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Simple as ABC.

Excess Distributions and Suspended Loss

In renewable energy partnership flip structures, it is common for the investor to have a negative capital account in the early years as it receives allocated losses and distributed cash. If the cumulative amounts of these items exceed the amount of investor's capital contribution to the partnership, then the investor must either "cure" the amount by contributing more capital to the partnership, or provide a Deficit Restoration Obligation (DRO) that promises a repayment by the investor in the event of liquidation.

With a DRO present, the investor's capital account balance is allowed to be negative because the partner has demonstrated an intention to repay the deficit. However, unlike the capital account, the outside basis is never allowed to drop below zero. The concept of a negative outside basis is similar to an over-depreciation of an asset; the IRS only allows recovery to the extent of the capital expenditure paid for an asset. Any recovery above the capital cost is avoided by recognizing taxable income.

To avoid a negative outside basis, a partner must first suspend any net taxable loss that it has been allocated from the partnership in the current year. Allocated losses reduce the outside basis. Suspending the loss not only eliminates the effect of the deduction from the partner's taxable income in the current year; it also eliminates the reduction of outside basis that would have occurred if the partner had taken the loss. A suspended loss balance may be applied to future years in which the partner has available outside basis to absorb the loss. However, if the losses are not used as of the date of dissolution of the partnership, then they are lost to the partner forever.

In the event that there is not a taxable loss in the current year, or if the taxable loss is not sufficient to eliminate the negative outside basis, then some of the cash that has been distributed to the partner is deemed as distributions in excess of basis, often called "excess distributions." The IRS does not require the partner to suspend cash distributions, as it does with losses. Instead, it treats the excess cash distributions as taxable income, which is taxed immediately. The taxable income increases the partner's outside basis so that it is no longer negative.

Rather than waiting until the end of the partnership investment to recoup the effect of this additional taxation (in the form of reduced gain from the elevated outside basis), the partnership may alternatively elect to step up the capital account by an amount equal to the excess distribution incurred by the partner. This additional capital contribution is shared by each partner according to its share of taxable income, and that shared amount is added to the partner's capital account. As with any increase in capital assets, the additional capital contribution is then depreciated over time. The method of depreciation of the asset should match the mix of asset types in the partnership at the time of the step-up. However, many LLC agreements apply a conservative 15-year straight-line method to the step-up for purposes of tax flip analysis.

In ABC, the PSHIP/BASIS and PSHIP/TAX reports display a column for Excess Distributions and Suspended Losses. PSHIP/CAPITAL displays the share of the additional capital contribution allocated to each partner. The PSHIP/DEPR report shows the depreciation associated with the step-up due to the additional capital contribution.

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