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ARTICLE

PARTNERSHIP SPECIAL ALLOCATIONS REVISITED

David Hasen

UNIVERSITY OF FLORIDA COLLEGE OF LAW

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David Hasen *349*

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All references and citations to sections in this issue are to sections of the Internal Revenue Code of 1986, as amended, unless otherwise indicated. All references and citations to regulations are to Treasury Regulations under the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

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PARTNERSHIP SPECIAL ALLOCATIONS REVISITED

by

David Hasen

ABSTRACT

Special allocations of items of partnership income, gain, loss, and deduction have long created difficulties for the tax law. The paper argues that most such allocations should not be respected for tax purposes because they inappropriately separate the character of partnership items from the partners that are economically entitled to them. The paper suggests that special allocations instead ought to be viewed as transactions in partnership interests between or among the partners themselves. A number of consequences follow. The paper also argues that Treasury's rules for establishing the partners' interests in the partnership when an allocation fails the test for substantiality likely are inconsistent with section 704(b) of the Internal Revenue Code.

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I. INTRODUCTION

Subchapter K[1] of chapter 1 of the Internal Revenue Code governs the tax treatment of partnerships. Very generally, it establishes a "pass-through" regime: partnerships themselves are not subject to income tax but rather function largely as accounting entities that allocate the partnership's items of income, gain, loss, and deduction among the partners, who are subject to tax on the items so allocated.[2] The allocation rules are complex, burdensome, and prone to abuse.[3]

Perhaps nowhere are the unattractive features of subchapter K more clearly on display than in the area of so-called special allocations — allocations of specific items of partnership income, gain, loss, and deduction ("IGLD") that do not generally track one or more partners' overall interest in the partnership.[4] Under section 704(b) and Treasury regulations interpreting that provision, special allocations will be respected for tax purposes if they either satisfy a detailed test for "substantial economic effect" or are deemed to be in accordance with the partners' interests in the partnership.[5] One of the difficulties with the special allocation rules is that they are quite complex. Another is that, despite their complexity, they are manifestly inadequate to the task: They permit assignments of partnership items that, in other contexts, including in subchapter K itself, both Congress and the courts have found inconsistent with basic principles of income taxation and have disallowed.[6]

Unfortunately, it is not readily apparent how Treasury's rules on special allocations could be made more effective within the existing framework of subchapter K. In enacting the current version of section 704(b), in 1976, Congress seems to have had in mind that income assignments among partners should be permissible as long as they are not, or are not unduly, tax-motivated.[7] Since that time, both the opportunities for

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1. I.R.C. §§ 701–777.

2. I.R.C. §§ 701, 702.

3. *See, e.g.*, George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141 (1999) [hereinafter Yin, *Future Taxation*] (one among many commentators noting these features of subchapter K).

4. I.R.C. § 704(b); Reg. § 1.704-1.

5. Reg. § 1.704-1.

6. *See, e.g.*, I.R.C. §§ 724 (character of ordinary income items contributed to partnership is retained), 751 (ratable allocation of ordinary and capital items of partnership income and loss on disposition or redemption of a partnership interest).

7. S.REP. NO. 94-938, pt. 1, at 100 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3438, 3536 ("The committee amendment provides generally that an allocation of overall income or loss (described under section 702(a)(9) [now section 702(a)(8)]), or of any item of income, gain, loss, deduction, or credit (described under section 702(a)(1)-(8) [now section 702(a)(1)-(7)]), shall be controlled by the partnership

abuse that section 704(b) makes available and the inadequacies of the Treasury regulations to police abuse have become more apparent.[8] In consequence, many commentators have suggested various types of simplifying reform,[9] most of which involve far-reaching changes to subchapter K or even beyond. George Yin, for example, has suggested a fundamental revamping of the business tax rules that would put all business entities onto one of two tracks, depending upon the entities' sophistication, the type of owners involved, and other factors.[10] Mark Gergen has suggested somewhat less sweepingly that special allocations be disallowed; the recommendation is part of a larger package of proposed reforms Gergen has suggested to subchapter K.[11]

This article joins the chorus of those who have argued that special allocations generally should be disallowed. As I develop below, an appropriate analysis of a special allocation is to consider it as a transfer of a partnership interest between or among two or more partners. As a general matter, such transactions would not be sales or exchanges but, instead, would be taxable as ordinary income to the recipient of the interest and would create an ordinary deduction to the transferor. There is not much reason why two economically identical arrangements, differing only in that one is structured as a partnership using special allocations, ought to generate different tax results. Accordingly, I indicate how one would derive the transactions in partnership interests that are economically equivalent to partnership special allocations in a variety of cases in order to show how most special allocations should be treated under the tax law. Further, because special allocations are tantamount to transfers of partnership interests, ancillary rules of subchapter K as well as other tax principles may come into

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agreement if the partner receiving the allocation can demonstrate that it has 'substantial economic effect,' i.e., whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences.").

8. *See, e.g.*, Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1, 9, *passim* (1990) [hereinafter Gergen, *Special Allocations*]; Yin, *Future Taxation*, *supra* note 3, at 154–55.

9. *See, e.g.*, Mark P. Gergen, *The End of the Revolution in Partnership Tax?*, 56 SMU L. REV. 343 (2003); Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 TAX L. REV. 69 (1992) [hereinafter Gergen, *Compensating Service Partners*]; Gergen, *Special Allocations*, *supra* note 8. *See also* Gregg D. Polsky, *Deterring Tax-Driven Partnership Allocations*, 64 TAX LAW. 97 (2011) [hereinafter Polsky, *Tax-Driven Allocations*]; Yin, *Future Taxation*, *supra* note 3.

10. Yin, *Future Taxation*, *supra* note 3.

11. Together, Gergen, *Compensating Service Partners*, *supra* note 9, and Gergen, *Special Allocations*, *supra* note 8, constitute a proposal to revamp subchapter K.

play in evaluating their tax consequences. Principal among these is the election under section 754 to take account of discrepancies between the basis and the fair market value of partnership property when an interest in the partnership is transferred. A further consequence would be the recognition of gain or loss by the transferor to the extent the fair market value of the interest transferred differed from its adjusted basis in the transferor's hands.

I also argue, however, that an exception to a general rule of not respecting special allocations ought to be available where there is a sufficient non-tax-avoidance motive to support the allocation. I also propose that the regulations under section 704(b) be modified to permit greater variation in the initial allocations of partners' interests in particular items of partnership property and therefore of particular items of partnership IGLD. Apart from these qualifications, special allocations generally should be disregarded, which is to say that accounting for the outcomes of special allocations generally should take place outside of the partnership itself. Perhaps counterintuitively, I believe that the recommendations offered here would result in a less burdensome set of partnership tax rules overall, even though the recommendations would add complexity to partnerships choosing to avail themselves of the special rules on allocations within the partnership. If, as I suspect, the appetite for special allocations is driven in large measure by the search for unwarranted tax benefits, then the adoption of complex rules that curb or eliminate the tax advantages of special allocations is likely to have a simplifying and compliance burden-reducing effect, even if the special allocation provisions themselves become more difficult to apply.

As I develop below, the principal benefit that respecting partnership special allocations affords is to enable the partners to engage in untoward tax avoidance by means of character assignment.[12] A character assignment separates the owner of a type of IGLD from the asset or arrangement that produces it. For example, a special allocation may shift capital income or loss from a partner who, based upon ownership, economically earns or bears it to another partner who, for tax reasons, derives greater benefit from capital income or loss than does the partner from whom it is allocated.[13] As a general matter, assignments of either amounts or kinds of IGLD are not permitted under the tax law.[14] Outside of the partnership area, Congress and

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12. See, for example, Regulations section 1.704-1(b)(5) for common examples of special tax items.

13. I am aware of at least one special allocation under which items of partnership capital gain are allocated to a partner having a profits interest. Document on file with author.

14. *See* Lucas v. Earl, 281 U.S. 111 (1930) (disallowance of income assignments). Various rules limit character assignment. *See, e.g.*, sections 702 (pass-through taxation of partnership items), 724 (preservation of character of income contributed to a partnership), 751 (requiring ratable allocation of ordinary and capital income and loss on disposition or redemption of a partnership interest).

the courts have agreed that items of IGLD should be taxed to the person who economically owns them, not to someone else.[15] Permitting special allocations seems to fly in the face of this general tax principle since, by definition, the special allocation creates a divergence between a partner's quantum of ownership of partnership property and the extent to which the partner enjoys or bears a particular item of IGLD in respect of partnership property. One might respond that Congress has overridden the principle in the special allocation area in favor of a weaker rule that permits income assignments when they are a consequence of, but not the motivating force behind, an otherwise business-driven allocation. But Congress's concern to avoid such assignments in other areas of subchapter K, together with the emerging consensus among tax scholars that most special assignments are tax-motivated, suggest it is time to reconsider that decision.[16]

Assignment generally comes in two flavors, but most special allocation problems concern just one: the inappropriate assignment of character, or type of income, from one partner to another. The other principal form of assignment, of amount, is less common. In a typical character assignment, each partner assigns one type of partnership item in exchange for another that is of greater value to the transferor than what was surrendered, the increased value coming in the form of tax benefits. By contrast, in an "amount" assignment, an item is simply shifted from one person to another but not in a reciprocal arrangement, again with attendant tax benefits.[17]Assignments of amount tend to arise in settings in which a

15. Examples of this policy in the Code include the rules in subchapter K cited in note fourteen as well as numerous provisions outside of subchapter K. *See* rules cited *supra* note 14; *see, e.g.*, I.R.C. §§ 1(g) (investment income of minor children taxed to parents on theory that parents are owners of the investments), 132(a)(2) (fringe benefits provided to dependents of employees are taxed to the employees), 382 (limiting availability to an acquiring corporation of an acquired corporation's net operating losses). The policy of disallowing income assignments was forcefully articulated in *Earl*, 281 U.S. at 113 (no anticipatory assignment of income from husband to wife where the wife was in a lower tax bracket). *See also* Commissioner v. Culbertson, 337 U.S. 733, 739–40 (1949) ("To hold that 'Individuals carrying on business in partnership' include persons who contribute nothing during the tax period would violate the first principle of income taxation: that income must be taxed to him who earns it.").

16. *See, e.g.*, Gergen, *Compensating Service Partners*, *supra* note 9; Gergen, *Special Allocations*, *supra* note 8; Calvin H. Johnson, *Partnership Allocations from Nickel-on-the-Dollar Substance*, 134 TAX NOTES 873 (Feb. 13, 2012); Polsky, *Tax-Driven Allocations*, *supra* note 9; Yin, *Future Taxation*, *supra* note 3.

17. BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES & GIFTS ¶ 75.2 (2007) [hereinafter BITTKER & LOKKEN, FEDERAL TAXATION]. Typical situations include assignments from one family member to another or from a donor of one kind or another to a donee. By contrast, because

special relationship between the assignor and assignee makes the assignment desirable, such as between family members. By contrast, character assignments generally create net after-tax value to both of the parties involved. Character assignments may be desirable to the partners because the character of income, unlike its amount, may have variable tax effect but not non-tax economic effect. As examples, on a pre-tax basis, tax-exempt interest is no different from taxable interest, and capital income is not different from ordinary income. A taxpayer is indifferent on a pre-tax basis between a dollar of one and a dollar of the other. However, on an after-tax basis, different partners, because of their particular tax situations, may place different values on the different types of income. A partner in a high tax bracket will gladly exchange one dollar of taxable interest for 75 cents of tax-exempt interest, while a tax-indifferent partner will be more than happy to accept the 25-cent fee for the tax break; if, however, the asset (or the relevant fractional interest in it) that gives rise to the tax-exempt interest is not also transferred, then the benefits and burdens associated with the right to the interest, which evidently were intended to be borne by the person enjoying the tax exemption, remain with someone else. Transactions such as these, where it is possible to separate the tax character of an item of IGLD from the economic arrangement that gives rise to the character, by definition generate undesired results, and they represent the central problem that special allocations pose for the tax law.

Another way of characterizing the point is to observe that special allocations are generally inconsistent with the aggregate theory of partnership taxation, though it is important to recognize that the aggregate theory is more limiting on partnership economics than is the idea that character assignments should not be permitted. (The theory is more limiting than would be denial of character assignments in the sense that it would require the partners to treat themselves as having ratable ownership even of partnership assets within individual tax classes, despite the fact that no tax consequences would flow from failing to respect varied ownership within individual classes.) Under the aggregate theory, the partners are considered to own a ratable share of each of the partnership's assets for tax purposes.[18]

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partners typically deal with each other at arm's length, they generally demand something of equal value in exchange for something surrendered, as may arise in a character assignment. The problem of income assignment does arise prominently in one partnership setting — the case of family partnerships, in which older generations of partners may attempt to pass partnership interests to their offspring on a tax-favored basis. *See* I.R.C. § 704(e)(1).

18. A leading treatise offers the following characteristic description of the aggregate understanding of the partnership: "Subchapter K represents a blending of two views as to the nature of partnerships. The first view is that a partnership is simply an aggregation of individuals, each of whom should be treated as the owner of a direct undivided interest in partnership assets and operations. This is sometimes

By contrast, under the competing "entity" theory, the partnership is viewed as separate from its partners, so that the partner is not considered to own a ratable share of each partnership asset but instead an interest in the entity, which interest is defined by the terms of the partnership agreement.[19] Subchapter K embodies a mix of entity and aggregate conceptions, but in general it favors the aggregate conception for purposes of determining the economic rights and obligations of the partners;[20] the entity theory generally applies for purposes of administrative convenience.[21] Special allocations are inconsistent with the aggregate theory because the theory embodies the idea that each partner's ownership of each item of partnership property is proportional to the partner's overall interest in the partnership, while the special allocation by definition departs from ratable ownership. Returning to the example of taxable and tax-exempt interest, a partnership in which the two partners each contribute $50 in exchange for equal partnership interests may purchase equal quantities of taxable and tax-exempt debt obligations. If the interest earned by these obligations is not allocated equally to the two partners, then under the aggregate theory, each receives an assignment of one type of interest income in exchange for parting with some of the other.

The foregoing considerations suggest that a resolution of the problem of special allocations would focus on methods by which to establish the associated non-equity-based transactions that would result in the allocations of income provided under the partnership agreement. In general, the most direct method to achieve the result is to view the partner receiving a net amount in excess of its ratable share as receiving a partnership interest from the other partner or partners. Such a constructive transaction arrives at the appropriate tax outcome, albeit at the cost of some complexity, without disturbing the aggregate analysis of the partners' interests in the partnership (PIP). Under this approach, each partner treats itself as earning the ratable share of each type of income, based upon relative partnership interests,

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referred to as the 'aggregate' or 'conduit' view of partnerships." WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 1.02 (2007) [hereinafter MCKEE ET AL., PARTNERSHIPS AND PARTNERS].

19. "The second view is that a partnership is a separate entity, with a tax existence apart from the partners. Under this view, a partner has no direct interest in partnership assets or operations, but only an interest in the partnership entity separate and apart from its assets and operations." *Id.*

20. *See, e.g.*, I.R.C. §§ 702 (pass-through of partnership items to partner), 724 (preserving character of certain contributed property), 732 (allocation of basis among capital and non-capital assets), 751 (requiring ratable allocation of ordinary and capital income on dispositions and redemptions of partnership interests).

21. *See, e.g.*, I.R.C. §§ 703(b) (elections affecting computation of taxable income to be made by the partnership), 706 (partnership has one taxable year), 754 (partnership election to recompute partnership's basis in its property on certain dispositions or redemptions of partnership interests).

through the partnership, and then as either transferring to or receiving from the other partner or partners a partnership interest equal in value to the net amount the partner loses or gains, respectively, by reason of the special allocation. Applied to the example in the preceding paragraph, each partner's initial inclusion will be taxable to the extent it is of non-tax-exempt interest,[22] while the transfer should generate a deduction under section 162 to the payor and an ordinary inclusion to the payee regardless of the character of the income item to the partnership.[23] The net effect would be that the recipient of a disproportionately large amount of tax-exempt interest will not avoid tax, while the recipient of a disproportionately large amount of taxable interest will continue to have a reduced quantity of taxable income.[24] Going forward, the partners will no longer have equal partnership interests.

There is, however, a feature of partnership operations that makes the straightforward application of a principle of ratable allocation somewhat more nuanced than might appear. It is that there is, and really can be, no entry in the partners' capital accounts that reflects anticipated labor income of the partnership.[25] Human capital, in short, cannot be reflected on the partnership's books. As a consequence, where a partner's compensation is based on partnership profits, one cannot determine PIP simply by reading off the partners' capital account balances except in the limited cases in which the income of the partnership does not depend upon any partner's labor, or where a partner is leaving the partnership, in which case the relevant labor income has accrued and should be reflected on the books, either as part of partnership goodwill or as embodied in identifiable partnership property.[26]

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22. I.R.C. §§ 61(a)(4) (interest generally includible), 103(a) (interest on certain municipal bonds excluded from gross income), 702(a) (partner includes allocable share of partnership items of IGLD).

23. Economically the exchange is closely similar to a notional principal contract, as developed below, which generally are treated as producing ordinary income and ordinary loss to the parties. *See* Reg. § 1.446-3; *infra* note 71 and accompanying text.

24. If, for example, each partner ratably earns $50 of each type of income and the special allocation provides for a full assignment of taxable income to the non-taxable partner and of tax-exempt income to the taxable partner, then each partner has $50 of taxable interest through the partnership, $50 of tax-exempt interest through the partnership, a $50 deduction on transfer to the other partner, and a $50 inclusion on the receipt.

25. Brad Borden makes a similar point in arguing that the test for allocations ought to be "deal-centric" rather than capital-account-centric. Bradley T. Borden, *Partnership Tax Allocations and the Internalization of Tax-Item Transaction*, 59 S.C. L. REV. 297, 344–45 (2008).

26. In many cases, partners are compensated in part on a basis other than with reference to partnership profits, in which case the payments are characterized under section 707(c) to that extent. Under that provision, payments generally are includible by the partner and deductible or capitalizable by the partnership (including

The arrangement in a typical "brains and money" partnership that anticipates all income to be derived from the sale of partnership services illustrates the difficulty. Often the agreement will provide that one partner contributes all the capital while the other contributes services, with the partners agreeing to some division of partnership profits.[27] The laboring partner's initial capital account balance may or may not reflect a percentage of total partnership capital equal to the percentage of profits to which the partner is entitled, and, even if it does equal that percentage, fluctuations in the capital accounts over time may not correspond to the agreement on the division of partnership income.

Consequently, it makes sense to construe the laboring partner's PIP as determined at least in part by the partner's share of partnership income as provided under the partnership agreement and not by the partners' capital account balances, assuming the partners deal with each other at arm's length. Thus, in determining PIP for purposes of analyzing special allocations, one must recognize that a partner's entitlement to partnership income that differs from the relative capital account balances may be appropriate to the extent partnership income depends upon services provided by the partners. The import of this observation has not so much to do with the analysis of ratable ownership under the aggregate theory as it does in recognizing that an agreement to divide partnership profits in a ratio different from the partners' capital account balances does not always constitute a "special allocation."

The analysis offered here suggests Congress should amend section 704(b) to eliminate special allocations to the extent they are inconsistent with PIP broadly understood. The principal goals are to remove the opportunities for abuse that arise under the special allocation rules and to make those rules consistent with Congress's evident concern, expressed in other provisions of subchapter K, that taxpayers not use the partnership form to shift the timing or character of income among partners for tax reasons. A secondary suggestion, and in effect an alternative one, is that Congress and Treasury move toward greater consistency across subchapter K. If Congress were to decide not to pursue the types of reform detailed here or by other commentators, one might wonder whether the rules on unwarranted character shifts in other Code provisions ought to survive. Although a repeal of these rules also would require Congressional action, repeal would appear to be appropriate given the manifest inconsistency between income- and character-shifting opportunities permitted to survive under section 704(b) and those shut down under such provisions as sections 707, 737, and 751.

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the recipient partner *qua* payor), depending upon the nature of the services for which the payment is made. *See* Reg. § 1.707-1(c).

27. *See* Curtis J. Berger, *W(h)ither Partnership Taxation?*, 47 TAX L. REV. 105, 108–09, 131–33 (1991) (discussing propriety of allocations in "money and brains" partnerships not in accordance with capital contributions).

The discussion proceeds as follows. Part II offers a general overview of the operation of the special allocation provisions under the section 704(b) regulations. Part III provides an abbreviated overview of the rules on substantial economic effect (SEE). Part IV identifies problems with some exemplary special allocations. Part V suggests two possible approaches to addressing the problem of special allocations, either or both of which Congress could adopt.

II. OVERVIEW

To give effect to the pass-through regime of partnership income taxation, the Code provides in most cases that the partnership is treated as an aggregate of its partners. In essence, aggregate treatment means that the income tax effect of the partnership's activity is accounted for wholly at the partner level.[28] If, for example, the partnership realizes net losses on sales of capital assets, whether the losses operate as an offset (to the extent permitted) to ordinary income or instead reduce capital gain is determined at the partner level. Similarly, if the partnership sells at a gain property used in its trade or business, then whether the sale generates a recapture of loss under section 1231 will be determined at the partner level, not the partnership level, even though the character of the item as a section 1231 loss is determined at the partnership level. While it is true that some provisions of subchapter K treat partnerships as entities, for the most part these provisions reflect the need for administrability[29] rather than a desire to treat the partnership in economic terms as separate from the partners. As an example, the already dauntingly complex rules on allocations of various partnership items would become substantially more complex if each partner had his or her own partnership tax year. As another example, similar complexity would arise if each partner could make the election under section 179 to expense certain depreciable business property. For these and other purposes, the partnership is treated as an entity.

The mandate of aggregate taxation is substantially complicated by the extraordinary flexibility the Code affords to partners in the arrangement of their economic deal.[30] If the Code required all items of partnership income

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28. I.R.C. § 703.

29. Examples of entity treatment include sections 703(b) (most partnership elections), 706 (determination of partnership tax year), and 754 (election to adjust "inside" basis of partnership assets on disposition or redemption of partnership interest).

30. *See* MCKEE ET AL., PARTNERSHIPS AND PARTNERS, *supra* note 18, at ¶ 1.03 ("One of the principal legislative objectives of Subchapter K was to afford partners 'flexibility' in allocating the tax burden of partnership transactions among themselves.").

to be allocated ratably to the partners based upon their overall interest in the partnership, the computation of the various items of partnership IGLD would be relatively straightforward (relatively, that is, by comparison with the rules that actually apply). Twenty-percent partners would receive 20 percent of the depreciation, ordinary income, capital gain, and so on of the partnership. Fifty-percent partners would receive 50 percent of these items. In general, the allocation of partnership items would be an exercise in determining the overall percentage interest each partner has in the partnership and the assignment of that portion of each partnership item to the partner.

The Code, however, permits the partners to allocate items of IGLD more or less however they wish, as long as the allocation either has SEE, or if it lacks SEE, is in accordance with PIP (or is so deemed in the case of items that by their nature cannot have SEE).[31] The animating idea appears to be that the types of business arrangements partners may find economically desirable are indefinitely varied, and tax rules that required one or another set of tax allocations would inefficiently impair the flexibility necessary to allow partners to craft their non-tax-motivated economic arrangements. Consequently, the Code and its accompanying body of regulatory provisions generally permit non-ratable allocations of specific partnership items, subject, however, to the principle that inappropriately tax-motivated allocations will not be respected.[32] The regime, in short, is limiting, not prescriptive. When it comes to the tax effect of allocations, no insistence on any particular arrangement is made. Instead, arrangements will be respected that do not run afoul of rules designed to ensure that substantiality is satisfied.

It is worth contrasting subchapter K's treatment of special allocations with other provisions in subchapter K that are designed to address inappropriate shifting of partnership items among the partners. These include principally section 751, which generally requires partners to account for items of ordinary income and loss and capital gain and loss properly allocable to them on disposition of a partnership interest (whether by sale or redemption); section 724, which provides for a carryover of character on property contributed to the partnership; and sections 731, 732, 733 and 735, which generally operate to ensure that unrealized items of partnership ordinary and capital income and loss carry over to a partner who receives a distribution of partnership property. Unlike these provisions, which set out detailed rules that govern the allocation of ordinary and capital items of the partnership, section 704(b) permits the partners wide latitude, subject to the

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31. I.R.C. § 704(b). Such items include allocations of non-recourse deductions and so-called "section 704(c) gain or loss," which by their nature cannot correspond to an economic burden borne by the partner to whom they are assigned.

32. Reg. § 1.704-1(b)(2)(iii).

principle that allocations deemed to reflect excessive tax motivation will not be respected.

III. SUBSTANTIAL ECONOMIC EFFECT

The regime for policing the allocation of partnership items among the partners is set out in section 704(b). It provides that a partner's distributive share of items of partnership IGLD generally is determined by the partner's interest in the partnership unless the partnership agreement provides for a different allocation of distributive shares and that allocation has SEE. At least until recently, as a practical matter the test meant that sophisticated partnerships generally sought to satisfy the SEE rules, since these provide a fair amount of both flexibility and certainty that a particular allocation will be respected for tax purposes.[33] By contrast, the concept of the partners' interest in the partnership is inherently more nebulous, though the regulations provide some guidance.[34]

In order for an allocation to have SEE, it must both have "economic effect" and be "substantial."[35]The rules on economic effect are detailed but largely mechanical. They are designed to ensure that allocations of partnership tax items correspond to the partners' actual business deal. The rules on substantiality, by contrast, focus on the extent to which the economic benefit of allocations is traceable to tax reduction rather than to pre-tax economics; they are less certain because they rely on such indefinite ideas as substantiality and the existence of a "strong likelihood" that an allocation will have primarily tax effect.[36]

A. *Economic Effect*

The test for economic effect actually comprises three alternative tests: the basic test, the "alternate test," and the test for "economic effect

33. Of late, many partnerships have opted to eschew the capital accounts method mandated by the SEE safe harbor in favor of "target allocations" that do not rely on capital accounts but instead seek to satisfy the PIP standard. *See* William G. Cavanagh, *Targeted Allocations Hit the Spot*, 129 TAX NOTES 89, 102–06 (Oct. 4, 2010).

34. Reg. § 1.704-1(b)(3), (5) Ex. 25.

35. Reg. § 1.704-1(b)(2)(iii).

36. Reg. § 1.704-1(b)(2)(iii)(a). The formulation in question technically requires that there must not be a strong likelihood that no partner's economic consequences will not be substantially diminished. Polsky reformulates the language as follows: "whether there exists a 'reasonable possibility' that any partner's economic consequences might be 'substantially diminished.'" Polsky, *Tax-Driven Allocations*, *supra* note 9, at 102.

equivalence."[37] Since the issues I discuss in Part IV arise under each of the tests, for simplicity the discussion treats the basic test as exemplary. Under that test, an allocation has economic effect if three requirements are met: (1) the partnership agreement must provide that capital accounts are maintained in accordance with the rules set out in Regulations section 1.704-1(b)(2)(iv); (2) liquidating distributions must be made in accordance with positive capital account balances; and (3) each partner must have an unlimited deficit restoration obligation (a "DRO"), meaning that on liquidation the partner must pay into the partnership the amount, if any, of the partner's negative capital account balance.[38]

The core of the basic test is the requirement that capital accounts be maintained in accordance with Regulations section 1.704-1(b)(2)(iv), which generally requires that capital accounts be increased by contributions of money or property and income or gain allocable to the partner, and reduced by distributions of money or property and items of loss or expense allocable to the partner. The idea is to ensure that capital accounts reflect the economic stakes of the partners. Consider the following simple example:

> *Example 1*— On Day 1 of Year 1, A and B each contribute \$200 to the newly-formed AB general partnership in exchange for interests in AB. The partnership agreement provides that their interests in items of partnership IGLD are equal, except that the partnership agreement assigns to A all items of depreciation with respect to real property owned by AB. A also is allocated, or charged back, all gain realized on the disposition of real property by AB up to previously taken depreciation thereon. Any remaining gain and all loss are shared equally by A and B.[39] The partnership agreement provides that capital accounts will be maintained in accordance with the section 704(b) regulations, liquidating distributions will be made in accordance with positive capital account balances, and each partner has an unlimited DRO.

The preceding arrangement, including the special allocation of real property depreciation and the chargeback to A, satisfies the basic test for economic effect. In particular, by incorporating reference to the 704(b)

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37. Reg. § 1.704-1(b)(2)(ii)(b) (basic test), (ii)(d) (alternate test), (ii)(i) (equivalence test).

38. Reg. § 1.704-1(b)(2)(ii).

39. Yin uses a closely similar example. Yin, *Future Taxation*, *supra* note 3, at 161.

regulations and the rules on liquidation, the agreement satisfies the basic test, as long as the partnership actually complies with it in practice.

Further development of the example illustrates the operation of the basic capital accounting rules as applied to the special allocation. Suppose that AB borrows $800 on a recourse basis and purchases Factory for $1,000, with no principal due on the loan until the earlier of the sale of Factory or five years from the date of borrowing, at which time the full principal amount becomes due. A's and B's initial capital accounts are $200 each. Their "outside bases" are $600 each, reflecting basis credit for the borrowing.[40] If depreciation is $50 per year[41] and all items of IGLD other than depreciation net to zero each year, then after one year, A receives a $50 depreciation deduction, and A's capital account and outside basis each drop by $50, to $150 and $550, respectively, while B's capital account and outside basis remain unchanged.[42] AB's "inside basis" in Factory likewise falls by $50, to $950. The allocation has economic effect because it is reflected in the actual dollar amounts to which the partners would be entitled on liquidation. In particular, if the partnership sold the property at its book value ($950) and the partnership liquidated, the loan would be repaid, A would receive $150, and B would receive $200.

Suppose this basic state of affairs continues until the end of Year 3, at which time AB sells Factory for $900. Immediately prior to the sale, A's capital account is $50, reflecting three years of depreciation at $50 per year,

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40. I.R.C. §§ 722 (basis includes amount of money contributed to the partnership), 752(a) (partner's assumption of a partnership liability is treated as the partner's contribution of money to the partnership).

41. As is customary in discussion of allocations involving depreciation, simplifying assumptions for the depreciation rules are made, including that neither the mid-year nor mid-month convention applies and useful lives often are assumed to be round numbers of years.

42. The accounting results and balance sheets set out in this paper follow the general rules for partnership tax accounting, in particular that the partnership's initial book accounts initially reflect the fair market value of partnership property and are adjusted downward by depreciation, upward by expenditures on partnership property, and adjusted up or down on disposition of partnership property. The partnership's adjusted basis in its property generally reflects the partnership's cost or the partner's basis in the case of contributed property, as adjusted by depreciation, expenditures, and other items. The partners' capital accounts reflect the same principles. The partners' bases in their partnership interests on formation of the partnership generally equal the bases of property contributed plus the fair market value of services, if any, they contribute to the partnership. *See* Reg. § 1.704-1(b)(2)(iv)(b). The accounting identity applicable to partnership balance sheets is that the partners' net equity plus partnership liabilities equals the book value of partnership property. See LAURA E. CUNNINGHAM & NOEL B. CUNNINGHAM, THE LOGIC OF SUBCHAPTER K, ch. 4 (4th ed. 2011) for an explication of partnership capital accounting.

and B's is $200. The adjusted basis of Factory immediately prior to the sale is $850, reflecting an additional two years of depreciation at $50 per year, so $50 of capital gain is recognized on the sale.[43] Pursuant to the special allocation of gain on Factory, the entire $50 of gain is allocated to A, increasing A's capital account to $100. The special allocation continues to have economic effect. On sale of Factory, the loan is repaid, leaving $300 in partnership assets (equal to the $200 initially contributed plus the $100 excess of amount realized on sale of Factory over the loan amount). If AB were to liquidate, A would be entitled to $100 in a liquidating distribution and B would be entitled to $200, consistent with their capital account balances.

Finally, suppose the same facts as above, except that the sale price of Factory is $700, meaning that AB realizes a $150 loss on the sale. The $150 loss is allocated equally to A and B, reducing A's capital account to negative $25 and B's to $125. The partnership has $900 of cash following the sale, $800 of which is used to repay the loan. If AB were to liquidate, A would be required under the DRO to contribute $25 to AB, and B would be entitled to a $125 distribution. Again, the economic effect regulations are satisfied.

B. Substantiality

The substantiality portion of the SEE test asks whether the economic advantage of an allocation otherwise having economic effect derives principally from tax benefits or reflects the transfer of a real (that is, non-tax) economic benefit and the assumption (by some partner) of a corresponding burden. As contrasted with the test for economic effect, the test for substantiality focuses on the inherently less definite concept of undue tax reduction. Though somewhat involved, the test generally involves two parts. First, the allocation must pass an initial test of substantiality, which provides that an allocation is (provisionally) substantial if it "will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences" (the "pre-tax test").[44] Second, and notwithstanding its satisfaction of the pre-tax test, if: (1) the after-tax consequences (in present value terms) to at least one partner of the allocation are enhanced when compared with the consequences that would arise in the absence of the allocation, and (2) there is a strong likelihood that the after-tax consequences of no partner will, in present value terms, be substantially diminished as a result of the allocation, then the allocation will be held to lack substantiality (the "insubstantiality test").[45] (In addition, there are further sub-tests of insubstantiality for so-called shifting and transitory

43. *See* I.R.C. § 1231.
44. Reg. § 1.704-1(b)(2)(iii)(a) (first sentence).
45. *Id.* (second sentence).

allocations.[46]) Because such terms as "substantial" and "strong likelihood" are imprecise and to some extent context-dependent, in many cases it is not possible to know with certainty whether an allocation lacks substantiality.[47]

The special allocation in Example 1 unambiguously qualifies as substantial in light of the presumption in the special allocation regulations that value equals book basis.[48] Specifically, it satisfies the pre-tax test because, without regard to tax consequences, it reduces the dollar value A will receive from the partnership on liquidation, since A's capital account is adjusted downward dollar-for-dollar by depreciation. Under the value-equals-book presumption, amounts subtracted from A's capital account because of depreciation are not expected to be restored on later disposition of Factory. In addition, the allocation does not satisfy the insubstantiality test because it reduces the after-tax value of A's interest in the partnership by the after-tax cost of an annual $25 reduction in A's capital account and increases B's capital account by the same amount (subject to differences in their marginal rates). It therefore is not "insubstantial."

Other special allocations, however, are more problematic. As contrasted with the allocation in Example 1, for most of them the decisive factor in determining SEE will be the second prong of the insubstantiality test, since nearly any allocation that plausibly passes muster will satisfy the pre-tax test but also will improve the after-tax consequences to at least one partner.[49] In those circumstances, the question becomes whether anyone bears a sufficient risk of a large enough after-tax cost from the improvement of a partner's after-tax position. If so, then the allocation may well be substantial; if not, it is likely not substantial.

Gregg Polsky provides an illustrative example,[50] modified from the special allocation regulations.[51] In Polsky's example, H and L form an equal partnership that is expected to generate between $450 and $550 of taxable income and of tax-exempt income each year. H is subject to a marginal tax rate of 50 percent, while L's rate is 15 percent. The partners allocate 84 percent of the tax-exempt income to H and all other income to L (in each case, whatever those income amounts happen to be). Other partnership items are allocated equally. Polsky notes that this is a relatively easy case in which to conclude the allocation lacks substantiality. As compared with an equal allocation of the two types of income, the worst case for H ($450 tax-exempt income and $550 taxable income) yields H $378 of after-tax income (= 0.84*$450) under the special allocation as compared to $362.50 of after-tax

46. Reg. § 1.704-1(b)(2)(iii)(c), (d)
47. *See, e.g.*, Polsky, *Tax-Driven Allocations*, *supra* note 9, at 103–04.
48. Reg. § 1.704-1(b)(2)(iii)(c) (flush language).
49. Polsky, *Tax-Driven Allocations*, *supra* note 9, at 101 & n.24.
50. *Id.* at 101.
51. Reg. § 1.704-1(b)(5) Ex. 5.

income (= 0.5*$450 + 0.5*$550*0.5) under an equal division. Therefore the first prong of the insubstantiality test is satisfied. The second prong also is satisfied, because in the worst case for L ($450 taxable income and $550 tax-exempt income), under the special allocation, L receives $470.50 (= $450*0.85 + 0.16*$550), while under an equal allocation, L would receive $466.25 (= 0.5*$450*0.85 + 0.5*$550).

The example is useful because it illustrates both the problem that Treasury faces in dealing with special allocations and the factors on which the partners need to focus in order to increase the probability that a tax-motivated special allocation nonetheless will be respected under the special allocation regulations. As Polsky notes, the effect of the allocation in his example is a sale of L's low tax rate to H. The reason the allocation fails, however, is not simply that such a sale occurs, but that there is no scenario under which a net tax savings is sufficiently offset by an after-tax loss for either partner to conclude that the risk of such a loss is "substantial."[52] In other words, the allocation results in a net transfer from Treasury to each partner under all scenarios. Where the prospect of an overall loss for any partner is absent, the capacity for arm's-length negotiations to control the abuse of tax benefits is removed, and it is safe to conclude that the parties will cooperate to reap a payment from Treasury that would be unavailable to them if they were acting individually.[53]

The analysis indicates that the principal question for the partners is how far they need to go in ensuring that at least one of them risks being enough worse off on an after-tax basis under some possible outcomes in order for what amounts to a sale of tax attributes on an expected value basis to be respected. Note, however, that this inquiry is not what Congress intended by the statutory requirement of "substantial economic effect." Congress's object was not to authorize tax-motivated allocations as long as they incorporated a substantial enough risk of an after-tax loss in some cases, but to authorize non-tax-motivated allocations even if, in some cases, they also would carry an expected tax benefit. As the legislative history to the current version of section 704(b) states: "[The amendment seeks] to prevent the use of special allocations for tax avoidance purposes, while allowing their use for bona fide business purposes."[54] An approach that focuses on the substantial enough possibility of a meaningful after-tax loss is a poor way to operationalize Congressional intent. Under the approach, the economic value of a tax-motivated allocation is measured on an *ex ante* basis (discounted by

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52. Polsky, *Tax-Driven Allocations*, *supra* note 9, at 102.

53. Compare section 1060, which relies on the adverse tax positions of the parties to a purchase and sale transaction to ensure proper allocation of the purchase price among the items sold.

54. S.REP. NO. 94-938, pt. 1, at 100 (1976), reprinted in 1976 U.S.C.C.A.N. 3438, 3536.

the risk premium associated with uncertain outcomes in particular cases), while the test for insubstantiality is applied *ex post*.[55] That is, the inquiry into whether there exists the requisite likelihood that a partner will be worse off focuses on the chances in any given situation of an unfavorable after-tax outcome, not on the expected tax value of the special allocation in the long run. Therefore, as long as it is reasonable to conclude that tax-motivated allocations having a positive expected value are sufficiently likely to cause a sufficiently adverse result to a partner in any given case, one can expect them to arise.

These considerations suggest that special allocations generally ought to be much more tightly controlled, if they are to be permitted at all. As long as special allocations can be accounted for outside of the partnership itself — so that opportunities for character assignment generally remain unavailable — there does not appear to be much basis to tolerate them as partnership-level arrangements for purposes of the tax law. If the allocations have a substantial non-tax business purpose, then they will proceed anyway, but with the same tax consequences that would apply if the persons involved were not partners. If, however, the allocations would not proceed in the absence of tax rules that authorize them, then in most cases, it would seem there is no reason for the tax law to respect them.

IV. SPECIAL ALLOCATION ECONOMICS

This part examines more closely the economic consequences of special allocations on the assumption that pure aggregate accounting applies at the partnership level. The assumption of pure aggregate accounting implies that special allocations must be analyzed, for tax purposes, as non-equity-based transactions either between or among the partners, or between one or more partners and the partnership itself. Stated otherwise, this part demonstrates how to account in tax terms for special allocations that depart from the pure aggregate theory of the partnership, assuming that partnership tax accounting proceeds on a pure aggregate theory.

A. *Depreciation and Gain Chargeback Example*[56]

> On Day 1 of Year 1, A and B each contribute $200 to the newly-formed AB general partnership in exchange for interests in AB. The partnership agreement provides that their interests in items of partnership IGLD are equal, except that the partnership agreement assigns to A all items of

55. Polsky discusses this difficulty. Polsky, *Tax-Driven Allocations*, *supra* note 9, at 107.

56. This Example is identical to Example 1, *supra* in Part III.A.

> depreciation with respect to real property owned by AB. A also is allocated, or charged back, all gain realized on the disposition of real property by AB up to previously taken depreciation thereon. Any remaining gain and all loss are shared equally by A and B. The partnership agreement provides that capital accounts will be maintained in accordance with the section 704(b) regulations, liquidating distributions will be made in accordance with positive capital account balances and each partner has an unlimited DRO. In Year 1, AB borrows $800 on a recourse basis and purchases Factory for $1,000. Interest only is due until the earlier of five years or the date on which AB disposes of Factory, at which time all outstanding interest and principal are due.

Table 1 sets out AB's opening balance sheet.

Table 1: Opening AB Balance Sheet

Partnership Assets			**Partnership Liabilities:** $800		
			Capital Accounts		
Asset	**A/B**	**Book**	**Partner**	**A/B**	**Book**
Cash	$200	$200	A	$600	$200
Factory	1,000	1,000	B	600	200
Total	$1,200	$1,200	Total	$1,200	$400

Under a pure aggregate theory of the partnership, each partner is considered to own a ratable share of the partnership's assets measured by the partner's capital account balance. Because the special allocation of depreciation has a disproportionate effect on the partners' capital account balances, it is not consistent with the aggregate theory. Therefore, under an aggregate theory, the effect of the allocation must be analyzed either as the result of transactions between or among the partners — that is, outside the partnership — or, possibly, as some other, non-equity-based arrangement between the partnership and either or both partners. It cannot be analyzed as an equity arrangement at the partnership level. Further, any effort to accommodate the special allocation under the basic capital account model will result in a series of constantly shifting capital account balances and, consequently, of ever-changing deemed payment arrangements between the partners or between the partnership and one or more partners.

Consider first the effect just of allocating the depreciation solely to A. In economic terms, prior to any disposition of the property, A annually experiences a $50 loss unmatched by B, even though A and B each have contributed one-half of the capital to AB. If, as we must suppose, A and B

deal with each other at arm's length, one ought to conclude that A is agreeing to a reduced overall interest in the partnership as a way to compensate B. Under a pure aggregate theory, there are two ways to understand the nature of this compensation, though in the end, they appear to come out the same. The first is to consider the compensation as an annual ownership shift in AB from A to B of a proportion of AB equal to what B otherwise would have suffered in depreciation, divided by total partnership equity, a ratio that increases over time as depreciation takes place, due to the declining book value of Factory. The second is as a guaranteed payment.

The capital shift analysis under the aggregate theory runs as follows. A and B each begin with equal depreciation allocations since their capital accounts are equal. After one year, each of their capital accounts drops by $25 as a result of depreciation[57] and each has a $25 tax deduction,[58] causing concomitant outside basis reductions[59] (and a $50 inside basis reduction to Factory[60]). Separately, as a way to provide B with an interest commensurate with what the parties believe will be B's overall contribution to the success of AB, A would be deemed to transfer to B a $25 equity interest in AB. This transfer is not an exchange because A receives nothing directly in return. Rather, A's return on the overall arrangement is reflected in A's resulting equity interest, which was calculated upon formation of the partnership to be worth what A ends up with after the transfer. Consequently the transfer should represent ordinary income to B[61] and, assuming A enjoys the benefits of B's efforts annually, an ordinary deduction to A under standard tax principles.[62]

At the end of Year 1, the $25 deemed transfer represents one-seventh of A's interest in AB (equal to the ratio of $25 to A's total equity interest of $175), and A's basis in that one-seventh interest would be $82.14.[63] In the transfer, B would assume one-seventh of A's share of the liability, or $57.14, for a net deduction to A of $25 and an outside basis for A of $492.86. B's outside basis increases to $657.14. However, since the economic deal provides that the partners remain equally liable on the loan even though A's equity interest is reduced relative to B's, for basis purposes there would follow a deemed contribution of $57.14 by A to the partnership and a

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57. Reg. § 1.704-1(b)(2)(iv)(b).

58. I.R.C. § 168.

59. I.R.C. § 702.

60. I.R.C. § 1016(a).

61. Compare I.R.C. §§ 61(a), 64 with I.R.C. § 1221.

62. I.R.C. § 162(a). If, however, A enjoys the benefits over time, A would have to capitalize the payment under section 263 and deduct it over the useful life of the benefit provided, assuming that period could be determined. *See* I.R.C. § 167.

63. A's basis includes A's share of the loan. I.R.C. § 752(a).

deemed distribution of the same from the partnership to B.[64] The resulting balance sheet is depicted in Table 2. This table is identical to the table that results simply from allocating depreciation to A under the capital accounting rules.

Table 2: AB Balance Sheet at End of Year 1

Partnership Assets			**Partnership Liabilities:** $800		
			Capital Accounts		
Asset	**A/B**	**Book**	**Partner**	**A/B**	**Book**
Cash	$200	$200	A	$550	$150
Factory	950	950	B	600	200
Total	$1,150	$1,150	Total	$1,150	$350

In subsequent years, the depreciation and deemed transfer amounts differ because of the different ownership ratios. The net effect is an annual transfer of equity from A to B such that a $50 increase in the disparity between the partners' equity arises each year. For example, during Year 2, B owns 4/7 ($200) and A 3/7 ($150) of partnership equity respectively. B, therefore, gets $28.57 in depreciation and A $21.43 leaving their capital account balances at $171.43 and $128.57, respectively. A then transfers a $28.57 equity interest to B. In Year 3, the ratio of equity ownership between A and B is 1:2 ($100:$200), meaning that B has a $33.33 depreciation deduction, A's is $16.67, and A transfers $33.33 in partnership capital to B, leaving A with a $50 capital interest, or one-fifth of total partnership equity and B with the remaining $200.

The second way of viewing the special allocation is as an agreement for AB to make an annual guaranteed payment to B (for as long as the partnership holds Factory) followed by a deemed contribution of the payment back to AB (since no distribution of the payment actually occurs). Such a payment is governed by section 707(c), which generally applies to amounts paid to a partner that do not depend on partnership profits, while the deemed contribution back is described in section 721(a). The theory supporting this characterization would be that B receives the "payment" from the partnership without regard to partnership income.[65] Consequently, it is not an equity payment but a non-equity-based form of compensation. As

64. Section 752 generally treats an assumption of a liability as the payment of cash and the off-loading of one as the receipt of cash. *See* I.R.C. § 752(a), (b).

65. I.R.C. § 707(c) provides: "To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses)."

contrasted with a partner's distributive share, guaranteed payments are always ordinary income to the partner and either deductible or capitalizable by the partnership depending upon the nature of the benefit provided to the partnership as determined under sections 162 and 263.[66] The overall effect is identical to the results under the capital shift: Each partner takes a $25 depreciation deduction. The deemed payment to B generates a $50 deduction under section 162(a), which is shared equally by A and B. With the depreciation deduction, each partner's capital account drops by $50, and each enjoys a $50 deduction. Separately, B has a $50 ordinary inclusion from the guaranteed payment, and the deemed contribution of the payment back to AB increases B's outside basis and capital account by $50 returning both to where they were at the beginning of Year 1. In subsequent years, the same cycle occurs, but the size of the payments increases in order to ensure that an additional $50 disparity in capital account balances between A and B occurs.[67]

Although the guaranteed payment characterization and capital shift analysis come out the same on the facts of the Example, the capital shift analysis is more general. Not every special allocation can be recharacterized as a guaranteed payment, because a special allocation may be equity-based. For example, a special allocation could accord a disproportionate percentage of net capital gain of the partnership to a partner. Because the size of such a special allocation is determined by an item of partnership income, the guaranteed payment analysis is inapt. Accordingly, the rest of the discussion compares results under current law to those under the more general capital shift analysis.

As indicated, the balance sheet in Table 2 is identical to the balance sheet AB will have under the special allocation regulations after one year simply by assigning the depreciation on Factory to A.[68] The agreement of the

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66. Reg. § 1.707-1(c).

67. At the beginning of Year 2, A's capital account is $150 and B's is $200, meaning A owns three-sevenths of AB and B owns four-sevenths. Based on their relative ownership interests, the $50 depreciation deduction will be allocated $21.43 to A and $28.57 to B. The amount of the guaranteed payment must be such that, when three-sevenths of it (the portion to which A is entitled as a deduction) is added to $21.43, the total is $50. That figure is $66.67, which B includes in gross income and of which B deducts four-sevenths, or $38.10, in B's capacity as a partner. The net effect of the $66.67 inclusion and $38.10 deduction is $28.57 of income to B, which B is deemed to contribute to AB, exactly offsetting B's depreciation deduction, again leaving B with a $200 capital account balance and A with a $100 capital account balance. For Year 3, the guaranteed payment would be $100.

68. The identity of results follows in part from the simplifying assumptions that there is no built-in gain or loss in the partnership and there is no section 754 election in effect. If either of these assumptions were false, the analyses would not come out the same. *See infra.* Text at note 79.

two follows from the fact that while the capital shift alters the partners' relative ownership interests from a 1:1 to a 4:3 ratio (after that year), the actual partnership interests in fact are 4:3, not 1:1, as long as Factory is presumed to have a fair market value equal to its book value, and there is no other net income or loss to the partnership. In other words, even though the partnership agreement nominally provides for an equal partnership (apart from depreciation), where there are no partnership items that would be divided on an equal basis, the partners' interests in the partnership are in fact governed by the ratio of their capital accounts, here 4:3, and the aggregate treatment of the partners remains in effect. It is, however, critically important to bear in mind that the identity of the results under the existing regulations and the capital shift analysis depends upon the value-equals-basis presumption of the special allocation regulations.[69] The presumption, which is based on administrative convenience, is generally inaccurate especially in the case of tangible personal property, which typically is subject to a variety of non-economic, taxpayer-favorable assumptions designed to promote business investment.[70] If, as is often the case, partnership property subject to depreciation has a greater fair market value than book value, then the economics of the allocation are not properly reflected on the partnership's books.

In any event, the effects of the inaccuracy surface once Factory is disposed of at any price other than book value, because the sharing ratio for items of capital income or loss differs from the ratio of the partners' capital account balances. Assuming the partnership's sole source of income is capital, it is not possible to account for these items under the aggregate theory unless one postulates some further set of transactions between the partners.

Consider as an example the sale of Factory at the end of Year 3 for $900 assuming, again, no other items of partnership income or loss other than depreciation. Table 3 sets out the balance sheet immediately prior to the sale.

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69. Reg. § 1.704-1(b)(2)(iii)(c) (flush language). For a discussion of the policies underlying these rules, see BITTKER & LOKKEN, FEDERAL TAXATION, *supra* n.17, at ¶ 1.1 and authorities cited therein.

70. Reg. § 1.701-2(a)(3); *see also* BITTKER & LOKKEN, FEDERAL TAXATION, *supra* n.17, at ¶ 86.4, text at nn.35–37. *See generally* I.R.C. § 168 (which provides for double-declining balance depreciation, short asset lives, and a presumption of zero-salvage value for many items of tangible business property).

Table 3: AB Balance Sheet at End of Year 3, Pre-Sale

Partnership Assets			**Partnership Liabilities:** $800		
			Capital Accounts		
Asset	**A/B**	**Book**	**Partner**	**A/B**	**Book**
Cash	$200	$200	A	$450	$50
Factory	850	850	B	600	200
Total	$1,050	$1,050	Total	$1,050	$250

Based on the capital shift analysis, A's partnership interest now stands at $50 while B's stands at $200. Under a ratable ownership theory of the partnership, any gains or losses realized by the partnership should be shared in a 1:4 ratio between A and B. Therefore, when Factory is sold at $900 for a $50 gain, the balance sheet should appear as in Table 4.

Table 4: AB Balance Sheet Immediately Post-Sale, Capital Shift Economics

Partnership Assets			**Partnership Liabilities:** $800		
			Capital Accounts		
Asset	**A/B**	**Book**	**Partner**	**A/B**	**Book**
Cash	$1,100	$100	A	$460	$60
			B	$640	$240
Total	$1,100	$1,100	Total	$1,100	$300

In total, A would have experienced a net loss of $140 while B would have experienced a gain of $40 for an overall partnership loss of $100 (equal to the difference between the purchase and sale prices of Factory). The $100 corresponds to the netting of $150 in depreciation against $50 of gain on disposition of Factory. By contrast, if there had been no special allocation of depreciation to A, the same overall result would have been reached, but each partner would have experienced a net loss of $50 in the form of $75 of ordinary deductions and $25 of capital gain. Thus, the overall effect, assuming, contrary to the actual partnership agreement, that the consequences of the capital shift are followed through on sale, is an income shift of the appropriate character given that the form of the income shift is a transfer of a partnership capital interest. A would have an overall loss reflecting A's experience of economic losses on Factory while B would have an overall gain reflecting B's enjoyment of gain without loss.

Of course, the actual effect of the special allocation in the Example is very different from what appears in Table 4. Under the terms of the special allocation, all of the $50 of gain is allocated to A as set out in Table 5.

Table 5: AB Balance Sheet Immediately Post-Sale, Special Allocation Economics

Partnership Assets			Partnership Liabilities: $800		
			Capital Accounts		
Asset	**A/B**	**Book**	**Partner**	**A/B**	**Book**
Cash	$1,100	$100	A	$500	$100
			B	$600	$200
Total	$1,100	$1,100	Total	$1,100	$300

The disposition of Factory at a price that differs from its book value highlights the crux of the economic question that the special allocation of depreciation raises. How should the allocation of gain (or loss) on the sale of Factory — a section 1231 (capital) asset — in a manner different from the partners' relative capital interests be understood? The issue is that A enjoys gain and suffers loss in respect of a 20 percent property interest that differs from 20 percent.

In order to answer this question, it becomes necessary to focus on the consequences under the partnership agreement of payouts (sales of Factory) under all possible alternatives. There are three: (1) If Factory is sold at book value, no deemed transfer arises; (2) if it is sold above book value but not at a price in excess of all gain chargeback, all gain goes to A, representing a transfer of 80 percent of the total gain from B to A; and (3) if it is sold below book value or above the gain chargeback amount, then all loss or all gain in respect of such excess, as the case may be, is divided equally between A and B, representing a shift of 30 percent of such loss or gain from B to A.

This set of payouts is similar to a form of stratified ownership of Factory much as one finds in a standard option transaction or even a notional principal contract or bullet swap.[71] The main difference is that all of the latter arrangements generally involve the complete separation, over some interval of possible prices, of opportunity for gain and risk of loss as measured by a reference asset. For example, if X sells Y a call option on one share of Brand X Corp. stock having a $100 strike price, Y acquires all opportunity for gain

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71. In a standard option transaction, one party purchases from a counterparty the right, but not the obligation, to purchase or sell an asset at a particular price on one or more dates. JOHN C. HULL, OPTIONS, FUTURES, AND OTHER DERIVATIVES, 179–84 (7th ed. 2009). In a standard notional principal contract, one party promises to make regular payments to a counterparty based upon the value of some reference index applied to a notional principal amount, while the counterparty promises to make regular payments to the first party based upon some other reference index as applied to the same notional principal amount. At each payment date, the parties net the amounts, with a payment going only to the party whose position's value exceeds that of the other party. *See* Reg. § 1.446-3.

on the share above $100 without bearing any risk of loss for prices below $100. Similarly, in a bullet swap, the parties to the arrangement agree to net the value of one position (or group of positions) against that of another.[72] The overall effect is to assign all gain in respect of the difference in values between the positions to one party. Under the special allocation, by contrast, the partners agree that over all intervals other than gain in respect of previous depreciation, both of them will bear risk of loss and opportunity for gain — just not in proportion to their ownership interests in Factory. This difference does not appear significant in terms of understanding the nature of the partners' agreement as akin to a risk-based property division much like that in an option or a swap.

In theory, one could attempt to capture the tax aspects of this arrangement on either an *ex ante* or an *ex post* basis. That is, one could assess the net expected value transfer (which undoubtedly runs from B to A given A's right to all gain chargeback) at some time prior to the cash-out of the special allocation and assess tax then or instead tax the transfer when the payout — which can go either way — occurs. A variety of considerations suggest that taxation on an *ex post* basis is strongly preferable. *Ex ante* taxation seems nearly impossible as a practical matter for at least four reasons. First, unless the partnership's property is publicly traded, it will be exceedingly difficult to value the net transfer (if any) from one partner to one or more other partners resulting from the special allocation. Second, even if the partnership property is publicly traded, the division itself is non-standard, complicating valuation further: there are unlikely to be comparable transactions in the market to which the partners can refer in valuing the special allocation. Third, it is not entirely clear when taxation would occur if it occurs before the property is sold. Would it happen when the special allocation became part of the partnership agreement? Annually? Fourth, the net value of the transfer varies depending upon the disparities in the partners' capital accounts, and these shift over time along with the value of the underlying property. Accordingly, even *ex ante* taxation could not occur less often than annually if there were any doubts about the partners' relative capital account balances from year to year.

In addition to these practical considerations, taxation at the creation of the special allocation would seem to be inconsistent with the Code's general policy of deferring taxation in connection with the realization of gain or loss on the formation of partnerships or the adjustment of relative ownership in the partnership among the partners.[73] This policy is embodied in numerous provisions, including those covering formation,[74] shifts of

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72. *See, e.g.*, Prop. Reg. § 1.1234A-1(c)(2) (defining bullet swaps).

73. For deferral on formation, *see* I.R.C. § 721. For deferral (where possible) on adjustment of ownership positions, *see* I.R.C. § 732.

74. I.R.C. § 721.

ownership interests, and liquidation.[75] And finally, and perhaps of greatest importance, the value-equals-book rule of the SEE regulations[76] is likely to distort materially the pricing of a special allocation on an *ex ante* basis. As noted previously, the rule is grounded in administrability and bears little relation to reality especially in the case of property subject to accelerated depreciation.[77] If partnership property is assumed to have an artificially low fair market value for future years, then efforts to price the value of a capital shift that takes the form of an option or option-like position on depreciable property (or a portion of it) having a strike price equal to book value are likely to understate, perhaps quite substantially, the value of the position.

These considerations would seem to point decisively to taxation on termination of the position, at which time the difficulties described above are absent, and no policy of continuing deferral would seem to be in play. A possibly countervailing consideration is that taxation on realization may create tax electivity or arbitrage opportunities if similar arrangements can be established in settings outside the partnership context in which a different set of timing or character rules applies. Nonetheless, given the uniqueness of most positions resulting from partnership special allocations, it appears that electivity and arbitrage worries should be minimal.

Accordingly, as the partnership realizes income or loss, a net transfer in partnership interest goes from one party to the other based upon the extent to which a partner is enjoying an extra gain or absorbing an extra loss relative to the partner's capital account. In the Example, if the property is sold at a loss, there is a net payment from A to B equal to 30 percent of the loss, since by capital ownership B suffers 80 percent of the loss but by the partnership aggregate theory it is just 50 percent. Conversely, if the property is sold at a gain, the net payment runs from B to A. To the extent the payment is made in respect of gain chargeback, it represents 80 percent of the gain; to the extent, if any, the payment is made in respect of gain in excess of gain chargeback, it will be for 30 percent of such gain. Critically, all of these payments would appear to be ordinary in character since they do not represent income or loss from the sale or exchange of a capital asset but, instead, reflect an agreement between the partners to compensate themselves with partnership interests in a manner different from the way that the return on partnership capital would redound to them. The idea that the character of the payment is not determined by the character of the gain or loss giving rise to it is grounded in the judgment that assignments of character, like income assignments, are not generally permitted under the income tax.

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75. I.R.C. § 731.

76. Reg. § 1.704-1(b)(2)(iii)(c) (flush language).

77. Generally, this property being personal tangible property. *See* I.R.C. § 168.

Note that these calculations would be made more complicated if there were built-in gain or loss in the transferring partner's partnership interest or if a section 754 election were in effect, assuming that special allocations were comprehensively treated as transactions in partnership interests. As an example of the former, suppose that A ends up making a payment of $15 of A's partnership interest to B and that that payment reflected one-quarter of the value of A's pre-transfer interest in the partnership. Suppose further (and contrary to the facts here) that A's basis in the partnership interest were $40. Then A's allocable basis in the portion transferred would be $10, and A would recognize $5 of gain on the transfer.[78]

The burdens that a section 754 election imposes on the parties are greater. Section 754 permits a partnership to elect to adjust the basis of the partnership's assets when there is a transfer of a partnership interest or a partnership interest is redeemed. The purpose of the election is to enable the partnership's tax attributes to reflect more accurately the tax profiles of the partners. As an example, if the equal XYZ partnership has $200 of assets and the assets have a $300 fair market value, X's sale to R of X's one-third interest would be for $100. On purchase, R has in effect paid for R's share of the built-in gain in the RYZ assets, even though the gain has not yet been taxed to the partners. However, if RYZ were to sell its assets for $300, R would be taxed on R's ratable share of the gain, in effect causing R to be double-taxed. R would eventually recoup the extra tax in the form of a loss when R sold the partnership interest or was redeemed, but the timing difference could be significant.

The section 754 election eliminates these consequences by requiring the partnership to adjust its basis on disposition or redemption of a partnership interest, pursuant to section 743 or section 734, respectively. Very generally, the partnership will adjust its basis in its assets with respect to the portion thereof that is attributable to the new partner.[79] In treating a special allocation as the disposition of a partnership interest for all purposes of subchapter K, any partnership for which a section 754 election is in effect would be required to adjust the basis in its assets to reflect the purchaser's fair market value basis therein.

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78. The requirement of gain or loss recognition to the transferor reflects the principle that the transferor realizes a benefit (detriment) to the extent the fair market value of the property transferred exceeds (falls short of) the transferor's basis. *See* Reg. § 1.83-6(b) (applying the principle in the compensation setting).

79. *See* I.R.C. §§ 734(b) (adjustment to partnership's basis on redemption of partnership interest), 743(b) (adjustment to partnership's inside basis on disposition of partnership interest), & 755 (mechanism for allocating the basis adjustment among the partnership's assets).

Moreover, the adjustment in many cases would be required on both sides. In Example 1, the effect of the special allocation is a simple transfer from A to B. In other settings, however, the transfer may in effect be the net of two transfers, each of which ought to trigger a section 743(b) adjustment.

B. Taxable and Tax-Exempt Securities Example

Polsky's example, discussed in Part III, is a variation on Example 5 from Regulations section 1.704-1(b)(5), which reads in pertinent part as follows:

> Individuals I and J are the only partners of an investment partnership. The partnership owns corporate stocks, corporate debt instruments, and tax-exempt debt instruments. Over the next several years, I expects to be in the 50 percent marginal tax bracket, and J expects to be in the 15 percent marginal tax bracket. There is a strong likelihood that in each of the next several years the partnership will realize between $450 and $550 of tax-exempt interest and between $450 and $550 of a combination of taxable interest and dividends from its investments. I and J made equal capital contributions to the partnership, and they have agreed to share equally in gains and losses from the sale of the partnership's investment securities. I and J agree, however, that rather than share interest and dividends of the partnership equally, they will allocate the partnership's tax-exempt interest 80 percent to I and 20 percent to J and will distribute cash derived from interest received on the tax-exempt bonds in the same percentages. In addition, they agree to allocate 100 percent of the partnership's taxable interest and dividends to J and to distribute cash derived from interest and dividends received on the corporate stocks and debt instruments 100 percent to J.[80]

As previously discussed, under the special allocations regulations, the substantiality question in practice turns on how great a risk of loss a partner must assume in order for there to be a sufficient likelihood that the

80. Reg. § 1.704-1(b)(5) Ex. (5)(i). The example assumes that dividends are taxed at ordinary rates rather than at the rate for net capital gains, as has been the case for non-corporate shareholders since 2003. *See* I.R.C. § 1(h)(3). As of this writing, dividends generally are taxed at preferential rates but it is uncertain whether they will continue to be so taxed.

after-tax prospects of the partner will be substantially diminished as compared to the results without the special allocation under outcomes that are reasonably likely to occur. In the example, Treasury concludes that the arrangement fails the substantiality test because there is no situation in which the low-tax partner is worse off than under a ratable allocation while in the worst-case scenario for the high-tax partner ($450 tax-exempt income and $550 taxable income), that latter partner is only $2.50 worse off on an after-tax basis than the partner would be under a ratable allocation, an amount that is not "substantial."[81]

Having concluded the allocation lacks substantiality, Treasury analyzes it under PIP.[82] In Treasury's view, the PIP analysis does not result in a disregard of the allocation but instead in a disregard of its tax effect: The allocation is treated as valid in the sense that it determines the partners' capital account balances but invalid to the extent it purports to allocate taxable and tax-exempt income as a means to achieve the balances. Accordingly, since there is $450 of tax-exempt income and the high-income partner's capital account is to be credited with 80 percent of that amount and none of the taxable income, that partner is allocated $360 of partnership income. The low-income partner is allocated the balance of partnership income, or $640.[83] Because the special allocation lacks SEE, Treasury views each partner as receiving a proportion of each type of partnership income equal to that partner's proportion of overall partnership income — presumably this is what is meant by PIP, in Treasury's view. Therefore, the high-taxed partner receives 36 percent of both partnership taxable income, or $198, and partnership tax-exempt interest, or $162, for $360 total and $99 of tax due (equal to 50 percent of $198). The low-taxed partner receives 64 percent of these items, or $352 and $288, respectively, for $640 total and $53 of tax due (equal to 15 percent of $352).

Treasury's PIP analysis has an apparent plausibility. It supposes that the partners intended to have the allocation for non-tax reasons and therefore that the allocation ought to be respected as a determination about how to allocate the (non-tax) attributes of partnership IGLD, including amounts thereof. Having reached that conclusion, the tax consequences would seem to follow from the usual principle of ratability, given that the stipulated tax consequences lack substantiality. If the allocation provides that a given partner ends up with X percent of partnership income, and if the allocation is taken at face value for non-tax purposes but not for tax purposes, then it would seem to follow that the partner's share of each of the various components of partnership income ought to be X percent as well.

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81. Reg. § 1.704-1(b)(5) Ex. (5)(ii).
82. I.R.C. § 704(b); Reg. § 1.704-1(b)(1).
83. Reg. § 1.704-1(b)(5) Ex. 5(ii).

The logic, however, is faulty. To conclude that the special allocation lacks SEE is in essence to determine that it is improperly tax-motivated. In other words, it is to conclude that the partners were not serious about their economic deal as specified in the allocation apart from its tax consequences or, stated in the converse, that the only basis upon which it did reflect their economic deal was with taxes factored in. Having concluded the tax consequences are not to be respected because the allocation was tax-motivated, it seems incorrect to continue to credit the allocation as reflecting the partners' deal on a pre-tax basis for purposes of the PIP analysis. Respecting the allocation for non-tax purposes is, in a sense, to contradict the regulations' initial determination that the allocation is tax-motivated. What drives the purported allocation is the link between the amounts of various items of IGLD and their type. If that were not the case, then the substantiality analysis should have been based upon a comparison with the outcome used in the PIP determination, since, by hypothesis, that is used as the tax-neutral baseline for the purpose of determining the tax consequences when the allocation fails substantiality.

Consequently, although the regulations allocate the types of partnership income in accordance with each partner's putative entitlement to overall partnership income, the entitlement itself remains unexplained. The facts of Example 5 state that the partners formed the partnership with equal capital contributions and that the partnership has no source of income other than from distributions on and sales and exchanges of securities.[84] On that basis, each partner would seem to own 50 percent of partnership capital and accordingly ought to be entitled to one-half of the partnership's income, at least on an *ex ante* basis. While the equal ownership ratio does not imply that the partners would bargain only for equal ratios of each item of partnership IGLD if tax considerations were not in play, for partners dealing with each other at arm's length, one would suppose that a departure from strict ratability for various types of IGLD would reflect an exchange of roughly equal expected values. Treasury's PIP analysis does not proceed on this basis. Once one takes tax benefits out of the picture, as the regulations' PIP analysis does, the high-tax partner is treated as exchanging a right to one-half of partnership investment income for a right to 40 percent of that income (on an expected value basis). That choice is unmotivated. If the underlying rationale of the SEE/PIP analysis is that partnership allocations that fail to track pre-tax economics with sufficient fidelity will be readjusted to be in accordance with PIP, the PIP inquiry ought to focus on pre-tax economics, not the economics of an allocation that, on a pre-tax basis, does not conform to the partners' actual interests in partnership capital. Instead, Treasury's PIP analysis functions as a kind of punishment designed to ensure that partners

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84. Reg. § 1.704-1(b)(5) Ex. 5(i).

adopt allocations that satisfy the SEE test. But, as others have noted,[85] that test is inherently ambiguous. Consequently, under Treasury's approach, allocations that lack SEE are apt to be reallocated in a manner that does not conform to PIP — arguably in conflict with the statute.

At least one commentator has suggested that a reason for the regulations' approach to PIP may be that a non-punitive PIP outcome — that is, one that simply disregarded the special allocation for all purposes — would substantially vitiate the force of the existing statutory scheme.[86] Because the statute provides that PIP is the fallback for an allocation that lacks SEE, a formula for PIP that simply disregarded a special allocation that lacked substantiality might not dissuade the partners from special allocations that had little likelihood of success, as the penalty would be the arrangement that would have been in effect if no special allocation had been attempted. The effect would be to provide taxpayers with a free option, or two bites at the apple.[87] The point, while valid, should not be lent too much weight. In many cases an allocation that lacks substantiality would have had substantiality if more after-tax risk had been built in, and overly aggressive taxpayers will have forgone the more modest benefits they could have had by attempting more reasonable allocations. Further, a position that is too aggressive will in fact be subject to penalties.[88] And, finally, it is not up to Treasury to compensate for defects in the statutory scheme if doing so violates the scheme.

Treasury's substantiality/PIP analysis may be usefully compared with the alternative of simply disregarding the assignment effects of the allocation, which is to say not disregarding the assignment *in toto*, as the substantiality analysis does, but viewing the ultimate capital account balances as the result of supplementing the aggregate theory of partnership taxation with transfers of partnership interests necessary to reach those balances. Such an approach is much more consistent with the theory of PIP as set out in the regulations since the regulations take the position that the allocation is valid even though the means to get there are not (since the allocation lacks substantiality). Accordingly, the baseline is the set of transactions that, on a pre-tax basis, get to the allocation, which is to say the aggregate theory supplemented by non-partnership-level transactions.

The analysis is straightforward as applied to Example 5. Under the same facts as in Example 5 ($550 of taxable income and $450 of tax-exempt income, no other net income or loss to the partnership), each partner is treated as receiving allocations from the partnership of $275 of taxable

85. Polsky, *Tax-Driven Allocations*, *supra* n.9; Yin, *Future Taxation*, *supra* n.3.

86. Polsky, *Tax-Driven Allocations*, *supra* n.9, at 115–16.

87. *Id.*

88. I.R.C. § 6662.

income and $225 of tax-exempt income. Since the net effect of the special allocation is the transfer of $140 in value from H to L (equal to $275, or one-half of the taxable income, less $135, or 30 percent of the tax-exempt income), H ends up with a partnership interest $360 greater in value than at the beginning of Year 1, and L with a partnership interest $640 greater in value.[89] After these transactions, the high-tax partner's taxable income is $135 (equal to the $275 inclusion of partnership taxable income less the net $140 payment to the low-tax partner), and the high-tax partner's tax liability is $68 on $360 of total (taxable plus tax-exempt) income. The low-tax partner's taxable income is $415 (equal to the $275 inclusion of partnership taxable income plus the $140 net payment from the high-tax partner), and the low-tax partner's tax liability is $62 on $640 of total (taxable plus tax-exempt) income. The partners' combined tax liability is $130 on $550 of taxable income and $1,000 of total income, or 23.6 percent and 13 percent respectively. By contrast, if the special allocation had been respected, the high-tax partner's return would have been $360 of tax-exempt income, and the low tax-partner's would have been $550 of taxable income and $90 of tax-exempt income, resulting in total combined tax paid of $82.50 on $550 of combined taxable income, or 15 percent on the combined taxable income and 8.3 percent on combined total income.

It is important to note that, as contrasted with the Depreciation/Gain Chargeback Example, in more complicated settings, the preceding analysis would need some refinement. The exchange here cannot be viewed simply as the transfer of a $140 partnership interest from H to L. From the 50-50 baseline, H gives up $275, equal to the amount of taxable income owned by H on a ratable basis, and receives $135, equal to sixty percent of L's ratable share of tax-exempt income. These two transfers are equivalent to a single net transfer of a $140 partnership interest only if there is no unrealized gain or loss in both partners' partnership interests and a section 754 election is not in effect. If the first of these requirements is not met, then each partner must reckon the consequences of the disposition of a partnership interest for an amount different from its basis;[90] if the second is not met, the partnership's bases in its assets will need to be adjusted to reflect both transfers.[91]

Because the facts assume no variation between inside and outside basis (following the accounting for each partner's ratable share under section 702) and that no section 754 election is in effect, these issues may be disregarded. Table 6a sets out the partners' tax liabilities and rates (as a percentage of shares of total partnership income) under the aggregate

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89. The valuations assume no change to the values of the underlying assets of the partnership.

90. *See* I.R.C. § 61.

91. *See* I.R.C. § 743(b).

analysis as well as under the alternative assumptions that the SEE is valid and that Treasury's PIP analysis applies.

Table 6a: Tax Liabilities and Rates[92] on Total Partnership Income Under Alternative Theories: $450 Tax-Exempt Interest and $550 Taxable Income[93]

Partner	SA Respected Amount/Rate		PIP Amount/Rate		Aggregate Theory Amount/Rate	
High-Tax	$0	0%	$99	27.5%	$68	18.9%
Low-Tax	83	12.9	53	8.3	62	9.7
Total	$83	8.3%	$152	15.2%	$130	13%

Table 6b sets out the partners' after-tax receipts under these alternatives.

Table 6b: Total After-Tax[94] Amounts Under Alternative Theories: $450 Tax-Exempt Interest and $550 Taxable Income

Partner	SA Respected	PIP	Aggregate Theory
High-Tax	$360	$261	$292
Low-Tax	557	587	578
Total	$917	$848	$870

V. POSSIBLE APPROACHES TO SPECIAL ALLOCATIONS

It is not immediately clear why partnership special allocations ought to be tolerated when the aggregate theory supplemented by non-partnership-level transactions would seem to achieve the desirable result of accounting for pre-tax economics without sacrificing tax accuracy. Here I suggest two possible reforms, consistent with this general observation. The first is that greater flexibility in accounting for varying ownership arrangements within the partnership would go some way toward alleviating concerns about different ownership ratios for different types of partnership property. Second, I suggest that a limited place for special allocations may remain where it is clear that tax avoidance is not the principal motivation and, critically, material tax reduction does not arise. From this perspective, partnerships

92. Rates are expressed as the percentage of all partnership income, both taxable and non-taxable, allocated to the partner that is paid in tax.

93. Figures are rounded to the nearest dollar and the nearest one-tenth percent.

94. Under each theory, the pre-tax amounts are $360 for the high-tax partner and $640 for the low-tax partner.

could be viewed as the mechanism by which (among other things) character assignments are permitted when there is a legitimate business-purpose-driven reason for them.

Subpart A argues that the best approach to dealing with special allocations is not to abrogate the aggregate theory but instead to make it more nuanced through what might be termed a partnership within a partnership ("PWP"), or mini-partnership, approach. Subpart B discusses the limited situations in which genuine character assignments ought to be tolerated — those cases in which policy considerations favor character assignments through special allocations.

A. Partnership Within a Partnership

In many situations, for non-tax reasons the partners may wish to have a sharing arrangement with respect to some items of partnership property that differs from the larger sharing arrangement reflected in their capital accounts. Indeed, this is just what a special allocation is. As long as the partners carry through the consequences of the altered sharing consistently, there should be no problem of improper assignment. Consider that, instead of a special allocation, the partners in many cases could have established a separate partnership that owned just the assets for which a different sharing arrangement was desired and effectuated through a special allocation. If allocations in that separate partnership tracked the capital account balances or, more generally, the PIP in that partnership, there would be no special allocation. Accordingly, the provision of special rules that permit varying ownership ratios of specific items of partnership property in a single partnership ought to not pose a problem as long as the ownership ratios are respected all the way down.

1. Simple Disproportionate Allocation

The simplest kind of special allocation that can be accommodated under the PWP approach is one that assigns all aspects of the ownership of an item of partnership property to the partners in a ratio that differs from the overall ownership ratio. Where the ownership is carved out of existing partnership property, there would be a taxable transfer at the formation of the special allocation, and thereafter the treatment of all items in respect of the carved-out item would be treated as though part of its own partnership. The consequences of transactions or events with respect to the special allocation could, in principle, simply pour over into the larger partnership, but only as long as earnings in respect of partnership capital are allocated in accordance with the ratio of capital account balances. Example 2 illustrates these features.

> *Example 2* — On Day 1 of Year 1, E and F each contribute $100x to the EF partnership in exchange for 50-percent interests therein. The EF partnership agreement satisfies the requirements of the section 704(b) regulations for economic effect. The partnership agreement further provides that all items of partnership IGLD will be shared equally, except that E and F will share items of partnership IGLD in respect of partnership depreciable property 70-30, respectively.

On the same day that EF is formed, the partnership purchases Warehouse for $150x. Since E and F share all items in respect of Warehouse 70-30, the purchase of Warehouse effectuates a $30x capital transfer from F to E. Like the transfer of a portion of Factory from A to B in the Depreciation/Gain Chargeback Example, this transfer must be understood as a payment to E, not as the sale or exchange of a capital asset. Accordingly, the transfer is deductible to F and includible as ordinary income to E. Subsequent to the purchase, E and F establish separate partnership capital subaccounts for their respective interests in Warehouse by deducting appropriate balances from their principal accounts. Items of IGLD in respect of Warehouse are allocated in the 70-30 ratio.

Suppose Warehouse is depreciable over fifteen years on a straight-line basis at $10x per year. In each year, E takes $7x of depreciation and F takes $3x, adjusting the Warehouse accounts accordingly. In theory, the partners could maintain completely separate capital accounts consistently for Warehouse as though it were a separate partnership, or they could cause the results of the Warehouse account to pour over into the general capital accounts, provided that sharing ratios in the larger partnership were adjusted to reflect the adjusted ratio of capital account balances. (Note, however, that the sharing ratio would apply solely with respect to items of capital income, not with respect to items of labor income.[95])

2. *Disproportionate Allocation Coupled with Special Allocation*

It is also possible to combine disproportionate allocations with special allocations that are recharacterized as ratable allocations together with transactions between the partners (or, in some cases, between the partnership and the partners but not on the basis of partnership equity). The purpose of such an arrangement would be to minimize the extent to which an allocation that varies from the basic allocation of the partnership agreement produces untoward tax consequences. In general, a special allocation creates assignment problems because it allocates part but not all aspects of

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95. *See supra* Introduction.

ownership of a partnership item to the partners in a ratio that differs from the general sharing ratio. Accordingly, one can view a special allocation as a departure from ratability with respect to a feature of ownership. Once one can choose the underlying sharing ratio against which the departure is measured, it is possible to minimize the adverse tax consequences of the special allocation by choosing the disproportionate allocation from which the least tax distortion arises under the special allocation.

The Taxable and Tax-Exempt Securities Example discussed previously illustrates how such rules might operate. In that example (as set out in the Treasury regulations), the high-tax partner, whom I refer to as H, is allocated 80 percent of partnership tax-exempt income, and the low-tax partner, whom I refer to as L, is allocated the remaining partnership income. The partners share in all other items of partnership IGLD equally.[96] The facts state that the partnership is expected to realize between $450 and $550 of each type of interest income annually. The consequences of the special allocation under the pure aggregate theory are set out in Part IV.

Under the disproportionate approach presently under consideration, the adverse consequences of the special allocation could be mitigated to some extent. Consider that all income of the partnership derives either from distributions on the securities or from dispositions of the securities (which also can generate loss). Rather than begin with equal ownership of the securities (so that non-ratable allocations of distributions trigger deemed transactions under the aggregate theory but gains and losses on dispositions, at least initially, do not), one might begin with ownership ratios that reflect, or more nearly reflect, the sharing agreement on distributions. If H is to receive 80 percent of the distributions, then H might be deemed to own 80 percent of the tax-exempt obligations and a reduced (or perhaps even zero) interest in the taxable obligations. Distributions on the securities then would be allocated with little or no recharacterization, but gains and losses on dispositions of the securities would be re-allocated, in effect reversing the consequences under the existing rules and applying the aggregate theory to the special allocation.

To see how such an arrangement might play out, it is worth developing the example in somewhat more detail. In general, the return on tax-exempt debt is discounted to reflect the tax benefit, meaning that the fair market values of the two sets of securities cannot be approximately the same given that the expected distributions are expected to be approximately the same. The tax-exempt securities must have a higher face amount since they generate less interest per dollar invested, but the total interest paid (on a pre-tax basis) is roughly equal for the two types of instrument. The size of the discount on tax-exempt debt tends toward (though generally does not

96. Reg. § 1.704-1(b)(5) Ex. (5)(i). In the example, H and L are I and J respectively.

reach[97]) an interest rate such that the after-tax yield on taxable debt subject to the highest marginal rate approximates the yield on tax-exempt debt.[98] If the maximum individual tax rate is 35 percent, it is reasonable to assume that the rate on tax-exempt debt reflects a 30 percent discount from the rate on taxable debt.

Suppose that the pre-tax rate of return on taxable debt is 10 percent and therefore that the rate on tax-exempt debt is seven percent. If total distributions are expected to be $500 for each type of security, the partnership's basket of taxable securities would be worth approximately $5,000 while the basket of tax-exempt securities would be worth approximately $7,142.[99] Table 7 sets forth the capital accounts of the partnership on these assumptions. Again to keep things simple, the example supposes that the partnership purchases the securities using cash contributed by the partners.

Table 7: HL Initial Balance Sheet–Capital Accounting Rules

Partnership Assets			**Partnership Liabilities:** $0		
			Capital Accounts		
Asset	**A/B**	**Book**	**Partner**	**A/B**	**Book**
Taxable securities	$5,000	$5,000	H	$6,071	$6,071
Tax-exempt securities	7,142	7,142	L	6,071	6,071
Total	$12,142	$12,142	Total	$12,142	$12,142

Under the terms of the example, the partners contribute equal amounts of cash in exchange for their partnership interests. The partnership then purchases the securities and allocates partnership items according to the partnership agreement. As discussed above, the consequences of doing so if the aggregate theory applies include deemed taxable transactions between the partners.

97. For an analysis of the reasons why the rate on tax-exempt debt fails to capitalize fully the tax benefit it offers, see Calvin H. Johnson, *A Thermometer for the Federal Tax System: The Overall Health of the Tax System as Measured by the Implicit Tax*, 56 SMU L. REV. 13 (2003).

98. For example, according to edwardjones.com, as of Aug. 31, 2012, rates on AAA-rated municipal bonds topped out at 3.14 percent while those on investment-grade corporate debt topped out at 4.10 percent. EDWARD JONES, https://www.edwardjones.com/en_US/market/rates/current_rates/index.html (last visited Sept. 1, 2012).

99. That is, $500 is 10 percent of $5,000 and 7 percent of $7,142.

Another possibility, however, is that the partners employ some kind of disproportionate allocation to minimize the adverse tax consequences of the allocation. For example, the partnership could immediately allocate 80 percent of the tax-exempt securities to H and adjust ownership in the taxable securities appropriately. The value of 80 percent of the tax-exempt securities is $5,714. Since the partners contribute equal amounts, or $6,071 under the assumptions used here, it would seem likely that H would continue to own $357 worth of the additional partnership securities. The partnership's capital accounts would include separate entries for tax-exempt securities, allocated 80-20 to H and L, and for taxable securities, allocated entirely to L, in both cases but for $357 of securities that could be composed of any combination of taxable and tax-exempt securities and would be allocated to H. To the extent partnership income derived from distributions on the securities, there would be only minimal further transactions deemed to occur between the partners (specifically, distributions on the portion of taxable securities that L owns). By contrast, gains or losses realized on dispositions of the securities would be allocated between the partners roughly equally triggering deemed transfers between the partners under the aggregate theory because of the disproportionate ownership. In the case of the disposition of a tax-exempt security, approximately 30 percent of the gain or loss realized would be deemed shifted from H to L while in the case of the disposition of taxable securities, slightly less than 50 percent of the gain or loss would run in the opposite direction. Whether this arrangement proved superior to the default arrangement (equal ownership interests) would depend upon the partners' expectations about the sources of partnership income and loss.

B. Permissible Character Assignments

The assignment of character is not intrinsically problematic; rather, it is the tax-motivated assignment of character that by its nature creates difficulties. In the case of most character assignments, the purpose of the special allocation is to reduce after-tax income without reducing concomitantly the aggregate pre-tax economic return of all the partners. The result is achieved by the partners' cooperation with each other in a way that effectively produces a payment from the Treasury to the partnership, which payment is divided among the partners. Example 5 from the special allocation regulations illustrates how this would work if the example satisfied the SEE rules. (And, presumably, it would be possible to build enough additional after-tax risk into the partners' sharing arrangement for those rules to be satisfied even though the expected after-tax value of the allocation to all partners would exceed the expected after-tax value of ratable allocations of partnership income.) In that situation, the special allocation will generally increase the returns of both partners relative to the returns they would receive absent the allocation, even though the economic activity of the

partnership — holding taxable and tax-exempt securities — and its pre-tax income are the same.

In other situations, however, it may be appropriate to permit character assignments.[100] Where untoward tax motivation is absent, the question becomes whether the interest in providing flexibility to the partners in their economic arrangement outweighs the policy reasons that favor differentiating among types of income for tax purposes. One such frequently recurring situation involves so-called tax-exempt bond partnerships (a "TEBP"). TEBPs are investment vehicles used primarily by money market funds to obtain short-term-rate, variable returns on tax-exempt obligations in a highly liquid form.[101] The demand for TEBPs exists because issuers of tax-exempt bonds generally prefer to issue bonds having a longer fixed-rate term, while a number of investors seek shorter-term variable yields as well as reduced risk to the capital invested.[102] Consequently, the market does not supply short-term tax-exempt debt obligations directly in quantities that match demand or with sufficient liquidity to enable investors to avoid risk of loss. TEBPs fill this lacuna by creating synthetic short-term tax-exempt bonds that generally can be put back to the partnership at or close to purchase price.[103] In a typical TEBP, a sponsor creates the TEBP as a state-law trust that is treated as a partnership for federal tax purposes.[104] The trust purchases tax-exempt debt obligations having a variety of maturity dates and issues two types of certificates in exchange for contributions: variable and residual. Holders of the variable certificates (the primary investors) are entitled to a variable rate of return on their capital contributions; the returns are funded by payments on the underlying tax-exempt obligations held by the trust. Holders of the residual certificates are entitled to any remaining trust income. The returns on the variable certificates generally track short-term interest rates. The variable holders' instrument is a synthetic short-term variable-rate bond. The rate on the synthetic bond is always less than the blended rate achieved by the TEBP. The money market fund generally has a

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100. Other commentators who generally oppose special allocations have recognized that in limited circumstances special allocations may be appropriate. *See, e.g.*, Darryll K. Jones, *Towards Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047, 1099 (2006) (arguing that in the rare case in which the partners can demonstrate a sufficient non-tax motivation, a special allocation may be permissible).

101. *See generally* STANLEY I. LANGBEIN, FEDERAL INCOME TAXATION OF BANKS & FINANCIAL INSTITUTIONS, ¶ 3.07[10][B] (discussion of TEBPs).

102. *See* Notice 2008-80, 2008-2 C.B. 820.

103. *Id.*

104. *See* Reg. § 301.7701-4.

right to put its certificates to the partnership on short notice, such as seven days, at a price that is at or close to fair market value.[105]

The principal tax issue for TEBPs concerns the qualification of the returns for tax-exempt status when they are paid to holders of interests in the money market fund. Money market funds are generally formed as regulated investment companies — mutual funds — which are corporations subject to pass-through treatment on their earnings as long as a number of detailed requirements are met.[106] Among the requirements that must be satisfied if tax-exempt returns earned by the money market fund are to be passed through to its holders as tax-exempt are that at least 50 percent of the money market fund's assets by value consist of tax-exempt obligations and the fund distributes at least 90 percent of its net excludable interest income to its holders.[107] Because the tax year of the money market fund may differ from that of the TEBP, it is possible that these rules will not be satisfied for every tax period during which the money market fund holds its certificates. The IRS has addressed this issue in a number of revenue procedures.[108]

There is, however, a subsidiary issue that TEBPs pose in the context of an analysis of whether assignments of character should be permitted. (The issue does not arise if one assumes, as the IRS must, that the SEE rules are valid.) In order for all amounts distributed in respect of the residual certificates to qualify as tax-exempt, an assignment of tax-exempt income among the TEBP's partners must be permissible. Otherwise, allocations of income from distributions on the underlying bonds that differ from the ratable distributions would be treated as taxable transfers from the variable to the residual interest holders, not as distributions of tax-exempt interest income. Under the theory proposed here, the transfers would be of partnership interests themselves.

It is not readily apparent whether the failure to account for the allocations of taxable and tax-exempt income as transfers of partnership interests is abusive. The economic substance of the partners' arrangement is that the variable holders take a reduced rate of return and surrender most of the opportunity for gain in exchange for liquidity and the elimination of most risk of loss. If the parties engaged in these transactions outside of a partnership, the net effect would likely be a liquidity purchase by the mutual funds (since transfer of the opportunity for gain and risk of loss likely offset). The question is how to characterize a payment for liquidity for income tax

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105. *See* Notice 2008-80, 2008-2 C.B. 820 (describing the features of TEBPs).

106. *See* I.R.C. §§ 851–855 (Subchapter M of Chapter 1 of the Code covering regulated investment companies.)

107. I.R.C. § 852(a).

108. Rev. Proc. 2003-84, 2002-2 C.B. 1159, Rev. Proc. 2002-68, 2002-2 C.B. 753, Rev. Proc. 2002-16, 2002-1 C.B. 572.

purposes. For the funds, it is either an ordinary business expense[109] or a capital outlay.[110] Although the mutual funds are not taxable[111] and no deduction would be available to the mutual funds for the expenses of producing tax-exempt income anyway,[112] the characterization matters because it affects whether the funds are able to pass through tax-exempt income to their shareholders. Section 852 permits a regulated investment company such as a money market fund to pass tax-exempt income to its holders as tax-exempt only if certain requirements are met. In particular, the fund must distribute at least 90 percent of its tax-exempt income, net of deductions disallowed under section 265 (and section 171(a)(2)), to its holders during the taxable year.[113] Because the provision does not permit an offset for capitalized expenditures, a liquidity payment that qualified as a capital outlay would not reduce the amount of tax-exempt income the fund would have to distribute to its holders in order for the tax-exempt character to pass through to them. However, if the liquidity payment qualified as a business expense, then, although it would be disallowed under section 265, it would count as an offset to the amount needed to be distributed.

As a general matter, business outlays are deductible, subject to certain limitations.[114] The principal limitation relevant for this discussion is that the payment be "ordinary" rather than capital in nature.[115] A capital payment is generally understood as a payment for the purchases of an item, tangible or not, having material value beyond the taxable year of purchase,[116] whereas "ordinary" generally means providing a short-term benefit[117] and typically is deductible as long as "necessary," or fitting.[118] Payments for liquidity, as long as made for the current year tax year, certainly are "necessary" and likely qualify as ordinary when they are not made in connection with the acquisition of the asset with respect to which the liquidity is provided. The IRS has held in field service advice that liquidity payments, to the extent not in excess of the actual market cost of liquidity,

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109. *See* I.R.C. § 162.
110. *See* I.R.C. § 263.
111. I.R.C. §§ 561, 852(b)(2).
112. I.R.C. § 265(a)(1).
113. I.R.C. § 852(a)(1)(B).
114. I.R.C. § 162(a).
115. *See* I.R.C. § 263.
116. INDOPCO v. Commissioner, 503 U.S. 79, 87–88 (1992).
117. Deputy v. DuPont, 308 U.S. 488, 495 (1940).
118. Welch v. Helvering, 290 U.S. 111, 113 (1933) ("necessary" means "'appropriate and helpful.'").

are deductible.[119] Further, liquidity payments are closely similar to guarantee fees, which also generally are deductible.[120]

The issue in the TEBP context is clouded by the fact that the agreement to take a reduced return in exchange for liquidity arguably represents a cost of the partnership interest and therefore could be viewed as requiring capitalization under the general rule that acquisition costs of capital assets must be capitalized.[121] Under this view, the amounts paid for the liquidity would not be deductible under section 162 (assuming the disallowance under section 265 did not apply) but would be added to the mutual fund's basis in the TEBP interest. In favor of the view that the liquidity payments represent a cost of the partnership interest are that the liquidity is not separately purchased and is not an optional payment; on the other side, the fact that the liquidity payment is ongoing rather than up front in nature points in favor of characterization as ordinary.[122]

It is my understanding that it was the uncertainty in the characterization of the liquidity payment as "ordinary" versus capital that gave rise to the decision to structure the money market funds' investments in pools of tax-exempt obligations as a partnership.[123] As indicated above, in the partnership setting the issue disappears because the liquidity payment is made through a partnership special allocation, and the allocation clearly has SEE. The special allocation mimics a deduction for liquidity through the mechanism of an exclusion from gross income of the amounts that would be paid for liquidity. For present purposes, however, where the appropriateness of special allocations themselves is the focus of the inquiry, the question is whether the motive of characterizing a liquidity payment as in effect deductible (by simply directing it to the other partners) rather than potentially capitalizable is improper and so should not be permitted.

The question is somewhat closer than in the usual special allocation setting, which I have argued generally involves an inappropriately tax-motivated assignment of character. From the perspective of the money market funds, the issue is whether it becomes possible to create, with sufficient certainty, a variable-return tax-exempt obligation when the market does not supply those obligations directly. The question is one of tax risk. If the liquidity payment would properly be deductible, then the use of the

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119. F.S.A. 1992-927.

120. IRS Rev. Rul. 70-544, 1970-2 C.B. 6, *modified by* Rev. Rul. 74-169, 1974-1 C.B. 147 and *clarified by* Rev. Rul. 84-10, 1984-1 C.B. 155.

121. *See* Reg. § 1.263(a)-(4) (requiring capitalization of costs to acquire intangible assets such as corporate stock).

122. *See generally* BITTKER & LOKKEN, FEDERAL TAXATION, *supra* n.17, at ¶ 105A.1 (discussing factors relevant to the capitalization-versus-deduction question).

123. E-mail from George G. Wolf to author (Aug. 13, 2012, 4:29:46 PDT) (on file with the author).

partnership structure with a special allocation is unnecessary; the same result could be had outside of the partnership structure. If, however, the liquidity payment ought to be capitalized, then it is not possible for money market funds to invest in variable-rate, synthetic tax-exempt debt and to pass the tax exemption on to their holders. It, thus, becomes necessary to evaluate the tax significance of the distinction between a capitalizable payment and a deductible one in the context of the tax rules for money market funds.

As discussed previously, the main reason for requiring capitalization of certain business outlays under an income tax is to ensure that income is properly timed. If a payment produces a material on-going benefit to the taxpayer, it would be inappropriate to permit a deduction for the full amount of the payment in the period it is made, because the taxpayer has not "lost," or at any rate has not converted into goods or services, the full value of the payment in that period. Rather, the taxpayer has purchased an asset that has value even at the close of the period of purchase.

The significance of the issue, however, is diminished in the case of money market funds, which as regulated investment companies are largely tax-exempt because of the deduction to which they are entitled for dividends paid.[124] The tax question becomes whether there should be a taxable inclusion for the money market fund's holders if the purchase of liquidity protection for tax-exempt income is properly characterized as a capitalizable cost rather than as an ordinary and necessary business expense that is nonetheless not deductible by reason of section 265. If there is, then the availability of the partnership form as a way around capitalization permits tax reduction that arguably is untoward; if there is not, then, at least on the funds' side, there does not seem to be much reason to preclude use of the partnership form as a way to get around the technical difficulty that a liquidity payment would not qualify as a reduction of income for purposes of the 90 percent distribution requirement (assuming, that is, that the payment would have to be capitalized).[125] The principal basis for concluding that untoward tax reduction does not occur is that the payments are not deductible in any case, because of the anti-arbitrage rule of section 265(a), which generally denies deductions for costs incurred in order to generate tax-exempt income.

In addition, the technical rule that capitalizable costs do not count for purposes of calculating the 90 percent rule of section 852(a)(1) does not appear to have a deep theoretical foundation. Even if an outlay for liquidity protection would properly be capitalized rather than deducted, it does not appear that effectively permitting a deduction (by the mechanism of an exclusion through the partnership form) for the protection that is purchased provides a tax benefit. The outlay, recall, is made on an on-going basis in the

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124. I.R.C. § 561.
125. I.R.C. § 852(a)(1)(B).

form of a reduced rate of return on the TEBP's securities. The effect of permitting an immediate deduction (or exclusion) of amounts actually paid (constructively received and paid over) is not, then, to accelerate the deduction for a capital item because only the portion of the outlay attributable to the current year is actually made in the current year, and only that portion is effectively deducted under the partnership arrangement (by means of the exclusion).[126] In short, if the only tax concern were the treatment of money market fund shareholders, the use of the partnership form to get around the technical difficulties that section 852(a)(1)(B) creates does not appear problematic.

There remains, however, the treatment of the holders of residual interests in the TEBP. Outside of the partnership setting, a liquidity payment would be taxable to the recipient as ordinary income. Under the partnership special allocation, the liquidity payment takes the form of tax-exempt interest redirected from the variable holders to the residual holders (assuming they are the liquidity providers; in some cases they are not[127]). Consequently, there is a net reduction in total tax revenue. However, the fact that a revenue loss arises should not be determinative, by itself, of whether the special allocation ought to be permitted.

In light of these considerations, it would appear that the tax policy issue for TEBPs is whether the failure of the market to supply an investment vehicle for which legitimate demand exists is a sufficient basis to permit the residual holders, through the mechanism of a special allocation, to avoid tax on what is effectively compensation income. The issue is not what the right answer to the question is, or even if there is a right answer in the abstract, but whether it would be reasonable for the IRS or Treasury to conclude that the tax revenue loss is worth it. Unlike the typical special allocation for which the impetus is tax avoidance, the special allocation in the TEBP case is not motivated by untoward tax avoidance. (The motivation is tax-based in that it is to ensure the preservation of a tax exclusion, but the exclusion itself is provided under the Code.) However one comes down on the answer to the underlying question, the factors to be weighed in making the determination differ from those in the usual special allocation in that valid considerations exist on both sides. In other words, Congress or Treasury could reasonably believe that fixing market imperfections justifies providing an otherwise untoward tax benefit to the residual holders.

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126. Even accrual method taxpayers would be unable to deduct the portion of a liquidity payment attributable to future years because neither the amount nor the fact that the obligation is fixed. *See* Reg. § 1.461-1(a)(2)(i). In addition, economic performance occurs only as liquidity protection is provided. *See* I.R.C. § 461(h)(2)(A).

127. Notice 2008-80, 2008-2 C.B. 820.

VI. CONCLUSION

Partnership special allocations present a problem under the tax law. In the abstract, it may seem reasonable to permit partners, when motivated by a non-tax business purpose, to use special allocations to assign types and perhaps even amounts of partnership IGLD among themselves in ways that vary from their ratably determined economic rights to these items. This abstract idea seems to have motivated the 1976 amendments to section 704(b), which permit assignments that have "substantial economic effect."[128] In practice, however, the rules that govern special allocations are too lenient. They permit many assignments that are clearly tax-motivated and that on an *ex ante* basis have positive value because of taxes. The rules have a further problem in that, in cases in which they classify a special allocation as lacking SEE, they provide a determination of PIP that seems at odds with the concept of PIP itself.

It is not clear how anything other than a substantial narrowing or elimination of the availability of special allocations within the framework of partnership accounting can address these difficulties. An elimination of special allocations would require accounting for the results of special allocations outside of the partnership, much as has been explored here in the framework of aggregate accounting. A narrowing of the special allocation provisions as suggested in Part V would entail largely the same accounting, with, however, the possibility for limited exceptions to aggregate accounting where non-tax business concerns motivate the allocation and tax considerations are adjudged insignificant enough in relation to those concerns to warrant the special allocation.

An alternative to the approach of narrowing or eliminating special allocations would be to move in the opposite direction, in which case the effort should extend beyond section 704 to other aspects of subchapter K. One might conclude that the abuses that the SEE rules permit are simply too costly to police or too small to worry about, since they generally involve character and not amounts. While I am not of the view that this is the appropriate course, reasonable minds can disagree.[129] If Congress were to make the judgment that the character-motivated shifts under the SEE rules are not abusive, it would seem Congress ought to make the same judgment about character shifts across the board. In particular, it would seem that Congress should apply similar reasoning to other provisions of subchapter K, many of which seek to prevent the same type of abuse that the SEE rules in their current form permit. Of particular note in this context would be section 751, which mandates a complicated and quite burdensome test and set of

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128. I.R.C. § 704(b).

129. *See, e.g.*, MCKEE ET AL., PARTNERSHIPS AND PARTNERS, *supra* n.18, at ¶ 21.01[2] (arguing that concerns over character shifts are overstated).

constructive transactions in order to determine whether liquidations or dispositions of partnership interests are disproportionately tilted toward capital or ordinary items and, if they are, to recharacterize the transaction in a manner that prevents character shifts. Repeal or significant narrowing of the scope of section 751 would seem to reduce compliance costs, administrative burdens and costly tax planning.