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Reg. Section 1.704-1(b)(2)(iii)(c)

Partner's distributive share

(a) Effect of partnership agreement. A partner's distributive share of any item or class of items of income, gain, loss, deduction, or credit of the partnership shall be determined by the partnership agreement, unless otherwise provided by section 704 and paragraphs (b) through (e) of this section. For definition of partnership agreement see section 761(c).

(b) Determination of partner's distributive share.

(0) Cross-references.

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(1) In general.

(i) Basic principles. Under section 704(b) if a partnership agreement does not provide for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner, or if the partnership agreement provides for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner but such allocation does not have substantial economic effect, then the partner's distributive share of such income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with such partner's interest in the partnership (taking into account all facts and circumstances). If the partnership agreement provides for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner, there are three ways in which such allocation will be respected under section 704(b) and this paragraph. First, the allocation can have substantial economic effect in accordance with paragraph (b)(2) of this section. Second, taking into account all facts and circumstances, the allocation can be in accordance with the partner's interest in the partnership. See paragraph (b)(3) of this section. Third, the allocation can be deemed to be in accordance with the partner's interest in the partnership pursuant to one of the special rules contained in paragraph (b)(4) of this section and §1.704-2. To the extent an allocation under the partnership agreement of income, gain, loss, deduction, or credit (or item thereof) to a partner does not have substantial economic effect, is not in accordance with the partner's interest in the partnership, and is not deemed to be in accordance with the partner's interest in the partnership, such income, gain, loss, deduction, or credit (or item thereof) will be reallocated in accordance with the partner's interest in the partnership (determined under paragraph (b)(3) of this section).

(ii) Effective/applicability date.

(a) Generally. Except as otherwise provided in this section, the provisions of this paragraph are effective for partnership taxable years beginning after December 31, 1975. However, for partnership taxable years beginning after December 31,

1975, but before May 1, 1986, (January 1, 1987, in the case of allocations of nonrecourse deductions as defined in paragraph (b)(4)(iv)(a) of this section) an allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner that is not respected under this paragraph nevertheless will be respected under section 704(b) if such allocation has substantial economic effect or is in accordance with the partners' interests in the partnership as those terms have been interpreted under the relevant case law, the legislative history of section 210(d) of the Tax Reform Act of 1976, and the provisions of this paragraph in effect for partnership taxable years beginning before May 1, 1986. Paragraphs (b)(2)(iii)(a) (last sentence), (b)(2)(iii)(d), (b)(2)(iii)(e), and (b)(5) Example 28, Example 29, and Example 30 of this section. The last sentence of paragraph (b)(2)(iv)(g)(3) of this section is applicable for partnership taxable years ending on or after September 24, 2019. However, a partnership may choose to apply the last sentence in paragraph (b)(2)(iv)(g)(3) of this section for the partnership's taxable years ending on or after September 28, 2017. A partnership may rely on the last sentence in paragraph (b)(2)(iv)(g)(3) of this section in regulation project REG-104397-18 (2018-41 I.R.B. 558) (see §601.601(d)(2)(ii)(b) of this chapter) for the partnership's taxable years ending on or after September 28, 2017, and ending before the partnership's taxable year that includes September 24, 2019. Furthermore, the last sentence of paragraph (b)(2)(ii)(b)(3) of this section and paragraphs (b)(2)(ii)(b)(4) through (7) and (b)(2)(ii)(c) of this section apply to partnership taxable years ending on or after October 9, 2019. However, taxpayers may apply the last sentence of paragraph (b)(2)(ii)(b)(3) of this section and paragraphs (b)(2)(ii)(b)(4) through (7) and (b)(2)(ii)(c) of this section for partnership taxable years ending on or after October 5, 2016. For partnership taxable years ending before October 9, 2019, see §1.704-1 as contained in 26 CFR part 1 revised as of April 1, 2019.

(b) Rules relating to foreign tax expenditures.

(1) In general. Except as otherwise provided in this paragraph (b)(1)(ii)(b)(1), the provisions of paragraphs (b)(3)(iv) and (b)(4)(viii) of this section (regarding the allocation of creditable foreign taxes) apply for partnership taxable years beginning on or after October 19, 2006. The rules that apply to allocations of creditable foreign taxes made in partnership taxable years beginning before October 19, 2006 are contained in §1.704-1T(b)(1)(ii)(b)(1) and (b)(4)(xi) as in effect before October 19, 2006 (see 26 CFR part 1 revised as of April 1, 2005). However, taxpayers may rely on the provisions of paragraphs (b)(3)(iv) and (b)(4)(viii) of this section for partnership taxable years beginning on or after April 21, 2004. The provisions of paragraphs (b)(4)(viii)(a)(1), (b)(4)(viii)(c)(1), (b)(4)(viii)(c)(2)(ii) and (iii), (b)(4)(viii)(c)(3) and (4), (b)(4)(viii)(d)(1), and Examples 1, 2, and 3 in paragraphs (b)(6)(i), (ii), and (iii) of this section apply for partnership taxable years that both begin on or after January 1, 2016, and end after February 4, 2016. For the rules that apply to partnership taxable years beginning on or after October 19, 2006, and before January 1, 2016, and to taxable years that both begin on or after January 1, 2016, and end on or before February 4, 2016, see § 1.704-1(b)(1)(ii)(b), (b)(4)(viii)(a)(1), (b)(4)(viii)(c)(1), (b)(4)(viii)(c)(2)(ii) and

(iii), (b)(4)(viii)(c)(3) and (4), (b)(4)(viii)(d)(1), and (b)(5), Example 25 (as contained in 26 CFR part 1 revised as of April 1, 2015).

(2) Transition rule. Transition relief is provided herein to partnerships whose agreements were entered into prior to April 21, 2004. In such case, if there has been no material modification to the partnership agreement on or after April 21, 2004, then the partnership may apply the provisions of paragraph (b) of this section as if the amendments made by paragraphs (b)(3)(iv) and (b)(4)(viii) of this section had not occurred. If the partnership agreement was materially modified on or after April 21, 2004, then the rules provided in paragraphs (b)(3)(iv) and (b)(4)(viii) of this section shall apply to the later of the taxable year beginning on or after October 19, 2006 or the taxable year within which the material modification occurred, and to all subsequent taxable years. If the partnership agreement was materially modified on or after April 21, 2004, and before a tax year beginning on or after October 19, 2006, see §§1.704-1T(b)(1)(ii)(b)(1) and 1.704-1T(b)(4)(xi) as in effect prior to October 19, 2006 (26 CFR part 1 revised as of April 1, 2005). For purposes of this paragraph (b)(1)(ii)(b)(2), any change in ownership constitutes a material modification to the partnership agreement. This transition rule does not apply to any taxable year (and all subsequent taxable years) in which persons that are related to each other (within the meaning of section 267(b) and 707(b)) collectively have the power to amend the partnership agreement without the consent of any unrelated party.

(3) Special rules for certain inter-branch payments.

(i) In general. The provisions of §1.704-1(b)(4)(viii)(d)(3) apply for partnership taxable years ending after February 9, 2015. See 26 CFR 1.704-1T(b)(4)(viii)(d)(3) (revised as of April 1, 2014) for rules applicable to taxable years beginning on or after January 1, 2012, and ending on or before February 9, 2015.

(ii) Transition rule. Transition relief is provided by this paragraph (b)(1)(ii)(b)(3)(ii) to partnerships whose agreements were entered into before February 14, 2012. In such cases, if there has been no material modification to the partnership agreement on or after February 14, 2012, then, for taxable years beginning on or after January 1, 2012, and before January 1, 2016, and for taxable years that both begin on or after January 1, 2012, and end on or before February 4, 2016, these partnerships may apply the provisions of §1.704-1(b)(4)(viii)(c)(3)(ii) and (b)(4)(viii)(d)(3) (see 26 CFR part 1 revised as of April 1, 2011). For taxable years that both begin on or after January 1, 2016, and end after February 4, 2016, these partnerships may apply the provisions of §1.704-1(b)(4)(viii)(d)(3) (see 26 CFR part 1 revised as of April 1, 2011). For purposes of this paragraph (b)(1)(ii)(b)(3), any change in ownership constitutes a material modification to the partnership agreement. The transition rule in this paragraph (b)(1)(ii)(b)(3)(ii) does not apply to any taxable year in which persons bearing a

relationship to each other that is specified in section 267(b) or section 707(b) collectively have the power to amend the partnership agreement without the consent of any unrelated party (and all subsequent taxable years).

(4) Special rules for covered asset acquisitions. Paragraphs (b)(4)(viii)(c)(4)(v) through (vii) of this section apply to covered asset acquisitions (CAAs) (as defined in §1.901(m)-1(a)(13)) occurring on or after March 23, 2020. Taxpayers may, however, choose to apply paragraphs (b)(4)(viii)(c)(4)(v) through (vii) of this section before the date paragraphs (b)(4)(viii)(c)(4)(v) through (vii) of this section are applicable provided that they (along with any persons that are related (within the meaning of section 267(b) or 707(b)) to the taxpayer)--

(i) Consistently apply paragraphs (b)(4)(viii)(c)(4)(v) through (vii) of this section, §1.901(m)-1, and §§1.901(m)-3 through 1.901(m)-8 (excluding §1.901(m)-4(e)) to all CAAs occurring on or after January 1, 2011, and consistently apply § 1.901(m)-2 (excluding §1.901(m)-2(d)) to all CAAs occurring on or after December 7, 2016, on any original or amended tax return for each taxable year for which the application of the provisions listed in this paragraph (b)(1)(ii)(b)(4)(i) affects the tax liability and for which the statute of limitations does not preclude assessment or the filing of a claim for refund, as applicable;

(ii) File all tax returns described in paragraph (b)(1)(ii)(b)(4)(i) of this section for any taxable year ending on or before March 23, 2020, no later than March 23, 2021; and

(iii) Make appropriate adjustments to take into account deficiencies that would have resulted from the consistent application under paragraph (b)(1)(ii)(b)(4)(i) of this section for taxable years that are not open for assessment.

In addition, paragraph (b)(2)(iv)(d)(4), paragraph (b)(2)(iv)(f)(1), paragraph (b)(2)(iv)(f)(5)(iv), paragraph (b)(2)(iv)(h)(2), paragraph (b)(2)(iv)(s), paragraph (b)(4)(ix), paragraph (b)(4)(x), and Examples 31 through 35 in paragraph (b)(5) of this section apply to noncompensatory options (as defined in §1.721-2(f)) that are issued on or after February 5, 2013.

(iii) Effect of other sections. The determination of a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) under section 704(b) and this paragraph is not conclusive as to the tax treatment of a partner with respect to such distributive share. For example, an allocation of loss or deduction to a partner that is respected under section 704(b) and this paragraph may not be deductible by such partner if the partner lacks the requisite motive for economic gain (see, e.g., *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966)), or may be disallowed for that taxable year (and held in suspense) if the limitations of section 465 or section 704(d) are applicable. Similarly, an allocation that is respected under section 704(b) and this paragraph

nevertheless may be reallocated under other provisions, such as section 482, section 704(e)(2), section 706(d) (and related assignment of income principles), and paragraph (b)(2)(ii) of §1.751-1. If a partnership has a section 754 election in effect, a partner's distributive share of partnership income, gain, loss, or deduction may be affected as provided in §1.743-1 (see paragraph (b)(2)(iv)(m)(2) of this section). A deduction that appears to be a nonrecourse deduction deemed to be in accordance with the partners' interests in the partnership may not be such because purported nonrecourse liabilities of the partnership in fact constitute equity rather than debt. The examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address the effect of other sections or limitations on such allocations.

(iv) Other possible tax consequences. Allocations that are respected under section 704(b) and this paragraph may give rise to other tax consequences, such as those resulting from the application of section 61, section 83, section 751, section 2501, paragraph (f) of §1.46-3, §1.47-6, paragraph (b)(1) of §1.721-1 (and related principles), and paragraph (e) of §1.752-1. The examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address other tax consequences that may result from such allocations.

(v) Purported allocations. Section 704(b) and this paragraph do not apply to a purported allocation if it is made to a person who is not a partner of the partnership (see section 7701(a)(2) and paragraph (d) of §301.7701-3) or to a person who is not receiving the purported allocation in his capacity as a partner (see section 707(a) and paragraph (a) of §1.707-1).

(vi) Section 704(c) determinations. Section 704(c) and §1.704-3 generally require that if property is contributed by a partner to a partnership, the partners' distributive shares of income, gain, loss, and deduction, as computed for tax purposes, with respect to the property are determined so as to take account of the variation between the adjusted tax basis and fair market value of the property. Although section 704(b) does not directly determine the partners' distributive shares of tax items governed by section 704(c), the partners' distributive shares of tax items may be determined under section 704(c) and §1.704-3 (depending on the allocation method chosen by the partnership under §1.704-3) with reference to the partners' distributive shares of the corresponding book items, as determined under section 704(b) and this paragraph. (See paragraphs (b)(2)(iv)(d) and (b)(4)(i) of this section.) See §1.704-3 for methods of making allocations under section 704(c), and §1.704-3(d)(2) for a special rule in determining the amount of book items if the remedial allocation method is chosen by the partnership. See also paragraph (b)(5) Example (13)(i) of this section.

(vii) Bottom line allocations. Section 704(b) and this paragraph are applicable to allocations of income, gain, loss, deduction, and credit, allocations of specific items of income, gain, loss, deduction, and credit, and allocations of partnership net or "bottom line" taxable income and loss. An allocation to a partner of a share of partnership net or "bottom line" taxable income or loss shall be treated as an allocation to such partner of the same share of each item of income, gain, loss, and deduction that is taken into account in computing such net or "bottom line" taxable income or loss. See example (15)(i) of paragraph (b)(5) of this section.

(2) Substantial economic effect.

(i) Two-part analysis. The determination of whether an allocation of income, gain, loss, or deduction (or item thereof) to a partner has substantial economic effect involves a two-part analysis that is made as of the end of the partnership taxable year to which the allocation relates. First, the allocation must have economic effect (within the meaning of paragraph (b)(2)(ii) of this section). Second, the economic effect of the allocation must be substantial (within the meaning of paragraph (b)(2)(iii) of this section).

(ii) Economic effect.

(a) Fundamental principles. In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.

(b) Three requirements. Based on the principles contained in paragraph (b)(2)(ii)(a) of this section, and except as otherwise provided in this paragraph, an allocation of income, gain, loss, or deduction (or item thereof) to a partner will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides-

(1) For the determination and maintenance of the partners' capital accounts in accordance with the rules of paragraph (b)(2)(iv) of this section,

(2) Upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (2) and requirement (3) of this paragraph (b)(2)(ii)(b)), by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), and

(3) If such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (3)), he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances (in accordance with requirement (2) of this paragraph (b)(2)(ii)(b)). Notwithstanding the partnership agreement, an obligation to restore a deficit balance in a partner's capital account, including an obligation described in paragraph (b)(2)(ii)(c)(1) of this section, will not be respected for purposes of this section to the extent the obligation is disregarded under paragraph (b)(2)(ii)(c)(4) of this section.

(4) For purposes of paragraphs (b)(2)(ii)(b)(1) through (3) of this section, a partnership taxable year shall be determined without regard to section 706(c)(2)(A).

(5) The requirements in paragraphs (b)(2)(ii)(b)(2) and (3) of this section are not violated if all or part of the partnership interest of one or more partners is purchased (other than in connection with the liquidation of the partnership) by the partnership or by one or more partners (or one or more persons related, within the meaning of section 267(b) (without modification by section 267(e)(1)) or section 707(b)(1), to a partner) pursuant to an agreement negotiated at arm's length by persons who at the time such agreement is entered into have materially adverse interests and if a principal purpose of such purchase and sale is not to avoid the principles of the second sentence of paragraph (b)(2)(ii)(a) of this section.

(6) The requirement in paragraph (b)(2)(ii)(b)(2) of this section is not violated if, upon the liquidation of the partnership, the capital accounts of the partners are increased or decreased pursuant to paragraph (b)(2)(iv)(f) of this section as of the date of such liquidation and the partnership makes liquidating distributions within the time set out in the requirement in paragraph (b)(2)(ii)(b)(2) of this section in the ratios of the partners' positive capital accounts, except that it does not distribute reserves reasonably required to provide for liabilities (contingent or otherwise) of the partnership and installment obligations owed to the partnership, so long as such withheld amounts are distributed as soon as practicable and in the ratios of the partners' positive capital account balances.

(7) See Examples 1.(i) and (ii), 4.(i), 8.(i), and 16.(i) of paragraph (b)(5) of this section for issues concerning paragraph (b)(2)(ii)(b) of this section.

(c) Obligation to restore deficit.

(1) Other arrangements treated as obligations to restore deficits. If a partner is not expressly obligated to restore the deficit balance in such partner's capital account, such partner nevertheless will be treated as obligated to restore the deficit balance in his capital account (in accordance with the requirement in paragraph (b)(2)(ii)(b)(3) of this section and subject to paragraph (b)(2)(ii)(c)(2) of this section) to the extent of-

(A) The outstanding principal balance of any promissory note (of which such partner is the maker) contributed to the partnership by such partner (other than a promissory note that is readily tradable on an established securities market), and

(B) The amount of any unconditional obligation of such partner (whether imposed by the partnership agreement or by state or local law) to make subsequent contributions to the partnership (other than pursuant to a promissory note of which such partner is the maker).

(2) Satisfaction requirement. For purposes of paragraph (b)(2)(ii)(c)(1) of this section, a promissory note or unconditional obligation is taken into account only if it is required to be satisfied at a time no later than the end of the partnership taxable year in which such partner's interest is liquidated (or, if later, within 90 days after the date of such

liquidation). If a promissory note referred to in paragraph (b)(2)(ii)(c)(1) of this section is negotiable, a partner will be considered required to satisfy such note within the time period specified in this paragraph (b)(2)(ii)(c)(2) if the partnership agreement provides that, in lieu of actual satisfaction, the partnership will retain such note and such partner will contribute to the partnership the excess, if any, of the outstanding principal balance of such note over its fair market value at the time of liquidation. See paragraph (b)(2)(iv)(d)(2) of this section. See Examples 1.(ix) and (x) of paragraph (b)(5) of this section.

(3) Related party notes. For purposes of paragraph (b)(2) of this section, if a partner contributes a promissory note to the partnership during a partnership taxable year beginning after December 29, 1988, and the maker of such note is a person related to such partner (within the meaning of §1.752-4(b)(1)), then such promissory note shall be treated as a promissory note of which such partner is the maker.

(4) Obligations disregarded.

(A) General rule. A partner in no event will be considered obligated to restore the deficit balance in his capital account to the partnership (in accordance with the requirement in paragraph (b)(2)(ii)(b)(3) of this section) to the extent such partner's obligation is a bottom dollar payment obligation that is not recognized under §1.752-2(b)(3) or is not legally enforceable, or the facts and circumstances otherwise indicate a plan to circumvent or avoid such obligation. See paragraphs (b)(2)(ii)(f), (b)(2)(ii)(h), and (b)(4)(vi) of this section for other rules regarding such obligation. To the extent a partner is not considered obligated to restore the deficit balance in the partner's capital account to the partnership (in accordance with the requirement in paragraph (b)(2)(ii)(b)(3) of this section), the obligation is disregarded and paragraph (b)(2) of this section and §1.752-2 are applied as if the obligation did not exist.

(B) Factors indicating plan to circumvent or avoid obligation. In the case of an obligation to restore a deficit balance in a partner's capital account upon liquidation of a partnership, paragraphs (b)(2)(ii)(c)(4)(B)(i) through (iv) of this section provide a non-exclusive list of factors that may indicate a plan to circumvent or avoid the obligation. For purposes of making determinations under this paragraph (b)(2)(ii)(c)(4), the weight to be given to any particular factor depends on the particular case and the presence or absence of any particular factor is not, in itself, necessarily indicative of whether or not the obligation is respected. The following factors are taken into consideration for purposes of this paragraph (b)(2):

(i) The partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation.

(ii) The partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership.

(iii) The obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's

capital account as provided in §1.704-1(b)(2)(iv) is negative other than when a transferee partner assumes the obligation.

(iv) The terms of the obligation are not provided to all the partners in the partnership in a timely manner.

(d) Alternate test for economic effect. If-

(1) Requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied, and

(2) The partner to whom an allocation is made is not obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section), or is obligated to restore only a limited dollar amount of such deficit balance, and

(3) The partnership agreement contains a "qualified income offset," such allocation will be considered to have economic effect under this paragraph (b)(2)(ii)(d) to the extent such allocation does not cause or increase a deficit balance in such partner's capital account (in excess of any limited dollar amount of such deficit balance that such partner is obligated to restore) as of the end of the partnership taxable year to which such allocation relates. In determining the extent to which the previous sentence is satisfied, such partner's capital account also shall be reduced for-

(4) Adjustments that, as of the end of such year, reasonably are expected to be made to such partner's capital account under paragraph (b)(2)(iv)(k) of this section for depletion allowances with respect to oil and gas properties of the partnership, and

(5) Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to section 704(e)(2), section 706(d), and paragraph (b)(2)(ii) of §1.751-1, and

(6) Distributions that, as of the end of such year, reasonably are expected to be made to such partner to the extent they exceed offsetting increases to such partner's capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made (other than increases pursuant to a minimum gain chargeback under paragraph (b)(4)(iv)(e) of this section or under § 1.704-2(f); however, increases to a partner's capital account pursuant to a minimum gain chargeback requirement are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain.

For purposes of determining the amount of expected distributions and expected capital account increases described in (6) above, the rule set out in paragraph (b)(2)(iii)(c) of this section concerning the presumed value of partnership property shall apply. The partnership agreement contains a "qualified income offset" if, and only if, it provides that a partner who unexpectedly receives an adjustment,

allocation, or distribution described in (4), (5), or (6) above, will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible. Allocations of items of income and gain made pursuant to the immediately preceding sentence shall be deemed to be made in accordance with the partners' interests in the partnership if requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied. See examples (1)(iii), (iv), (v), (vi), (vii), (ix), and (x), (15), and (16)(ii) of paragraph (b)(5) of this section.

(e) Partial economic effect. If only a portion of an allocation made to a partner with respect to a partnership taxable year has economic effect, both the portion that has economic effect and the portion that is reallocated shall consist of a proportionate share of all items that made up the allocation to such partner for such year. See examples (15)(ii) and (iii) of paragraph (b)(5) of this section.

(f) Reduction of obligation to restore. If requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied, a partner's obligation to restore the deficit balance in his capital account (or any limited dollar amount thereof) to the partnership may be eliminated or reduced as of the end of a partnership taxable year without affecting the validity of prior allocations (see paragraph (b)(4)(vi) of this section) to the extent the deficit balance (if any) in such partner's capital account, after reduction for the items described in (4), (5), and (6) of paragraph (b)(2)(ii)(d) of this section, will not exceed the partner's remaining obligation (if any) to restore the deficit balance in his capital account. See example (1)(viii) of paragraph (b)(5) of this section.

(g) Liquidation defined. For purposes of this paragraph, a liquidation of a partner's interest in the partnership occurs upon the earlier of (1) the date upon which there is a liquidation of the partnership, or (2) the date upon which there is a liquidation of the partner's interest in the partnership under paragraph (d) of §1.761-1. For purposes of this paragraph, the liquidation of a partnership occurs upon the earlier of (3) the date upon which the partnership is terminated under section 708(b)(1), or (4) the date upon which the partnership ceases to be a going concern (even though it may continue in existence for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its partners). Requirements (2) and (3) of paragraph (b)(2)(ii)(b) of this section will be considered unsatisfied if the liquidation of a partner's interest in the partnership is delayed after its primary business activities have been terminated (for example, by continuing to engage in a relatively minor amount of business activity, if such actions themselves do not cause the partnership to terminate pursuant to section 708(b)(1)) for a principal purpose of deferring any distribution pursuant to requirement (2) of paragraph (b)(2)(ii)(b) of this section or deferring any partner's obligations under requirement (3) of paragraph (b)(2)(ii)(b) of this section.

(h) Partnership agreement defined. For purposes of this paragraph, the partnership agreement includes all agreements among the partners, or between one or more partners and the partnership, concerning affairs of the partnership and responsibilities of partners, whether oral or written, and whether or not embodied in a document referred to by the partners as the partnership agreement. Thus, in determining whether distributions are required in all cases to be made in accordance with the partners' positive capital account

balances (requirement (2) of paragraph (b)(2)(ii)(b) of this section), and in determining the extent to which a partner is obligated to restore a deficit balance in his capital account (requirement (3) of paragraph (b)(2)(ii)(b) of this section), all arrangements among partners, or between one or more partners and the partnership relating to the partnership, direct and indirect, including puts, options, and other buy-sell agreements, and any other "stop-loss" arrangement, are considered to be part of the partnership agreement. (Thus, for example, if one partner who assumes a liability of the partnership is indemnified by another partner for a portion of such liability, the indemnifying partner (depending upon the particular facts) may be viewed as in effect having a partial deficit makeup obligation as a result of such indemnity agreement.) In addition, the partnership agreement includes provisions of Federal, State, or local law that govern the affairs of the partnership or are considered under such law to be a part of the partnership agreement (see the last sentence of paragraph (c) of §1.761-1). For purposes of this paragraph (b)(2)(ii)(h), an agreement with a partner or a partnership shall include an agreement with a person related, within the meaning of section 267(b) (without modification by section 267(e)(1)) or section 707(b)(1), to such partner or partnership. For purposes of the preceding sentence, sections 267(b) and 707(b)(1) shall be applied for partnership taxable years beginning after December 29, 1988 by (1) substituting "80 percent or more" for "more than 50 percent" each place it appears in such sections, (2) excluding brothers and sisters from the members of a person's family, and (3) disregarding section 267(f)(1)(A).

(i) Economic effect equivalence. Allocations made to a partner that do not otherwise have economic effect under this paragraph (b)(2)(ii) shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if requirements (1), (2), and (3) of paragraph (b)(2)(ii)(b) of this section had been satisfied, regardless of the economic performance of the partnership. See examples (4)(ii) and (iii) of paragraph (b)(5) of this section.

(iii) Substantiality.

(a) General rules. Except as otherwise provided in this paragraph (b)(2)(iii), the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. Notwithstanding the preceding sentence, the economic effect of an allocation (or allocations) is not substantial if, at the time the allocation becomes part of the partnership agreement; (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with such partner's tax attributes that are unrelated to the partnership will be taken into account. See examples (5) and (9) of paragraph (b)(5) of this section. The economic effect of an allocation is not substantial in the two situations described in paragraphs (b)(2)(iii)(b) and (c) of this section. However, even if an allocation is not described therein, its economic effect may be insubstantial under the general rules stated in this

paragraph (b)(2)(iii)(a). References in this paragraph (b)(2)(iii) to allocations includes capital account adjustments made pursuant to paragraph (b)(2)(iv)(k) of this section. References in this paragraph (b)(2)(iii) to a comparison to consequences arising if an allocation (or allocations) were not contained in the partnership agreement mean that the allocation (or allocations) is determined in accordance with the partners' interests in the partnership (within the meaning of paragraph (b)(3) of this section), disregarding the allocation (or allocations) being tested under this paragraph (b)(2)(iii).

(b) Shifting tax consequences. The economic effect of an allocation (or allocations) in a partnership taxable year is not substantial if, at the time the allocation (or allocations) becomes part of the partnership agreement, there is a strong likelihood that-

(1) The net increases and decreases that will be recorded in the partners' respective capital accounts for such taxable year will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such year if the allocations were not contained in the partnership agreement, and

(2) The total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership). If, at the end of a partnership taxable year to which an allocation (or allocations) relates, the net increases and decreases that are recorded in the partners' respective capital accounts do not differ substantially from the net increases and decreases that would have been recorded in such partners' respective capital accounts had the allocation (or allocations) not been contained in the partnership agreement, and the total tax liability of the partners is (as described in (2) above) less than it would have been had the allocation (or allocations) not been contained in the partnership agreement, it will be presumed that, at the time the allocation (or allocations) became part of such partnership agreement, there was a strong likelihood that these results would occur. This presumption may be overcome by a showing of facts and circumstances that prove otherwise. See examples (6), (7)(ii) and (iii), and (10)(ii) of paragraph (b)(5) of this section.



(c) Transitory allocations. If a partnership agreement provides for the possibility that one or more allocations (the "original allocation(s)") will be largely offset by one or more other allocations (the "offsetting allocation(s)"), and, at the time the allocations become part of the partnership agreement, there is a strong likelihood that-

(1) The net increases and decreases that will be recorded in the partners' respective capital accounts for the taxable years to which the allocations relate will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such years if the original allocation(s) and offsetting allocation(s) were not contained in the partnership agreement, and

(2) The total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account

tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership)

the economic effect of the original allocation(s) and offsetting allocation(s) will not be substantial. If, at the end of a partnership taxable year to which an offsetting allocation(s) relates, the net increases and decreases recorded in the partners' respective capital accounts do not differ substantially from the net increases and decreases that would have been recorded in such partners' respective capital accounts had the original allocation(s) and the offsetting allocation(s) not been contained in the partnership agreement, and the total tax liability of the partners is (as described in (2) above) less than it would have been had such allocations not been contained in the partnership agreement, it will be presumed that, at the time the allocations became part of the partnership agreement, there was a strong likelihood that these results would occur. This presumption may be overcome by a showing of facts and circumstances that prove otherwise. See examples (1)(xi), (2), (3), (7), (8)(ii), and (17) of paragraph (b)(5) of this section. Notwithstanding the foregoing, the original allocation(s) and the offsetting allocation(s) will not be insubstantial (under this paragraph (b)(2)(iii)(c)) and, for purposes of paragraph (b)(2)(iii)(a), it will be presumed that there is a reasonable possibility that the allocations will affect substantially the dollar amounts to be received by the partners from the partnership if, at the time the allocations become part of the partnership agreement, there is a strong likelihood that the offsetting allocation(s) will not, in large part, be made within five years after the original allocation(s) is made (determined on a first-in, first-out basis). See example (2) of paragraph (b)(5) of this section. For purposes of applying the provisions of this paragraph (b)(2)(iii) (and paragraphs (b)(2)(ii)(d)(6) and (b)(3)(iii) of this section), the adjusted tax basis of partnership property (or, if partnership property is properly reflected on the books of the partnership at a book value that differs from its adjusted tax basis, the book value of such property) will be presumed to be the fair market value of such property, and adjustments to the adjusted tax basis (or book value) of such property will be presumed to be matched by corresponding changes in such property's fair market value. Thus, there cannot be a strong likelihood that the economic effect of an allocation (or allocations) will be largely offset by an allocation (or allocations) of gain or loss from the disposition of partnership property. See examples (1)(vi) and (xi) of paragraph (b)(5) of this section.

(d) Partners that are look-through entities or members of a consolidated group.

(1) In general. For purposes of applying paragraphs (b)(2)(iii)(a), (b), and (c) of this section to a partner that is a look-through entity, the tax consequences that result from the interaction of the allocation with the tax attributes of any person that is an owner, or in the case of a trust or estate, the beneficiary, of an interest in such a partner, whether directly or indirectly through one or more look-through entities, must be taken into account. For purposes of applying paragraphs (b)(2)(iii)(a), (b), and (c) of this section to a partner that is a member of a consolidated group (within the meaning of § 1.1502-1(h)), the tax consequences that result from the interaction of the allocation with the tax attributes of the consolidated group and with the tax attributes of another member with respect to a separate return year must be taken into account. See paragraph (b)(5) Example 29 of this section.

(2) Look-through entity. For purposes of this paragraph (b)(2)(iii)(d), a look-through entity means-

(i) A partnership;

(ii) A subchapter S corporation;

(iii) A trust or an estate;

(iv) An entity that is disregarded for Federal tax purposes, such as a qualified subchapter S subsidiary under section 1361(b)(3), an entity that is disregarded as an entity separate from its owner under §§301.7701-1 through 301.7701-3 of this chapter, or a qualified REIT subsidiary within the meaning of section 856(i)(2); or

(v) A controlled foreign corporation if United States shareholders of the controlled foreign corporation in the aggregate own, directly or indirectly, at least 10 percent of the capital or profits of the partnership on any day during the partnership's taxable year. In such case, the controlled foreign corporation shall be treated as a look-through entity, but only with respect to allocations of income, gain, loss, or deduction (or items thereof) that enter into the computation of a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, enter into any person's income attributable to a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, or would enter into the computations described in this paragraph if such items were allocated to the controlled foreign corporation. See paragraph (b)(2)(iii)(d)(6) for the definition of indirect ownership.

(3) Controlled foreign corporations. For purposes of this section, the term controlled foreign corporation means a controlled foreign corporation as defined in section 957(a) or section 953(c). In the case of a controlled foreign corporation that is a look-through entity, the tax attributes to be taken into account are those of any person that is a United States shareholder (as defined in paragraph (b)(2)(iii)(d)(5) of this section) of the controlled foreign corporation, or, if the United States shareholder is a look-through entity, a United States person that owns an interest in such shareholder directly or indirectly through one or more look-through entities.

(4) United States person. For purposes of this section, a United States person is a person described in section 7701(a)(30).

(5) United States shareholder. For purposes of this section, a United States shareholder is a person described in section 951(b) or section 953(c).

(6) Indirect ownership. For purposes of this section, indirect ownership of stock or another equity interest (such as an interest in a partnership) shall be determined in accordance with the principles of section 318, substituting the phrase "10 percent" for the phrase "50 percent" each time it appears.

(e) De minimis rule.

(1) Partnership taxable years beginning after May 19, 2008 and beginning before December 28, 2012. Except as provided in paragraph (b)(2)(iii)(e)(2) of this section, for purposes of applying this paragraph (b)(2)(iii), for partnership taxable years beginning after May 19, 2008 and beginning before December 28, 2012, the tax attributes of de minimis partners need not be taken into account. For purposes of this paragraph (b)(2)(iii)(e)(1), a de minimis partner is any partner, including a look-through entity that owns, directly or indirectly, less than 10 percent of the capital and profits of a partnership, and who is allocated less than 10 percent of each partnership item of income, gain, loss, deduction, and credit. See paragraph (b)(2)(iii)(d)(6) of this section for the definition of indirect ownership.

(2) Nonapplicability of de minimis rule.

(i) Allocations that become part of the partnership agreement on or after December 28, 2012. Paragraph (b)(2)(iii)(e)(1) of this section does not apply to allocations that become part of the partnership agreement on or after December 28, 2012.

(ii) Retest for allocations that become part of the partnership agreement prior to December 28, 2012. If the de minimis partner rule of paragraph (b)(2)(iii)(e)(1) of this section was relied upon in testing the substantiality of allocations that became part of the partnership agreement before December 28, 2012, such allocations must be retested on the first day of the first partnership taxable year beginning on or after December 28, 2012, without regard to paragraph (b)(2)(iii)(e)(1) of this section.

(iv) Maintenance of capital accounts.

(a) In general. The economic effect test described in paragraph (b)(2)(ii) of this section requires an examination of the capital accounts of the partners of a partnership, as maintained under the partnership agreement. Except as otherwise provided in paragraph (b)(2)(ii)(i) of this section, an allocation of income, gain, loss, or deduction will not have economic effect under paragraph (b)(2)(ii) of this section, and will not be deemed to be in accordance with a partner's interest in the partnership under paragraph (b)(4) of this section, unless the capital accounts of the partners are determined and maintained throughout the full term of the partnership in accordance with the capital accounting rules of this paragraph (b)(2)(iv).

(b) Basic rules. Except as otherwise provided in this paragraph (b)(2)(iv), the partners' capital accounts will be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) if, and only if, each partner's capital account is increased by (1) the amount of money contributed by him to the partnership, (2) the fair market value of property contributed by him to the partnership (net of liabilities that the partnership is considered to assume or take subject to), and (3) allocations to him of partnership income and gain (or items thereof), including

income and gain exempt from tax and income and gain described in paragraph (b)(2)(iv)(g) of this section, but excluding income and gain described in paragraph (b)(4)(i) of this section; and is decreased by (4) the amount of money distributed to him by the partnership, (5) the fair market value of property distributed to him by the partnership (net of liabilities that such partner is considered to assume or take subject to), (6) allocations to him of expenditures of the partnership described in section 705(a)(2)(B), and (7) allocations of partnership loss and deduction (or item thereof), including loss and deduction described in paragraph (b)(2)(iv)(g) of this section, but excluding items described in (6) above and loss or deduction described in paragraphs (b)(4)(i) or (b)(4)(iii) of this section; and is otherwise adjusted in accordance with the additional rules set forth in this paragraph (b)(2)(iv). For purposes of this paragraph, a partner who has more than one interest in a partnership shall have a single capital account that reflects all such interests, regardless of the class of interests owned by such partner (e.g., general or limited) and regardless of the time or manner in which such interests were acquired. For liabilities assumed before June 24, 2003, references to liabilities in this paragraph (b)(2)(iv)(b) shall include only liabilities secured by the contributed or distributed property that are taken into account under section 752(a) and (b).

(c) Treatment of liabilities. For purposes of this paragraph (b)(2)(iv), (1) money contributed by a partner to a partnership includes the amount of any partnership liabilities that are assumed by such partner (other than liabilities described in paragraph (b)(2)(iv)(b)(5) of this section that are assumed by a distributee partner) but does not include increases in such partner's share of partnership liabilities (see section 752(a)), and (2) money distributed to a partner by a partnership includes the amount of such partner's individual liabilities that are assumed by the partnership (other than liabilities described in paragraph (b)(2)(iv)(b)(2) of this section that are assumed by the partnership) but does not include decreases in such partner's share of partnership liabilities (see section 752(b)). For purposes of this paragraph (b)(2)(iv)(c), liabilities are considered assumed only to the extent the assuming party is thereby subjected to personal liability with respect to such obligation, the obligee is aware of the assumption and can directly enforce the assuming party's obligation, and, as between the assuming party and the party from whom the liability is assumed, the assuming party is ultimately liable.