Real Estate Partnerships: The Basics and Some Technical Stuff

by James Manzione

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In this report, Manzione highlights tax issues that commonly arise in real estate partnership agreements and explains some potential effects of various technical tax provisions in those agreements.

Table of Contents

I. Introduction

This report is intended as a guide for tax lawyers who are advising clients entering into real estate partnerships.[1] It highlights some frequently overlooked issues and emphasizes opportunities to draft and negotiate technical tax provisions typically included in real estate partnership agreements.

II. Basic Financial Concepts

Before jumping into the technical aspects of real estate partnership investments, it may be helpful to review some basics. If I plan to buy an asset today and sell it tomorrow, and two assets each cost the same amount today, the better investment is the asset that will generate more net profit when I sell it tomorrow. Notice that I said "generate more net profit" rather than "sell for a higher dollar amount." Because different transactions generate different transaction costs, an accurate analysis of investment options compares the difference in net profit rather than the difference in gross profit (or gross amount received).

For example, if I could buy assets A and B for $100 each today and tomorrow sell A for $105 and B for $110, B is a better investment only if the difference between the transaction costs for the two sales doesn't exceed the difference between the sales prices. That is, if the sale of asset B will generate $6 of transaction costs (for example, because the law provides that profit from the sale of B is taxed at 60 percent), and the sale of asset A will generate no transaction costs (because the law provides that profit from the sale of A is exempt from tax), A is the better investment despite selling for $5 less than B, as shown in Table 1:

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[1] This report uses the term "partnership" to refer to any entity classified as a partnership for federal income tax purposes.

Table 1

Asset A	Asset B
$105 sales price	$110 sales price
($100) asset cost	($100) asset cost
$0 transaction cost	($6) transaction cost
$5 net profit	$4 net profit

For many investments, taxes exceed all other transaction costs and thus significantly influence the investment's return. Part of why investors hire tax lawyers is to reduce the tax transaction costs of their investments and thereby increase their returns. If asked by an investor to advise on the alternatives above, the tax lawyer's job is easy: Just compare the way the law taxes profit from the two investments, do some simple arithmetic, and report back to the investor. But other investments will require an understanding of more complex financial and legal concepts.

Example 1: Ignoring taxes for the moment, assume a real estate investor spends $2 million to acquire a commercial building, receives monthly net operating income (NOI) of $10,000, spends $1 million in renovation costs at the end of year 2, and sells the building for $3.5 million at the end of year 3. The cash flows from this investment are shown in Table 2.

The investor's pretax profit on the real estate investment is $860,000 ($3.5 million sales price plus $360,000 operating income minus $2 million purchase price minus $1 million renovation cost). But $860,000 does not tell the whole story. Spending $2 million today and $1 million two years later to get $10,000 per month for three years and $3.5 million three years after spending the initial $2 million is not the same as spending $3 million today to get $3.86 million tomorrow. One reason is the time value of money.

A. Time Value of Money

The theory behind the time value of money is that an investor will value a dollar today more than a dollar in the future (and, by extension, a dollar tomorrow more than a dollar three years from now) because it believes it can invest the dollar today, earn a return, and thus have more than a dollar in the future. That is, if an investor is given a choice between $2 million today and $2 million a year from now, it will of course choose the $2 million today because it believes that it can invest that $2 million (for example, in a one-year bond paying 5 percent simple interest per annum) and then have more than $2 million in a year (in the bond example, $2.1 million). Similar logic applies to spending money, including on taxes: An investor would rather spend a dollar in the future than a dollar today because the investor believes that it could invest the dollar that it would have spent today and thus have some money left over when it has to spend the dollar in the future.

How much the investor values an amount today over an amount in the future depends on the return that the investor expects to receive during the intervening period. To determine how much an investor thinks an amount today will be worth in the future, use the following equation:

$$FV = PV * (1 + r)^n$$

where FV is the future value, PV is the value today, r is the rate of return on investment during the period, and n is the number of periods. In the simple example above, the future value of the bond would be calculated as $2 million $* (1 + 0.05)^1$ = $2.1 million (the investment's pretax future value).

B. Compounding

If, instead, $2 million were invested in a two-year bond paying 5 percent per year compounded annually, the future value equation would yield a pretax future value of $2,205,000 ($2 million $* (1 +

Table 2

Purchase Date	Months 1-23	Month 24	Months 25-35	Month 36
($2,000,000)	$10,000 per month	$10,000 ($1,000,000) ($990,000)	$10,000 per month	$10,000 $3,500,000 $3,510,000

0.05)^2). Because the investment compounds at the end of year 1, the previous period's return is added to the investment before it is multiplied by (1 + r). This means that in year 2, the investor again earns a $100,000 return on the initial $2 million investment but also earns a $5,000 return on the first year's $100,000 return.

If a return compounds more frequently than annually, simply divide the annual *r* in the above formula by the number of compounding periods per year and make sure to use the total number of compounding periods rather than the number of years for *n*.[2] For example, the formula for the pretax future value of a $1,000 investment in a two-year bond paying 5 percent per annum compounded quarterly would be $1,000 * (1 + 0.0125)^8 — or $1,104.49.[3]

C. Present Value

Related to future value is the concept of present value, which tells you how much an investor thinks an amount in the future is worth today. Present value can be calculated as follows:

$$PV = FV/(1 + r)^n$$

which is just an algebraic rearrangement of the future value formula provided earlier. The r in the future value equation is often referred to as the discount rate because it is used to discount the value of the future dollars.

Tax lawyers should assume that an investor seeks to maximize the present value of the net profit it receives from an investment by maximizing the present value of money it receives and minimizing the present value of money it spends. For anyone who accepts the theory behind the time value of money, this is common sense: An investor cares only about the amount that actually increases its wealth — that is, net profit, meaning gross profit reduced by all transaction costs (including taxes) — and an investor values net profit received sooner over net profit received later because it discounts the value of future profits using the present value formula. To maximize the present value of net profits, an

investor will try to accelerate receipts and defer expenses. For example, an investor would rather earn $100 today and pay a $50 expense in three years than earn $100 today and pay a $50 expense today.[4]

Calculating the present value of the net profit received from an investment requires the investor to add the present value of each amount it gets and subtract from that sum the present value of each amount it spends. The solution to this calculation is the investment's net present value. In Example 1, the net present value of the investment (ignoring taxes) using a 5 percent discount rate compounded monthly is about $442,048.45. The net present value and the chosen discount rate are inversely related — the higher the chosen discount rate for a given set of cash flows, the lower the net present value. If the investor in Example 1 uses a 10 percent discount rate, compounded monthly, the net present value of the investment (ignoring taxes) drops to about $86,591.77. If the investor uses a 12 percent discount rate, compounded monthly, the net present value of the investment (ignoring taxes) drops to a negative number — about negative $40,253.75.

D. Internal Rate of Return

Investors often describe the success of their investments using a metric related to net present value: the internal rate of return. The internal rate of return is the discount rate (*r*) at which the net present value of an investment is zero. Given a series of cash flows, in most scenarios the internal rate of return must be solved for iteratively using a financial calculator or computer program such as Microsoft Excel.[5] In Example 1, the internal rate of return (ignoring taxes and using a few simplifying assumptions beyond the scope of this report) is about 11.35 percent.

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[2] Continuous compounding is also possible and can be calculated using the mathematical constant *e*.

[3] The 0.0125 is the 0.05 annual interest rate divided by the four compounding periods per year, and the 8 exponent is the total number of compounding periods (in this case, quarters) until maturity.

[4] Assuming a 5 percent discount rate compounded annually, the $50 expense in three years has a present value of only $43.19 ($50/1.05^3), leaving the investor $6.81 better off from a present value standpoint as a result of deferring the expense for three years (that is, compare $100 *minus* $50 to $100 *minus* $43.19).

[5] For a thorough explanation of the math behind internal rate of return and various other financial concepts relevant to real estate partnerships, see Bradley T. Borden, "Math Behind Financial Aspects of Partnership Distribution Waterfalls," *Tax Notes*, Oct. 20, 2014, p. 305.

As discussed in more detail later, real estate partnership agreements typically provide that cash flow will be distributed pro rata according to the partners' percentage share of contributions until the partners who contributed capital achieve a specified internal rate of return on their capital contributions (but ignoring their taxes on the partnership's income). This internal rate of return threshold (the preferred return) acts as an interest rate that is multiplied by a partner's total unreturned capital contributions, the product of which is added to the amount of the partner's unreturned capital contributions at the end of the chosen compounding period and thus increases the partner's distribution entitlement.

As an illustration of how a preferred return acts as an interest rate on undistributed capital, consider a partnership with only two partners, A and B. Assume partner A contributes all $100 of the partnership's capital and is entitled to all distributions until it earns an internal rate of return of 8 percent compounded annually. In a scenario in which the partnership distributes no cash, A has a $125.97 distribution entitlement after three years, calculated by assuming the $100 original capital contribution earned 8 percent interest compounded annually for each of the three years.[6]

This calculation of the preferred return produces a result that is consistent with the definition of internal rate of return as the discount rate at which the net present value of an investment is zero, as can be seen by subtracting the $100 present value of the investor's capital contribution from the $100 present value (assuming annual compounding and an 8 percent discount rate) of $125.97 to be received in three years.[7] The same is true in more complex scenarios, such as when the partnership distributes $30 to partner A at the end of year 1 and $50 to A at the end of year 2. In that scenario, A is entitled to $36.98 at the end of year 3, which is exactly the amount A would have left if it invested $100 in a bank account paying 8 percent

interest compounded annually and withdrew $30 after one year and $50 after two years.[8]

As discussed in more detail later, in typical real estate partnership agreements internal rate of return calculations directly affect the partnership's cash distributions and thus indirectly affect the partnership's tax allocations. Thus, familiarity with those financial concepts is important for tax lawyers to understand how a real estate partnership agreement operates and how it might be changed for a client's benefit.

III. Real Estate Partnerships

A. Typical Structure of Investment

Typically, a partnership that purchases real estate will borrow 50 to 90 percent of the purchase price from lenders.[9] The lenders will require the partnership to make scheduled payments that, when aggregated, sum to the amount borrowed plus interest. The remainder of the real estate's purchase price is funded by capital contributions from the partners. Before a real estate investment's disposition, the only revenue the investment generates is rental income. This revenue is first used to pay expenses necessary to operate the property (such as property tax, maintenance, management, insurance, and utility fees). What remains is the partnership's operating income.

A real estate partnership will use the operating income first to make any scheduled loan payments for the period, typically based on either an interest-only schedule or an amortization schedule. Under an interest-only schedule, each payment (other than the final payment) is a payment of the principal amount times a given interest rate, and the final payment is a repayment of the entire

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[6] $100 * 1.08^3 = $125.97.

[7] ($125.97/1.08^3) - $100 = $0.

[8] The $100 would grow to $108 at the end of the first year ($100 * 1.08). A distribution of $30 at the end of the first year would reduce the $108 to $78, which would grow to $84.24 ($78 * 1.08) at the end of the second year. A distribution of $50 at the end of the second year would reduce the $84.24 to $34.24, which would grow to $36.98 ($34.24 * 1.08) at the end of the third year. Assuming 8 percent interest compounded annually, the present value of $30 in one year is $27.78 ($30/1.08); the present value of $50 in two years is $42.87 ($50/1.08^2); and the present value of $36.98 in three years is $29.36 ($36.98/1.08^3). These sum to $100 (but for a rounding error) and, when reduced by the $100 capital contribution, result in a net present value of $0.

[9] For nontax reasons, the borrower is typically a wholly owned subsidiary of the partnership that is disregarded as separate from the partnership for federal income tax purposes. For simplicity, I ignore this and proceed as if the partnership itself is the borrower.

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principal amount plus the interest for the final period. Under an amortization schedule, each payment is for a fixed amount (composed of both principal and interest) that gradually reduces the principal amount to zero by the loan's maturity date. After making the scheduled loan payments for the period, the real estate partnership will then set aside a portion of any remaining amount as reserves for future expenses and finally distribute the balance (the distributable cash) to its partners according to the distribution waterfall in the partnership agreement.

A typical real estate partnership has two types of partners: capital partners and a "promote" partner. Capital partners contribute cash or other property to the partnership and are entitled to pro rata distributions of distributable cash according to their respective percentage interests (defined, for each partner, as the percentage equal to that partner's capital contributions divided by the sum of all partners' capital contributions) until they achieve a specified internal rate of return on their investment (the preferred return). A promote partner typically serves in a decision-making role for the partnership and, as a reward for the partnership's success, is entitled to a specified percentage of each distribution of distributable cash after the capital partners receive their preferred return.

B. Typical Structure of Agreement

The partners' entitlement to distributable cash is governed by the distribution waterfall in the partnership agreement. It generally reads something like this:

> Distributable cash shall be distributed in the following order of priority:
>
> First, pro rata to the capital partners according to their respective percentage interests until each has received a return of its capital contributions.
>
> Second, pro rata to the capital partners according to their respective percentage interests until each has received an internal rate of return on its capital contributions of 10 percent, compounded annually.
>
> Third, 80 percent to the capital partners according to their respective percentage

> interests and 20 percent to the promote partner.

For simplicity, I refer to those waterfall provisions as the base case distribution provisions. In practice, there are many variations. For example, the capital partners' preferred return need not be 10 percent or compounded annually, and the promote partner's promote percentage need not be 20 percent. Moreover, many distribution waterfalls contain an additional level (between levels 2 and 3) entitling the promote partner to all distributable cash until it has received 20 percent of all amounts distributed in excess of the capital partners' capital contributions.[10]

A partner is not taxed on a distribution from a partnership unless the amount of the distribution exceeds the partner's outside basis in its partnership interest.[11] However, a partner is taxed annually on its distributive share of partnership income, reduced by the partner's distributive share of partnership deductions and credits.[12] A partner's distributive share of partnership income, deductions, and credits is generally determined by allocation provisions in the partnership agreement.[13] Because those provisions are typically different from the distribution waterfall, there are frequently mismatches between the amount distributed to a partner and the amount allocated to it. A partner can realize phantom income if it receives an allocation of taxable income without a corresponding distribution of cash.

Mismatches in real estate partnerships' distributable cash and partnership income, deductions, and credits are common even when the distribution and allocation provisions are identical (for example, all distributable cash is distributed 50-50, and all partnership income, deductions, and credits are allocated 50-50). This is the result of differences in the meaning of the terms (that is, distributable cash as compared to

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[10]Sometimes this catch-up provision entitles the promote partner to only 50 percent (or some other percentage) of distributable cash until it has received 20 percent of all amounts distributed in excess of contributions.

[11]*See* section 731. For the rules on the calculation of outside basis, see section 705.

[12]*See* sections 61(a)(12) and 63.

[13]*See* section 704.

partnership income, deductions, and credits). Those differences stem primarily from four facts:

1. depreciation reduces taxable income but has no effect on the amount of cash generated by a real estate project;

2. only the interest component of debt service is deductible for tax purposes even though the principal component of debt service also reduces the cash available for distribution;

3. the receipt of borrowed proceeds (including from refinancing) increases cash but is not treated as taxable income, because there is an obligation to repay; and

4. amounts set aside for reserves and thus unavailable for distribution may nonetheless be included in taxable income.

Other differences can also arise, such as when a deduction is allowed for interest under the original issue discount tax rules or when a deduction is denied for an expense that must be capitalized under the uniform capitalization rules.

Most real estate partnerships use complex, target allocation provisions.[14] The following provisions, which I refer to as the base case allocation provisions, are an example of typical target allocation provisions:

Provision 1

After giving effect to the special allocations described elsewhere in the agreement, book income and book loss or individual items thereof for each taxable year or other applicable period shall be allocated among the partners in a manner such that the capital account of each partner immediately after making such allocation is, as nearly as possible, equal to (i) the distributions that would be made to such

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partner if the partnership were dissolved, its affairs wound up and its assets sold for cash equal to their book value, all partnership liabilities (including the partnership's share of the liabilities of any lower-tier partnerships) were satisfied (limited with respect to each nonrecourse liability to the book value of the assets securing such liability), and the net assets of the partnership were distributed to the partners pursuant to the distribution waterfall minus (ii) any amount such partner is obligated to return to the partnership, such partner's share of "partnership minimum gain" and such partner's share of "partner nonrecourse debt minimum gain" (each as defined in the regulations and computed immediately before such hypothetical sale of assets).

Provision 2

Income, gains, losses, and deductions for federal, state, and local income tax purposes shall be allocated among the partners in as nearly as possible the same manner as the allocation of book income and book loss and items thereof, except that allocations of taxable income, gain, loss, and deduction with respect to any asset with a book value that differs from its adjusted basis for U.S. federal income tax purposes shall take account the variation between its book value and its adjusted basis for U.S. federal income tax purposes in a manner permitted under section 704(c) and the regulations thereunder.

The following terms and features are important in understanding the base case allocation provisions:

- A partner's capital account is defined in the agreement as (1) the amount of money contributed by the partner, plus the net fair value of other property contributed by the partner, plus any allocation of book income to the partner; minus (2) any money distributed to the partner, minus the net fair value of any other property distributed to the partner, minus any allocation of book loss to the partner.

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[14]Several excellent articles discuss target allocation provisions in depth. *See* Todd D. Golub, "Target Allocations: The Swiss Army Knife of Drafting (Good for Most Situations — But Don't Bet Your Life on It)," 87 *Taxes* 157 (2009); New York State Bar Association Tax Section, "Report on Partnership Target Allocations" (Sept. 23, 2010); William G. Cavanagh, "Targeted Allocations Hit the Spot," *Tax Notes*, Oct. 4, 2010, p. 89; and Daniel S. Goldberg, "The Target Method for Partnership Special Allocations and Why It Should Be Safe Harbored," 69 *Tax Law.* 663 (2016).

- The book value of any partnership asset is defined in the agreement as (1) the gross fair value of the asset at the time of its contribution to the partnership; or (2) the partnership's tax basis in the asset (if it is an asset purchased by the partnership). Book value is adjusted for depreciation and if the partnership revalues its assets to their gross fair values as permitted by the regulations.[15]

- The term "book income and book loss" is defined in the agreement as the partnership's taxable income and loss with some adjustments, the most important of which are that (1) depreciation is based on the book value (rather than tax basis) of the partnership's assets; (2) any increase or decrease in the book value of property as a result of a revaluation of partnership assets is treated as an item of book income or book loss (despite having no immediate tax effect); (3) tax-exempt income and nondeductible, noncapitalizable expenses are treated as items of book income and book loss, respectively; and (4) specially allocated items are not included in book income and book loss.

- The term "special allocations" refers to a series of provisions contained elsewhere in the partnership agreement. Special allocations vary from agreement to agreement and are mostly beyond the scope of this report, but the typical real estate partnership agreement contains at least the following types of special allocation provisions: (1) provisions allocating deductions attributable to the purchase of property with nonrecourse debt proceeds (or with proceeds guaranteed or lent by a partner) according to specific rules; (2) provisions requiring that gain from the property producing those deductions and attributable to them be allocated to the partners that received the benefit of those deductions; and (3) provisions preventing or reversing the allocation of items that would cause any partner's capital account to fall below zero by an amount exceeding the

amount the partner is obligated (or is deemed obligated under the regulations) to return to the partnership.

- The clause in Provision 1 above beginning with the word "minus" backs out specific capital account adjustments that otherwise would make it impossible for the base case allocation provisions to operate correctly.[16]

Putting aside the minus clause, Provision 1 allocates book income and book loss so that each partner's capital account is equal to the amount that the partner would receive if the partnership sold its assets for their book values, paid off its debts, and distributed the net proceeds according to the distribution waterfall. Because the partnership agreement defines book income and book loss as the partnership's taxable income and loss with some adjustments, book income and book loss will differ from taxable income and loss whenever those adjustments are made. Provision 2 causes allocations of tax items to mirror allocations of book income and book loss "as nearly as possible" (language acknowledging that the two amounts may differ), except in the special case of tax items arising from an asset with a book value that differs from its tax basis.[17]

Essentially, the two provisions look to how each item of income or loss realized by the partnership changes the partners' entitlements to distributions in liquidation of the partnership (under the assumption that the liquidation occurs immediately after the items are realized). Provision 1 allocates book income to a partner to the extent the partnership's realization of an item increases the amount that the partner would be entitled to in an immediate liquidation. It allocates book loss to a partner to the extent that the partnership's realization of an item decreases the amount that the partner would be entitled to in an immediate liquidation. Provision 2 causes

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[15]I discuss revaluations of partnership assets in more depth in Section IV.C.

[16]To understand the minus clause, assume a 50-50 partnership has assets that have a book value of $700, liabilities of $900, and capital accounts of -$100 each for its two partners. If the partnership were to earn $10, the minus clause ensures that the $10 of income is allocated $5 to each partner. Without it, the accountant might try to get the capital accounts to equal the $0 that each partner would be entitled to receive in liquidation if the partnership's assets were sold for $200 less than the partnership's liabilities. But that wouldn't work, because there is nowhere near enough income.

[17]Section 704 and its extensive regulations mandate specific allocations in this circumstance.

Table 3

Assets	=	Liabilities	+	Capital Partner A Capital Account	+	Capital Partner B Capital Account	+	Promote Partner Capital Account
$1,000 real estate	=	$900 debt	+	$70	+	$30	+	$0

Table 4

Assets	=	Liabilities	+	Capital Partner A Capital Account	+	Capital Partner B Capital Account	+	Promote Partner Capital Account
$1,000 real estate	=	$900 debt	+	$70	+	$30	+	$0
+ $20 cash				+/-?		+/-?		+/-?
$1,020 total assets								

Table 5

Assets	=	Liabilities	+	Capital Partner A Capital Account	+	Capital Partner B Capital Account	+	Promote Partner Capital Account
$1,000 real estate	=	$900 debt	+	$70	+	$30	+	$0
+ $20 cash				+ $12.60		+ $5.40		+ 2
$1,020 total assets				$82.60		$35.40		$2

tax items to follow book items, except when they do not correspond, in which case either there will be no tax item (such as when the partnership earns tax-exempt income) or the tax item will be governed by section 704(c) and its regulations.

The following example illustrates how the base case allocation provisions work.

Example 2: Assume capital partner A contributes $70, capital partner B contributes $30, and the promote partner contributes $0 to a partnership. Further assume the partnership buys real estate for $1,000 with the $100 of contributed cash and $900 of borrowed proceeds. Immediately after the purchase, the partnership's balance sheet would appear as shown in Table 3.

Assume that in its first year of operation the partnership earns $50 of rental income and pays $30 of operating and interest expenses. The assets and liabilities portions of the partnership's balance sheet after those operations would appear as shown in Table 4.

Because the balance sheet must balance, it is clear that the sum of the partners' capital accounts must equal $120 ($1,020 assets minus $900 liabilities). Under the distribution waterfall described above, if the partnership's assets were sold for $1,020 and the $900 partnership debt were paid off, the capital partners would first receive

their contributions back ($70 to A and $30 to B). The capital partners would then receive their 10 percent preferred return ($7 to A and $3 to B). The remaining $10 would be distributed 80 percent pro rata to the capital partners according to their percentage interests ($5.60 to A and $2.40 to B) and 20 percent ($2) to the promote partner. The base case allocation provisions cause income to be allocated so that each partner's capital account equals the amount the partner would be entitled to receive under the distribution waterfall in an immediate liquidation (assuming a sale of the partnership's assets for book value). As a result, the base case allocation provisions require an allocation of $12.60 to A, $5.40 to B, and $2 to the promote partner, producing the final year 1 balance sheet as shown in Table 5.

Example 2 illustrates the tension between the distribution of distributable cash and the allocation of taxable income. There is distributable cash of $20 that, under the distribution waterfall, will be distributed $14 to A and $6 to B. The promote partner receives no distribution despite owing tax on its $2 allocation.

That overallocation of income can be thought of as a prepayment of the tax liability associated with the amount that the promote partner would receive under the partnership's distribution

Table 6

Year	1	2	3	4	5	6	7	8	9	10
NOI ($)	600,000	612,000	624,240	636,725	649,459	662,448	675,697	689,211	702,996	717,056
Interest ($)	(600,000)	(600,000)	(600,000)	(600,000)	(600,000)	(600,000)	(600,000)	(600,000)	(600,000)	(600,000)
Depreciation ($)	(230,769)	(230,769)	(230,769)	(230,769)	(230,769)	(230,769)	(230,769)	(230,769)	(230,769)	(230,769)
Taxable income ($)	(230,769)	(218,769)	(206,529)	(194,044)	(181,310)	(168,321)	(155,072)	(141,558)	(127,774)	(113,714)
Distributable cash ($)	0	12,000	24,240	36,725	49,459	62,448	75,597	89,211	102,996	117,056

provisions if the partnership were to immediately liquidate and the book values of the partnership's assets reflected their actual fair market values. Of course, the partnership may not immediately liquidate, and the book values may not reflect the actual fair market values of the partnership's assets. Regardless, the promote partner is paying a current tax and, in exchange, will receive a distribution of a corresponding amount free from tax in the future.[18]

As discussed in Section II, investors should seek to accelerate the receipt of cash and defer the payment of tax to maximize the present value of their investments. The overallocation in Example 2 does just the opposite. Section IV examines techniques to prevent overallocations in some situations and explains how, in other situations, the agreement might include a tax distribution provision to address a mismatch between distributions and allocations.

Because of tax deductible depreciation, many real estate investments generate distributable cash even while generating tax losses. Consider the following example.

Example 3: Assume a real estate partnership purchases a commercial building for $15 million, $3 million of which comes from equity sources ($2.1 million from capital partner A and $900,000 from capital partner B) and $12 million of which comes from an interest-only loan bearing interest at 5 percent. The $15 million purchase price is allocated

60 percent to the building and 40 percent to the land.[19] Assume the building generates $600,000 of NOI in its first year (a modest 4 percent cap rate[20]) and that the NOI increases by 2 percent each year. If the partnership owned only the building, its distributable cash (assuming, for simplicity, that no amounts are set aside as reserves for future expenses) and taxable income for a 10-year period would appear as shown in Table 6.

Assuming the base case distribution and allocation provisions, all the losses would be allocated to the capital partners pro rata according to their percentage interests. That result follows from an examination of the assets and liabilities sections of the balance sheet at the end of year 1 as shown in Table 7.

Recall that depreciation reduces book value. If the partnership sold its real estate for its book value of $14,769,231 and paid off its $12 million debts, the partnership would be left with $2,769,231. This falls short of the capital partners' $3 million capital contributions. As a result, the distribution waterfall mandates that the entire $2,769,231 be distributed to the capital partners pro rata according to their percentage interests: 70 percent to A ($1,938,461.70) and 30 percent to B ($830,769.30). Under the allocation provisions, the partners' capital accounts thus must receive allocations of book loss sufficient to bring the balances of those accounts in line with the amount each partner would receive in an immediate liquidation, as shown in Table 8.

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[18]If the promote partner receives nothing in liquidation, it will have a capital loss equal to the amount of income allocated to it and not reversed through allocations of loss or deduction. *See* section 731.

[19]Note that, in practice, a portion of the purchase price may be allocated to improvements with shorter recovery periods, leading to even higher losses in early years.

[20]The "cap rate," short for capitalization rate and defined as a property's NOI divided by its purchase price or value, is a common metric used in real estate valuation and analysis.

Table 7

Assets	=	Liabilities	+	Capital Partner A Capital Account	+	Capital Partner B Capital Account	+	Promote Partner Capital Account
$15,000,000 real estate ($230,769) depreciation $14,769,231 real estate book value	=	$12,000,000 debt	+	$2,100,000 +/- ?	+	$900,000 +/- ?	+	$0 +/- ?

Table 8

Assets	=	Liabilities	+	Capital Partner A Capital Account	+	Capital Partner B Capital Account	+	Promote Partner Capital Account
$15,000,000 real estate ($230,769) depreciation $14,769,231 real estate book value	=	$12,000,000 debt	+	$2,100,000 ($161,538.30) $1,938,461.70	+	$900,000 ($69,230.70) $830,769.30	+	$0

The entire loss of $230,779 is therefore allocated to the capital partners in year 1, as is the entire loss in each of the nine remaining years. Subject to the code's myriad loss limitation rules, the capital partners could use those losses to offset ordinary income from other sources.

IV. Select Technical Considerations

A. Tax Distributions

As demonstrated by Example 2, the base case distribution and allocation provisions can cause a partner to owe tax on an allocation of income despite receiving no distribution of cash with which to pay the tax (phantom income). To deal with this mismatch, an agreement might include a tax distribution provision similar to the following[21]:

> To the extent a partner receives or is expected to receive allocations of taxable income or gain for a tax year (or a portion

> thereof) ("Allocated Income") but has not otherwise received (or, but for this section, is not otherwise expected to receive) aggregate distributions of distributable cash under the distribution waterfall with respect to such tax year (or portion thereof) sufficient to pay such partner's Hypothetical Tax Amount on such partner's Allocated Income (such shortfall, the "Distribution Shortfall"), the partnership shall, to the extent possible, distribute a sufficient amount of distributable cash to satisfy such Distribution Shortfall for each partner before distributing the remaining net cash flow under the distribution waterfall.

> The term "Hypothetical Tax Amount" means, with respect to each partner, an amount equal to the product of (a) the amount of such partner's Allocated Income, multiplied by (b) the highest marginal combined federal, state, and local income tax rate applicable to a resident in New York, New York during the tax year.

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[21] This is merely one example of a tax distribution provision. It may not be adequate for all situations. For a summary of the various issues that should be considered when drafting a tax distribution provision, see Bahar A. Schippel, "Boilerplate Tax Distribution Provisions Can Get You Into Hot Water," 32 *Tax Mgmt. Real Est. J.* 46 (2016).

Any distribution to a partner under this section shall be treated as a preliminary distribution of future amounts due to such partner under the distribution waterfall, and any future distributions due to such partner under the distribution waterfall shall be reduced by the amount of distributions under this section. In the event that, at the time of liquidation of the partnership, distributions under this section have not been fully recouped against amounts distributable under the distribution waterfall, the partner who received such excess distributions shall be obligated to recontribute the amount of such excess to the partnership in connection with the dissolution of the partnership.

To understand this tax distribution provision, reconsider Example 2. Assume that the highest marginal combined federal, state, and local income tax rate applicable to a resident in New York City is 50 percent. Because the allocated income amounts are $12.60 for capital partner A, $5.40 for capital partner B, and $2 for the promote partner, the hypothetical tax amounts for each partner are 50 percent of those amounts: $6.20, $2.70, and $1, respectively. But for the tax distribution section, A would receive $14, B would receive $6, and the promote partner would receive $0. From this, it is apparent that only the promote partner has a distribution shortfall, the amount of which is $1. As a result, the promote partner is distributed $1, and the remaining $19 is distributed according to the distribution waterfall ($13.30 to A and $5.70 to B).

Now consider the italicized text from the excerpt, which I call the future distribution offset. It reduces the amount a partner is entitled to receive under the distribution waterfall by the amount that the partner receives as a tax distribution. This is a logical result in some scenarios. For example, assume a partnership in which cash was distributed first to capital partner A until A received $50, then to capital partner B until B received $50, and then 60 percent to B and 40 percent to A. If the partnership distributed $10 to A under the tax distribution provision above, it makes perfect sense that if the partnership had $90 to distribute in its second year, the partnership would distribute $40 to A and $50 to

B. That would put the partners in the position they would have been in had there been no tax distributions: Each partner gets $50 of the first $100 distributed, with A getting the first $50 and B getting the last $50.

But does a future distribution offset always produce appropriate economic results for a partnership with the base case distribution provisions? Again consider Example 2, in which the promote partner receives a $1 tax distribution in year 1. At the end of year 1 in that example, the capital partners' preferred return entitlement (the amount they were entitled to receive before any distribution to the promote partner) had grown from $100 to $110 ($100 * 1.1) but was then reduced by the $19 distribution to $91. At the end of year 2 but before any distributions, their preferred return entitlement had grown to $100.10 ($91 * 1.1). If the partnership had $200 of distributable cash at the end of year 2, the distribution waterfall would ordinarily cause the capital partners to receive the first $100.10, with the capital partners and the promote partner splitting the remaining $99.90, 80 percent to the capital partners ($79.92) and 20 percent to the promote partner ($19.98).

The future distribution offset, however, would cause a $1 shift in those amounts, requiring instead that the capital partners receive $80.92 and the promote partner receives $18.98.[22] But that would not put the partners in the same position as if no tax distribution had occurred in year 1. Without tax distributions, the capital partners would have received $20 in year 1, reducing their preferred return entitlement to $90, which would have grown to $99 ($90 * 1.1) by the end of year 2. Of the $200 distributed in year 2, the capital partners would have received $179.80 (their $99 preferred return entitlement plus 80 percent of the remaining $101).

The results are thus different in each of the three scenarios (no tax distributions, tax distributions without a future distribution offset,

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[22]Practitioners may reasonably disagree with this interpretation of the future distribution offset, arguing instead that the $1 should be "re-run" through the waterfall. That interpretation would result in less cash being distributed to the capital partners than I assume for purposes of the examples in this report and thus wouldn't change the conclusion of my argument.

and tax distributions with a future distribution offset), as shown in Table 9:

Table 9

Scenario	Year 1 Distribution To Capital Partners	Year 2 Distribution To Capital Partners	Total Distributions To Capital Partners
No tax distributions	$20	$179.80	$199.80
No future distribution offset	$19	$180.02	$199.02
Future distribution offset	$19	$181.02	$200.02

But before concluding that tax distributions with a future distribution offset always put the capital partners in a better position than no tax distributions, consider what would occur if the partnership did not have the $200 of distributable cash until year 4. In that case, the capital partners' growing preferred return entitlement would lead to the results as shown in Table 10:

Table 10

Scenario	Year 1 Distribution To Capital Partners	Year 4 Distribution To Capital Partners	Total Distributions To Capital Partners
No tax distributions	$20	$183.96[a]	$203.96
No future distribution offset	$19	$184.22[b]	$203.22
Future distribution offset	$19	$185.22[c]	$204.22
[a]$90 * (1.1)^3 = \$119.79$; $200 - \$119.79 = \$80.21$; $\$119.79 + (0.8 * \$80.21) = \$183.96$.			
[b]$91 * (1.1)^3 = \$121.12$; $200 - \$121.12 = \$78.88$; $\$121.12 + (0.8 * \$78.88) = \$184.22$.			
[c]$91 * (1.1)^3 = \$121.12$; $200 - \$121.12 = \$78.88$; $\$121.12 + (0.8 * \$78.88) = \$184.22$; $\$184.22 + \$1 = \$185.22$.			

At first, the results appear consistent with the previous example. Recall, however, the financial concepts discussed in Section II. Because the capital partners receive more cash in year 1 in the

no-tax-distribution scenario, that scenario has the highest net present value (using a 10 percent discount rate) and internal rate of return, despite netting the capital partners less total cash than the future-distribution-offset scenario.[23]

To understand why the scenarios produce different results, focus on what the capital partners receive in exchange for giving up some of their year 1 distribution to the promote partner through the tax distribution. In the no-future-distribution-offset scenario with $20 earned in year 1 and $200 earned in year 2, the capital partners give up $1 in year 1 for a $1.10 increase in their year 2 preferred return entitlement.[24] This exchange shifts $1.10 of the $200 year 2 distributable cash away from level 3 of the distribution waterfall. As a result, the capital partners receive 100 percent of the $1.10 rather than 80 percent of the $1.10. The capital partners have traded $1 in year 1 for $0.22 in year 2 — a bad trade.

The future distribution offset represents a form of rough justice designed to compensate the capital partners for the unfair result that arises without an offset. Taking into account both the $1 offset and the $0.22 increase that occurs from shifting $1.10 away from level 3 of the distribution waterfall, the capital partners in this example have in effect traded $1 of year 1 distributions for $1.22 of year 2 distributions (a return of 22 percent per annum).

Although the return in this example is high, that will not always be the case. In the scenario in which the partnership does not earn the $200 until year 4, the $1 shortfall to the capital partners in year 1 is made up by shifting $1.33 (the $1.10 that was shifted in year 2 plus two additional years of a 10 percent preferred return) away from level 3 of the distribution waterfall, netting the capital partners an additional $0.26 ($1.33 - (80 percent * $1.33)). Adding the $1 offset results in a trade by

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[23]The net present value (using a 10 percent discount rate) and internal rate of return for the no-tax-distribution scenario are $43.83 and 21.8 percent, respectively. In comparison, the net present value (using a 10 percent discount rate) and internal rate of return for the no-future-distribution offset scenario are $43.10 and 21.56 percent, respectively, and the net present value and internal rate of return for the future-distribution-offset scenario are $43.78 and 21.72 percent, respectively.

[24]Compare their year 2 preferred return entitlement in the no-tax-distribution scenario ($99) with their year 2 preferred return entitlement in the scenario of a tax distribution without future offset ($100.10).

the capital partners of $1 in year 1 for $1.26 in year 4 — an internal rate of return of 8 percent. If the capital partners could have invested the forgone $1 year 1 distribution in an investment generating an internal rate of return greater than 8 percent, the future-distribution-offset scenario leaves them in a worse position than the no-tax-distribution scenario.

Tax lawyers negotiating tax distribution provisions should understand how those provisions can affect a client's returns. It would not be unreasonable for a tax lawyer representing a capital partner with bargaining power to ask for the future distribution offset to be equal to an amount that would generate an internal rate of return on the forgone initial distribution equal to a specific amount.

B. Revaluations

As mentioned earlier, the regulations under section 704 permit partnerships to revalue their assets in some circumstances.[25] A revaluation changes the book values of the partnership's assets to their then-current fair market values, and the increase or decrease in the assets' book values is treated as an item of book income or book loss that gets allocated to the partners under the partnership's allocation provisions. Because revaluations are merely changes made to numbers in the partnership's books, they have no immediate tax results.[26] What, then, is the purpose of a revaluation?

In some partnerships, the answer is clear. Consider Example 4, in which a partnership that liquidates in accordance with the partners' capital account balances and allocates each partner a fixed percentage share of all items of income and loss.

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[25] The circumstances that permit revaluations are listed in reg. section 1.704-1(b)(2)(iv)(*f*). The most important circumstances are contributions that increase a person's interest in the partnership and distributions that decrease a person's interest in the partnership.

[26] Section 704(c) and its regulations, however, try to require allocations of taxable income and loss to follow the previous allocations of book income and book loss when the revalued assets are eventually sold. Consider a partnership that revalues its one asset from $50 to $100 in year 1, allocating all $50 of the book income (but no tax income) to partner A. If, in year 2, the partnership sold the asset for $100, the partnership would allocate no additional book income to partner A but, as a result of section 704(c) and its regulations, would allocate $50 of tax income to partner A. More complex rules apply when the partnership depreciates revalued assets.

Example 4: Assume partners A and B form a 50-50 partnership in which all distributions and allocations are consistent with the partners' percentage interests. With $100 contributions from each of A and B, the partnership purchases an asset for $200 that later appreciates to $1,000. New partner C then contributes $500 for a one-third percentage interest in the partnership, which dilutes the percentage interests of A and B equally so that each partner now has a one-third percentage interest. If the partnership does not revalue the asset and then sells it for $1,000, the $800 of gain would be allocated $266.67 to each partner and produce the following capital account balances:

Table 11

Partner A	Partner B	Partner C
$100	$100	$500
+$266.67	+$266.67	+$266.67
$366.67	$366.67	$766.67

A liquidation in accordance with those capital account balances would not be in accordance with the partners' economic deal. Instead of each partner receiving one-third of the partnership's $1,500 total assets (that is, the $1,000 asset plus the $500 contribution from C), C receives more than 50 percent and the other partners each receive less than 25 percent.

If, however, the partnership revalues the asset immediately upon partner C's contribution and allocates the resulting $800 of book income equally between partners A and B, the partners' capital account balances would appear as follows:

Table 12

Partner A	Partner B	Partner C
$100	$100	$500
+$400	+$400	—
$500	$500	$500

These capital accounts are consistent with the partners' economic deal, and because the capital accounts in this example govern the amounts the partners are entitled to receive in liquidation, they justify the revaluation. But that will not always be the case. Consider the following example.

Table 13

Assets	=	Liabilities	+	Capital Partner A Capital Account	+	Capital Partner B Capital Account	+	Promote Partner Capital Account
$1,000 real estate	=	$900 debt	+	$70	+	$30	+	$0

Table 14

Assets	=	Liabilities	+	Capital Partner A Capital Account	+	Capital Partner B Capital Account	+	Promote Partner Capital Account
$1,500 real estate	=	$900 debt	+	$351.40[a]	+	$150.60[b]	+	$98[c]

[a]If the partnership distributed its net proceeds after selling its assets for book value and paying off its liabilities, A would receive its $70 initial contribution plus its $7 share of preferred return (70 percent * $10) plus its $274.40 share of residual distributions (70 percent * 80 percent * $490).

[b]If the partnership distributed its net proceeds after selling its assets for book value and paying off its liabilities, B would receive its $30 initial contribution plus its $3 share of preferred return (30 percent * $10) plus its $117.60 share of residual distributions (30 percent * 80 percent * $490).

[c]If the partnership distributed its net proceeds after selling its assets for book value and paying off its liabilities, the promote partner would receive its $98 share of residual distributions (20 percent * $490).

Example 5: Partners A and B again form a partnership with $100 each. Assume that the partnership contains a distribution waterfall that provides that all distributable cash is distributed in accordance with the partners' percentage interests (originally 50-50 between A and B); the partnership purchases an asset for $200; the asset appreciates to $1,000; and partner C then contributes $500 cash for a one-third interest in the partnership, entitling C to one-third of all partnership distributions. Assume also that the partnership contains the base case allocation provisions and liquidates in accordance with the distribution waterfall rather than the partners' capital account balances. If the partnership did not revalue the asset to $1,000 upon C's contribution, A and B would each have $100 capital accounts, and C would have a $500 capital account — the same initial result as in the no-revaluation scenario of Example 4.

But that would not be the case if the asset were then sold for $1,000. Instead, the base case allocation provisions would cause gain from the sale to be allocated to the partners so that their capital accounts reflect how the proceeds of the partnership's liquidation would be distributed. In this example, the $1,500 of assets would be distributed $500 to each partner (in accordance with the distribution waterfall), causing the base case allocation provisions to allocate the $800 gain

as $400 to A and $400 to B, so that each of the three partners has a $500 capital account balance. The result would be the same if the partnership had revalued the asset, suggesting that a revaluation serves no purpose in this example.

Despite the result in Example 5, in some cases a revaluation will affect the partners even if the partnership liquidates in accordance with the distribution waterfall rather than the partners' capital accounts. Consider Example 6, in which a partnership with the base case distribution and allocation provisions liquidates in accordance with the distribution waterfall.

Example 6: Assume that the partnership has the initial balance sheet as shown in Table 13.

Assume that at the end of year 1, when the real estate has appreciated to $1,500, the partnership grants an additional interest[27] to the promote partner in exchange for its services and then revalues the partnership's asset. The $500 of appreciation would be treated as book income realized by the partnership. That book income would be allocated among the partners (without any corresponding tax allocation) to produce the balance sheet as shown in Table 14.

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[27]Assume the additional interest entitles the promote partner to all profits from the sale of the partnership's real estate exceeding $3,000 and thus is irrelevant for purposes of this example (other than that it permits a revaluation).

Table 15

Capital Partner A	Capital Partner B	Promote Partner
$364.70[a]	$156.30[b]	$100[c]

[a]A's $70 initial contribution plus its $7 share of year 1 preferred return (70 percent * $10) plus its $7.70 share of year 2 preferred return (70 percent * $11) plus its $280 share of residual distributions (70 percent * 80 percent * $500).

[b]B's $30 initial contribution plus its $3 share of year 1 preferred return (30 percent * $10) plus its $3.30 share of year 2 preferred return (30 percent * $11) plus its $120 share of residual distributions (30 percent * 80 percent * $500).

[c]20 percent * $500.

Table 16

Assets	=	Liabilities	+	Capital Partner A Capital Account	+	Capital Partner B Capital Account	+	Promote Partner Capital Account
$1,000 real estate	=	$900 debt	+	$70	+	$30	+	$0

Now assume that in year 2 the partnership earns $21 of rental income. Assuming the revaluation occurred in year 1, the partners would be entitled to the amounts as shown in Table 15 if, at the end of year 2, the partnership's $1,521 of book value assets were sold, its $900 of liabilities were paid off, and its $621 of net proceeds were distributed according to the waterfall.

As a result, under the base case allocation provisions, A would receive a $13.30 allocation, B would receive a $5.70 allocation, and the promote partner would receive a $2 allocation, so that their capital account balances equaled the amounts they would be entitled to receive in liquidation of the partnership.

If the partnership had not revalued at the end of year 1, its balance sheet at the beginning of year 2 would appear as shown in Table 16.

Assuming again that the partnership earned $21 of rental income in year 2 and, at the end of year 2, sold its assets (including the $21 of cash) for their $1,021 book value, paid off its $900 liabilities, and distributed its $121 of net proceeds according to the waterfall, the partners would be entitled to the amounts as shown in Table 17.

As a result, under the base case allocation provisions, A would receive a $14.70 allocation, B would receive a $6.30 allocation, and the promote partner would receive no allocation.

The decision to revalue thus shifts $2 of income (both book income and taxable income) away from the capital partners to the promote partner. It does not affect the distributions those partners receive; in both cases there is only $21 of distributable cash, and it is distributed, in accordance with the distribution waterfall, $14.70 to A and $6.30 to B. The promote partner would understandably object to a revaluation in this instance, but if that partner has no say in when the partnership revalues its assets, it will be stuck with the result. A tax lawyer representing a client that could end up like the promote partner in Example 5 should insist that the client have a say in deciding whether the partnership will revalue its assets.

Table 17

Capital Partner A	Capital Partner B	Promote Partner
$84.70[a]	$36.30[b]	$0[c]

[a]A's $70 initial contribution plus its $7 share of year 1 preferred return (70 percent * $10) plus its $7.70 share of year 2 preferred return (70 percent * $11). There would be no residual distribution.

[b]B would receive its $30 initial contribution plus its $3 share of year 1 preferred return (30 percent * $10) plus its $3.30 share of year 2 preferred return (30 percent * $11). There would be no residual distribution.

[c]Because there would be no residual distribution, the promote partner would receive nothing.

Note that because the revaluations in this example have no effect on the distributions the partners receive, it is unclear if they are even allowed under the regulations (which permit revaluations only if made for a "substantial

nontax business purpose"). Nonetheless, almost all partnership agreements permit revaluations with no reference to the regulations' business purpose requirement. A tax lawyer unable to procure a client's right to object to and prevent revaluations should insist that the business purpose requirement be explicitly incorporated into the partnership agreement. Doing so will give pause to a partnership that revalues its assets in a situation like Example 6, in which the only practical result is a shifting of the partnership's taxable income.

C. PMG and Nonrecourse Deductions

The typical real estate partnership agreement contains provisions similar to the following:

> Provision 3
>
> Notwithstanding any other provision of this agreement, "nonrecourse deductions" (as defined in reg. section 1.704-2(b)), if any, of the partnership shall be allocated among the partners in accordance with their respective percentage interests.
>
> Provision 4
>
> Notwithstanding any other provision of this agreement, if in any period during which adjustments to the partners' capital accounts are made there is a net decrease in "partnership minimum gain" (as defined in reg. section 1.704-2(d)), then each partner shall first be allocated items of gross income for such period (and, if necessary, subsequent periods) in an amount equal to the portion of such partner's share of the net decrease in "partnership minimum gain," determined in accordance with reg. section 1.704-2(g); provided, however, if there is insufficient gross income to make the above allocation for all partners for such period, the gross income shall be allocated between the partners in proportion to the respective amounts they would have been allocated had there been an unlimited amount of gross income for such period.

The section 704 regulations clarify the underlying terms of these provisions. They state that partnership minimum gain (PMG) 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."[28] Generally, a partnership nonrecourse liability is a liability for which no partner bears the economic risk of loss.

For purposes of this report, assume a loan to the partnership is secured only by the real estate purchased with the loan proceeds. Thus, under the regulations, if a partnership borrowed $390,000 to buy real estate for $390,000, and the loan was secured only by the real estate, the partnership's initial PMG would be zero because the partnership would realize no gain on a sale of the real estate for no consideration other than the satisfaction of the $390,000 liability ($390,000 amount realized minus $390,000 basis). If, however, in the next year, the partnership had depreciated the real estate's basis to $380,000 but had not paid off any of the liability, the PMG would be $10,000 because the partnership would realize $10,000 of gain on a disposition of the real estate for the satisfaction of the liability ($390,000 amount realized minus $380,000 basis).

The regulations define the amount of nonrecourse deductions (NRDs) as equal to the net increase in PMG during the year (reduced by the amount of specified distributions of the proceeds from nonrecourse borrowings).[29] In the example just mentioned, the amount of NRDs for the year in which the PMG grows from $0 to $10,000 is, of course, equal to $10,000. Provision 3 would allocate this $10,000 deduction in accordance with the partner's percentage interests (defined generally for each partner as the percentage equal to that partner's capital contributions divided by the sum of all partners' capital contributions). Provision 4 would allocate income in the same proportions upon a subsequent decrease in PMG. This would happen if, for example, the liability were reduced to $0 upon a transfer of the $380,000 basis property to

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[28]Reg. section 1.704-2(d)(1).

[29]Reg. section 1.704-2(b)(c).

Table 18

Assets	=	Liabilities	+	Capital Partner Capital Account	+	Promote Partner Capital Account
$500 real estate Y $500 real estate Z $1,000 total assets	=	$900 debt	+	$100	+	$0

Table 19

Assets	=	Liabilities	+	Capital Partner Capital Account	+	Promote Partner Capital Account
$500 real estate Z $550 cash $1,050 total assets	=	$450 debt	+	$100 + $402 $502	+	$0 + $98 $98

Table 20

Assets	=	Liabilities	+	Capital Partner Capital Account	+	Promote Partner Capital Account
$500 real estate Z $550 cash ($550) distribution $500 total assets	=	$450 debt	+	$502 ($462) $40	+	$98 ($88) $10

the lender and the partnership realized $10,000 of gain.[30]

To understand how these rules come into play in a typical real estate partnership, consider the following example.

Example 7: Assume there is a partnership between a capital partner (which contributes $100) and a promote partner (which contributes only its services), and the partnership agreement has the base case allocation and distribution provisions. Further assume the partnership uses the $100, plus $900 of proceeds from a nonrecourse borrowing, to purchase two parcels of real estate for $500 each (which serve as the sole security for the $900 loan), producing the initial balance sheet for the partnership as shown in Table 18.

Now assume the partnership sells real estate Y for $1,000 at the end of year 1 and pays off $450 of

the nonrecourse liability. Assume for simplicity that the real estate is not placed in service in year 1 and thus generates no depreciation or other deductions. At the end of year 1, the partnership would have $1,050 of assets and only $450 of liabilities. If the partnership were then liquidated and the $600 net proceeds were distributed, the capital partner would receive $502 [$100 * 1.1 + 0.8($600 - ($100 * 1.1))], and the promote partner would receive $98 (0.2($600 - ($100 * 1.1))). As a result, under the base case allocation provisions, the capital partner would be allocated $402 and the promote partner would be allocated $98, producing the year 2 beginning balance sheet as shown in Table 19.

If the $550 of cash were then distributed according to the distribution waterfall, the partnership's balance sheet would appear as shown in Table 20.

The $462 distribution to the capital partner is explained by the distribution of its $100 initial capital contribution plus its $10 preferred return plus its $352 (80 percent) share of the residual

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[30]I do not discuss Provision 4 further in this report. For a more thorough treatment, see Terence Floyd Cuff, "Some Nuances of the Minimum Gain Chargeback," in Practising Law Institute, *Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures and Other Strategic Alliances* (Apr. 2002).

Table 21

Assets	=	Liabilities	+	Capital Partner Capital Account	+	Promote Partner Capital Account
$500 real estate Z	=	$450 debt	+	$40	+	$10
($15) depreciation				+ $12		+ $3
+15 cash				($12)		($3)
$500 total assets				$40		$10

Table 22

Assets	=	Liabilities	+	Capital Partner Capital Account	+	Promote Partner Capital Account
$455 real estate Z	=	$450 debt	+	$40	+	$10
$45 cash						
$500 total assets						

$440. The $88 distribution to the promote partner corresponds to the remaining $88.

Now assume that in year 2 the partnership earns rent of $100, pays operating expenses of $60, pays interest expense of $25, and claims depreciation deductions equal to $15. From a balance sheet perspective, the partnership is breaking even, generating $15 of net cash that is reduced by a corresponding $15 depreciation deduction and allocated so that the partners maintain the capital account balances as shown in Table 21.

Assume the partnership continues to generate the same numbers for two more years, producing a year 4 final balance sheet as shown in Table 22.

If we assume the partnership generates the same numbers for one more year, something a bit strange happens: The ($15) depreciation deduction causes the real estate's basis to fall to $440, producing $10 of PMG ($450 liability minus $440 basis). Because it increases PMG by $10, $10 of the $15 depreciation deduction is an NRD that gets allocated, before any other allocations, according to the partners' percentage interests. The capital partner, as the partnership's sole contributor of capital, has a 100 percent percentage interest. As a result, all ($10) of the NRD is allocated to the capital partner before the allocation of any other items.

The remaining $10 of net income, composed of $15 of net income before depreciation and ($5) of non-NRD depreciation, is allocated according to

the base case allocation provisions so that the partners' capital account balances equal the net amounts they are entitled to receive in liquidation (assuming the nonrecourse liability is satisfied solely by the property securing it) minus their shares of PMG. Assuming the $450 nonrecourse liability is satisfied by the $440 real estate securing it, the partnership's remaining $60 of cash would be distributed $48 to the capital partner (80 percent of $60) and $12 to the promote partner (20 percent of $60).

As a result, the partners must then receive allocations so that their capital accounts equal these amounts minus their shares of PMG. The capital partner has a share of PMG equal to $10, and the promote partner has no share of PMG. The capital partner has a capital account balance equal to $30 (the initial $40 minus the $10 NRD), and the promote partner has a capital account balance equal to $10. Therefore, the capital partner is allocated $8 (so that its capital account equals its $48 liquidation entitlement minus its $10 share of PMG), and the promote partner is allocated $2, as shown in Table 23.

From an overall perspective, the partnership still breaks even. However, instead of each partner being allocated $0, the capital partner is allocated $2 of loss, and the promote partner is allocated $2 of income. If the partnership continues to generate the same income and expenses in subsequent years, the shift in the amount of income allocated to the promote

Table 23

Assets	=	Liabilities	+	Capital Partner Capital Account	+	Promote Partner Capital Account
$455 real estate Z ($10 NRD) ($5 regular depreciation) $45 cash $15 cash $500 total assets	=	$450 debt	+	$40 ($10 NRD) + $8 target allocation $38	+	$10 + $2 target allocation $12

partner, and loss allocated to the capital partner, would grow to $3 (given that all $15 of depreciation would be an NRD that gets allocated entirely to the capital partner).

But why is this the case? That is, why do partnership agreements typically provide that nonrecourse deductions are allocated in accordance with percentage interests even when percentage interests do not represent the way income and other deductions are allocated after the capital partners achieve their preferred return threshold? I cannot think of a reason.[31] Tax lawyers could prevent distortions like the one illustrated above by eliminating the boilerplate language causing nonrecourse deductions to be allocated in accordance with percentage interests. In its place, they should propose language allocating nonrecourse deductions consistently with other deductions, as determined by the partners (or by a specific partner) in good faith.

D. The BBA Rules

For tax years beginning in 2018 or later, most real estate partnerships are governed by the partnership audit rules in sections 6221 to 6241.[32] These rules were enacted under the Bipartisan Budget Act of 2015 (BBA). The BBA rules require that partnerships bear the primary liability for the underpayment of tax by their partners.

The BBA rules are harsh. If an audit results in an upward adjustment to the partnership's taxable income, the BBA rules make the

partnership liable for the amount of the adjustment multiplied by the highest income tax rate applicable to individuals or corporations (the product of which is the imputed underpayment). This rule is particularly harsh when the partners in the year the audit occurs (the adjustment year) are different from the partners in the year that is being audited (the reviewed year). In that case, the new partners will see the amount of cash available for distribution by the partnership reduced by tax liabilities of the partnership that are attributable to income for which they may have received no economic benefit.

The BBA rules contain a few provisions that mitigate the harshness of that result. Notable among them is the push-out election in section 6226. If a partnership makes a valid push-out election within 45 days of receiving a notice of final partnership adjustment, the partnership is no longer liable for the imputed underpayment; instead, the reviewed-year partners take the adjustment into account by increasing the tax they owe in the year the notice of final partnership adjustment was provided (the reporting year) by the net amount their taxes would increase had the adjustment been taken into account in the reviewed year (a correction amount).

Under the regulations, a separate correction amount is calculated for the reviewed year and for any year between the reviewed year and the reporting year (intervening years). A push-out election makes a reviewed-year partner liable for the aggregate of all correction amounts plus all related penalties, additions to tax, and additional amounts. Interest accrues on each correction amount from the due date of the return (without extension) for the year to which the correction

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[31]It is certainly not a legal requirement. *See* reg. section 1.704-2.

[32]Some partnerships may elect out of the BBA rules under section 6221(b) if they have only individual or corporate partners (or, in the case of a deceased partner, the estate of that partner).

amount relates, at the federal short-term rate plus 5 percent. That interest rate is 2 percent higher than the rate that applies in the absence of a push-out election. That is, if the partnership does not make a push-out election for the imputed underpayment, interest is computed at the federal short-term rate plus 3 percent on the imputed underpayment, and it accrues from the due date for the adjustment-year return (without extension).

At first glance, an extra 2 percent worth of interest seems like a small price to pay for shifting the liability for taxes back from the partnership to the partners and removing the application of the "highest income tax rate applicable to individuals or corporations" rule for purposes of calculating the amount of the liability. However, incurring this additional interest cost may be unnecessary if the partnership agreement contains sufficient protections to ensure that no partner bears the economic burden of a tax liability for which it is not responsible. To accomplish this goal, a partnership agreement could contain a provision that requires the partners, in the event of an audit, to cooperate in a pull-in procedure described in section 6225(c)(2)(B).

In a pull-in procedure, the partnership submits on behalf of the relevant partners all information and payment of any tax, penalties, additions to tax, additional amounts, and interest that would be required to be provided if the relevant partner were filing an amended return that took into account the partnership adjustments made as a result of the audit (both in the reviewed year and in any other year in which tax attributes may be affected by the audit adjustment). Assuming that all partners participate in the pull-in procedure by paying the partnership their share of the amounts owed and that the partnership pays all these amounts to the government, this payment is treated as a modification of the imputed underpayment from its original amount to zero, thus eliminating any additional liability of the partnership. A fully completed pull-in procedure thus has the same effect as a push-out election, except that interest accrues at the federal short-term rate plus 3 percent rather than 5 percent.

To understand the differences between the push-out election and the pull-in procedure, consider the following example.

Example 8: Assume a partnership reports a $100 expense for the purchase of property for which it claims a deduction under section 179 for its 2020 tax year on its tax return filed April 15, 2021. Further assume the $100 expense is allocated $50 to capital partner A, who is in the 25 percent tax bracket, and $50 to capital partner B, who is in the 37 percent tax bracket. Assume that in December 2022 the IRS determines that the $100 expense was not deductible under section 179 because it should have been treated as an acquisition of property not eligible for depreciation.

If a push-out election is made for the $100 adjustment, A and B would be required to increase the tax they owe for the year the adjustment was finalized (2022) by their aggregate correction amounts plus interest on those amounts at 6.6 percent (assuming for this example that the federal short-term rate is 1.6 percent). The aggregate correction amount for A would be $18.50 ($50 * 37 percent) and for B would be $12.50 ($50 * 25 percent). Assuming interest at 6.6 percent compounded annually for two years, these amounts grow to $21.02 and $14.20, respectively. Those respective amounts would be added to the amount of tax owed by A and B on April 15, 2023. If the partnership instead used the pull-in procedure, the partnership would pay $20.24 and $13.68 on behalf of A and B, respectively ($1.30 less than if the push-out election were made).

For a real estate partnership to potentially realize those interest savings, its partnership agreement should not require a push-out election. Instead, it should require the partners (and any former partners that were partners in the reviewed year) to participate in a pull-in procedure. If the agreement requires the partners to fund the amounts necessary for participation in a pull-in procedure and the partnership does not participate in that procedure until it receives that amount, there is no creation of risk that the

Table 24

Assets	=	Liabilities	+	Capital Partner A Capital Account	+	Capital Partner B Capital Account	+	Promote Partner Capital Account
$900 real estate $100 cash $1,000 total assets	=	$900 debt	+	$70	+	$30	+	$0

partnership will end up liable for the imputed underpayment.[33]

If the partners do not fund enough to fully complete the pull-in procedure, the partnership can make a subsequent push-out election and avoid any liability for the imputed underpayment. Many real estate partnership agreements are not drafted with this possibility in mind. Instead, they either require a push-out election or assume that the partnership will pay the imputed underpayment and then seek indemnification from the partners to which it relates. In assuming the latter, these agreements typically contain language providing that the payment of the imputed underpayment is treated as a distribution to those partners and thus reduces their entitlements under the distribution waterfall.

If the partners instead pay the necessary amounts to the partnership so that the partnership can participate in a pull-in procedure, typical agreements are often unclear on how to account for that payment. Because the payment is effectively a substitute for a tax payment made by the partners, it should have no effect on the partners' capital accounts, percentage interests, or distribution entitlements. To accomplish this, the agreement could provide that each payment (the first by the partner to the partnership, and the second by the partnership to the government) is ignored, or that the payment by the partner to the partnership is treated as a capital contribution that does not increase the contributing partner's percentage interest followed by an offsetting special allocation of the expense representing the payment by the partnership to the government.

However, the partnership adjustment (in Example 8, transforming a $100 deduction into $100 additional basis in partnership property) does affect the partners' capital accounts. This should also be addressed by the partnership agreement. In Example 8, the $100 adjustment would increase the partnership's inside basis as well as the partners' aggregate outside bases and capital accounts by $100.

Proposed regulations would require that the adjustments be allocated in the adjustment year in the same manner that they would have been allocated had they actually arisen in the reviewed year. Because the partnership in this example is a simple 50-50 partnership, it is clear that the adjustments to the capital accounts (which drive the adjustments to the outside bases) should be made in the same 50-50 ratio. In a more complex partnership, the effect of the proposed regulations' method for allocating the adjustments can be illustrated in the following example.

Example 9: Assume a partnership agreement has the base case allocation and distribution provisions and that the partnership has the balance sheet as shown in Table 24 before a $100 section 179 deduction.

Assume that before the section 179 deduction the partnership had exactly $100 of taxable income. If the expense were deductible, the partnership would have no taxable income, and it would have the same balance sheet as above. If, however, the expense had to be added to the basis of the partnership property, the partnership would have $100 of additional income to allocate.

The proposed regulations would require that the $100 adjustment be allocated as it would have been allocated had it arisen in the reviewed year.[34]

[33]*See* reg. section 301.6226-3(h)(5) (providing an example illustrating that the partnership may first reduce the imputed underpayment through the modification process and then make a push-out election under section 6226 to relieve the partnership of any remaining liability under the BBA rules).

[34]*See* prop. reg. section 1.704-1(b)(4)(xi).

Under the base case distribution and allocation provisions, allocations consistent with the proposed regulations would be $57.40 to capital partner A, $24.60 to capital partner B, and $18 to the promote partner, producing the following capital accounts[35]:

Table 25

Capital Partner A Capital Account	+	Capital Partner B Capital Account	+	Promote Partner Capital Account
$127.40	+	$54.60	+	$18

However, these capital accounts do not match the partners' entitlements to distributions in the adjustment year (assumed to be two years after the end of the reviewed year) because those entitlements would reflect an additional two years of preferred return accrual. Instead, the entitlements to the $200 of net proceeds after an additional two years are as follows[36]:

Table 26

Capital Partner A	+	Capital Partner B	+	Promote Partner
$130.63	+	$55.99	+	$13.38

A's capital account is $3.23 below its distribution entitlement; B's capital account is $1.39 below its distribution entitlement; and the promote partner's capital account is $4.62 above its distribution entitlement. The base case allocation provisions would look to these distribution entitlements and capital accounts for purposes of determining future allocations. Will that work? What happens if, in the same year, the partnership earns $5 of rental income? That would get factored into the distribution entitlements too, increasing them slightly for each

partner. This $5 would then need to be allocated. But it is only $5, and the capital partners' capital accounts are off by more than that. It is not clear (to me at least) what the accountants should do in this situation, though attempting to apply both the proposed regulations and the base case allocation provisions in a mechanical fashion does not look fruitful. To provide some flexibility in situations like this, tax lawyers should consider including clauses in their clients' partnership agreements that allow for the equitable adjustment of capital accounts and allocation provisions in the event of a partnership adjustment.

V. Conclusion

Tax lawyers who regularly review real estate partnership agreements could benefit from considering the issues addressed in this report. In my experience, these issues arise in nearly every real estate partnership agreement — from a simple joint venture between two individuals to a complex multitiered fund featuring foreign, tax-exempt, and real estate investment trust investors. By paying attention to these issues, a tax lawyer can find opportunities to enhance a client's economic return on investment. If the deal is large enough, the increase in the client's return can far exceed the tax lawyer's bill. Keep in mind, however, that there are many issues not addressed in this report that a tax lawyer may also need to be aware of when reviewing a real estate partnership agreement. ∎

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[35]Of the $200 net proceeds available for distribution in liquidation after one year, capital partner A would be entitled to 70 percent * [($100 * 1.1) + (0.8($200 - ($100 * 1.1)))] = $127.40; capital partner B would be entitled to 30 percent * [($100 * 1.1) + (0.8($200 - ($100 * 1.1)))] = $54.60; and the promote partner would be entitled to 0.2($200 - ($100 * 1.1)) = $18.

[36]Of the $200 net proceeds available for distribution in liquidation after three years, capital partner A would be entitled to 70 percent * [($100 * 1.1^3) + (0.8($200 - ($100 * 1.1^3)))] = $130.63; capital partner B would be entitled to 30 percent * [($100 * 1.1^3) + (0.8($200 - ($100 * 1.1^3)))] = $55.99; and the promote partner would be entitled to 0.2($200 - ($100 * 1.1^3)) = $13.38.