Nonrecourse Debt, Minimum Gain, and Why the LLC Agreement Keeps Going On and On About Allocations

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Many LLC Agreements Have Two Sets of Allocations

- ***Primary Allocations:*** These apply except as otherwise provided by another set of allocations, often called "Regulatory Allocations" (or sometimes labeled "Special Allocations").
- ***Regulatory Allocations:*** Override the primary allocations and address special situations singled out by the regulations under Section 704(b) of the Code. Regulatory allocations often include:
  - Minimum Gain Chargeback.
  - Partner (or Member) Minimum Gain Chargeback.
  - Qualified Income Offset.
  - Gross Income Allocation.
  - Nonrecourse Deductions.
  - Limitation on Loss Allocations.

Why Are "Regulatory Allocations" Needed?

- <u>Answer:</u> Because of the possibility of negative capital accounts (when the LLC member is not required to make any contribution to bring its capital account back up to zero).
- A positive capital account generally should imply the amount that a member would be ***entitled to receive*** if the LLC sold all its assets at their "book value" and distributed the proceeds.
  - For present purposes, "book value" means the value as determined in accordance with the 704(b) regulations
- Does a negative capital account therefore imply the amount that a member would be ***required to contribute*** to the LLC if the LLC sold all its assets at their "book value" and distributed the proceeds?

"Capital Accounts" In General

- Typical LLC Agreements define "Capital Accounts" in accordance with the regulations under Section 704(b) of the Internal Revenue Code.
- The positive capital account as defined by the typical LLC agreement is generally the amount that each member would receive if the LLC were to:
  - Sell all its assets at "book value,"
  - Pay its liabilities as necessary, and
  - Distribute the remaining proceeds to the members in liquidation.
- Positive allocations (and contributions) generally should increase the amount that the members would receive on liquidation.
- Negative allocations (and distributions) generally should decrease the amount that the members would receive on liquidation.

"Capital Accounts" In General

- If the member does not have to contribute capital then what does a negative capital account mean?
- It might seem logical that if the member's capital account is negative at the time of the liquidation, the member would have to contribute capital to the LLC to bring its capital account back to zero.
- After the LLC has paid off all its liabilities and distributed all its assets in liquidation, it should have no assets or liabilities.
- If the LLC has no assets or liabilities, the capital accounts of the members should be zero.

The Tax Rules Cannot Impose an Obligation to Restore a Negative Capital Account

- If the capital account system were theoretically pure, perhaps a negative capital account would always imply an obligation to make a capital contribution.
  - However, the tax regulations cannot force a member to make a capital contribution.
  - Moreover, as the law has developed, members may receive tax-free distributions, and/or take deductions, that are funded by debt -- even if the member has no liability for ever repaying the debt.

The Tax Rules Can Require Allocations that Prevent or Cure a Negative Capital Account

- However, if the member doesn't have an obligation to make a capital contribution when its capital account is negative, the IRS can require the LLC to make allocations that ***prevent a negative capital account from arising or eliminate one that does arise.***
- Many of the regulatory allocations address problems created when negative capital accounts result from the losses or distributions that are funded with nonrecourse debt (i.e., debt for which the member has no liability).

What Causes Negative Capital Accounts?

- Negative capital accounts arise because the member:
  - Receives distributions in excess of its capital account, and/or
  - Is allocated deductions in excess of its capital account.
- Where do those distributions and deduction allocations come from, if not from the member's own capital account?
  - Most commonly, they come from amounts that the LLC has borrowed, including amounts borrowed on a nonrecourse basis.
  - Amounts that the LLC borrows are included in the tax basis that the members have in their LLC interests but they are not included in the members' capital accounts.
  - The amount of liabilities (including nonrecourse liabilities) that are included in a member's basis is determined by the regulations under Section 752 of the Code.

Example: Nonrecourse Debt

- A and B contribute $50 each to LLC.
  - A and B have exactly equal interests in the LLC.
  - Their capital accounts start at $50 each.
  - Each has a $50 basis in its LLC interest.
- LLC takes out an $900 interest-only nonrecourse loan from unrelated bank to acquire a $1,000 building.
  - Capital accounts of A and B remain at $50 each.
  - However, the debt increases basis from $50 each to $500 each.
- The building has a $1,000 basis.
  - The fact that the building was largely debt-financed does change the fact that its basis is the full purchase price.
- Assume the building is depreciable at $100/year over ten years.

Equity-Financed Deductions

- Year 1: The Easy Case; No Regulatory Allocations Needed
  - In Year 1 LLC takes $100 depreciation, allocated $50 each to A and B.
  - A and B have enough basis to deduct the depreciation (although there may be other limitations on their ability to take deductions).
  - Capital accounts of A and B decrease from $50 each to ***zero each.***
  - "Book value" of the building (under the 704(b) regulations) is now $900.
  - If the LLC sells the building for the $900 "book value":
    - The bank gets the $900, and the loan is repaid in full.
    - A and B get zero.
    - Zero capital account of A and B equals the zero amount they receive on liquidation.
    - Allocation of $100 depreciation to A and B reflects that instead of receiving $100 on liquidation they receive zero.
  - The LLC has nonrecourse debt outstanding, but the $100 depreciation is not attributable to the debt, so is ***not*** considered a nonrecourse deduction.
  - No negative capital accounts and no need to apply regulatory allocations.

Nonrecourse Deductions

- <u>Year 2: Regulatory Allocations Are Needed</u>
  - –In Year 2 LLC takes an additional $100 depreciation, but how is it allocated?
  - –If it is allocated to A and B their capital accounts will become ***negative $50 each***.
  - –However, because of the borrowing, A and B do have enough basis to deduct the depreciation (if the depreciation is allocated to them).
  - –"Book value" of the building is now $800.
  - –If the LLC sells the building for the $800 "book value":
    - »The bank gets only $800.
    - »The remaining $100 of debt owed to the bank does not get paid.
    - »A and B still get zero – the same as in Year 1 -- and have no obligation to pay $100 to restore the negative capital accounts.
  - –The allocation of $100 depreciation to A and B does not reflect a reduction in the amount they get on liquidation or an additional amount they are required to contribute on liquidation.
  - –The $100 depreciation is a "nonrecourse deduction," reflecting a reduction in the amount the bank receives in repayment of the loan on a liquidation of the LLC at "book value."

Minimum Gain Chargeback

- Is it a mistake to allocate the year two depreciation to A and B?
  - ***Should the $100 depreciation be allocated to the bank?***
- Depreciation cannot be allocated to the lender; the lender is not an LLC member/partner.
  - Depreciation must be allocated to A and B.
- Did A and B get a costless $100 depreciation deduction courtesy of the bank?
  - A and B did get a tax benefit by deducting $100 when they did not suffer an economic loss.
  - ***However, the "minimum gain" rules force them to pay for that tax benefit eventually***, even if they otherwise could have avoided paying.

Minimum Gain and Minimum Gain Chargeback

- "Minimum gain" tracks deductions where a lender (not a partner or member) is at risk for an LLC liability.
- "Minimum gain" is the excess of the nonrecourse debt over the "book value" of the property that the debt encumbers.
  - In our example, after year two the minimum gain is $100.
  - $100 is the minimum amount of gain that will have to be allocated ("charged back") to A and B when the building is sold.
  - If the building is simply surrendered to the bank, with no cash proceeds going to A and B, they will have to recognize that $100 minimum gain.
  - The chargeback is a kind of "phantom income" to A and B, but offsets the "phantom deduction" (i.e., the deduction of the bank’s money) that A and B previously enjoyed.

"Partnership Minimum Gain" vs. "Partner Minimum Gain"

- What we have been discussing so far technically is "Partnership Minimum Gain" (sometimes referred to in LLC agreements as "Company Minimum Gain" or "LLC Minimum Gain").
  - Partnership minimum gain arises when ***no partner*** is deemed to bear the economic risk of loss for the nonrecourse debt (i.e., when deductions are attributable to "partnership nonrecourse debt").
- The rules for so-called "Partner Nonrecourse Debt Minimum Gain" (or "Member Nonrecourse Debt Minimum Gain") parallel these rules.
  - However, partner nonrecourse debt minimum gain arises when ***one or more partners*** bears the risk of loss for nonrecourse debt (i.e., when deductions are attributable to "partner nonrecourse debt").
- In our example, if A had guaranteed the debt (or even if the lender had simply been related to A), the debt would have been partner nonrecourse debt rather than partnership nonrecourse debt.
  - All the depreciation in excess of capital accounts would have been allocated to A.
  - The minimum gain would have been partner nonrecourse debt minimum gain, and would have been charged back entirely to A when the property was sold.