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Stephen Utz

University of Connecticut School of Law

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ALLOCATION AND REALLOCATION IN ACCORDANCE WITH THE PARTNERS' INTERESTS IN THE PARTNERSHIP

Stephen Utz*

I. INTRODUCTION

If a partnership agreement either fails to allocate an item of partnership income, gain, deduction, credit, or loss, or does so invalidly, section 704(b) requires the item to be allocated "in accordance with the partners' interests in the partnership" (PIP). A brief portion of the section 704(b) regulations interpret this reallocation standard, providing guidelines of varying specificity.¹ Commentators agree that the guidelines are vague and puzzling. The courts have not often had to apply this portion of the regulation. However, in the event that the courts do employ section 704(b), they have assigned an implicit priority to the different guidelines, eliminating some from discussion without comment, and avoiding any general discussion of the reallocation problem. This elliptical judicial practice follows that of the examples in the regulation itself.² As a consequence, reallocation presents, apart from a few straightforward safe harbors, straits of uncertainty for taxpayers and their advisors. This article examines the regulatory guidelines and offers a taxonomy of situations to which they apply. The article concludes that the guidelines do not provide systematic answers—so that the courts have been right to apply them selectively and intuitively—because the guidelines represent policy concerns that cannot be readily harmonized.

When properly analyzed, the relevant portion of the regulation appears to contemplate two standards of allocation (or reallocation). The first standard would allocate partnership items that have tax consequences, whether they affect non-tax economic consequences or not, in the same proportion as the partners would share the economic consequences of partnership operations, distributions and liquidation in a no-tax world (the *virtual-economic-agreement standard*).³

*Professor of Law, University of Connecticut School of Law; Visiting Professor of Philosophy, Trinity College; Louisiana State University, B.A., 1967; Cambridge (England), Ph.D., 1977; University of Texas, J.D., 1979.

¹Reg. § 1.704-1(b)(3), -1(b)(4). Among other things, the first subparagraph asserts that reallocation should be made item by item; that partners' interests nonetheless are presumed to be equal per capita; that allocations that are invalid because of the absence of a capital account deficit restoration obligation are to be cured by reallocating partnership items to reflect the economic benefits and burdens for the partners severally if all partnership property were sold at book value and the partnership liquidated; and that all facts and circumstances relevant to the economic arrangement of the partners should be considered in reallocating items. Reg. § 1.704-1(b)(3). Regulation section 1.704-1(b)(4) provides special rules for reallocations to reflect revaluations, proper sharing of credits excess percentage depletion, nonrecourse deductions, and allocations of adjusted tax basis of partnership oil or gas property under section 613A(c)(7)(D).

²See, e.g., Reg. § 1.704-1(b)(5), Ex. (5).

³It is interesting to note that this comes close to, but is not necessarily the same as, the standard of reallocation that applied summarily before the revision of the section 704(b) regulations in 1985. The earlier reallocation procedure was simply to *disregard* a defective affirmative allocation, i.e., to allocate all partnership items in accordance with the explicit partnership agreement *apart from* the

The second standard requires allocations that eliminate capital account deficits of partners who have no deficit restoration obligation, or otherwise match economic risk and tax advantage, without regard to the partners' intended economic arrangement (the *curative standard*). It is characteristic of curative allocations to depart from the partners' economic agreement.⁴ Thus, the two standards often have incompatible consequences; they are certainly not interchangeable or equivalent. Despite the regulation's unambiguous imposition of both standards, it is written as if it established a univocal standard; the regulations' extensive reliance on the phrase "in accordance with the partner's interest in the partnership" suffices to suggest this. This equivocation creates a risk of discordant allocation decisions by courts and confusion for taxpayers and their advisors.

II. OVERVIEW OF REALLOCATION PROBLEMS

A. *Incomplete Versus Affirmatively Invalid Allocation Agreements*

Briefly, situations in which the regulatory guidelines may apply fall into three groups: (I) those in which a partnership agreement fails to allocate some partnership item or items; (II) those in which the partners have agreed to allocate some partnership item or items in a manner that does not have economic effect and is not *deemed* to be in accordance with PIP under a special rule (*e.g.*, the rule for nonrecourse deductions⁵); and (III) those in which an agreed upon allocation lacks substantiality. Groups I and II may overlap trivially. For example, allocations among limited partners who have no deficit restoration obligations under state law may belong to group II if the allocation fails the alternate economic effect test. And, those allocations may also belong in group I if the limited partnership agreement fails altogether to allocate partnership items. The complete failure to allocate partnership items does not require a remedy of the sort the regulatory guidelines specifically designed for group II, but a partial failure may require the remedy. Hence, the overlap between groups I and II cannot be handled in a single way. Groups I and III do not overlap because, by definition,

offending provision. *See, e.g.*, *Allison v. United States*, 701 F.2d 933 (Fed. Cir. 1983) (where the principal purpose of the allocation of all intangible drilling costs to one partner was tax avoidance, the allocation was to be disregarded).

⁴As those familiar with section 704(b) regulations well know, the "qualified income offset" (QIO) that provides limited partnerships with their only means of giving allocations economic effect, within the meaning of the regulations, requires that *real* economic consequences should be adjusted, at least in the short run, when a limited partner's capital account unexpectedly drops to a negative figure. The QIO, a provision of the partnership agreement, "provides that a partner who unexpectedly receives an adjustment, allocation, or distribution [that creates or increases a deficit in the partner's capital account] will be allocated items of income and gain . . . in an amount and manner sufficient to eliminate such deficit balance as quickly as possible." Reg. § 1.704-1(b)(2)(ii)(d). Since the regulations also require partnerships that seek to come within the safe harbor in question to subject themselves to the requirement that net partnership assets be distributed at liquidation in accordance with partners' capital accounts, the required QIO allocation not only rectifies tax consequences but also changes the partners' economic rights by adjusting their capital accounts.

⁵*See infra* text accompanying notes 25-27.

group I includes only cases in which the partners have failed to agree on an allocation, while group III includes only cases in which the partners have agreed on an allocation that lacks substantiality. Groups II and III may overlap, although the remedy for an expressly agreed allocation that lacks economic effect can easily be made substantial, so that in practice a decision maker confronted with a problem case belonging to group II need not be concerned with the peculiarities of remedies for cases in group III. Otherwise, the problems presented by the three groups have little in common.

Cases in group I, though perhaps of less consequence, are unlikely to require the type of corrective measure embodied in the regulatory guidelines designed to remedy affirmative allocations that lack substantial economic effect. Indeed, the failure to agree on an allocation is usually a different sort of problem than that resulting from agreements that threaten to abuse the permissive regime of the section 704(b) regulations.

Cases in group II are perhaps the easiest to deal with. They are invariably cases in which partners agree to divorce tax consequences from economic consequences in a striking fashion. If an allocation does not affect economic consequences currently, it can only do so by threatening partners' liquidation preferences. A partner who is not obligated to restore a capital account deficit risks losing only his or her initial contribution to a partnership, and so if such a partner has a negative capital account, the risk associated with the negative figure is nil. Regulation section 1.704-1(b)(3)(iii) expressly provides a narrow remedy based on a comparison of the results of a liquidation of the partnership at the end of the year of the allocation with the results of a liquidation at the end of the previous year. The purpose is to single out the consequences of the allocation on the partners' risks of loss. Although the remedy is not spelled out in full, the regulation indicates that the economic consequences for the partners of a winding up after the sale of all partnership assets at book value is the touchstone for proper allocation of current-year partnership items of gain or loss.

The guidelines for compulsory reallocation of partnership items are evidently framed to deal with all defective allocations, and in particular, to deal both with failure to allocate and with agreed upon allocations that do not have economic effect or are insubstantial. As suggested above, this comprehensive design implicitly results in a bifocal approach. Yet, courts have apparently been misled at times by the regulation's semantically single approach. Although the regulation enunciates several principles and rules for remedying allocation defects, it seems not to contemplate the need for triage or sorting of situations so as to match them with the appropriate principles and rules. Instead, by bunching them together, the regulation seems to indicate that all the principles and rules are apposite in every case.

Although the regulation does not indicate how to choose among the regulatory guidelines in order to decide which to apply in any given situation,⁶ the

⁶Examples appended to the regulation follow the guidelines implicitly without expressly commenting on how the choice among the guidelines is to be made. For example, Regulation section 1.704-1(b)(5), Example (1) indicates that the factors listed at Regulation section 1.704-1(b)(3)(ii)

guidelines cannot all simultaneously govern a set of facts, and some yield acceptable results only in a limited range of cases. This article sets forth a view of the guidelines' relevance and applicability.

B. *Statutory and Regulatory Provisions*

Section 704 gives partners a privilege not shared by co-owners of other entities: they are allowed to allocate the income-related incidents of partnership in a manner that can differ from that in which they share economic benefits and burdens. In brief, partners are allowed to divorce the tax and economic consequences of partnership operations and asset dispositions, at least in certain ways, if they expressly agree to do so. Section 704 grants this privilege by giving effect to the partnership agreement⁷ within broad limits.⁸ The overarching limitation, perhaps as well known as any feature of Subchapter K, denies efficacy to an agreed allocation that does not have "substantial economic effect," a concept that is the subject of lengthy and meticulous elaboration in the current regulations.

A brief survey of the special allocation regulations will serve to introduce the reallocation guidelines. According to the regulations, an allocation has substantial economic effect if it has economic effect and that effect is substantial.⁹ An allocation has economic effect if the allocated item is reflected in the partners' capital accounts, and if the partners' agreement as to these accounts satisfies three basic requirements: (1) they are kept in a manner specified in the regulations (roughly corresponding to traditional partnership capital accounting), (2) the partners agree to distribute partnership assets at liquidation in accordance with capital accounts (*i.e.*, to distribute assets equal in value to each partner's capital account before dividing any surplus in accordance with partners' profit shares), and (3) each partner is obligated to restore any deficit in his or her capital account within a specified time after the partnership is terminated or after the partner leaves the partnership.¹⁰ These three requirements—capital account maintenance, liquidation in accordance with capital accounts, and capital account deficit restoration—provide a safe harbor for substantial economic effect.

Example 1: A, B and C are equal general partners in a business that uses a printing press, with an initial basis of \$25,000. A and B agree that all the partnership's depreciation deductions with respect to the printing press shall be

should be considered, apparently without reference to the special guideline in Regulation section 1.704-1(b)(3)(iii), when a partnership allocation lacks economic effect because the partnership agreement does not require liquidation proceeds to be distributed in accordance with capital accounts—the situation famously dealt with in *Orrisch v. Commissioner*, 55 T.C. 395; 403-04, *aff'd* 1973 WL 154461 (9th Cir. 1973) (*per curiam*) (unpublished opinion).

⁷A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement. I.R.C. § 704(a).

⁸The limits are set primarily by section 704(b), which requires that partnership items shall be allocated in accordance with the partner's interest in the partnership if the agreement does not provide an allocation or if the allocation it does provide does not have "substantial economic effect."

⁹Reg. § 1.704(b)(2)(i).

¹⁰Reg. § 1.704(b)(2)(ii)(b).

allocated exclusively to C until her capital account is exhausted, and that the annual net bottomline figure for other items of partnership income, deduction and loss shall be allocated equally among them, without adjustment for the allocation of depreciation to C. The partnership agreement requires capital accounts to be maintained in accordance with the tax regulations, requires distribution of partnership assets at liquidation in accordance with capital accounts and requires capital account deficit restoration within a specified time after the partnership is terminated or after the partner leaves the partnership. Thus, C's capital account is adjusted downward not only for C's share of any net partnership loss from items other than depreciation but, even in a profitable year, for the partnership's entire depreciation deduction with respect to the printing press. The depreciation allocation has economic effect.

A variant of the safe harbor is created by the "alternate economic effect test," which permits partnerships, some of whose partners, such as limited partners, do not have an obligation to restore capital account deficits, nevertheless to make allocations that have substantial economic effect.¹¹ An allocation satisfies this alternate test if the partnership agreement requires capital account maintenance in accordance with the regulations, requires liquidation in accordance with capital accounts, but instead of requiring capital account deficit restoration requires that any partner without such an obligation must be allocated items of partnership income as soon as there is income to allocate, whenever the partner has a capital account deficit.

Example 2: Same facts as *Example 1*, except that C is a limited partner, and the partnership agreement provides for a "qualified income offset," *i.e.*, it provides that a partner who unexpectedly receives an adjustment, allocation, or distribution that either creates or increases an agreed upon or expected capital account reduction of certain kinds will be allocated items of income and gain in an amount and manner sufficient to eliminate his or her capital account deficit as quickly as possible.¹²

An allocation has economic effect as well if, although the partnership agreement lacks one or more of the requirements of the primary or alternate economic effect tests, the normal application of state law will produce the same economic effect as partnership agreement provisions that expressly meet the economic effect definition.¹³

Example 3: Same facts as *Example 1*, except that the partnership agreement does not expressly require the distribution of partnership assets in accordance with capital accounts or capital account restoration with a specified time after

¹¹STEPHEN UTZ, FEDERAL INCOME TAXATION OF PARTNERS AND PARTNERSHIPS § 6.06 (3d ed. 1995).

¹²Reg. § 1.704-1(b)(2)(ii)(d) (setting forth the alternate economic effect test and the definition of QIO).

¹³No state currently has a partnership law that would meet the alternate economic effect test, which requires a peculiar QIO or provision for rapid replenishment of capital account deficits when they arise.

the liquidation of the partnership interests. Nonetheless, state law *does* impose the distribution and capital account restoration requirements set forth in the regulations, at least where, as here, the partners do not expressly agree otherwise. The allocation has economic effect under the economic effect equivalence test.

If an allocation has economic effect, this economic effect must also be substantial, in order to be respected under the regulations.¹⁴ The economic effect of an allocation is substantial, roughly speaking, if the allocation may be economically detrimental to the appropriate partners or if there is no strong likelihood that no partner will suffer an economic detriment but some partner may enjoy a tax benefit by virtue of the allocation.

Example 4: There is a reasonable possibility, on the facts of *Example 1*, that the ABC partnership's depreciation allocation to C will substantially affect the dollar amounts to be received by the partners from the partnership, independent of tax consequences, because the partnership business may fail before C's capital account is restored either by profit on the sale of the printing press or otherwise, *and* given the partners' individual tax situations there is not a strong likelihood that the after-tax consequences of no partner will, in present value terms, be substantially diminished compared to the consequences if the allocation were not made.¹⁵

"Nonrecourse deductions,"¹⁶ *i.e.*, deductions that create or increase "partnership minimum gain," cannot have economic effect.¹⁷ Briefly, a partnership's acquisition or improvement of an asset with the proceeds of nonrecourse financing increase the partnership's basis in the asset (so-called "inside basis"), and partners' bases in their partnership interests ("outside basis") also reflect the liability, usually in proportion to the partners' profit shares.¹⁸ In contrast, a partner's capital account is not adjusted upward to reflect increases in his or her share of partnership liabilities that the partner does not assume.¹⁹ Deductions

¹⁴Reg. § 1.704-1(b)(2)(iii)

¹⁵These two conditions reflect the requirements of Regulation section 1.704-1(b)(2)(iii)(a), which contains the primary definition of substantiality.

¹⁶Reg. § 1.704-2(b)(1), -2(c).

¹⁷Reg. § 1.704-2(b)(1).

¹⁸The formula for allocating nonrecourse liabilities among partners is somewhat more complex. When a partner contributes nonrecourse-debt-encumbered property to a partnership, a portion of the nonrecourse liability that equals the contributor's, and hence the partnership's, minimum gain on disposing of the property is not allowed to be shifted to the other partners. Hence, only the rest of the nonrecourse liability is susceptible of being "shared" by them. Reg. § 1.752-3(a)(1). In addition, the partners may simply agree to allocate nonrecourse liabilities in any manner that reasonably anticipates the future allocation of nonrecourse deductions among them. Reg. § 1.752-3(a)(2). Only in the absence of section 704(c) and partners' agreements to the contrary are nonrecourse liabilities allocated simply in accordance with partners' profit shares. Reg. § 1.752-3(a)(3).

¹⁹"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)). . . ." Reg. § 1.704-1(b)(2)(iv)(c).

arising from the partnership's exploitation of any asset, such as depreciation deductions, permit the partnership to recover inside basis and typically also reduce partners' capital accounts.²⁰ The regulations define nonrecourse deductions as those that create or increase partnership minimum gain.²¹ Minimum gain is defined, in turn, as the gain the partnership would realize on disposing of property subject to a nonrecourse liability for no consideration apart from satisfaction of the liability.²² In other words, minimum gain is the gain the partnership would realize on surrendering the recourse-liability-encumbered property to the creditor/mortgagee after an event of default. Under *Commissioner v. Tufts*,²³ the amount realized in such a situation includes the balance of the nonrecourse debt, even though the taxpayer may not actually experience an economic benefit on surrendering the property.

The regulations deem certain allocations of nonrecourse deductions to be in accordance with PIP, despite the absence of substantial economic effect.²⁴ The requirements for deemed acceptability of special nonrecourse deduction allocations are: (1) that the partnership agreement satisfy the requirements of the primary or alternate economic effect test throughout its life; (2) that from the year of the first allocation of nonrecourse deductions through the rest of the partnership's life the nonrecourse deductions be allocated in a manner reasonably consistent with allocations having substantial economic effect of some other significant partnership item attributable to the collateral of the nonrecourse debt; and (3) that from the first year in which the partnership has nonrecourse deductions or distributes proceeds of a nonrecourse liability allocable to an increase in partnership minimum gain, the partnership agreement must contain a "minimum gain chargeback."²⁵ A minimum gain chargeback is an allocation in the partnership agreement of income and gain in an amount equal to the net decrease in a partner's share of minimum gain for any taxable year in which there is such a net decrease.²⁶ The gist of this permissive regime is to allow partners to allocate nonrecourse deductions with very little constraint apart from the linking of nonrecourse deductions with liability for the *Tufts*-type gain or the minimum gain that is associated with them; the partner who benefits from an allocation of the nonrecourse deductions must be responsible for the tax burden of the corresponding minimum gain.

Example 5: Same facts as *Example 1*, except that (1) it is agreed that C will be allocated all depreciation not only until C's capital account is exhausted, but beyond that point as well, (2) the printing press was acquired with the proceeds of a nonrecourse loan whose balance exactly equals the portion of the press's

²⁰Reg. § 1.704-1(b)(2)(iv)(g)(3).

²¹Reg. § 1.704-2(c).

²²Reg. § 1.704-2(d).

²³461 U.S. 300 (1983).

²⁴Reg. § 1.704-2(b)(1).

²⁵Reg. § 1.704-2(e)(1) to - (3).

²⁶Reg. § 1.704-2(f)(1).

inside basis that remains after C's capital account is exhausted, and (3) the partnership agreement also provides that a substantial item of expense, the cost of maintaining the printing press, shall also be allocated exclusively to C along with all the partnership minimum gain resulting from the depreciation of the printing press. The nonrecourse deductions from the printing press are the depreciation deductions that cause the partnership to have minimum gain. The special allocation of these deductions does not have substantial economic effect but is deemed to be allocated in accordance with C's interest in the partnership.

There are many variations on the safe harbors just illustrated, as well as special rules that attenuate their requirements. For example, the regulatory definition of substantiality provides that the adjusted basis of partnership property, or the property's book value if properly reflected on the partnership books at a book value different from adjusted basis, is the *fair market value* of the property and that adjustments to the property's basis or book value thereafter is matched by corresponding changes in the property's fair market value.²⁷ The obviously intended point of this basis-equals-FMV rule is to countenance the substantial economic effect of special allocations of depreciation that can easily be predicted to exceed the economic depreciation of the property. Thus, the safe harbors themselves are capacious enough to permit a virtually sure thing of taxes saved disproportionately to a partnership's economic interest in at least the liquidation proceeds of the partnership.

C. Regulatory Reallocation Guidelines

The opening assertion of the reallocation regulation is that "partner's interest in the partnership" as used in section 704(b) "[signifies] the manner in which the partners have agreed to share the economic benefit or burden" of allocated items.²⁸ One is not immediately told whether the relevant *economic* benefit or burden is before or after tax. Elsewhere in the section 704(b) regulations, in the substantiality test for example, the "economic effect of an allocation" is its effect "independent of tax consequences."²⁹ Thus, allocation "in accordance with the partner's interest in the partnership" would also seem to be required to imple-

²⁷Reg. § 1.704-1(b)(2)(iii)(c).

²⁸References in section 704(b) and this paragraph to a partner's interest in the partnership, or to the partner's interests in the partnership, signify the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated." Reg. § 1.704-1(b)(3)(i).

²⁹Regulation section 1.704-1(b)(2)(iii) speaks of "the dollar amounts to be received by the partners from the partnership, independent of tax consequences." The definition of PIP at Regulation section 1.704-1(b)(3)(i) speaks of the "economic arrangement of the partners" or the "overall economic arrangement of the partners," both phrases apparently referring to partners' agreed pre-tax sharing of partnership items. Elsewhere, however, Regulation section 1.704-1(b)(2)(iii) repeatedly refers to "the after-tax economic consequences of [a partner]." It is important to note that "economic consequences" and "overall economic arrangement" in the PIP portion of the regulation are not used interchangeably, but both refer to "pre-tax economic consequences," *i.e.*, to "the dollar amounts to be received by the partners from the partnership, independent of tax consequences," at least with respect to particular misallocated or unallocated partnership items.

ment the partners' pre-tax agreement.³⁰ Given that the PIP criterion for reallocation may be triggered by a failure of partners to reach any express agreement concerning their sharing of economic consequences, the partners' pre-tax agreement may have to be inferred from a variety of factors.³¹ But in the first of several special rules that follow the general provisions under discussion here, the regulation states that determining partners' distributive shares in accordance with PIP entails making adjustments for the section 704(c) variation between the basis and fair market value of property contributed to a partnership. This is just one of several indications that the regulation has a double aspect.

The regulation next states that, generally, sharing in accordance with PIP (*i.e.*, in accordance with "the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated") "may or may not" reflect "the overall economic arrangement of the partners."³² A parenthetical explanation immediately follows. When reallocation standards stated later in the subparagraph require the allocation of a disproportionate amount of income to the partner to eliminate a capital account deficit, the allocation does not correspond to the overall economic arrangement of the partners. That is, it corresponds neither to overall profit ratios of the partners nor to the partners' usual percentage interests in the items disproportionately allocated where the partners' agreement would have allocated these item by item. In other words, a PIP allocation may be disproportionate to the division of the bottom-line consequences apart from tax effects.

The regulation's statement that "this sharing arrangement," *i.e.*, sharing in accordance with PIP, need not correspond to the partners' overall economic arrangement also apparently means that a PIP allocation need not apply to all items in the same ratios or even follow a prevailing formula, if any, used for the largest dollar amount of partnership items.³³ It is worthwhile to note that a special rule confirms this approach for credits. Credits are deemed allocated in accordance with PIP if they follow valid allocations of deduction or loss or other downward capital account adjustments, whether taxable or not, arising for the year from the same expenditure that gives rise to the credit. Credits are also deemed allocated in accordance with PIP if they follow the allocation of partnership receipts, whether taxable or not, from which they arise.³⁴ A similar rule applies to excess percentage depletion.³⁵

³⁰The regulations on substantiality speak of "economic consequences" in this sense, *i.e.*, in the sense of economic consequences apart from tax consequences. No ambiguity apparently results there or here, nor does it seem possible that the regulation may be seriously misread as a result. Reg. § 1.704-1(b).

³¹See *infra* text accompanying notes 45-49.

³²Reg. § 1.704(b)(3).

³³This is the plain implication of the next sentence after the parenthetical discussed in the previous paragraph of the text above, which offers the illustration that "a partner with an overall interest in the partnership of 50% may have an interest of 90% in a particular item of income or deduction." See ARTHUR B. WILLIS, ET. AL., PARTNERSHIP TAXATION & 10.02[2], at pp. 10-25 (revised ed. 2000).

³⁴Reg. § 1.704-1(b)(4)(ii).

³⁵Reg. § 1.704-1(b)(4)(iii).

Let us call this first guideline the *differentiation principle*: that allocation in accordance with PIP can differ from, and indeed is not even presumed to be, a bottom-line allocation of all partnership items. The regulation obviously indulges in a deliberate distortion of the ordinary meaning of partner's interest in the partnership, when it suggests that the *corrective* allocation needed to rectify an unexpected capital account deficit follows the interest of the partner or partners affected by the allocation. The partner's interest in the partnership would surely not differ from year to year in the manner contemplated here. It is useful to recall that we speak of a partner's interest in a partnership in the non-tax context as well, where that interest is the aggregate of the partner's economic rights in the partnership.³⁶

In general, allocation in accordance with PIP may not correspond to the agreement the partners would have made in a no-tax world. This does not, however, apply to allocations that cannot have economic effect "such as nonrecourse deductions. . . ."³⁷ Let us call this further guideline the *nonrecourse exception*. Its significance is twofold. First, special allocations of nonrecourse deductions, *i.e.*, allocations that differ from a single formula for all partnership items, can at best pass muster if they are deemed to be in accordance with PIP under the regulatory safe harbor discussed above. The general principles of § 1.704-2(b)(3), therefore, cannot and do not provide an alternative to the safe harbor. Thus, while the regulatory presentation of the safe harbor is inexplicit on this point, failure to come within the safe harbor dooms any special allocation of nonrecourse deductions to reallocation in accordance with the "overall economic arrangement of the partners," *i.e.*, in accordance with bottom-line percentages. Second, the exclusion of nonrecourse deductions from the coverage of the guideline that generally respects item-by-item allocations, and the inapplicability of the rules (to be discussed below) concerning allocations made defective by the absence of a capital account deficit restoration obligation, apparently subordinate the reallocation of nonrecourse deductions to the presumption that partners share all partnership items equally.³⁸

In the same paragraph, two more important guidelines are announced. First, the paragraph states that determinations of PIP are to be made by taking into

³⁶See *August v. Moran*, 717 A.2d 807, 808 (Conn. App. 1998).

³⁷Except with respect to partnership items that cannot have economic effect (such as nonrecourse deductions of the partnership), this sharing arrangement may or may not correspond to the overall economic arrangement of the partners. Thus, a partner who has a 50% overall interest in the partnership may have a 90% interest in a particular item of income or deduction. Reg. § 1.704-1(b)(3)(i).

³⁸Reg. § 1.704-1(b)(3)(iii) ("Certain determinations"). The guideline exception for allocations that cannot have economic effect raises the question whether the PIP regulation does or does not apply to allocations under section 704(c) that are determined not to be in accordance with any reasonable method of taking the basis/value difference of contributed property into account. See Reg. § 1.704-3(a)(i). Such allocations cannot have economic effect either, and yet some such allocation is required by section 704(c) and Regulation section 1.704-3. Obviously, the latter should control any reallocation made necessary by partners' attempt to employ an unreasonable allocation method to correct for pre-contribution gain or loss. It is difficult to see, however, how Regulation section 1.704-1(b)(3) can be read as not overriding the application of Regulation section 1.704-3.

account all facts and circumstances relating to the economic arrangement of the partners.³⁹ Given the date on which this portion of the section 704(b) regulations was made final, it is natural to interpret "all facts and circumstances" as including facts about the partners' tax situations apart from the partnership,⁴⁰ and this is indirectly confirmed by an example.⁴¹

The other guideline announced in the paragraph is the presumption that the partners' interests are equal on a per capita basis (the *equality presumption*).⁴² This presumption can be rebutted by the taxpayer or the Service, who may "[establish] facts and circumstances that show that the partners' interests in the partnership are otherwise."⁴³ The presumption is straightforward. The rubric for rebutting the presumption is rendered ambiguous by the double standard of the regulation for determining PIP. The equality presumption is reminiscent of the similar presumption in the Uniform Partnership Act (UPA) for determining partners' interests in the context of a winding up.⁴⁴ Given this correspondence, it seems natural to suppose that rebutting the equality presumption should be possible only if evidence can be presented to establish that the partners actually agreed to share partnership items in a different manner; for this is the manner of rebuttal of the equality presumption that the UPA contemplates.⁴⁵ But in the broader context of the regulation, allocation in accordance with PIP can be curative, *i.e.*, not necessarily in proportion to the partners' intended sharing of the economic consequences of partnership items.

Next the regulation lists four factors that "are among those" to be considered in determining PIP: the partners' contributions to partnership capital, their interests in economic profits and losses apart from tax consequences, their interests in cash flow and other non-liquidating distributions, and their "rights to distributions of capital upon liquidation."⁴⁶ Most commentators have found this factors

³⁹Reg. § 1.704-1(b)(3)(i).

⁴⁰The regulation became final in 1986, when the revised regulations under section 752 were under review. It is a hallmark of the latter to take into account all side agreements of the partners that may affect their ultimate responsibility for partnership liabilities.

⁴¹Reg. § 1.704-1(b)(5), Ex. (6). The example deals with an insubstantial allocation of section 1231(b) property loss to a partner who otherwise has section 1231 gains for the year. The required reallocation in accordance with PIP is simply in proportion to the net decreases in the partners' capital accounts due to the allocation under the partnership agreement of all items of deduction and loss for the year. Since the invalid allocation was invalid by virtue of reflecting the partners' tax situations apart from partnership tax incidents, it must also be said that the reallocation takes their tax situations into account, for otherwise the reallocation might not compensate for the tax advantages to be thwarted.

⁴²Reg. § 1.704-1(b)(3)(i).

⁴³Reg. § 1.704-1(b)(3).

⁴⁴UNIF. PARTNERSHIP ACT § 8.06 (1997); UNIF. PARTNERSHIP ACT § 40(b) (1914).

⁴⁵UNIF. PARTNERSHIP ACT § 8.06 (1997); UNIF. PARTNERSHIP ACT § 40(b) (1914).

⁴⁶Reg. § 1.704-1(b)(3)(i)(d). It is interesting to note that this factors test figured more prominently in the provision on PIP in the earlier version of the regulation. See Reg. § 1.704-1(b)(2). Presumably, "distributions of capital" here includes all distributions of value, whether recognized as capital by the partnership's accounting method or not. For example, the distribution of accounts receivable by a cash method partnership should be considered a distribution of capital for this purpose.

test “vague”⁴⁷ or elusive.⁴⁸ The factors listed, however, illustrate again that the approach to PIP in the regulation straddles two quite different standards of reallocation. The first, the virtual-economic-agreement standard, favors allocation of misallocated or unallocated items in accordance with the percentage interests of the partners in profits and losses from the assets and activities that generate these items. The second, or curative standard, permits and indeed requires deviation from the economic standard in order to restore the economic consequences shifted among the partners by one or more partners’ negative capital accounts or by the failure of the partnership to respect capital accounts in other ways. Of the four factors listed in the regulation, the second factor listed—the partners’ profit and loss shares—is of primary relevance to the virtual-economic-agreement standard of allocation, although the partners’ rights to cash flow and nonliquidating distributions would trump this if the tax accounting requirements of the section 704(b) regulations were not followed. Normally, however, the partners’ capital contributions and liquidation preferences (the first and fourth factors) would not be relevant. For the curative standard, however, capital contributions and liquidation preferences, as well as the other two factors, are of great importance, because this interpretation of PIP focuses on the goal of giving economic effect to allocations that could but do not have it.⁴⁹

On the whole, the factors test seems to represent the virtual-economic-agreement standard more than the curative standard. This is so in part because non-tax partnership law defines a partner’s interest in a partnership by reference to the sum of the partner’s rights with respect to these factors.⁵⁰ A general partner’s rights may also be managerial, but both general and limited partners have financial rights and these are defined primarily or even exclusively by reference to the factors enumerated in the regulation. A more basic reason for associating the factors test with the virtual-economic-agreement standard rather than with the curative standard is that the factors themselves do not indicate any curative purpose but are instead specifically non-tax aspects of the partners’ arrangement—indeed, the second factor, “[t]he interest of the partners in economic profit and losses”⁵¹ apart from tax consequences, seems openly to allude to the virtual-economic-agreement standard. Thus, given the primacy of the factors test in determining PIP, the regulation seems to come down squarely in favor of the virtual-economic-agreement standard.

⁴⁷Richard M. Lipton, Leslie H. Loffman & Sanford C. Present, *Sustaining Partner Allocations—IRS’s Key Ruling on Deficit Restoration Obligations*, 88 J. TAX’N 80, 86-87 (1998) (discussing “the vague PIP test”).

⁴⁸Lawrence Lokken, *Partnership Allocations*, 41 TAX L. REV. 545, 614 (1986) (stating that “meaningful generalization about the application of these factors is not possible”).

⁴⁹Nonrecourse deduction allocations and allocations intended to eliminate the cash/book discrepancies with which section 704(c) is concerned would not be affected by the first and fourth factors but should instead be controlled entirely by the third and fourth factors.

⁵⁰Lipton, Loffman & Present, *supra* note 48; Lokken, *supra* note 49.

⁵¹Reg. § 1.794-1(b)(3)(ii)(b).

Lest we draw this inference too hastily, however, the regulation immediately thereafter outlines an approach for determining PIP when a special allocation fails to have substantial economic effect because one or more partners do not have an unconditional obligation to restore a capital account deficit.

PIP is arrived at in such a case, with respect to the portion of the allocation that lacks comparative effect, under a comparative method. First, it is determined how distributions and contributions would be made if all partnership property were sold and the partnership liquidated immediately after the end of the taxable year in question. Next, it is determined how distributions and contributions would be made if all partnership property were sold at book value and the partnership liquidated immediately following the end of the prior taxable year. The result is then adjusted for certain items. (For example, depletion allowances reasonably expected to be made to the partner's capital account as of the end of the taxable year, allocations of loss and deduction reasonably expected to be made to such partner under sections 704(e)(2) and 706(d) as of the end of the year, and some net reductions of the partner's capital account reasonably expected to be made as of the end of the year.)⁵² Commentators have noted that the effect of this special rule is simply to make the relevant PIP reallocation in "exactly the same manner as if a QIO were contained in the partnership agreement."⁵³ Why did not the regulation writers just say so expressly? The obvious reason for their reticence is that they wished to preserve the illusion that the PIP standard is unified and principled, not plural and ad hoc.

Several examples show that the point of the comparison is to expose which partners would bear the economic burden of the invalid portion of the allocation and to what extent. For example, if a limited partner is designated for allocation of a \$25,000 cost recovery deduction but has a capital account of only \$20,000 at the beginning of the taxable year, only \$20,000 of the deduction can validly be allocated to the limited partner, even if the partnership agreement contains a QIO. In this situation, the remaining \$5,000 of the deduction must be reallocated in accordance with the partners' interests in the partnership. If the partnership agreement provides that any proceeds from the sale of the cost recovery property would be allocated to the sole general partner, then a sale of the property at book value at the end of the year of the allocation would have the effect of placing the economic burden of \$5,000 of the \$25,000 cost recovery deduction on the general partner.⁵⁴ Another example illustrates a reallocation required to correct for reasonably expected fluctuations in the partners' capital accounts that would

⁵²Reg. § 1.704-1(b)(3)(iii).

⁵³Lipton, Loffman & Present, *supra* note 47, at 87. The principal judicial interpretation of this portion of the regulation found it valid, although the Service itself found it necessary to change position, concerning the application of the comparative liquidation test after prevailing in the Tax Court. *Interhotel Co. v. Commissioner*, 74 T.C.M. (CCH) 819 (1997), 1997 T.C.M. (RIA) ¶ 97,449, *vacated and remanded*, 221 F.3d 1348 (9th Cir. 2000) (unpublished opinion) (accepting the Service's concession that it erred in convincing the Tax Court not to include a minimum gain chargeback in calculations for comparative liquidation test).

⁵⁴Reg. § 1.704-1(b)(5), *Ex. 1(iv); Ex. 15(ii), -(iii)*.

deprive an otherwise valid allocation of economic effect.⁵⁵

The thrust of the examples is that reallocation in accordance with PIP should straightforwardly undo the shifting of potential economic burdens among partners that would result from allocations that are not given economic effect by capital account adjustments or allocations of loss on the sale of partnership assets. Thus, the special rule at issue is curative and not especially concerned with implementing the partners' overall or specific economic arrangement apart from tax consequences.

Finally, section 1.704-1(b)(4) provides special rules for reallocations to reflect revaluations, proper sharing of credits, excess percentage depletion, nonrecourse deductions, and allocations of adjusted tax basis of partnership oil or gas property under section 613A(c)(7)(D).⁵⁶ These special rules further illustrate the regulation's employment of the very different economic and curative standards. The first rule requires any reallocation that may be necessary to compensate for properly created discrepancies between the book values and tax bases of partnership property. For example, this special rule requires that gain inherent in stock held by a partnership, if recognized after a new partner's admission, is to be allocated to the erstwhile partners, when partnership assets were revalued at the admission of the new partner. The pre-admission gain yields an upward adjustment to the capital accounts of the erstwhile partners, so that the pre-admission gain does not appear as a book gain if the property is sold after the new partner joins. Hence, the tax gain should be allocated in accordance with the partners' interests in the partnership, which according to the special rule means allocation of the gain to the erstwhile partners only.⁵⁷

The second special rule requires that tax credits should in general be allocated in the same manner as profits and losses from the property from which the credits arise. Allocations of tax credits normally have no economic effect because these do not trigger capital account adjustments.⁵⁸ Except for the now-repealed section 38 credits,⁵⁹ tax credits are allocated among the partners in the same proportion as deductions or losses that arise from the expenditures that

⁵⁵Reg. § 1.704-1(b)(5), Ex. 1(vi).

⁵⁶Reg. § 1.704-1(b)(4)(i), -(1)(b)(4)(v). The remainder of section 1.704-1(b)(4) does not expressly add to the guidelines for determining PIP. Regulation section 1.704-1(b)(4)(vi), however, indicates that any amendment to a partnership agreement may have to be scrutinized to determine whether, if the amendment had been in place during prior taxable years, the pattern of allocations would have been valid; if not, then the amendment is treated as if it had always been part of the partnership agreement for purposes of making any reallocations and determining the appropriate limitations period.

⁵⁷Reg. § 1.704-1(b)(5), Ex. (14)(i).

⁵⁸An exception exists for adjustments to capital accounts that are required under Regulation section 1.704-1(b)(2)(iv)(j) with respect to partnership section 38 property for tax credits and tax credit recapture. Section 38 was repealed before the section 704(b) regulations were promulgated, but the draftspersons apparently included this provision for credit adjustments as a precaution in case section 38 should be revived.

⁵⁹Reg. § 1.704(b)(4)(ii). Regulation section 1.704-1(b)(4)(ii) simply ratifies that these are allocated in accordance with Regulation sections 1.46-3(f) and 1.48-8(a)(4)(iv).

give rise to them, or in the same manner as the allocation of taxable or nontaxable profits from receipts of the partnership.⁶⁰ An example illustrates this principle: a partnership with a targeted jobs credit to allocate attempts to give it all to one of two otherwise equal partners, but since both share equally in the expenditure for wages that gives rise to the credit, they must both share the credit equally.⁶¹

The regulation refers to the separate full regulation section on nonrecourse deductions for the special rule classifying certain allocations of nonrecourse deductions, which cannot have economic effect, as valid because in accordance with PIP.⁶² These need no further discussion at this point, apart from the observation that the safe harbor for nonrecourse deduction allocations is a principal departure from the virtual-economic-agreement standard, but one that also deviates from the curative standard, unless we regard the discretionary sharing of nonrecourse deductions as rectifying what would otherwise be the only possible allocation, *viz.*, allocation in proportion to the partners' overall economic arrangement.

Finally, two subparagraphs stretch the concept of the partner's interest in the partnership to encompass the allocations elsewhere approved with respect to excess percentage depletion under section 613 and of the adjusted tax basis of partnership oil and gas property under section 613A.⁶³

A crucial subparagraph on amendments of partnership agreements, as previously noted, provides that any partnership agreement amendment that removes a feature of the previous agreement on which the validity of an allocation depended under the substantial economic effect test(s) or under the special rules of section 1.704-1(b)(4) shall be closely scrutinized to ascertain whether the modification was in fact part of the original agreement. Scrutiny will be directed to the possibility that the overt agreement that satisfied the safe harbors was never intended to be the real agreement of the partners concerning relevant contributions, distributions and related economic consequences of the partnership. If so, the altered agreement will be treated as if it had always been in effect, for purposes of reallocations and for determining appropriate limitations periods.

This guideline for allocations with respect to amendments of partnership agreements (the *amendment guideline*) belongs with those primarily concerned with reallocating previously unallocated or misallocated partnership items. The obvious reason is that feigned compliance with a rule or safe harbor is strategically akin to incomplete compliance with the economic effect test, arrangements that render allocations that do have economic effect insubstantial, and similar, potentially abusive allocation schemes. Like the rest of the reallocation regulation, the amendment guideline also contemplates reallocation based on two quite different standards, the standard of the partners' economic agreement apart from tax

⁶⁰Reg. § 1.704-1(b)(4)(ii).

⁶¹Reg. § 1.704-1(b)(5), Ex. 11.

⁶²Reg. § 1.704-1(b)(4)(iv). See *supra* text accompanying note 16.

⁶³Reg. § 1.704-1(b)(4)(iii), -1(b)(4)(v).

consequences and the curative standard. Thus, the reallocation guidelines as formulated and as illustrated in the examples switch back and forth between the incompatible economic standard and the curative reallocation standard.

III. MATCHING THE REGULATION WITH THE MAIN CATEGORIES OF PROBLEMS

At first glance, it may seem that, despite the confusion the undeclared bifurcated approach of the regulation may cause, a differentiated approach of the kind the bifurcated approach represents is appropriate, given our survey of the differences among the problems to be dealt with.⁶⁴ There are three broad groups of situations in which reallocation may be needed.

Group I consists of failures by partners to agree on an allocation of items for either financial or tax purposes. Normally, failures of this category are problems not only for the tax law but also for state partnership law, because the partners' oversight can just as easily result in disputes among them over their economic arrangement—how the profits and losses of the business are to be shared—as in disputes over the allocation of the business's tax attributes. As this cursory description implies, the obvious solution is to ascertain the economic arrangement the partners intended and give it effect for financial purposes. When a state court has decided how financial consequences of the partnership are to be allocated, the tax allocation should be based on that decision, supplementing it only as far as is necessary to resolve allocation issues peculiar to federal partnership tax law, such as the division of partnership items of different character or from domestic and non-domestic sources.

Group II, which consists of cases in which the partners have agreed to allocate one or more partnership items in a manner that does not have economic effect and is not deemed valid under a special rule, at first glance represents a very different type of problem. The partners must have agreed to an allocation but their agreement is not to be respected. The necessary reallocation must *alter* the economic arrangement the partners intended. Hence, it may seem that there can be no overlap between the problems in groups I and II or between the requisite solutions to those problems. But this is true only of part of group I and all of group II.⁶⁵ If group I includes *partial* as well as *complete* failures to allocate, then it includes situations in which the partners take different views of how some item is to be allocated, according to an explicit agreement that is ambiguous or just incomplete in detail. The motivation for such disagreements may be a difference in the tax advantages that flow from the disputants' interpretations of their agreement.

Example. The AB partnership owns a single asset, purchased with the proceeds of a nonrecourse loan. General partner A and limited partner B, who agree otherwise to share profits equally, agreed to allocate all depreciation deductions

⁶⁴See *supra* Section II.A.

⁶⁵See the discussion in Part II.A, *supra*.

to B along with sufficient gain on disposition of the asset to restore any deficit in B's capital account. Except for the required minimum gain chargeback, the depreciation allocation satisfies all the requirements for being deemed to be in accordance with PIP. A takes the view that capital account deficit restoration agreement implies a minimum gain chargeback to B. B, who is willing to lose the benefit of depreciation deductions previously allocated to him, argues that the gain chargeback is triggered only by dispositions of the asset at a financial gain, not dispositions involving only minimum gain.

The integrity of the partnership allocation regime apparently requires a curative approach in such situations, not one simply dictated by the partners' original intent.

IV. REALLOCATION PROBLEMS FOR INCOMPLETE PARTNERSHIP AGREEMENTS

When a partnership agreement fails to allocate some or all of the partnership items that must be allocated, the reallocation provisions of the regulation apply. At first glance, it would seem that in these situations, only the *economic* approach, distinguished above as one of the two approaches represented by the reallocation provisions, should be relevant. After all, the regulation itself proclaims as a general principle that PIP as used in section 704(b) "[signifies] the manner in which the partners have agreed to share the economic benefit or burden" of allocated items.⁶⁶ A natural inference is the further conclusion that federal tax allocation of the unaccounted-for items should follow state law allocation.

The UPA,⁶⁷ partly codifying common law and partly extending common law, provides partial default rules for partners' "economic arrangement," as that term is used in Regulation section 1.704-1(b)(3)(a). Absent a specific agreement among partners, both versions of the Act require that partnership creditors must be repaid before any other division of partnership assets is made; and that partners must contribute in accordance with their interests in the partnership to pay creditors' claims, if existing partnership assets do not suffice for that purpose. If the assets do suffice to pay creditors, the excess must then be used to satisfy debts of the partnership to partners. Any remaining assets go first to repay partners' contributions to partnership capital. This is usually understood to mean that assets *by value* are distributable to partners in accordance with the *book* value of their interests in partnership assets. Any surplus of the value of partnership assets beyond these claims is divided equally among the partners. Thus, at winding up, previous disproportionate contributions to a partnership by partners do not legally imply disproportionate profit shares, and since pre-winding up allocations of net operating profits would result in operating or liquidating distributions that violate the foregoing default rule, the rule implies equal allocations of profits during the life of the partnership as well.

⁶⁶Reg. § 1.704-1(b)(3)(i).

⁶⁷UNIF. PARTNERSHIP ACT § 806 (1997); UNIF. PARTNERSHIP ACT (1914) § 40.

The UPA does not expressly indicate how partnership accounts, including capital accounts are to be maintained. The regulations under section 704(b) do prescribe rules for maintaining capital accounts, ostensibly for purposes of the economic effect tests only, *i.e.*, partnerships that do not wish to invoke the substantial economic effect test in justification of allocations of partnership items are free to violate these capital account maintenance rules.

A. Estate of Tobias v. Commissioner

In two cases, however, the Tax Court, in reliance on the reallocation provisions of the regulation, has refused to remedy an allocation failure by following a state court's determination about the proper manner of allocation under the circumstances. The most recent of these is *Estate of Tobias v. Commissioner*.⁶⁸ In *Tobias*, two brothers operated an animal farm as partners for more than twenty years, with only a cursory oral partnership agreement.⁶⁹ Both partners put land at the disposal of the partnership but agreed for the relevant years that the partnership should pay rent for the land, which they also agreed should remain their separate property. Otherwise, one of the partners, whose estate was the petitioner in this case, contributed a disproportionate amount of labor and capital. This decedent partner eventually evicted the other from the business and forbade him from entering the business premises.⁷⁰ A state court held the exclusion of the partner to have been wrongful and declared him entitled to dissolution of the partnership, with an equal share of any profits that remained after the partners had been repaid their capital contributions.⁷¹ It was conceded, however, that the decedent had contributed far more to partnership capital than his brother had, and his capital contribution could not be repaid out of the proceeds of a sale of partnership assets.⁷² The state court ordered all partnership assets remaining after creditors were paid to be distributed to the estate of the brother who had contributed the largest amount.⁷³ The decedent caused partnership returns to be re-filed for open taxable years showing that the partners shared partnership income equally. On audit, the Service questioned this allocation, determining inconsistently instead that all the business income belonged the decedent and that 50% of the income belonged to the excluded brother.

The Tax Court held that since the state court had found only one of the partners was entitled to all the proceeds of the sale of the partnership assets, he alone should be allocated the the partnership's income for the disputed years.⁷⁴ The court reasoned that because any increase in the value of the partnership's

⁶⁸81 T.C.M. (CCH) 1163, 2001 T.C.M. (RIA) ¶ 2001-267.

⁶⁹*Id.* at 1164, 2001 T.C.M. (RIA) ¶ 2001-267 at 269.

⁷⁰*Id.* at 1165, 2001 T.C.M. (RIA) ¶ 2001-267 at 268.

⁷¹*Id.*

⁷²*Id.*

⁷³*Id.*

⁷⁴*Id.*

assets during the disputed years would accrue to the one partner's benefit, through the judicially ordered liquidation distribution, only he should be credited with that income for tax purposes.⁷⁵

The court's reasoning relied significantly on the regulatory factors test, according to which the partners' rights to the proceeds of a liquidation of partnership assets is one of four factors listed as important. The factors test also points to the importance of the partners' interests in economic profits and losses, but the Tax Court found this factor irrelevant to the case, because the state court, following the language of the UPA, said the partners here would share the profits of the business only after they were repaid their capital contributions, and there were not to be sufficient assets to repay the contributions. Noting this, the Tax Court in silence implied that with no profits to share, the profit rights of the partners were irrelevant.

The Tax Court's opinion is erroneous. The court should have held that the partners shared profits equally for the disputed years, with each partner's capital account to be increased by his annual share of profits, even though the result could not have entitled one of the partners to a net positive liquidating distribution from the partnership. Despite the state court's formulation of the partners' rights, the court clearly did hold that they had equal profit shares, and this sharing arrangement should control the allocation of profits under the reallocation regulation. In partnership accounting, profit shares are not ignored simply because one partner's capital account exceeds the value of partnership assets. Indeed, the UPA requires that on the winding up of a partnership, even partners with positive capital accounts must contribute in proportion to their loss shares to make up any difference between the total book value of partnership capital and the actual value of partnership assets; any other rule would de facto permit partners with lower capital account balances to shift any accumulated net partnership loss to those with higher capital account balances, contrary to the agreed upon rules for sharing operating losses.

The lesson of the case is plainly that the highly ambiguous factors test contained in the regulation can prompt a court to ignore the partners' actual economic arrangement in a reallocation case that only requires that arrangement to be given effect for tax purposes.

B. *Vecchio v. Commissioner*

Judge Whalen in *Estate of Tobias* relied pointedly, he thought, on the full Tax Court's most recent reallocation case, *Vecchio v. Commissioner*.⁷⁶ But *Vecchio* is peculiar in that the problem *Vecchio* dealt with straddles the categories of failure to allocate and improper allocation and it also straddles the categories of partnership allocations and transfers of partners' interests, that are otherwise

⁷⁵*Id.* at 1171, 2001 (RIA) ¶ 2001-267 at 270.

⁷⁶*Id.* at 1168-69, 2001 T.C.M. (RIA) ¶ 2001-267, at 273-74 (quoting *Vecchio v. Commissioner*, 103 T.C. 170, 185-86 (1994)).

separately governed by sections 704(b) and 706.⁷⁷ The Tax Court does not acknowledge, however, that these rival statutory and regulatory schemes are at least partly concerned with policy goals.

Vecchio, Equity, and Berzon were partners in a commercial building, with 47.5%, 49%, and 3.5% profits interests respectively.⁷⁸ When a dispute arose between Vecchio and Equity, they at first agreed to manage the property jointly, but then they could not agree whether the partnership should retain or distribute operating profits.⁷⁹ Litigation in state court led to a judgment requiring Vecchio to purchase Equity's interest by September 30, 1981 or, in the alternative, requiring Vecchio to assign and transfer to Equity on that date one-half of his interest in the partnership. Vecchio did find a buyer and the sale was consummated on November 17, 1980. The purchase price was to be paid in installments. Equity cooperated in the sale and thereafter asserted the right to be paid in full from the first installment of sale proceeds. Vecchio refused, and Equity again sought the state court's assistance. The court found that the early sale terminated the partnership and triggered an earlier closing date for implementation of the court's first order requiring Vecchio either to buy Equity out or transfer half of his interest to Equity instead. At the time of the sale, Equity had a large capital account deficit. The state court found that the partnership terminated with the sale and ordered Vecchio to pay Equity the final purchase price of its partnership interest, as adjusted for a previous cash distribution and for early payment.⁸⁰ The partnership tax return treated the sale of the building as an installment sale, so that only a portion of the partnership's profit on the sale contract was recognized in the year of the sale.

The issues before the Tax Court were (1) whether the partnership agreement, as interpreted by the state court, validly allocated the relevant partnership items; (2) if not, how the relevant items should be allocated without regard to the sale; and (3) how the sale should affect the imposed allocation. Concerning (1), the court held that no allocation of partnership items associated with the sale and termination of the partnership could have substantial economic effect, because the partnership agreement violated the three "fundamental principles" for economic effect.⁸¹ Because the regulations require the full economic consequences

⁷⁷The case is also peculiar in another respect. Although the facts occurred before promulgation of the regulations under section 704(b) (Dec. 31, 1985), the regulations applied to partnership taxable years beginning after December 31, 1975, and so applied to the facts of this case. Reg. § 1.704-1(b)(1)(ii)

⁷⁸Vecchio replaced another individual partner, Takacs, in the midst of the dispute with Equity. 103 T.C. at 176. Because the change in ownership of the Takacs/Vecchio interest has no bearing on the issues, only Vecchio will be referred to in this discussion.

⁷⁹See *id.* Equity was entitled in the event of liquidation to recover its capital contribution before any partnership assets were distributed to either of the other partners. Apparently, Equity wished the partnership to allocate and distribute operating profits to it in early implementation of this preference. See *id.* at 175.

⁸⁰*Id.* at 178-79. The adjustment for early payment reduced the total purchase price by an amount deemed to be Equity's share of partnership profits for the 294 days by which the actual sale and termination date (Dec. 10, 1980) anticipated the court's deadline (Sept. 30, 1981) for Berzon's purchase of Equity's interest. *Id.* at 179.

⁸¹Reg. § 1.704-1(b)(2)(ii)(b)(1).

of an installment sale to be taken into account in the accounting period in which the sale is effective under state law, the Tax Court held that any other or further allocation of actually-received sale proceeds from the first installment violated the first fundamental principle of economic effect because the partners' capital accounts could not validly be adjusted to reflect the allocation.⁸² Equity's liquidation preference, the court further held, violated the second fundamental principle, because it contemplated the possibility that Equity should receive more in liquidation than a portion of partnership assets simply pro-rated to its share of partnership book capital. Finally, the court held that the written partnership agreement expressly relieved Equity of any obligation to make further contributions to partnership capital, thereby negating any requirement that Equity must restore any capital account deficit.⁸³ (Since the partnership agreement antedated the current regulations, of course it did not include a qualified income offset and therefore could not satisfy the alternate economic effect test.)⁸⁴

Having decided that the allocation of building sale profits that the partners had agreed upon did not have economic effect, the court resorted to reallocation in accordance with PIP. Importantly, the court treated the regulatory standard as requiring reallocation in accordance with the partners' economic arrangement in all cases.⁸⁵ Section II.C of this article argues that two standards are in fact implicit in the regulations, an *economic* and a *curative* standard. An improper allocation that fails because a partner does not have the obligation to restore a capital account deficit is subject to a special rule that implements the curative and not the economic standard.⁸⁶ PIP is determined in such a case, with respect to the portion of the allocation that lacks economic effect, by comparing (1) how distributions and contributions would be made if all partnership property were sold at book value and the partnership liquidated immediately after the end of the taxable year in question, with (2) how distributions and contributions would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the prior taxable year, and adjusting the result for certain items.⁸⁷

The court, however, could have chosen to treat this not as an attempted improper allocation but as a failure to allocate. On the court's reading of the partnership agreement, the restoration of Equity's capital account was permitted to be made out of Equity's normal share of partnership profits but was neither permitted nor required to be made out of partnership profits *before* they could be allocated to any other partner, as the curative approach set forth in the realloca-

⁸²See *Vecchio v. Commissioner*, 103 T.C. 170, 190-91 (1994).

⁸³*Id.* at 191-92.

⁸⁴Reg. § 1.704-1(b)(2)(ii)(d).

⁸⁵103 T.C. at 194 ("The fundamental principle for requiring that an allocation have economic effect is that the allocation must be consistent with the underlying economic arrangement of the partners.").

⁸⁶The regulation explicitly makes such allocations subject to a rule that implicitly has the same effect as a QIO. Reg. § 1.704-1(b)(3)(iii); see *supra* text accompanying notes 52-54.

⁸⁷See *supra* text accompanying notes 51-52.

tion regulation demands. The court took the view that a priority allocation to restore Equity's capital account deficit would itself lack substantial economic effect because it would not match the pro rata allocation of the full contract gain among all three partners' capital accounts in accordance with the capital account maintenance requirements of the regulation. Nevertheless, the court decided that the partners' economic arrangement, which provided the standard to be followed for reallocation in accordance with PIP, did require a gain chargeback to Equity because Equity had benefited from a disproportionate allocation of depreciation of the partnership's sole asset. Obviously, when a priority allocation of partnership profits occurs pursuant to a qualified income offset, as required by the regulation, partners' capital accounts are not adjusted in the same manner as they are before and after the QIO becomes effective. So here, the court should have held that the portion of the allocation to Equity that restored a capital account deficit should be accompanied by a curative capital account adjustment that deviates from the normal requirements of the capital account maintenance requirements. Only the further allocation of a portion of the installment sale gain to Equity, to compensate Equity for its initial capital contribution, would apparently run afoul of the capital account maintenance requirements, because it would not serve a curative purpose. But instead of characterizing this return of Equity's capital contribution as an allocation without economic effect because not in proportion to the installment sale adjustment of all the partners' capital accounts, the court could have decided to characterize the return of the capital contribution as a liquidation of Equity's partnership interest. (Equity's interest was clearly worth more than the initial capital contribution, because the sole asset of the partnership had been sold at a substantial profit.) Such a characterization would have been fully justified by the PIP virtual-economic-agreement standard, because it would clearly implement the state court's alteration of the partnership agreement.

The Tax Court's reasoning in *Vecchio* neither faithfully applies the regulation nor squarely confronts the bifurcated standard implicit in the regulation. Instead, the court apparently relied on its own unarticulated sense of tax fairness under the circumstances, just as it apparently did again in *Tobias*. This intuitive method yields a strained result, because the court is compelled to acknowledge both that the partnership agreement does not require a gain chargeback *and* to hold that the partners' economic arrangement *does* require one. Even when the ambiguity created by the state court's construction of the partnership agreement is taken into account, the Tax Court still appears to have embraced the fiction that a curative allocation was just what the partners had in mind. Given that *Vecchio* is the Tax Court's most elaborate and latest interpretation of the reallocation provisions of the regulation, the free-wheeling approach taken in the case, though intuitively satisfying, creates considerable uncertainty.

V. SHOULD THE STANDARD BE EXPLICITLY BIFURCATED?

It is tempting to conclude that, because the reallocation standard that the regulation states conceals a double standard, this should simply be acknowl-

edged. A straightforward move like this on the part of the Service might elicit congressional disapproval or judicial challenge to the administrative positions implicit in the regulation, but the current wobbly formulation seems even more likely to elicit authoritative condemnation, at least eventually. On the other hand, if the courts, unprompted by the Service, were to interpret the regulation as declaring a bifurcated standard, they might be willing to work with it, *i.e.*, to apply a virtual-economic-agreement approach to reallocation when partnership agreements are incomplete, and a curative approach when partnership agreements affirmatively require invalid allocation of items. Either administrative or judicial bluntness seems preferable to the confusing status quo.

Unfortunately, as *Vecchio* illustrates, determining whether a defective partnership agreement is merely incomplete or badly off on the wrong foot is neither easy nor straightforward. In *Vecchio*, the original partnership agreement did not contain a gain chargeback or QIO, and the amended partnership agreement that covered the entry of a new partner created the possibility for the first time that a QIO would be necessary to avoid invalid allocations; hence, the facts that gave rise to the case fall between these two stools: they were neither unintentionally incomplete nor (apparently) deliberately abusive.

Given the need for a principled inquiry whether the virtual-economic-agreement standard or the curative standard is appropriate in the particular case, mechanical bifurcation of the reallocation standard is out of the question. The regulation implicitly recognizes this already, by declaring that various factors are relevant in determining the partner's interest in the partnership.⁸⁸ The factors test, as we have seen, partly conceals the ambiguity of the problem: whether PIP should be divined from the intended economic arrangement of the partners or from some unintended correction of their arrangement. *Tobias* illustrates the Tax Court's uncertainty of direction in resolving this ambiguity in a concrete case.

It is worthwhile, therefore, to attempt to anticipate areas in which the standard, even if it is acknowledged to be an appropriately double standard, still encounters problems. *Vecchio* deals with one such problem area—the overlap between section 704(b) and section 706(c)(3). Section 704(b) broadly governs partnership allocations that normally appear in a fully explicit partnership agreement. Section 706(c)(3) deals with transactions among partners or between partners (sometimes, newly admitted partners) to which the partnership is not a party, *viz.*, transfers of entire or partial partnership interests among partners, and the section is designed to prevent retroactive allocation of gains and losses among partners. Furthermore, closely related to section 706(c), section 706(d) is intended to frustrate accounting-method-based strategies to make retroactive allocation of foreseeable items that have not yet been reflected on the partnership's books.

Why might the application of both section 704 and section 706 to the same allocation problem challenge the viability of the regulatory reallocation

⁸⁸See *supra* text accompanying notes 45-49.

standard(s)? The obvious answer is that section 706 flatly prohibits tax-advantaged allocations of partnership items, when it applies at all, while section 704 permits a large range of such allocations, subject only to limitations that are designed to ensure that the partners have a business purpose in making those allocations. Moreover, the policies these sections implement, though related, are not identical. It is generally acknowledged that section 704 is designed to serve the principle of tax neutrality, *viz.*, that tax laws should not bias economic decisions but rather should leave them unaffected as far as possible. By allowing partners to allocate partnership items along with their tax consequences, however the partners wish, the allocation regime of section 704 tries to avoid deterring investors and sole proprietors of going concerns from entering into combinations that have a non-tax purpose, and in order to do this the section allows the partners to preserve some of the tax consequences they would otherwise enjoy if they refrained from joining forces.⁸⁹ Both the economic effect and substantiality tests patently focus on economic motivation apart from tax consequences as a touchstone of validity. In contrast, the policy behind section 706 is simply to prevent certain tax-advantaged transactions, whatever their non-tax motivation.

Although the case has yet to arise, it is conceivable that section 704(b) and section 707(a)(2)(B) might both apply, with different results, to the same transaction.⁹⁰ Section 707(a)(2)(B) should arguably override section 704(b), even though both sections in this respect are designed to implement the policy against tax-sensitive allocations.

Example: A and B form a partnership. A contributes \$100,000 in cash, and B contributes an existing business, which A and B agree is worth at least \$80,000 but acknowledge may be worth as much as \$100,000. The partners therefore agree that if an outside appraisal of the business bears out a higher value one year after the partnership is formed, B's capital account will be increased by the difference between that amount and \$80,000, B's initial capital account balance. Although the agreement may be entirely innocent of tax motivation, it creates the possibility that A, by forgoing an equal share of future partnership profits through the agreed-upon increase in B's capital account, will compensate B with untaxed dollars for part of the value of the contributed business, which A of course partly owns through the partnership after its formation. Section 707(a)(2) may apply to this transaction, even though it passes muster as a special allocation having substantial economic effect under section 704(b).

But if it is correct to regard the allocation as invalid under section 707(a)(2)(B), would the curative or the economic approach to reallocation be more appropriate? The curative standard appears only to contemplate restoration of the type of

⁸⁹The original regulations implementing section 704(b), as enacted in 1954, gave primacy to "[w]hether the partnership or a partner individually has a business purpose for the allocation. . . ." Reg. § 1.704-1(b)(2). See ARTHUR B. WILLIS, HANDBOOK OF PARTNERSHIP TAXATION 139-44 (1957).

⁹⁰See RICHARD L. DOERNBERG & HOWARD E. ABRAMS, FEDERAL INCOME TAXATION OF CORPORATIONS AND PARTNERSHIPS 797 (3d ed. 2000)(illustrating problematical application of Regulation section 707(a)(2)(A) to an otherwise valid allocation of income to top up capital account of contributor of asset of uncertain value).

partnership agreement that would come within one of the regulatory safe harbors, but this arrangement apparently already does so. The economic standard, paradoxically, might be more curative than the curative standard, assuming that the economic standard requires tax treatment in accordance with economic substance, and we interpret section 707(a)(2)(B) as properly indicating what the economic substance of the transaction is.

The overlap of the economic and the curative approaches is also troubling with respect to allocations of nonrecourse deductions that are not accompanied by a reasonably consistent allocation having substantial economic effect of some other significant partnership item attributable to the debt collateral. As explained briefly above,⁹¹ although allocations of nonrecourse deductions cannot by definition have economic effect, they are deemed to be in accordance with PIP if at relevant times: (1) the partnership agreement satisfies the requirements of the primary or alternate economic effect test, (2) the nonrecourse deductions are allocated in a manner reasonably consistent with an allocation having substantial economic effect of some other significant partnership item attributable to the collateral of the nonrecourse debt; and (3) the partnership agreement contains a "minimum gain chargeback."⁹² Of these requirements, (1) and (3) impose a real burden that is obviously related to the tax benefit of the nonrecourse deduction allocation. In particular, to the extent that a partner is allocated any amount of nonrecourse deductions, (3) requires that he or she should also be liable for the *Tufts* gain that will result from the partnership's disposition of the collateral and that he or she should be allocated that amount of gain in other partnership items if this prospective *Tufts* gain is reduced by the partnership's repayment of the nonrecourse debt. Requirement (2), on the other hand, could be satisfied if items or gain or loss that are relatively small or large in amount as compared with the nonrecourse deductions are allocated among the partners in very roughly the same proportion. It is perhaps not too cynical to describe this requirement as window dressing to give the safe harbor as having some relation to substantial economic effect. If a partnership agreement satisfies (1) and (3) but not (2), it is difficult to see why it should not still be regarded as in accordance with PIP. Such an allocation would obviously be faithful to the partners' economic arrangement, because it would be their arrangement, and it would not apparently be abusive of the nonrecourse deduction safe harbor, precisely because requirement (3) is of no special consequence. Obviously, the four-factor test for PIP would yield no serious guidance for a court confronted by such a defective nonrecourse deduction allocation. On the other hand, regulation section 1.704-1(b)(3)(iii)⁹⁴ suggests that a defective use of a regulatory safe harbor should be cured by the exclusively curative imposition of the missing requirement or requirements. Again, the twofold approach of the regulations is inconclusive in this borderline case.

⁹¹See *supra* text accompanying notes 23-25.

⁹²Reg. § 1.704-2(e)(1), to -(3).

⁹³See *supra* text accompanying notes 51-53.

In summary, the border between situations in which the economic standard is more appropriate and situations in which the regulatory curative standard is more appropriate is not entirely clear. Hence, the option of applying the regulatory standard in the spirit in which it was written is not a mechanical one.

VI. CONCLUSION

The elaborate reallocation standard in the current section 704(b) regulations suffers from apparently intentional ambiguity, providing that in unspecified circumstances one or the other of two incompatible approaches to reallocation shall be followed. Clarifying the regulation will not be a simple matter, because determining which of the two incompatible approaches makes sense in a particular case sometimes requires a substantive decision about the innocence or abusiveness of the actual partnership agreement.