The Imperfect Approach[[1]](#footnote-1)

# Introduction[[2]](#footnote-2)

The practice for allocating a partnership’s income, gain, loss and deduction exists in a curious status quo. Myriad partnerships base their determinations of each partner’s distributive share on a facts-and-circumstances determination governed by a regulation that is 641 words long (most of which just restates legislative history) and for which the most relevant caselaw is not particularly illuminating. A sea of additional cases, guidance, and legislative history dating back to the first revenue acts is of uncertain continuing relevance, are rarely relied on and even more rarely discussed.

Meanwhile, immediately adjacent to the 641 words guiding most partnerships, there resides a roughly 12,000-word, highly complex safe harbor that, despite is length, is ultimately so narrow as to be wholly impractical for most commercial transactions. A third bucket of items (which are ineligible for the safe harbor by its terms) are subject to their own specially tailored rules that, if satisfied, deems allocation of the items to satisfy the facts-and-circumstances test.

Nevertheless, despite its odd shape, (very) informal surveys indicate that most practitioners seem comfortable that the foregoing regime works reasonably well enough in practice. The vast majority of determinations are straightforward or otherwise handled reasonably well by a widely developed (but not explicitly sanctioned) market practice. Complicated cases are rare, but in commercial deals even complicated cases rarely (if ever) carry the troublesome tinge of tax avoidance; a desire for simple certainty of the parties’ responsibility for taxes (rather than structured after-tax outcomes) is more often the source of consternation. Moreover, while the statutory labels have changed, the substantive analysis performed by taxpayers, practitioners, the IRS and the courts in making distributive share determinations in ordinary course commercial transactions has been the same since 1913 in many critical ways, without particular controversy outside a few areas so well-known as to have practically become their own areas of specialty.

However, there are increasing pressures on the curious status quo stemming from commercial developments and changes in law over the last 40 years, in principal part from the newly broadened scope, power and mandate of enforcement with respect to partnerships. While these pressures raise the stakes across subchapter K, an articulation of the status quo and an accompanying update to the meager regulatory allocation rules relied on daily in ordinary course commercial dials may become an acute priority.

The following attempts to summarize briefly some of the potential pressures on the current system (Part III), provide an articulation of the status quo (in Part IV), and suggest (modest) resulting updates to the current regulations (in Appendix I). However, the discussion begins with a history of the distributive shares rules (in Part II) that attempts to inform the curious status quo described above and perhaps, in during so, provide additional clarity that may also help relieve some of the pressures of uncertainty under the current system.

# A History of the Partnership Tax Allocation Rules

The Code and its predecessors going back to 1913 have had rules stating that partners are subject to tax on their “divided” or “distributive” shares of a partnership’s income (regardless of whether or not actually distributed).[[3]](#footnote-3) However, no revenue act or predecessor tax code,[[4]](#footnote-4) nor any regulations,[[5]](#footnote-5) attempted to define “divided” or “distributive” share prior to the 1954 code.

The entire 110 years of authorities on partnerships remain relevant, however, in at least two respects. First, looking from 1913 forward, the early statutes and authorities form the narrative that explains the structure of current section 704(b). Perhaps more importantly, however, is that there have been only three significant statutory changes to section 704(b) (or its predecessor) since 1913—a clarification in 1939 that was in effect an amendment to the predecessor of section 702 and not relevant to this discussion, and the changes in 1954 and 1976 discussed in detail below. In none of these instances did Congress express the view that the changes to the statute represented significant departures from applicable law. Although neither the 1954 nor the 1976 amendments were retroactively effective, the 1954 legislative history indicates it was Congress’s view that the “new” section 704(b) was “substantially in accord with existing practice,”[[6]](#footnote-6) and the 1976 amendments clarified an ambiguity (albeit a material one) in the 1954 code and codified the 1956 regulations, with prominent contemporary commentators observing “little significant change” in the law.[[7]](#footnote-7) In short, as the law applies to most commercial transactions, not much has changed. As a result, the entire body of authorities may help inform a current understanding of the law of distributive share determinations.

## **1913-1954**

The Service made little attempt to provide guidance during this period as to the meaning of the term “distributive share,” but the disputes that did arise were generally decided in favor of taxpayer “flexibility.” There is little evidence prior to 1954 of particular taxpayer controversy regarding the question of what constituted a partner’s “distributive share” outside of four areas well-known to practitioners today and which implicate unique and distinct tax policy considerations: so-called “item” allocations with respect to income, gain, loss, deduction and credit (addressed in section 704(b) of the 1954 code), salaries and interest payable to partners (addressed in section 707 of the 1954 code), contributed property (partially addressed in the 1934 Act and again in section 704(c) of the 1954 code), and family partnerships (first addressed by the 1951 Act). Of these issues, the “item” and “special” allocation and guaranteed payment authorities are most interesting to the present discussion, although the following briefly mentions principles potentially derived from contributed property and family partnership authorities.

### **“Item” and “Bottom Line” Allocations**

It is uncertain to what extent “item” allocations were actually permitted in the era before the enactment of the 1954 code; while there are conflicting IRS pronouncements and practitioner commentary from the era,[[8]](#footnote-8) the weight of the guidance seems to indicate (and the 1954 legislative history makes explicitly clear) that “item” allocations were practiced and at least acquiesced to before 1954.

In 1919, the Service ruled in Office Decision 140: “Income from a particular source can not be allocated to one partner of a partnership for income tax purposes, but must be divided pro rata among the several partners.”[[9]](#footnote-9) (This was the ruling in its entirety.) However, this ruling was subject to general skepticism,[[10]](#footnote-10) was repeatedly and subtly refined by subsequent rulings,[[11]](#footnote-11) and was drastically narrowed in 1957 (under the 1939 code, but relying on the Senate’s admonition that the 1954 code reflected pre-existing practice) to cases where the partnership agreement was wholly silent on the method of allocations.[[12]](#footnote-12) A 1930 court ruled that, as early as 1919, parties were permitted significant flexibility in allocating taxable income: “Partners may adjust between themselves their distributive share in such proportion and in such manner as they may desire.”[[13]](#footnote-13) As early as 1923, the Service ruled that partners could share losses disproportionately, and in 1957 the Service stated affirmatively that, at least under the 1939 Code, profit could be specially allocated under principles similar to those of section 704(b) of the 1954 code.[[14]](#footnote-14) Perhaps notably, authorities respecting “item” allocations in this era generally involved current distributions of the “item” at issue, and none of the authorities addressed the abusive shifting or transitory planning that Congress called on the IRS to police in 1954.[[15]](#footnote-15)

Whatever the uncertainty concerning “item” allocations, taxpayers were generally given flexibility in allocating bottom-line profit. In *Taylor v. Commissioner*, the Service challenged a four-person partnership under the 1918 Act that had amended its income allocations from a scheme based on relative capital contributions to a scheme based on equal (25 percent) proportions; the Board of Tax Appeals found for the taxpayer, ruling as early as 1925 that “[i]t is fundamental in the law of partnerships … that the percentages to be received by the individual partners may be varied from time to time as they agree.”[[16]](#footnote-16) In *Thompson & Black v. Commissioner*, a case under the 1917 excess profits tax, the Tax Court implicitly respected a non-pro rata allocation by a partnership in which the partners amended the terms of their partnership to allow one partner (T) to participate disproportionately in the profits of a new venture, in exchange for a subordinated interest in the partnership’s other ventures (with the intent of effectively indemnifying the other partner (B) for its profits from the partnership’s historic ventures from T’s share of the partnership total profits).[[17]](#footnote-17)

Taxpayers were also permitted to make allocations of bottom-line loss, though the courts were observant of economic substance (although not by that name). In *Hood v. Commissioner*, under the 1924 Act, the question was not so much the taxpayer’s “share” of the partnership’s loss, but whether the partner in fact suffered a loss at all: The Service successfully denied the taxpayer his purported proportionate share of the partnership’s losses to the extent that the parties made clear that (despite their documents) the taxpayer was not responsible for restoring any deficit balance in his capital account: “[The taxpayer] was not entitled to deduct any part of the losses of the firm, since he would never have to pay any part of those losses.”[[18]](#footnote-18) In *Curtis v. Commissioner*, decided under the 1942 Act, a special loss allocation to a partner was respected where it was effectively borne by the partner, notwithstanding that the partners agreed to a subordinated catch-up allocation of profits to the reimbursing partner in subsequent years: “[I]t is clear that the possibility, at the end of 1942, of recoupment by petitioner in 1943 remained in the realm of conjecture. True, petitioner was not required to prove beyond imaginable peradventure that no recoupment was possible, nevertheless, speculative chances of repayment furnish no basis for delaying the taking of a loss.”[[19]](#footnote-19)

### **Salaries and Interest**

Concerns around what would be dubbed “guaranteed payments” dealt largely with the tension of adhering to the principles of partnership taxation at the cost of countenancing potential timing and character benefits to partners.[[20]](#footnote-20) Courts addressing these question prior to the enactment of section 707(c) in 1954 generally allowed the partnership principles to trump in the face of stark character and timing discrepancies.[[21]](#footnote-21) However, these cases did not in each case concern (or provide enough information for the reader to determine) the resulting “distributive share” of each salaried or lending partner. Although these cases are historical footnotes to section 707(c), they may provide insight into making determinations under section 704(b); specifically, these authorities would give weight to the cash currently distributed to the partners (one of the factors under Treas. Reg. § 1.704-1(b)(3)).[[22]](#footnote-22)

In *Estate of Tilton v. Commissioner*, a case concerning so-called salary and interest payments to a partner, the Board of Tax Appeals stated in dicta that it found “no significance in the withdrawals made by the partners during the taxable year” and that “[s]uch withdrawals, whether of anticipated profits or of capital, in no way affected the shares of distributive partnership profits due each of the partners at the close of the accounting period of the partnership and have no relation to the issues of the proceeding.”[[23]](#footnote-23) But this dicta in the *Tilton* decision was apparently lost on a subsequent Board of Tax Appeals court in the same year, which observed in *Blake v. Commissioner* that, “we held [in *Tilton*] that so-called salary of a partner was a part of his distributive share of the net income of the partnership” and affirmatively held in the case at issue “[t]he distributive share of this petitioner in the net income of this partnership included the amount to which he was entitled as interest on his capital.”[[24]](#footnote-24) Contemporary commentators shared the view of the *Blake* court; a 1930 commentary in *Taxes* observed that: “[i]t seems quite clear that if the profits of the year are large enough, each partner’s share of taxable income is made up of his credit for salary, plus his credit for interest on capital plus his share of the credit for profits after deductions of salaries and interest on capital.”[[25]](#footnote-25) Treasury Regulations first adopted in [\_] followed this approach for allocating income with respect to such purported salary payments in recognition of such “salary” distribution representing a portion of the partner’s distributive share.[[26]](#footnote-26)

Cases dealing with “salary” distributions in excess of partnership taxable income shed further light on how earlier authorities dealt with allocations of taxable income in the face of priority partner entitlements. In *Lloyd v. Commissioner*, under the 1921 Act, the court was faced with a partnership in which the partners were paid salaries that exceeded the partner’s net income as computed before reduction for the purported salaries (the principal issue in the case); however, such salaries were also disproportionate to the manner in which the partners shared residual profit and loss.[[27]](#footnote-27) The court allocated the taxable income of the partnership solely to the “salaried” partners and among such partners in the proportion to the how the “salaries” were disbursed: “[I]tis our view that these petitioners are entitled to take all of the partnership profits up to the aggregate of their salaries … before the remaining partners may share in the profits.”[[28]](#footnote-28)

### **Contributed Property**

The computation of partners’ distributive shares with respect to contributed property in this period yields some tentative lessons for purposes of this discussion – not necessarily lessons in how to allocate economic income (because the issue was principally the allocation of deferred taxable income, not current operating income), but an articulation of the tax law’s deference to partnership principles over strict timing principles. Contemporary scholars (who worked on the 1954 code) referred to the issue as “perhaps the most baffling question in the entire muddled field of partnership taxation.”[[29]](#footnote-29)

This discussion will attempt to keep the history brief. In 1932, the Service issued G.C.M. 10092, which required partnerships to compute gain or loss with respect to contributed property using the historic basis (as adjusted) of the contributing partner, with any resulting recognized built-in gain or loss allocated to the contributing partner – generally speaking, the same result that has applied been mandatory section 704(c) since 1984 (and was elective under the 1954 code prior to 1984).[[30]](#footnote-30) However, G.C.M. 10092 was confused[[31]](#footnote-31) and generally rejected by the courts as to its reasoning and its result—in significant part on the basis that the resulting deferral was only the extension of a timing benefit (which would terminate on a sale of partnership equity or a sufficient partnership distribution) that had its origins in the nonrealization of the gain or loss on the contribution of the property that was a bedrock of the partnership scheme.[[32]](#footnote-32) Moreover, the Treasury and the Service issued regulations under the 1939 code that contradicted G.C.M. 10092, requiring sharing of taxable income according to the partnership’s profit and loss sharing ratios, which “strangely coexisted” with G.C.M. 10092 from 1934 to 1950.[[33]](#footnote-33) In the 1954 code, Congress generally followed the “entity” approach of the courts (subject to the “clarification” that the partnership use a carryover basis for the contributed property), but allowed taxpayers to elect to take into account the difference between value and basis of contributed property when making allocations under the “ceiling” approach of G.C.M. 10092 (and current section 704(c)).[[34]](#footnote-34) “Elective” application of section 704(c) (as we know it today) was the law from 1955-1984.

The lessons to be derived from the treatment of contributed property warrant caution because the tensions are obviously more stark and the approach adopted in 1954 was eventually revised – the treatment of contributed property had the potential not only to extend deferral significantly, but also to permit temporary “shifting” of income and loss. Nevertheless, the principal arguments in favor of the “entity” approach adopted by the courts (and advocated for simplicity’s sake by the ALI and ultimately enacted by Congress in 1954) were whether the importance of the flexibility of the partnership rules were to be adhered to, notwithstanding a significant timing shift among taxpayers.[[35]](#footnote-35) Congress effectively countenanced such a system with respect to contributed property in 1954 and, implicitly blessed similar principles regarding allocations governed by section 704(b) of the 1954 code where (setting aside item and special allocations) the timing benefits were even more tenuous.[[36]](#footnote-36)

### **Family Partnerships**

One other line of pre-1954 cases is worth briefly noting, albeit cautiously because (like the contributed property authorities) it also implicates important tax policies not particularly relevant to the question discussed here: allocations by partnerships among related parties. Prior to 1951, courts in these cases, which largely culminated in *Commissioner v. Tower*,[[37]](#footnote-37) repeatedly emphasized that, if a partnership itself was valid, its allocation of profit and loss as set forth in the partnership agreement was to be respected.[[38]](#footnote-38) However, this observation should not be carried too far, as the Service and the courts during this period were capable of disregarding, for example, the parties’ distributive shares as set forth on the partnership’s books and records if those records did not reflect the “agreement of the partners.”[[39]](#footnote-39)

Beyond the above, there is little published authority or other guidance as to how taxpayers in this era were substantiating their partnership allocations. One of the only pre-1954 articles to address the topic deemed cases other than the above to be “relatively simple.”[[40]](#footnote-40) Arthur Willis’s 1957 treatise provides no discussion of appropriately allocating bottom-line income (outside the partnership “salary” scenario), and summarized the law of special allocations before 1954 in nine sentences.[[41]](#footnote-41) Observers in 1954 implicitly acknowledged pre-1954 law as requiring allocations in accordance with economic realities.[[42]](#footnote-42) Broadly speaking, the authorities reflect a deference to (and perhaps an assumption as to the operation of) the non-tax laws governing partnerships and the impact of the financial accounting books and records of the economics of the partnership, but neither authorities nor commentators performed significant inquiry into the integrity of these assumptions.[[43]](#footnote-43)

## **The 1954 Code and Regulations**

Among numerous other partnership issues, clarifying the general definition of “distributive” share was a point of concern for the drafters of the 1954 code; however, it was not a high priority.[[44]](#footnote-44) The language of section 704(b) of the 1954 code can initially be traced to the work of the American Law Institute (ALI), which reflected the input of scholars and practitioners who had been actively debating the relevant issues over the course of the previous decade and which released a report in May 1953 and draft statutes in January and February 1954 in anticipation of imminent Congressional action.[[45]](#footnote-45)

The January 1954 ALI report made a point of addressing the absence of a definition for “distributive share” and proposed the following distributive share rule, in relevant part: “A partner’s distributive share of income, gain, loss, or credit shall be determined by the partnership agreement.”[[46]](#footnote-46) In proposing such a broad rule, the ALI commentators consciously considered the scope of the resulting allocations that could result, including allocation waterfalls in which income would be shared among partners in different ratios based on different levels of gain from an asset.[[47]](#footnote-47) The 1954 ALI report also specifically noted that “salary” amounts would “be included in the amount of partnership profits a partner is entitled to receive and would enter into the computation of his distributive share of partnership profits.”[[48]](#footnote-48) Partnership losses would also follow the partnership agreement, but “only if [the partner] has suffered a monetary loss, *i.e.*, only if he suffers a reduction in his capital account, or, under the agreement, he is liable to make up that loss to the partnership.”[[49]](#footnote-49) The 1954 ALI report was wholly silent regarding the treatment of item or special bottom-line allocations.[[50]](#footnote-50)

### **The 1954 House Report**

The House was actively considering the 1954 code when the 1954 ALI report was published in January;[[51]](#footnote-51) on March 9, 1954, the House passed its version of subchapter K, which borrowed in significant part from the 1954 ALI report but also included deviations, including with respect to the determination of “distributive share.” The House version of section 704(a)-(b) (which became the operative language of the 1954 code) provided as follows:

(a) Effect of partnership agreement. A partner’s distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

(b) Distributive share determined by income or loss ratio. A partner’s distributive share of any item of income, gain, loss, deduction, or credit shall be determined in accordance with his distributive share of taxable income or loss of the partnership, as described in section 702(a)(9) [of the 1954 code], for the taxable year, if—

(1) the partnership agreement does not provide as to the partner’s distributive share of such item, or

(2) the principal purpose of any provision in the partnership agreement with respect to the partner’s distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle.

The House report offered little explanation for its language, noting: “The taxation of partnership income or other items directly to partners requires a determination of each partner’s share of such items. In general, such shares will be determined in accordance with the partnership agreement as under existing practice.”[[52]](#footnote-52) The technical summary accompanying the House report is notable for setting forth the rationale for its mechanic, which explains the 1976 mechanic that governs today:

[Section 704(b)] provides that if a principal purpose of any provision in the partnership agreement dealing with a partner’s distributive share of a particular item is to avoid or evade the Federal income tax, the partner’s distributive share of that item shall be redetermined in accordance with his distributive share of partnership income or loss. For example, if the provisions of a partnership agreement allocate all partnership loss on the sale of depreciable property used in a trade or business to one partner or allocate a greater portion of the foreign tax credit to one partner than to another partner, such provisions may be disregarded, and such items attributed to all partners in accordance with the provisions of the partnership agreement for sharing partnership income or loss.[[53]](#footnote-53)

### **The April 1954 ABA-ALI Comments**

Of great note in the history of section 704(b), the American Bar Association (ABA) and ALI submitted a joint response to the House legislation on April 8, 1954, which suggested two “drafting comments” regarding the House version of section 704(a)-(b) of the 1954 code.[[54]](#footnote-54) First, the ABA/ALI letter suggest dropping the “principal purpose” language, noting that such similar language had been “markedly unsuccessful when employed in section 129 [the predecessor to current section 269]” and “[i]t is believed that it would be equally unsuccessful in the proposed use.”[[55]](#footnote-55) Second, the ABA and ALI made the following observation:

There is no greater opportunity for tax avoidance through “rigging” the distributive shares of income or loss with respect to a particular item than there is in setting the general distributive shares of profit or loss. It is believed that more successful results would be obtained if this provision were omitted from the statute and, instead, there was a comment in the Committee Report that the Committee is satisfied the courts will see to it that the distributive shares specified in the partnership agreement reflect economic realities, rather than tax fictions.[[56]](#footnote-56)

What was not emphasized in the ABA/ALI letter was the urgency of their initial observation – the House language (which would ultimately be enacted) had not only failed to subject to bottom-line allocations to the “principal purpose” standard, but had (by its literal terms) failed to subject to subject bottom-line allocations to *any* standard. It would be 1979 (and after Congress amended the statute in 1976 to resolve the matter) before a court would clearly articulate one.

### **The June 1954 Senate Report**

The Senate did not adopt the ABA and ALI’s suggestion to drop the “principal purpose” approach or expand the rule policing special allocations to include allocations of bottom-line taxable income as well as allocations of “items,”[[57]](#footnote-57) but did take up the suggestion to address their intent more explicitly in the Committee Report.[[58]](#footnote-58) In the Senate Finance Committee’s June 18, 1954 report, the Committee’s technical report restated House’s technical summary with the following changes (emphasis added):

For example, if the provisions of a partnership agreement allocate all partnership loss on the sale of depreciable property used in a trade or business to one partner or allocate a greater portion of the foreign tax credit to one partner ~~than to another partner~~ *while allocating to the other partner or partners an equivalent amount of partnership loss or deduction of a different nature*, such provisions may be disregarded *if the principal purpose is tax avoidance or tax evasion.* ~~, and~~ *Such* items *would then* be attributed to all the partners in accordance with the provisions of the partnership agreement for sharing partnership income or loss *generally*.

*Where, however, a provision in a partnership agreement for a special allocation of certain items has substantial economic effect and is not merely a device for reducing the taxes of certain partners* *without actually affecting their shares of partnership income, then such a provision will be recognized for tax purposes. For example, a partnership agreement whereby a member of the firm who is resident in Puerto Rico is to receive a percentage of the income derived from sources within Puerto Rico which is greater than his distributive share of partnership income generally, will be recognized for tax purposes. Similarly, an agreement under which one partner is to receive all the interest income of the partnership from tax exempt bonds, and the other partner is to receive all the dividend income from stock, will be given effect, unless it is a device for the allocation of the interest exemption without any real economic effect on either partner’s share of the total partnership income.[[59]](#footnote-59)*

Regulators and practitioners have spent 69 years dissecting the paragraph above. First, the Senate committee’s choice of the phrase “substantial economic effect” warrants special attention; it was not a term used in the April ALI-ABA report. The phrase is close to the expression “economic substance,” but the modern reader should be warned not to jump to conclusions: Although *Gregory v. Helvering* had been decided 20 years earlier, a review of caselaw and literature of the era indicates that its holding had not yet taken on the name “economic substance doctrine.”[[60]](#footnote-60) Nevertheless, Congress may have intended to incorporate analogous concepts.[[61]](#footnote-61) It is tempting to give credit to Rabkin and Johnson’s influential 1942 article on partnerships—which observes, in a discussion of allocations with respect to contributed property, that “the cardinal principle of the income tax law [is] that the event which fixes tax liability be an incident of *substantial economic consequences*.”[[62]](#footnote-62) Unfortunately, the author has found no support for the point.

Notwithstanding the committee report’s admonition, the initial reactions to the legislative language saw no clear language requiring bottom-line allocations under section 704(b) tie to economic realities.[[63]](#footnote-63) Further, the meaning of the paragraph in the Senate report – in particular, its first sentence (“*Where, however, a provision in a partnership agreement for a special allocation of certain items has substantial economic effect and is not merely a device for reducing the taxes of certain partners without actually affecting their shares of partnership income, then such a provision will be recognized for tax purposes.”)* was heavily debated—both as to the weight of its authority, and as to the whether it was to be interpreted as in effect as a twofold test with the “principal purpose” test.[[64]](#footnote-64)

### **The 1955 Proposed Regulations**

In the 1955 proposed regulations issued under section 704(b) of the 1954 code, Treasury and the Service incorporated language echoing the language 1954 Senate report, but downplayed the role of “substantial economic effect” and removed the qualifier implying that status as an impermissible device might also require the allocation “actually affect[] their shares of partnership income”:

*However, where a provision in a partnership agreement for a special allocation of a certain item or class of items is not a device for reducing taxes of certain partners and has substantial economic effect, then such a provision will be recognized for tax purposes. In determining whether the principal purpose of any provision in the partnership for a special allocation is the avoidance or evasion of Federal income tax, each such provision must be considered on its own merits in relation to all the surrounding facts and circumstances. The presence or absence of substantial economic effect in the special allocation provided for in the agreement is only one of the facts and circumstances to be considered.* [[65]](#footnote-65)

The proposed regulations also included three examples – one mirroring the House report involving an invalid allocation of section 1231(b) loss from depreciable property used in a trade or business coupled with an “equivalent” amount of loss or deduction of a different character to other partners,[[66]](#footnote-66) one mirroring the Senate’s Puerto Rico-source income example (with the qualifier that, to be respected, the allocation would have the non-tax purposes of, for example, “encourage[ing] Puerto Rican transactions),[[67]](#footnote-67) and a third exploring the Senate Report’s example concerning special allocations of “all” tax-exempt interest and dividend income.[[68]](#footnote-68)

### **The 1956 ALI Draft**

In response to the proposed regulations, on April 24, 1956 the ALI published a tentative draft including proposed revisions to the 1954 code, but more importantly also including a significant discussion of the Senate report and the proposed regulations that would impact the 1956 final regulations, practitioner thinking (as reflected in subsequent literature) around section 704(b), and subsequent guidance.[[69]](#footnote-69) Largely driven by the 1956 ALI report, development of the 1956 final regulations under section 704(b) were apparently “the most troublesome point in the preparation of the partnership Regulations.”[[70]](#footnote-70)

The 1956 ALI report argued that the Senate report and the proposed regulations “appeared” to elevate “substantial economic effect” test to the level of a conjunctive requirement with the statutory “principal purpose” test, and urged that statutory language be clarified to relegate the “economic effect” test to a factor on the grounds that it was “unduly rigid” or “harsh” to operate as a standalone requirement for every allocation; moreover, certain deductions themselves may not have economic effect by their terms (e.g., accelerated depreciation or percentage depletion).[[71]](#footnote-71) The final regulations issued later in 1956 effectively adopted the ALI approach.[[72]](#footnote-72)

Next, the ALI report’s draft statutory language would have included the following: “For purposes of ascertaining whether the provision has a substantial economic effect, the effect of the provision upon any partner’s income or capital interest, as well as its effect upon the tax imposed by this subtitle upon any partner, shall be taken into account.”[[73]](#footnote-73) In the author’s examination, this appears to be the first articulation of what would eventually become the two-part “substantial economic effect” that has been set forth in Treas. Reg. § 1.704-1(b)(2) since 1985. While the final 1956 regulations did not reflect this exact articulation of the law, it nevertheless had a two-fold effect.

First, while the 1956 regulations made no reference to income or capital interests, the tie between “economic effect” and a partner’s “capital interest” (as reflected in its capital account) that would repeatedly be observed by commentators after the enactment of the 1954 code appears to have its origin in the 1956 ALI report. Second, the ALI report emphasized that the Senate report and proposed regulations had potentially over-emphasized the relevance of an allocation’s pre-tax effect on partners, and, in a “significant departure from what appears to be present law” that was “contrary” to “implications” contained in the Senate report and the proposed regulations, the ALI recommend revising the statute to clearly take into account the after-tax consequences to the partners. The ALI report in particular went on to criticize the Senate report’s second example regarding special allocations of tax-exempt and taxable income (reflected in example 3 of the proposed regulations), demonstrating the significant partner-level after-tax effects of such permitted allocations, noting it was “futile to measure the economic effect of a special allocation by the distributive share of each partner in the partnership income” and that “[i]f the criterion is to be meaningful, consideration must be given to each partner’s net income after taxes” (which, presumably, would be within the purview of the statutory “tax avoidance” standard). Variations involving “a significant element of uncertainty in the periodic amounts of the items specially allocated” would be more likely to be respected because of the partner’s assumption of the “risk of fluctuation” in the allocated item.[[74]](#footnote-74)

### **The 1956 Regulations**

The final regulations issued in 1956 included the following formulation of Treas. Reg. § 1.704-1(b)(1)-(2):

(1) If the partnership agreement makes no specific provision for the manner of sharing one or more items or classes of items, a partner’s distributive share of such items shall be determined in accordance with the provisions of the partnership agreement for the division of the general profits or losses (that is, the taxable income or loss of the partnership as described in section 702(a)(9)). In applying this rule, the manner in which the net profit or loss (computed after excluding any item subject to a recognized special allocation) is actually credited on the partnership books to the accounts of the partners will generally determine each partner’s share of taxable income or loss as described in section 702(a)(9).

(2) If the principal purpose of any provision in the partnership agreement determining a partner’s distributive share of a particular item is to avoid or evade the Federal income tax, the provision shall be disregarded and the partners’ distributive shares of that item shall be determined in accordance with the ratio in which the partners divide the general profits or losses of the partnership (as described in section 702(a)(9)). In determining whether the principal purpose of any provision in the partnership agreement for a special allocation is the avoidance or evasion of Federal income tax, the provision must be considered in relation to all the surrounding facts and circumstances. Among the relevant circumstances are the following: whether the partnership or a partner individually has a business purpose for the allocation; whether the allocation has “substantial economic effect,” that is, whether the allocation may actually affect the dollar amount of the partners’ shares of the total partnership income or loss independently of tax consequences; whether related items of income, gain, loss, deduction, or credit from the same source are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocation.

The final 1956 regulations also revised the examples from the 1955 regulations and added two additional regulations.[[75]](#footnote-75) The conclusion of Example 1 was revised to add a rationale that explained it took into account the taxes paid by the partners when measuring the allocation’s “effect” – a factor that, like “overall tax consequences” reference in the general rule, was not supported by legislative language or the language of the House or Senate Report: “Since the purpose and effect of this allocation is solely to reduce the taxes of certain partners without actually affecting their shares of partnership income, such allocation will not be recognized.”[[76]](#footnote-76)

Example 3 of the 1955 regulations was revised to add that the special allocations with respect to the tax-exempt interest and dividends also included “all gain or loss” from the bonds and stock, respectively—a fact not present in the Senate report and which may have been intended to avoid the concerns raised by the ALI by introducing further potential economic consequences into the facts, or even suggesting the example was relying on an analysis akin to Revenue Ruling 55-39 by treating the stocks and bonds as deemed distributed.[[77]](#footnote-77) A new example 4 respected changes in allocations following a book-up (with revisions for the current regulatory regime, example 14 of Treas. Reg. § 1.704-1(b)(5)).[[78]](#footnote-78)

New example 5 of the 1956 regulations (with revisions for the current regulatory regime, example 3 of Treas. Reg. § 1.704-1(b)(5)) sanctioned a partnership (G and F) where certain expenses (research and development; interest) would be “charged” to one partner (G), subject to a special allocation of partnership gross income (90 percent) to G until G had received income equal to such previously “charged” expenses and any other partnership losses suffered by G, after which the income and loss of the partnership would be shared equally.[[79]](#footnote-79) An author of the 1956 regulations described their intent as “allow[ing] partners the broadest possible scope in working out their joint business arrangements for business purposes.”[[80]](#footnote-80)

The initial views of the “substantial economic effect” standard was that it was the critical determinant[[81]](#footnote-81) but also “nebulous.”[[82]](#footnote-82) However, the 1956 regulations soon gave rise to the conclusion among commentators and practitioners that “substantial economic effect” correlated with “charges” to partnership capital accounts; one practitioner noted as early as 1956 that “[t]here are numerous situations in which the federal income tax consequences may depend upon the relationships or amounts of the capital accounts.”[[83]](#footnote-83)

The 1954 code spurred the creation of by the House Way and Means Committee of an advisory group to study new subchapter K, which delivered an initial report in May 1957 and a final report in December 1957; however, neither report raised any issue with section 704(b) of the 1954 code.[[84]](#footnote-84) The committee’s work resulted in H.R. 9662 (the Trust and Partnership Revision Act of 1960), which was passed by the House, but not the Senate;[[85]](#footnote-85) H.R. 9662 did not include any changes to section 704(b) of the 1954 code.[[86]](#footnote-86)

## **1954-1976**

The 1954 version of section 704(b) held for 22 years before it was revised into its current form in 1976. In that intervening period, there was little guidance from the Service on the meaning of “distributive share.”[[87]](#footnote-87) At the same time, several cases generally proved the ABA and ALI’s predictions in their 1954 letter correct. Writing in 1972, one commentator coyly described this period in the development of the law of section 704(b) as “devoid of history”; of course, activity was apparently abounding, just not in the courts: “The reason for this remarkable state of affairs are not easy to discern. Certainly taxpayers have been taking advantage of this unique opportunity. Hence, the Internal Revenue Service, for some unexplained reason, must be ‘responsible’ for this surprising lack of activity.”[[88]](#footnote-88)

In Revenue Ruling 66-187, issued under the 1954 code, the Service recognized a special allocation of interest income by a partnership that was formed for short periods (usually two months) to bid on and purchase tax-exempt municipal bonds, sell those bonds, and then distribute the unsold bonds (or the proceeds from the sales to the members) in termination of the syndicated partnership.[[89]](#footnote-89) The partners shared gain or loss on the bonds and expenses in accordance with their membership interest, but the partnership specially allocated the interest income among the members who “advanced” the funds (as capital contributions, and not loans) used by the partnership to acquire the bonds, because such partners were implicitly entitled to such interest income: “[the allocation] is simply a method of allocating the bond interest to those members who in fact provided the funds to purchase the bond issues.”[[90]](#footnote-90) In Rev. Rul. 67-518, the Service respected a guaranteed payment limited to profits of a foreign branch as a special allocation of foreign-source income (similar to rulings under pre-1954 law),[[91]](#footnote-91) and in Rev. Rul . 68-139, the Service respected a special allocation of intangible drilling and development costs in accordance with the contributions of the partners who funded the costs.[[92]](#footnote-92)

### ***Kresser*, *Orrisch*, *Harris***

Despite the Service’s silence in this period, there were significant developments in section 704(b) practice that would eventually prompt the 1976 Act. Limited partnerships became a favored vehicle for individual tax shelter planning,[[93]](#footnote-93) with strategies apparently based on the aggressive reading of the statute, previewed in 1954 by the authors of the ALI reports, that section 704(b) policed only “abusive” item allocations and that, by implication, bottom-line section 704(a) allocations need bear no relationship to economics at all.[[94]](#footnote-94) Three court cases in this era demonstrated the Service’s struggle with this taxpayer position.

In *Kresser v. Commissioner*, the Service successfully disallowed an oral amendment to a partnership agreement that attempted to shift the partnership’s entire income (a bottom-line allocation) in 1965 to one partner, with a concordant obligation to restore the other partners in subsequent years by reducing the benefited partner’s subsequent entitlements to future income (or absorbing a disproportionate share of partnership loss) on the basis that “the so-called allocation of 1965 income … was in fact anything more than a paper transaction having no consequences of substance.”[[95]](#footnote-95) The court was arguably forced to rely on the sham-type analysis to reach its conclusion, because the taxpayers persuasively argued that the statute’s “tax avoidance” rule did not apply to bottom-line allocations;[[96]](#footnote-96) a footnote in *Kresser* prompted Congress to extend section 704(b)’s scope to include “bottom-line” allocations in the 1976 Act.[[97]](#footnote-97)

One of the more notable Service successes was *Orrisch v. Commissioner*, in which the Service successfully disallowed a special allocation of depreciation deductions with respect to an apartment building to a partner pursuant to an oral amendment to the partnership agreement that provided that, in the event of a sale, the partner would also pay the tax on the gain attributable to the specially allocated depreciation.[[98]](#footnote-98) While the court considered tax motives for the allocation, particular emphasis was placed on the “substantial economic effect” of the allocation under the 1956 regulations.[[99]](#footnote-99) Notably, from a historical perspective, the court observed that “[u]nder *normal accounting procedures*, if the building were sold at a gain less than the amount of such disparity petitioners would either be required to contribute to the partnership a sum equal to the remaining deficit in their capital account after the gain on the sale had been added back or would be entitled to receive a proportionately smaller share of the partnership assets on liquidation.”[[100]](#footnote-100) In the case at hand, however, the court observed that “we do not think the partners ever agreed to such an arrangement” and that, on dissolution, “we think the partners contemplated an equal division of the partnership assets which would be adjusted only for disparities in cash contributions or withdrawals,” with the result that the special allocation does not “actually affect the dollar amount of the partners’ share of the total partnership income or loss independently of tax consequences” within the meaning of the regulation referred to above.[[101]](#footnote-101) By contrast, the special allocation of loss was upheld by the Tax Court in *Harris v. Commissioner* where the taxpayer successfully demonstrated that the loss was economically borne by the taxpayer via a corresponding decrease to the taxpayer’s capital account.[[102]](#footnote-102)

Although it was not at issue in the cases above or in any Service guidance, this period did see taxpayers more explicitly associating the “substantial economic effect” prong of the 1956 regulations with partnership capital accounts, particularly after *Orrisch*.[[103]](#footnote-103) As prominent commentators observed in 1978 of pre-1976 law: “Most commentators believe, and the staff of the Joint Committee on Taxation has stated, however, that the presence or absence of substantial economic effect can be determined by an analysis of the effect of the allocation on the partners’ capital accounts.”[[104]](#footnote-104)

### **1974 ABA Report**

In 1974, the ABA published a four-year study of H.R. 9662, which had been passed by the House (but not the Senate) in 1960 and reflected the recommendations of the 1957 subchapter K advisory group.[[105]](#footnote-105) The report included seven recommendations, including that section 704(b) be amended to police bottom-line allocations as well as item allocations.[[106]](#footnote-106) However, bringing bottom-line allocations within the ambit of the “principal purpose” test necessitated a different test for reallocating invalid allocations to avoid circular reasoning, and so the ABA proposed (in their words) the “imperfect approach” that the allocation be done by reference to the “total interest of the partner in the profits and capital of the partnership, taking into account all facts and circumstances.”[[107]](#footnote-107) For these purposes, the ABA noted that “some of the most relevant facts would be the interests of the respective partners in partnership cash flow and the rights of the partners to distributions of capital upon liquidation.”[[108]](#footnote-108) Remarking on its “imprecision,” the ABA concluded: “Given the myriad possible provisions of the partnership agreement, a more precise rule does not appear to be feasible.”[[109]](#footnote-109)

## **Tax Reform Act of 1976**

By 1976, the inadequacy of the “principal purpose” standard, and the pre-eminence of the economic effect regulation, had become apparent. Moreover, a 1976 Joint Committee on Taxation report all but conceded that partnerships were employing special allocations to achieve tax-driven returns of the type attempted in *Kresser* and *Orrisch*, notwithstanding the “principal purpose” standard: “Special allocations of profits, losses, income items, and deductions may be used to combined tax-oriented and nontax-oriented investors in a single partnership. Typically, the tax benefits and large portions of the capital appreciation on resale are given to the high-income investor, while greater security and first return of cashflow are given to the nontax-oriented investor.”[[110]](#footnote-110)

### **The House Report**

In the House version of revised section 704(b), the limit on special allocations was expanded to address bottom-line allocations (as urged by the ABA and ALI in 1954, flagged in the court’s footnote in *Kresser*, and recommended by the ABA again in 1974).[[111]](#footnote-111) The House would have left the “principal purpose” test in place, while also adding a “business purpose” requirement from the regulations.[[112]](#footnote-112) The House also introduced a rule providing that, for partnerships lacking a “permanent method” for allocating income under former section 702(a)(9) (*i.e.*, a bottom-line allocation), an allocation that lacked business purpose or carried an impermissible tax avoidance purpose would be reallocated in accordance with the “partner’s interest in the partnership, taking into account all facts and circumstances” – the introduction of the term, although the concept closely tracks the ABA recommendation from 1974.[[113]](#footnote-113) A partnership would be considered to have a “permanent method” of allocating taxable income or loss if “(1) it has consistently applied such method over a number of years, and (2) it meets both the business purpose and significant tax avoidance tests.”[[114]](#footnote-114) A “partner’s interest in the partnership” would be determined by taking into account “all the facts and circumstances,” and among the “relevant factors” to be taken into account would be “the interests of respective partners in cash flow and their rights to distribution of capital upon liquidation.”[[115]](#footnote-115)

### **The Senate Report**

The Senate followed the House in expanding section 704(b)(2) to address bottom-line allocations (also specifically citing the *Kresser* footnote), but departed from the House’s revision to the “principal purpose” test and called for a test based only on “substantial economic effect” as set forth in the 1956 regulations (“i.e., whether the allocation may actually affect the dollar amount of the partners’ shares of the total partnership income”); however, the Senate expressed continued approval of the other regulatory factors that “could possibly relate to the determination of the validity of an allocation.”[[116]](#footnote-116) Importantly, the Senate noted: “While there is a difference in language, the intent of the committee amendment and the House bill are essentially the same—both versions seek to prevent the use of special allocations for tax avoidance purposes, while allowing their use for bona fide business purposes.”[[117]](#footnote-117)

The Senate version also eschewed the first step in the House’s redetermination scheme of looking to a partnership’s “permanent method” for allocating bottom-line taxable income (“because of the difficultly in defining ‘permanent method of allocating’ the items”), and instead required a redetermination solely in accordance with a “partner’s interest in the partnership,” the second step of the House scheme.[[118]](#footnote-118) The Senate cited the same factors as the House for determining a “partner’s interest in the partnership,” with one addition: “the interests of *the ~~respective~~* partnersin *profits and losses (if different from the that of taxable income or loss);* cash flow*;* and their rights to distribution of capital upon liquidation.”[[119]](#footnote-119) In the first major contemporaneous summary of the legislation, William McKee, William Nelson and Robert Whitmire wrote: “While the scope of the facts and circumstances test for determining a partner’s interest in the partnership is uncertain, it seems both probable and proper that the test will resolve itself into an economic effect test.”[[120]](#footnote-120)

In its summary of the 1976 Act, the Joint Committee on Taxation included a critical footnote when describing how parties would demonstrate allocations had “substantial economic effect”:

The determination of whether an allocation may actually affect the dollar amount of the partners’ share of total partnership income or loss, independent of tax consequences, will to a substantial extent involved an examination of how these allocations are treated in the partners’ capital accounts for financial (as opposed to tax) accounting purposes: this assumes that these accounts actually reflect the dollar amounts that the partners would have the rights to receive upon the liquidation of the partnership.[[121]](#footnote-121)

Notably, the Joint Committee also observed, in its explanation of the provision, that “other factors that could possibly relate to the determination of the validity of an allocation are set forth under the present regulations” and cited the 1956 version of Treas. Reg. § 1.704-1(b)(2).[[122]](#footnote-122)

Reaction to the changes to section 704(b) were fairly muted: “The revision of section 704(b) was probably less substantive than it might otherwise seem.”[[123]](#footnote-123) While the 1976 Joint Committee report was the first official mention from a Congressional body of the relevance of capital accounts to section 704(b) and would inspire significant regulatory attention over the next decade, it is notable that the codification of the “substantial economic effect” test was not generally considered a change in post-1954 law, just as the 1954 codification was, generally, not considered a change in pre-1954 law.[[124]](#footnote-124) Nevertheless, several cases decided after the 1976 Act (but relating to pre-1976 years) more explicitly adopted the capital account formulation for testing allocations.[[125]](#footnote-125) Moreover, in at least two post-1976 cases, the IRS successfully argued that an economic substance-like analysis applied to bottom-line allocations under section 704(a) (despite, following *Kresser*, the absence of any clear statutory limitation on such allocations).[[126]](#footnote-126)

## **The 1985 Regulations**

The 1976 Act introduced the need for guidance on two new statutory regimes and their relationship: “substantial economic effect” (SEE) and a “partner’s interest in the partnership” (PIP). Practitioners forecast that guidance under SEE would look to the partnership agreement provisions governing “profits and loss, distributions (both periodic and on termination), the obligation to make contributions (both initially and throughout the term of the partnership), and the amount credited to the capital account (for contributed property or for other consideration).”[[127]](#footnote-127) Commentators after *Orrisch* were especially quick to observe that mere reliance on capital accounts would be incomplete without adequate assurance that those capital accounts reflected economic entitlements.[[128]](#footnote-128)

### **The 1979 ALI Draft**

In apparent anticipation of the regulatory effort necessitated by the 1976 Act’s changes to section 704(b), the ALI published a draft in March 1979 that would prove influential in the subsequent development of the current section 704(b) regulations.[[129]](#footnote-129) The 1979 draft examined a number of current issues in the practice of determining distributive shares and concluded that the 1976 Act’s language was sufficient to address them all, and then so recommended “principles” for general application:[[130]](#footnote-130)

1. Except as provided below, the economics of the partnership agreement should govern the allocation of tax consequences. When a tax allocation has no relationship to the economic arrangement among the partners, the tax allocation should be ignored.
2. If an allocation may have a substantial economic effect it will be recognized for tax purposes. In determining whether an allocation may have substantial economic effect, the likelihood and magnitude of the economic effect must be weighed against the shifting of tax consequences resulting from the allocation.
3. When the parties choose a generally applicable allocation of profit and loss, which reflects the substance of their economic arrangement, that allocation should be sustained even though there may be a more appropriate allocation for a specific item.[[131]](#footnote-131)

The 1979 ALI draft went on to provide “generalizations” regarding the “balancing” contemplated by the second principle above, which are quoted in their entirety due to their continuing relevance to determinations under PIP:[[132]](#footnote-132)

1. When there is a realistic chance that an allocation will have substantial economic effect, the allocation will generally be recognized for tax purposes, regardless of tax saving achieved by the allocation or the subjective intent of the parties.
2. In evaluating the tax consequences of an allocation, the fact that substantially the same tax result could have been achieved by the partners without relying on the Subchapter K rules indicates the allocation should normally be recognized.
3. The relative equity contributions of the parties will only conclusively determine the allocation of tax losses up the amount of such equity.
4. Tax losses attributable to equity financing or recourse borrowing may be allocated to the partners who ultimately have to contribute funds to the partnership if the losses are ultimately suffered by the partnership. This will generally be the result regardless of the tax motivation or tax savings effect of such allocation.
5. When the chance that an allocation of tax losses will have an economic effect is remote, and the chance of the partnership ever realizing an ultimate loss is remote, the allocation may still be sustained.
6. The fact that a partner may receive less distributions in the future because of an allocation of tax losses to him does not in itself justify the allocation if he can never be required to contribute funds to the partnership as a result of the allocation.
7. In determining whether a tax allocation for a particular period should be sustained, economic allocations during the corresponding period an proximate periods should, in general, be given more weight than allocations of economic factors at a remote point in time.
8. Tax allocations based upon economic factors which are extremely unlikely to occur should, in general, be given little or no weight.
9. An allocation of an item of gross income that has the same effect as a special allocation of losses should only be sustained if such a special allocation of losses would have been sustained.

None of the regulations under the 1976 Act (principally in 1983 and 1985) specifically addressed the 1979 ALI draft. Nevertheless, the 1979 ALI draft was likely the most important input from outside the government during the regulatory process, and the deviations between the 1979 ALI draft and the subsequent regulations provide some of the only insight (if it can be called that) into that regulatory effort.

### **The 1983 Proposed Regulations**

Proposed regulations under the 1976 Act were published in March 1983, and approached “substantial economic effect” with the two-part test that is still law today and which was first articulated in 1956 by the ALI. Although the regulation was generally effective for partnership taxable years beginning after December 31, 1983, “the fundamental principles contained … relating to the substantial economic effect test [were] generally applicable for partnership taxable years beginning after December 31, 1975.”[[133]](#footnote-133)

“Economic effect” rules generally mandated the capital account analysis that had been broadly relied upon prior to 1976.[[134]](#footnote-134) However, the proposed 1983 regulations fashioned SEE as a safe harbor by conditioning satisfaction of SEE on liquidating in accordance with capital accounts that were maintained in accordance with (relatively simplified) Treasury and IRS accounting rules.[[135]](#footnote-135) As discussed, maintenance of capital accounts (along with income and draw accounts, each with contractually enforceable deficits) were partnership financial accounting practices that gradually took on prominence in the tax practice as a means of substantiating item allocations under the 1954 code; these practices eventually become sufficiently widespread that they were adopted as state-law defaults in the Revised Uniform Partnership Act in 1993.[[136]](#footnote-136)

The new “substantiality” regime contained language that was not reflected in the 1954 or 1976 legislative history, but that had been advocated by the ALI in 1956; the 1983 preamble provides a single sentence to explain the origin of the rule: “[T]he economic effect must be substantial when weighed against the shifting of tax consequences resulting from the allocation.”[[137]](#footnote-137) For determining a partner’s interest in the partnership, the 1983 preamble stated that “a partner’s interest in the partnership is to be determined with reference to the underlying economic arrangement of the partners relating to the particular allocation under consideration.”[[138]](#footnote-138)

The 1983 formulation of the “substantiality” rule had two parts: A general mirrored the second principle from the 1979 ALI draft and contemplated a “weighing” of “the likelihood and magnitude of a shift in the economic consequences among partners” against “the shifting of tax consequences resulting from the allocation (or allocations), particularly tax consequences which result from the interaction of the allocation (or allocations) with the partners’ nonpartnership tax attributes.”[[139]](#footnote-139) That “weighing” at the beginning of a tax year would look for a “disproportionately large” shift in tax consequences when compared to the economic consequences of the allocation, and there was a “strong likelihood” of such a “disproportionately large” shift, the allocation would be insubstantial; further, the test would be performed again at the end of the taxable year, and if the “disproportionately large” benefit in fact occurred, the taxpayer had the burden of overcoming the presumption that there had been a “strong likelihood” of such benefit occurring.[[140]](#footnote-140) A second rule provided that an allocation that was “transitory due to a largely offsetting allocation (or allocations)” and which would “significantly reduce the overall tax liabilities of the partners” would be insubstantial if, at the time of the allocation, there was “strong likelihood” that the allocation would be transitory.[[141]](#footnote-141) The 1983 proposed regulations also contained a precursor to the 1985 “value equals basis” presumption (labeled “effect of economic performance” in 1983) as an exception to substantiality rules where the otherwise strongly likely “disproportionately large” benefit arises as a result of a timing benefit reflected in the Code.[[142]](#footnote-142)

Three examples were included in the 1983 proposed regulation to illustrate the new substantiality rules, including three examples that revisited examples from the 1954 legislative history and the 1956 regulations.[[143]](#footnote-143) To explain the impact of these changes, it’s helpful to follow the evolution of each example.

Example 1 of the 1956 regulations, which became example 6 of the 1983 regulations, concerns a special allocation of section 1231(b) losses, and has its origins in subchapter K legislative history. The 1954 House report stated that a bare special allocation of section 1231(b) losses “may be disregarded” if its principal purpose was to avoid or evade federal income tax; the example was revised in the Senate’s report to add that the suspicious transaction also included “an equivalent amount” of partnership loss being allocated to other partners. The difference had potential consequences – the House report seemed to contemplate both a shifting or transitory allocation as having a potential “principal purpose,” but the Senate seemed to limit its purview to shifting allocations.[[144]](#footnote-144) The regulatory history added another chapter – the 1955 proposed regulations followed the Senate report’s facts but reached a different conclusion, declaring the allocation invalid on its facts (without regard to any further “principal purpose” analysis).[[145]](#footnote-145) The 1956 regulations maintained the facts and conclusions of the 1955 regulations, but offered additional reasoning for its conclusion that took into account the taxes paid by the partners – a factor not supported by the language of the House or Senate Report (but perhaps the product of 1956 ALI report): “Since the purposes and effect of this allocation is solely to reduce the taxes of certain partners without actually affecting their shares of partnership income, such allocation will not be recognized.”[[146]](#footnote-146) In 1983, the facts and the conclusion were the same (except for the added fact that the partnership maintained qualifying capital accounts), but this time, because there was a “strong likelihood” of the offsetting allocations, the transaction was an invalid “shifting” allocation. The 1983 example also concluded that the “overall tax liabilities of the partners” were also “significantly reduced,” a further evolution from the 1956 regulation that would have only required a reduction in taxes of “certain partners.”[[147]](#footnote-147)

Example 3 of the 1956 regulations, which became example 7 of the 1983 regulations, concerns a partnership that used “surplus” funds to purchase an equal dollar amount of tax-exempt bonds and corporate stock, with “all” interest allocated to one partner, and “all” dividends allocated to the other. The example has its origins in the critical paragraph added by the Senate to its 1954 report, which concluded (without providing any additional information about the partners) that such an allocation would be respected, “unless it is a device for the allocation of the interest exemption without any real economic effect on either partner’s share of the total partnership income.”[[148]](#footnote-148) The 1955 proposed regulations duped the facts from the Senate’s example, but modified the conclusion to require the allocation not be “a device for the allocation of tax-exempt interest without having substantial economic effect on either partner’s share of the total partnership income.”[[149]](#footnote-149) The 1955 regulations also included a contrasting example of an invalid allocation (in which the “principal purpose” was apparently present from its facts) where only the first $10,000 of each item was so specially allocated, with the balance allocated evenly, the interest-allocated partner had “substantial income from other sources,” and the allocations had no “real economic effect.”[[150]](#footnote-150) As discussed above, the ALI was strongly critical of both the example in the Senate report and the 1955 regulations.[[151]](#footnote-151) The final 1956 version of the example added that, in the valid allocation only, gain or loss from bonds and stock, respectively, was also specially allocated.[[152]](#footnote-152) The contrasting example also was changed to make clear the import of the interest-allocated partner having “substantial income from other sources” was that the partner was in a higher tax bracket and struck the observation that the allocation had no “real economic effect.”[[153]](#footnote-153) The 1983 example modified the facts of the 1956 example into 90%/10% splits of each item and added that the partnership maintained qualifying capital accounts, but its conclusion remained the same (notably without performing any “weighing” of tax savings to economic effect under the 1983 substantiality rule), leaving in place the issues raised by the ALI in 1956.[[154]](#footnote-154) In the contrasting 1983 example, the facts remained the same as 1956 (adjusted for 90%/10% split), but an assumption was added that, as of the beginning of the year, there was a strong likelihood that that more than $10,000 would be earned with respect to both the bonds and the stock.[[155]](#footnote-155) The conclusion remained the same, although in 1983 it was because the contrasting example failed the “weighing” test. Interestingly, the 1983 contrasting example noted that the allocation would have passed the “weighing” test had there either not been a strong likelihood that both investments would earn more than $10,000 or that there had been a strong likelihood that the difference in the amounts earned between the investments would be insignificant, an arguable concession to the ALI criticisms.[[156]](#footnote-156)

Example 5 of the 1956 regulations, which became example 3 of the 1983 regulations, concerns a special allocation of partnership deductions subject to a “chargeback.” The example was not present in the 1954 legislative history, or in the 1955 proposed regulations, but chargebacks had been respected under pre-1954 law.[[157]](#footnote-157) As noted above, the 1956 example sanctioned a partnership (G and F) where certain expenses (research and development; interest) would be “charged” to one partner (G) at a time where net income and loss (exclusive of specially charge items) would be shared 90% to G/10% to H until the loans were repaid and G had “received” through his 90% share the full amount of the specially allocated expenses and any other partnership losses allocated to G, after which the income and loss of the partnership would be shared equally.[[158]](#footnote-158) The 1983 example adds to the facts that the electronic devices being developed and marketed were “experimental” electronic devices and that the partnership maintains qualifying capital accounts, and concludes the allocations are substantial because there was not a “strong likelihood” at the time the special allocations were made in the partnership agreement that the economic effect of such allocations would be transitory due to largely offsetting allocations.

For purposes of determining a partner’s interest in the partnership, the 1983 rules provided that the determination was an item-by-item analysis that “signif[ied] the manner in which the partners have agreed to share the economic benefit or burden with respect to the income, gain, loss, deduction, or credit (or item thereof) that is allocated,” that “this sharing arrangement may or may not correspond to the overall economic arrangement of the partners,”[[159]](#footnote-159) and that “[t]he determination of [PIP] … be made by taking into account all facts and circumstances relating to the economic arrangement of the partners,” including the following (which may be “relevant”):

1. The partners’ relative contributions to the partnership;
2. The interests of the partners in economic profits and losses (if different from that in taxable income or loss);
3. The interests of the partners in cash flow and other distributions; and
4. The rights of the partners to distributions of capital and other property upon liquidation.[[160]](#footnote-160)

The regulatory PIP factors were largely drawn from the legislative history of the 1976 Act.[[161]](#footnote-161) Moreover, in a stark illustration of the intended audience for the 1983 regulations, all partners’ interests in the partnership were presumed to be equal (determined on a per capita basis), which presumption could be overcome by the taxpayer (or the IRS) proving facts and circumstances that showed otherwise.[[162]](#footnote-162)

Treas. Reg. § 1.704-1(b)(3) included cross-references to several examples in Treas. Reg. § 1.704-1(b)(5) intended to illustrate the application of SEE and PIP. Unfortunately, none of the examples was primarily intended to illustrate the PIP factors, nor do they in any instance use language that clearly tracks the language of the factors.[[163]](#footnote-163)

### **The 1983 Comments**

The ALI published a tentative draft in 1985 in response to the 1983 proposed regulations; the 1985 ALI draft includes the same “principles” and “generalizations” as in their 1979 draft and the final regulations did not (in ways relevant to this discussion) reflect the changes proposed by the ALI.

[Discussion subject to ongoing FOIA efforts]

### **The 1985 Regulations**

Final regulations under the 1976 Act were published in 1985. Notably, the effective date language was “clarified” to “make clear that the detailed requirements contained in the regulations concerning the maintenance of capital accounts are not mandated for taxable years beginning before May 1, 1986.”[[164]](#footnote-164) For taxable years beginning after December 31, 1975, but before May 1, 1986, the preamble provided that an allocation that did not have substantial economic effect under the final 1985 regulations nevertheless “may have substantial economic effect under section 704(b), as interpreted by case law prior regulations [sic], and the legislative history of the [1976 Act].”[[165]](#footnote-165) Read in one light, Treasury was conceding that its regulatory “safe harbor” for determining substantial economic effect did not necessarily reflect the principles that had governed the determination of distributive shares under post-1976 law (or, by inference, post-1913 law).

In the final regulations, “substantiality” was revised from two rules to four rules. First, a new pre-tax effect rule was added that mirrors the 1954 Senate report and 1955 and 1956 regulations and largely restates the economic effect rules – that there “be a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.”[[166]](#footnote-166) Second, and most notably, the “weighing” rule from 1983 was completely eliminated and in its place was substituted a test of whether there was both a “strong likelihood” that, as a result of the allocation, the “after-tax economic consequences” of at least one partner may, in present value terms, be enhanced, and a “strong likelihood” that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished. Third, the rules divided the “shifting” rule from 1983 into two rules: a rule addressing temporal offsetting allocations to a partner, and a rule addressing shifts among partners in a single year, in each case testing for a decrease in “the total tax liability of the partners” (for their respective taxable years in which the allocations will be taken into account and taking into account tax consequences that result from the interaction of the allocation with partner tax attributes that are unrelated to the partnership).[[167]](#footnote-167)

The revision of the “general” substantiality rule, the re-introduction of the “dollar” test, and the introduction of temporal shifting prohibition to accompany the contemporaneous shifting prohibition prompted conforming updates to the substantiality examples.[[168]](#footnote-168)

The oft-debated example 3 of the 1956 regulations (now example 7) was revised again, both as to its facts and its conclusions, potentially to further mute the implications of the 1954 Senate report example.[[169]](#footnote-169) To recap, the 1956 example concerned a special allocation by a two-person partnership of all the partnership’s tax-exempt interest to one partner, and taxable dividends to the other (as well as, in each case, all gain or loss from the respective asset). First, the period of investment in the example was limited to 3 years and it was added that, at the time the allocations become part of the partnership agreement, there was not a strong likelihood that the gain or loss from the sale of the stock would be substantially equal to the gain or loss from the sale of the tax-exempt bonds, but there was a strong likelihood that the tax-exempt interest and the taxable dividends realized from these investments during the 3-year period would not differ substantially. Under these facts, the example concludes that allocations of the gain or loss on the sale of the bonds and stock was substantial, but not the interest or dividends, which were impermissibly transitory because there was a strong likelihood that, at the end of the 3-year period, the net increases and decreases capital accounts would be the same as the baseline, and that the total taxes of the partners for the taxable years at issues would be reduced as a result of such allocations.[[170]](#footnote-170) The contrasting examples generally remained the same as in the 1983 proposed regulations.

Example 5 of the 1956 regulation (now example 3) remained the same as to its facts and conclusions, but it was further added to the reasoning that the conclusion that the chargeback wasn’t a transitory allocation was “in view of the nature of the partnership’s activities” (i.e., develop and market experimental electronic devices).

The PIP rules remained the same as in the 1983 regulations, but a rule was added for partnerships that maintain and liquidate in accordance with capital accounts, but where the partner at issue does not have a sufficient restoration obligation for its negative capital account balances; in this case, a partner’s interest in the partnership with respect to such items that lack is determined on the basis of contributions and distributions in a hypothetical liquidation of the partnership.[[171]](#footnote-171) Since being finalized in 1985, the PIP and substantiality rules have been updated twice, in 2008 and 2012, in a manner not especially relevant to this discussion.[[172]](#footnote-172)

## **1985-Present**

Outside the 1985 regulations (and the 2008 and 2012 updates), there has been one published Service ruling focusing principally on substantiality, and none on PIP.[[173]](#footnote-173) In Revenue Ruling 99-43, the Service addressed a workout of a nonrecourse loan that triggered cancellation of indebtedness income and a book loss, in which the partnership agreement was amended to specially allocate to an insolvent partner all of the cancellation of indebtedness income and an amount of the book loss equal to the disproportionate amount cancellation of indebtedness income; the Service (“not surprisingly”[[174]](#footnote-174)) ruled the allocation failed both the general “after-tax” test and shifting allocation test of Treas. Reg. § 1.704-1(b)(2)(iii).[[175]](#footnote-175)

Paralleling this, there have been very few cases on SEE and those cases that do exist seem principally to demonstrate confusion among both taxpayers and the courts. For example, in the recent case of *Clark Raymond & Co. v. Commissioner*, the Service successfully challenged a partnership’s allocations for failure to maintain safe harbor-compliant capital accounts, but was unsuccessful in convincing the Tax Court to then take the appropriate next steps to allocate the resulting income properly among the partners.[[176]](#footnote-176) By giving strict effect to “regulatory” partnership provisions intended (in vain) to maintain qualifying capital accounts and then failing to allocate the resulting book gain appropriately among the partners, the court was snared (like many practitioners) by two of the more common traps in the 1985 regulations – nonpurposive application of a thicket of regulatory allocations that have congealed into boilerplate and misapplication of complex book accounting rules that produce unintended tax outcomes.

The case law interpreting PIP has not fared much better, and has been viewed as generally unsatisfying in extracting useful principles; however, PIP caselaw (while not necessarily uniform in its approach or application) has provides some clarity on how a partner’s interest in the partnership is determined (or at least applied) and has helped to highlight divergences between PIP and SEE.[[177]](#footnote-177)

In *Vecchio v. Commissioner*, the taxpayer was a partner in a partnership that disposed of assets in an installment sale that gave rise to significant partnership-level gain in the year of the sale, all of which the partnership specially allocated to another partner (Equity) to restore Equity’s negative capital account balance (that had resulted from the allocation of losses in prior taxable years not under examination and that Equity was not obligated to restore), notwithstanding that the allocation provisions in the partnership agreement, which the court recognized could be and was orally modified, provided for income to be allocated 49 percent / 47.5 percent / 3.5 percent among the partners. The Tax Court upheld the allocation under PIP, stating that: “because Equity received the benefit of the prior deductions, Equity should bear the economic burden of gain in an amount necessary to bring its capital account to zero. Absent such allocation, the other partnership interests would have to bear part of the economic cost of the special allocation that resulted in the deficit capital account.”[[178]](#footnote-178) The court noted that, under the partnership’s distribution waterfall, Vecchio participated in liquidating proceeds only after Equity’s capital was returned; and therefore “bore the risk” that a sale of the property would not provide distributable proceeds in excess of Equity’s distribution right and so the “allocation of the gain taxable in the year of the sale of the real property also reflects the risk of economic loss in a later year borne by [taxpayer and its other partner] in the event that the purchaser of the real property should fail to pay an installment due in the later year.”[[179]](#footnote-179) *Vecchio* gives more color to the “symmetry” of the “two different roads” approach to SEE and PIP – the court focused its PIP analysis on ensuring that the partners’ *final* capital accounts reflected the amounts that the partners would have had were their partnership agreement compliant with SEE, but the “road” to those final capital accounts was allowed to differ from SEE.[[180]](#footnote-180)

In *Tobias v. Commissioner*, the taxpayer contributed significant capital and labor to a partnership with his brother, and, after the taxpayer evicted his brother from the business, a state court ordered a dissolution and accounting of the partnership pursuant to which the taxpayer’s brother had a right to 50 percent of the partnership’s assets after repayment of the taxpayer’s contributions.[[181]](#footnote-181) The Tax Court upheld the IRS’s rejection of the taxpayer’s position that (based on the state court’s ruling) only 50 percent of the gain resulting from the sale of the partnership’s assets were allocable to the taxpayer, applying the factors under PIP (and principally, the first factor relating to capital contributions) to conclude that “if the partnership had been liquidated at any time during the years in issue, all of the partnership assets would have been distributed to [the taxpayer] .... [T]herefore, [] during each of the years in issue [the taxpayer] bore the economic benefit of 100 percent of the income realized by the partnership.”[[182]](#footnote-182) As has been noted, the *Tobias* court’s imputation of a special allocation in pre-liquidation years, performed with the benefit of hindsight, may have not necessarily have represented the parties’ understanding or necessarily been the result reached under SEE.[[183]](#footnote-183)

In *PNRC Ltd. Partnership v. Commissioner*, the partnership allocated profits 60 percent / 40 percent but allocated losses 99 percent / 1 percent, and liquidating proceeds were to distributed in accordance with the partners’ interests in profits, not positive capital account balances, and so the allocations lacked economic effect (and, therefore, SEE).[[184]](#footnote-184) The Tax Court reallocated prior losses in accordance with the relative capital contributions of the partners, finding, without explanation, that these were “most indicative” of PIP, apparently without regard to whether that allocation would accord with amounts that would be received in a liquidating distribution.[[185]](#footnote-185)

By contrast, in *TIFD III-E Inc. v. United States*, a partnership’s allocation of 2 percent of its operating income to the taxpayer was not insubstantial under the general rule of Treas. Reg. § 1.704-1(b)(2)(iii), notwithstanding that the taxpayer’s relative capital contribution was approximately 82 percent (and that such allocation resulted in significant U.S. tax savings to the taxpayer), because the district court found the taxpayer’s PIP with respect to the operating income matched its allocation under the partnership agreement based on the partnership’s non-liquidating and liquidating distributions of such income.[[186]](#footnote-186)

It’s tempting to summarize the story of the post-1985 taxpayer and practitioner approach to navigating section 704(b) through the literature: with a few exceptions,[[187]](#footnote-187) there was a long period of study of the technical and policy issues with the substantiality rules in the 1985 regulations (and, to some extent, the capital account maintenance rules),[[188]](#footnote-188) followed by a long period (continuing through this paper) of studying non-SEE-compliant methods of performing allocations[[189]](#footnote-189) and the contours of determining a “partner’s interest in the partnership.”[[190]](#footnote-190)

# Post-1986 Developments Affecting Partnership Landscape

In the period since the 1985 regulations were finalized, partnerships and partnership taxation have undergone momentous changes. In the era when the 1985 regulations were developed, partnerships were principally vehicles for three forms of transactions: professional services firms, real estate ventures and tax shelters (the latter two of which were not necessarily distinct categories). It would be a challenge to overstate the sudden and substantial increase in the use of partnerships in the intervening years; today they are, for many tax and commercial law practitioners, the default choice.

In the same period, partnerships have been the focus of significant activity and attention, both as a result of issues originating from within the world of subchapter K and from outside developments introducing new pressures and prompting new questions. These developments, arising both from evolving commercial practices and more recently from changes in adjacent law, have spurred a reconsideration of the curious status quo under section 704(b) with an eye to a clearer articulation of current law in the face of future enforcement activities or even dramatic legislative revision. The following provides some brief historical context for the position that taxpayers, practitioners and the IRS find themselves in today.

## **Development of LLCs and the Explosion of Tax Partnerships**

The limited liability company first came into form in Wyoming in 1977, but underwent a “meteoric” rise in the 1990s, aided in part by the Service ruling in 1988 that LLCs would be taxed as partnerships.[[191]](#footnote-191) As other states enacted LLC statutes and sought their own revenue rulings, the Service eventually resorted to revising the entity classification themselves to allow LLCs to elect treatment as partnerships (or corporations or disregarded entities).[[192]](#footnote-192) At the same time, the final repeal of the *General Utilities* doctrine in 1986 raised the effective tax rate of C corporations, making the “pass-through” form an increasingly inviting form of business organization.[[193]](#footnote-193) The broad migration of business activity away from C corporations prompted significant academic reconsideration of the dual pass-through schemes of subchapter K and subchapter S, although no material changes came about.[[194]](#footnote-194)

Meanwhile, the number of partnerships continued to explode, prompting changes to the partnership audits rules in 2015 (discussed below). A July 2023 report from the Governmental Accountability Office stated that between 2002 and 2019, the number of large partnerships—with over $100 million in assets and 100 or more partners—increased almost 600 percent.[[195]](#footnote-195)

## **Distribution-Measured Deals and Pre-Eminence of Target Allocations**

At the same time that interest in the partnership form was growing, interest in SEE-compliant partnership agreements was waning.[[196]](#footnote-196) As early as 1989, one practitioner noted: “It has been suggested that one leaves the regulations’ safe harbor at his peril. From the standpoint of the economic deal, the opposite is true: one incorporates the safe harbor at their economic peril.”[[197]](#footnote-197)

The pre-eminence of non-SEE-compliant allocation methods – in particular, the “target” or “forced” allocation method – was reified by the “common” use of “cash-driven” distributions for both current and liquidating distribution in partnerships during the period, driven (at least in part, according to the Tax Section of the New York State Bar Association) by “deference to [tax-exempt or tax-insensitive] investors, which control significant pools of capital.”[[198]](#footnote-198)

## **Treas. Reg. § 1.701-2**

At the same time that partnerships were becoming vastly more popular (and the section 704(b) regulations less functional), the IRS and Treasury issued the subchapter K anti-abuse regulation, which purports to authorize the IRS to recast certain partnership transactions that are inconsistent with the intent of subchapter K and to treat a partnership as an aggregate of its members where more appropriate to carry out the purposes of particular Code sections.[[199]](#footnote-199) The regulation begins from premise that “[s]ubchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax,” and concedes in certain examples concede, where “clearly contemplated,” subchapter K’s intent includes significant deferral of taxation (including in the application of the regulatory substantiality rules).[[200]](#footnote-200) Such statements were and remain especially powerful given roughly contemporaneous developments in the tax law that generally limited deferral of taxation with respect to economic returns in other areas of business capital.[[201]](#footnote-201)

The validity of the anti-abuse regulation rests on its being a restatement of existing law, given that Treasury and the Service only had interpretive authority to issue it.[[202]](#footnote-202) The regulation provides that “if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners’ aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K,” the Service can recast the transaction.[[203]](#footnote-203) Whether a partnership falls into that category is determined “based on all of the facts and circumstances,” including (among other factors) “weighing” tests that echo the approach of the 1983 proposed regulations – for example, factors include “a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction” and whether “the present value of the partners’ aggregate federal tax liability is substantially less than had the partners owned the partnership’s assets and conducted the partnership’s activities directly.”[[204]](#footnote-204)

## **Section 7701(o)**

Another adjacent development, but one affecting the determination of section 704(b) distributive shares, was the “codification” of the economic substance doctrine.[[205]](#footnote-205)

Following the “significant[]” growth in corporate tax shelters in the 1990s (and the resulting IRS challenges, many on the basis of economic substance),[[206]](#footnote-206) the Treasury commenced a study in 1999 that prompted an initial codification proposal in 2001;[[207]](#footnote-207) the Senate passed nine bills codifying the doctrine in various forms between 2003 to 2008.[[208]](#footnote-208) In 2010, the 111th Congress passed (and President Obama signed into law) a codification intended to “clarif[y]” and “enhance” the judicial doctrine by providing a “uniform” definition.[[209]](#footnote-209) Resolving a multi-circuit split,[[210]](#footnote-210) section 7701(o)(1) states that “[i]n the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.”

In a departure from the previously proposed legislation,[[211]](#footnote-211) section 7701(o)(2)(A) includes a “special rule where taxpayer relies on profit potential” that provides that “[t]he potential for profit of a transaction shall be taken into account in determining whether the [conjunctive requirements above] are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.” This “profit potential” is notable in two critical respects to the law of partnership distributive shares. First, it has its origins in a seminal 1966 economic substance doctrine case, *Goldstein v. Commissioner*,[[212]](#footnote-212) in which the court looked at the profit potential but was “focused on the relative puniness of that potential”;[[213]](#footnote-213) therefore, notwithstanding the observation that the test represents something “new”[[214]](#footnote-214) or an “enhance[ment]” of the law,[[215]](#footnote-215) the rule may represent a mere articulation of the doctrine as it has always existed.[[216]](#footnote-216) Second, the codified “profit potential” test bears resemblance to the “weighing” test suggested by the ALI in 1979 and that was initially proposed as the regulatory substantiality test in the 1983.

## **Centralized Partnership Audit Regime**

Against the backdrop of this explosion of partnerships and concerns of abuse,[[217]](#footnote-217) Congress took notice of the dearth of IRS audits of partnerships. A 2014 Government Accountability Office report noted that the number of large partnerships had more than tripled from tax year 2002 to 2011 (with almost two-thirds of such partnerships having more than 1,000 direct and indirect partners), and yet the IRS audited “few” large partnerships” and “[m]ost audits resulted in no change to the partnership’s return and the aggregate change was small.”[[218]](#footnote-218) One of the culprits was the administrative procedures required by Code’s 1982-era partnership audit rules.[[219]](#footnote-219)

In response, Congress enacted a radically simplified centralized partnership audit regime in 2015 (which took effect in 2018), and which dramatically simplified the IRS’s ability to audit partnerships and assess and collect taxes, most notably by (absent an election) collecting from the partnership any shortfall in partnership-related taxes due from the partners (including interest and penalties).[[220]](#footnote-220)

# The Imperfect Approach[[221]](#footnote-221)

The state of the regulations under section 704(b) today is curious but functional. Treas. Reg. § 1.704-1(b)(2) is nearly 12,000 words long (not counting its dozen of examples) and only relied on in relatively rare circumstances, principally to structure tax-advantaged transactions; Treas. Reg. § 1.704-1(b)(3) is 641 words,[[222]](#footnote-222) is used daily, and is the foundation for the principal drafting strategy for nearly all business-driven (as opposed to tax-driven) agreements.

Despite the odd state of regulatory affairs, the status quo seems satisfactory (or at least, as satisfactory as any period since 1913). While there have been calls to conform the SEE safe harbor to modern drafting approaches and even recent calls to eliminate it for being too taxpayer-friendly, SEE in its current state seems to serve most effectively as a form of regulatory ballast. A better metaphor might be to that of a holy book that one learns in school and aspires to live by, but also departs from in the face of practical necessity. If any criticism could be fairly handed down with respect to Treas. Reg. § 1.704-1(b)(2), it’s that it may simply be too unwieldy at its current length, and that critical provisions – notably the substantiality rules of Treas. Reg. § 1.704-1(b)(2)(iii) – could use a plain-English rewrite.

Beyond these skin-deep complaints, however, there are areas where, as a result of the post-1985 legal and commercial developments noted above in Part III, taxpayers and the IRS could be well-served by clarification of the current regime, largely regarding applications of the PIP rules on which most taxpayers and practitioners routinely rely and where many examiners are likely expected to become familiar. As noted throughout Part I, the number of words deployed in Treas. Reg. § 1.704-1(b)(2) when compared to Treas. Reg. § 1.704-1(b)(3) is just one example of how the law of distributive shares has been dominated by efforts to curb abuse, rather than focused on the simpler but nevertheless critical tasks of performing straightforward allocations in non-tax-driven deals. The SEE regulation is designed to ensure economic outcomes are reasonable in the face of tax-driven allocations of income and loss, not necessarily to ensure tax outcomes are correct in the face of economic-driven allocations of income and loss. The former has been the predominant focus of Congress, the IRS and the courts since 1913, while the latter has been the source of relatively little controversy (and there does not seem to be a reason to take drastic measures as if there were).

What follows are three suggestions for better articulating the status quo in Treas. Reg. § 1.704-1, accompanied by suggested regulatory language in Appendix I. However, before hazarding to make such suggestions, it is important to address briefly the central tension to the application of section 704(b) – the conflict between flexibility and substance – as these principles wholly inform the attempted articulation of the status quo below.

## **Flexibility and Substance**

As a practitioner, the day-to-day importance of the partnership form is hard to overstate—it is a first-order tool for the novel transaction, and typically the default form of organization for the ordinary course arrangement. There are myriad reasons for this, the principal perhaps being the absence of any reasonably suitable alternative – whether because of entity level tax under subchapter C, the comparative lack of guidance for business organization under subchapter J, the unavailability (or just the potential costs or pitfalls) of organization under subchapter L, M or S, or the unsuitability of organization under subchapter T.

But there are other reasons beyond scarcity of choice that favor organization under subchapter K and that set it apart from other forms of tax organization that are best summed up in the watchword used, repeatedly, by both Congress, the Treasury and numerous commentators to describe subchapter K’s defining characteristic: flexibility.[[223]](#footnote-223) Comparative “flexibility” is found throughout subchapter K – for example, its incorporation, distribution, combination and liquidation provisions contain fewer restrictions than the corresponding mechanics in subchapter C, nor are there threshold membership or asset restrictions as under subchapters M or S. But the ability of the partners to determine, by agreement, their distributive shares of partnership income, gain, loss, deduction and credit is arguably the very “flexibility” that defines the partnership form.

Interestingly, there has been little attempt at a positive articulation for what is encompassed (if anything) by the term “flexibility.” The negative case, however, has been repeatedly; as Arthur Willis observed as early as 1957: “Wherever an attempt is made by statute to permit flexibility in tax consequences, the possibility arises for tax avoidance through unintended uses of the statutory pliancy.”[[224]](#footnote-224) Treas. Reg. § 1.701-2 begins with an acknowledgement of the “intent” of subchapter K to accommodate “a flexible economic arrangement,” and then sets about attempting to provide strictures on how much flexibility subchapter K in fact permits.

Perhaps the firmest positive articulations of “flexibility” is in the anti-abuse regulation of Treas. Reg. § 1.701-2(b), where Treasury and the IRS acknowledged that “certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income.” In setting forth the standard that would become the “partner’s interest in the partnership,” the Tax Section of the American Bar Association said something similar when it described its standard of determining distributive shares as the “imperfect approach.”

What “imperfections” does the flexibility under section 704(b) permit, and just how “imperfect” can the approach be? As a general observation, subchapter K generally permits imperfections in timing of income or loss,[[225]](#footnote-225) is more scrutinous of imperfections in character and source (especially where permanent),[[226]](#footnote-226) and abhors imperfections in determinations of the amount of income or loss.[[227]](#footnote-227) Put differently, subchapter K’s unique tolerance for such imperfections could generally be read as placing a primacy on tax neutrality in the organization and operations of business ventures, at the cost of complete horizontal or vertical equity.[[228]](#footnote-228)

The critical question for this discussion, and most challenging, is the extent to which subchapter K’s policy of flexibility (and tolerance for imperfection) extends to section 704(b). Explicit nonrecognition provisions such as section 721 (and, to perhaps a lesser extent, section 731) carry the weight of express Congressional acquiescence to imperfection. But this is arguably more semantic than substantive, as section 704(b) squarely permits rearrangements among partners that are tantamount to transactions upon which “nonrecognition” has been bestowed elsewhere by Congress.[[229]](#footnote-229)

To that end, under current law, there appears (to the author) to be three general principles governing PIP that are not expressly reflected in Treas. Reg. § 1.704-1(b)(3) or adequately shown as applying in Treas. Reg. § 1.704-1(b)(5) examples: that PIP is based on the parties’ reasonably expected pre-tax economic outcomes, that PIP generally assumes a consistent approach with respect to the relevant allocation, and that the arrangement be permissible under generally applicable tax principles.[[230]](#footnote-230)

## **Reasonable Possibilities**

Although it is not express in Treas. Reg. § 1.704-1(b)(3), PIP is based on the parties’ reasonable expectations. Deference (or adherence) to investors’ reasonable expectations is a cornerstone of the development of section 704(b),[[231]](#footnote-231) subchapter K,[[232]](#footnote-232) tax neutrality informing nonrecognition provisions in corresponding business tax provisions of the Code, and even the economic substance doctrine itself.[[233]](#footnote-233)

Most notably, the substantiality rules in the SEE (a safe harbor) are expressly built upon “reasonable possibilities” in Treas. Reg. § 1.704-1(b)(2)(iii). Under the general substantiality rule, the economic effect of an allocation (or allocations) is substantial if there is a “*reasonable possibility*” that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. Certainly no higher bar applies under PIP.

Moreover, “reasonable possibilities” can differ. Different reasonably expected possibilities can result from the same facts and circumstances: reasonable determinations under PIP can differ from outcomes under SEE, and reasonable determinations under PIP by one taxpayer can differ from reasonable determinations under PIP by another taxpayer on the same facts. This is implicit throughout Treas. Reg. § 1.704-1(b), but should be made explicit. For example, Treas. Reg. § 1.704-1(b)(3)(i) explains how its rules may apply in a manner different from the result mandated by SEE:

[A] partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in a particular item of income or deduction. (For example, in the case of an unexpected downward adjustment to the capital account of a partner who does not have a deficit make-up obligation that causes such partner to have a negative capital account, it may be necessary to allocate a disproportionate amount of gross income of the partnership to such partner for such year so as to bring that partner’s capital account back up to zero.)[[234]](#footnote-234)

In *Vecchio v. Commissioner*, the Tax Court observed that this example would apply to any downward adjustment (including one that was “intentional”), and not just a downward adjustment that was “unexpected.”[[235]](#footnote-235) The parenthetical example is notable because it contemplates a result that would differ from the result contemplated by Treas. Reg. § 1.704-1(b)(1)(i), which provides:

To the extent an allocation under the partnership agreement of income, gain, loss, deduction, or credit (or item thereof) to a partner does not have substantial economic effect, is not in accordance with the partner’s interest in the partnership, and is not deemed to be in accordance with the partner’s interest in the partnership, such income, gain, loss, deduction, or credit (or item thereof) will be reallocated in accordance with the partner’s interest in the partnership (determined under [Treas. Reg. § 1.704-1(b)(3)]).

In the parenthetical example in Treas. Reg. § 1.704-1(b)(3)(i), the allocation of the item of deduction would fail to satisfy SEE, to the extent it caused the partner to have a negative capital account in excess of its deficit make-up obligation.[[236]](#footnote-236) However, Treas. Reg. § 1.704-1(b)(3)(ii) does not necessarily require such item of deduction to be “reallocated” (because, notwithstanding that the allocation fails to meet the requirements of SEE, it apparently satisfies PIP), but rather notes that it “may be necessary” to instead make an allocation of “gross income” to such partner to bring that partner’s capital account back up to zero.[[237]](#footnote-237)

Moreover, by the words of section 704(b), determining PIP requires making a determination “taking into account all facts and circumstances,” and arguably implicit in any such “facts and circumstances”-based determination is the potential that such “facts and circumstances” would be interpreted differently by different parties to reach potentially different conclusions.

## **Consistency**

Just as the substantiality rules in SEE rely on reasonably expected possibilities (and only recharacterize transactions with a “strong likelihood” of prohibited outcomes), so too are the substantiality rules in the SEE regulations based on a principle of consistency.[[238]](#footnote-238) The substantiality tests are generally measured as of the time the allocation becomes part of the partnership agreement (and are initially applied on a forward-looking basis assuming the partnership agreement as drafted will govern); a modification in an allocation would typically require a re-examination of its substantiality.

Similar principles would seem implicit to determinations under PIP: Reasonable expectations should be permitted deference to the extent consistently adhered to; by contrast, changes in reasonable expectations that actually affect methods for making determinations under section 704(b) would be open to re-determination as to their compliance with PIP.

## **Generally Applicable Tax Principles**

Allocations under PIP are governed by generally applicable tax principles; this is already broadly restated in Treas. Reg. § 1.704-1(b)(1)(iii), but the application of the economic substance doctrine to PIP is worth particular attention because of its convergent evolution alongside section 704(b). Moreover, in applying such generally applicable tax principles, it should be clear that, while principles common to SEE and PIP would be fairly applicable under PIP, principles unique to SEE (including stricter features of the SEE safe harbor) are not directly relevant to PIP.

### **PIP and Economic Substance**

As discussed above, section 704(b) has a complex historic relationship with the economic substance doctrine; to summarize:

* pre-1954 courts performed economic effect-like analysis in determining the validity of allocations (of special allocations of net losses and income chargebacks);
* 1954 legislative history emphasized the importance of “substantial economic effect” to section 704(b) “item” allocations before the “economic substance doctrine” went by that name;[[239]](#footnote-239)
* in response to the ALI raising numerous planning possibilities under section 704(b) (1954) that would likely offend what is now known as the “economic substance” doctrine, the 1956 regulations included “overall tax consequences” as a factor in determining whether item allocations had a principal purpose of avoidance (a factor generally ignored by contemporary commentators);
* after *Kresser* (and language in *Orrisch*) raised concerns about non-economic allocations under section 704(a), Congress amended section 704(b) to subject bottom-line allocations to an economic reality requirement, with the Joint Committee noting that the 1956 factors would continue to be relevant to post-1976 allocations;
* in post-1976 cases, courts applied *Gregory* and *Knetsch* to section 704(a) (1954) cases to disallow non-economic allocations; and
* in formulating the current SEE regulations, the IRS initially proposed (in 1983) a weighing test like that reflected in *Goldstein* and current section 7701(o)(2), before opting for a more safe harbor-like objective approach.

There is no controversy to the idea that PIP determinations are bound by economic realities at the partnership level; it’s stated in Treas. Reg. § 1.704-1(b)(3). More uncertain is to what degree partner-level tax consequences are taken into account in PIP. Treas. Reg. § 1.704-1(b)(3) is silent, as is section 704(b)(2) (and, arguably, its legislative history).[[240]](#footnote-240)

However, the question under PIP is generally not whether the partner-level consequences are taken into account in an economic substance-like analysis, but when and how. The question of when it applies is, in one sense, academic: As crafted by the courts, the economic substance doctrine generally applies to disallow the benefit of a transaction to which the operative law has already been applied (and so PIP would apply first, then the doctrine).[[241]](#footnote-241) By contrast, if consistent with the 1976 Joint Committee report, the 1956 factors continue to apply under PIP, a version of the doctrine arguably embedded in the factors (“overall tax consequences,” or other factors from the wellspring of the 1956 ALI report) may apply to the determination of PIP itself. Moreover, if applicable, the 1956 factors may express unique features of the doctrine that could supplement the usual operation of section 7701(o). More vexing is when the economic substance doctrine (or the version developed under section 704) is “relevant” to a PIP determination – a threshold question under section 7701(o) that should preclude its application to ordinary course commercial transactions and may prevent a complete marriage of the section 7701(o) analysis and determinations of economic reality under PIP.

Where relevant, the economic substance doctrine itself would generally require, for example, that the “allocation” (or more precisely, the “distribution” or “expenditure,” where in fact controlling the allocation) “changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position” and that “the taxpayer has a substantial purpose (apart from Federal income tax effects)” for the allocations (or the distribution or expenditure, as applicable). Although the words of section 7701(o) are laden with their own history (which developed within and without subchapter K), their literal terms are quite similar to certain of the 1956 factors and section 704(a) (1954) caselaw analysis and in reading them side-by-side one can see the two threads potentially converging.

### **PIP and SEE “Substantiality”**

Another question that arises under PIP is whether (and if so, to what degree) analysis of economic reality under PIP is affected by the regulatory economic effect and substantiality tests of Treas. Reg. § 1.704-1(b)(2).

Here, again, the uncertain relationship between SEE and PIP reasserts itself. Although not explicitly equated in the Code or the Treasury regulations, SEE and PIP are closely linked and in many (if not most) instances would produce the same result; however, this is not necessarily assured, and there are noted instances where SEE is unable to apply or the two regimes diverge.[[242]](#footnote-242) Treas. Reg. § 1.704-1(b)(1)(i) frames SEE and PIP as one of three “ways” an allocation will be respected.[[243]](#footnote-243) That said, there are common principles in SEE and PIP regimes that can be derived from certain clearly overlapping rules that are worth noting.

First, explicit in PIP is an emphasis on the tax consequences corresponding to the “economic benefits or burden” of the tested income or loss. The rule effectively mirrors the “economic effect” test of Treas. Reg. § 1.704-1(b)(2)(ii), which defines consistency with the “underlying economic arrangement” to mean “that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.”[[244]](#footnote-244) Several examples in Treas. Reg. § 1.704-1(b)(5) that are specifically cross-referenced by Treas. Reg. § 1.704-1(b)(3) reiterate the “economic benefit or burden” analysis, which is also implicitly reflected in the PIP factors relating to interests in economic profits and losses, cash flows and distributions.[[245]](#footnote-245)

Second, while not as explicitly analogous to PIP as the “economic effect” principles in Treas. Reg. § 1.704-1(b)(2)(ii), certain substantiality principles Treas. Reg. § 1.704-1(b)(2)(iii) that have their foundations in either the economic substance doctrine or in elements of the 1954 legislative history that may continue to inform PIP (as discussed above).[[246]](#footnote-246) Notably, the dollar-affect test of Treas. Reg. § 1.704-1(b)(2)(iii)(*a*) comes directly from, and the anti-shifting rule in Treas. Reg. § 1.704-1(b)(2)(iii)(*b*) has its origins in, the 1954 Senate report and 1956 regulations;[[247]](#footnote-247) if the 1956 regulatory factors have continuing relevance to determinations under PIP, so may these rules.[[248]](#footnote-248)

That said, while there exists a “basic symmetry” between the regimes,[[249]](#footnote-249) SEE and PIP do not, by their terms or their application, exactly overlap;[[250]](#footnote-250) in effect, SEE operates like a safe harbor (and, while not referred to as such in Treas. Reg. § 1.704-1, are colloquially referred to as such by tax writers in Congress, in commentary, major treatises and elsewhere in the Treasury regulations and in other IRS guidance).[[251]](#footnote-251) Approached as a safe harbor, the SEE “substantiality” standard is all but definitionally narrower than what is required under PIP and should not be applied to subject a PIP determination to greater scrutiny than would be applied under section 7701(o).

# Conclusion

This Article began by focusing on the curious status quo of the SEE and PIP rules as finalized in the 1985 version of Treas. Reg. §. 1.704-1. While the superficial comparison of the two regimes is amusing when considering their relative usefulness in everyday practice, any contrast is potentially misleading to the task of articulating the actual status quo in non-tax-driven commercial transactions today. For these deals, the true status quo has little to do with SEE; it’s based on PIP, and moreover, the day-to-day analysis performed today resembles what has probably been the relevant analysis since 1913.

Nevertheless, the prevalence of a few unaddressed questions that arise in routine application of Treas. Reg. § 1.704-1(b)(3), coupled with pressures from forthcoming audit campaigns and super-charged assessment procedures, would seem to invite revisiting Treas. Reg. § 1.704-1 to give taxpayers and examiners a more complete picture of the governing law. Appendix I includes a few suggestions.

APPENDIX I: Suggested Updates to Treas. Reg. § 1.704-1

To come.

APPENDIX II: Historic Statutory Language[[252]](#footnote-252)

The Revenue Act of 1913, Section II, Subdivision D stated:

Persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of the partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid under the provisions of this section.[[253]](#footnote-253)

Section 218(a) of the Revenue Act of 1918 stated:

There shall be included in the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year…..[[254]](#footnote-254)

Section 182 of the 1939 code stated:

In computing the net income of each partner, he shall include, whether or not distribution is made to him:

(a) As a part of his short-term capital gains or losses, his distributive share of the net short-term capital gain or loss of the partnership.

(b) As a part of his long-term capital gains or losses, his distributive share of the net long-term capital gain or loss of the partnership.

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b) [of the 1939 code].

Section 704(a)-(b) of the 1954 code stated:

(a) Effect of partnership agreement. A partner’s distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

(b) Distributive share determined by income or loss ratio. A partner’s distributive share of any item of income, gain, loss, deduction, or credit shall be determined in accordance with his distributive share of taxable income or loss of the partnership, as described in section 702(a)(9) [of the 1954 code], for the taxable year, if—

(1) the partnership agreement does not provide as to the partner’s distributive share of such item, or

(2) the principal purpose of any provision in the partnership agreement with respect to the partner’s distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle.

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1. NTD: Citations incomplete; as noted, a portion of the 1985 discussion remains subject to ongoing FOIA efforts. [↑](#footnote-ref-1)
2. References to the “Code” are to the Internal Revenue Code of 1986, as amended, “subchapter” references are to subchapter of chapter 1 of the Code (unless otherwise indicated), and “section” references to sections of the Code. Predecessors to the Code are generally referred as a “code” (e.g., the Internal Revenue Code of 1954 is referred to as the “1954 code” and the Internal Revenue Code of 1939 is referred to as the “1939 code”). References to the “Service” or the “IRS” are to the U.S. Internal Revenue Service (and include the Bureau of Internal Revenue for years before 1953), and references to the “Treasury” are to the U.S. Department of the Treasury. [↑](#footnote-ref-2)
3. See Appendix II; *see infra* notes [\_] (discussing pre-1954 changes to allocation rules relating to contributed property and partnership interests received by gifts). [↑](#footnote-ref-3)
4. J. Paul Jackson, Mark H. Johnson, Stanley S. Surrey & William C. Warren, *A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners—American Law Institute Draft*, 9 Tax L. Rev. 109 , 114 (1954) (hereinafter ALI January 1954 Report). [↑](#footnote-ref-4)
5. Article 322, Regulations 45, 1918 Act; Article [\_], Regulations 62, 1921 Act; Article 336, Regulations 65, 1924 Act; Article 336, Regulations 69, 1926 Act; Article 902, Regulations 74, 1928 Act; Article [\_], Regulations 77, 1932 Act; Article [\_], Regulations 86, 1934 Act; Article [\_], Regulations 94, 1936 Act; Article [\_], Regulations [\_], 1937 Act; to come. [↑](#footnote-ref-5)
6. S. Rept. No. 1622 (1954), at 379. [↑](#footnote-ref-6)
7. See *infra* McKee, 1976 Act. [↑](#footnote-ref-7)
8. *See* Paul Little, Federal Income Taxation of Partnerships ¶¶ 3.6, n.11; 3.10 n. 7 and accompanying text (1952) (citing O.D. 140 for the proposition that “partners may not allocate income from a particular source to one or more more partners,” while observing that G.C.M. 17255 had in fact permitted just such an allocation but only where “strong reliance was placed on its particular facts”); McDonald, *infra* note 56, at 174 (suggesting there was “considerable doubt” before the enactment of the 1954 code whether or not each partner had to share pro rata in each typo of income or loss, deduction or credit, to which the partnership was entitled.”). NTD: Still searching for pre-1954 editions of Rabkin & Johnson treatise. [↑](#footnote-ref-8)
9. C.B. 1, 174 (1919); *see also* Ruprecht v. Comm’r, 16 B.T.A. 919 (1929) (holding partners to the terms of proportionate partnership allocations in their enforceable partnership agreement, notwithstanding a subsequent agreement to share profits from one property disproportionately). [↑](#footnote-ref-9)
10. Joseph P. Driscoll, *Tax Problems of Partnerships—Special Allocation of Specific Items*, 10 Major Tax Plan. 421 (1958). [↑](#footnote-ref-10)
11. G.C.M. 13771, C.B. XIII-2, 229 (1934), as modified by G.C.M. 17255, C.B. XV-2, 243 (1936) (implicitly respecting “salary” distribution to a non-U.S. partner disproportionately drawn from non-U.S. sources as a disproportionate allocation of such non-U.S. income to such non-U.S. partner). [↑](#footnote-ref-11)
12. Rev. Rul. 57-138, 1957-1 C.B. 543 (“The partnership agreement involved in O.D. 140 … apparently contained no provision regarding the division of various items of partnership income …. It follows, then, that O.D. 140 [] stands only for the proposition that in the absence of such an agreement, partnership income must be divided pro rata among the several partners.”). Rev. Rul. 57-138 was issued under the 1939 code and revoked Rev. Rul. 56-134, 1956-1 C.B. 649, issued the prior year, which had errantly interpreted O.D. 140 to preclude special allocations completely: “Different items of income of a single partnership cannot be divided differently between the partners depending upon the source any more than can various items of property held by the partnership be conceived as being held in different ratios or being owned in different ratios by different partners.” *See also* I.T. 3824, 1946-2 C.B. 37; O.D. 121, 1 C.B. 97 (1919) (permitting a partner’s WWI service income to be contributed to and become taxable income of the partnership, but with character determined at partnership, not partner, level); O.D. 648, 3 C.B. 125 (1920) (same); A.R.M. 25, 2 C.B. 104 (1920) (same); Donald McDonald, *Distributive Shares of Partnership Income and Loss*, 15 N.Y.U Inst. on Fed. Tax’n 41, 50 (1957). [↑](#footnote-ref-12)
13. Hellman v. United States, 44 F.2d 83 (Ct. Cl. 1930). [↑](#footnote-ref-13)
14. *Id.*; I.T. 1849, II-2 C.B. 6 (1923); s*ee also* Rev. Rul. 55-39, 1955-1 C.B. 403 (apparently resolving the question of a special allocation under the 1939 code before Rev. Rul. 57-138 by deeming the partnership assets to be held directly by the partners). [↑](#footnote-ref-14)
15. *Supra*. [↑](#footnote-ref-15)
16. 2 B.T.A. 1159 (1925). [↑](#footnote-ref-16)
17. 11 B.T.A. 729 (1928). [↑](#footnote-ref-17)
18. 19 B.T.A. 962 (1930); *see also* Lederer v. Parrish, 16 F.2d 928 (3d Cir. 1927). [↑](#footnote-ref-18)
19. 183 F.2d 7 (7th Cir. 1950). Prior to 1954, partnership losses in excess of a partner’s outside basis could be currently deducted. Rev. Rul. 57-203, 1957-1 C.B. 544 (“[U]nder the 1939 Code, a partner is required to report in his individual income tax return the full amount of his distributive share of the partnership loss, whether he makes good his share of such loss out of his pocket, by way of a charge against his partnership capital account or with borrowed funds which he is obligated to reply in a subsequent year.”). [↑](#footnote-ref-19)
20. Most notably, a partner able to treat a “salary” or “interest” as, in effect, a mere distribution of the partner’s distributive share of partnership income could entitle the recipient partner to preferential character treatment and (due to significant flexibility in determining (and re-determining) the taxable year of the partnership) to defer the recognition of “salary” income by one taxable year, while also allowing the partnership to avoid deduction limitations that might otherwise apply to salary or interest payments (e.g., capitalization). J. Rex Dibble, *Allocations of Partnership Profits and Losses*, 2 Maj. Tax Plan. 43 (1950); ALI January 1954 Report, *supra* note 4, at [\_] (discussing the 1954 effort to curtail these specific timing and character benefits in the case of guaranteed payments, while otherwise leaving the pre-1954 law in place). [↑](#footnote-ref-20)
21. Est. of Tilton v. Comm’r, 8 BTA 914 (1927) (salary and interest treated as distributions); Blake v. Comm’r, 9 BTA 651 (1927) (interest treated as distributive share); Brown v. Comm’r, 10 B.T.A. 1036 (1928); Pauli v. Comm’r, 11 BTA 784 (1928) (following *Tilton*); Lloyd v. Comm’r, 15 B.T.A. 82 (1929); Thompson v. Comm’r, 18 B.T.A. 1192 (1930); Finucane v. United States, 21 F.Supp. 122 (Ct. Cl. 1937) (interest on loan by partner to partnership treated as distributive share); G.C.M. 2467, VII-2 CB 188 (1928); GCM 6582, VIII-36 C.B. 7 (1929) (following *Lloyd*). [↑](#footnote-ref-21)
22. To introduce some key defined terms: The practice under section 704(b) today centers around the determination of a “partner’s interest in the partnership” under Treas. Reg. § 1.704-1(b)(3) (“PIP”), applied with one eye on the substantial economic effect safe harbor under Treas. Reg. § 1.704-1(b)(2) (“SEE”). [↑](#footnote-ref-22)
23. 8 B.T.A. 914 (1927). [↑](#footnote-ref-23)
24. Blake v. Comm’r, 9 B.T.A. 651 (1927) (interest treated as distributive share); see also Pauli v. Comm’r, 11 BTA 784 (1928). [↑](#footnote-ref-24)
25. E. E. Wakefield, *Taxable Income from Partnerships*, 8 Taxes 7 (1930). [↑](#footnote-ref-25)
26. Reg. 111, Sec. 29.183-1 (Dibble, at 2). These authorities were reiterated in 1934. G.C.M. 1418, 1939-2 C.B. 249. [↑](#footnote-ref-26)
27. 15 B.T.A. 82 (1929). (“The distributive share in the net income of a partnership which a partner is required to return includes not only his specific share fixed by the partnership agreement, which in these cases appears to be a proportional one based upon the capital contribution of each partner, but, also, any additional amount which the partner is entitled to take as compensation.”). [↑](#footnote-ref-27)
28. *Id.* The court used the partnership’s loss sharing ratios for allocating the amount of the excess of the “salary” payments over net income (before salaries) that was drawn from each partner’s capital. *See also* GCM 6582, VIII-36 C.B. 7 (1929) (following *Lloyd*); Schwartz v. Comm’r, 7 B.T.A. 223 (1927) (implicitly computing distributive shares in same manner as *Lloyd*); Wakefield, *supra* note 16 (discussing *Lloyd* and GCM 6582). The 1954 code reversed these cases for purposes of treating “guaranteed payments” as part of a partner’s distributive share in determining the character of the partner’s income; under section 707(c) of the 1954 code, all such payments are ordinary to the partner. *See* *infra* note [\_] (1954 House Report); J. Paul Jackson, Mark H. Johnson, Stanley S. Surrey & Carolyn K. Tenen, *The Internal Revenue Code of 1954: Partnerships*, 54 Colum. L. Rev. 1183, 1202 (1954) (hereinafter *1954 Code: Partnerships*); Rev. Rul. 69-180, 1969-1 C.B. 183; *see also, e.g.*, Miller v. Comm’r, 52 T.C. 752 (1969) (treating guaranteed payments as non-distributive share income for purposes of section 911); Chester M. Howe, *Computation of Partnership and Partner’s Income; Allocation of Special Items; Treatment of Losses; Elections and Credits; Techniques of Handling Tax Audit of Partnership*, 28 N.Y.U. Inst. on Fed. Tax’n 521, 530 (1970). [↑](#footnote-ref-28)
29. *See 1954 Code: Partnerships*, *supra* note 25, at 1204. [↑](#footnote-ref-29)
30. XI-1 C.B. 114 (1932), revoked by GCM 26379, 1950-1 C.B. 58 (1950). [↑](#footnote-ref-30)
31. The Service conflated capital contributions and capital accounts – determining that, in the case of a property contributed at a value in excess of basis, such contributed *property* (or the proceeds thereof) was, up to its value upon contribution, itself “distributable” to the contributing partner, notwithstanding the terms of the partnership agreement. [↑](#footnote-ref-31)
32. Archbald v. Comm’r, 27 B.T.A. 837 (1933), *aff’d*, Helvering v. Archbald, 70 F.2d 720 (2d Cir. 1934); Helvering v. Walbridge, 70 F2d 683 (2d Cir. 1934); Chisholm v. Comm’r, 79 F.2d 14 (2d Cir. 1935) ; Board. Planters Gin Co. v. Comm’r, 28 B.T.A. 22 (1933); Donner v. Comm’r, 32 B.T.A. 364 (1935); Eaton v. Comm’r, 37 B.T.A. 715 (1938); Flannery v. U.S., 25 F.Supp. 677 (D. Md. 1938). *See also* Valentine Brookes, *The Strange Nature of the Partnership under the Income Tax Law*, 5 Tax L. Rev. 35, 40-43 (1949) (recounting Congress’s attempt to reverse *Archbald* and *Walbridge* in the Revenue Act of 1942). [↑](#footnote-ref-32)
33. *See also* Charles W. Davis, *Partners and Partnerships: Determination of Tax Liability under the 1954 Code*, 32 Taxes 964, 969 (1954). [↑](#footnote-ref-33)
34. In 1984, Congress made the optional “ceiling” approach of the 1954 code mandatory. Tax Reform Act of 1984, § 71, P.L. 98-369. [↑](#footnote-ref-34)
35. Jackson et al, *1954 Code: Partnerships*, *supra* note 23, at 1205 (““Under these rules, the partners will have to consider upon formation of the partnership not only the consequences that may result during current operation from the sharing in basis of all contributed property, but also the compensating gains or loss that may be realized sometime in the distant future. The value of these potential gains and losses may often be difficult to assess, since tax rates may change and a capital losses might not be fully utilized.”); *see also* Am. Bar Ass’n Sec. of Tax’n, *Report of the Committee on Taxation of Partnerships* (1949), at 89-98. [↑](#footnote-ref-35)
36. The 1954 system (without the ceiling rule election) still applies today under subchapter S. [↑](#footnote-ref-36)
37. 327 U.S. 280 (1946). [↑](#footnote-ref-37)
38. *See, e.g.,* Canfield v. Comm’r, 168 F.2d 907 (6th Cir. 1948); Woosley v. Comm’r, 168 F.2d 330 (6th Cir. 1948). .James W. R. Brown, *The Partnership and Federal Income Taxes*, 31 Ne. L. Rev. 531, 535 n. 27 (1952) (“Prior to the Revenue Act of 1951, it was generally held that if a partnership was valid shares of profit provided in the partnership agreement could not be changed by the commissioner or the courts.”). The Revenue Act of 1951 included the predecessor to section 704(e). [↑](#footnote-ref-38)
39. *E.g.*, Loback v. Comm’r, T.C.M. P50098 (1950). [↑](#footnote-ref-39)
40. Dibble, *supra* note 15, at 43. [↑](#footnote-ref-40)
41. Arthur Willis, Handbook of Partnership Taxation 138-139 (1957) (hereinafter 1957 Handbook). [↑](#footnote-ref-41)
42. *1954 Code: Partnerships*, *supra* note 23, at 1187. [↑](#footnote-ref-42)
43. *See, e.g.*, Driscoll, *supra* note 7 (generally equating economic effect with capital account impact without discussing assumptions concerning relevance of partnership capital accounts). [↑](#footnote-ref-43)
44. The issue was not addressed in Johnson and Rabkin’s seminal 1942 article, nor was it discussed in any depth at the 1949 St. Louis ABA panel on partnerships, the 1951 NYU Institute panel on partnerships, or in the 1953 ALI Report, *infra* note 35. Jacob Rabkin & Mark H. Johnson, *The Partnership under the Federal Tax Laws*, 55 Harv. L. Rev. 909 (1942). *But see* Willis, 1957 Handbook, supra note [\_], at 137 (“Of all the provisions of the 1954 Code dealing with the taxation of partnership, none raises more fascinating intellectual problems than the one permitting special allocation of specific partnership items.”). [↑](#footnote-ref-44)
45. Mark P. Gergen, *The Story of Subchapter K: Mark H. Johnson’s Quest*, in Business Tax Stories 207 (2005); Surrey & Warren, *supra* note 2; ALI January 1954 Report, *supra* note 3. The 1954 report in particular warrants special attention because it played a critical role in the development of subchapter K of chapter 1 of the Internal Revenue Code of 1954. Gergen, *id.*, at [\_]. [↑](#footnote-ref-45)
46. ALI January 1954 Report, at 174. The report noted that this result was “probably” a proper interpretation of pre-1954 code law. *Id.* The report also observed: “This omission [of a definition of distributive share] has resulted in a great deal of confusion in cases where, for example, a partner is entitled to a guaranteed annual salary, or where distributions from the partners’ capital accounts are made to the partners.” *Id.* at 114. [↑](#footnote-ref-46)
47. ALI January 1954 Report, at 115. [↑](#footnote-ref-47)
48. *Id.* [↑](#footnote-ref-48)
49. *Id.* at 115-116. [↑](#footnote-ref-49)
50. *See* Driscoll, *supra* note 7, at 424 n.8 (1958) (observing that the ALI’s ignoring special allocations “was an excusable oversight in view of the complexity of the problem”). [↑](#footnote-ref-50)
51. February 1954 ALI – to come. [↑](#footnote-ref-51)
52. House Rep. No. 1137, at 66 (1954). [↑](#footnote-ref-52)
53. *Id.* at A223. [↑](#footnote-ref-53)
54. Letter of ABA & ALI, in Bernard D. Reams Jr., Internal Revenue Acts of the United States: The Revenue Act of 1954 with Legislative Histories and Congressional Documents 459, 477-478 (1954) (hereinafter 1954 ABA/ALI Letter). [↑](#footnote-ref-54)
55. *Id.* Congress demurred in 1954 but came around to the ABA/ALI view on both points in 1976. *See infra* note [\_]; *see also* Driscoll, *supra* note 36; *see also* Michael Boone, *Partnership Taxation: The Allocation of Specific Items of Income and Loss under 1954 Code*, 20 Sw. L.J. 840, 844 (1966) (“Realistically, in most situations, the partners will agree to a special allocation only if it results in some tax benefit.”); *but see* Joseph Gelband, *Allocations of Income and Deductions Among Partners*, 21 N.Y.U. Inst. on Fed. Tax’n 997, 1001-02 (1963) (discussing non-tax-driven reasons for making special allocations). [↑](#footnote-ref-55)
56. 1954 ABA/ALI Letter, *supra* note 38, at 478. [↑](#footnote-ref-56)
57. As with ABA and ALI’s first comment, this comment would also be adopted in 1976. *See infra* note [\_]. [↑](#footnote-ref-57)
58. *See also* *Driscoll*, *supra* note 7, at 425 (“It is nevertheless apparent that the report of the Finance Committee that the problems implicit in special allocations were carefully explored in the interim between the House and Senate action.”). [↑](#footnote-ref-58)
59. S. Rept. No. 1622, at 379 (1954). [↑](#footnote-ref-59)
60. 293 U.S. 465 (1935). *Knetsch v. United States* was not handed down until 1960. 364 U.S. 361 (1960). The “economic substance” label does not seem to have become shorthand until *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), although “substance” (as differentiated from “sham”) was articulated as the concern in *Est. of Franklin v. Comm’r*, 544 F.2d 1045 (9th Cir. 1976). *See also* Louis S. Freeman, *Interest, Contingent Interest and Original Issue Discount: Some Emerging Tax Strategies in Corporate and Real Estate Financings*, 59 Taxes 942, 955 n. 65 (1981) (observing the *Knetsch* “economic substance doctrine” being applied in *Est. of Franklin*). [↑](#footnote-ref-60)
61. The doctrine’s origins date to Learned Hand’s decision in *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934), *aff’d*, 293 U.S. 465 (1935); *see* Higgins v. Smith, 293 U.S. 473 (1940); *see also* Joseph Bankman, *The Economic Substance Doctrine*, S. Cal. L. Rev. (2000); Bittker; TMP. [↑](#footnote-ref-61)
62. Rabkin & Johnson, *supra* note 38, at 918 (emphasis added). [↑](#footnote-ref-62)
63. Jackson et al, *1954 Code: Partnerships*, *supra* note 23, at 1187 (“Nor is it clear from the statute whether the allocation of items for tax purposes must be in accord with the economic reality of the partnership agreement or whether the agreement as to the tax incidence of the various items may be at variance with the economic sharing of such items as long as tax avoidance is not the primary motive for the agreement.”); Sherwin Kamin, *Partnership Income and Loss Allocations before and after the Tax Reform Act of 1976*, 30 Tax Law. 667, 669-670 (1977). [↑](#footnote-ref-63)
64. *See* ALI Report. [↑](#footnote-ref-64)
65. T.D. 6175, 1956-1 C.B. 211. [↑](#footnote-ref-65)
66. Prop. Treas. Reg. 1.704-1(b)(2) Ex. 1 (1955). [↑](#footnote-ref-66)
67. Prop. Treas. Reg. 1.704-1(b)(2) Ex. 2 (1955). [↑](#footnote-ref-67)
68. Prop. Treas. Reg. 1.704-1(b)(2) Ex. 3 (1955). [↑](#footnote-ref-68)
69. 1956 ALI Draft, (Tent. Draft No. 11, April 24, 1956). [↑](#footnote-ref-69)
70. McDonald, *supra* note 58, at 177. [↑](#footnote-ref-70)
71. *Id.* at 184, 191 *See also infra* note [\_] (discussing contemporaneous developments in the “economic substance” doctrine). [↑](#footnote-ref-71)
72. *See also* McDonald, *supra* note 9, at 52. [↑](#footnote-ref-72)
73. 1956 ALI Draft, (Tent. Draft No. 11, April 24, 1956). [↑](#footnote-ref-73)
74. *Id.* at 187-188. [↑](#footnote-ref-74)
75. T.D. 6175 (May. 25, 1956). [↑](#footnote-ref-75)
76. Treas. Reg. § 1.704-1(b)(5) Ex. 1 (1956); see also 1956 ALI Report. [↑](#footnote-ref-76)
77. *Id.* Boone, *supra* note 51, at [\_]; Donald McDonald, *The Impact of the Partnership Agreement on Taxation under Subchapter K*, 16 Proc. Ann. Tul. Tax Inst. 354, 359 (1966). [↑](#footnote-ref-77)
78. T.D. 6175 (May. 25, 1956); *see generally* Kamin, *supra* note 57. [↑](#footnote-ref-78)
79. *See* Driscoll, *supra* note 7, at 444-45 (arguing that chargeback profit percentage was irrelevant to the analysis). The example was amended in 1964 to note that, prior to forming their partnership, each of G and F were sole proprietors engaged in the business in which their partnership was to be engaged. T.D. 6771 (1964). *See also* Giora Ben-Horin, *Real Estate Syndications, Limited Partnerships*, 24 Major Tax Plan. 71, 93-94 (1972). [↑](#footnote-ref-79)
80. McDonald, *supra* note 9, at 54. [↑](#footnote-ref-80)
81. Martin B. Cowan, *Partnership—Distributive Shares—Disallowance of Special Allocations*, BNA Tax Mgmt Portfolio 283 (1973), at A-5-6 (“Notwithstanding its relegation to apparent equality with a number of other non-conclusive factors in the regulations, virtually all of the commentators have concluded that the presence or absence of a ‘substantial economic effect’ remains the most important single factor in determining the validity of a special allocation under [section] 704(b)(2). Unless the alternate reading [of the ALI 1956 Draft] is correct, the examples in the 1954 Senate Report … indicate the presence or absence of this factor is virtually conclusive.”). [↑](#footnote-ref-81)
82. *See, e.g.*, J. Nelson Young, *Partners and Partnerships under the 1954 Code*, 1955 U. Ill. L. F. 533, 549 (1955); Davis, *supra* note 28, at 969; [↑](#footnote-ref-82)
83. *See, e.g.*, John B. Norberg, *Importance of Accounting Principles in Drafting Partnership Agreement*, 8 Major Tax Plan. 183, 184 (1956) (“Because the partners often have contributions or withdrawals not in correct ratio, this concept is unacceptable for accounting records under the 1954 Internal Revenue Code. Prior to 1954, these differences in contemplated financial relationships were primarily a business matter which could cause substantial misunderstanding between the partners. But now, these difference could have a tax significance.”); *see also* McDonald, *supra* note 57, at 179 (referring to charges to income accounts and capital accounts as connoting substantial economic effect). *But see, e.g.*, John R. Herzfeld, *How to Use the Partnership Form for “Tailor Made” Tax Results*, J Tax’n 58 (Jan. 1954) (providing detailed advice on allocating under the 1956 regulations with reference to capital accounts); Gilbert Dreyfuss, *Special Tax Allocations among Partners*, 45 L.A. B. Bull. 480

(1970) (same; interpreting example 5 of the 1956 regulations to support allocating expenses and losses in accordance with contributions funding such expenditures). [↑](#footnote-ref-83)
84. *Revised Report on Partners and Partnerships: Received by the Subcommittee on Internal Revenue Taxation from the Advisory Group on Subchapter K of the Internal Revenue Code of 1954*, 85th Cong., 2d Sess. (1957); Dale E. Anderson & Melvin A. Coffee, *Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K (First Installment)*, 15 Tax L. Rev. 285 (1960). [↑](#footnote-ref-84)
85. ABA Committee on Partnerships, *Recommendations*, 27 Tax Law. 811, 839 (1974) (hereinafter *Recommendations*). [↑](#footnote-ref-85)
86. S. Rep. No. 1616 (1960), at 99. [↑](#footnote-ref-86)
87. The 1956 regulations were amended once in this period, in 1964, to clarify an example. T.D. 6771, 1964-2 C.B. 177. [↑](#footnote-ref-87)
88. Howard M. Koff, *Partnerships and the Special Allocation: The Winds of Change*, 50 Taxes 5, 6 (1972). *But see* William S. McKee, The *Real Estate Tax Shelter: A Computerized Exposé*, 57 Va. L. Rev. 521 (1971) (hereinafter *Tax Shelter*); William S. McKee, *Partnership Allocations in Real Estate Ventures:* Crane, Kresser *and* Orrisch, 30 Tax L. Rev. 1 , 1 n.1 (1974) (hereinafter *Ventures*). [↑](#footnote-ref-88)
89. 1966-2 C.B. 246. [↑](#footnote-ref-89)
90. *Id.* [↑](#footnote-ref-90)
91. 1967-1 C.B. 188; *see also supra* note 8 and accompanying text. *But see* McKee ¶ 11.02[2][b][iii] n. 101 (suggesting such an allocation may be transitory under current law: “The validity of such an allocation scheme under current law apparently depends on the likelihood that the limitation will come into play; if there is a strong likelihood that it will not, an allocation of a percentage of partnership income limited to certain foreign-source income should not be treated as a valid allocation of foreign-source income.”). [↑](#footnote-ref-91)
92. 1968-1 C.B. 311. [↑](#footnote-ref-92)
93. 1976 JCT reports. [↑](#footnote-ref-93)
94. See supra Jackson et al, *1954: Partnerships*, at 1187; Kamin. [↑](#footnote-ref-94)
95. 54 T.C. 1621 (1970); *see also* Sellers v. Comm’r, 36 T.C.M. 305 (1977); Holladay v. Comm’r, 72 T.C. 571 (1979), *aff’d,* 649 F.2d 1176 (5th Cir. 1981). [↑](#footnote-ref-95)
96. *But see* *Ventures*, *supra* note 69, at 38 (noting the *Kresser* analysis “seems to smack of the substantial economic effect test” and noting that, in this era before current Treas. Reg. § 1.704-2, bottom-line allocations likely failed a non-statutory “substantial economic effect” test when they resulted in negative capital accounts that a partner had no obligation to restore under, e.g., *Gregory v. Commissioner*, 293 U.S. 465 (1935), and *Gilbert v. Commissioner*, 248 F.2d 399 (2d Cir. 1957)). [↑](#footnote-ref-96)
97. *Id.* (“We are faced with the petitioners’ troublesome argument that [section] 704(b)(2) applies only to ‘items' of income, etc., dealt with in pars. (1) through (8) of [section] 702(a) and does not govern par. (9) relating to the composite of all of the partnership’s income (sometimes referred to as its "ordinary income") which is here involved. The point is not without difficulty. Although there is general language in *Smith v. Commissioner*, 331 F. 2d 298, 301 (7th Cir. 1964), in accord with the Government’s argument, the structure of the statute itself and language in the legislative history would seem to give support to petitioners’ position. See S. Rept. No. 1622, 83d Cong., 2d Sess., p. 379. However, in view of our conclusion that there was not in fact a bona fide reallocation of income among the partners, we do not reach the question whether [section] 704(b)(2) is applicable to [section] 702(a)(9).”). In *Smith v. Commissioner*, 331 F.2d 298 (7th Cir. 1964), the taxpayer unsuccessfully challenged his partner’s oral amendment effecting a special bottom-line allocation of all the partnership’s losses (which the parties expected to be profit) to the other partner; the Service, in the position of defending the special allocation, successfully argue that it did not have tax avoidance as a principal purpose, notwithstanding that the deal among the parties was in effect the payment by the other partner of the taxpayer’s taxes (“your taxes”). *See also* Davis, *supra* note 28, at 968; Roland L. Basset, *Allocation of Income, Gain and Loss in Partnership Taxation*, 38 Tul. L. Rev. 104, 117-118 (1963). [↑](#footnote-ref-97)
98. 55 T.C. 395 (1970), *aff'd per curiam*, 31 A.F.T.R.2d 1069 (9th Cir. 1973). [↑](#footnote-ref-98)
99. *Id.* [↑](#footnote-ref-99)
100. *Id.* (emphasis added). *See also* Koff, *supra* note 58, at 7 (On the lessons of *Orrisch*: “[T]he partners’ capital accounts play a central role in ascertaining whether a special allocation of an item of deduction posses substantial economic effect.” (emphasis in original.)). [↑](#footnote-ref-100)
101. *Id.* [↑](#footnote-ref-101)
102. 61 T.C. 770 (1974) (“Petitioner received the cash proceeds of the sale; the loss allocated to him was applied to reduce his capital account, and his share of the related items of future profits, losses, and proceeds in case of liquidation was reduced proportionately. Such an economic impact sharply distinguishes the instant situation from that which obtained in [*Orrisch*], where, as far as the Court could determine, the depreciation allocation produced only a transitory “economic effect.’”). [↑](#footnote-ref-102)
103. *See, e.g.*, Boone, *supra* note 51, at 846; John A. McGuire, *Limited Partnerships: Steps That Can Be Taken to Overcome Problems in the Area*, 34 J. Tax’n 235, 237-38 (1971) (illustrating special allocations purportedly complying with the 1956 regulations by way of capital account reductions that (again, by assumption) affect liquidating distributions); Richard L. Bibart, *Partnership Taxation*, 40 U. Cin. L. Rev. 456, 473-476 (1971); Daniel S. Shapiro, *Tax Planning for Equity Financing by Real Estate Developers*, 50 Taxes 530 (1972); John A. McGuire, *When Will a Special Allocation Among Partners Be Recognized?*, 37 J. Tax’n 74 (1972); *Ventures*, *supra* note 69, at 36-45; Clay C. Long, *Tax Shelters in Real Estate Partnerships: An Analysis of Tax Hazards That Still Exist*, J. Tax’n 312, 315 (May 1972) (suggesting *Orrisch* may have passed muster if the deductions had properly been recorded in capital accounts, on the basis that the 1956 regulations required only that allocations “may” actually affect the dollar amount). [↑](#footnote-ref-103)
104. William S. McKee, William F. Nelson & Robert L. Whitmire, *The Tax Reform Act of 1976: Changes Affecting the Taxation of Partnerships and Partners*, 33 Tax L. Rev. 485, 499 (1978) (hereinafter 1976 Act) (“It seems reasonably safe to conclude that the 1976 amendments effected little significant change in the prior law with respect to special allocations of specific items.”). [↑](#footnote-ref-104)
105. *See Recommendation*s, *supra* note 76. [↑](#footnote-ref-105)
106. *Id.* at 849. [↑](#footnote-ref-106)
107. *Id.* [↑](#footnote-ref-107)
108. *Id.* [↑](#footnote-ref-108)
109. *Id.* [↑](#footnote-ref-109)
110. Joint Committee on Taxation, *Tax Shelters: Use of Limited Partners*, JCS 29-75 (Sept. 13, 1975), at 9. The 1974 ABA report noted that “tax shelter seminars” were routinely coaching taxpayers on how to achieve the intended result in *Orrisch* by the simple expedient of drafting their agreements using a untouchable bottom-line allocation of loss rather than an item allocation of depreciation. *See Recommendation*s, *supra* note 76, at 850. *See generally* Kamin, *supra* note 57; Cowan, *Substantial Economic Effect-The Outer Limits for Partnership Allocations*, 39 N.Y.U. Inst. on Fed Tax’n, 23.01 (1981). [↑](#footnote-ref-110)
111. H.R. Rep. 94-658 (1975), at 125-126. [↑](#footnote-ref-111)
112. *Id.* This particular refinement may have its origins in the 1957 version of Arthur Willis’s treatise. *See* 1957 Handbook, *supra* note 33, at 162 (suggesting adding a statutory business purpose requirement to special allocations). [↑](#footnote-ref-112)
113. *Id.* at 127. [↑](#footnote-ref-113)
114. *Id.* [↑](#footnote-ref-114)
115. *Id.* [↑](#footnote-ref-115)
116. S. Rep. 94-938 (1976), at 99-100; S. Rep. No. 94-1236 (1976) (Conf. Rep.), at 422 (describing Senate changes as “minor”). [↑](#footnote-ref-116)
117. *Id.* [↑](#footnote-ref-117)
118. *Id.* [↑](#footnote-ref-118)
119. *Id*. (emphasis added). [↑](#footnote-ref-119)
120. *Id.* [↑](#footnote-ref-120)
121. Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976 (Comm. Print 1976), at 95 n.6. [↑](#footnote-ref-121)
122. *Id*. at 94-95. [↑](#footnote-ref-122)
123. *1976 Act*, *supra* note 71, at 499 (“It seems reasonably safe to conclude that the 1976 amendments effected little significant change in the prior law with respect to special allocations of specific items.”); Donald J. Weidner, *Partnership Allocations and Tax Reform*, 5 Fla. St. U. L. Rev. 1 (1977) (“little, if any, change in the law”). [↑](#footnote-ref-123)
124. *See supra* note [\_]. [↑](#footnote-ref-124)
125. Magaziner v. Comm’r, T.C. Memo 1978-205; Hamilton v. United States (Ct. Cl. 1982); Allison v. Comm’r (Fed Cir. 1983); Goldfine v. Comm’r, 80 T.C. 843 (1980); Ogden v. Comm'r, 84 T.C. 871 (1985); Cowan, *supra* note 66, at A-3; see also infra note [\_] (noting effective date for 1985 final regulations) [↑](#footnote-ref-125)
126. Holladay v. Comm’r, 72 T.C. 571 (1979) , *aff’d*, 649 F.2d 1176 (5th Cir. 1981); Boynton v. Comm’r, 72 T.C. 1147 (1979), *aff’d*, 649 F.2d 1168 (5th Cir. 1981). [↑](#footnote-ref-126)
127. Kamin, *supra* note 57, at 687; *see also* William S. McKee, *Partnership Allocations: The Need for an Entity Approach*, 66 Va. L. Rev. 1039 (1980) (advocating capital account analysis for determining substantial economic effect). Kamin also was an early observer of the “immediate theoretical difficulty” with the new regime: “if the ‘partner’s interest in the partnership’ is to be interpreted to require a totally different allocation [than SEE], there would be the anomalous result that the allocation called for by section 704(b) would be not necessarily reflect each partner’s participation in the result of the taxable year’s activities.” *Id*. at 684. [↑](#footnote-ref-127)
128. *See, e.g.*, Donald J. Weidner, *Partnership Allocations and Capital Accounts Analysis*, 42 Ohio St. L.J. 467 (1981); Kelly J. Kirkland, *Drafting Special Allocation Provisions under Section 704(b) and (c)(2)*, 60 Taxes 203 (1982). [↑](#footnote-ref-128)
129. The 1979 ALI draft cites five secondary sources: the McKee and Willis treatises, McDonald’s 1967 article on the development of the 1956 regulations, McKee’s 1972 article on nonrecourse deductions, and Kamin’s 1977 article. [↑](#footnote-ref-129)
130. The draft proposed six principles; the papers omits principles addressing credits, percentage depletion, nonrecourse debt deductions, and section 704(c) items, which are beyond the scope of this discussion. The ALI published another draft in 1985 that substantially repeated the principles. 1985 ALI Draft. [↑](#footnote-ref-130)
131. 1979 ALI Draft, at 131-33 (cross-references to examples omitted). [↑](#footnote-ref-131)
132. *Id.* at 133-34 (cross-references to examples omitted). [↑](#footnote-ref-132)
133. 48 F.R. 9871 (March 9, 1983). [↑](#footnote-ref-133)
134. *See supra* note [\_]. [↑](#footnote-ref-134)
135. Prop. Treas. Reg. § 1.704-1(b)(2)(ii) (1983). [↑](#footnote-ref-135)
136. Donald J. Weidner and John W. Larson, *The Revised Uniform Partnership Act: The Reporters' Overview*, 49

Bus. Law. 1 (1993). The reporter was a tax scholar and author of several articles on capital account maintenance following the 1976 Act. [↑](#footnote-ref-136)
137. *Id.* [↑](#footnote-ref-137)
138. *Id.* In the 1983 regulatory formulation of PIP, if that economic arrangement could be determined, each partner’s interest in the partnership would be presumed to be equal (in reliance on the 19114 Uniform Partnership Act), which could be rebutted by facts and circumstances which show that the economic arrangement is otherwise.This presumption was removed in 2008. T.D. 9398 (May 19, 2008) (“[B]ecause the per capita presumption failed to consider factors relevant to a determination of the manner in which the partners agreed to share the economic benefits or burdens corresponding to the allocation of partnership items, the correct result was reached in very few cases. Accordingly, the Treasury Department and IRS believe that any benefits of the presumption are outweighed by the potential for incorrect determinations.”). *See also* Barron v. Comm’r, T.C. Memo 1992-598; Holdner v. Comm’r, T.C. Memo 2010-175, *aff’d*, 483 F. App’x 383 (9th Cir. 2012); Ballantyne v. Comm’r, T.C. Memo 2002-160. [↑](#footnote-ref-138)
139. *Id.* [↑](#footnote-ref-139)
140. *Id.* [↑](#footnote-ref-140)
141. *Id.* The 1983 regulations also recited the factors from the 1956 regulations as “additional factors” in weighing the likelihood and magnitude of a shift in the economic consequences against the shifting of tax consequences, although these were dropped in the final 1985 regulations. (“whether the partnership or a partner individually has a non-tax business purpose for the allocation; whether related items of income, gain, loss, deduction, and credit from the same source are subject to the same allocation; whether the allocation was made without recognition of normal business factors; whether the allocation was made only after the amount thereof could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocation.”). [↑](#footnote-ref-141)
142. *See generally* Gregory J. Marich, *Substantial Economic Effect and the Value Equals Basis Conundrum*,

42 Tax L. Rev. 509 (1987). [↑](#footnote-ref-142)
143. Prop. Treas. Reg. § 1.704-1(b)(5) Exs. 5, 6, 7(ii) (1983). [↑](#footnote-ref-143)
144. *See supra* note [\_]. [↑](#footnote-ref-144)
145. Prop. Treas. Reg. § 1.704-1(b)(5) Ex. 1 (1955). [↑](#footnote-ref-145)
146. Treas. Reg. § 1.704-1(b)(5) Ex. 1 (1956). [↑](#footnote-ref-146)
147. Prop. Treas. Reg. § 1.704-1(b)(5) Ex. 6 (1983). [↑](#footnote-ref-147)
148. *See supra* note [\_]. [↑](#footnote-ref-148)
149. Prop. Treas. Reg. § 1.704-1(b)(5) Ex. 3 (1955). [↑](#footnote-ref-149)
150. *Id.* [↑](#footnote-ref-150)
151. *See supra* note [\_]. [↑](#footnote-ref-151)
152. Treas. Reg. § 1.704-1(b)(5) Ex. 3 (1956). Although not expressed, the allocation in the revised 1956 example raised the issue of whether the bonds and stock were even partnership assets. *See* Rev. Rul. 55-39, 1955-1 C.B. 403. [↑](#footnote-ref-152)
153. *Id.* [↑](#footnote-ref-153)
154. Prop. Treas. Reg. § 1.704-1(b)(5) Ex. 7(i) (1983). The percentage split was presumably added to side-step the question of whether Rev. Rul. 55-39, 1955-1 C.B. 403, applied to determine the outcome. [↑](#footnote-ref-154)
155. *Id.* [↑](#footnote-ref-155)
156. *Id.* [↑](#footnote-ref-156)
157. *See supra* note [\_]. [↑](#footnote-ref-157)
158. *See* *supra* note [\_]. [↑](#footnote-ref-158)
159. In two of the PIP examples in Treas. Reg. § 1.704-1(b)(5) (Examples 8 and 19(iii)), however, PIP is determined in part by reference to “other allocations” (although in each case, the conclusion is more likely driven by equal sharing of liquidating distributions in the facts of the example). *See also* Treas. Reg. § 1.704-2(e)(2) (requiring nonrecourse deductions be “reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities”); Treas. Reg. § 1.46-3(f)(2) (in the absence of special allocations, requiring the allocation of investment tax credits be “determined in accordance with the ratio in which the partners divide the general profits of the partnership”). In cases involving a missing or disputed partnership agreement (both before and after the enactment of the PIP rule), courts have made a determination of the overall arrangement among the parties in determining PIP (or otherwise determining allocations). *See*, *e.g.*, Mammoth Lakes Project v. Comm’r, 61 T.C. 1630 (1991); Reed v. Comm’r, T.C. Memo 1978-58; Brooks v. Comm’r, T.C. Memo 1995-400; Shumaker v. Comm’r, T.C. Memo 1985-582; McDonald v. Comm’r, T.C. Memo 1996-87; Renkenmeyer, Campbell & Weaver, LLP v. Comm’r, 136 T.C. 137 (2011); Phipps v. United States, 414 F.2d 1366 (Ct. Cl. 1969); IRS Field Serv. Adv. 200108003 (Oct. 24, 2000); *see also* Stephen Utz, *Allocation and Reallocation in Accordance with the Partners’ Interest in the Partnership*, 56 Tax Law. 357 (2003) (proposing Treas. Reg. § 1.704-1(b)(3) be modified to set forth a separate rule for such “missing agreement” cases). [↑](#footnote-ref-159)
160. *Id.* [↑](#footnote-ref-160)
161. *See supra* note [\_]. [↑](#footnote-ref-161)
162. Prop. Treas. Reg. § 1.704-1(b)(3) (1983). [↑](#footnote-ref-162)
163. Treas. Reg. § 1.704-1(b)(5) Exs. 1, 4, 5, 6, 7, 8, 10, 16 and 19(iii). [↑](#footnote-ref-163)
164. T.D. 8065 (Dec. 31, 1985). [↑](#footnote-ref-164)
165. *Id.* [↑](#footnote-ref-165)
166. Treas. Reg. § 1.704-1(b)(2)(iii)(*a*). [↑](#footnote-ref-166)
167. Treas. Reg. § 1.704-1(b)(2)(iii)(*b*)-(c). The value equals basis presumption was added to the transitory temporal shifting rule, as was a presumption that allocations were not temporally transitory if at the time the allocations became part of the partnership agreement, there was a strong likelihood that the offsetting allocations would not, in large part, be made within five years after the original allocations is made (determined on a first-in, first-out basis). *Id.* [↑](#footnote-ref-167)
168. Former Example 1 (Example 6) was generally unaffected by the new substantiality rules, but was updated to reflect application of the new PIP reallocation rule in Treas. Reg. § 1.704-1(b)(3)(iii). Treas. Reg. § 1.704-1(b)(5) Ex. 6. [↑](#footnote-ref-168)
169. Treas. Reg. § 1.704-1(b)(5) Ex. 7. [↑](#footnote-ref-169)
170. *Id.* [↑](#footnote-ref-170)
171. Treas. Reg. § 1.704-1(b)(3)(iii); *see also* Marich, *supra* note 125 (reasoning the rule’s function was to operate as a backstop for the alternate economic effect test). [↑](#footnote-ref-171)
172. T.D. 9398 (May 19, 2008) (applying the partner-level substantiality tests on a look-through basis for passthrough entity partners); *see also supra* note 122 (discussing the removal of the *per capita* presumption); T.D. 9607 (Dec. 28, 2012) (eliminating *de minimis* rule for testing substantiality of partnership allocations) [↑](#footnote-ref-172)
173. *Cf.* Rev. Proc. 2007-65, 2007-2 C.B. 967 (section 704(b) safe harbor for flip partnership allocations of section 45 wind credits); Rev. Proc. 2014-12, 2014-3 I.R.B. 415 (section 704(b) safe harbor for flip partnership allocations of section 47 credits); Rev. Proc. 2020-12, 2020-11 I.R.B. (section 704(b) safe harbor for flip partnership allocations of section 45Q credits). [↑](#footnote-ref-173)
174. McKee ¶ 11.02[2][b][i]. [↑](#footnote-ref-174)
175. 1999-4 C.B. 506. See also Priv. Ltr. Rul. 9540034 (July 5, 1995); Priv. Ltr. Rul. 9207027 (Nov. 19, 1991); FSA 1998-330; FSA 200133003 (Mar. 9, 2001); FSA 200137059 (Mar. 9, 2001). [↑](#footnote-ref-175)
176. *See, e.g.*, Clark Raymond & Co., PLLC v. Comm’r, T.C. Memo. 2022-105 [↑](#footnote-ref-176)
177. One practitioner surveying the case law in 2007 tallied eleven different methods that courts had ostensibly used to determine PIP. Paul Carman, *In Search of Partner’s Interest in the Partnership: The Alternative of Substantial Economic Effect*, J. of Tax’n (Oct. 2007). *See also* Rev. Rul. 92-97, 1992-2 C.B. 124 (allocation of cancellation of debt income that lacks SEE reallocated in accordance with partners’ share of the decrease in the discharged liabilities). [↑](#footnote-ref-177)
178. 103 T.C. 170 (1994). [↑](#footnote-ref-178)
179. *Id. See also* Goldfine v. Comm’r, 80 T.C. 843 (1983) (in a case for a pre-PIP taxable year, disregarding a special allocation of depreciation); Miller v. Comm’r, T.C. Memo 1984-336 (reallocating special allocation of loss not reflected in capital accounts). [↑](#footnote-ref-179)
180. Although not explicit, the facts indicate that the assets in *Vecchio* were generating rent or other operating income; while prior years were apparently not at issue, the court nevertheless gave no indication that either the losses giving rise to the unenforceable negative capital account deficit needed to be reallocated or that an allocation of gross items of operating income (as under Treas. Reg. § 1.704-1(b)(2)(ii)(d)(*3*)) would have been required under PIP. *But* *see* Utz, *supra* note 12, at 378 (criticizing the *Vecchio* court for failing to faithfully apply Treas. Reg. § 1.704-1(b)(3); *see also* Walter D. Schwidetzky, *In Defense of the PIP Regulations*, 72 Tax Law. 519, 537 (2019) (noting “the court's approach was ... wrong by effectively allowing prior years’ allocations to stand when those allocations did not have substantial economic effect.”). [↑](#footnote-ref-180)
181. T.C. Memo 2001-37. [↑](#footnote-ref-181)
182. *Id.* [↑](#footnote-ref-182)
183. *See* Utz, *supra* note 12, at 375 (calling the *Tobias* decision “erroneous” for failure to follow the allocation of the state court during the pre-liquidation years). [↑](#footnote-ref-183)
184. T.C. Memo 1993-335 (noting that the partners also did not have an obligation to restore positive capital account balance and that the allocation would also have failed the equivalence test under Treas. Reg. § 1.704-1(b)(2)(ii)(*i*)). [↑](#footnote-ref-184)
185. *Id.*; *see also* Harrell v. Comm’r, T.C. Memo 1978-211 (allocating in accordance with capital contributions); IRS Field Serv. Adv. 200131013 (Aug. 3, 2001) (basing PIP on relative capital contributions); *but see* Hogan, T.C. Memo 1990-295 (basing PIP on overall interests and declining to rely solely on relative capital contributions); TIFD III-E Inc. v. United States, 342 F. Supp. 2d 94 (D. Conn. 2004) (rejecting PIP based on relative capital contributions). [↑](#footnote-ref-185)
186. 342 F. Supp. 2d 94 (D. Conn. 2004) (noting “[c]ontribution of capital to the partnership is one factor that may be considered, but it has little weight in this case when balanced against the other factors.”), *rev’d on other grounds*, 459 F.3d 220 (2d. Cir. 2006) (commonly referred to as the “Castle Harbour” cases). [↑](#footnote-ref-186)
187. Thomas W. Henning & William M. Ruddy, *Partnership Allocations—Drafting the Partnership Agreement to Meet the Safe Harbor and Fit the Economic Deal*, 41 Maj. Tax Planning ¶ 2205.1 (1989) (an early entry in the genre of careful practitioners noting that “safe harbor” agreements were commercially unworkable). Anecdotally, by the time the author was in law school, educators were teaching that drafting “safe harbor”-compliant partnership agreements was effectively impossible. [↑](#footnote-ref-187)
188. Lawrence Lokken, *Partnership Allocations*, 41 Tax L. Rev. 545, 613 (1986); Marich, *supra* note 126; James H. Boyd et al., *Despite Regulations, The Test for Substantially in Allocations is Difficult to Apply*, 7 J. Partnership Tax’n 36 (1990); Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 Tax L. Rev. 1 (1990); Curtis J. Berger, *W(h)ither Partnership Taxation*, 47 Tax L. Rev. 105 (1991); Barksdale Hortenstine & Gregory J. Marich, *An Analysis of the Rules Governing Partnership Allocations: Sections 704(b), 704(c), and 752*, Practicing Law Institute (1994); Edward J. Buchholz, *Substantiality under Section 704(b) - Some Forgotten Issues and Some Ancient Concepts Revisited*, 19 Va. Tax Rev. 165 (1999); Richard M. Leder, *Tax-Driven Partnership Allocations with Economic Effect: The Overall After-Tax Present Value Test for Substantiality and other Considerations*, 54 Tax Law. 753 (2001); Philip F. Postlewaite, *I Come to Bury Subchapter K, not to Praise It*, 54 Tax Law. 451 (2001); Jason Francl, *LTR 200440009 Underscores Need for Guidance under Substantiality Test*, 4 J. Tax’n Global Transactions 73 (2005); Thomas W. Henning, *Partnership Exit Strategies and the Failure of the Substantiality Test*, 63 Tax Law. 43 (2011); Gregg D. Polsky, *Deterring Tax-Driven Partnership Allocations*, 64 Tax Law. 97 (2010); Andrea Monroe, *Too Big to Fail:* *The Problem of Partnership Allocations*, 30 Va. Tax Rev.. 465 (2011). [↑](#footnote-ref-188)
189. Thomas C. Lenz, *Using the Targeted Capital Account Approach to Allocate Income and Loss—Is it Better than the Traditional Layered Approach?*, J. Passthrough Entities, March–April 2002; Brian J. O’Connor & Steven R. Schneider, *Capital-Account-Based Liquidations: Gone With the Wind, or Here to Stay?*, 102 J. Tax’n 21 (2005); Darryll K. Jones, Towards Equity and Efficiency in Partnership Allocations, 25 Va. Tax. Rev. 1047 (2006); Terence F. Cuff, *Working With Target Allocations--Idiot-Proof or Drafting for Idiots?*, J. Real Estate Tax’n (2008); Terence F. Cuff, Working With Target Allocations--Drafting in Wonderland, J. Real Estate Tax’n (2008); Terence F. Cuff*, Several Thoughts on Drafting Target Allocation Provisions*, Taxes, (March 2009); Todd D. Golub, *Target Allocations: The Swiss Army Knife of Drafting (Good for Most Situations—but Don’t Bet Your Life on it)*, Taxes (March 2009); N.Y. State Bar Ass’n, *Report on Partnership Target Allocations* (Sept. 23, 2010); James Brown, *Anticipatory Allocation*s, Tax Forum (2015); Daniel S. Goldberg, *The Target Method for Partnership Special Allocations and Why It Should Be Safe-Harbored*, 69 Tax. Law. 663 (2016); James R. Hamill, *The Uncertainty of Targeted Partnership Allocations: The View From Below*, Taxes (Jan. 12, 2021). [↑](#footnote-ref-189)
190. Stephen Utz, *Allocation and Reallocation in Accordance with the Partners' Interests in the Partnership*, 56 Tax Law. 357 (2003); Paul Carman, *In Search of Partner's Interest in the Partnership: The Alternative of Substantial Economic Effect*, J. Tax’n (Oct. 2007); Simon Friedman, *Some Thoughts on Partners’ Interests in Partnerships*, Tax Notes (2009); Bradley T. Borden, *The Allure and Illusion of Partners' Interests in a Partnership*, 79 U. Cin. L. Rev. 1077 (2011); Walter D. Schwidetzky, *In Defense of the PIP Regulations*, 72 Tax Law. 519 (2019). [↑](#footnote-ref-190)
191. Susan Pace Hammill, *The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure*, in Business Tax Stories 295, 296 (2005); Rev. Rul. 88-76, 1988-2 C.B. 360. [↑](#footnote-ref-191)
192. Hammill, *supra* note 173, at 302-308. [↑](#footnote-ref-192)
193. *Id.* at 302 [↑](#footnote-ref-193)
194. *See, e.g.*, Florida Law Symposium; George K. Yin & David J. Shakow, Am. Law Inst. Federal Income Tax Project: Taxation of Private Business Enterprise, Reporters’ Study (July 1999). [↑](#footnote-ref-194)
195. Gov’t Accountability Office, *Tax Enforcement: IRS Audit Processes Can Be Strengthened to Address a Growing Number of Large, Complex Partnerships* (July 27, 2023), available at https://www.gao.gov/products/gao-23-106020. [↑](#footnote-ref-195)
196. This may be overstating the case; practitioners may have avoided Treas. Reg. § 1.704-1(b)(2)-compliant partnership agreements from the very outset. Thomas W. Henning & William M. Ruddy, *supra* note 170. [↑](#footnote-ref-196)
197. *Id*. (criticizing an admonition in the 1988 Supp. No. 2 version of the McKee treatise); O’Connor & Schneider, *supra* note 172 (“Over the past few years, however, fewer tax practitioners have recommended capital-account-based liquidations for LLCs. In fact, in some industry settings, liquidation provisions based on capital accounts have virtually disappeared from LLC agreements altogether.”); N.Y. State Bar Ass’n, *supra* note 172, at 3 (“In our experiences, investors and business people overwhelmingly prefer their partnership agreements to require liquidating distributions in accordance with the cash-driven distribution priorities of the agreement rather than in accordance with capital accounts.”). [↑](#footnote-ref-197)
198. N.Y. State Bar Ass’n, *supra* note 172, at 5. [↑](#footnote-ref-198)
199. 59 FR 25581; T.D. 8588 (Dec. 29, 1994). The regulation was amended once, in 1995. T.D. 8592 (Apr. 12, 1995). [↑](#footnote-ref-199)
200. Treas. Reg. § 1.701-2(a)(3). [↑](#footnote-ref-200)
201. P.L. 101-508, Sec. 11322; T.D. 9643 (Dec. 20, 1995) (finalizing regulations under section 305(c)); CPDI regs. [↑](#footnote-ref-201)
202. The preamble to the proposed regulation and the Treasury Decision cited only the 1954 and 1976 legislative history for authority. *See supra* note 179; *see also, e.g.,* See, e.g., McKee 1.05; *ABA Tax Section Members Say Antiabuse Rule Is Not A Valid Exercise of IRS Authority*, 94 Tax Notes Today 146-50; Linda D. Jellum, *Dodging the Taxman: Why the Treasury’s Anti-Abuse Regulation is Unconstitutional*, U. of Miami. L. Rev. 152 (2015); Alan Gunn, *The Use and Misuse of Antiabuse Rules: Lessons from the Partnership Antiabuse Regulations*, 54 S.M.U. L. Rev. 159 (2001). [↑](#footnote-ref-202)
203. Treas. Reg. § 1.701-2(b). [↑](#footnote-ref-203)
204. Treas. Reg. § 1.701-2(c). Two examples in Treas. Reg. § 1.701-2 analyze transactions involving “special” allocations under section 704(b) with principal purpose of reducing federal tax liability (presumably substantially and on a present value basis); however, both examples pass muster because they comply with Treas. Reg. § 1.704-1(b)(2). Treas. Reg. § 1.701-2(d) Exs. 5-6. [↑](#footnote-ref-204)
205. *See generally*, William D. Chip, *The Economic Substance Doctrine*, Tax Management Portfolio, 508-2nd [↑](#footnote-ref-205)
206. 1999 Treasury White Paper; 1999 JCT Report; NYSBA 1999 Report; Yin, Corporate Tax Shelters. [↑](#footnote-ref-206)
207. President’s Fiscal Year 2001 Budget. [↑](#footnote-ref-207)
208. Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President’s Fiscal Year 2010 Budget Proposal; Part Two: Business Tax Provisions*, JCS 3-09, at 53 n.150 (Sept. 2009); *see also* N.Y. State Bar Ass’n, *Report On Codification Of The Economic Substance Doctrine* (Jan. 5, 2011) (parsing the profit potential test). [↑](#footnote-ref-208)
209. P.L. 111-152, 124 Stat. 1029 (Mar. 30, 2010); Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the “Reconciliation Act of 2010,” as Amended, in Combination with the “Patient Protection and Affordable Care Act,”* JCX-18-10 at 143 nn. 303-305 and accompanying text (Mar. 21, 2010). [↑](#footnote-ref-209)
210. Joint Committee on Taxation, *id.*, at 152. [↑](#footnote-ref-210)
211. *See supra* note 184 (discussing how previous bills would have also imposed a requirement that the pre-tax profit exceed a “risk free rate of return”). [↑](#footnote-ref-211)
212. 364 F.2d 734 (2d Cir. 1966); *see also* Sheldon v. Comm’r, 94 T.C. 738, 768 (1990). [↑](#footnote-ref-212)
213. David P. Hariton, *Sorting out the Tangle of Economic Substance*, 52 Tax Law. 235, 249 (1999); *see also* David P. Hariton, *When and How Should the Economic Substance Doctrine Be Applied*, 60 Tax L. Rev. 29 (2006). [↑](#footnote-ref-213)
214. N.Y. State Bar Ass’n, *supra* note 184. [↑](#footnote-ref-214)
215. Joint Committee on Taxation, *supra* note 185. [↑](#footnote-ref-215)
216. The approach to taking into account pre-tax profit was advocated by the New York State Bar in its 1999 report. See *supra*. *See also* McKee, *Ventures*, *supra* note 69, at 21 (applying “*Gregory*-*Gilbert*” economic substance standards to analyzing partnership allocations). [↑](#footnote-ref-216)
217. *But see* listed partnership transactions, LB&I campaigns, and PGP. [↑](#footnote-ref-217)
218. Gov’t Accountability Office, *Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency* (Sept. 18, 2014), *available at* https://www.gao.gov/products/gao-14-732. [↑](#footnote-ref-218)
219. *Id.* [↑](#footnote-ref-219)
220. P.L. No. 114–74. Amended in 2018 by , P.L. 115-141 [↑](#footnote-ref-220)
221. Citations to come. [↑](#footnote-ref-221)
222. 348 words if you don’t count the redetermination rule or the special creditable foreign tax expenditures rule. [↑](#footnote-ref-222)
223. S. Rep. No. 1622 (1954): Simplicity, flexibility, and equity; Treas. Reg. § 1.701-2(a) (“Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax.”); Cowan; Koff; Herzfeld [↑](#footnote-ref-223)
224. Willis (1957), at 14 [↑](#footnote-ref-224)
225. Sections 721, 723, 724, 731, 734(b), 743(b); Treas. Reg. § 1.704-2(b); *but see* 734(d), 743(d); Treas. Reg. § 1.704-3(a)(10). [↑](#footnote-ref-225)
226. Sections 751, 864(c)(8), 1446(f); Treas. Reg. § 1.704-1(b)(2)(iii)(*b*). [↑](#footnote-ref-226)
227. Section 732(f). In tax shelter terms, subchapter K (like subchapter C) may broadly permit deferral, and some conversion, but exclusion. *Cf*. Shaviro. [↑](#footnote-ref-227)
228. See, e.g., Treas. Reg. § 1.707-1(c) Ex. 2; *cf.* section 305, 467, 1271-1275, 1298; Treas. Reg. § 1.446-3. However, it would be dangerous to over-generalize here, as there are certainly instances when subchapter K’s principles relent when conflicting with other principles of income taxation (in particular, timing and character of service income). Section 704(e); Treas. Reg. § 1.721-1(b)(1). [↑](#footnote-ref-228)
229. Exchanges under section 1031 and reorganizations under section 368(a)(1)(E), to name two. [↑](#footnote-ref-229)
230. Section 7701(o)(1). These are not necessarily the only principles that should inform the outcome; in their 1985 report in response to the proposed 1983 regulations, the ALI listed an additional several principles that could apply and which taxpayers are likely well-advised to consider in complicated cases. However, not all of the 1985 ALI principles are necessarily supported by current law. *See supra* note [\_] and accompanying text. [↑](#footnote-ref-230)
231. 1954 Senate report; 1956 ALI report. [↑](#footnote-ref-231)
232. Treas. Reg. § 1.707-1(c) Ex. 2. [↑](#footnote-ref-232)
233. Section 7701(o)(2). [↑](#footnote-ref-233)
234. Treas. Reg. § 1.704-1(b)(3)(i) (third sentence). [↑](#footnote-ref-234)
235. 103 T.C. 170 n. 20 (1994). *But see* Marich, *supra* note [\_], at n. 22 (1987) (suggesting example was added only to prohibit an end run around the qualified income offset requirement of the alternate test for economic effect in Treas. Reg. § 1.704-1(b)(2)(ii)(*d*)(3)). However, the example can be harmonized with Treas. Reg. § 1.704-1(b)(2)(ii)(*d*)(3) as both reach the same ultimate result (*i.e.*, no negative capital account) by different means and the example in Treas. Reg. § 1.704-1(b)(3)(i) uses the term “may” to invoke its approach. [↑](#footnote-ref-235)
236. Note that the “downward adjustment” referred to in the example is not by its terms limited to one described in Treas. Reg. § 1.704-1(b)(2)(ii)(*d*)(*4*)-(*6*) that would be cured by a qualified income offset. [↑](#footnote-ref-236)
237. At least one scholar has noted the divergence between SEE and PIP, and suggested that PIP be divided into two rules – one to address situations in which Treas. Reg. § 1.704-1(b)(3) applies because there is no partnership agreement (and so Treas. Reg. § 1.704-1(b)(3) has to operate to recreate one), and one to address situations where Treas. Reg. § 1.704-1(b)(3) applies because the allocations fail Treas. Reg. § 1.704-1(b)(2) (and so Treas. Reg. § 1.704-1(b)(3) has to operate to reallocate the income in the manner intended to achieve the outcome of Treas. Reg. § 1.704-1(b)(2)). *See* Utz, *supra* note [\_]. While these suggestions would perhaps clarify the application of Treas. Reg. § 1.704-1(b)(3), it is notable that they are not how Treas. Reg. § 1.704-1(b)(3) is applied under current law by the IRS or the courts; the author concludes that current Treas. Reg. § 1.704-1(b)(3) is “intentionally ambiguous.” [↑](#footnote-ref-237)
238. The economic effect rules in the SEE regulations are also based on a principle of consistency, although the consistency required by that regulation is impractically rigid in critical ways, as discussed above. [↑](#footnote-ref-238)
239. But apparently not bottom-line allocations, although it’s unclear if this was ever intentional. *See supra* notes [\_]. [↑](#footnote-ref-239)
240. See supra note [\_] (1956 ALI Report). [↑](#footnote-ref-240)
241. This also seems to be how Treas. Reg. § 1.704-1(b)(1)(iii) applies generally applicable law. In any case, whether applying before or after, its *in terrorem* effect is likely the same. [↑](#footnote-ref-241)
242. Commentators agree with this conclusion. *See*, *e.g.*, Eric B. Sloan, Matthew J. Sullivan & Jennifer A. Ray, 712-4th T.M., Partnerships — Taxable Income; Allocation of Distributive Shares; Capital Accounts ¶ IV.2.C (“If an allocation cannot satisfy the objective standard for determining whether it is in accordance with the partners’ interests in the partnership (e.g., because the maintenance requirement or the effectuation requirement is not satisfied), it still may be valid under a more subjective inquiry into the partners’ interests in the partnership.”); William S. McKee, William F. Nelson & Robert L. Whitmire, Federal Taxation of Partnerships and Partners (February 2022) (hereinafter McKee) ¶ 11.02[3] (“[I]t is far from clear that identical results would in fact be achieved under both [PIP] and the [SEE] safe harbor.”). [↑](#footnote-ref-242)
243. “There are three ways in which such allocation will be respected under section 704(b) and [Treas. Reg. § 1.704-1(b)(1)].” [↑](#footnote-ref-243)
244. Treas. Reg. § 1.704-1(b)(2)(ii)(*a*). [↑](#footnote-ref-244)
245. Treas. Reg. § 1.704-1(b)(5) Exs. 1, 4, 5 and 10. [↑](#footnote-ref-245)
246. *Cf*. Treas. Reg. § 1.704-1(b)(3)(iii) (substantiality requirement explicitly incorporated in the “objective” PIP test). [↑](#footnote-ref-246)
247. “A reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.” *See also supra* notes [\_] and accompanying text. [↑](#footnote-ref-247)
248. Making such determinations effectively requires making a determination of what was intended by the examples of the 1954 Senate report (and the continued persuasive authority of the 1956 regulations), or even what the state of partnership practice was before 1954. [↑](#footnote-ref-248)
249. Lawrence Lokken, *Partnership Allocations*, 41 Tax L. Rev. 545, 613 (1986). [↑](#footnote-ref-249)
250. *See supra* note [\_]; *see also* Internal Revenue Service, Market Segment Specialization Program Audit Technique Guide: Partnership, 6-3 (2002) (“[PIP] and [SEE] can be viewed as two different roads leading to the same destination. ... The essence of both tests is to tie the tax allocations to the partners’ economic sharing arrangement.”). [↑](#footnote-ref-250)
251. *See*, *e.g.*, Treas. Reg. §§ 1.701-2(d) Ex. 6, 1.752-7(c)(2); T.D. 9557 (Nov. 17, 2011); *see also supra* note [\_]; Gregory J. Marich, *Substantial Economic Effect and the Value Equals Basis Conundrum*, 42 Tax L. Rev. 509, 509 (1987). [↑](#footnote-ref-251)
252. Citations to come. [↑](#footnote-ref-252)
253. The same language appeared in Section 8(e) of the Revenue Act of 1916, and the Revenue Act of 1917, § 201, 39 Stat. 1000. [↑](#footnote-ref-253)
254. The same language appeared in Section 218(a) of the Revenue Act of 1921, the Revenue Act of 1924, and the Revenue Act of 1926. The Revenue Act of 1928 effected a renumbering (generally in place until the 1954 code) that moved the language to Section 182(a), where it remained in the Revenue Act of 1932. Another renumbering of the partnership provisions moved the language to Section 182 in the Revenue Act of 1934, where it remained in the Revenue Act of 1935, the Revenue Act of 1936, and the Revenue Act of 1937. [↑](#footnote-ref-254)