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Capital Accounts and Outside Basis

The IRS requires partnerships to keep a record of 1) capital contributions made by a partner, 2) cash distributions received by a partner, and 3) allocations of income and loss received by a partner. The ongoing balance of this record is referred to as a “capital account.” The IRS relies on the capital account to insure that distributions and allocations to each partner are not motivated entirely by the tax advantage of one or more of the partners. Rather, the IRS requires that the partners in the partnership are primarily motivated by the economics of the underlying partnership activities. Uneven distributions or allocations can make a partnership more than a simple prorated sharing arrangement. The capital accounts track each partner’s claim on the assets of the partnership.

Under certain conditions, the IRS allows a capital account to be negative at the end of each fiscal year. This can occur when the cumulative distributed cash and allocated losses exceed a partner’s capital contributions plus allocated income to date. A negative capital account implies a disinvested position on the underlying assets of the partnership, so the IRS requires assurance that the partner with a negative capital account provides restitution to cover its deficit position in the event of liquidation. In a renewable energy partnership flip transaction, this is often accomplished using a Deficit Restoration Obligation (DRO) clause in the LLC agreement. A DRO is a promise by a partner to pay the partnership an amount equal to the partner’s negative capital account should the partnership dissolve.

In addition to the capital account, partners are also required to maintain a balance called “outside basis.” Similar to an adjusted basis of a capital asset, the outside basis tracks the tax position of a partner’s investment in its partnership interest. If a partner were to sell its position in the partnership to another party, or if the partnership were to liquidate, the amount of the partner’s outside basis would reduce its taxable gain. Should its partnership interest be worth less than its outside basis amount, then the partner would incur a taxable loss equal to the difference between the sale amount and its outside basis.

The outside basis and the capital account have very similar calculations. Both include capital contributions, cash distributions, and allocations of income and loss. However, the outside basis also includes a share of any debt that the partner has adopted as part of its partnership investment. And, unlike a capital account, the outside basis may never be negative at the end of a fiscal year. To prevent a negative basis, a partner must either suspend any allocated losses, or pay taxes on distributions received in excess of basis. In either situation, the partner’s capital account necessarily differs from its outside basis.

Another important difference between the two accounts is in the nature of a partner’s contribution to the partnership. If a partner contributes property instead of cash, as is common for the sponsor in renewable energy partnerships, then the partner’s adjusted basis in the property at the time of



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contribution is represented in its outside basis. By contrast, the fair market value of the property at the time of the contribution is included in the partner's capital account. If the fair market value is greater than the adjusted basis, then the contributing partner recognizes the gain in the pattern of the remaining original depreciation schedule at the time of contribution. These taxable deferred gain charges are represented in the outside basis, but are not included in the partner's capital account.

In ABC, the PSHIP/CAPITAL and PSHIP/BASIS reports display each partner's capital account and outside basis.

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