PHANTOM GAIN – IT'S MAGIC

"MINIMUM" GAIN ARISING FROM PARTNERSHIP NONRECOURSE DEBT

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Section 702(a) provides a list of items arising from partnership operations that are to be separately distributed to each partner. Subsequently, the partner takes into account his distributive share of the partnership items in determining his income tax.

Unlike a corporation, where profits must be distributed based on a stock ownership percentage, a partnership agreement may allow custom allocations of income and expenses to flow through to the partners. These customized distributions do not have to be proportional to a partner's interest in the partnership. Furthermore, since liquidating distributions to the partners are made in accordance to the partners' capital accounts, legitimate economic allocations are necessary under the Code. As an ongoing matter, a partnership usually maintains capital accounts for each partner to properly reflect the economic allocations among the partners.

While a partner's distributive share of partnership items is determined by the partnership agreement, Section 704(b) is the starting point to determine the validity of allocations to the partners. The allocations are respected under 704(b) if the allocations conform to one of the three criteria under the Regulations:

1. the allocation is in accordance with the partner's interest in the partnership,
2. the allocation has substantial economic effect or,
3. the allocation is deemed to be in accordance with the partner's interest in the partnership (a facts and circumstances test)

Of the three provisions to validate an allocation, the primary method provided by the Regulations under 704(b) is the substantial economic effect test. The substantial economic effect test consists of a two-part test made at the end of the taxable year of the allocation. The two-part test requires that the tax allocation have economic effect and that the economic effect be substantial. The Regulations further state various requirements for meeting the economic effect test and the substantiality test.

Additionally, Treasury Regulation 1.704-2 contains rules to allocate deductions and losses attributable to non-recourse debt. Since partners aren't liable for nonrecourse debt, deductions and losses from nonrecourse debt do not create any economic effect. Specifically, an economic effect is established when a tax burden results from an allocation of income or gain or a tax benefit arises from a loss allocation. Since a creditor alone bears any economic burden from the nonrecourse debt, any deduction allocations do not result in an economic effect. Therefore, the taxpayer must then attempt to allocate nonrecourse deductions in accordance with the partner's interest in the partnership.

While determining the allocation of non-recourse deductions, the proper amount of minimum gain must also be calculated. Minimum gain provides tax responsibility for allocations of nonrecourse deductions. When a partner receives a non-recourse deduction, a proper share of minimum gain should also be provided to that partner. 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. Simply put, minimum gain is the excess of nonrecourse debt over the basis of property subject to debt.

Minimum gain arises when depreciation deductions decrease the partnership's basis below the balance of the nonrecourse debt. For example, if a building is purchased through nonrecourse financing for $800,000 and year 1 depreciation is $200,000, the basis would equal $600,000. Following *Commissioner v. Tufts*, nonrecourse debt, not the fair market value of the property, is used to determine the taxable gain upon disposition of the property. Consequently, a hypothetical sale of the property would result in a minimum gain of $200,000. This phantom or minimum gain must be allocated along with the corresponding nonrecourse deduction of $200,000.

However, often the potential taxable gain realized upon disposition of the property is not the gain used to determine the partnership minimum gain. If any of the partnership properties has a book basis that is different than its tax basis, then the book basis (capital account value) is used to determine minimum gain. Simply, the book gain is difference between the nonrecourse liability and the book value of the property. As an example, after a partner contributes property with a FMV of $10,000 and a tax basis of $6,000 to the partnership, the partnership uses the property as collateral to acquire a $10,000 nonrecourse debt. Under this example, there is no minimum gain because the book basis of $10,000 equals the amount of the nonrecourse debt.

Minimum gain attributable to a property may also decrease. A decrease results when there are reductions in the amount by which the nonrecourse liability exceeds the basis of the property. Such a decrease would occur when the basis of the property increases or upon the decrease of the nonrecourse debt upon repayment.

After the amount of minimum gain is computed separately for each property subject to a nonrecourse debt, the gains are aggregated to determine the partnership minimum gain. Next, the partnership minimum gain on the last day of the current taxable year is compared to the partnership minimum gain on the last day of the prior taxable year. Any net increase in the partnership minimum gain for the year will equal the amount of partnership nonrecourse deductions for a taxable year. In contrast, a net decrease from the prior year will result in a partnership minimum gain chargeback for the taxable year. Consequently, each partner must be allocated items of partnership income and gain for that year equal to the partner's share of the net decrease in partnership minimum gain. It should be noted that any decreases in minimum gain due to revaluations of property are added back.

Since the minimum gain is a phantom gain, the allocation of the nonrecourse deduction still does not have an economic effect. Consequently, the nonrecourse deduction must be allocated according to the partner's interest in the partnership. Regulation 1-704-2(e) provides a test that deems allocations of nonrecourse deductions to be in accordance with the partner's interests in the partnership.

If that test is not satisfied, Treasury Regulation 1.704-1(b)(3) should then be utilized to determine the validity of a nonrecourse debt allocation. Section 1.704-1(b)(3) provides a facts-and-circumstances test that provides guidelines for a nonrecourse deduction to be allocated according to the partner's interest in the partnership. Additionally, the Regulations also provide a safe harbor for a proper allocation in lieu of utilizing the facts-and circumstances test.

After nonrecourse deductions and minimum gain are calculated, it should be quite evident that minimum gain is just as real as Santa Claus.