

business M is in the business M CFTE category and \$75,000 of income of business M attributable to the disregarded payment and the \$50,000 of net income attributable to business N are in the business N CFTE category. Under paragraph (b)(4)(viii)(d)(I) of this section, the \$10,000 of country X taxes is allocated to the business M CFTE category and all \$25,000 of the country Y taxes is allocated to the business N CFTE category. The allocations of country X taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 75 percent to A and 25 percent to B. The allocations of country Y taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 50 percent to A and 50 percent to B.

Example 25 through (e) [Reserved] For further guidance, see § 1.704-1(b)(5) *Example 25* through (e).

(f) *Expiration date.* The applicability of this section expires on February 9, 2015.

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§ 1.704-2 Allocations attributable to nonrecourse liabilities.

(a) *Table of contents.* This paragraph contains a listing of the major headings of this § 1.704-2.

§ 1.704-2 Allocations attributable to nonrecourse liabilities.

- (a) Table of contents.
- (b) General principles and definitions.
- (1) Definition of and allocations of nonrecourse deductions.
- (2) Definition of and allocations pursuant to a minimum gain chargeback.
- (3) Definition of nonrecourse liability.
- (4) Definition of partner nonrecourse debt.
- (c) Amount of nonrecourse deductions.
- (d) Partnership minimum gain.
- (1) Amount of partnership minimum gain.
- (2) Property subject to more than one liability.
 - (i) In general.
 - (ii) Allocating liabilities.
- (3) Partnership minimum gain if there is a book/tax disparity.
- (4) Special rule for year of revaluation.
- (e) Requirements to be satisfied.
- (f) Minimum gain chargeback requirement.
 - (1) In general.
 - (2) Exception for certain conversions and refinancings.
 - (3) Exception for certain capital contributions.
 - (4) Waiver for certain income allocations that fail to meet minimum gain chargeback

requirement if minimum gain chargeback distorts economic arrangement.

- (5) Additional exceptions.
- (6) Partnership items subject to the minimum gain chargeback requirement.
- (7) Examples.
 - (g) Shares of partnership minimum gain.
 - (1) Partner's share of partnership minimum gain.
 - (2) Partner's share of the net decrease in partnership minimum gain.
 - (3) Conversions of recourse or partner nonrecourse debt into nonrecourse debt.
 - (h) Distribution of nonrecourse liability proceeds allocable to an increase in partnership minimum gain.
 - (1) In general.
 - (2) Distribution allocable to nonrecourse liability proceeds.
 - (3) Option when there is an obligation to restore.
 - (4) Carryover to immediately succeeding taxable year.
 - (i) Partnership nonrecourse liabilities where a partner bears the economic risk of loss.
 - (1) In general.
 - (2) Definition of and determination of partner nonrecourse deductions.
 - (3) Determination of partner nonrecourse debt minimum gain.
 - (4) Chargeback of partner nonrecourse debt minimum gain.
 - (5) Partner's share of partner nonrecourse debt minimum gain.
 - (6) Distribution of partner nonrecourse debt proceeds allocable to an increase in partner nonrecourse debt minimum gain.
 - (j) Ordering rules.
 - (1) Treatment of partnership losses and deductions.
 - (i) Partner nonrecourse deductions.
 - (ii) Partnership nonrecourse deductions.
 - (iii) Carryover to succeeding taxable year.
 - (2) Treatment of partnership income and gains.
 - (i) Minimum gain chargeback.
 - (ii) Chargeback attributable to decrease in partner nonrecourse debt minimum gain.
 - (iii) Carryover to succeeding taxable year.
 - (k) Tiered partnerships.
 - (1) Increase in upper-tier partnership's minimum gain.
 - (2) Decrease in upper-tier partnership's minimum gain.
 - (3) Nonrecourse debt proceeds distributed from the lower-tier partnership to the upper-tier partnership.
 - (4) Nonrecourse deductions of lower-tier partnership treated as depreciation by upper-tier partnership.
 - (5) Coordination with partner nonrecourse debt rules.
 - (1) Effective dates.
 - (1) In general.
 - (i) Prospective application.

§ 1.704-2

26 CFR Ch. I (4-1-12 Edition)

(ii) Partnerships subject to temporary regulations.

(iii) Partnerships subject to former regulations.

(2) Special rule applicable to pre-January 30, 1989, related party nonrecourse debt.

(3) Transition rule for pre-March 1, 1984, partner nonrecourse debt.

(4) Election.

(m) Examples.

(b) *General principles and definitions—*

(1) *Definition of and allocations of nonrecourse deductions.* Allocations of losses, deductions, or section 705(a)(2)(B) expenditures attributable to partnership nonrecourse liabilities (“nonrecourse deductions”) cannot have economic effect because the creditor alone bears any economic burden that corresponds to those allocations. Thus, nonrecourse deductions must be allocated in accordance with the partners’ interests in the partnership. Paragraph (e) of this section provides a test that deems allocations of nonrecourse deductions to be in accordance with the partners’ interests in the partnership. If that test is not satisfied, the partners’ distributive shares of nonrecourse deductions are determined under § 1.704-1(b)(3), according to the partners’ overall economic interests in the partnership. See also paragraph (i) of this section for special rules regarding the allocation of deductions attributable to nonrecourse liabilities for which a partner bears the economic risk of loss (as described in paragraph (b)(4) of this section).

(2) *Definition of and allocations pursuant to a minimum gain chargeback.* To the extent a nonrecourse liability exceeds the adjusted tax basis of the partnership property it encumbers, a disposition of that property will generate gain that at least equals that excess (“partnership minimum gain”). An increase in partnership minimum gain is created by a decrease in the adjusted tax basis of property encumbered by a nonrecourse liability below the amount of that liability and by a partnership nonrecourse borrowing that exceeds the adjusted tax basis of the property encumbered by the borrowing. Partnership minimum gain decreases as reductions occur in the amount by which the nonrecourse liability exceeds the adjusted tax basis of the property encumbered by the liability. Allocations of

gain attributable to a decrease in partnership minimum gain (a “minimum gain chargeback,” as required under paragraph (f) of this section) cannot have economic effect because the gain merely offsets nonrecourse deductions previously claimed by the partnership. Thus, to avoid impairing the economic effect of other allocations, allocations pursuant to a minimum gain chargeback must be made to the partners that either were allocated nonrecourse deductions or received distributions of proceeds attributable to a nonrecourse borrowing. Paragraph (e) of this section provides a test that, if met, deems allocations of partnership income pursuant to a minimum gain chargeback to be in accordance with the partners’ interests in the partnership. If property encumbered by a nonrecourse liability is reflected on the partnership’s books at a value that differs from its adjusted tax basis, paragraph (d)(3) of this section provides that minimum gain is determined with reference to the property’s book basis. See also paragraph (i)(4) of this section for special rules regarding the minimum gain chargeback requirement for partner nonrecourse debt.

(3) *Definition of nonrecourse liability.* *Nonrecourse liability* means a nonrecourse liability as defined in § 1.752-1(a)(2) or a § 1.752-7 liability (as defined in § 1.752-7(b)(3)(i)) assumed by the partnership from a partner on or after June 24, 2003.

(4) *Definition of partner nonrecourse debt.* *Partner nonrecourse debt* or *partner nonrecourse liability* means any partnership liability to the extent the liability is nonrecourse for purposes of § 1.1001-2, and a partner or related person (within the meaning of § 1.752-4(b)) bears the economic risk of loss under § 1.752-2 because, for example, the partner or related person is the creditor or a guarantor.

(c) *Amount of nonrecourse deductions.* The amount of nonrecourse deductions for a partnership taxable year equals the net increase in partnership minimum gain during the year (determined under paragraph (d) of this section), reduced (but not below zero) by the aggregate distributions made during the

year of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain (determined under paragraph (h) of this section). See paragraph (m), *Examples* (1)(i) and (vi), (2), and (3) of this section. However, increases in partnership minimum gain resulting from conversions, refinancings, or other changes to a debt instrument (as described in paragraph (g)(3)) do not generate nonrecourse deductions. Generally, nonrecourse deductions consist first of certain depreciation or cost recovery deductions and then, if necessary, a pro rata portion of other partnership losses, deductions, and section 705(a)(2)(B) expenditures for that year; excess nonrecourse deductions are carried over. See paragraphs (j)(1) (ii) and (iii) of this section for more specific ordering rules. See also paragraph (m), *Example* (1)(iv) of this section.

(d) *Partnership minimum gain*—(1) *Amount of partnership minimum gain.* The amount of partnership minimum gain is determined by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains. The amount of partnership minimum gain includes minimum gain arising from a conversion, refinancing, or other change to a debt instrument, as described in paragraph (g)(3) of this section, only to the extent a partner is allocated a share of that minimum gain. For any partnership taxable year, the net increase or decrease in partnership minimum gain is determined by comparing the partnership minimum gain on the last day of the immediately preceding taxable year with the partnership minimum gain on the last day of the current taxable year. See paragraph (m), *Examples* (1) (i) and (iv), (2), and (3) of this section.

(2) *Property subject to more than one liability.* (i) *In general.* If property is subject to more than one liability, only the portion of the property's adjusted tax basis that is allocated to a nonrecourse liability under paragraph (d)(2)(ii) of this section is used to com-

pute minimum gain with respect to that liability.

(ii) *Allocating liabilities.* If property is subject to two or more liabilities of equal priority, the property's adjusted tax basis is allocated among the liabilities in proportion to their outstanding balances. If property is subject to two or more liabilities of unequal priority, the adjusted tax basis is allocated first to the liability of the highest priority to the extent of its outstanding balance and then to each liability in descending order of priority to the extent of its outstanding balance, until fully allocated. See paragraph (m), *Example* (1) (v) and (vii) of this section.

(3) *Partnership minimum gain if there is a book/tax disparity.* If partnership property subject to one or more nonrecourse liabilities is, under § 1.704-1(b)(2)(iv) (d), (f), or (r), reflected on the partnership's books at a value that differs from its adjusted tax basis, the determinations under this section are made with reference to the property's book value. See section 704(c) and § 1.704-1(b)(4)(i) for principles that govern the treatment of a partner's share of minimum gain that is eliminated by the revaluation. See also paragraph (m), *Example* (3) of this section.

(4) *Special rule for year of revaluation.* If the partners' capital accounts are increased pursuant to § 1.704-1(b)(2)(iv) (d), (f), or (r) to reflect a revaluation of partnership property subject to a nonrecourse liability, the net increase or decrease in partnership minimum gain for the partnership taxable year of the revaluation is determined by:

(i) First calculating the net decrease or increase in partnership minimum gain using the current year's book values and the prior year's partnership minimum gain amount; and

(ii) Then adding back any decrease in minimum gain arising solely from the revaluation.

See paragraph (m), *Example* (3)(iii) of this section. If the partners' capital accounts are decreased to reflect a revaluation, the net increases or decreases in partnership minimum gain are determined in the same manner as in the year before the revaluation, but by using book values rather than adjusted tax bases. See section 7701(g) and § 1.704-1(b)(2)(iv)(f)(1) (property being

revalued cannot be booked down below the amount of any nonrecourse liability to which the property is subject).

(e) *Requirements to be satisfied.* Allocations of nonrecourse deductions are deemed to be in accordance with the partners' interests in the partnership only if—

(1) Throughout the full term of the partnership requirements (1) and (2) of § 1.704-1(b)(2)(ii)(b) are satisfied (*i.e.*, capital accounts are maintained in accordance with § 1.704-1(b)(2)(iv) and liquidating distributions are required to be made in accordance with positive capital account balances), and requirement (3) of either § 1.704-1(b)(2)(ii)(b) or § 1.704-1(b)(2)(ii)(d) is satisfied (*i.e.*, partners with deficit capital accounts have an unconditional deficit restoration obligation or agree to a qualified income offset);

(2) Beginning in the first taxable year of the partnership in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, the partnership agreement provides for allocations of nonrecourse deductions in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities;

(3) Beginning in the first taxable year of the partnership that it has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain, and thereafter throughout the full term of the partnership, the partnership agreement contains a provision that complies with the minimum gain chargeback requirement of paragraph (f) of this section; and

(4) All other material allocations and capital account adjustments under the partnership agreement are recognized under § 1.704-1(b) (without regard to whether allocations of adjusted tax basis and amount realized under section 613A(c)(7)(D) are recognized under § 1.704-1(b)(4)(v)).

(f) *Minimum gain chargeback requirement—(1) In general.* If there is a net decrease in partnership minimum gain for a partnership taxable year, the minimum gain chargeback require-

ment 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)).

(2) *Exception for certain conversions and refinancings.* A partner is not subject to the minimum gain chargeback requirement to the extent the partner's share of the net decrease in partnership minimum gain is caused by a re-characterization of nonrecourse partnership debt as partially or wholly recourse debt or partner nonrecourse debt, and the partner bears the economic risk of loss (within the meaning of § 1.752-2) for the liability.

(3) *Exception for certain capital contributions.* A partner is not subject to the minimum gain chargeback requirement to the extent the partner contributes capital to the partnership that is used to repay the nonrecourse liability or is used to increase the basis of the property subject to the nonrecourse liability, and the partner's share of the net decrease in partnership minimum gain results from the repayment or the increase to the property's basis. See paragraph (m), *Example* (1)(iv) of this section.

(4) *Waiver for certain income allocations that fail to meet minimum gain chargeback requirement if minimum gain chargeback distorts economic arrangement.* In any taxable year that a partnership has a net decrease in partnership minimum gain, if the minimum gain chargeback requirement would cause a distortion in the economic arrangement among the partners and it is not expected that the partnership will have sufficient other income to correct that distortion, the Commissioner has the discretion, if requested by the partnership, to waive the minimum gain chargeback requirement. The following facts must be demonstrated in order for a request for a waiver to be considered:

(i) The partners have made capital contributions or received net income allocations that have restored the previous nonrecourse deductions and the distributions attributable to proceeds of a nonrecourse liability; and

Internal Revenue Service, Treasury

§ 1.704-2

(ii) The minimum gain chargeback requirement would distort the partners' economic arrangement as reflected in the partnership agreement and as evidenced over the term of the partnership by the partnership's allocations and distributions and the partners' contributions.

(5) *Additional exceptions.* The Commissioner may, by revenue ruling, provide additional exceptions to the minimum gain chargeback requirement.

(6) *Partnership items subject to the minimum gain chargeback requirement.* Any minimum gain chargeback required for a partnership taxable year consists first of a pro rata portion of certain gains recognized from the disposition of partnership property subject to one or more partnership nonrecourse liabilities and income from the discharge of indebtedness relating to one or more partnership nonrecourse liabilities to which partnership property is subject, and then, if necessary, consists of a pro rata portion of the partnership's other items of income and gain for that year. If the amount of the minimum gain chargeback requirement exceeds the partnership's income and gains for the taxable year, the excess carries over. See paragraphs (j)(2)(i) and (j)(2)(iii) of this section for more specific ordering rules.

(7) *Examples.* The following examples illustrate the provisions in § 1.704-2(f).

Example. 1. Partnership AB consists of two partners, limited partner A and general partner B. Partner A contributes \$90 and Partner B contributes \$10 to the partnership. The partnership agreement has a minimum gain chargeback provision and provides that, except as otherwise required by section 704(c), all losses will be allocated 90 percent to A and 10 percent to B; and that all income will be allocated first to restore previous losses and thereafter 50 percent to A and 50 percent to B. Distributions are made first to return initial capital to the partners and then 50 percent to A and 50 percent to B. Final distributions are made in accordance with capital account balances. The partnership borrows \$200 on a nonrecourse basis from an unrelated third party and purchases an asset for \$300. The partnership's only tax item for each of the first three years is \$100 of depreciation on the asset. A's and B's shares of minimum gain (under paragraph (g) of this section) and deficit capital account balances are \$180 and \$20 respectively at the end of the third year. In the fourth year, the partnership earns \$400 of net operating income and

allocates the first \$300 to restore the previous losses (*i.e.*, \$270 to A and \$30 to B); the last \$100 is allocated \$50 each. The partnership distributes \$200 of the available cash that same year; the first \$100 is distributed \$90 to A and \$10 to B to return their capital contributions; the last \$100 is distributed \$50 each to reflect their ratio for sharing profits.

	A	B
Capital account on formation	\$90	\$10
Less: Net loss in years 1-3	(\$270)	(\$30)
Capital account at end of year 3	(\$180)	(\$20)
Allocation of operating income to restore nonrecourse deductions	\$180	\$20
Allocation of operating income to restore capital contributions	\$90	\$10
Allocation of operating income to reflect profits	\$50	\$50
Capital accounts after allocation of operating income	\$140	\$60
Distribution reflecting capital contribution ..	(\$90)	(\$10)
Distribution in profit-sharing ratio	(\$50)	(\$50)
Capital accounts following distribution	(\$0)	(\$0)

In the fifth year, the partnership sells the property for \$300 and realizes \$300 of gain. \$200 of the proceeds are used to pay the nonrecourse lender. The partnership has \$300 to distribute, and the partners expect to share that equally. Absent a waiver under paragraph (f)(4) of this section, the minimum gain chargeback would require the partnership to allocate the first \$200 of the gain \$180 to A and \$20 to B, which would distort their economic arrangement. This allocation, together with the allocation of the \$100 profit \$50 to each partner, would result in A having a positive capital account balance of \$230 and B having a positive capital account balance of \$70. The allocation of income in year 4 in effect anticipated the minimum gain chargeback that did not occur until year 5. Assuming the partnership would not have sufficient other income to correct the distortion that would otherwise result, the partnership may request that the Commissioner exercise his or her discretion to waive the minimum gain chargeback requirement and recognize allocations that would allow A and B to share equally the gain on the sale of the property. These allocations would bring the partners' capital accounts to \$150 each, allowing them to share the last \$300 equally. The Commissioner may, in his or her discretion, permit this allocation pursuant to paragraph (f)(4) of this section because the minimum gain chargeback would distort the partners' economic arrangement over the term of the partnership as reflected in the partnership agreement and as evidenced by the partners' contributions and the partnership's allocations and distributions.

Example 2. A and B form a partnership, contribute \$25 each to the partnership's capital, and agree to share all losses and profits 50 percent each. Neither partner has an unconditional deficit restoration obligation and all the requirements in paragraph (e) of this section are met. The partnership obtains a nonrecourse loan from an unrelated third party of \$100 and purchases two assets, stock for \$50 and depreciable property for \$100. The nonrecourse loan is secured by the partnership's depreciable property. The partnership generates \$20 of depreciation in each of the first five years as its only tax item. These deductions are properly treated as nonrecourse deductions and the allocation of these deductions 50 percent to A and 50 percent to B is deemed to be in accordance with the partners' interests in the partnership. At the end of year five, A and B each have a \$25 deficit capital account and a \$50 share of partnership minimum gain. In the beginning of year six, (at the lender's request), A guarantees the entire nonrecourse liability. Pursuant to paragraph (d)(1) of this section, the partnership has a net decrease in minimum gain of \$100 and under paragraph (g)(2) of this section, A's and B's shares of that net decrease are \$50 each. Under paragraph (f)(1) of this section (the minimum gain chargeback requirement), B is subject to a \$50 minimum gain chargeback. Because the partnership has no gross income in year six, the entire \$50 carries over as a minimum gain chargeback requirement to succeeding taxable years until their is enough income to cover the minimum gain chargeback requirement. Under the exception to the minimum gain chargeback in paragraph (f)(2) of this section, A is not subject to a minimum gain chargeback for A's \$50 share of the net decrease because A bears the economic risk of loss for the liability. Instead, A's share of partner nonrecourse debt minimum gain is \$50 pursuant to paragraph (i)(3) of this section. In year seven, the partnership earns \$100 of net operating income and uses the money to repay the entire \$100 nonrecourse debt (that A has guaranteed). Under paragraph (i)(3) of this section, the partnership has a net decrease in partner nonrecourse debt minimum gain of \$50. B must be allocated \$50 of the operating income pursuant to the carried over minimum gain chargeback requirement; pursuant to paragraph (i)(4) of this section, the other \$50 of operating income must be allocated to A as a partner nonrecourse debt minimum gain chargeback.

(g) *Shares of partnership minimum gain*—(1) *Partner's share of partnership minimum gain.* Except as increased in paragraph (g) (3) of this section, a partner's share of partnership minimum

gain at the end of any partnership taxable year equals:

(i) The sum of nonrecourse deductions allocated to that partner (and to that partner's predecessors in interest) up to that time and the distributions made to that partner (and to that partner's predecessors' in interest) up to that time of proceeds of a nonrecourse liability allocable to an increase in partnership minimum gain (see paragraph (h)(1) of this section); minus

(ii) The sum of that partner's (and that partner's predecessors' in interest) aggregate share of the net decreases in partnership minimum gain plus their aggregate share of decreases resulting from revaluations of partnership property subject to one or more partnership nonrecourse liabilities.

For purposes of § 1.704-1(b)(2)(ii)(d), a partner's share of partnership minimum gain is added to the limited dollar amount, if any, of the deficit balance in the partner's capital account that the partner is obligated to restore. See paragraph (m), *Examples* (1)(i) and (3)(i) of this section.

(2) *Partner's share of the net decrease in partnership minimum gain.* 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. A partner's share of any decrease in partnership minimum gain resulting from a revaluation of partnership property equals the increase in the partner's capital account attributable to the revaluation to the extent the reduction in minimum gain is caused by the revaluation. See paragraph (m), *Example* (3)(ii) of this section.

(3) *Conversions of recourse or partner nonrecourse debt into nonrecourse debt.* A partner's share of partnership minimum gain is increased to the extent provided in this paragraph (g)(3) if a recourse or partner nonrecourse liability becomes partially or wholly nonrecourse. If a recourse liability becomes a nonrecourse liability, a partner has a share of the partnership's minimum gain that results from the conversion equal to the partner's deficit capital account (determined under § 1.704-1(b)(2)(iv)) to the extent the

partner no longer bears the economic burden for the entire deficit capital account as a result of the conversion. For purposes of the preceding sentence, the determination of the extent to which a partner bears the economic burden for a deficit capital account is made by determining the consequences to the partner in the case of a complete liquidation of the partnership immediately after the conversion applying the rules described in § 1.704-1(b)(2)(iii)(c) that deem the value of partnership property to equal its basis, taking into account section 7701(g) in the case of property that secures nonrecourse indebtedness. If a partner nonrecourse debt becomes a nonrecourse liability, the partner's share of partnership minimum gain is increased to the extent the partner is not subject to the minimum gain chargeback requirement under paragraph (i)(4) of this section.

(h) *Distribution of nonrecourse liability proceeds allocable to an increase in partnership minimum gain*—(1) *In general.* If during its taxable year a partnership makes a distribution to the partners allocable to the proceeds of a nonrecourse liability, the distribution is allocable to an increase in partnership minimum gain to the extent the increase results from encumbering partnership property with aggregate nonrecourse liabilities that exceed the property's adjusted tax basis. See paragraph (m), *Example* (1)(vi) of this section. If the net increase in partnership minimum gain for a partnership taxable year is allocable to more than one nonrecourse liability, the net increase is allocated among the liabilities in proportion to the amount each liability contributed to the increase in minimum gain.

(2) *Distribution allocable to nonrecourse liability proceeds.* A partnership may use any reasonable method to determine whether a distribution by the partnership to one or more partners is allocable to proceeds of a nonrecourse liability. The rules prescribed under § 1.163-8T for allocating debt proceeds among expenditures (applying those rules to the partnership as if it were an individual) constitute a reasonable method for determining whether the nonrecourse liability proceeds are dis-

tributed to the partners and the partners to whom the proceeds are distributed.

(3) *Option when there is an obligation to restore.* A partnership may treat any distribution to a partner of the proceeds of a nonrecourse liability (that would otherwise be allocable to an increase in partnership minimum gain) as a distribution that is not allocable to an increase in partnership minimum gain to the extent the distribution does not cause or increase a deficit balance in the partner's capital account that exceeds the amount the partner is otherwise obligated to restore (within the meaning of § 1.704-1(b)(2)(ii)(c)) as of the end of the partnership taxable year in which the distribution occurs.

(4) *Carryover to immediately succeeding taxable year.* The carryover rule of this paragraph applies if the net increase in partnership minimum gain for a partnership taxable year that is allocable to a nonrecourse liability under paragraph (h)(2) of this section exceeds the distributions allocable to the proceeds of the liability ("excess allocable amount"), and all or part of the net increase in partnership minimum gain for the year is carried over as an increase in partnership minimum gain for the immediately succeeding taxable year (pursuant to paragraph (j)(1)(iii) of this section). If the carryover rule of this paragraph applies, the excess allocable amount (or the amount carried over under paragraph (j)(1)(iii) of this section, if less) is treated in the succeeding taxable year as an increase in partnership minimum gain that arose in that year as a result of incurring the nonrecourse liability to which the excess allocable amount is attributable. See paragraph (m), *Example* (1)(vi) of this section. If for a partnership taxable year there is an excess allocable amount with respect to more than one partnership nonrecourse liability, the excess allocable amount is allocated to each liability in proportion to the amount each liability contributed to the increase in minimum gain.

(i) *Partnership nonrecourse liabilities where a partner bears the economic risk of loss*—(1) *In general.* Partnership losses, deductions, or section 705(a)(2)(B) expenditures that are attributable to a

particular partner nonrecourse liability (“partner nonrecourse deductions,” as defined in paragraph (i)(2) of this section) must be allocated to the partner that bears the economic risk of loss for the liability. If more than one partner bears the economic risk of loss for a partner nonrecourse liability, any partner nonrecourse deductions attributable to that liability must be allocated among the partners according to the ratio in which they bear the economic risk of loss. If partners bear the economic risk of loss for different portions of a liability, each portion is treated as a separate partner nonrecourse liability.

(2) *Definition of and determination of partner nonrecourse deductions.* For any partnership taxable year, the amount of partner nonrecourse deductions with respect to a partner nonrecourse debt equals the net increase during the year in minimum gain attributable to the partner nonrecourse debt (“partner nonrecourse debt minimum gain”), reduced (but not below zero) by proceeds of the liability distributed during the year to the partner bearing the economic risk of loss for the liability that are both attributable to the liability and allocable to an increase in the partner nonrecourse debt minimum gain. See paragraph (m), *Example* (1) (viii) and (ix) of this section. The determination of which partnership items constitute the partner nonrecourse deductions with respect to a partner nonrecourse debt must be made in a manner consistent with the provisions of paragraphs (c) and (j)(1) (i) and (iii) of this section.

(3) *Determination of partner nonrecourse debt minimum gain.* For any partnership taxable year, the determination of partner nonrecourse debt minimum gain and the net increase or decrease in partner nonrecourse debt minimum gain must be made in a manner consistent with the provisions of paragraphs (d) and (g)(3) of this section.

(4) *Chargeback of partner nonrecourse debt minimum gain.* If during a partnership taxable year there is a net decrease in partner nonrecourse debt minimum gain, any partner with a share of that partner nonrecourse debt minimum gain (determined under para-

graph (i)(5) of this section) as of the beginning of the year must be allocated items of income and gain for the year (and, if necessary, for succeeding years) equal to that partner’s share of the net decrease in the partner nonrecourse debt minimum gain. A partner’s share of the net decrease in partner nonrecourse debt minimum gain is determined in a manner consistent with the provisions of paragraph (g)(2) of this section. A partner is not subject to this minimum gain chargeback, however, to the extent the net decrease in partner nonrecourse debt minimum gain arises because a partner nonrecourse liability becomes partially or wholly a nonrecourse liability. The amount that would otherwise be subject to the partner nonrecourse debt minimum gain chargeback is added to the partner’s share of partnership minimum gain under paragraph (g)(3) of this section. In addition, rules consistent with the provisions of paragraphs (f) (2), (3), (4), and (5) of this section apply with respect to partner nonrecourse debt in appropriate circumstances. The determination of which items of partnership income and gain must be allocated pursuant to this paragraph (i)(4) is made in a manner that is consistent with the provisions of paragraph (f)(6) of this section. See paragraph (j)(2) (ii) and (iii) of this section for more specific rules.

(5) *Partner’s share of partner nonrecourse debt minimum gain.* A partner’s share of partner nonrecourse debt minimum gain at the end of any partnership taxable year is determined in a manner consistent with the provisions of paragraphs (g)(1) and (g)(3) of this section with respect to each particular partner nonrecourse debt for which the partner bears the economic risk of loss. For purposes of § 1.704-1(b)(2)(ii)(d), a partner’s share of partner nonrecourse debt minimum gain is added to the limited dollar amount, if any, of the deficit balance in the partner’s capital account that the partner is obligated to restore, and the partner is not otherwise considered to have a deficit restoration obligation as a result of bearing the economic risk of loss for any partner nonrecourse debt. See paragraph (m), *Example* (1)(viii) of this section.

(6) *Distribution of partner nonrecourse debt proceeds allocable to an increase in partner nonrecourse debt minimum gain.* Rules consistent with the provisions of paragraph (h) of this section apply to distributions of the proceeds of partner nonrecourse debt.

(j) *Ordering rules.* For purposes of this section, the following ordering rules apply to partnership items. Notwithstanding any other provision in this section and § 1.704-1, allocations of partner nonrecourse deductions, nonrecourse deductions, and minimum gain chargebacks are made before any other allocations.

(1) *Treatment of partnership losses and deductions.* (i) *Partner nonrecourse deductions.* Partnership losses, deductions, and section 705(a)(2)(B) expenditures are treated as partner nonrecourse deductions in the amount determined under paragraph (i)(2) of this section (determining partner nonrecourse deductions) in the following order:

(A) First, depreciation or cost recovery deductions with respect to property that is subject to partner nonrecourse debt;

(B) Then, if necessary, a pro rata portion of the partnership's other deductions, losses, and section 705(a)(2)(B) items.

Depreciation or cost recovery deductions with respect to property that is subject to a partnership nonrecourse liability is first treated as a partnership nonrecourse deduction and any excess is treated as a partner nonrecourse deduction under this paragraph (j)(1)(i).

(ii) *Partnership nonrecourse deductions.* Partnership losses, deductions, and section 705(a)(2)(B) expenditures are treated as partnership nonrecourse deductions in the amount determined under paragraph (c) of this section (determining nonrecourse deductions) in the following order:

(A) First, depreciation or cost recovery deductions with respect to property that is subject to partnership nonrecourse liabilities;

(B) Then, if necessary, a pro rata portion of the partnership's other deductions, losses, and section 705(a)(2)(B) items.

Depreciation or cost recovery deductions with respect to property that is

subject to partner nonrecourse debt is first treated as a partner nonrecourse deduction and any excess is treated as a partnership nonrecourse deduction under this paragraph (j)(1)(ii). Any other item that is treated as a partner nonrecourse deduction will in no event be treated as a partnership nonrecourse deduction.

(iii) *Carryover to succeeding taxable year.* If the amount of partner nonrecourse deductions or nonrecourse deductions exceeds the partnership's losses, deductions, and section 705(a)(2)(B) expenditures for the taxable year (determined under paragraphs (j)(1)(i) and (ii) of this section), the excess is treated as an increase in partner nonrecourse debt minimum gain or partnership minimum gain in the immediately succeeding partnership taxable year. See paragraph (m), *Example (1)(vi)* of this section.

(2) *Treatment of partnership income and gains.* (i) *Minimum gain chargeback.* Items of partnership income and gain equal to the minimum gain chargeback requirement (determined under paragraph (f) of this section) are allocated as a minimum gain chargeback in the following order:

(A) First, a pro rata portion of gain from the disposition of property subject to partnership nonrecourse liabilities and discharge of indebtedness income relating to partnership nonrecourse liabilities to which property is subject;

(B) Then, if necessary, a pro rata portion of the partnership's other items of income and gain for that year.

Gain from the disposition of property subject to partner nonrecourse debt is allocated to satisfy a minimum gain chargeback requirement for partnership nonrecourse debt only to the extent not allocated under paragraph (j)(2)(i) of this section.

(ii) *Chargeback attributable to decrease in partner nonrecourse debt minimum gain.* Items of partnership income and gain equal to the partner nonrecourse debt minimum gain chargeback (determined under paragraph (i)(4) of this section) are allocated to satisfy a partner nonrecourse debt minimum gain chargeback in the following order:

(A) First, a pro rata portion of gain from the disposition of property subject to partner nonrecourse debt and discharge of indebtedness income relating to partner nonrecourse debt to which property is subject.

(B) Then, if necessary, a pro rata portion of the partnership's other items of income and gain for that year.

Gain from the disposition of property subject to a partnership nonrecourse liability is allocated to satisfy a partner nonrecourse debt minimum gain chargeback only to the extent not allocated under paragraph (j)(2)(i) of this section. An item of partnership income and gain that is allocated to satisfy a minimum gain chargeback under paragraph (f) of this section is not allocated to satisfy a minimum gain chargeback under paragraph (i)(4).

(iii) *Carryover to succeeding taxable year.* If a minimum gain chargeback requirement (determined under paragraphs (f) and (i)(4) of this section) exceeds the partnership's income and gains for the taxable year, the excess is treated as a minimum gain chargeback requirement in the immediately succeeding partnership taxable years until fully charged back.

(k) *Tiered partnerships.* For purposes of this section, the following rules determine the effect on partnership minimum gain when a partnership ("upper-tier partnership") is a partner in another partnership ("lower-tier partnership").

(1) *Increase in upper-tier partnership's minimum gain.* The sum of the nonrecourse deductions that the lower-tier partnership allocates to the upper-tier partnership for any taxable year of the upper-tier partnership, and the distributions made during that taxable year from the lower-tier partnership to the upper-tier partnership of proceeds of nonrecourse debt that are allocable to an increase in the lower-tier partnership's minimum gain, is treated as an increase in the upper-tier partnership's minimum gain.

(2) *Decrease in upper-tier partnership's minimum gain.* The upper-tier partnership's share for its taxable year of the lower-tier partnership's net decrease in its minimum gain is treated as a decrease in the upper-tier partnership's minimum gain for that taxable year.

(3) *Nonrecourse debt proceeds distributed from the lower-tier partnership to the upper-tier partnership.* All distributions from the lower-tier partnership to the upper-tier partnership during the upper-tier partnership's taxable year of proceeds of a nonrecourse liability allocable to an increase in the lower-tier partnership's minimum gain are treated as proceeds of a nonrecourse liability of the upper-tier partnership. The increase in the upper-tier partnership's minimum gain (under paragraph (k)(1) of this section) attributable to the receipt of those distributions is, for purposes of paragraph (h) of this section, treated as an increase in the upper-tier partnership's minimum gain arising from encumbering property of the upper-tier partnership with a nonrecourse liability of the upper-tier partnership.

(4) *Nonrecourse deductions of lower-tier partnership treated as depreciation by upper-tier partnership.* For purposes of paragraph (c) of this section, all nonrecourse deductions allocated by the lower-tier partnership to the upper-tier partnership for the upper-tier partnership's taxable year are treated as depreciation or cost recovery deductions with respect to property owned by the upper-tier partnership and subject to a nonrecourse liability of the upper-tier partnership with respect to which minimum gain increased during the year by the amount of the nonrecourse deductions.

(5) *Coordination with partner nonrecourse debt rules.* The lower-tier partnership's liabilities that are treated as the upper-tier partnership's liabilities under §1.752-4(a) are treated as the upper-tier partnership's liabilities for purposes of applying paragraph (i) of this section. Rules consistent with the provisions of paragraphs (k)(1) through (k)(4) of this section apply to determine the allocations that the upper-tier partnership must make with respect to any liability that constitutes a nonrecourse debt for which one or more partners of the upper-tier partnership bear the economic risk of loss.

(1) *Effective/applicability dates.*—(1) *In general.*—(i) *Prospective application.* Except as otherwise provided in this paragraph (1), this section applies for partnership taxable years beginning on or

after December 28, 1991. For the rules applicable to taxable years beginning after December 29, 1988, and before December 28, 1991, see former §1.704-1T(b)(4)(iv). For the rules applicable to taxable years beginning on or before December 29, 1988, see former §1.704-1(b)(4)(iv).

(ii) *Partnerships subject to temporary regulations.* If a partnership agreement entered into after December 29, 1988, and before December 28, 1991, or a partnership agreement entered into on or before December 29, 1988, that elected to apply former §1.704-1T(b)(4)(iv) (as contained in the CFR edition revised as of April 1, 1991), complied with the provisions of former §1.704-1T(b)(4)(iv) before December 28, 1991—

(A) The provisions of former §1.704-1T(b)(4)(iv) continue to apply to the partnership for any taxable year beginning on or after December 28, 1991, (unless the partnership makes an election under paragraph (1)(4) of this section) and ending before any subsequent material modification to the partnership agreement; and

(B) The provisions of this section do not apply to the partnership for any of those taxable years.

(iii) *Partnerships subject to former regulations.* If a partnership agreement entered into on or before December 29, 1988, complied with the provisions of former §1.704-1(b)(4)(iv)(d) on or before that date—

(A) The provisions of former §1.704-1(b)(4)(iv) (a) through (f) continue to apply to the partnership for any taxable year beginning after that date (unless the partnership made an election under §1.704-1T(b)(4)(iv)(m)(4) in a partnership taxable year ending before December 28, 1991, or makes an election under paragraph (1)(4) of this section) and ending before any subsequent material modification to the partnership agreement; and

(B) The provisions of this section do not apply to the partnership for any of those taxable years.

(iv) Paragraph (f)(2), the first sentence of paragraph (g)(3), and the third sentence of paragraph (1)(4) of this section apply to liabilities incurred or assumed by a partnership on or after October 11, 2006 other than liabilities incurred or assumed by a partnership

pursuant to a written binding contract in effect prior to October 11, 2006. The rules applicable to liabilities incurred or assumed (or subject to a binding contract in effect) prior to October 11, 2006 are contained in this section in effect prior to October 11, 2006. (See 26 CFR part 1 revised as of April 1, 2006.)

(v) The first sentence of paragraph (f)(6) of this section and paragraphs (j)(2)(i)(A) and (j)(2)(ii)(A) of this section apply on and after November 17, 2011.

(2) *Special rule applicable to pre-January 30, 1989, related party nonrecourse debt.* For purposes of this section and former §1.704-1T(b)(4)(iv), if—

(i) A partnership liability would, but for this paragraph (1)(2) of this section, constitute a partner nonrecourse debt; and

(ii) Sections 1.752-1 through 1.752-3 or former §§1.752-1T through -3T (whichever is applicable) do not apply to the liability;

the liability is, notwithstanding paragraphs (i) and (b)(4) of this section, treated as a nonrecourse liability of the partnership, and not as a partner nonrecourse debt, to the extent the liability would be so treated under this section (or §1.704-1T(b)(4)(iv)) if the determination of the extent to which one or more partners bears the economic risk of loss for the liability under §1.752-1 or former §1.752-1T were made without regard to the economic risk of loss that any partner would otherwise be considered to bear for the liability by reason of any obligation undertaken or interest as a creditor acquired prior to January 30, 1989, by a person related to the partner (within the meaning of §1.752-4(b) or former §1.752-1T(h)). For purposes of the preceding sentence, if a related person undertakes an obligation or acquires an interest as a creditor on or after January 30, 1989, pursuant to a written binding contract in effect prior to January 30, 1989, and at all times thereafter, the obligation or interest as a creditor is treated as if it were undertaken or acquired prior to January 30, 1989. However, for partnership taxable years beginning on or after December 29, 1988, a pre-January 30, 1989, liability, other than a liability subject to paragraph (1)(3) of this section or former §1.704-1T(b)(4)(iv)(m)(3)

(whichever is applicable), that is treated as grandfathered under former §§1.752-1T through -3T (whichever is applicable) will be treated as a nonrecourse liability for purposes of this section provided that all partners in the partnership consistently treat the liability as nonrecourse for partnership taxable years beginning on or after December 29, 1988.

(3) *Transition rule for pre-March 1, 1984, partner nonrecourse debt.* If a partnership liability would, but for this paragraph (1)(3) or former §1.704-1T(b)(4)(iv), constitute a partner nonrecourse debt and the liability constitutes grandfathered partner nonrecourse debt that is appropriately treated as a nonrecourse liability of the partnership under §1.752-1 (as in effect prior to December 29, 1988)—

(i) The liability is, notwithstanding paragraphs (i) and (b)(4) of this section, former §1.704-1T(b)(4)(iv), and former §1.704-1(b)(4)(iv), treated as a nonrecourse liability of the partnership for purposes of this section and for purposes of former §1.704-1T(b)(4)(iv) and former §1.704-1(b)(4)(iv) to the extent of the amount, if any, by which the smallest outstanding balance of the liability during the period beginning at the end of the first partnership taxable year ending on or after December 31, 1986, and ending at the time of any determination under this paragraph (1)(3)(i) or former §1.704-1T(b)(4)(iv)(m)(3)(i) exceeds the aggregate amount of the adjusted basis (or book value) of partnership property allocable to the liability (determined in accordance with former §1.704-1(b)(4)(iv)(c) (1) and (2) at the end of the first partnership taxable year ending on or after December 31, 1986); and

(ii) In applying this section to the liability, former §1.704-1(b)(4)(iv)(c) (1) and (2) is applied as if all of the adjusted basis of partnership property allocable to the liability is allocable to the portion of the liability that is treated as a partner nonrecourse debt and as if none of the adjusted basis of partnership property that is allocable to the liability is allocable to the portion of the liability that is treated as a nonrecourse liability under this paragraph (1)(3) and former §1.704-1T(b)(4)(iv)(m)(3)(i).

For purposes of the preceding sentence, a grandfathered partner debt is any partnership liability that was not subject to former §§1.752-1T and -3T but that would have been subject to those sections under §1.752-4T(b) if the liability had arisen (other than pursuant to a written binding contract) on or after March 1, 1984. A partnership liability is not considered to have been subject to §§1.752-2T and -3T solely because a portion of the liability was treated as a liability to which those sections apply under §1.752-4(e).

(4) *Election.* A partnership may elect to apply the provisions of this section to the first taxable year of the partnership ending on or after December 28, 1991. An election under this paragraph (1)(4) is made by attaching a written statement to the partnership return for the first taxable year of the partnership ending on or after December 28, 1991. The written statement must include the name, address, and taxpayer identification number of the partnership making the statement and must declare that an election is made under this paragraph (1)(4).

(m) *Examples.* The principles of this section are illustrated by the following examples:

Example 1. Nonrecourse deductions and partnerships minimum gain. For *Example 1*, unless otherwise provided, the following facts are assumed. LP, the limited partner, and GP, the general partner, form a limited partnership to acquire and operate a commercial office building. LP contributes \$180,000, and GP contributes \$20,000. The partnership obtains an \$800,000 nonrecourse loan and purchases the building (on leased land) for \$1,000,000. The nonrecourse loan is secured only by the building, and no principal payments are due for 5 years. The partnership agreement provides that GP will be required to restore any deficit balance in GP's capital account following the liquidation of GP's interest (as set forth in §1.704-1 (b) (2)(ii)(b)(3)), and LP will not be required to restore any deficit balance in LP's capital account following the liquidation of LP's interest. The partnership agreement contains the following provisions required by paragraph (e) of this section: a qualified income offset (as defined in §1.704-1(b)(2)(ii)(d)); a minimum gain chargeback (in accordance with paragraph (f) of this section); a provision that the partners' capital accounts will be determined and maintained in accordance with §1.704-

Internal Revenue Service, Treasury

§ 1.704-2

1(b)(2)(ii)(b)(I); and a provision that distributions will be made in accordance with partners' positive capital account balances (as set forth in § 1.704-1(b)(2)(ii)(b)(2)). In addition, as of the end of each partnership taxable year discussed herein, the items described in § 1.704-1(b)(2)(ii)(d) (4), (5), and (6) are not reasonably expected to cause or increase a deficit balance in LP's capital account. The partnership agreement provides that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, all partnership items will be allocated 90 percent to LP and 10 percent to GP until the first time when the partnership has recognized items of income and gain that exceed the items of loss and deduction it has recognized over its life, and all further partnership items will be allocated equally between LP and GP. Finally, the partnership agreement provides that all distributions, other than distributions in liquidation of the partnership or of a partner's interest in the partnership, will be made 90 percent to LP and 10 percent to GP until a total of \$200,000 has been distributed, and thereafter all the distributions will be made equally to LP and GP. In each of the partnership's first 2 taxable years, it generates rental income of \$95,000, operating expenses (including land lease payments) of \$10,000, interest expense of \$80,000, and a depreciation deduction of \$90,000, resulting in a net taxable loss of \$85,000 in each of those years. The allocations of these losses 90 percent to LP and 10 percent to GP have substantial economic effect.

	LP	GP
Capital account on formation	\$180,000	\$20,000
Less: net loss in years 1 and 2	(153,000)	(17,000)
Capital account at end of year 2	\$27,000	\$3,000

In the partnership's third taxable year, it again generates rental income of \$95,000, operating expenses of \$10,000, interest expense of \$80,000, and a depreciation deduction of \$90,000, resulting in net taxable loss of \$85,000. The partnership makes no distributions.

(i) *Calculation of nonrecourse deductions and partnership minimum gain.* If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the end of the third year, it would realize \$70,000 of gain (\$800,000 amount realized less \$730,000 adjusted tax basis). Because the amount of partnership minimum gain at the end of the third year (and the net increase in partnership minimum gain during the year) is \$70,000, there are partnership nonrecourse deductions for that year of \$70,000, consisting of depreciation deductions allowable with respect to the building of \$70,000. Pursuant to the partnership agreement, all partnership

items comprising the net taxable loss of \$85,000, including the \$70,000 nonrecourse deduction, are allocated 90 percent to LP and 10 percent to GP. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect.

	LP	GP
Capital account at end of year 2	\$27,000	\$3,000
Less: net loss in year 3 (without nonrecourse deductions)	(13,500)	(1,500)
Less: nonrecourse deductions in year 3	(63,000)	(7,000)
Capital account at end of year 3	(\$49,500)	(\$5,500)

The allocation of the \$70,000 nonrecourse deduction satisfies requirement (2) of paragraph (e) of this section because it is consistent with allocations having substantial economic effect of other significant partnership items attributable to the building. Because the remaining requirements of paragraph (e) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be in accordance with the partners' interests in the partnership. At the end of the partnership's third taxable year, LP's and GP's shares of partnership minimum gain are \$63,000 and \$7,000, respectively. Therefore, pursuant to paragraph (g)(1) of this section, LP is treated as obligated to restore a deficit capital account balance of \$63,000, so that in the succeeding year LP could be allocated up to an additional \$13,500 of partnership deductions, losses, and section 705(a)(2)(B) items that are not nonrecourse deductions. Even though this allocation would increase a deficit capital account balance, it would be considered to have economic effect under the alternate economic effect test contained in § 1.704-1(b)(2)(ii)(d). If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the beginning of the partnership's fourth taxable year (and had no other economic activity in that year), the partnership minimum gain would be decreased from \$70,000 to zero, and the minimum gain chargeback would require that LP and GP be allocated \$63,000 and \$7,000, respectively, of the gain from that disposition.

(ii) *Illustration of reasonable consistency requirement.* Assume instead that the partnership agreement provides that all nonrecourse deductions of the partnership will be allocated equally between LP and GP. Furthermore, at the time the partnership agreement is entered into, there is a reasonable likelihood that over the partnership's life it will realize amounts of income and gain significantly in excess of amounts of loss and deduction (other than nonrecourse deductions). The equal allocation of excess income and gain has substantial economic effect.

§ 1.704-2

	LP	GP
Capital account on formation	\$180,000	\$20,000
Less: net loss in years 1 and 2	(153,000)	(17,000)
Less: net loss in year (without nonrecourse deductions)	(13,500)	(1,500)
Less: nonrecourse deductions in year 3	(35,000)	(35,000)
Capital account at end of year 3	(\$21,500)	(\$33,500)

The allocation of the \$70,000 nonrecourse deduction equally between LP and GP satisfies requirement (2) of paragraph (e) of this section because the allocation is consistent with allocations, which will have substantial economic effect, of other significant partnership items attributable to the building. Because the remaining requirements of paragraph (e) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be in accordance with the partners' interests in the partnership. The allocation of the nonrecourse deductions 75 percent to LP and 25 percent to GP (or in any other ratio between 90 percent to LP/10 percent to GP and 50 percent to LP/50 percent to GP) also would satisfy requirement (2) of paragraph (e) of this section.

(iii) *Allocation of nonrecourse deductions that fails reasonable consistency requirement.* Assume instead that the partnership agreement provides that LP will be allocated 99 percent, and GP 1 percent, of all nonrecourse deductions of the partnership. Allocating nonrecourse deductions this way does not satisfy requirement (2) of paragraph (e) of this section because the allocations are not reasonably consistent with allocations, having substantial economic effect, of any other significant partnership item attributable to the building. Therefore, the allocation of nonrecourse deductions will be disregarded, and the nonrecourse deductions of the partnership will be reallocated according to the partners' overall economic interests in the partnership, determined under § 1.704-1(b)(3)(ii).

(iv) *Capital contribution to pay down nonrecourse debt.* At the beginning of the partnership's fourth taxable year, LP contributes \$144,000 and GP contributes \$16,000 of addition capital to the partnership, which the partnership immediately uses to reduce the amount of its nonrecourse liability from \$800,000 to \$640,000. In addition, in the partnership's fourth taxable year, it generates rental income of \$95,000, operating expenses of \$10,000, interest expense of \$64,000 (consistent with the debt reduction), and a depreciation deduction of \$90,000, resulting in a net taxable loss of \$69,000. If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the end of that year, it would realize no gain (\$640,000 amount realized less \$640,000 ad-

26 CFR Ch. I (4-1-12 Edition)

justed tax basis). Therefore, the amount of partnership minimum gain at the end of the year is zero, which represents a net decrease in partnership minimum gain of \$70,000 during the year. LP's and GP's shares of this net decrease are \$63,000 and \$7,000 respectively, so that at the end of the partnership's fourth taxable year, LP's and GP's shares of partnership minimum gain are zero. Although there has been a net decrease in partnership minimum gain, pursuant to paragraph (f)(3) of this section LP and GP are not subject to a minimum gain chargeback.

	LP	GP
Capital account at end of year 3	(\$49,500)	(\$5,500)
Plus: contribution	144,000	16,000
Less: net loss in year 4	(62,100)	(6,900)
Capital account at end of year 4	\$32,400	\$3,600
Minimum gain chargeback carryforward	\$0	\$0

(v) *Loans of unequal priority.* Assume instead that the building acquired by the partnership is secured by a \$700,000 nonrecourse loan and a \$100,000 recourse loan, subordinate in priority to the nonrecourse loan. Under paragraph (d)(2) of this section, \$700,000 of the adjusted basis of the building at the end of the partnership's third taxable year is allocated to the nonrecourse liability (with the remaining \$30,000 allocated to the recourse liability) so that if the partnership disposed of the building in full satisfaction of the nonrecourse liability at the end of that year, it would realize no gain (\$700,000 amount realized less \$700,000 adjusted tax basis). Therefore, there is no minimum gain (or increase in minimum gain) at the end of the partnership's third taxable year. If, however, the \$700,000 nonrecourse loan were subordinate in priority to the \$100,000 recourse loan, under paragraph (d)(2) of this section, the first \$100,000 of adjusted tax basis in the building would be allocated to the recourse liability, leaving only \$630,000 of the adjusted basis of the building to be allocated to the \$700,000 nonrecourse loan. In that case, the balance of the \$700,000 nonrecourse liability would exceed the adjusted tax basis of the building by \$70,000, so that there would be \$70,000 of minimum gain (and a \$70,000 increase in partnership minimum gain) in the partnership's third taxable year.

(vi) *Nonrecourse borrowing; distribution of proceeds in subsequent year.* The partnership obtains an additional nonrecourse loan of \$200,000 at the end of its fourth taxable year, secured by a second mortgage on the building, and distributes \$180,000 of this cash to its partners at the beginning of its fifth taxable year. In addition, in its fourth and fifth taxable years, the partnership again generates rental income of \$95,000, operating expenses of \$10,000, interest expense of \$80,000 (\$100,000 in the fifth taxable year reflecting

the interest paid on both liabilities), and a depreciation deduction of \$90,000, resulting in a net taxable loss of \$85,000 (\$105,000 in the fifth taxable year reflecting the interest paid on both liabilities). The partnership has distributed its \$5,000 of operating cash flow in each year (\$95,000 of rental income less \$10,000 of operating expense and \$80,000 of interest expense) to LP and GP at the end of each year. If the partnership were to dispose of the building in full satisfaction of both nonrecourse liabilities at the end of its fourth taxable year, the partnership would realize \$360,000 of gain (\$1,000,000 amount realized less \$640,000 adjusted tax basis). Thus, the net increase in partnership minimum gain during the partnership's fourth taxable year is \$290,000 (\$360,000 of minimum gain at the end of the fourth year less \$70,000 of minimum gain at the end of the third year). Because the partnership did not distribute any of the proceeds of the loan it obtained in its fourth year during that year, the potential amount of partnership nonrecourse deductions for that year is \$290,000. Under paragraph (c) of this section, if the partnership had distributed the proceeds of that loan to its partners at the end of its fourth year, the partnership's nonrecourse deductions for that year would have been reduced by the amount of that distribution because the proceeds of that loan are allocable to an increase in partnership minimum gain under paragraph (h)(1) of this section. Because the nonrecourse deductions of \$290,000 for the partnership's fourth taxable year exceed its total deductions for that year, all \$180,000 of the partnership's deductions for that year are treated as nonrecourse deductions, and the \$110,000 excess nonrecourse deductions are treated as an increase in partnership minimum gain in the partnership's fifth taxable year under paragraph (c) of this section.

	LP	GP
Capital account at end of year 3 (including cash flow distributions)	(\$63,000)	(\$7,000)
Plus: rental income in year 4	85,500	9,500
Less: nonrecourse deductions in year 4	(162,000)	(18,000)
Less: cash flow distributions in year 4	(4,500)	(500)
Capital account at end of year 4	(\$144,000)	(\$16,000)

At the end of the partnership's fourth taxable year, LP's and GP's shares of partnership minimum gain are \$225,000 and \$25,000, respectively (because the \$110,000 excess of nonrecourse deductions is carried forward to the next year). If the partnership were to dispose of the building in full satisfaction of the nonrecourse liabilities at the end of its fifth taxable year, the partnership would realize \$450,000 of gain (\$1,000,000 amount realized less \$550,000 adjusted tax basis). Therefore, the net increase in partnership minimum

gain during the partnership's fifth taxable year is \$200,000 (\$110,000 deemed increase plus the \$90,000 by which minimum gain at the end of the fifth year exceeds minimum gain at the end of the fourth year (\$450,000 less \$360,000)). At the beginning of its fifth year, the partnership distributes \$180,000 of the loan proceeds (retaining \$20,000 to pay the additional interest expense). Under paragraph (h) of this section, the first \$110,000 of this distribution (an amount equal to the deemed increase in partnership minimum gain for the year) is considered allocable to an increase in partnership minimum gain for the year. As a result, the amount of nonrecourse deductions for the partnership's fifth taxable year is \$90,000 (\$200,000 net increase in minimum gain less \$110,000 distribution of nonrecourse liability proceeds allocable to an increase in partnership minimum gain), and the nonrecourse deductions consist solely of the \$90,000 depreciation deduction allowable with respect to the building. As a result of the distributions during the partnership's fifth taxable year, the total distributions to the partners over the partnership's life equal \$205,000. Therefore, the last \$5,000 distributed to the partners during the fifth year will be divided equally between them under the partnership agreement. Thus, out of the \$185,000 total distribution during the partnership's fifth taxable year, the first \$180,000 is distributed 90 percent to LP and 10 percent to GP, and the last \$5,000 is divided equally between them.

	LP	GP
Capital account at end of year 4	(\$144,000)	(\$16,000)
Less: net loss in year 5 (without nonrecourse deductions)	(13,500)	(1,500)
Less: nonrecourse deductions in year 5	(81,000)	(9,000)
Less: distribution of loan proceeds	(162,000)	(18,000)
Less: cash flow distribution in year 5	(2,500)	(2,500)
Capital account at end of year 5	(\$403,000)	(\$47,000)

At the end of the partnership's fifth taxable year, LP's share of partnership minimum gain is \$405,000 (\$225,000 share of minimum gain at the end of the fourth year plus \$81,000 of nonrecourse deductions for the fifth year and a \$99,000 distribution of nonrecourse liability proceeds that are allocable to an increase in minimum gain) and GP's share of partnership minimum gain is \$45,000 (\$25,000 share of minimum gain at the end of the fourth year plus \$9,000 of nonrecourse deductions for the fifth year and an \$11,000 distribution of nonrecourse liability proceeds that are allocable to an increase in minimum gain).

(vii) *Partner guarantee of nonrecourse debt.* LP and GP personally guarantee the "first" \$100,000 of the \$800,000 nonrecourse loan (*i.e.*,

only if the building is worth less than \$100,000 will they be called upon to make up any deficiency). Under paragraph (d)(2) of this section, only \$630,000 of the adjusted tax basis of the building is allocated to the \$700,000 nonrecourse portion of the loan because the collateral will be applied first to satisfy the \$100,000 guaranteed portion, making it superior in priority to the remainder of the loan. On the other hand, if LP and GP were to guarantee the “last” \$100,000 (*i.e.*, if the building is worth less than \$800,000, they will be called upon to make up the deficiency up to \$100,000), \$700,000 of the adjusted tax basis of the building would be allocated to the \$700,000 nonrecourse portion of the loan because the guaranteed portion would be inferior in priority to it.

(viii) *Partner nonrecourse debt.* Assume instead that the \$800,000 loan is made by LP, the limited partner. Under paragraph (b)(4) of this section, the \$800,000 obligation does not constitute a nonrecourse liability of the partnership for purposes of this section because LP, a partner, bears the economic risk of loss for that loan within the meaning of § 1.752-2. Instead, the \$800,000 loan constitutes a partner nonrecourse debt under paragraph (b)(4) of this section. In the partnership’s third taxable year, partnership minimum gain would have increased by \$70,000 if the debt were a nonrecourse liability of the partnership. Thus, under paragraph (i)(3) of this section, there is a net increase of \$70,000 in the minimum gain attributable to the \$800,000 partner nonrecourse debt for the partnership’s third taxable year, and \$70,000 of the \$90,000 depreciation deduction from the building for the partnership’s third taxable year constitutes a partner nonrecourse deduction with respect to the debt. See paragraph (i)(4) of this section. Under paragraph (i)(2) of this section, this partner nonrecourse deduction must be allocated to LP, the partner that bears the economic risk of loss for that liability.

(ix) *Nonrecourse debt and partner nonrecourse debt of differing priorities.* As in Example 1 (viii) of this paragraph (m), the \$800,000 loan is made to the partnership by LP, the limited partner, but the loan is a purchase money loan that “wraps around” a \$700,000 underlying nonrecourse note (also secured by the building) issued by LP to an unrelated person in connection with LP’s acquisition of the building. Under these circumstances, LP bears the economic risk of loss with respect to only \$100,000 of the liability within the meaning of § 1.752-2. See § 1.752-2(f) (Example 6). Therefore, for purposes of paragraph (d) of this section, the \$800,000 liability is treated as a \$700,000 nonrecourse liability of the partnership and a \$100,000 partner nonrecourse debt (inferior in priority to the \$700,000 liability) of the partnership for which LP bears the economic risk of loss. Under paragraph (i)(2) of this section, \$70,000

of the \$90,000 depreciation deduction realized in the partnership’s third taxable year constitutes a partner nonrecourse deduction that must be allocated to LP.

Example. 2. Netting of increases and decreases in partnership minimum gain. For Example 2 unless otherwise provided, the following facts are assumed. X and Y form a general partnership to acquire and operate residential real properties. Each partner contributes \$150,000 to the partnership. The partnership obtains a \$1,500,000 nonrecourse loan and purchases 3 apartment buildings (on leased land) for \$720,000 (“Property A”), \$540,000 (“Property B”), and \$540,000 (“Property C”). The nonrecourse loan is secured only by the 3 buildings, and no principal payments are due for 5 years. In each of the partnership’s first 3 taxable years, it generates rental income of \$225,000, operating expenses (including land lease payments) of \$50,000, interest expense of \$175,000, and depreciation deductions on the 3 properties of \$150,000 (\$60,000 on Property A and \$45,000 on each of Property B and Property C), resulting in a net taxable loss of \$150,000 in each of those years. The partnership makes no distributions to X or Y.

(i) *Calculation of net increases and decreases in partnership minimum gain.* If the partnership were to dispose of the 3 apartment buildings in full satisfaction of its nonrecourse liability at the end of its third taxable year, it would realize \$150,000 of gain (\$1,500,000 amount realized less \$1,350,000 adjusted tax basis). Because the amount of partnership minimum gain at the end of that year (and the net increase in partnership minimum gain during that year) is \$150,000, the amount of partnership nonrecourse deductions for that year is \$150,000, consisting of depreciation deductions allowable with respect to the 3 apartment buildings of \$150,000. The result would be the same if the partnership obtained 3 separate nonrecourse loans that were “cross-collateralized” (*i.e.*, if each separate loan were secured by all 3 of the apartment buildings).

(ii) *Netting of increases and decreases in partnership minimum gain when there is a disposition.* At the beginning of the partnership’s fourth taxable year, the partnership (with the permission of the nonrecourse lender) disposes of Property A for \$835,000 and uses a portion of the proceeds to repay \$600,000 of the nonrecourse liability (the principal amount attributable to Property A), reducing the balance to \$900,000. As a result of the disposition, the partnership realizes gain of \$295,000 (\$835,000 amount realized less \$540,000 adjusted tax basis). If the disposition is viewed in isolation, the partnership has generated minimum gain of \$60,000 on the sale of Property A (\$600,000 of debt reduction less \$540,000 adjusted tax basis). However, during the partnership’s fourth taxable year it also generates rental income of \$135,000, operating expenses of \$30,000, interest expense of

Internal Revenue Service, Treasury

§ 1.704-2

\$105,000, and depreciation deductions of \$90,000 (\$45,000 on each remaining building). If the partnership were to dispose of the remaining two buildings in full satisfaction of its nonrecourse liability at the end of the partnership's fourth taxable year, it would realize gain of \$180,000 (\$900,000 amount realized less \$720,000 aggregate adjusted tax basis), which is the amount of partnership minimum gain at the end of the year. Because the partnership minimum gain increased from \$150,000 to \$180,000 during the partnership's fourth taxable year, the amount of partnership nonrecourse deductions for that year is \$30,000, consisting of a ratable portion of depreciation deductions allowable with respect to the two remaining apartment buildings. No minimum gain chargeback is required for the taxable year, even though the partnership disposed of one of the properties subject to the nonrecourse liability during the year, because there is no net decrease in partnership minimum gain for the year. See paragraph (f)(1) of this section.

Example. 3. Nonrecourse deductions and partnership minimum gain before third partner is admitted. For purposes of Example 3, unless otherwise provided, the following facts are assumed. Additional facts are given in each of Examples 3 (ii), (iii), and (iv). A and B form a limited partnership to acquire and lease machinery that is 5-year recovery property. A, the limited partner, and B, the general partner, contribute \$100,000 each to the partnership, which obtains an \$800,000 nonrecourse loan and purchases the machinery for \$1,000,000. The nonrecourse loan is secured only by the machinery. The principal amount of the loan is to be repaid \$50,000 per year during each of the partnership's first 5 taxable years, with the remaining \$550,000 of unpaid principal due on the first day of the partnership's sixth taxable year. The partnership agreement contains all of the provisions required by paragraph (e) of this section, and, as of the end of each partnership taxable year discussed herein, the items described in § 1.704-1(b)(2)(i)(d) (4), (5), and (6) are not reasonably expected to cause or increase a deficit balance in A's or B's capital account. The partnership agreement provides that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, all partnership items will be allocated equally between A and B. Finally, the partnership agreement provides that all distributions, other than distributions in liquidation of the partnership or of a partner's interest in the partnership, will be made equally between A and B. In the partnership's first taxable year it generates rental income of \$130,000, interest expense of \$80,000, and a depreciation deduction of \$150,000, resulting in a net taxable loss of \$100,000. In addition, the partnership repays \$50,000 of the nonrecourse liability, reducing

that liability to \$750,000. Allocations of these losses equally between A and B have substantial economic effect.

	A	B
Capital account on formation	\$100,000	\$100,000
Less: net loss in year 1 ..	(50,000)	(50,000)
Capital account at end of year 1 ...	\$50,000	\$50,000

In the partnership's second taxable year, it generates rental income of \$130,000, interest expense of \$75,000, and a depreciation deduction of \$220,000, resulting in a net taxable loss of \$165,000. In addition, the partnership repays \$50,000 of the nonrecourse liability, reducing that liability to \$700,000, and distributes \$2,500 of cash to each partner. If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the end of that year, it would realize \$70,000 of gain (\$700,000 amount realized less \$630,000 adjusted tax basis). Therefore, the amount of partnership minimum gain at the end of that year (and the net increase in partnership minimum gain during the year) is \$70,000, and the amount of partnership nonrecourse deductions for the year is \$70,000. The partnership nonrecourse deductions for its second taxable year consist of \$70,000 of the depreciation deductions allowable with respect to the machinery. Pursuant to the partnership agreement, all partnership items comprising the net taxable loss of \$165,000, including the \$70,000 nonrecourse deduction, are allocated equally between A and B. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect.

	A	B
Capital account at end of year 1	\$50,000	\$50,000
Less: net loss in year 2 (without nonrecourse deductions)	(47,500)	(47,500)
Less: nonrecourse deductions in year 2	(35,000)	(35,000)
Less: distribution	(2,500)	(2,500)
Capital account at end of year 2	(\$35,000)	(\$35,000)

(i) *Calculation of nonrecourse deductions and partnership minimum gain.* Because all of the requirements of paragraph (e) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be made in accordance with the partners' interests in the partnership. At the end of the partnership's second taxable year, A's and B's shares of partnership minimum gain are \$35,000 each. Therefore, pursuant to paragraph (g)(1) of this section, A and B are treated as obligated to restore deficit balances in their capital accounts of \$35,000 each. If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the beginning of the partnership's third taxable

year (and had no other economic activity in that year), the partnership minimum gain would be decreased from \$70,000 to zero. A's and B's shares of that net decrease would be \$35,000 each. Upon that disposition, the minimum gain chargeback would require that A and B each be allocated \$35,000 of that gain before any other allocation is made under section 704 (b) with respect to partnership items for the partnership's third taxable year.

(ii) *Nonrecourse deductions and restatement of capital accounts.* (a) *Additional facts.* C is admitted to the partnership at the beginning of the partnership's third taxable year. At the time of C's admission, the fair market value of the machinery is \$900,000. C contributes \$100,000 to the partnership (the partnership invests \$95,000 of this in undeveloped land and holds the other \$5,000 in cash) in exchange for an interest in the partnership. In connection with C's admission to the partnership, the partnership's machinery is revalued on the partnership's books to reflect its fair market value of \$900,000. Pursuant to § 1.704-1(b)(2)(iv)(f), the capital accounts of A and B are adjusted upwards to \$100,000 each to reflect the revaluation of the partnership's machinery. This adjustment reflects the manner in which the partnership gain of \$270,000 (\$900,000 fair market value minus \$630,000 adjusted tax basis) would be shared if the machinery were sold for its fair market value immediately prior to C's admission to the partnership.

	A	B
Capital account before C's admission	(\$35,000)	(\$35,000)
Deemed sale adjustment	135,000	135,000
Capital account adjusted for C's admission	\$100,000	\$100,000

The partnership agreement is modified to provide that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, partnership income, gain, loss, and deduction, as computed for book purposes, are allocated equally among the partners, and those allocations are reflected in the partners' capital accounts. The partnership agreement also is modified to provide that depreciation and gain or loss, as computed for tax purposes, with respect to the machinery will be shared among the partners in a manner that takes account of the variation between the property's \$630,000 adjusted tax basis and its \$900,000 book value, in accordance with § 1.704-1(b)(2)(iv)(f) and the special rule contained in § 1.704-1(b)(4)(i).

(b) *Effect of revaluation.* Because the requirements of § 1.704-1(b)(2)(iv)(g) are satisfied, the capital accounts of the partners (as adjusted) continue to be maintained in accordance with § 1.704-1(b)(2)(iv). If the part-

nership were to dispose of the machinery in full satisfaction of the nonrecourse liability immediately following the revaluation of the machinery, it would realize no book gain (\$700,000 amount realized less \$900,000 book value). As a result of the revaluation of the machinery upward by \$270,000, under part (i) of paragraph (d)(4) of this section, the partnership minimum gain is reduced from \$70,000 immediately prior to the revaluation to zero; but under part (ii) of paragraph (d)(4) of this section, the partnership minimum gain is increased by the \$70,000 decrease arising solely from the revaluation. Accordingly, there is no net increase or decrease solely on account of the revaluation, and so no minimum gain chargeback is triggered. All future nonrecourse deductions that occur will be the nonrecourse deductions as calculated for book purposes, and will be charged to all 3 partners in accordance with the partnership agreement. For purposes of determining the partners' shares of minimum gain under paragraph (g) of this section, A's and B's shares of the decrease resulting from the revaluation are \$35,000 each. However, as illustrated below, under section 704(c) principles, the tax capital accounts of A and B will eventually be charged \$35,000 each, reflecting their 50 percent shares of the decrease in partnership minimum gain that resulted from the revaluation.

(iii) *Allocation of nonrecourse deductions following restatement of capital accounts.* (a) *Additional facts.* During the partnership's third taxable year, the partnership generates rental income of \$130,000, interest expense of \$70,000, a tax depreciation deduction of \$210,000, and a book depreciation deduction (attributable to the machinery) of \$300,000. As a result, the partnership has a net taxable loss of \$150,000 and a net book loss of \$240,000. In addition, the partnership repays \$50,000 of the nonrecourse liability (after the data of C's admission), reducing the liability to \$650,000 and distributes \$5,000 of cash to each partner.

(b) *Allocations.* If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the end of the year, \$50,000 of book gain would result (\$650,000 amount realized less \$600,000 book basis). Therefore, the amount of partnership minimum gain at the end of the year is \$50,000, which represents a net decrease in partnership minimum gain of \$20,000 during the year. (This is so even though there would be an increase in partnership minimum gain in the partnership's third taxable year if minimum gain were computed with reference to the adjusted tax basis of the machinery.) Nevertheless, pursuant to paragraph (d)(4) of this section, the amount of nonrecourse deductions of the partnership for its third taxable year is \$50,000 (the net increase in partnership minimum gain during the year determined by adding back the \$70,000 decrease in

Internal Revenue Service, Treasury

§ 1.704-2

partnership minimum gain attributable to the revaluation of the machinery to the \$20,000 net decrease in partnership minimum gain during the year). The \$50,000 of partnership nonrecourse deductions for the year consist of book depreciation deductions allowable with respect to the machinery of \$50,000. Pursuant to the partnership agreement, all partnership items comprising the net book loss of \$240,000, including the \$50,000 nonrecourse deduction, are allocated equally

among the partners. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in § 1.704-1(b)(4)(i), the partnership agreement provides that the depreciation deduction for tax purposes of \$210,000 for the partnership's third taxable year is, in accordance with section 704(c) principles, shared \$55,000 to A, \$55,000 to B, and \$100,000 to C.

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	(\$35,000)	\$100,000	(\$35,000)	\$100,000	\$100,000	\$100,000
Less: nonrecourse deductions	(9,166)	(16,666)	(9,166)	(16,666)	(16,666)	(16,666)
Less: items other than nonrecourse deductions in year 3	(25,834)	(63,334)	(25,834)	(63,334)	(63,334)	(63,334)
Less: distribution	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)
Capital account at end of year 3	(\$75,000)	\$15,000	(\$75,000)	\$15,000	\$15,000	\$15,000

Because the requirements of paragraph (e) of this section are satisfied, the allocation of the nonrecourse deduction is deemed to be made in accordance with the partners' interests in the partnership. At the end of the partnership's third taxable year, A's, B's, and C's shares of partnership minimum gain are \$16,666 each.

(iv) *Subsequent allocation of nonrecourse deductions following restatement of capital accounts.* (a) *Additional facts.* The partners' capital accounts at the end of the second and third taxable years of the partnership are as stated in Example 3(iii) of this paragraph (m). In addition, during the partnership's fourth taxable year the partnership generates rental income of \$130,000, interest expense of \$65,000, a tax depreciation deduction of \$210,000, and a book depreciation deduction (attributable to the machinery) of \$300,000. As a result, the partnership has a net taxable loss of \$145,000 and a net book loss of \$235,000. In addition, the partnership repays \$50,000 of the nonrecourse liability, reducing that liability to \$600,000, and distributes \$5,000 of cash to each partner.

(b) *Allocations.* If the partnership were to dispose of the machinery in full satisfaction

of the nonrecourse liability at the end of the fourth year, \$300,000 of book gain would result (\$600,000 amount realized less \$300,000 book value). Therefore, the amount of partnership minimum gain as of the end of the year is \$300,000, which represents a net increase in partnership minimum gain during the year of \$250,000. Thus, the amount of partnership nonrecourse deductions for that year equals \$250,000, consisting of book depreciation deductions of \$250,000. Pursuant to the partnership agreement, all partnership items comprising the net book loss of \$235,000, including the \$250,000 nonrecourse deduction, are allocated equally among the partners. That allocation of all items, other than the nonrecourse deductions, has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in § 1.704-1(b)(4)(i), the partnership agreement provides that the depreciation deduction for tax purposes of \$210,000 in the partnership's fourth taxable year is, in accordance with section 704(c) principles, allocated \$55,000 to A, \$55,000 to B, and \$100,000 to C.

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Capital account at end year 3	(\$75,000)	\$15,000	(\$75,000)	\$15,000	\$15,000	\$15,000
Less: nonrecourse deductions	(45,833)	(83,333)	(45,833)	(83,333)	(83,333)	(83,333)
Plus: items other than nonrecourse deduction in year 4	12,499	5,000	12,499	5,000	5,000	5,000
Less: distribution	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)
Capital account at end of year 4	(\$113,334)	(\$68,333)	(\$113,333)	(\$68,333)	(\$68,333)	(\$68,333)

§ 1.704-2

26 CFR Ch. I (4-1-12 Edition)

The allocation of the \$250,000 nonrecourse deduction equally among A, B, and C satisfies requirement (2) of paragraph (e) of this section. Because all of the requirements of paragraph (e) of this section are satisfied, the allocation is deemed to be in accordance with the partners' interests in the partnership. At the end of the partnership's fourth taxable year, A's, B's, and C's shares of partnership minimum gain are \$100,000 each.

(v) *Disposition of partnership property following restatement of capital accounts.* (a) *Additional facts.* The partners' capital accounts at the end of the fourth taxable year of the partnership are as stated above in (iv). In addition, at the beginning of the partnership's fifth taxable year it sells the machinery for \$650,000 (using \$600,000 of the proceeds to repay the nonrecourse liability), resulting in a taxable gain of \$440,000 (\$650,000 amount realized less \$210,000 adjusted tax basis) and a book gain of \$350,000 (\$650,000 amount realized less \$300,000 book basis). The partnership has no other items of income, gain, loss, or deduction for the year.

(b) *Effect of disposition.* As a result of the sale, partnership minimum gain is reduced from \$300,000 to zero, reducing A's, B's, and C's shares of partnership minimum gain to zero from \$100,000 each. The minimum gain chargeback requires that A, B, and C each be allocated \$100,000 of that gain (an amount equal to each partner's share of the net decrease in partnership minimum gain resulting from the sale) before any allocation is made to them under section 704(b) with respect to partnership items for the partnership's fifth taxable year. Thus, the allocation of the first \$300,000 of book gain \$100,000 to each of the partners is deemed to be in accordance with the partners' interests in the partnership under paragraph (e) of this section. The allocation of the remaining \$50,000 of book gain equally among the partners has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in § 1.704-1(b)(4)(i), the partnership agreement provides that the \$440,000 taxable gain is, in accordance with section 704(c) principles, allocated \$161,667 to A, \$161,667 to B, and \$116,666 to C.

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Capital account at end of year 4	(\$113,334)	(\$68,333)	(\$113,334)	(\$68,333)	(\$68,333)	(\$68,333)
Plus: minimum gain chargeback	138,573	100,000	138,573	100,000	100,000	100,000
Plus: additional gain	23,094	16,666	23,094	16,666	16,666	16,666
Capital account before liquidation	\$48,333	\$48,333	\$48,333	\$48,333	\$48,333	\$48,333

Example. 4. Allocations of increase in partnership minimum gain among partnership properties. For *Example 4*, unless otherwise provided, the following facts are assumed. A partnership owns 4 properties, each of which is subject to a nonrecourse liability of the partnership. During a taxable year of the partnership, the following events take place. First, the partnership generates a depreciation deduction (for both book and tax purposes) with respect to Property W of \$10,000 and repays \$5,000 of the nonrecourse liability secured only by that property, resulting in an increase in minimum gain with respect to that liability of \$5,000. Second, the partnership generates a depreciation deduction (for both book and tax purposes) with respect to Property X of \$10,000 and repays none of the nonrecourse liability secured by that property, resulting in an increase in minimum gain with respect to that liability of \$10,000. Third, the partnership generates a depreciation deduction (for both book and tax purposes) of \$2,000 with respect to Property Y and repays \$11,000 of the nonrecourse liability secured only by that property, resulting in a decrease in minimum gain with respect to that liability of \$9,000 (although at the end of that year, there remains minimum

gain with respect to that liability). Finally, the partnership borrows \$5,000 on a nonrecourse basis, giving as the only security for that liability Property Z, a parcel of undeveloped land with an adjusted tax basis (and book value) of \$2,000, resulting in a net increase in minimum gain with respect to that liability of \$3,000.

(i) *Allocation of increase in partnership minimum gain.* The net increase in partnership minimum gain during that partnership taxable year is \$9,000, so that the amount of nonrecourse deductions of the partnership for that taxable year is \$9,000. Those nonrecourse deductions consist of \$3,000 of depreciation deductions with respect to Property W and \$6,000 of depreciation deductions with respect to Property X. See paragraph (c) of this section. The amount of nonrecourse deductions consisting of depreciation deductions is determined as follows. With respect to the nonrecourse liability secured by Property Z, for which there is no depreciation deduction, the amount of depreciation deductions that constitutes nonrecourse deductions is zero. Similarly, with respect to the nonrecourse liability secured by Property Y, for which there is no increase in minimum gain, the amount of depreciation deductions

that constitutes nonrecourse deductions is zero. With respect to each of the nonrecourse liabilities secured by Properties W and X, which are secured by property for which there are depreciation deductions and for which there is an increase in minimum gain, the amount of depreciation deductions that constitutes nonrecourse deductions is determined by the following formula:

net increase in the partnership minimum gain for that taxable year X total depreciation deductions for that taxable year on the specific property securing the nonrecourse liability to the extent minimum gain increased on that liability (divided by) total depreciation deductions for that taxable year on all properties securing nonrecourse liabilities to the extent of the aggregate increase in minimum gain on all those liabilities.

Thus, for the liability secured by Property W, the amount is \$9,000 times \$5,000/\$15,000, or \$3,000. For the liability secured by Property X, the amount is \$9,000 times \$10,000/\$15,000, or \$6,000. (If one depreciable property secured two partnership nonrecourse liabilities, the amount of depreciation or book depreciation with respect to that property would be allocated among those liabilities in accordance with the method by which adjusted basis is allocated under paragraph (d)(2) of this section).

(ii) *Alternative allocation of increase in partnership minimum gain among partnership properties.* Assume instead that the loan secured by Property Z is \$15,000 (rather than \$5,000), resulting in a net increase in minimum gain with respect to that liability of \$13,000. Thus, the net increase in partnership minimum gain is \$19,000, and the amount of nonrecourse deductions of the partnership for that taxable year is \$19,000. Those nonrecourse deductions consist of \$5,000 of depreciation deductions with respect to Property W, \$10,000 of depreciation deductions with respect to Property X, and a pro rata portion of the partnership's other items of deduction, loss, and section 705(a)(2)(B) expenditure for that year. The method for computing the amounts of depreciation deductions that constitute nonrecourse deductions is the same as in (i) of this *Example 4* for the liabilities secured by Properties Y and Z. With respect to each of the nonrecourse liabilities secured by Properties W and X, the amount of depreciation deductions that constitutes nonrecourse deductions equals the total depreciation deductions with respect to the partnership property securing that particular liability to the extent of the increase

in minimum gain with respect to that liability.

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§ 1.704-3 Contributed property.

(a) *In general*—(1) *General principles.* The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Under section 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution. Notwithstanding any other provision of this section, the allocations must be made using a reasonable method that is consistent with the purpose of section 704(c). For this purpose, an allocation method includes the application of all of the rules of this section (e.g., aggregation rules). An allocation method is not necessarily unreasonable merely because another allocation method would result in a higher aggregate tax liability. Paragraphs (b), (c), and (d) of this section describe allocation methods that are generally reasonable. Other methods may be reasonable in appropriate circumstances. Nevertheless, in the absence of specific published guidance, it is not reasonable to use an allocation method in which the basis of property contributed to the partnership is increased (or decreased) to reflect built-in gain (or loss), or a method under which the partnership creates tax allocations of income, gain, loss, or deduction independent of allocations affecting book capital accounts. See § 1.704-3(d). Paragraph (e) of this section contains special rules and exceptions. The principles of this paragraph (a)(1), together with the methods described in paragraphs (b), (c) and (d) of this section, apply only to contributions of property that are otherwise respected. See for example § 1.701-2. Accordingly, even though a partnership's allocation method may be described in