(500)	-	(500)	(500)	(500)	-	(500)
Residual Balance	$-	$400	($400)	$-	$-	($400)	$400	$-

LDR Agreements are incredibly useful tools and clearly define the partner's economic rights within a partnership at various points in time, especially upon liquidation of the partnership or a partner's interest in the partnership. However, it is common for uncertainty to reign when attempting to determine each partner's share of partnership income and loss for any given tax period. Despite the high degree of complexity and greater level of uncertainty, partners receive a Schedule K-1 reporting their distributive shares of partnership items. Partners then report these items on their tax returns and the world moves on.

But what happens when the allocations contain errors?[2] One partner may be allocated too much income while another is not allocated enough. Providing the statute of limitations is open, the partnership may be able to file an amended tax return or administrative adjustment request ("AAR"). It is rare for a partnership to take this step solely to correct allocation errors. Instead, these errors often remain unresolved until the termination of the partnership or a partner's interest in the partnership. Since a partnership is not obligated to file an amended return or AAR, this approach seems acceptable. Eventually, everything will come out in the wash!

However, as will be discussed in this article, allocation errors can lead to many seemingly unrelated consequences. Before long, a one-time allocation error can turn into an ongoing progression of errors. For example, allocations errors, when not appropriately considered, can lead to further errors relating to:

- calculation of gain or loss on the future sale of a partnership interest,
- gain characterization under Section 751,
- future allocations under Section 704(c),
- calculation of Section 743(b) and Section 734(b) basis adjustments, and
- liability allocations under Section 752.

Further, as the IRS continues to expand the depth of information that partnerships are required to disclose, care should be taken in evaluating the accuracy of the

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1 All "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Reg." references are to the Treasury Regulations promulgated under the Code. References to the "IRS" are to the Internal Revenue Service, and references to the "Treasury" are to the United States Department of the Treasury.

2 For purposes of this article, use of the word "error" and its derivatives is intended to address situations in which the income or loss allocations reflected on the partner's Schedule K-1 may be subject to challenge and reversal. Additionally, errors may include tax reporting positions that are not supported by a more-likely-than-not level of authority thereby creating financial statement disclosure considerations under Accounting Standards Codification ("ASC") 740.

3 Beginning with tax returns filed for the 2019 tax year, the IRS is requiring significant disclosure around Section 704(c) built-in gains and losses, Section 704(c) allocations, and Section 743(b) basis adjustments. When coupled with other information already included on each partner's Schedule K-1, e.g., tax basis capital, capital percentage, and liabilities, the IRS presumably will have sufficient information to use data analytics to identify potential abnormalities that may generate inquiry.

4 The IRS published Notice 2020-43 on June 5, 2020, requesting comments on proposed methods to determine each partner's tax basis capital account to be disclosed on Form 1065, Schedule K-1 for taxable years that end on or after December 31, 2020. Notice 2020-43 provides two methods that the IRS has proposed for use in determining reportable tax basis capital. Interestingly, the Modified Outside Basis Method focuses on determining a partner's outside tax basis while the Modified Previously Taxed Capital Method appears intended to capture the partner's share of inside tax basis. As will be discussed, it's possible that these balances may not be identical.

5 Section 722.

6 Section 742.

7 Other adjustments required in determining a partner's outside tax basis are outside of the scope of this article.

8 Section 752(a).

9 Section 752(b).

10 In this situation, the cumulative outside tax basis may be greater or less than total partnership inside tax basis. For example, assume a partner acquires an interest in a partnership for $100 from a partner having a $0 outside tax basis and $0 share of inside tax basis. Further, no Section 754 election is made by the partnership. The purchasing partner's outside tax basis will be $100 even though their share of inside tax basis will remain $0.

11 Under the traditional method, tax allocations to the noncontributing partners of cost recovery deductions with respect to Section 704(c) property generally must, to the extent possible, equal book allocations to those partners. However, total income, gain,

EXHIBIT 2

Partner C Outside Basis	
Consideration Paid	$X
Liabilities Assumed	X
Less: Share of Inside Tax Basis	
Cash Received on Liquidation	-X
Less: Gain Allocation	+X
Plus: Loss Allocation	-X
Liabilities Assumed	-X
Section 743(b) Basis Adjustment	$X

amounts to be reported. As partnerships begin to report partner tax basis capital accounts, Section 704(c) built-in gains and losses, and capital ownership percentages, identifying potential allocation errors arguably becomes much easier.[3]

Introducing the Stars of the Show

Subchapter K attempts to create a workable system of applying tax principles to economic arrangements. Critical to the effective operation of this system is the determination of a variety of basis amounts and the ability to distinguish between a partner's tax basis in their partnership interest ("outside tax basis"), the partner's share of the partnership's tax basis in its assets ("inside tax basis"), and the partner's Section 704(b) capital accounts. Understanding the general determination of these basis amounts is key to then evaluating the impact that allocation errors may have on future transactions and reporting.[4]

Outside Tax Basis

A partner's outside tax basis is determined under Section 705(a) and initially includes the tax basis of any property contributed to the partnership[5] or the purchase price paid for the interest if acquired from another partner.[6] This initial basis will be increased or decreased for subsequent contributions and distributions of property or cash. Additionally, outside tax basis is adjusted by the partner's distributive share of taxable and tax-exempt income as well as deductible and non-deductible expenditures.[7] A partner's outside tax basis is also adjusted by the partner's allocable share of partnership liabilities as determined under Section 752. Consequently, as a partner's share of liabilities increases, the partner is deemed to make a cash contribution to the partnership.[8] Similarly, a reduction in the partner's allocable share of partnership liabilities is treated as deemed distribution of cash.[9]

Inside Tax Basis

Under the aggregate theory of partnership taxation, the sum of the partner's outside tax basis should be equal to the partnership's total tax basis in its assets. Further, each partner's outside tax basis should be equal to their share of inside tax basis. For example, when a partner contributes an asset having a $100 tax basis, the partner will have an initial outside tax basis of $100 under Section 722. Further, the partnership will have a $100 inside tax basis in the same asset under Section 723. Subsequent activities undertaken by the partnership having an impact on tax basis, e.g., generation and allocation of taxable or non-taxable income or loss, will have an equal impact on the partner's outside tax basis and the partnership's inside tax basis.

Exceptions to this general rule of inside/outside tax basis equality can occur in certain situations. For example, a purchase of a partnership interest where a Section 754 election is not in effect will create an inside/outside tax basis disparity.[10] Additionally, variances between a partner's outside tax basis and share of inside tax basis can occur even though cumulative outside tax basis will equal inside tax basis. For example, application of the ceiling limitation under the Section 704(c) traditional method can result in a shift of a partner's share of inside basis even though total inside and outside tax basis can remain equal.[11] Similarly, certain distributions of partnership property can result in a partner-to-partner disparity.[12] As will be discussed, incorrect income or loss allocations should not impact total inside tax basis or a partner's cumulative outside tax basis. However, al-

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loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year. In other words, under the traditional method, it is possible that a noncontributing partner's share of Section 704(b) cost recovery deductions will not be matched by a corresponding allocation of tax deductions. This is referred to as the ceiling rule. When the ceiling rule applies to property with an unrecognized built-in gain, the noncontributing partner's share of tax deductions reducing outside tax basis will result in a greater outside tax basis relative to its inside tax basis. Similarly, the ceiling rule limitation will result in the contributing partner's outside tax basis being lower than its share of inside tax basis. Consider the following example: Partner A contributes cash of $1,000 and Partner B contributes property valued at $1,000 and having a tax basis of $100. The partners agree to apply the traditional method under Section 704(c). The partnership generates no net income or expense other than cost recovery deductions attributable to the asset contributed by Partner B. Over time, the asset contributed by Partner B generates $1,000 of Section 704(b) cost recovery deductions and $100 of tax cost recovery deductions. Partner A is entitled to $500 of the Section 704(b) cost recovery deductions and is allocated 100% of the tax deductions. Because the Section 704(b) deductions allocated to Partner A ($500) exceed the available tax deductions attributable to the asset contributed by Partner B ($100), there is a $400 ceiling limitation. A reconciliation of the Section 704(b), outside tax basis, and share of inside tax basis capital accounts of Partner A and Partner B is shown in Exhibit 1. Further, Exhibit 1 reflects the effects of a liquidating distribution assuming the asset contributed by Partner B has no remaining value on date of liquidation. Also, as shown in Exhibit 1, the annual ceiling limitation creates a disparity in partner's outside tax basis relative to their share of inside tax basis. This disparity is ultimately reconciled upon liquidation of the partnership. Partner A will recognize a capital loss to the extent of its excess outside tax basis ($900) over the total cash received on liquidation ($500). Similarly, Partner B will recognize a capital gain equal to the excess of cash received ($500) in excess of its outside tax basis ($100).

12 Disparities between inside tax basis and outside tax basis may occur as a result of the rules under Section 705(a)(2) and Section 732(a)(2). Under Section 705(a)(2), a partner's outside tax basis is reduced (*but not below zero*) by distributions by the partnership equal to the lesser of the partnership's inside tax basis in the distributed property or the partner's total outside tax basis. For example, assume a partnership makes a current distribution of property having an inside tax basis of $100 to a partner having a total outside tax basis of $90. Under applicable rules, the partnership's total inside tax basis will be reduced by $100 while the cumulative outside tax basis will be reduced by only $90. Note that this disparity may be cured via a Section 734(b) adjustment, providing a Section 754 election is in effect.

EXHIBIT 3

Liquidating Distribution Rights – Year 1	Partner A	Partner B	Total
Tier 1: Preferred Return	$-	$150	$150
Tier 2: Partner B Unreturned Capital	-	1,000	1,000
Tier 3: Partner A Unreturned Capital	750	-	750
Tier 4: 50/50 Distributions	-	-	-
Total Liquidating Distribution Rights	$750	$1,150	$1,900

EXHIBIT 4

Income/(Loss) Allocations – Year 1	Partner A	Partner B	Total
Opening Capital	$-	$-	$-
Contributions – Year 1	1,000	1,000	2,000
Distributions – Year 1	-	-	-
Partially Adjusted Capital	$1,000	$1,000	$2,000
Liquidating Distributions Rights – Year 1	750	1,150	1,900
Income/(Loss) Allocation – Year 1	($250)	$150	($100)

location errors may, similar to the ceiling limitation impact under Section 704(c), generate disparities across impacted partners.[13]

Section 704(b) Basis Capital Account

Related to the concept of inside tax basis and outside tax basis is a partner's Section 704(b) basis capital account. Under Reg. 1.704-1(b)(2)(iv), partnerships will maintain capital accounts by applying tax principles to the economic activities of the partnership. In other words, a partner's Section 704(b) capital account is determined similarly to the partner's outside tax basis. A key difference, of course, is that for purposes of Section 704(b), economic balances apply with differences being addressed via the application of Section 704(c).[14]

Notwithstanding the proximity to outside tax basis, it is important to appreciate that the determination of a partner's Section 704(b) capital account is not derived from outside tax basis. Instead, inside tax basis, outside tax basis, and Section 704(b) capital are determined in parallel, each subject to specific rules that need to be appropriately applied. This understanding becomes critical when allocation errors are reported on a partner's Schedule K-1. As we will see, while an allocation error likely impacts a partner's outside tax basis, the error should not impact the partner's Section 704(b) capital account or their share of inside tax basis.

And the Antagonist: Partnership Income and Loss Allocations

Section 704(a) provides that a partner's distributive share of income, gain, loss, or deduction is to be determined based on the terms of the partnership agreement. Section 704(b), however, modifies this general rule such that the allocation provisions of a partnership agreement may be followed only if such allocations have substantial economic effect. Where the allocations provided for in the partnership agreement do not have substantial economic effect, the allocations must be determined based on the partner's interest in the partnership ("PIP"). Regulations promulgated under Section 704(b) provide extensive guidance to assist taxpayers and their advisors in determining whether allocations have substantial economic effect. Reg. 1.704-1(b)(2)(ii) provides rules regarding economic effect.

For allocations to have economic effect, the partner to whom the allocation is made must receive the economic benefit or bear the economic burden of such proposed allocation.[15] Treasury regulations create three effective safe harbors for determining whether the allocation provisions of an operating agreement have economic effect. These safe harbors include the general and alternate test for economic effect and economic effect equivalence.

Under the general test for economic effect, the operating agreement must contain the following provisions: (1) the partnership will determine and maintain the partner's capital accounts in accordance with applicable Treasury regulations,[16] (2) upon liquidation of

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13 To the extent corrective allocations are allowed, then it is possible for temporary differences to exist until corrected. However, absent corrective allocations, these disparities are presumably corrected only upon liquidation of the partnership in a manner consistent with the impact of a ceiling limitation under Section 704(c).

14 An additional notable difference between Section 704(b) basis and outside tax basis is the inclusion of a partner's share of liabilities for purposes of determining outside tax basis.

15 Reg. 1.704-1(b)(2)(ii)(*a*).

16 Reg. 1.704-1(b)(2)(ii)(*b*)(*1*).

17 Reg. 1.704-1(b)(2)(ii)(*b*)(*2*).

18 Reg. 1.704-1(b)(2)(ii)(*b*)(*3*).

19 Reg. 1.704-1(b)(2)(ii)(*d*)(*1*).

20 Reg. 1.704-1(b)(2)(ii)(*d*)(*3*).

21 Reg. 1.704-1(b)(2)(ii)(*i*).

22 *Id.*

23 In situations where the allocation provisions of an operating agreement do not have substantial economic effect, the statute requires allocations to be determined in accordance with the partner's interest in the partnership. While this analysis should certainly consider whether the allocation provisions call for net income or loss allocations only, inclusion of a "net" allocation provision is not controlling.

24 Reg. 1.704-1(b)(3)(i).

25 Reg. 1.704-1(b)(3)(ii).

EXHIBIT 5

Capital Account Summary	Partner A 704(b) Basis	Partner A Tax Basis	Partner B 704(b) Basis	Partner B Tax Basis	Total 704(b) Basis	Total Tax Basis
Capital Contribution	$1,000	$800	$1,000	$1,000	$2,000	$1,800
FYE 1 Income/Loss	(250)	(250)	150	150	(100)	(100)
FYE 2 Income/Loss	(250)	(250)	150	150	(100)	(100)
FYE 3 Income/Loss	(250)	(250)	150	150	(100)	(100)
Capital at FYE 3	$250	$50	$1,450	$1,450	$1,700	$1,500

EXHIBIT 6

Capital Account Summary	Partner A 704(b) Basis	Partner A Tax Basis	Partner B 704(b) Basis	Partner B Tax Basis	Total 704(b) Basis	Total Tax Basis
Capital Contribution	$1,000	$800	$1,000	$1,000	$2,000	$1,800
FYE 1 Income/Loss	(250)	(50)	150	(50)	(100)	(100)
FYE 2 Income/Loss	(250)	(50)	150	(50)	(100)	(100)
FYE 3 Income/Loss	(250)	(50)	150	(50)	(100)	(100)
Capital at FYE 3	$250	$650	$1,450	$850	$1,700	$1,500

the partnership, liquidating distributions are required in all cases to be made in accordance with positive capital account balances,[17] and (3) the partnership agreement contains a deficit restoration obligation.[18]

Under the alternate test for economic effect, the operating agreement must contain the first two requirements described under the general test for economic effect.[19] Additionally, in lieu of a deficit restoration obligation, the operating agreement must contain a qualified income offset provision.[20]

If allocations under terms of the partnership agreement fail to satisfy the general or alternate test for economic effect, regulations contain an economic effect equivalence rule.[21] Under the economic effect equivalence rule, allocations made to a partner that do not otherwise have economic effect shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year, a liquidation of the partnership at the end of such year or the end of any future year would produce the same economic results to the partners as would occur if requirements under the general or alternate test for economic effect had been satisfied, regardless of the economic performance of the partnership.[22]

Pursuant to Section 704(b), if allocations pursuant to the terms of an operating agreement fail to have substantial economic effect, the partnership is required to allocate items of income, gain, loss, or deductions in accordance with the partner's interest in the partnership.[23] In general, the partner's interest in the partnership reflects the manner in which the partners have agreed to share the economic benefit or burden corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated.[24] The determination of a partner's interest in the partnership is made by taking into consideration all facts and circumstances relating to the arrangement of the partners. Factors considered in the determination of a partner's interest in the partnership include:

- the partners' relative contributions to the partnership,
- the interests of the partners in economic profits and losses (if different than that in taxable income or loss),
- the interests of the partners in cash flow and other non-liquidating distributions, and
- the rights of the partners to distributions of capital upon liquidation.[25]

Foreshadowing Before the Show Begins

As will be illustrated in our case study, allocation errors may create disparities between a partner's Section 704(b) capital account and outside tax basis. However, allocation errors should not impact existing disparities between a partner's Section 704(b) capital account and share of inside tax basis. As a result of the interaction among Section 704(b) capital, outside tax basis, and a partner's share of inside tax basis, accurate tracking of

EXHIBIT 7

Capital Account Summary	Partner A 704(b) Basis	Partner A Tax Basis	Partner B 704(b) Basis	Partner B Tax Basis	Total 704(b) Basis	Total Tax Basis
Capital Contribution	$1,000	$800	$1,000	$1,000	$2,000	$1,800
FYE 1 Income/Loss	(250)	(50)	150	(50)	(100)	(100)
FYE 2 Income/Loss	(250)	(50)	150	(50)	(100)	(100)
FYE 3 Income/Loss	(250)	(50)	150	(50)	(100)	(100)
Capital at FYE 3	$250	$650	$1,450	$850	$1,700	$1,500
Capital Revaluation	1,250	-	500	-	1,750	-
Pre-Transaction Capital	$1,500	$650	$1,950	$850	$3,450	$1,500

capital account balances is critical to ensuring future partnership and partner reporting. Of particular interest in this story, is the potential impact on:

- calculation of gain or loss on the future sale of a partnership interest,
- gain characterization under Section 751,
- future allocations under Section 704(c),
- calculation of Section 743(b) basis adjustments, and
- liability allocations under Section 752.

EXHIBIT 8

Partner A Gain Calculation		
Proceeds Received		$750
Less: Tax Basis in AB, LLC	$650 * 50% =	$325
Recognized Gain		$425

Gain or Loss Recognized by the Partner

When a partner sells all or part of their interest in a partnership, gain or loss will be recognized in an amount equal to the difference between the amount realized and their outside tax basis.[26] For purposes of determining gain or loss, the partner's outside tax basis is determined under Section 705.[27] The amount of tax basis allocated to the sale will vary depending on whether the partner's share of partnership liabilities is in excess of outside tax basis.[28] Gain or loss recognized on the sale of a partnership interest will generally be treated as gain or loss recognized on the sale of a capital asset, except as otherwise provided in Section 751.[29] Notwithstanding this general rule, the selling partner will recognize ordinary income or loss to the extent of his or her interest in the partnership attributable to "Section 751 assets" as determined under Section 751(c) and Section 751(d). The recognized capital gain or loss will be long-term, short-term, or a combination based on the selling partner's holding period in the partnership interest sold.[30]

Gain Characterization under Section 751

Under Section 751(a), consideration received by a transferor will be considered as received on the sale or exchange of property other than a capital asset to the extent the proceeds are attributable to the transferor's interest in Section 751 assets. Under Reg. 1.751-1(a)(2), the selling partner's income or loss attributable to his or her interest in Section 751 assets is the amount of income or loss generated from Section 751 assets, including any remedial allocation under Reg. 1.704-3(d), that would have been allocated to the selling partner if the partnership had sold all of its property in a fully taxable transaction for consideration equal to the FMV of the partnership property. Consequently, the amount of ordinary income or loss recognized by the selling partner will be determined, in part, based on Section 704(c) principles.

Future Allocations under Section 704(c)

Section 704(c) and applicable Treasury regulations create a complex system intended to ensure that the tax consequences of any built-in gain or loss are eventually borne by the partner(s) to whom the appreciation or depreciation is creditable.[31] For example, if a partner contributes property valued at $100 having a tax basis of $90, the $10 built-in gain should generally be borne by the contributing partner. This is often accomplished via special allocations of cost recovery deductions or gain on the disposition of the property. Section 704(c) also applies to built-in gains or losses generated upon the revaluation of partnership property pursuant to Reg.1.704-1(b)(2)(iv)(f) & (s).[32] Additionally, principles of Section 704(c) generally apply to a transferee partner to the extent of the built-in gains or losses inherent in the transferred partnership interest.[33]

Section 743(b) Basis Adjustment

Section 743(b) allows a partnership to adjust the tax basis of its assets in connection with a sale or exchange of a partnership interest providing the partnership makes or has a Section 754 election in effect. In general, the Section 743(b) basis adjustment is equal to the excess of the transferee partner's basis in the acquired partnership interest over the transferee partner's share of the adjusted basis to the partnership of partnership property.[34] The transferee partner's share of partnership property is equal to the sum of the transferee partner's share of previously taxed capital plus his or her share of partnership liabilities.[35] A transferee partner's share of previously taxed capital is equal to the amount of cash that would be distributed to the transferee partner upon liquidation of the partnership immediately following a hypothetical sale of partnership assets plus/minus the amount of tax loss/gain that would be allocated to the transferee partner following the hypothetical sale of partnership assets.

Assuming the purchase price paid by the transferee partner reflects the FMV of the acquired interest and the underlying Section 704(b) capital accounts reflects this valuation, the Section 743(b) adjustment to the transferee partner should be equal to the amount of Section 704(c) built in gain or loss that would be specially allocated to the transferee partner. This calculation is reflected in the formula in Exhibit 2.

Future Liability Allocations under Section 752

A partner's share of partnership liabilities increases a partner's outside tax basis. Whether to utilize loss allocations or absorb cash distributions, determining a partner's share of liabilities can be significant. For purposes of determining how to allocate partnership liabilities, a threshold question is whether the liability is considered recourse or nonrecourse. To the extent any partner or related person bears economic risk of loss ("EROL") with respect to a liability, the liability is considered recourse.[36] All other liabilities are considered nonrecourse.[37]

Recourse liabilities are generally allocated to the partner (or partners) bearing EROL.[38] Although a complete analysis of the recourse liability allocation rules is outside the scope of this article, there are a few important considerations. To determine a partner's EROL, it is generally necessary to determine whether the partner (or person related to the partner) would ultimately be called upon to satisfy all or a portion of the liability upon default by the partnership.[39] Under relevant rules, a partner can have EROL to the extent the partner has an obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership.[40] Consequently, accurate tracking of the partner's Section 704(b) capital account may impact the determination of a partner's EROL with respect to a liability.

The allocation of nonrecourse liabilities generally considers how partnership income or gain may be allocated to the partner in the future. This is accomplished by creating a three-tier allocation model. Under this model, nonrecourse liabilities are allocated in the following manner:

- First, to each partner to the extent of the partner's share of partnership minimum gain.[41]
- Next, to each partner in an amount equal to taxable gain that would be allocated to the partner under Section 704(c) if the partnership disposed of partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration.[42]
- Finally, excess nonrecourse liabilities allocated to each partner in accordance with the partner's share of partnership profits. However, regulations provide that the partnership agreement may, subject to certain restrictions, specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities. Excess nonrecourse liabilities may also be allocated among the partners in amounts based on the manner the partnership would allocate nonrecourse deductions attributable to the liabilities. Finally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on Section 704(c) property.[43]

The accurate allocation of nonrecourse liabilities depends on the accurate determination of minimum gain and Section 704(c) amounts. Consequently, the accurate allocation of nonrecourse liabilities is dependent on the accurate determination of each partner's Section 704(b) capital account and share of partnership inside

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26 Section 1001(a).

27 Reg. 1.741-1(a).

28 Revenue Ruling 84-53, 1984-1 CB 159, illustrates the basis consequences when a partner sells an interest in a partnership. Importantly, the revenue ruling provides the following guidance depending on whether the partner's share of partnership liabilities under Section 752 exceeds the partner's total outside basis. *Allocable Liabilities Exceed Outside Basis*: The adjusted basis of the transferred portion of the interest equals an amount that bears the same relation to the partner's adjusted basis in the entire interest as the partner's share of liabilities that is considered discharged on the disposition of the transferred portion of the interest bears to the partner's share of all partnership liabilities, as determined under Section 752. *Outside Basis Exceeds Allocable Liabilities*: The transferor partner first excludes from outside tax basis an amount equal to the partner's allocable share of all partnership liabilities. A part of the remaining adjusted basis (if any) is then allocated to the transferred portion of the interest based on the ratio of the fair market value ("FMV") of the transferred partnership interest to the FMV of the entire interest. The sum of the amount so allocated plus the amount of the partner's share of liabilities that is considered discharged on the disposition of the transferred interest equals the adjusted basis of the transferred portion of the interest.

29 Section 741.

30 Reg. 1.1223-3.

31 Section 704(c) and Reg. 1.704-3(a)(1).

32 Reg. 1.704-3(a)(6)(i).

33 Reg. 1.704-3(a)(7). From a capital account maintenance perspective, to the extent of the transferred partnership interest, this rule requires the transferee partner to step into the shoes of the transferor partner's share of Section 704(b) and inside tax basis capital. As discussed in this article, the disparity between the transferor partner's outside tax basis and share of inside tax basis is eliminated via a Section 743(b) basis adjustment. However, if a Section 754 election is not made, then this disparity will remain.

34 Reg. 1.743-1(b).

35 Reg. 1.743-1(d)(1).

36 Reg. 1.752-1(a)(1).

37 Reg. 1.752-1(a)(2).

38 Reg. 1.752-2(a).

39 Reg. 1.752-2(b).

40 Reg. 1.752-2(b)(3)(i)(B).

41 Reg. 1.752-3(a)(1).

42 Reg. 1.752-3(a)(2).

43 Reg. 1.752-3(a)(3).

EXHIBIT 9

Capital Account Summary	Partner A 704(b) Basis	Partner A Outside Tax Basis	Partner B 704(b) Basis	Partner B Outside Tax Basis	Partner C 704(b) Basis	Partner C Outside Tax Basis	Total 704(b) Basis	Total Outside Tax Basis
Capital Contribution	$1,000	$800	$1,000	$1,000	-	-	$2,000	$1,800
FYE 1 Income/Loss	(250)	(50)	150	(50)	-	-	(100)	(100)
FYE 2 Income/Loss	(250)	(50)	150	(50)	-	-	(100)	(100)
FYE 3 Income/Loss	(250)	(50)	150	(50)	-	-	(100)	(100)
Capital at FYE 3	$250	$650	$1,450	$850	-	-	$1,700	$1,500
Capital Revaluation	1,250	-	500	-	-	-	1,750	-
Pre-Transaction Capital	$1,500	$650	$1,950	$850	-	-	$3,450	$1,500
Partner C Contribution	-	-	-	-	250	250	250	250
Partner C Unit Purchase	(750)	(325)	-	-	750	325	-	-
Post-Transaction Capital	$750	$325	$1,950	$850	$1,000	$575	$3,700	$1,750

tax basis. Failure to accurately track these amounts is likely to lead to errors in the allocation of nonrecourse liabilities.

EXHIBIT 10

Section 704(c) Built-in Gain/(Loss)	Partner A	Partner B	Partner C	Total Gain
Forward Section 704(c) Layer	$100	$-	$100	$200
Reverse Section 704(c) Layer	$625	$500	$625	$1,750
Total Gain Allocated	$725	$500	$725	$1,950

Let the Show Begin – Detailed Case Study

A case study follows.

Relevant Facts

In the formation of AB, LLC, a limited liability company taxed as a partnership, Partner A contributes non-depreciable appreciated property valued at $1,000 with a tax basis of $800. Partner B contributes cash of $1,000. The operating agreement of AB, LLC provides that Partner B will be entitled to an annual non-compounding 15% preferred return on the $1,000 capital contribution. Further, the AB, LLC operating agreement provides that, upon liquidation, Partner B will be entitled to receive any unpaid preferred return plus its unreturned capital contributions before Partner A receives any distributions. Partner A is then entitled to receive its unreturned capital contributions. Any remaining capital is then distributed equally between Partner A and Partner B. Finally, the AB, LLC operating agreement provides that net profits and net losses are to be allocated equally between Partner A and Partner B with a final year "catch up" allocation made in the year of liquidation in order to cause the partner's respective capital accounts to equal their liquidating distribution entitlement. In the event there is insufficient income in the year of liquidation, the operating agreement provides that a guaranteed payment will be made as necessary.

In Years 1–3, AB, LLC generates a $100 net loss and no cash distributions are made to either partner. The net loss of AB, LLC includes gross income of $150 and gross deductions of $250.

On the first day of Year 4, new Partner C contributes cash of $1,000 to AB, LLC in exchange for an interest in the partnership. Immediately upon receipt of the contribution, $750 is distributed to Partner A in partial redemption of Partner A's interest in AB, LLC. The pre-contribution fair market value of AB, LLC is $3,450.

AB, LLC will revalue its Section 704(b) capital when allowed under Reg. 1.704-1(b)(2)(iv)(*f*). Additionally, AB, LLC will make a Section 754 election in any year in which an adjustment under either Section 734(b) or Section 743(b) is available.

Annual Profit & Loss Allocations

Based on the terms of the AB, LLC operating agreement, the allocation provisions do not satisfy the general or alternate test of economic effect.[44] Further, because the allocation provisions contained within the operating agreement do not cause the partner's capital accounts at the end of each year to equal their respective liquidating distribution rights, the allocations do not have economic effect equivalence.[45] Consequently, to determine the correct income or loss allocations, it is necessary to determine each partner's interest in the AB, LLC partnership pursuant to Reg. 1.704-1(b)(3), i.e., based on the PIP Rules.

In applying the PIP Rules, accurate allocation of annual income can be accomplished with reference to changes in the partner's liquidating distribution rights.[46] For example, Exhibit 3 shows the partner's liquidating distribution rights at the end of Year 1.

To achieve these Section 704(b) capital account targeted balances, it would be necessary to allocate Partner B $150 of gross income each year and Partner A gross deductions of $250 as reflected in Exhibit 4.

Assuming the partners' respective interests in AB, LLC are determined with reference to liquidating distribution rights, Exhibit 5 reflects the allocation of items of gross income and gross expense necessary to achieve the correct targeted capital account balances over the Years 1–3.

Notwithstanding the likely need to allocate items of gross income and deduction to achieve the partner's respective liquidating distribution rights, assume AB, LLC instead follows the explicit allocation provisions of the operating agreement. Thus, AB, LLC allocates the annual $100 net loss equally between Partner A and Partner B. Based on this allocation methodology, Partner A and Partner B would have Section 704(b) and tax basis capital accounts as shown in Exhibit 6.[47]

It is important to note that although the amounts reported on the partner's Schedule K-1 reflect a purportedly incorrect allocation of taxable income,[48] the economic theory underlying Section 704(b) and the applicable regulations should operate to prevent incorrect Section 704(b) allocations. In other words, the partner's economic arrangement is not impacted based on tax return reporting, whether correct or incorrect. Consequently, the author believes that under the existing statute and regulations, the Section 704(b) capital accounts should always reflect the correct allocation of income or loss regardless of the amounts shown on a partner's Schedule K-1.

Subsequent Investment by Partner C

At the beginning of Year 4, Partner C contributes $1,000 of cash to AB, LLC. Immediately following receipt of this capital contribution, AB, LLC distributes $750 to Partner A in partial redemption of their interest in AB, LLC. This relatively straightforward series of steps will likely create the following consequences:

- In the absence of facts demonstrating otherwise, it is anticipated that Partner C's capital contribution will be recharacterized as a disguised sale of partnership interests under Section 707(a)(2)(B). For purposes of this case study, we assume sale consideration is equal to the total amount of cash distributed to Partner A in partial redemption of their interest in AB, LLC.[49] This sale transaction will result in gain or loss recognition by Partner A.
- The remaining balance invested by Partner C will be viewed as a capital contribution of $250 in exchange for a newly issued interest. This contribution should be nontaxable under Section 721. Further, issuance of the AB, LLC interest should be a revaluation event under Reg. 1.704-1(b)(2)(iv)(*f*). Consequently, the Section 704(b) capital accounts may be adjusted immediately prior to Partner C's capital contribution. For purposes of this case study, we assume that AB, LLC chooses to revalue its capital accounts.
- Providing that AB, LLC makes a valid election under Section 754, Partner C will be able to benefit from a Section 743(b) adjustment resulting from the purchase of the interest from Partner A.

Capital Account Revaluation

Reg. 1.704-1(b)(2)(iv)(*f*) provides that a partnership may adjust the partners' Section 704(b) capital accounts upon the occurrence of certain events.[50] As a

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44 This conclusion is reached because the facts indicate that AB, LLC liquidates in accordance with a specific distribution waterfall rather than in accordance with positive Section 704(b) capital accounts.

45 Because Partner B is entitled to a 15% preferred return and 100% of his or her unreturned capital contributions before Partner A is entitled to any distribution, it is clear that the ending targeted capital account balances cannot be achieved with a 50/50 allocation net profits or net losses under the facts described.

46 There is a lack of clarity around a partner's interest in the partnership. However, a reasonable interpretation of these rules would be to evaluate the partner's rights to partnership capital as a proxy for the partner's interest in the partnership. For a discussion of the many uncertainties involving the determination of a partner's interest in the partnership, see Cuff, "Some Conjectures on Target Allocation Provisions," 40 J. of Real Estate Tax'n 127 (Second Quarter 2013).

47 Under this methodology, the allocations would effectively distort total Section 704(c) gain of the partnership, i.e., Partner B would end up with $600 of built-in gain. If AB, LLC were to liquidate, it would presumably need to make some sort of corrective allocation or creation of a guaranteed payment to adjust the partner's respective Section 704(b) capital account balances. It is unclear what technical support exists for such a position. See New York State Bar Association *Report No. 1357 on Guaranteed Payments and Preferred Returns* (11/14/2016) for a discussion on the allocation of net income or loss and, when necessary to achieve partner's liquidating distribution rights, the allocation of items of gross income and deduction.

48 Given the lack of clear guidance for determining allocations based on a partner's interest in the partnership, it is certainly possible that different allocation approaches may be supportable. However, certain positions are likely to have a higher degree of support. For example, based on the facts of this case study, a gross income allocation is more likely to be sustained on an IRS examination than allocations limited to net income. This can become important in a variety of instances. For example, where allocations have financial statement implications, tax positions generally need to be supported by a more-likely-than-not level of authority to record benefits under ASC 740. Additionally, in the context of transactions, the determination of a Section 743(b) adjustment, allocation of liabilities, or Section 704(c) allocations can be impacted by these positions. Partners should therefore be aware of the potential consequences associated with the different allocation approaches.

49 See Section 707(a)(2)(B); Communications Satellite Corp. v. United States, 625 F.2d 997 45, AFTR2d 80-1189 (Ct. Cl., 1980); and Jupiter Corp. v. United States, 2 Cl. Ct. 58, 51 AFTR2d 83-823 (1983). See also, "Disguised Sales of Partnership Interests: A Framework for Analyzing Transactions," 127 JTAX 246 (December 2017) for a discussion of possible exceptions.

50 Assuming that the adjustments are made for a substantial non-tax business purpose, the occurrence of any of the following events allows the partnership to revalue partner capital: (1) a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership; (2) liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership; (3) the grant of an interest in the partnership (other than a de minimis interest) on or after May 6, 2004, as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner; (4) the issuance by the partnership of a noncompensatory option (other than an option for a de minimis partnership interest); or (5) under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

EXHIBIT 11

Capital Account Summary	Partner A 704(b) Basis	Partner A Outside Tax Basis	Partner B 704(b) Basis	Partner B Outside Tax Basis	Partner C 704(b) Basis	Partner C Outside Tax Basis	Total 704(b) Basis	Total Outside Tax Basis
Capital Contribution	$1,000	$800	$1,000	$1,000	-	-	$2,000	$1,800
FYE 1 Income/Loss	(50)	(50)	(50)	(50)	-	-	(100)	(100)
FYE 2 Income/Loss	(50)	(50)	(50)	(50)	-	-	(100)	(100)
FYE 3 Income/Loss	(50)	(50)	(50)	(50)	-	-	(100)	(100)
Capital at FYE 3	$850	$650	$850	$850	-	-	$1,700	$1,500
Capital Revaluation	650	-	1,100	-	-	-	1,750	-
Pre-Transaction Capital	$1,500	$650	$1,950	$850	-	-	$3,450	$1,500
Partner C Contribution	-	-	-	-	250	250	250	250
Partner C Unit Purchase	(750)	(325)	-	-	750	325	-	-
Post-Transaction Capital	$750	$325	$1,950	$850	$1,000	$575	$3,700	$1,750

EXHIBIT 12

Section 704(c) Built-in Gain/(Loss)	Partner A	Partner B	Partner C	Total Gain
Forward Section 704(c) Layer	$100	$-	$100	$200
Reverse Section 704(c) Layer	$325	$1,100	$325	$1,750
Total Gain Allocated	$425	$1,100	$425	$1,950

result of revaluing partner capital, the partnership will increase or decrease each partner's capital accounts by the amount of the unrealized Section 704(b) appreciation or depreciation that is inherent in the underlying partnership assets. For purposes of this case study, we have assumed that Partner C's capital contribution creates an allowable partnership capital revaluation. Exhibit 7 illustrates the partner's Section 704(b) and tax basis capital immediately following the revaluation, but preceding Partner C's capital contribution and sale of AB, LLC interests from Partner A to Partner C.[51]

Partner A Gain Recognition

Partner A will recognize gain or loss on the sale of Partner A's interest in AB, LLC in an amount equal to the excess of proceeds received over his or her basis in the disposed interest.[52] Partner A's tax basis used for purposes of this calculation is determined under Section 705.[53] Section 705(a) provides that a partner's adjusted basis in a partnership interest includes the partner's distributive share of taxable income or loss. This presumably means that whatever income or losses are allocated to Partner A are properly reflected in Partner A's outside tax basis. Consequently, Partner A should have an outside tax basis in his or her interest in AB, LLC equal to $650, as reflected in Exhibit 7. Upon receipt of the $750 purchase consideration, Partner A will recognize gain equal to the excess of the $750 over a portion of the $650 basis allocated to the transferred interest. Since Partner A sells 50% of his or her interest in AB, LLC (as measured by the percentage of total consideration received ($750) relative to the total value of the pre-sale partnership interest ($1,500)), Partner A would recognize gain or $425 as reflected in Exhibit 8.[54]

Partner C Section 743(b) Adjustment

The calculation of gain recognition by Partner A is relatively straightforward. In theory, Partner C's Section 743(b) basis adjustment should be similarly straightforward. In fact, a partner's share of inside tax basis and outside tax basis are often equal.[55] Consequently, a typical back-of-the-envelope Section 743(b) calculation simply looks to the gain recognized by the selling partner. Under this approach, Partner C may believe he or she will be entitled to a $425 Section 743(b) basis adjustment, i.e., the amount of gain recognized by Partner A. If this were correct, it would also mean that Partner C would be allocated $425 of gain following a hypothetical sale of the AB, LLC assets followed by a distribution of the resulting cash.[56]

Partner C's purchase of 50% of Partner A's interest in AB, LLC results in a transfer of 50% of Partner A's share of inside tax basis capital. If we look to Partner A's outside tax basis determined via actual Schedule K-1 allocations as representing Partner A's share of inside tax basis, Partner A would effectively transfer $325 of tax basis to Partner C. This is reflected in Exhibit 9.

As noted previously, a partner's outside tax basis (less allocable liabilities) is often equal to their share of inside tax basis capital. However, a partner's share of inside tax basis should not change as a result of incorrect allocations of annual income or loss. To conclude otherwise would be to support a position that prior year allocation errors can simply be "trued up" in the future.

To illustrate, consider the consequences of a fully taxable disposition of AB, LLC assets, allocation of the resulting income or loss, and then a distribution of available cash to the partners in the liquidation of the partnership.

As shown in Exhibit 9, AB, LLC has total Section 704(b) capital of $3,700 and inside tax basis of $1,750 (excluding the effects of Partner C's Section 743(b) basis adjustment). A disposition of the assets at FMV would result in total gain of $1,950. This gain is precisely equal to the total amount of Section 704(c) built-in gain inherent in AB, LLC's assets including the $200 forward Section 704(c) layer relating to the assets contributed by Partner A and the $1,750 reverse Section 704(c) layer recorded immediately before Partner's C capital contribution to AB, LLC.

Since the sale of assets will result in $0 of Section 704(b) gain,[57] the entire $1,950 gain will be allocated under principles of Section 704(c). As noted above, there are two components to the total Section 704(c) built-in gain, i.e., a $200 forward layer and a $1,750 reverse layer. Since Partner C purchased 50% of Partner A's interests in AB, LLC, we would expect that an allocable Section 704(c) layer allocable to Partner A would shift to Partner C. Further, there should be no change to Partner B's total Section 704(c) built-in gain.

The entire $200 forward Section 704(c) layer was attributable to Partner A and upon sale of a 50% interest in AB, LLC, 50% of this layer should transfer to Partner C. Consequently, $100 of the total Section 704(b) built-in gain will be specially allocated to both Partner A and Partner C. The additional $1,750 gain relates to the revaluation that occurs immediately before Partner C's investment in AB, LLC. As shown in Exhibit 9, the revaluation gain is allocated $1,250 to Partner A and $500 to Partner B. Since this revaluation gain creates the entire reverse Section 704(c) layer, it will drive the remaining allocation of taxable gain. Based on Partner C's 50% acquisition of Partner A's interest in AB, LLC, Partner C will be specially allocated 50% ($625) of the revaluation gain originally allocated to Partner A. Exhibit 10 summarizes the total taxable gain to be allocated to the AB, LLC partners following a taxable disposition of assets.

Since Partner C would be allocated $725 upon a taxable disposition of AB, LLC assets immediately following its investment in AB, LLC, Partner C should have an available Section 743(b) adjustment to reduce the net gain recognized to $0.[58]

As a result of the allocation errors there is now a difference between Partner A's outside tax basis and the inside tax basis capital held by Partner A and Partner C. Exhibit 13 illustrates these differences.[59]

As illustrated in Exhibits 11 and 12, taxpayers and their advisors need to evaluate the impact that allocation errors have on a partner's Section 704(b) capital balance, outside tax basis, and inside tax basis. The author generally believes the results reflected in Exhibit 13 are appropriate. However, other viable positions may exist at varying levels of technical support.

Future Liability Allocations under Section 752

For simplicity, our case study did not include the existence of liabilities. However, the allocation of recourse and nonrecourse liabilities can be impacted by the partner's Section 704(b) capital account and the partner's share of inside tax basis. For illustration purposes, assume AB, LLC has $100 of partnership liabilities. Assume further that the liabilities are nonrecourse and no partner or partnership minimum gain[60] exists. The liabilities will therefore be treated as excess nonrecourse liabilities allocated under the third tier described in Reg. 1.752-3(a)(3). Finally, assume the partners agree that the $100 excess nonrecourse liability is to be allocated based on each partner's share of Section 704(c) built-in gain or loss.

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51 Exhibit 7 reflects the partners' Section 704(b) capital accounts as determined based on liquidating distribution rights. Further, the tax basis amounts reflect the amounts reported to each partner on Schedule K-1 and as shown in Exhibit 6. As discussed later, these amounts effectively equate to the partner's outside tax basis exclusive of the partner's share of liabilities under Section 752.

52 Section 1001(a).

53 Reg. 1.741-1(a).

54 See Revenue Ruling 84-53.

55 As previously discussed, variations between inside and outside basis most often occur in situations where a transaction subject to Section 734 or Section 743 occurs, but a Section 754 election is not in effect. Additionally, application of the basis allocation rules under Section 732 can create variations following certain property distributions. Finally, application of the ceiling limitation rule under Reg. 1.704-3 can create a variation.

56 As noted earlier, under Reg. 1.743-1(d)(1), the Section 743(b) adjustment to Partner C is equal to the amount of gain that would be allocated to Partner C if AB, LLC were to sell the property for value equivalent to Partner C's proportionate purchase price. If calculated solely with reference to Partner A's outside tax basis capital account, the Section 743(b) adjustment to Partner C would equal $425 (calculated as the difference between Partner A's Section 704(b) and tax basis capital amounts).

57 Total sale consideration of $3,700 less total Section 704(b) basis of $3,700 results in $0 Section 704(b) gain.

58 Inherent in the allocations shown in Exhibits 9 and 10 is the necessity that the partner's Section 704(b) capital accounts are adjusted by the correct amounts regardless of how items are reported on Schedule K-1. Consider the following illustration where the Section 704(b) capital accounts are maintained consistently with the reported Schedule K-1 allocations, i.e., the Section 704(b) capital account include the allocation errors. These results are reflected in Exhibit 11. If we were to look to the capital accounts reflected in Exhibit 11, the entire $200 forward Section 704(c) layer remains attributable to Partner A and 50% of this layer should transfer to Partner C. Consequently, $100 of the total recognized gain would continue to be specially allocated to both Partner A and Partner C. However, the additional $1,750 gain relating to the revaluation is now allocated $650 to Partner A and $1,100 to Partner B. Based on Partner C's 50% acquisition of Partner A's interest in AB, LLC, Partner C would be specially allocated $325 of the revaluation gain originally allocated to Partner A. These results are summarized in Exhibit 12. Although this result is tempting, it's important to bear in mind that these allocations would effectively reverse the prior year allocation errors. For example, Partner B should have been allocated total income of $450 during Years 1–3 but was allocated total losses of $150. This $600 variance is the difference in allocation amounts reflected in Exhibit 10 and Exhibit 12. Ultimately, then, advisors will need to decide whether making corrective allocations in future years is a viable alternative.

59 Note that the amounts reflected under the tax basis columns are now intended to reflect the partner's share of inside tax basis rather than outside tax basis. As discussed earlier, variances between inside and outside tax basis can be created as a result of the ceiling limitation under Section 704(c). Based on the capital account maintenance approach reflected in Exhibit 13, the ceiling limitation impact would be included in the inside tax basis amounts and the reconciliation to post-transaction outside basis.

60 See Reg. 1.704-2(d).

EXHIBIT 13

Capital Account Summary	Partner A 704(b) Basis	Partner A Outside Tax Basis	Partner B 704(b) Basis	Partner B Outside Tax Basis	Partner C 704(b) Basis	Partner C Outside Tax Basis	Total 704(b) Basis	Total Outside Tax Basis
Capital Contribution	$1,000	$800	$1,000	$1,000	-	-	$2,000	$1,800
FYE 1 Income/Loss	(250)	(250)	150	150	-	-	(100)	(100)
FYE 2 Income/Loss	(250)	(250)	150	150	-	-	(100)	(100)
FYE 3 Income/Loss	(250)	(250)	150	150	-	-	(100)	(100)
Capital at FYE 3	$250	$50	$1,450	$1,450	-	-	$1,700	$1,500
Capital Revaluation	1,250	-	500	-	-	-	1,750	-
Pre-Transaction Capital	$1,500	$50	$1,950	$1,450	-	-	$3,450	$1,500
Partner C Contribution	-	-	-	-	250	250	250	250
Partner C Unit Purchase	(750)	(25)	-	-	750	25	-	-
Post-Transaction Capital	$750	$25	$1,950	$1,450	$1,000	$275	$3,700	$1,750
Post-Transaction Inside Basis		$25		$1,450		$275		$1,750
Cumulative Allocation Errors		300		(600)		-		(300)
Section 743(b) Adjustment		-		-		725		725
Post-Transaction Outside Basis		$325		$850		$1,000		$2,175

Under these facts, a comparison of the built-in gain amounts as reflected in Exhibit 9 and Exhibit 11 illustrate the impact on liability allocations. The tables in Exhibits 14 and 15 are intended to illustrate one relatively simple consequence that can result from the accurate tracking of a partner's Section 704(b) capital and share of inside tax basis. As the complexity of partnership activities increase, so too will the range of possible implications.

EXHIBIT 14

(Exhibit 10 — Reproduced)

Section 704(c) Built-in Gain/(Loss)	Partner A	Partner B	Partner C	Total Gain
Forward Section 704(c) Layer	$100	$-	$100	$200
Reverse Section 704(c) Layer	$625	$500	$625	$1,750
Total Gain Allocated	$725	$500	$725	$1,950
Liability Allocation	$37.18	$25.64	$37.18	$100

EXHIBIT 15

(Exhibit 12 — Reproduced)

Section 704(c) Built-in Gain/(Loss)	Partner A	Partner B	Partner C	Total Gain
Forward Section 704(c) Layer	$100	$-	$100	$200
Reverse Section 704(c) Layer	$325	$1,100	$325	$1,750
Total Gain Allocated	$425	$1,100	$425	$1,950
Liability Allocation	$21.80	$56.40	$21.80	$100

The Epilogue

Our case study highlights several significant issues that are relevant to most tax partnerships. When income and loss allocation errors occur, these issues take on added significance due to the impact on future partnership allocation reporting. The manner that the partner's Section 704(b) capital, outside tax basis, and share of inside tax basis are tracked may impact the transferor's gain on sale, the transferee's Section 743(b) basis adjustment, future Section 704(c) allocations of income or loss, and Section 752 liability allocations.

Where allocation errors have been identified, taxpayers and their advisors will need to determine next steps. Advisors will usually suggest to their clients that filing an amended tax return or AAR is an appropriate method of correcting prior year errors. This approach allows the partners to minimize potential exposure on future IRS examinations and causes inside and outside bases to properly reflect the overall economic deal. However, given the administrative complexity associated with correcting previously filed partnership tax returns, whether via an amended return or AAR, this approach is not often pursued.[61]

Assuming amended tax returns are not filed, the partnership will need to decide how to track Section 704(b) capital, outside tax basis, and each partner's share of inside tax basis. One approach is to ensure that the partner's Section 704(b) capital accounts and share of inside tax basis capital are maintained with inclusion of the correct allocations of income or loss while the partner's outside tax basis is determined based on the actual allocations of taxable income or loss. The results of this approach are illustrated in Exhibit 13 and reflect, in the author's view, the most appropriate treatment based on existing technical support and the ultimately derived tax and economic consequences.

At least two other approaches are seen in practice. Each of these approaches, however, rely on some sort of future corrective allocation, making application worrisome.

One alternative approach involves recording a corrective allocation in the year the errors are discovered to reverse the cumulative effect of prior year errors. Under this approach, the partnership would create a special allocation in the year the errors are discovered. In our case study, Partner A and Partner B were allocated a $50 loss in each of Years 1 through Year 3. However, assuming each partner was misallocated $200 per year and the allocation error is discovered in Year 4, a corrective allocation of $600 would need to be recorded. On the partnership's Year 4 tax return, the regular Year 4 income and loss allocations would then be adjusted to reflect the entire $600 offsetting income and loss allocation between Partner A and Partner B.

A second approach involves reflecting the partner's Section 704(b) capital accounts with inclusion of the correct allocations of income or loss but calculating the partner's share of inside tax basis and outside tax basis with respect to the actual allocations of taxable income or loss. This approach was discussed at length earlier and the results are reflected in Exhibit 9.

As a threshold matter, allocations of taxable income follow the allocation of Section 704(b) income, subject to special allocations under Section 704(c). As previously discussed, the Section 704(b) capital accounts should always reflect the correct allocations notwithstanding the amounts that have been reported on the partnership tax return and partner's Schedule K-1. Consequently, upon review, it becomes clear precisely in which year the incorrect allocations have occurred.[62]

While there is simplicity in recording a corrective allocation, the lack of authority supporting these allocations is worrisome. If reviewed upon examination, the corrective allocation approach is subject to challenge. With limited, if any, technical support allowing for corrective allocations, taxpayers and their advisors take a significant risk when pursuing this approach. It is important to note that upon examination, there is risk that the IRS will also challenge the prior year allocations.

Regardless of the potential approaches that may be taken with respect to addressing allocation errors, it is clear that the IRS is increasing its focus on partnership tax compliance. Given the recently expanded Schedule K-1 reporting disclosures, care should be taken in determining how to most appropriately track the partner's capital and basis amounts.[63] ●

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[61] Note that as a result of the CARES Act, Pub. L. No. 116-136, and related guidance, significant opportunities exist to increase prior year expenses and reduce overall tax liabilities. For example, the CARES Act allows taxpayers to claim bonus depreciation with respect to qualified improvement property. While taxpayers may claim these benefits via an automatic accounting method change by filing IRS Form 3115, *Application for Change in Accounting Method*, it may be more advantageous for partnerships to file an amended partnership tax return. Under Rev. Proc. 2020-23, 2020-18 IRB 749, partnerships subject to the centralized partnership audit regime may file, subject to certain requirements, either an amended partnership tax return or administrative adjustment request for their 2018 and 2019 tax years.

[62] A variation of Approach #2 would be to report the Section 704(b) capital accounts with inclusion of the allocation errors. However, since the partner's Section 704(b) capital accounts are required to reflect the partner's economic interest in the partnership, it is not clear what authority exists to support this position. It is important to note that there are many open issues surrounding the allocation of income and expense in the context of targeted allocation agreements. In our case study, we assumed that gross income allocations would be required. If a viable position exists to avoid gross income allocations, then the Section 704(b) capital accounts and outside tax basis balances would likely still be equal. Thus, it is important to distinguish between errors in the allocation of taxable income versus supportable positions where a different allocation method may be appropriate. In either situation, however, the partner's Section 704(b) capital accounts should reflect their existing interests in the underlying partnership economics.

[63] The IRS is pursuing a strategy to increase overall partnership income tax reporting accuracy. Part of this strategy includes expanding required disclosures. These enhanced disclosure requirements are being phased in through 2020 tax filings. In particular, the required disclosures will include reporting partner's outside tax basis capital and Section 704(c) built-in gain (loss) amounts as of the beginning and ending of the year. Additionally, the partner's capital percentage is reported as of the beginning and ending of the year. Per the 2019 Form 1065, Schedule K-1 instructions, the capital percentage should reflect the amount the partner "would receive if the partnership was liquidated at the end of its tax year by the distribution of undivided interests in the partnership's assets and liabilities." Thus, this percentage may equate to the partner's share of Section 704(b) capital. Armed with this required disclosure information, the IRS will presumably be in a position to run various analytical models to identify potential areas of exposure.