
John C. Siegesmund

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I F I HAD TO PICK a section of Subchapter K that is the single most important, my choice would be Section 704, which deals with partnership allocations. Whatever else can be said about a partnership, at the bottom line it is an organization designed to make money. The things partners are most interested in are how much money they are going to make and when they are going to get it. Consequently, if they never read anything else in a partnership agreement, I can almost guarantee you they will read the section on allocations. I can also almost guarantee you that if that section is improperly drafted, big problems will result.

It is important to have some historical perspective on Section 704 in order to understand where we are now and where we are going. Prior to 1976, the rule was that if a partnership allocation was made for the avoidance or evasion of federal income tax, it would not be approved and would result in a reallocation in accordance with the partners' interests in the partnership. There were about 6 tests in the regulations for determining what the words “avoidance or evasion” meant, but it came to pass that the most important was the substantial economic effect test. Generally, this required that an allocation had to actually affect the amount of dollars that a partner would ultimately receive from the partnership. That is to say, the allocation had to have more than a simple tax effect; it had to have economic effect as well.

In 1976, the law was changed and the substantial economic effect test became the sole standard for determining the validity of partnership allocations. I think that on the whole, most of us who practice partnership taxation had a pretty good feel for the meaning of that rule. However, there were always a few questions, and the IRS in its wisdom decided to clarify certain areas. In March of last year, they brought out 30 pages of regulations interpreting the three words “substantial economic effect.” Although the proposed regulations are in many ways helpful they also have raised a number of difficult and troublesome problems.

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I think it is an indication of the magnitude of the problems presented by
the proposed regulations that we have been waiting so many months to see
the final regulations. These issues are extremely complex, and they result in
no small part because Subchapter K is in many ways tremendously flexible.
Any attempt to impose certainty on such a flexible body of law necessarily
results in complexity, and the IRS needs time to grapple with this situation.

Nevertheless, I think we should attempt to understand the proposed regu-
lations for at least two reasons. First, the general thinking is that the final regu-
lations will be pretty much like the proposed regulations. There will be some
changes, but I think we can anticipate what, or at least where, they will be.
Second, understanding the proposed regulations will give us a much better con-
text for understanding the final regulations when they are issued.

Turning to the substance of the proposed regulations there are generally
three ways an allocation of income, gain, loss, deductions, or credits can be
acceptable. The first and most important way is for the allocation to have,
in fact, substantial economic effect. The second way is for the allocation to
be in accordance with the partners’ interests in the partnership under all the
facts and circumstances. This is obviously a very subjective and uncertain test.
The third way is for the allocation to satisfy one of six special tests in the
regulations.

I have a couple of general comments about the proposed regulations. The
regulations make it clear, and I think all of us thought this was the case, that
allocations are not an all or nothing proposition. If an allocation is invalid,
only the invalid part of the allocation will be reallocated among the partners.
In other words, an error respecting part of the agreement or part of an alloca-
tion scheme does not invalidate the whole agreement. Only the part that is in-
valid will have to be readjusted.

My second general comment is that the effective date of the proposed
regulations is the start of this year, January 1, 1984. I think it is probably safe
to say that the final regulations will revise the effective date to a later time.
More interestingly, the proposed regulations said that the “fundamental prin-
ciples” of the regulations would govern prior years. Many of us got rather
severe cramps at the statement because we had no idea what a “fundamental
principle” was. “Fundamental”, I suppose, is what someone believes is im-
portant. One of the things I believe is going to be changed in the final regula-
tions is that the provision referring to “fundamental principals” governing prior
years will be dropped in favor of something a little more comprehensible, like
a “prevailing principles of law” standard. Basically, that would mean reference
to the old established caselaw tests. I think these old tests were what the Ser-
vice had in mind all along, anyway, but the words “fundamental principles”
scared people.

Another thing to keep in mind about the special allocation regulations
is that they are not the last word on the subject. There are other sections of
the Code, in particular Section 706, which can invalidate a particular alloca-
tion. Consequently, the fact that an allocation may pass muster under Section
704 is not conclusive of the ultimate tax effect. I am going to come back to
this point shortly because the fact that an allocation may be valid under Sec-
tion 704 but still be invalid under other provisions can lead to some curious
results.

So much for generalities. Let’s go to the specifics. The major test, of course,
of the regulations is that an allocation will be approved if it has substantial
economic effect. This means it has to pass two tests. Number one, the alloca-
tion has to have economic effect; and, number two, such economic effect has
to be “substantial.” Let’s examine these one at a time.

The economic effect test stems from a line of older cases. In order for
an allocation to have economic effect, the allocation has to be mirrored, dollar
for dollar, in economic reality. If partners have been allocated a deduction
or a loss for tax purposes, they have to take the chance that loss is occurring
out there in the real world. Conversely, if partners have income allocated to
them for tax purposes, they have to be allowed to reap the benefit of its profit
someday. The regulations do not care when this must occur; they do not
care when the losses are borne economically, nor do they care when gains are
reaped, provided that it occurs sometime during the life of the partnership.

There are two ways to satisfy the economic effect test. The first way is
by satisfying the following three mechanical requirements: First, the alloca-
tion has to be reflected as an appropriate increase or decrease in the partner’s
capital account. An allocation of profits increases the capital account; an alloca-
tion of losses decreases it. Second, liquidation proceeds must, throughout the
life of the partnership, be distributed in accordance with the balances in the
partners’ capital accounts. Third, if any partner has a deficit balance in his
capital account, meaning either that the partnership lost more money than he
put into the deal or that the partner took more money out of the deal than
he put into it, then he has to restore his negative capital account balance to
the partnership for distribution to partners who have positive capital account
balances. If those three requirements are met, you automatically have alloca-
tions with economic effect.

The second way to satisfy the economic effect test is to meet the capital
account equivalence test. If the partnership agreement does not contain the
three mechanical requirements, the allocations in the agreement will still be
okay if the same result is achieved. It seems to me that reliance on the capital
account equivalence test is always somewhat risky since you take the chance
that some unforeseen glitch will arise later and create a substantial variance in
the results achieved by your formula and those which would have been achieved
if the three mechanical requirements had been met. In other words, since
the test is whether the effect is the same as if the mechanical requirements were met, why not just meet those requirements?

When is economic effect determined? The regulations have a very useful rule that economic effect is determined at the end of each partnership year. There are at least two instances when that is beneficial. First, an allocation that might not have economic effect when it is made might have economic effect by year end. Let me give you an example which will be familiar to practitioners who do private placement offerings, or even public offerings. When a tax shelter limited partnership is sold, the promotor/general partner will sometimes form the partnership, commence activities and start generating losses before all investors are signed up. Investors who sign up early and are admitted to the partnership will therefore get more first year losses than those who sign up late. However, the promoter agrees that if the offering does not sell by a given date everyone will get their money back.

Now, if we view this situation in isolation, the allocation of losses to the initial limited partners at the moment the losses arise does not have substantial economic effect. Why? Because they do not know they are going to bear those losses at that moment. If the partnership does not close, the initial limited partners will not bear the losses, since the general partner has said, "I'll take the losses, you'll get cashed out." If it was not for the timing rule, one would have severe doubts about the economic effect of such an allocation. This rule says that as long as, by year end, everything has shaken out, the allocation is okay.

The second salient feature of the year-end rule is that economic effect can be tested on a year to year basis. This is particularly important in limited partnerships. One of the hallmarks of limited partnerships is that the limited partners do not have to put up additional money. This is why people want to be limited partners. Consequently, the last thing they want to see in the partnership agreement is a deficit capital account charge-back provision. It is typically explicit in the agreement that the limited partners will never have to make additional contributions. This means that the third of the three mechanical requirements is not met, since the charge-back provision is not there. But, since we test on a year to year basis, as long as the need for a capital account charge-back provision is irrelevant in any given year, absence of such will not invalidate the allocation. So, for example, if a limited partner puts in $100, and is allocated a first-year loss of $10, his capital account goes to $90 and thus is not a deficit capital account at that point. Failure to have a charge-back provision in the agreement is not fatal at that point. Of course, if he should ever have a negative account balance, absence of a charge-back feature would then be fatal. But, if he does not ever have a negative account balance, testing on a year to year basis saves the allocations.

The regulations contain some anti-avoidance rules to prevent partners from manipulating their capital accounts to get the desired results, but I'm not going
to go into any detail respecting these. Suffice it to say that the Service is thinking ahead of us to keep us from making dubious capital account adjustments.

Example One of the regulations illustrates the basic workings of the economic effect test. A very simple fact situation is presented. Two partners each put $40,000 into a partnership. In year one there is a $20,000 loss from the partnership, which is allocated to partner A. If his capital account is debited with that amount, the allocation has economic effect. That is, if that loss is actually occurring, then when the partnership liquidates, there will only be $60,000 of property left to distribute. If A gets $20,000, and partner B gets $40,000, A will have borne the actual loss, and the allocation will have had economic effect.

If the partners agree that they will split liquidation distributions fifty-fifty, no matter what, the loss allocation does not have economic effect and the loss will have to be reallocated.

In year two of the example, partner A gets a $25,000 additional loss. This pulls his capital account down to a negative figure. In other words, he has been allocated for tax purposes $45,000 of total losses, but he has only put $40,000 into the deal. If he does not have to make up the $5,000 differential, he will have received a $5,000 tax loss without having to bear a corresponding economic loss. For this reason, the allocation is invalid. On the other hand, if Partner A has to put $5,000 back into the deal in order to make the other partner whole, economic effect results and the allocation will be allowed.

Notice that it does not matter when Partner A has to put the money back into the deal. It only matters that the day of reckoning will come some day. This rule can work wonders if we consider the time value of money. If you are a partner in a partnership that is going to last for fifty years, you can take all the losses you want as long as you promise to bear them economically at the end. The time value of money is not important under the Code. All that matters is that the partners get even some day.

Another interesting thing to notice about Example One of the regulations where the partner goes negative on his capital account is that in most situations, a partner cannot get any benefit from some of his “excess” loss allocations anyway. The reason is that when no debt is involved, the partner runs out of basis. In the example, there is only $40,000 basis to Partner A in the deal. Moreover, he is only at risk for $40,000. If he is allocated $45,000 of losses, $5,000 has no tax effect. The only way he could have obtained tax benefit from the losses allocated to him would have been to have put more money into the deal so as to create enough basis to release all the tax losses to him.

There is an interesting interplay between Section 706 and Section 704 that I want to mention because it affected me once when I was doing a syndication. Section 706 provides that if a partner comes into a partnership late in
the year, you have to apportion the losses occurring during the year to take into account his late entry. So, if someone comes in on December 31, he can not get a whole year’s worth of losses allocated to him.

But what if the partnership agreement lets the partner who comes in on the last day of the year receive all the losses and he bears them fully in his capital account? This would have substantial economic effect. Such a partner who comes in on the last day of the year would bear the economic burden of the losses but not receive the tax benefits of the losses because of Section 706. Now, I ask you, is tax policy better served by making sure that we can’t manipulate deductions for late-entry partners or is it better served by making sure that those who are actually going to bear losses get full loss treatment for tax purposes?

Let me give you a couple of drafting tips respecting economic effect in partnership agreements. To me the intelligent way to begin a partnership agreement when a client comes into your office is to try to make an initial determination of the economics of the deal. That is to say, ask who is going to get the ultimate profits and who is going to get the cash flow. Clients quite reasonably are not particularly concerned about how little marks on an accountant’s ledger will be recorded. What they want to know is when they are going to get checks and how big those checks are going to be.

Let me give you an example of a typical situation. A is going to put $100 in a partnership, B is going to put in services, but it is a fifty-fifty deal. The clients, however, say they want all cash flow and profits to go to A until A gets his $100 back. You ask them why they are doing that, and they say they simply want A to get his money back first. What if the deal only makes $200 at the bottom line? Who is going to walk away with the money? Well, A’s capital account is going to be credited with $100 of profit, and it will go up to $200. By liquidating in accordance with the capital accounts, he will walk away with $200. He will double his money before B gets to come into the deal. The clients then say, “Oh, that’s not the deal.” The deal is that A gets $50 of profit, B gets $50 of profit, and A gets his $100 back. What they are saying is that the profits go fifty-fifty, but the cash flow goes 100% to A until he gets back $100. Now B wants to know if he will get taxed on income while A gets his cash flow preference. The answer is probably yes. The next question is whether anything can be done about this, and the answer is no. Why not? Because the economic effect test requires this result. We cannot allocate profits to A, the money man, until he has $100 of profits but then split profits fifty-fifty.

Clients simply have to be made aware of this dilemma. It is surprising to me how many partnership agreements are written so as to allocate an amount of income first to the “money partner.” The partners are appalled when I tell them the money partner gets to double his money before the services partner
participates. The way I go about analyzing these things is to try to get some handle from the clients as to what the bottom line allocation of profits and losses is supposed to be. I allocate accordingly then worry about cash flow, which is purely a timing question. What the Code is interested in is who is going to get the profits, not how cash flow works.

Obviously, the heart and sole of the economic effect test is the maintenance of capital accounts. Not, surprisingly, the proposed regulations have some extensive provisions on how to maintain capital accounts. The general rule is that the capital accounts are maintained in accordance with tax accounting principles. This does not produce very many anomalies except in one or maybe two circumstances. One circumstance involves contributions to the partnership. Let's look at a simple example.

Two partners go into a deal. One has property with a basis of zero, worth $10,000, and the other has $10,000 cash. Realistically, the partners think they are fifty-fifty partners, and they are. They have both put the same amount of value into the partnership. But under tax accounting principles, their capital accounts are zero versus ten. That just seems kind of odd. It is hard to make the clients understand why one’s capital account is nothing while the other’s is $10,000.

This leads to all sorts of confusion. As we will see, the proposed regulations pull back from this result and provide a special rule to the effect that we do not have to maintain the capital accounts in accordance with tax principles respecting contributed property or distributed property. Why the general rule is like it is, I just don’t know. I think it leads to a lot of confusion, and I hope it disappears in the final regulations, but I do not think it will.

The only benefit I can think of from this general rule is that it discourages attempts to manipulate the capital accounts to get a desired result. For example, consider a partner’s contribution of services in the form of “know-how”. Is this property or services? Let’s say the other partner contributes cash. The person who is going to put in the know-how says, “I want my capital account to be the same as yours so I can absorb a lot of losses before my account goes negative.” The IRS, I think, may have a legitimate concern here if indeed services are involved.

There are certain special capital account adjustment rules. There are three such rules and they stem primarily from the general rule that capital accounts have to be maintained in accordance with tax accounting principles. The first rule involves transfers.

When you sell an interest in a partnership, ordinarily the basis of the assets inside the partnership is not adjusted. In other words, it stays the same although the outside basis may be increased to reflect the sales price. Similarly, the general rule is that the capital account of the transferor carries over to the transferee.
But what happens if the partners decide to adjust the inside basis of assets pursuant to Sections 743 and 754? If they decide to do so, an election to make a corresponding adjustment to the capital account of the transferee is also available. The adjustment is not mandatory and the partnership agreement must authorize the necessary adjustment. I am sure that many partnership agreements out there permit a Section 754 election but fail to refer to the step-up for capital account purposes as well.

An interesting aspect of this rule is that if the other partner’s capital accounts are not also increased, a conceptual problem arises. Let me illustrate. Suppose two partners go into a partnership with nothing, so that they both get zero capital accounts. Somehow, however, they acquire a piece of property. That property becomes worth $10,000. Now one of the partners wants to sell his interest. What’s the value? It’s worth $5,000; half the partnership. He sells for $5,000. The person coming in can set a stepped-up capital account of $5,000. What about the guy who stayed in? His property is also worth $5,000, so why is his capital account kept at zero? I guess the result just logically follows from the proposition that we are going to maintain our capital accounts in accordance with tax accounting principles. But it does not seem to make a lot of sense, and it is troublesome.

Another exception to the tax accounting principles rule is for preliquidation adjustments. Take the example I just gave you, but let’s suppose one partner puts in $5,000 while the other partner puts in nothing but services while receiving a 50% share of the profits. The partnership acquires a piece of property. The property appreciates in value, but the appreciation is not yet fully realized. Now the partnership is going to liquidate, so how much should each partner get? One has a capital account of $5,000 and a 50% share of the profits; the other one has a capital account of zero but also is entitled to 50% of the profits. Assume the property has appreciated by $5,000. The second partner is entitled to $2500 of value out of the partnership, because if they had sold the property, there would be a $5,000 gain, and half would go to his capital account. But such is not the result according to the unadjusted capital accounts.

If upon liquidation nothing goes to the partner with the zero capital account, he is going to talk to his attorney because that is not right. The rules take this type of situation into account and permit valuation of the property so that each partner’s capital account can be adjusted as if a sale occurred prior to liquidation.

Unfortunately, the rules do not say what happens if just one partner is getting out absent a liquidation. I have been using a two-man partnership, which is not a good example, but consider a three-man partnership. One of the partners wants to withdraw. He has just as much right to get everything he is entitled to as the partners in a two-man partnership that liquidates. Unless the regulations permit an adjustment for a withdrawing partner, a serious problem
The third permitted adjustment pertains to depletion respecting oil and gas properties. I am going to forego a discussion of this adjustment for three reasons. One, this is a fairly arcane subject; two if I had to pick one section of these regulations that is most riddled with anomalies, this would be the one; and three, I get a headache every time I try to understand what it's about. Consequently, we will move on.

The second half of the substantial economic effect test is substantiality. Back when all we had to go on was the language of Section 704 itself, there were those of us who thought that the term “substantial” equated to “close enough.” That is, if an allocation did not really have complete economic effect, but was “close enough,” it would be O.K. Well, that is not how the regulations see it at all. The regulations really have a whole different approach to the concept of substantiality. They contemplate a shift in economic consequences that is to say, of material importance or significance, when compared to the shift in tax consequences. The classical example of this is where one partner is allocated $10,000 of tax exempt income and the other partner is allocated $10,000 of taxable income. Economically, this is a wash. But for tax purposes, of course, the difference is considerable. Each partner’s capital account may get adjusted just right, but the economic effect is not substantial in comparison with the respective tax consequences.

The regulations apply the substantiality test differently in different circumstances. In the case of allocations occurring within one year, we must ask whether there is a strong likelihood at the start of the year that the allocations in question will cause a shift in tax consequences that is disproportionate to the shift in economic consequences. Moreover, if such disproportionality does occur at the end of the year, there will be a presumption that the likelihood of such existed from the outset. Obviously, this is a very subjective test, but I think it is not going to be particularly troublesome. Most of us will be able to sense when we are too close to tax manipulation. If $10,000 of nontaxable income goes to one partner while $10,000 of nontaxable income goes to another, you will begin to smell a rat.

Multiple year allocations will be more difficult to evaluate. What we are looking for here is whether the economic effect of an allocation will be transitory. Although an allocation may have in one year a significant effect due to later allocations the effect of the current allocation may not be permanent. The only example in the regulations that illustrates this involves an unusual situation, or at least a situation that seems to make a poor illustration — a partnership having only AAA corporate bonds. One of the partners has an expiring NOL, and all of the income for the year is allocated to that partner so he can use up his NOL. The other partner is then given an equivalent amount of income in future years until he gets caught up, and then they go back to
their old sharing ratio of fifty-fifty. The example further says the partnership cannot be liquidated without everyone’s consent. Under these fairly unique facts the regulations say the allocation to the first partner in the first year is transitory. I submit we are not helped very much by this example.

One helpful thing the regulations do tell us is that there is an exception for so-called “economic performance.” The clearest example of this is depreciation. We will assume conclusively that if property is depreciating for tax purposes, it is depreciating economically in the real world. Many partnership agreements have charge-back provisions to the effect that when property is sold, the partners who received the depreciation will first be allocated an equivalent amount of the gain. Such an allocation would be transitory if the property really is not depreciating. But, because of the economic performance exception, we won’t look at economic reality. We will just pretend the property really is depreciating.

Interestingly, the regulations also approve an income charge-back. In this situation the partners who are allocated depreciation are allocated income to get their capital accounts back to their original levels. The logic of the rule approving this type of charge-back is somewhat more elusive. Suppose a building is subject to a thirty year lease, which is going to produce every year like clockwork a certain amount of rental income. The assumption that the building is truly depreciating, does not necessarily support an assumption that the income charge-back will be insufficient to get the partner receiving the depreciation back to even. However, the regulations say that if a charge back provision operates not only respecting gains but also respecting income, it is still good and one does not have to worry about the fact that the allocations of depreciation were transitory.

We might jump to the conclusion that the regulations are a blessing for charge-back provisions. They are not. As far as I am concerned, this aspect of the regulations is going to cause a lot of headaches down the road. Consider the typical real estate deal. Deductions will primarily come from three sources. These are depreciation, taxes, and interest. We know that charge-back allocations to make the partners even respecting depreciation will not be regarded as transitory. What about the losses attributable to taxes and interest? They also go into the bottom line for allocation of losses. If the partners are entitled to get back income or gain until they have not only made up depreciation losses but also made up losses from interest and taxes, does such a provision involve transitory allocations? This question may be difficult to answer without further guidance.

So much for substantial economic effect. The second major way an allocation can be approved is if it is in accordance with the partner’s interest in the partnership. This is a very subjective test. There is a lot of blather in the regulations about looking into all the facts and circumstances, but I think it boils
down to a simple concept. If we are going to allocate something in accordance with a partner’s interest in the partnership, we are going to allocate it in the way that yields substantial economic effect. That is, we must look to the partners who really bear the losses and who really bear the benefit of the income.

The only variations from this approach involve the special rules that address allocations that by their nature cannot have substantial economic effect. For example, we cannot allocate losses attributable to nonrecourse loans in accordance with who actually bears the risk of the loss, since the person who actually bears the risk is the bank, which is not a partner.

The special tests involving allocations that by their nature cannot have substantial economic effect raise many problems. The IRS could have taken the position that such items should simply be allocated in accordance with the partners’ interests in the partnership and ducked those problems; rather the Service courageously plunged into this area and tried to make some sense out of it. The job was a long way from perfect, although a noble effort, and I think much of the reason of the delay in the final regulations is that the Service is still trying to resolve the problems which people saw in their first effort.

The first special test pertains to disparities between book and capital accounts. As we have seen, the general rule is that capital accounts have to be maintained in accordance with tax accounting principles. Unfortunately, persons who go into partnerships with contributions of appreciated property that are equal in value, think of themselves as being equal partners and expect to see equal capital accounts. After all, tax basis is a concept that only a tax lawyer or tax accountant could possibly love. Most clients have no idea what their basis is, and they couldn’t care less, except to the extent that it affects their taxes. They are primarily interested in relative values. If we adhered exclusively to the general rule requiring the use of tax accounting principles, there would be all sorts of traps for the unwary who enter partnership agreements and the courts would be clogged with cases involving challenged allocations. More importantly, there is no harm, as a general matter, in setting capital accounts by reference to the value of property. Thus a special rule provides that adjustments to the capital accounts of the partners to reflect unrealized appreciation or depreciation of partnership property will not affect the validity of partnership allocations, provided four special sub-rules are observed.

First, adjustments have to be made in accordance with financial accounting principles. Second, adjustments must be made principally for non-tax business reasons. Third, the adjustments made must be the sole reason for the disparity between the tax capital accounts and the governing book accounts. Fourth, such adjustments can be made only in accordance with a contribution of property, distribution of property, sale or exchange of a partnership interest, or admission of a new partner.
In the case of contributed property, the proposed regulations set forth an additional requirement that the partners elect to have the provisions of Section 704(c)(2) apply to the partnership. Section 704(c)(2) provides that allocations of gain, loss, depreciation and depletion on contributed property will be made by taking account of the variation between the basis of property to the partnership and its fair market value at the time of contribution. This requirement came under heavy criticism because it purported to require adoption of a provision the Code makes optional. Although I believe the Service has decided to eliminate this rule from its regulations, the Tax Reform Act of 1984 will make Section 704(c)(2) mandatory anyway.

There are some examples in the proposed regulations that illustrate this special rule. In Example 13 of the regulations we have a two-person partnership. One person contributes $10,000 cash to the partnership, and the other person contributes property worth $10,000 having a basis of $3,000. Both receive capital accounts of $10,000. The property appreciates to $12,000 and is then sold. For tax purposes, a $9,000 gain results. Because the capital accounts have already been adjusted to take account of the first $7,000 gain, a further adjustment cannot be made to reflect this gain and substantial economic effect therefore is technically lacking. But, if the partnership elects Section 704(c)(2), the first $7,000 of tax gain will be allocated to the contributing partner and the partners will be allowed to split the ultimate "real" gain on a fifty-fifty basis without running afoul of Section 704.

There is an interesting twist here that is important to keep in mind. There is an alternative way to proceed. The parties could have given the property contributor a $3,000 capital account going in, and then allocated the first $7,000 of gain on the sale to him. Gain above that would have been split fifty-fifty. That would have produced, if the property were ultimately sold for $12,000, identical results to the first way. But if the property did not increase in value, if it declined in value instead, different results would occur.

The reason this produces different results is that in the first situation where both partners have $10,000 initial capital accounts they are going to share the book loss economically. That is, if the property drops in value to $8,000 there is a $2,000 loss to be allocated to the partners. Their capital accounts would become $9,000 each, and that is the way they will liquidate. The cash contributor has lost $1,000. If we allocate the second way whereby gain is first allocated to the property contributor, the gain of $5,000 will raise his capital account to $8,000, leaving the capital accounts in the ratio of 10 to 8, and that is the way they will liquidate. In the second case, the property contributor eats 100% of the book loss. In the first case, the book loss is shared.

Why is this difference relevant in the real world? It is relevant because no one really knows what value is. The partner with $10,000 cash may question whether the other partner's property is really worth $10,000. There pro-
probably is no uncertainty regarding the property contributor's basis of $3,000. So the cash contributor will be willing to give his partner the first $7,000 of gain on the property. But if the property is actually worth less than $10,000, the cash partner will be unwilling to share in the loss resulting from a miscalculation of worth. Consequently, the deal may have to reflect such misgivings.

Entry of a new partner into a partnership can produce similar problems. When a new partner comes into a partnership, even if the partnership is deemed dissolved for state law purposes, it is, of course, normally deemed a continuing partnership for tax purposes. When a new partner comes in, the special rule permits the existing partners to increase their capital accounts to reflect the true economic relationship of the parties.

Consider two partners who put $10,000 each into the partnership, which is used to buy some property that appreciates to $50,000. Somebody else wants to come into the partnership. He is willing to pay $25,000 to the partnership for a 1/3 interest, since the other two partners already have $25,000 in value each. The original partners can raise their capital accounts to $25,000 each to reflect the true relationship of the parties. This is not a Section 704(c)(2) situation, since the property that is already in the partnership is not “contributed” at this point. Consequently, election of Section 704(c)(2) is not required here, although the regulations require that allocations be made to eliminate the disparity between book and tax capital accounts based on the principles of Section 704(c)(2).

It is possible that in certain circumstances, particularly where appreciated property decreases in value after the admission of a new partner, you will bump your head on the so-called “ceiling rule” of Section 704. That is, simultaneous allocation of a loss and a gain on a sale of partnership property is not permitted. Consequently, if all the property is sold, you will not be able to bring your tax accounts and your book accounts into exact parity. The regulations permit you to do the best you can to bring the accounts into line, and liquidation in accordance with book accounts is permitted, even though there may still be a disparity.

I want to cover a few additional topics, including treatment of tax credits. Credits have no economic effect because they are not really in the nature of profit or income; they are just creatures of the tax laws. Consequently, they cannot be allocated under substantial economic effect principles. The applicable special rule says they have to be allocated in accordance with the partners’ interests in the partnership. If all items of gain, income, loss, or deduction respecting a particular item are allocated a certain way, a credit arising from that item should tag along.

Percentage depletion is another item that may not have substantial economic effect. After the basis of a mineral property is depleted to zero, any further depletion allowed is just a gift from the government. The rule for excess
percentage depletion on hard minerals is similar to the rule for credits. If one allocates gain, loss, deduction, and credit from a depletable property, the same way the percentage depletion in excess of basis may be allocated in the same manner.

Nonrecourse debt is particularly difficult to allocate because loss generated by nonrecourse borrowings cannot have substantial economic effect to the partners. It has plenty of substantial economic effect to the banker if it is really occurring, but it cannot effect the partners because they will not bear the loss. The property will bear the loss. So how do the regulations handle such allocations?

The regulations provide that losses attributable to nonrecourse loans will be sustained if one of three alternative tests is met. First, the three mechanical requirements for economic effect can be satisfied. Second, the capital account equivalence test can be satisfied. Third, a special rule can be satisfied. This special rule requires that the first two requirements of the mechanical economic effect test be met (that is, maintainence of capital accounts and liquidation in accordance with capital accounts) and two other requirements must also be satisfied. First the allocation must not cause the sum of the deficit capital accounts which need not be restored on liquidation to exceed the “minimum gain” at year end. Minimum gain is the minimum amount of gain that would be recognized if the partnership simply walked away from the property. This is the difference between debt and basis. Second the partnership agreement must provide that partners with deficit capital account balances resulting from allocations of loss or deduction attributable to the nonrecourse debt shall, to the extent possible, be allocated income or gain in an amount no less than the minimum gain and at a time no later than the time at which the minimum gain is reduced below the sum of their deficit capital account balances.

To be frank, I have only the vaguest idea of what the IRS is insisting on by this second requirement. It appears what the Service has in mind is that if one is to get tax losses attributable to nonrecourse debt, he has to be charged back gain or income as soon as possible to get even. I can visualize the following scenario going through their minds at the IRS when they drafted this aspect of the regulation. Consider a simple partnership with nothing but nonrecourse debt of $100. The partnership purchases a building with the nonrecourse debt, and depreciates it $10. The $10 loss flows through to the partners. Who is really bearing the risk of that loss? The answer is the bank. When the partnership makes $10 in rents, the rent money goes over to the bank to pay the debt. If the bank had been in the driver’s seat, it would have income from the rent allocated to it. Because the partners get to take the loss that “properly” belongs to the bank, they have to pick up the “income” that would go to the bank.

Theoretically, I think this rule stems from the idea that if one gets the benefits, he should bear the burdens as well, in a tax sense. The problem with
this rule is that I am not sure how it applies out there in the real world. I also don’t exactly know how this rule affects my partnership agreements. Because of these uncertainties and the problems that this provision has created, it is my understanding that this provision is being substantially revamped by the IRS and will eventually bear very little relationship to the provision in the proposed regulations.

I want to discuss one more point on percentage depletion respecting allocations relating to gas and oil properties. There is a theory prevalent west of the Mississippi that the IRS does not understand mineral taxation. I did not subscribe to that theory whole-heartedly until these regulations were drafted. I think the provisions involving oil and gas allocations will be substantially redone. What they will look like when they come out, I don’t know. There are many problems with these provisions, but I cannot begin to discuss them here.

The only other thing I want to mention pertains to amendments to the partnership agreement. The special allocation rules say the Service will approve allocations, provided certain provisions are put into the partnership agreement. The Service is concerned that when allocations are made, everything in the agreement will be proper but later on the agreement will be amended to get rid of bothersome compliance provisions. Thus, the Service reserves the right to ignore such amendments. I query whether they can ignore certain amendments in all circumstances.

In conclusion, let me say that I think these proposed regulations are a mixed blessing. They have certainly clarified some problems. They are certainly a noble effort by the IRS. They confirm some things that were not clear before. At the same time, they have opened up a vast number of ambiguities and questions. I was looking the other day at an offering memorandum that I wrote about two years ago, and my section on allocations in the offering was short, relatively clear, and straightforward. I felt relatively comfortable reading it. I just finished doing another offering. My section this time on allocations was four pages long. I think it is charitable to say it reads rather opaquely, and I certainly don’t feel comfortable with it is ultimate accuracy. Frankly, in view of the Section 704 regulations, I feel it will be some time before I get that comfort level back.