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Partnership Allocations and Capital Accounts Analysis

DONALD J. WEIDNER*

I. INTRODUCTION

This Article concerns the extent to which partners may divide the deductions and tax losses of their partnerships as they see fit. The subject will continue to create controversy because it is one that is approached, at the extremes, with one of two irreconcilable viewpoints. The first may be characterized as that of the public-spirited, incentive-induced entrepreneur. It is his, or her, position that the entrepreneur who qualifies for a deduction, for example, a depreciation deduction by constructing, owning, and operating an apartment house, ought to be able to use that deduction, at least to the extent of being able to allocate it to his or her partners in the apartment house venture. If, for example, our entrepreneur constructs and operates many depreciable assets, thus engaging in a great deal of the kind of behavior Congress seeks to encourage, so that he has more deductions than necessary to shelter his own income from tax, why should he not be free to pass those deductions on to his co-adventurers? To rule otherwise, it is argued, is to deny the benefit of the incentive to precisely those members of the private sector most successful at engaging in the encouraged activity. In the case of the investment credit, for example, there is express statutory provision for the allocability of the credit between lessor and lessee.¹ If a moving force in a transaction has no taxable income against which to apply the deduction, let him place it on the bargaining table with present or prospective partners. Otherwise, the incentive has no value to him.

The opposing viewpoint may be characterized as that of the public-spirited, treasury-protecting revenue agent defending the progressive rate structure. The hypothetical defender of the Treasury who seeks something called "tax equity" protests that the average citizen may not go into his backyard and, over the fence, purchase the mortgage interest deductions of his neighbors. If this is so, why should the same result, only on a much grander

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1. The Internal Revenue Code of 1954, *as amended*, § 48(d) provides that the lessor of new property subject to the investment credit may elect to pass that credit on to the lessee. *See S. REP. NO. 1881, 87th Cong., 2d Sess. 19 (1962)*:

Permitting the investment credit to be passed on to the lessee in these cases is believed to be desirable since, as a result of this provision, it is possible for the lessor to pass the benefit of the investment credit on to the party actually generating the demand for the investment.

Treas. Reg. § 1.46-3(f) (1972) provides specific rules governing the allocation of investment credit among partners.

scale, be achieved by becoming a limited partner in a neighbor's business venture? The notion is a simple one: it is unseemly to permit either a neighborhood or a national marketplace at which individuals can trade in tax deductions or losses; to tolerate it does violence to the progressive rate structure many see as crucial to achieving "tax equity."

These two fundamentally different attitudes collide head-on in the current controversy about partnership allocations, which never will be resolved to the satisfaction of all concerned. This Article begins with a summary of the most important rules and decisions on the freedom partners have to allocate partnership deductions and losses among themselves. It then proceeds to a statement and evaluation of what has come to be known as the "capital accounts analysis" of special allocations.

II. THE PRIMARY AUTHORITY

A. *The Basic Rules*

The four basic rules of partnership allocation can be stated simply. First, partners are generally free to determine in their "partnership agreement" how to allocate among themselves partnership income, gain, loss, deduction, or credit.² Second, the "partnership agreement" includes any modifications that are made up until the time required for the filing of the partnership return.³ Third, an allocation in the partnership agreement will be disregarded if it "does not have substantial economic effect."⁴ Finally, if an allocation in the partnership agreement is disregarded because it lacks substantial economic effect, its subject will be reallocated "in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances)"⁵ These last two rules reached their present form as a result of the Tax Reform Act of 1976.⁶

The present "substantial economic effect" requirement replaces pre-1976 Act language that said an allocation will be disregarded if its "principal purpose . . . is the avoidance or evasion of any tax"⁷ Nevertheless,

2. I.R.C. § 704(a).

3. I.R.C. § 761(c).

4. I.R.C. § 704(b)(2). Section 704(e)(2) specifically provides for the allocation of partnership income between the donor and the donee of a partnership interest. Section 706(c)(2)(A) provides rules for allocations in the event a partner sells or exchanges his entire partnership interest during the year, or whose interest is completely liquidated during the year. Section 706(c)(2)(B) provides rules for allocations in the event partners' interests in the partnership vary during the year. See *Rodman v. Commissioner*, 542 F.2d 845 (2d Cir. 1976); *Marriott v. Commissioner*, 73 T.C. Adv. Sh. 1129 (1980); *Moore v. Commissioner*, 70 T.C. 1024 (1978).

5. I.R.C. § 704(b).

6. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976) [hereinafter referred to as the 1976 Act].

7. Immediately prior to the passage of the 1976 Act, I.R.C. § 704(b) stood as follows:

(b) DISTRIBUTIVE SHARE DETERMINED BY INCOME OR LOSS RATIO.—A partner's distributive share of any item of income, gain, loss, deduction, or credit shall be determined in accordance with his distributive share of taxable income or loss of the partnership, as described in section 702(a)(9), for the taxable year, if—

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

there are several reasons why authority under the "principal purpose" limitation retains its vitality. Most basically, it is not clear that Congress intended any substantive change in the law when it replaced the "principal purpose" limitation with the "substantial economic effect" requirement. It is ironic that when the "principal purpose" limitation was introduced in 1954, the Senate Report explained it in terms of "substantial economic effect."⁸ In part because of this legislative history, and because "substantial economic effect" language subsequently became prominent in the "principal purpose" Regulations,⁹ there appears to have emerged, prior to the 1976 Act, a consensus that the fundamental test for determining whether an allocation satisfies the "principal purpose" limitation is whether it has "substantial economic effect." Another reason for concluding that authority under the "principal purpose" limitation retains its vitality is that the legislative history of the 1976 Act repeatedly refers to existing law to determine what constitutes substantial economic effect.¹⁰

The present reallocation mechanism of "the partner's interest in the partnership (determined by taking into account all facts and circumstances)"

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

Section 702(a)(9) has been renumbered § 702(a)(8), and citations herein will reflect the change.

8. S. REP. NO. 1622, 83rd Cong., 2d Sess. 379 (1954), explained the "principal purpose" limitation, in part, as follows:

Where, however, a provision in a partnership agreement for a special allocation of certain items has substantial economic effect and is not merely a device for reducing the taxes of certain partners without actually affecting their shares of partnership income, then such a provision will be recognized for tax purposes.

The legislative history indicates little more than that partners were to have substantial leeway to determine allocations among themselves and that they were to be permitted to share income in a different manner than they share in losses. Both the House and the Senate Reports contain the following statement:

In the case of a partnership where there is a different ratio for sharing income than that applicable for sharing losses, the income ratio shall be applicable if the partnership has taxable income in the particular taxable year, and the loss ratio shall be applicable in any year in which the partnership has a loss.

H.R. REP. NO. 1337, 83d Cong., 2d Sess. A233 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 379 (1954).

9. The Regulations state that the following are among the relevant circumstances in determining whether the principal purpose of an allocation in a partnership agreement is the avoidance or evasion of tax:

[1] Whether the partnership or a partner individually has a business purpose for the allocation; [2] whether the allocation has "substantial economic effect", that is, whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences; [3] whether related items of income, gain, loss, deduction, or credit from the same source are subject to the same allocation; [4] whether the allocation was made without recognition of normal business factors and [5] only after the amount of the specially allocated item could reasonably be estimated; [6] the duration of the allocation; and [7] the overall tax consequences of the allocation.

Treas. Reg. § 1.704-1(b)(2) (1964)(emphasis added). The examples in the Regulations indicate that an allocation is not to be disregarded simply because it results in a tax saving to all partners. On the other hand, an allocation will not be upheld simply because it was the *sine qua non* of a transaction.

10. Consider, for example, the following statement in the Senate Report:

Also, the committee believes that allocations of special items and overall allocations should be restricted to those situations where the allocations have substantial economic effect, as presently interpreted by the regulations and case law.

S. REP. NO. 94-938, 94th Cong., 2d Sess. 99-100 (1976). See also text accompanying notes 95-98 *infra*. But see Solomon, *Current Planning for Partnership Startup, Including Special Allocations, Retroactive Allocations, and Guaranteed Payments*, 37 N.Y.U. INST. FED. TAX. 13-1, 13-10 (1979).

replaces the pre-1976 Act reallocation mechanism of the "taxable income or loss of the partnership, as described in section 702(a)[8]." ¹¹ This was one of several 1976 Act changes designed to make clear that the "substantial economic effect" requirement applies to bottom line allocations of partnership taxable income or loss just as it does to allocations of particular items of income and deduction. The Commissioner of Internal Revenue has since conceded that the old "principal purpose" limitation does not apply to bottom line allocations. ¹²

B. Orrisch and Capital Accounts

What must be addressed at the outset is the unfortunate tendency to assume that an allocation has at least some economic effect if it is reflected in the partners' capital accounts. Such a notion should not have survived *Orrisch v. Commissioner*, ¹³ the grand old case on partnership allocations. *Orrisch* illustrates one critical point that cannot be overemphasized: the partners' capital accounts may have *no economic significance*. ¹⁴

Orrisch involved two husband and wife couples, the Orrisches and the Crisafis, who in 1963 entered into a partnership in which everything was to be divided on a 50-50 basis. The Orrisches contributed \$26,500 in cash, the Crisafis contributed \$12,500 in cash, and the partnership purchased two apartment houses that were paid for almost entirely with borrowed funds. In 1966 the Crisafis, who had substantial tax losses from other sources and had not reported taxable income at any time during the life of the partnership, orally agreed that for 1966 and subsequent years all of the depreciation deductions of the partnership would be allocated to the Orrisches, who were in need of tax losses. The Orrisches' capital account was lowered by the full amount of the depreciation deductions allocated to them, with the result that their capital account was reduced far below that of the Crisafis.

The Tax Court carefully considered the partners' capital accounts to determine their significance. If the partners were to continue making equal contributions and withdrawals, said the court, when the buildings are fully depreciated, the Orrisches' capital account will be lower than the Crisafis' capital account by an amount approximately equal to the undepreciated basis of the buildings when the special allocations began. ¹⁵ If the property were sold

11. See note 7 *supra*. For discussion of the new reallocation mechanism, see Kamin, *Partnership Income and Loss Allocations Before and After the Tax Reform Act of 1976*, 30 TAX LAW. 667, 683-84 (1977).

12. See text accompanying notes 40-44 *infra*.

13. 55 T.C. 395 (1970), *aff'd per curiam*, 31 A.F.T.R.2d 73-1069 (9th Cir. 1973).

14. Nor does a partner's capital account necessarily reflect his basis in his partnership interest. See Treas. Reg. § 1.705-1(a)(1) (1956):

The adjusted basis of a partner's interest in a partnership is determined without regard to any amount shown in the partnership books as the partner's "capital", "equity", or similar account. For example, A contributes property with an adjusted basis to him of \$400 (and a value of \$1,000) to a partnership. B contributes \$1,000 cash. While under their agreement each may have a "capital account" in the partnership of \$1,000, the adjusted basis of A's interest is only \$400 and B's interest, \$1,000.

15. 55 T.C. 395, 403 (1970).

at a gain, the taxable gain would first be “charged back” to the Orrisches, that is, credited to their capital account until it was brought back up to equal that of the Crisafis. Any additional taxable gain was to be divided equally between the two partners. In short, if the gain on sale were equal to or greater than the depreciation specially allocated to the Orrisches, capital accounts would be made and then maintained equal. Any proceeds from the sale of the buildings would be divided equally. “In such circumstances,” said the court, “the only effect of the allocation would be a trade of tax consequences”¹⁶ The Orrisches would absorb the Crisafis’ taxable gain on the sale of the buildings to the same extent they were previously allocated the Crisafis’ depreciation deductions. Nevertheless, the court pressed on in its consideration of whether the special allocation of depreciation might have some non-tax effect:

To find *any* economic effect of the special allocation agreement aside from its tax consequences, we must, therefore, look to see who is to bear the economic burden of the depreciation if the buildings should be sold for a sum less than their original cost.¹⁷

Under normal accounting principles, the court said, the disparity in capital accounts caused by the special allocation of depreciation would be treated as a debt to the partnership *or* would affect the division of proceeds from the sale of partnership assets.¹⁸ It found no indication, however, that the partners intended normal accounting principles to control the significance of their capital accounts. No debt was intended and proceeds from the sale of the buildings were to be divided equally. In short, the only significance of the charge of specially allocated depreciation against the Orrisches’ capital account was that it reflected the extent to which the Orrisches would absorb the Crisafis’ taxable gain in the event the property were sold at a gain.¹⁹

It was therefore clear in *Orrisch* that the special allocation of depreciation failed, in the words of the Regulations, to “actually affect the dollar amount of the partners’ shares of the total partnership income or loss independently of tax consequences.”²⁰ The court, however, went beyond a recitation of the tests in the Regulations and attempted to clarify the basic meaning of the

16. *Id.*

17. *Id.* (emphasis added).

18. *Id.* at 403-04.

19. *Orrisch* is strikingly similar to Treas. Reg. § 1.704-1(b) (2), Example 1 (1964):

Example (1). The provisions of a partnership agreement for a year in which the partnership incurs losses on the sale of depreciable property used in the trade or business are amended to allocate such losses to one partner who has no such gains individually. An equivalent amount of partnership loss or deduction of a different character is allocated to other partners who individually have gains from the sale of depreciable property used in the trade or business. Since the purpose and effect of this allocation is solely to reduce the taxes of certain partners without actually affecting their shares of partnership income, such allocation will not be recognized.

The only major difference is that the Crisafis did not immediately receive deductions of a different character (they did not appear to need deductions of any character for the years in question). Instead, they were to be relieved of taxable gain on the sale of the buildings to the same extent they had given up their depreciation deductions.

20. Treas. Reg. § 1.704-1(b)(2) (1964).

principal purpose limitation. It explained the "substantial economic effect" language in the Senate Report as follows:

This reference to "substantial economic effect" did not appear in the House Ways and Means Committee report . . . and was apparently added in the Senate Finance Committee to allay fears that special allocations of income or deductions would be denied effect in every case where the allocation resulted in a reduction in the income tax liabilities of one or more of the partners. The statement is an affirmation that special allocations are ordinarily to be recognized if they have *business validity apart from their tax consequences*.²¹

The court said the special allocation to the Orrisches "was adopted for a tax-avoidance rather than a business purpose" and "did not reflect normal business considerations but was designed primarily to minimize the overall tax liabilities of the partners."²² The depreciation was therefore reallocated according to "taxable income or loss of the partnership, as described in section 702(a)[8],"²³ that is, according to the partners' 50-50 ratio for sharing general profits or losses.

The court's emphasis on business purpose is somewhat clouded because of its roundabout response to the Orrisches' assertion that the purpose of the special allocation of depreciation was to compensate them for their greater economic investment in the enterprise. The court stated that the evidence did not support the "contention" that the special allocation had been adopted "in order to equalize the capital accounts of the partners."²⁴ Its reasoning was simple: equalization of capital accounts could not have been the goal because the special allocation of depreciation sent the capital account of the Orrisches further below the capital account of the Crisafis than it previously had been above it. The court's discussion of the increased disparity in capital accounts is misleading because the Orrisches did not argue that their goal was to equalize capital accounts.²⁵ The Orrisches' argument was one that would have to be refuted by something more than simple subtraction.

Recall that the Orrisches initially contributed twice the amount of cash than the Crisafis contributed. The Orrisches' real argument was that the

21. 55 T.C. 395, 400-01 (1970)(citations omitted)(emphasis added).

22. *Id.* at 401.

23. I.R.C. § 704(b)(prior to the 1976 Act). *See* note 7 *supra*.

24. 55 T.C. 395, 401-02 (1970).

25. The capital accounts in *Orrisch* did not accurately reflect current economic investment in the partnership, nor did they accurately reflect tax basis, nor were they the determinant of any allocation ratios. They reflected all cash contributions, withdrawals and distributions, all items of partnership taxable income and loss, but did not include partners' shares of partnership liabilities. The computation of capital accounts used in *Orrisch* is not uncommon, particularly among partnerships that have no allocation ratios based on capital accounts. Such a computation produces a figure that does not accurately reflect tax basis because the partner's share of partnership liabilities is not included. Actual economic investment is not reflected because tax losses are deducted. For example, under the *Orrisch* system, if partner A were to contribute \$100 additional cash to the partnership, his capital account would be increased by \$100, as would his actual economic investment in the enterprise. If he were then to receive a "pass-through" of \$100 of partnership tax losses, his capital account would be lowered by \$100, not merely by the actual dollar amount the loss would save him on his tax bill, which is the true measure of the reduction of his actual economic investment in the partnership. Therefore, the Orrisches had no reason to equalize capital accounts per se.

special allocation of depreciation was an attempt to equalize the capital *investments* of the partners, not their capital *accounts*.²⁶ The two are not necessarily the same. Capital accounts often involve a strange mixture of apples and oranges, at least from an investor's point of view. Consider, for example, the taxpayer in the 50 percent bracket who contributes \$100 in cash and receives in return a \$100 credit on his capital account. If he subsequently is allocated a \$100 depreciation deduction, his capital account (at least under the system used in *Orrisch*) is reduced to zero. But he would not consider that his entire capital investment has been returned to him. Rather, he would consider that his investment has been returned only to the extent of the \$50 saving on his tax bill that resulted from the depreciation deduction. So, too, with the *Orrisches*. Although their capital account was lowered by the full amount of depreciation allocated to them, their cash investment was returned in only a fraction of that amount, depending on their tax bracket. Indeed, *the total amount of depreciation specially allocated to the Orrisches in the years in question would not have been sufficient to return them their excess capital investment had they been in the 50 percent bracket*. Therefore, the increased disparity in capital accounts did not negate an intention to equalize economic investment, and the question remained whether the approach adopted was permissible.

The court directly addressed this issue in a footnote that indicated its awareness that the capital accounts in *Orrisch* did not accurately reflect the economic investment of the partners:

We recognize that petitioners had more money invested in the partnership than the *Crisafis* and that it is reasonable for the partners to endeavor to equalize their investments, since each one was to share equally in the profits and losses of the enterprise. However, we do not think that sec. 704(a) permits the partners' prospective tax benefits to be used as the medium for equalizing their investments, and it is apparent that the economic burden of the depreciation (which is reflected by the allowance for depreciation) was not intended to be the medium used.²⁷

The court, therefore, admitted that the increased disparity in capital accounts did not refute that equalization of investment was the goal of the special allocation. More importantly, it held that it is impermissible to equalize investment in the manner attempted.

Orrisch therefore contains a strong suggestion that initial contribution to capital is not an appropriate determinant of the allocation of depreciation deductions if initial capital contributions do not also control the allocation of any of the economic benefits or burdens of the partnership. Stated differently, depreciation deductions may not be allocated according to the ratio of what

26. Brief for Appellant at 9, *Orrisch v. Commissioner*, 31 A.F.T.R.2d 1069 (9th Cir. 1973):

The Tax Court in its decision finds it incredible that equalization of the capital accounts was the objective of the special allocation. Clearly, the Tax Court misread the evidence, for nowhere is this stated to be the objective; rather the evidence states that the depreciation was allocated because of the inequity in the capital and the likelihood of *Orrisch* having to put in more money.

27. 55 T.C. 395, 402 n.5 (1970).

the partners *put in* to the partnership unless that ratio also determines the allocation of some economic incident of what the partners *take out* of the partnership.

This analysis is not confined to allocations of depreciation deductions. It is equally applicable to bottom line allocations of partnership loss. Consider, for example, the fairly common real estate partnership that has a positive cash flow yet reports a tax loss that is entirely due to depreciation deductions. The same basic principles should apply as apply to the allocation of depreciation itself.²⁸ Stated differently, there is nothing about the *Orrisch* opinion that suggests that it applies only to naked allocations of depreciation and not to allocations of tax losses that represent the depreciation that remains after depreciation has first been applied to shelter net cash flow and debt amortization from tax.

The question that is being asked all across the country is what must be done to the special allocation of depreciation or loss to give it substantial economic effect? Is it sufficient if it affects the distribution of some or all of net cash flow, of proceeds of refinancing, or of proceeds on the sale of partnership assets? Or is one of these economic incidents more important than the other, depending on the situation? There is no clear answer to these questions, but the court in *Orrisch* suggested that the allocation would have been upheld if it had had some impact on the distribution of proceeds on the sale of partnership assets. It did so when it explored who would "bear the economic burden of the depreciation" if the buildings were sold for less than their cost,²⁹ and in so doing provided support for the capital accounts analysis discussed below.

C. *Holladay* and "Objective Economic Substance"

Probably the most significant allocations case since *Orrisch* is the Tax Court's recent decision in *Holladay v. Commissioner*.³⁰ *Holladay* forces a reevaluation of *Kresser v. Commissioner*,³¹ which was probably best known for the sympathy it expressed for the argument that bottom line allocations are not subject to the principal purpose limitation. The argument relies on the fact that the principal purpose limitation, by its terms, applies only to allocations of "any item." The theory, for which dictum in *Kresser* indicates sympathy, is that taxable income or loss is a "composite" that is not an "item" within the meaning of the principal purpose limitation. *Kresser* became less controversial after the 1976 Act made clear that bottom line allocations are indeed subject to the substantial economic effect requirement. By the time of *Holladay*, the *Kresser* dictum was only relevant to years prior to

28. This is especially true now that the 1976 Act expressly applies the substantial economic effect requirement to bottom line allocations. See text accompanying notes 11-12 *supra*. But see *McDougal v. Commissioner*, 62 T.C. 720 (1974).

29. See text accompanying note 17 *supra*.

30. 72 T.C. 571 (1979).

31. 54 T.C. 1621 (1970).

the effective date of the 1976 Act's allocation provisions. Ironically, *Holladay* interprets *Kresser* as a major weapon in the government's arsenal against tax-saving partnership allocations.

Kresser involved two real estate partnerships that were controlled by one William H. Appleton and operated under oral agreements. Appleton had a large net operating loss carryover that was to expire if not used by the end of 1965. At a meeting of less than all the partners it was resolved to allocate all 1965 income to Appleton. It was stated that 1965 income allocated to Appleton would be restored to the other partners in subsequent years by reducing his share of distributable income, or, in years of no net income, by charging him with net losses. Notwithstanding these pronouncements, actual cash distributions and withdrawals during 1965 were in less than half the amount of 1965 taxable income and were made in accordance with the partners' overall sharing ratios. Indeed, Appleton received cash distributions in 1965 that were less than 10 percent of 1965 taxable income. What distributions were made were reported as returns of capital or distributions of income that had been taxed in prior years.

The court acknowledged that the principal purpose limitation would have been violated if it were applicable. It specifically declined, however, to decide whether the principal purpose limitation applied "to the composite of all of the partnership's income." It indicated its sympathy for the item-composite distinction in a footnote:

While we are fully prepared to accept the contention that the principal purpose of the alleged modifications was the "avoidance or evasion" of tax on Appleton within the meaning of sec. 704(b)(2), we are faced with the petitioners' troublesome argument that sec. 704(b)(2) applies only to "items" of income, etc., dealt with in pars. (1) through [7] of sec. 702(a) and does not govern par. [8] relating to the composite of all of the partnership's income (sometimes referred to as its "ordinary income") which is here involved. The point is not without difficulty. Although there is general language in *Smith v. Commissioner*, . . . in accord with the Government's argument, the structure of the statute itself and language in the legislative history would seem to give support to petitioners' position. However, in view of our conclusion that there was not in fact a bona fide reallocation of income among the partners, we do not reach the question whether sec. 704(b)(2) is applicable to sec. 702(a)[8].³²

Instead of disposing of the "bottom line" issue, the *Kresser* court relied on two other grounds to disregard the allocation.

First, it said there was no proof that the partnership agreement had been amended in a manner sufficient to effect the allocation. Section 761(c) provides that a partnership agreement may be amended until the time required for filing the partnership return by consent of all the partners or by any other manner provided in the partnership agreement.³³ The court was not persuaded that all partners had agreed to the allocation nor did it find any agreement that allocations could be changed without the consent of all the partners.

32. *Id.* at 1631 n.5 (citations omitted).

33. I.R.C. § 761(c).

Second, the court found that the alleged reallocation of income to Appleton was a "paper transaction having no consequences of substance" that "did not in reality shift the 1965 income from the other partners to him."³⁴ The likelihood that Appleton "personally guaranteed that the amounts allocated to him would be restored to the other partners regardless of the success or failure of the enterprises"³⁵ suggested that the transaction was in the nature of a loan. On the other hand, said the court, the fact that Appleton's withdrawals were far less than the amount of income allocated to him suggested that not even so much as a loan had occurred.

In short, *Kresser* was not very strong authority for the proposition that bottom line allocations are free from the principal purpose limitation. It certainly does not even suggest that what may be called "pure" bottom line allocations of tax losses are exempt. By "pure" bottom line allocation is meant an allocation of the partnership's annual taxable income or loss that has no effect on the allocation of the partnership's economic consequences. The allocation involved in *Kresser* purported to be more than a "pure" bottom line allocation; it purported to be an allocation of both the tax and economic consequences of a year's operations. *Holladay* makes clear that the *Kresser* court's decision to disregard the allocation on economic reality grounds is much more significant than its dictum that the principal purpose limitation might not have been applicable.³⁶

Holladay involved a pure bottom line allocation of tax losses for 1970-1973, years governed by the "principal purpose" limitation. One Durand A.

34. 54 T.C. 1621, 1631-32 (1970).

35. *Id.* at 1631.

36. Prior to the 1976 Act, bottom line allocations were less obviously vulnerable than naked allocations of depreciation because of the wording of the Code's reallocation mechanism. Recall that § 704(b) provided that if an allocation does not pass muster under the principal purpose limitation it will be disregarded and reallocated according to the partners' ratio for sharing "taxable income or loss of the partnership, as described in section 702(a)[8]." Two questions immediately present themselves. First, is the reallocation mechanism the partnership's bottom line? If the answer is yes, it would be pointless to apply the principal purpose limitation to the bottom line allocation. If the answer is no, the question becomes how to reallocate a bottom line allocation that violates the principal purpose limitation.

The answer to both questions lies in the fact that the pre-1976 Act reallocation mechanism, the norm of "taxable income or loss, as described in section 702(a)[8]," was intended to be the partners' ratio for sharing the overall economic profits and losses of the enterprise. Thus, the Regulations consider the effect of an allocation on "income or loss *independently* of tax consequences." Treas. Reg. § 1.704-1(b)(2) (1964)(emphasis added). More precisely, they provide that in the application of the reallocation mechanism

the manner in which the *net profit or loss* (computed after excluding any item subject to a recognized special allocation) is actually credited on the partnership books to the accounts of the partners *will generally determine each partner's share* of taxable income or loss as described in section 702(a)[8].

Treas. Reg. § 1.704-1(b)(1)(1964)(emphasis added). In short, the Regulations, Treas. Reg. § 1.704-1(b)(1) and (2) (1964), the Tax Court, *Orrisch v. Commissioner*, 55 T.C. 395, 399-400 (1970), and the commentators, *see, e.g.*, Jackson *et al.*, *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183, 1187 (1954), have consistently described the reallocation mechanism as the partners' overall ratio for sharing "profits or losses." Therefore, if an allocation of taxable income or loss is disregarded because it violates the principal purpose limitation, the losses should be reallocated according to the partners' shares in the economic consequences of the enterprise. This could be reflected in (1) their share of net cash flow, determined by taking into consideration guaranteed payments to promoters, (2) their share of proceeds of refinancing, (3) their share of proceeds of sale, or (4) a combination thereof, depending on the nature of the partnership, its assets and their financing. Or, in the terms of the post-1976 Act § 704(b), "in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances)."

Holladay was an attorney extremely sophisticated in real estate matters and closely involved in the ownership and management of two real estate investment trusts and their investment advisors. Holladay was approached by one Charles I. Babcock, Jr., who had begun construction of the first building of what was to be a multi-building apartment project. Babcock had initially relied on short term institutional financing to finance construction, and intended to build the apartment project, recover the equity invested in it, earn construction and management fees, and retain some ownership interest. He expected that most of the equity financing would be provided by a third party investor, with additional funds to come from institutional debt financing. After several unsuccessful attempts to obtain either the individual or the institutional financing, Babcock presented his situation to Holladay, who, after investigation of the project's profit potential, entered a partnership agreement with a corporation owned and controlled by Babcock.

The corporation contributed its equity in the project, for which it received a capital account of roughly \$275,000. Holladay made a \$750,000 initial contribution to capital and agreed to lend the partnership \$1,000,000 when needed.³⁷ Any additional financing was to be satisfied from sources outside the venture and "provided by each party equally."³⁸ Babcock himself had personally guaranteed the construction financing on the project, and Holladay used his own personal credit, contacts, and expertise to raise the permanent financing for the project. Distribution of cash, including both distributions of operating net cash flow and distributions of the proceeds of any refinancing or sale of partnership property, were first to be made in the following order: (a) a \$50,000 distribution to each of the two partners; (b) a \$150,000 distribution to the corporation; and (c) repayment of the loan from Holladay. Thereafter, all distributions were to be divided equally. The partnership agreement provided:

The amount of each distribution to a Joint Venturer shall be available to that Joint Venturer and shall be charged to that Joint Venturer's capital account regardless of whether the charge creates or increases a deficit in that Joint Venturer's capital account.³⁹

The partnership agreement allocated all 1970–1974 partnership tax losses to Holladay. Tax losses for years after 1974 were to be divided equally between the two partners, as was any gain in any year.

In light of what Judge Dawson, who had been the trier of fact and wrote the majority opinion, regarded as the "nearly equal division of economic benefits," the Tax Court disregarded the allocation of all 1970–1973 losses to Holladay, and held that he was entitled to only half of each year's loss. Judge

37. The amount of Holladay's capital account is not specified. No mention was made that Holladay's "loans" to the partnership might be recharacterized as contributions to capital. *Compare* *Hambuechen v. Commissioner*, 43 T.C. 90, 100–01 (1964).

38. The vagueness of this statement is not dispelled in the opinion. The two concurring opinions each referred, without explanation, to their uncertainty about the accuracy of the facts as stated in the majority opinion.

39. 72 T.C. 571, 579 (1979).

Dawson's opinion did so without purporting to decide whether the principal purpose limitation applies to bottom line allocations because the Commissioner had stipulated that it does not.⁴⁰ In the text of his opinion, Judge Dawson said that the issue "has never been judicially resolved," but in a footnote cited two cases that applied the principal purpose limitation to disregard bottom line allocations.⁴¹

Judge Dawson considered section 704(b)(2) entirely unnecessary to disregard the allocation to Holladay,⁴² noting commentators who "recognized the impact of the judicial doctrine of substance over form as adequate to deal with artificial attempts to allocate taxable income or losses."⁴³ Leaving aside for the moment what he considers "artificial," he said that the "opportunity for the application of such a judicial gloss arose in *Kresser*," whose lesson he summarized as follows:

In short, for allocations of partnership bottom line income or loss to be bona fide for Federal tax purposes the allocations must accurately reflect the economic basis upon which the partners have agreed to share the profits and losses.

The test is an objective one. The failure of the transactions in *Kresser* to pass muster under the objective economic substance test made it unnecessary for us to consider whether the subjective "principal purpose of avoidance or evasion of tax" test under section 704(b)(2) applied . . . to the composite of all income⁴⁴

Judge Dawson had no trouble concluding the "objective economic substance test" was violated.

Under the . . . agreement the purported allocation of all losses to petitioner for the years in issue in no way altered the economic return he would receive Regardless of the amount of tax losses incurred, petitioner was entitled to share equally, with one minor exception, all economic proceeds generated by the Joint

40. *Id.* at 587:

In the instant case [the Commissioner] has abandoned his position that section 704(b)(2) applies to bottom line loss allocations. Now, [the Commissioner] is "in agreement with [the taxpayer's] argument that as a matter of statutory construction code section 704(b)(2) [as it stood prior to the passage of the 1976 Act] has no application to allocations of taxable income or loss under code section 702(a)[8]."

41. *Id.* at 587 n.8:

But see *Rodman v. Commissioner* [76-2 USTC ¶9710], 542 F.2d 845, 856-59 (2d Cir. 1976) (Without addressing the item/bottom line distinction the Court stated that the retroactive allocation of taxable income to a new partner "falls within § 704(b)(2)'s caveat that a term in a partnership agreement cannot be controlling for tax purposes where its principal purpose is the evasion of taxes." 542 F.2d at 858); *Sellers v. United States*, an unreported case (E.D. Va. 1978, 42 A.F.T.R.2d 78-5075, 78-1 U.S.T.C. par. 9463; supplemental opinion 42 A.F.T.R.2d 78-6257, 78-2 U.S.T.C. par. 9829) (The Court applied the test of sec. 704(b)(2) to bottom line losses without discussion of the item/bottom line distinction.).

42. *Id.* at 588:

To disallow the allocation of losses for tax purposes to petitioner here, respondent relies solely on the holding in *Kresser* to the effect that for allocations to be bona fide they must accurately reflect the basis on which the petitioner and Babcock agreed to share the economic profits and bear the economic losses of the joint venture. We agree . . . that *Kresser* provides an appropriate approach to judge petitioner's case. Under that standard the purported allocation of losses to petitioner lacks economic substance.

43. *Id.* at 586.

44. *Id.* at 587.

Venture . . . Proceeds of the Joint Venture were to be distributed irrespective of the amount or deficit in the respective capital accounts of the joint venturers.⁴⁵

As in *Orrisch*, the taxpayer's capital account was reduced by the special allocation of tax write-off. As in *Orrisch*, the court concluded that the reduction in capital account had no economic significance. And, as in *Orrisch*, the court failed to state unequivocally that the allocation would have been upheld had the reduction in capital accounts affected the distributions on sale of the partnership property or liquidation of the partnership.

It is not clear how the "judicial gloss" of the "objective economic substance test" differs from the "subjective 'principal purpose'" test. Judge Tannenwald, concurring in the result, thought not at all:

[T]he majority opinion seems to do no more than say that the divergence between the allocation of "bottom line" profits and losses and *the actual division of funds during the taxable years in question* is, in and of itself, sufficient to sustain the [Commissioner's] position. But . . . this appears simply to make the test of "economic substance" or "economic effect" the same as that embodied in section 704(b)(2).⁴⁶

He clearly felt that the form-versus-substance doctrine should be confined to "sham" situations in which the transaction is constructed entirely for tax advantage.⁴⁷ Similarly, Judge Simpson, who also concurred in the result, noted that after the 1976 Act's "substantial economic effect" amendment, "a question might arise as to whether the 'judicial gloss' enunciated and applied by Judge Dawson is in addition to and different than the 'substantial economic effect' standard now set forth in section 704(b)(2)."⁴⁸

III. SPECIAL ALLOCATIONS AND CONTRIBUTED PROPERTY

The partnership agreement in *Holladay* originally stated that Holladay was being allocated the first five years' losses because the adjusted basis in the property contributed by the corporation, which became the partnership's basis in the property,⁴⁹ "differs substantially from the fair market value of said

45. *Id.* at 588. "The only variation from an equal division was that, after the first \$100,000 equity cash distribution was divided equally, Babcock Co. was entitled to the next \$150,000. This variation was itself independent of the presence or extent of losses allocated to petitioner for Federal tax purposes." *Id.*

46. *Id.* at 591 (emphasis added).

47. *Id.* at 590:

The application of the form-vs.-substance doctrine has usually occurred in the course of judicial determination of whether there was an economic basis for a particular transaction aside from the tax benefit. Or, to put it another way, the key element has been whether the transaction was constructed *entirely* for the tax advantage.

But see *Collins v. Commissioner*, 54 T.C. 1656, 1665 (1970), in which the Tax Court applied a "sham" analysis to strike down one feature of a transaction that, as a whole, clearly had economic purpose:

The transaction we find to be a sham is not the acquisition of the apartment house but the prepayment of interest and the loan agreement. We accept the contention that the motivating factor in the purchase of the apartment house was economic gain. It is the terms used to support the deduction of prepaid interest (the loan agreement) which we consider to be a sham.

48. 72 T.C. 571, 593 (1979).

49. I.R.C. § 723.

property at the time of its contribution.”⁵⁰ Perhaps because this justification was subsequently stricken from the agreement, the opinions in *Holladay* fail to discuss the Code’s specific authorization of special allocations with respect to contributed property.

A. *Distortions Absent Special Allocations*

Unless the partnership agreement provides otherwise, the partner who contributes property receives no special treatment with respect to that property; the partnership allocates any gain or loss, etc., just as if it had purchased the asset from a third party.⁵¹ Stated differently, unless there is a special allocation, the partners’ normal sharing ratios determine the allocation of any depreciation, depletion, or gain or loss on the sale of contributed property. This simple approach can cause problems when the property is contributed with an adjusted basis different from its fair market value.

Consider how a partner who contributes cash rather than property might be unintentionally penalized if he does not draft away the general rule that partners divide gain on the sale of contributed property according to their normal sharing ratios. Cash and Property form an equal partnership. Cash contributes \$1,000 cash and receives a \$1,000 basis in his partnership interest. Property contributes inventory with an adjusted basis of \$800 and a fair market value of \$1,000. Property’s basis in the inventory is “rolled over” and becomes not only his basis in his partnership interest⁵² but also the partnership’s basis in the inventory.⁵³ Shortly thereafter, the inventory is sold for \$1,000. Absent a provision in the partnership agreement to the contrary, the partnership’s \$200 gain on sale of the inventory is treated just as if it were gain on property the partnership acquired by purchase from an outsider. That is, each partner must report \$100 of the partnership’s gain on the sale of the inventory, and as a result each will have his basis in his partnership interest increased by \$100.⁵⁴

This tax result does not accurately reflect the economic reality of either Cash or Property. Each has a partnership interest that is worth \$1,000, a 50 percent interest in a partnership that now has \$2,000 in cash. Cash’s gain is overstated because, in economic reality, Cash has no gain. The partnership

50. 72 T.C. 571, 578 (1979).

51. I.R.C. § 704(c)(1). I.R.C. § 704(c)(3) provides an exception to the general rule that, unless the agreement provides otherwise, depreciation *etc.* will be allocated as if the property had been purchased by the partnership from an outsider. The exception provides for the continuation of any preexisting arrangement among partners who contribute undivided interests to a partnership:

UNDIVIDED INTERESTS.—If the partnership agreement does not provide otherwise, depreciation, depletion, or gain or loss with respect to undivided interests in property contributed to a partnership shall be determined as though such undivided interests had not been contributed to the partnership. This paragraph shall apply only if all the partners had undivided interests in such property prior to contribution and their interests in the capital and profits of the partnership correspond with such undivided interests.

52. I.R.C. § 722.

53. I.R.C. § 723.

54. I.R.C. § 705(a)(1)(A).

interest he now has is worth exactly the amount of cash he paid for it. Property's gain, on the other hand, is understated. He has "nailed down" the \$200 value in excess of his basis in the property he contributed. Perhaps it is easier to see that as having occurred when he received a partnership interest that reflected the full value of the property he contributed. The general rule, however, is that no gain or loss is recognized on contribution;⁵⁵ the transaction is not closed at that point, the contributing partner's basis in the property is simply rolled over into the partnership and into his interest. For tax purposes, the gain is "nailed down" by the partnership when it sells the asset.

The failure to accurately reflect economic reality penalizes the cash-contributing partner, at least in the short run. The size of the partnership interest Property received fully credited him with the precontribution appreciation in the property. However, and perhaps this was not anticipated, Cash has been allocated half of the taxable gain on that appreciation. The tax bill on that gain, however, is part of the cost of the value for which Property received full credit. Stated differently, the "equal" partnership has become, inadvertently, not exactly equal. The partners got equal sharing ratios because they contributed equal value, but then the equal sharing ratio was used to pass on part of the cost of the appreciation in value, the latent tax bill, to the partner who contributed hard cash.

In general, the gap between economic reality and the amount of gain or loss reported is "corrected" on liquidation of the partnership, or on a sale by the partners of their partnership interests. Property's basis in his partnership interest is still \$100 below its value. He will ultimately be required to report the additional \$100 gain that, in economic reality, he achieved. Assuming no other transactions, Property will realize \$100 of gain on a liquidation or sale of his interest, i.e., the difference between the amount of cash he will receive, \$1,000, and his \$900 adjusted basis in his partnership interest (\$800 initial basis increased by \$100 gain he reported on sale of inventory). Thus, his economic gain of \$200 (\$1,000 cash received versus the \$800 he paid for the inventory) is reported in two installments of \$100 each. Cash, on the other hand, has a basis in his partnership interest \$100 in excess of its value. He realizes a loss of \$100 on liquidation of the partnership, or on the sale of his partnership interest, measured by the difference between his \$1,100 adjusted basis in his partnership interest (\$1,000 initial basis increased by \$100 gain he reported on the sale of the inventory) and the amount of cash he receives, \$1,000. He realizes no economic gain or loss, and his break-even result is reflected on his tax returns as the net result of a \$100 gain followed by a \$100 loss. In tabular form, these results are shown in Example 1.

55. I.R.C. § 721(a).

EXAMPLE 1

Property Contributed With Value in Excess
of Basis: No Special Allocation to
Reflect the Built-In Potential for Gain

Equal Partnership Cash-Property has assets with \$2,000 total value: \$1,000 cash contributed by Cash plus inventory contributed by Property worth \$1,000 with an adjusted basis of \$800.

	<u>Partnership's Basis in Inventory</u>	<u>Basis of Partners in Partnership Interests</u>	
		<u>Cash</u>	<u>Property</u>
I. At Formation			
Property's basis in the Inventory is rolled over into his basis in his partnership interest and into the partnership's basis; Cash's initial basis is the amount of money he contributed			
	\$ 800	\$ 1,000	\$ 800
II. After Sale of Inventory for \$1,000			
a) Partnership Gain			
Amount realized	\$ 1,000		
less adjusted basis	- 800		
<u>Gain</u>	<u>\$ 200</u>		
b) Effect of sale of Inventory on partners (assuming sale proceeds not yet distributed)			
Initial Basis		\$ 1,000	\$ 800
Plus distributive share of gain (\$100 each)		<u>+ 100</u>	<u>+ 100</u>
Adjusted basis in Partnership interests		<u>\$ 1,100</u>	<u>\$ 900</u>
III. Upon Liquidation of the Partnership			
Gain (Loss) if partnership distributes all its cash in liquidation (\$1,000 each)			
Adjusted Basis		\$ 1,100	\$ 900
<u>Amount distributed</u>		<u>1,000</u>	<u>\$ 1,000</u>
		<u>\$ (100)</u>	<u>\$ 100</u>
		Loss (unrecovered cost)	Gain (distribution in excess of basis)

EXAMPLE 1 (Continued)

IV. Cumulative Gain (Loss)

<u>Recognized</u>		
Gain on Sale of Inventory	\$ 100	\$ 100
Gain (loss) on Liquidation	+ (100)	+ 100
<u>Cumulative gain (loss)</u> recognized	<u>\$ -0-</u>	<u>\$ 200</u>

There are two principal reasons why Cash may not be content with the offsetting loss, or reduced gain, he will ultimately receive because his basis in his partnership interest was increased by the amount of unreal gain he reported. First, he may not receive the "correction" for many years, perhaps not until the partnership is liquidated. He has, in effect, made an interest-free loan to the government (or to Property) for all those years. Second, in some situations, the long-run "correction" affects only the dollar amount of gain or loss recognized by the partners; characterization of the profit as ordinary income or capital gain remains permanently out of line with business reality. The \$100 share of partnership gain Cash reported on the sale of the inventory was ordinary income; yet the ultimate "correction" for Cash is a \$100 capital loss on the liquidation of his partnership interest.⁵⁶ Cash has, in effect, the reverse of a good tax shelter: he has achieved tax acceleration rather than tax deferral and substituted ordinary income for capital gain.

B. Special Allocations and Contributed Property

With respect to contributed property, section 704(c)(2) specifically authorizes special allocations of depreciation, depletion, and gain or loss on sale:

EFFECT OF PARTNERSHIP AGREEMENT.—If the partnership agreement so provides, depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, under regulations prescribed by the Secretary, be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.⁵⁷

The Regulations make clear that partners have a great deal of flexibility to make allocations concerning contributed property. Depreciation, depletion, or gain or loss with respect to contributed property may be allocated to take into account "all or any portion of the difference between the adjusted basis and the fair market value of contributed property at the time of contribution."⁵⁸ The allocation may apply to all contributed property or only to specific items.⁵⁹

56. I.R.C. § 741.

57. I.R.C. § 704(c)(2).

58. Treas. Reg. § 1.704-1(c)(2)(i)(1964)(emphasis added).

59. *Id.*

Most basically, the partner who contributes property may be specially allocated all the built-in pre-contribution gain or loss:

The appreciation or diminution in value represented by the difference between the adjusted basis and the fair market value of contributed property at the time of contribution may thus be attributed to the contributing partner upon a subsequent sale or exchange of the property by the partnership.⁶⁰

Thus, in Example 1, instead of waiting for the long-run "corrections," Cash and Property could have agreed on a special allocation to make initial tax reality conform to economic reality. The variation between the basis and the fair market value of the contributed property would be taken into account by allocating the \$200 built-in gain on the sale of the inventory entirely to Property. Property's initial basis in his partnership interest would be increased by the \$200 gain so allocated to him, with the result that he and Cash would each have a \$1,000 adjusted basis in his partnership interest, an adjusted basis exactly equal to value.

The partner who contributes cash also may be given special allocations of depreciation or depletion:

The appreciation or diminution in value represented by the difference between the adjusted basis and the fair market value of contributed property at the time of contribution . . . also may be used in allocating the allowable depreciation or depletion with respect to such property among the contributing partner and the noncontributing partners.⁶¹

These special allocations of depreciation and depletion may not exceed the amount of depreciation or depletion computed at the partnership level:

In any case, however, the total depreciation, depletion, or gain or loss allocated to the partners is limited to a "ceiling" which cannot exceed the amount of gain or loss realized by the partnership or the depreciation or depletion allowable to it.⁶²

The examples in the Regulations cumulate into the following. *C* and *D* form an equal partnership. *C* contributes machinery worth \$10,000, in which his adjusted basis is \$4,000. This adjusted basis of \$4,000 becomes the partnership's basis in the machinery and also becomes *C*'s basis in his partnership interest. *D* contributes \$10,000 in cash, which gives him a \$10,000 basis in his partnership interest. Assume the contributed property depreciates at an annual rate of 10 percent, and that the partnership computes an annual depreciation deduction of \$400. The contributed property is sold at the beginning of the second year for \$9,000. Absent any special allocation, the depreciation deductions on the machine will be divided equally, as will any gain or loss when the partnership sells the machine.

In this situation, the partner who contributes cash may insist on a special allocation of depreciation:

60. *Id.*

61. *Id.*

62. *Id.*

With his contribution of \$10,000 cash, *D* has, in effect, purchased an undivided one-half interest in the property for \$5,000. Since the property depreciates at an annual rate of 10 percent, *D* would have been entitled to a depreciation deduction of \$500 per year. However, since under the "ceiling" approach the partnership is allowed only \$400 per year (10 percent of \$4,000), no more than \$400 may be allocated between the partners, i.e., the partnership cannot allocate \$500 of depreciation to *D* and thereby treat *C* as if *C* had received an additional \$100 of income. Therefore, the partners allocate the \$400 deduction for depreciation entirely to *D* and none to *C* the contributor.⁶³

In short, the partners are permitted to adopt an aggregate approach that treats the cash contributing partner as having directly purchased a 50 percent interest in the asset contributed by his fellow partner. There is no suggestion that the allocation of all depreciation to the partner who contributes cash might violate the substantial economic effect requirement.⁶⁴

Continuing with the same fact pattern, couple the special allocation of depreciation deductions to *D*, the partner who contributed the cash, with a special allocation of gain on sale of machinery to *C*, the partner who contributed it with a value in excess of basis. The Regulations link the two types of special allocations without stating that they must be linked. They illustrate the allocation of the gain on sale of the machinery with a hypothetical agreement that

the portion of the proceeds attributable to the excess of the fair market value of the property at date of contribution (less accumulated depreciation on such value) over its basis at date of contribution (less accumulated depreciation on such basis) shall result in gain to the contributing partner only.⁶⁵

If the property is sold at the beginning of the second year for \$9,000, the \$5,400 partnership gain (\$9,000, the amount realized, less \$3,600, the adjusted basis of the partnership [\$4,000 initial basis less \$400 depreciation deduction]) is allocated pursuant to the agreement:

The fair market value of the property as depreciated is \$9,000 (\$10,000, the value on contribution, less \$1,000, the accumulated depreciation on such value). Under section 704(c)(2) and the terms of the partnership agreement, the \$5,400 difference between \$9,000, the fair market value as depreciated, and \$3,600, the adjusted basis of the property, represents the portion of the gain to be allocated to *C*. None of this gain is allocated to *D*.⁶⁶

Example 2 illustrates the results of the combined special allocations if the partnership liquidates after the machinery is sold and distributes \$9,500 each to *C* and *D*.

63. Treas. Reg. § 1.704-1(c)(2)(i), Example (1) (1964)(emphasis added).

64. I.R.C. § 704(b)(2).

65. Treas. Reg. § 1.704-1(c)(2)(i), Example (2)(1964).

66. *Id.*

EXAMPLE 2

Property Contributed With Value in Excess
of Basis: Special Allocations to
Reflect the Built-In Potential for Gain

Equal Partnership *CD* Formed with \$10,000 in cash contributed by *D* and Machinery contributed by *C* worth \$10,000 with an adjusted basis of \$4,000.

	Partnership's Basis in Machinery	Basis of Partners in Partnership Interests	
		<u>C</u>	<u>D</u>
I. <u>At Formation</u> (<i>C</i> 's basis in the machine is rolled over into his basis in his partnership interest and into the partnership's basis)	\$ 4,000	\$ 4,000	\$ 10,000
II. <u>After \$400 Depreciation Deduction</u> (allocated all to <i>D</i>)	\$ 4,000 - 400 <u>\$ 3,600</u>	\$ 4,000 <u>\$ 4,000</u>	\$ 10,000 - 400 <u>\$ 9,600</u>
III. <u>After Sale for \$9,000</u> Partnership Gain Allocated Entirely to <i>C</i> (assuming sale proceeds are not yet distributed)	<u>Partnership Gain</u> \$ 9,000 -3,600 <u>\$ 5,400</u>	\$ 4,000 +5,400 <u>\$ 9,400</u>	\$ 9,600 <u>\$ 9,600</u>
IV. <u>Upon Liquidation of the Partnership</u> Gain (loss) if partnership distributes all its cash in liquidation (\$9,500 each) Adjusted Basis <u>Amount Distributed</u>		\$ 9,400 9,500 <u>\$ 100</u> Gain (distribution in excess of basis)	\$ 9,600 9,500 <u>\$ (100)</u> Loss (unrecovered basis)
V. <u>Cumulative Gain (Loss [including depreciation])</u> <u>Recognized</u>		<u>\$ 5,500</u>	<u>(\$ 500)</u>

Note how this reflects economic reality. *C* reports cumulative gain of \$5,500, which exactly equals the amount by which his \$9,500 liquidating distribution exceeds the \$4,000 basis he had in the machinery when he contributed it. Conversely, the \$500 cumulative loss (including depreciation deductions) *D* reports exactly equals his \$500 cash loss. The special allocation of deprecia-

tion allows *D* an early write-off⁶⁷ and the special allocation of gain prevents him from recognizing gain he does not incur when the machinery is sold.

IV. THE "CAPITAL ACCOUNTS ANALYSIS"

At one level, it is somewhat of an oversimplification to talk of *the* capital accounts analysis. There is a central approach that is generally agreed upon as the essence of *a* capital accounts analysis. Beyond this central, agreed-upon essence, proponents of *a* capital accounts analysis may disagree as to its relevance or application in particular situations.⁶⁸ The purpose here is to explain the central approach and suggest some of its possible limitations.

A. Basic Statement and Authority

The basic proposition of capital accounts analysis is that special allocations, whether of particular items of deduction or of the partnership's bottom line, have substantial economic effect if (a) they are reflected in the capital accounts of the partners and (b) those capital accounts determine actual, economic distributions to the partners, either on the sale of partnership assets or on liquidation of the partnership. With respect to (a), the assumption is that the partners' capital accounts are computed the same way they were in *Orrisch*: *increased* by contributions to capital and by distributive shares of partnership income or gain; *decreased* by cash distributions and by shares of partnership deduction or loss; and *without regard* to the partners' shares of partnership liabilities.⁶⁹ With respect to (b), the assumption is that, unlike in *Orrisch*, capital accounts *do* determine the distributions in liquidation after partnership assets are sold. More specifically, capital accounts analysts generally require that negative capital accounts be observed as reflecting amounts that must be restored to the partnership. Insistence on this latter point caused members of the Texas tax bar to file *amicus* briefs in *Park Cities*

67. What if the depreciation deductions had overstated actual economic depreciation? In the context of the above example, the Regulations contain the following parenthetical:

If the property were sold for more than \$9,000 the portion of the gain in excess of \$5,400 would be allocated equally between the partners in accordance with their agreement for sharing gains.

Id.

68. Compare Freling, *Effects of Partnership Liabilities and Special and Retroactive Allocations*, ABA RESOURCE MATERIALS ON PARTNERSHIPS 301-21 (2d ed. 1980), with W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 10.03-04 (1977); Solomon, *Current Planning for Partnership Startup, Including Special Allocations, Retroactive Allocations, and Guaranteed Payments*, 37 N.Y.U. INST. FED. TAX. 13-1 (1979); Kamin, *Partnership Income and Loss Allocations Before and After the Tax Reform Act of 1976*, 30 TAX LAW. 667 (1977); A. WILLIS, *PARTNERSHIP TAXATION* §§ 64.02, 68.09, 68.11 (2d ed. 1976).

69. See Freling, *Effects of Partnership Liabilities and Special and Retroactive Allocations*, ABA RESOURCE MATERIALS ON PARTNERSHIPS 301, 318 (2d ed. 1980):

A partner's capital account should be the ultimate repository of all his financial transactions with the partnership. All contributions by the partner and all allocations of income and gain should increase the capital account, and distributions from the partnership (except in repayment of debts or payment of compensation to a partner) and all allocations of losses to the partner, should reduce the capital account.

*Corp. v. Byrd*⁷⁰ urging that a special allocation of tax write-offs be held to have had just such an effect. They were successful, and a \$2 million deficit in a general partner's capital account was held to constitute a debt to her partnership, even though her capital account was rendered negative by special allocations of what the court referred to as "depreciation losses" and not by cash withdrawals.⁷¹

Proponents of a capital accounts analysis can cite several mandates. One lies in the attention the *Orrisch* court gave to the partners' capital accounts "to see who is to bear the economic burden of the depreciation if the buildings should be sold for a sum less than their original cost."⁷² Another lies in the legislative history of the 1976 Act:

The determination of whether an allocation may actually affect the dollar amount of the partners' shares of total partnership income or loss, independent of tax consequences, will to a substantial extent involve an examination of how those allocations are treated in the partners' capital accounts for financial (as opposed to tax) accounting purposes; this assumes that these accounts actually reflect the dollar amounts that the partners would have the rights to receive upon the liquidation of the partnership.⁷³

Yet another mandate lies in *Magaziner v. Commissioner*,⁷⁴ a fairly recent Tax Court memorandum decision that directly embraces a capital accounts analysis, albeit in dictum.

70. 534 S.W.2d 668 (Tex. 1976). The UNIFORM PARTNERSHIP ACT § 18(a) simply provides that each partner must contribute toward partnership losses "according to his share in the profits," unless otherwise agreed.

71. 534 S.W.2d 668, 673-74 (Tex. 1976):

The court below adopted Mrs. Byrd's executor's argument that closing the non-cash depreciation from the profit and loss account to the capital account is not in fact a withdrawal and that she therefore was under no obligation to pay this amount back into the partnership upon dissolution. We believe that under the agreement, this capital deficiency created a valid claim of the partnership against Mrs. Byrd. This is because a capital deficit may be created by the charging of losses against a partner's capital account as well as by the withdrawal of funds by a partner. * * * Mrs. Byrd's capital account was not merely a receptacle or a repository to which such items as non-cash depreciation were to be allocated for bookkeeping purposes as the respondents contend. It is obvious from a practical standpoint that the allocation of all the partnership losses to the capital account of Mrs. Byrd was intended to have, and did result in, beneficial financial consequences to her.

It seems that these parties would not intend that Mrs. Byrd should receive the entire tax benefit from the nearly \$2,000,000 in partnership losses and never be required to suffer any actual financial loss as a result of those allocations.

72. 55 T.C. 395, 403 (1970).

73. STAFF OF THE JOINT COMMITTEE ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 95 n.6 (1976).

74. 37 T.C.M.(CCH) 873 (1978). Language from *Harris v. Commissioner*, 61 T.C. 770, 786 (1974), is also cited in support of a capital accounts analysis:

[O]f critical significance is the obvious "economic effect" of the allocation agreement. Petitioner received the cash proceeds of the sale; the loss allocated to him was applied to reduce his capital account, and his share of related items of future profits, losses, and proceeds in the case of liquidation was reduced proportionately.

Harris, however, involved a plan to liquidate the taxpayer's interest in the partnership completely. It did not involve the kind of gain charge-back discussed below which creates the possibility that liquidating distributions will be unaffected by the special allocation. *Harris* suggests that partners in a bail-out situation have the flexibility to allocate that complements their flexibility to characterize. See Weidner, *Partnership Allocations and Tax Reform*, 5 FLA. ST. U.L. REV. 1, 31-37 (1977).

Martin Magaziner was a dentist who contributed \$60,000 to become a partner of a builder who had already spent \$42,000 seed money to develop an apartment complex. Although the builder was not required to contribute any cash to the partnership, he did agree to supervise construction without any compensation, share equal responsibility with Magaziner for partnership liabilities, and be solely responsible for any construction cost overrun. The builder sold the necessary land to the partnership for fair market value less liabilities, and received in sole payment therefor the partnership's nonrecourse note. Both partners made subsequent capital contributions.

The partnership agreement allocated Magaziner all interest and depreciation deductions for the partnership's first two calendar years. His share of those items was reduced to 90 percent the third year and was reduced 10 percent each subsequent year until it reached 50 percent the seventh year. Other items of income and expense, and distributions, were divided equally. In the partnership's sixth year the complex was sold. Although Magaziner's capital account was "considerably less" than the builder's, he was allocated half of the taxable gain on the sale and, apparently pursuant to a modification to the partnership agreement, significantly more than half of the sale proceeds.

The court disregarded the allocation of all the interest and depreciation deductions to Magaziner. It said that a special allocation will be given effect only if it has business validity apart from its tax consequences, and that business validity will not be found unless the special allocation actually affects the dollar amount of the partners' shares of total partnership income or loss independently of tax consequences.

The court rejected Magaziner's argument that he was entitled to the allocation because he was the only one who was to contribute any cash to the partnership.⁷⁵ It did so in a way that endorsed the gain charge-back provision of the type used in *Orrisch*. It said it is "a normal business procedure" for partners who provide capital to insist that they be allocated initial partnership losses.

However, it is also customary that the partnership agreement provide that the same partners shall be charged with all partnership profits until they have recouped the losses previously charged to them. In the instant case the property was sold at a gain and the partnership liquidated. The partnership agreement did not provide for any gain charge back. Instead petitioner received more than 50 percent of the net proceeds upon sale of the realty and the taxable gain was equally divided⁷⁶

Echoing *Orrisch*, the court said that when there is a gain charge-back provision, "to see whether there is any economic effect of the special allocation,"

75. The court did not discuss whether the builder's nonrecourse loan to the partnership should be recharacterized as a contribution to capital. Although "debt-equity" principles have been developed and applied almost exclusively to the corporate context, the Tax Court has stated emphatically that they apply to partnerships as well. See *Hambuechen v. Commissioner*, 43 T.C. 90, 100-01 (1964).

76. 37 T.C.M.(CCH) 873, 876 (1978).

we must "look to see who is to bear the economic burden of the . . . deductions if the partnership property is sold for a sum less than its original cost and the partnership liquidated."⁷⁷ Going beyond *Orrisch*, the court expressly stated that an allocation has substantial economic effect if it survives a capital accounts analysis:

In other words, the partner who benefits from a special allocation of tax deductions must bear the entire economic cost (burden) of such deductions. Accordingly, if the allocation of an item of income or deduction to a partner is reflected in his capital account and the liquidation proceeds of the entity are distributed in accordance with the capital accounts, the allocation has substantial economic effect.⁷⁸

B. Application: Gain and Loss Charge-Backs

A capital accounts analysis can probably most easily be understood through a series of hypotheticals. Consider *AB* partnership in which *A* and *B* each contribute \$50,000 cash. The partnership purchases an apartment building for \$1,000,000 with the contributions of *A* and *B* and the proceeds of a \$900,000 mortgage on which interest only is paid. Rent receipts equal operating expenses plus mortgage interest. The partnership computes an annual depreciation deduction of \$50,000, which is allocated entirely to *A*. At the end of Year 1, the capital accounts of *A* and *B* are as follows:

EXAMPLE 3

	Year 1	
	A	B
Initial Capital Account	\$50,000	\$50,000
Less: Depreciation Deduction	(\$50,000)	—
Balance at End of Year 1	-0-	\$50,000

If operations and allocations continue unchanged, the partners' capital accounts at the end of Year 2 are as follows:

⁷⁷ *Id.* at 875.

⁷⁸ *Id.* The lack of equivocation on this point in *Magaziner*, a memorandum opinion, should be contrasted with the caution subsequently expressed in *Holladay*, which was reviewed by the court:

After the first five years profits and losses as computed for tax purposes were to be reported equally *without provision for a chargeback of income* to petitioner to adjust for excess tax losses previously allocated to him. *We express no opinion here as to what the result would have been if provision for a tax readjustment had been made* or if any of the other actual variables were altered.

⁷² T.C. 571, 589 n.10 (1979)(emphasis added).

	<u>Year 2</u>	
	A	B
Initial Year 2 Balance	-0-	\$50,000
Less: Depreciation Deduction	<u>(\$50,000)</u>	<u>-0-</u>
Balance at End of Year 2	<u>(\$50,000)</u>	<u>\$50,000</u>

If the depreciation deductions overstate economic depreciation and the building is sold at the end of Year 2 for \$1,100,000, there is a \$200,000 gain and that many dollars in sale proceeds after the \$900,000 mortgage is paid off. Now there is a question that should be answered by the partnership agreement: How is the \$200,000 taxable gain allocated between the partners? If there is a "gain charge-back" provision of the type discussed in *Orrisch* and *Magaziner*, the capital accounts of *A* and *B* prior to the distribution of any sale proceeds are as follows:

	A	B
Initial Year 2 Balance	-0-	\$ 50,000
Less: Depreciation	(\$ 50,000)	-0-
Gain charge-back [<i>Orrisch, Magaziner</i>]	100,000	-0-
Division of remaining gain	<u>50,000</u>	<u>50,000</u>
Balance at End of Year 2	<u>\$100,000</u>	<u>\$100,000</u>

Under the charge-back arrangement, *A* is specially allocated taxable gain on the sale of the property to the same extent he was specially allocated depreciation deductions on the property. The result is that his capital account is brought up to equal that of *B*. The remaining gain is divided equally between the two partners, thereby preserving the newly reinstated equality in capital accounts. If the \$200,000 proceeds from the sale of the property are then distributed in accordance with capital accounts, *A* and *B* each receive a \$100,000 distribution. In this situation, the gain charge-back is large enough to eliminate the disparity in capital accounts that might otherwise have affected distributions on liquidation.

Capital accounts analysis is risk oriented; it contends that allocations of depreciation have substantial economic effect even though gain charge-backs can eliminate the disparity in capital accounts and thus equalize distributions on liquidation. It is not necessary that a special allocation have economic effect in every eventuality; it is sufficient that an allocation *may* have eco-

conomic effect. Gain charge-backs operate only if the property is sold at a gain and, it is argued, there is no reason the recipient of the deduction must suffer an economic detriment if the partnership suffers no economic detriment.⁷⁹ *Orrisch* and *Magaziner* suggest there can be substantial economic effect notwithstanding the presence of a gain charge-back provision. Those cases direct us, when there is a gain charge-back provision, to consider the economic effect an allocation has if the property is sold at neither gain nor loss, at a gain less than the special allocation of depreciation, or at a loss.⁸⁰

Assume that the depreciation deduction in this example accurately reflects economic depreciation and the property is sold at the end of Year 1 for \$950,000, an amount equal to its adjusted basis and \$50,000 more than the amount of the mortgage. In this situation, there is no gain or loss to be charged to capital accounts and the gain charge-back provision is not called into play. Capital accounts analysis concludes that the special allocation of depreciation in Year 1 has substantial economic effect if the \$50,000 proceeds from sale are allocated in accordance with capital accounts, that is, entirely to *B*.

Assume, instead, that the partnership holds the property through Year 2 and depreciation deductions continue to reflect economic depreciation. If the property is sold at the end of Year 2 for \$900,000, an amount equal to both its adjusted basis and the amount of the mortgage, there is no gain or loss to be charged to capital account and no sale proceeds remain after the mortgage is paid. The partnership has no remaining assets or liabilities except that *B* still has a \$50,000 positive capital account whereas *A* now has a \$50,000 negative capital account. Capital accounts analysis provides that the allocation of depreciation to *A* in Year 2 has substantial economic effect only if *A* is required to make up the \$50,000 deficit in his capital account. *A* must pay \$50,000 into the partnership and bring his capital account to zero; the partnership must then distribute the \$50,000 to *B* and reduce his capital account to zero.

Opposite-signed capital accounts are considered inappropriate unless the negative account must be restored to the partnership.⁸¹ Capital accounts

79. W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 10.02[2][a] (1977).

80. See A. WILLIS, *PARTNERSHIP TAXATION* § 68.11 (2d ed. 1976)(emphasis added):

Most writers dealing with the special allocation of depreciation feel that if there is meticulous recognition of capital account balances on distribution in liquidation following sales of partnership property (including the depreciable property), the substantial economic effect of the special allocation of depreciation is guaranteed. If the gain on sale of the depreciable property, which gain is specially allocable to the partner who received the special allocation of depreciation, is insufficient to restore the capital account of the partner receiving the special allocation to where it would have been in the absence of any special allocation, he gets less in liquidation of the partnership. Doesn't that prove the economic reality of the special allocation of depreciation?

For some of the reasons stated below, Willis suggests that the answer to this question is not necessarily affirmative. See *id.* at § 68.11.

81. Solomon, *Current Planning for Partnership Startup, Including Special Allocations, Retroactive Allocations, and Guaranteed Payments*, 37 N.Y.U. INST. FED. TAX. 13-1, 13-23 (1979):

Principle: If a special allocation results in a partner having a negative capital account which he is not obligated to restore and other partners have positive capital accounts, the special allocation should not be respected. A special allocation under such circumstances does not have economic effect because the partners with the positive capital accounts are being burdened with all or part of the specially allocated deduction.

analysts view positive capital accounts as reflecting unrecovered investment and negative capital accounts as reflecting a recovery of more than investment. Thus, when one partner's negative capital account co-exists with another's positive capital account, the partner with the negative capital account is viewed as having recovered more than his investment at the expense of the partner who has not yet recovered his investment. Recall the situation that exists at the beginning of Year 2. *A* has a zero capital account and *B* has a \$50,000 positive capital account. *A* is viewed as having recovered his investment whereas *B* is viewed as having \$50,000 equity remaining in the partnership.⁸² It is considered permissible to allocate the \$50,000 depreciation deduction in Year 2 entirely to *A* if *A* agrees to shoulder the economic risk the deduction theoretically reflects. If the deduction is allocated entirely to *A* and he is not required to make up the resulting \$50,000 deficit in his capital account, the allocation lacks substantial economic effect. The deduction has permitted *A* to recover more than his investment at the same time that *B*'s positive capital account reflects that *B* has not yet recovered his investment. In this situation, it is *B* who forfeits his equity at the end of Year 2—bears the burden of the Year 2 depreciation—not *A*.⁸³ On the other hand, if *A* is required to pay the partnership \$50,000 to bring his capital account back up to zero, the partnership has the money to return *B* his \$50,000 unrecovered investment and reduce his capital account to zero. Stated differently, *A* bears the burden of the Year 2 depreciation if he is required to return *B*'s investment at his own expense.

Capital accounts analysts argue that the substantial economic effect requirement should be imposed on a yearly basis.⁸⁴ For example, the hypothetical under discussion could be seen as involving only one special allocation: that of all the depreciation to *A*. Capital accounts analysts state that the hypothetical should be viewed as involving a series of separate annual allocations, some of which might be upheld even if others are disregarded. Thus, even if the special allocation in Year 2 lacks substantial economic effect because *A* is not required to make up the deficit in his capital account, the special allocation in Year 1 might pass muster. Under this approach, the Year 1 allocation has substantial economic effect if the capital accounts at the end of Year 1 determine the distribution of sale proceeds if the property is sold at the end of Year 1 and the partnership liquidated.

The importance capital accounts analysts place on negative capital accounts is perhaps easiest to understand when depreciation deductions understate economic depreciation. Assume the building in the above example is sold at the end of Year 2 for \$800,000, an amount \$100,000 less than both its adjusted basis and the amount of the mortgage. The partnership agreement

82. As a matter of practical business and economic reality, *A* will not see himself as having fully recovered his investment. See text accompanying notes 24–27 *supra*.

83. W. MCKEE, W. NELSON & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 10.02[2][b] (1977).

84. *Id.*

must be consulted to determine how the \$100,000 loss is to be allocated. If it provides that the loss is allocated equally, the capital accounts at the end of Year 2 are as follows:

	A	B
Initial Year 2		
Balance	-0-	\$ 50,000
Less: Depreciation	(\$ 50,000)	-0-
Division of Loss	<u>(50,000)</u>	<u>(50,000)</u>
Balance at End of Year 2	<u>(\$100,000)</u>	<u>-0-</u>

Under the assumed facts, there are no proceeds from the sale, yet the mortgage lender is still owed \$100,000. Capital accounts analysis provides that the special allocations of depreciation to A have substantial economic effect if A must pay the entire \$100,000 deficiency. In that event, in the words of *Orrisch*, A "is to bear the economic burden of the depreciation . . ."⁸⁵

Because capital accounts analysis is risk-oriented, it presumably would be considered inappropriate to have a loss charge-back provision on the downside analogous to the gain charge-back discussed above. Consider, once again, the situation in which depreciation deductions understate actual economic depreciation and the building is sold for \$100,000 less than both its adjusted basis and the amount of the mortgage. Consider if the partnership agreement divides the loss equally between the partners only after B receives a loss charge-back equal to the depreciation that was specially allocated to A. Under such an arrangement, the capital accounts at the end of Year 2 are as follows:

	A	B
Initial Year 2		
Balance	-0-	\$ 50,000
Less: Depreciation	(\$50,000)	-0-
Less: Loss Charge- back	-0-	(\$100,000)
Division of remaining loss	<u>-0-</u>	<u>-0-</u>
Balance at End of Year 2	<u>(\$50,000)</u>	<u>(\$ 50,000)</u>

The loss charge-back to B reduces his capital account to the level of A's. If responsibility for the \$100,000 indebtedness is then allocated in accordance

85. 55 T.C. 395, 403 (1970). A provision in a partnership agreement that partners are to bear economic losses in a certain proportion may deprive them of the opportunity to allocate tax losses some other way, even if the allocation of tax losses has been made to the partner who will most probably bear the economic losses. See *Boynton v. Commissioner*, 72 T.C. 1147 (1979).

with capital accounts, *A* and *B* are each required to pay \$50,000 to the lender. In this situation, the loss charge-back is large enough to eliminate the disparity in capital accounts that could have given the allocation of depreciation economic effect.⁸⁶

C. Application: Nonrecourse Liabilities

Because capital accounts analysis is risk-oriented, capital accounts analysts have great difficulty explaining why their approach is valid when the depreciation deductions at issue are attributable to assets financed with nonrecourse liabilities. This issue is absolutely critical to publicly syndicated real estate tax shelters that take the form of limited partnerships. Limited partners may claim partnership deductions or losses only to the extent they have basis in their partnership interests.⁸⁷ Although their basis includes their cash contributions, the goal of a true tax shelter is to claim tax write-offs far in excess of the limited partners' cash investment. This goal is achieved when the limited partners share in partnership liabilities for basis purposes—when they are deemed to have made additional contributions of cash to the extent they share in partnership liabilities. Limited partners share in partnership liabilities for basis purposes only if the partnership liabilities are fully nonrecourse.⁸⁸

The weakness of capital accounts analysis in the nonrecourse situation is readily apparent. Recall the situation in which the partnership is left with no remaining assets and a \$100,000 liability. *A* has a \$100,000 negative capital account and *B* has a zero balance capital account. It makes sense to say that *A* bears the economic burden of the depreciation if *A* is required to pay the \$100,000 deficiency to the lender. But what if the mortgage is nonrecourse? In that event, it is the lender who bears the economic burden of the \$100,000 economic depreciation that resulted in the deficiency.

The McKee treatise, *Federal Taxation of Partnerships and Partners*, contains what is probably the most extensive advocacy of a capital accounts analysis. It contains a separate section on an "argument that can be made" to uphold the validity of special allocations of depreciation deductions attributable to nonrecourse liabilities. The argument in defense of such allocations is not that they affect capital accounts and hence the distribution of liquidation proceeds.⁸⁹ Instead, it is one that relies on an analogy to the individual pro-

86. Compare Treas. Reg. § 1.704-1(b)(2), Example (1)(1964), which disregards a cross-allocation of equal amounts of loss or deduction of different character.

87. I.R.C. § 704(d).

88. Treas. Reg. § 1.752-1(e) (1956).

89. To emphasize: the focus is on depreciation deductions that are available only because of "investment" in the form of nonrecourse liabilities. Because the approach of McKee's treatise is that a positive capital account reflects unrecovered investment and a negative capital account a recovery of more than investment, it counsels that opposite-signed capital accounts should be avoided even if financing is nonrecourse. If opposite-signed accounts exist, the economic burden of depreciation is seen on the partner with the positive capital account rather than on the partner whose account is made negative by the deductions. Once all capital accounts are reduced to zero or below, however, allocations of depreciation are seen as not having economic effect in the nonrecourse situation. The only burden of the deductions, therefore, is that they must eventually be restored to

erty owner. The individual is entitled to depreciation deductions attributable to nonrecourse liabilities because "he will eventually restore these deductions to income" in one of two ways.⁹⁰ If the investment is an economic success, it will generate income that will be taxable to the owner even though it must be paid over to the lender to amortize the mortgage. On the other hand, if the investment is not successful and the property is disposed of, the full amount of the mortgage, even if it is nonrecourse, will be treated as an "amount realized" by the owner.⁹¹ McKee argues that the limited partner who is allocated depreciation deductions attributable to nonrecourse liabilities should be in the same position as the individual owner. The only burden those deductions reflect to the partners is that future income must be diverted to amortize the debt and what debt is not amortized will be treated as an amount realized when the properties are disposed of. McKee argues that the special allocation of the depreciation should be upheld⁹² if that future tax burden is also allocated to the recipient of the deduction:

To summarize, deductions attributable to nonrecourse liabilities have economic substance only in the sense that they will be borne out of future taxable income. If a partner receiving a special allocation of such deductions is also charged with the income that the partnership will eventually realize and divert to pay the mortgage lender, he bears the only burden that can be borne with respect to such deductions. Perhaps this burden is sufficient to support the special allocation of the deductions.⁹³

Perhaps, but not likely. The comparison with the sole owner is not helpful precisely because the sole owner has all the benefits and burdens of property ownership, both tax and economic. There is no question that a partnership can claim depreciation deductions on the full amount of mortgage liabilities, even though those liabilities are fully nonrecourse. And, at least with respect to real estate, it is clear that partners, including limited partners, may claim depreciation deductions attributable to nonrecourse liabilities.⁹⁴ The question is one not presented in the case of the sole owner: to what extent can

income. See W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 10.03[1] (1977).

For an abortive attempt to manipulate capital accounts, see *Sellers v. United States*, 80-1 U.S.T.C. 83,609 (4th Cir. 1980). There, the general partner allocated all partnership tax losses to his brother, the limited partner. The idea appeared to be to justify the allocation on the ground that the limited partner was the only one who had a positive capital account. The general partner kept his own capital account negative by "contributing" personal liabilities to the partnership. The allocation was disregarded.

90. W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 10.03[1] (1977).

91. *Crane v. Commissioner*, 331 U.S. 1 (1947).

92. No matter how loss is allocated in the partnership agreement, a partner is not allowed any loss in excess of his basis in his partnership interest. I.R.C. § 704(d). A partner's basis in his partnership interest includes his share of partnership liabilities, I.R.C. § 752(a), which is determined by law rather than by agreement of the partners. Limited partners share in nonrecourse liabilities for basis purposes in the same ratio they share partnership profits. Treas. Reg. § 1.752-1(e) (1956).

93. W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 10.04 (1977).

94. The "at risk" limitation of I.R.C. § 465(a) does not apply to "the holding of real property." I.R.C. § 465(c)(3)(D).

economic benefits be separated from tax benefits? At the extreme, can one partner be "paid off" with tax benefits instead of economic benefits? This is exactly what was going on in *Orrisch*: the Orrisches were specially allocated depreciation deductions to reward them for their superior financial contribution. They agreed to absorb a corresponding amount of taxable gain on the sale of the buildings as part of the deal. The arrangement was struck down as a naked trading in tax consequences, and it is not clear why the result would have been any different if they had agreed in the alternative to report an equal amount of income applied to repay mortgage principal. The McKee approach is an income charge-back that eliminates capital account disparities even if there is no gain. The result is that the transitory disparities in capital accounts, caused by the special allocations of depreciation, are systematically eliminated and thus prevented from having any effect on the distribution of liquidation proceeds.

There is no easy resolution of the application of capital accounts analysis to deductions or losses attributable to nonrecourse liabilities. At one level, it is a matter of debate among capital accounts analysts themselves. At least one leading capital accounts analyst specifically repudiates the McKee "argument" and cautions that capital account disparities cannot be systematically eliminated; they must have the potential for economic effect in at least some situations.⁹⁵ At a more fundamental level, it is difficult to understand why a risk-oriented analysis should determine the validity of allocations among the partners when the economic risk involved falls outside the partnership.⁹⁶

95. Solomon, *Current Planning for Partnership Startup, Including Special Allocations, Retroactive Allocations, and Guaranteed Payments*, 37 N.Y.U. INST. FED. TAX. 13-1 (1979), recommends a different charge-back than does McKee in order to "increase the likelihood" that a special allocation of depreciation attributable to nonrecourse debt will be respected. Solomon insists that the charge-back be one that will not equalize capital accounts in all situations:

Conclusion: A special allocation of depreciation attributable to nonrecourse indebtedness should be accompanied by a gain chargeback provision which applies only to a disposition of partnership property. Avoid a gain chargeback provision which applies to both (i) taxable income used to pay off the nonrecourse indebtedness and (ii) gain recognized on the disposition of property.

Id. at 13-26, 13-27. Similarly, Solomon recommends that if the special allocation is of bottom line loss rather than depreciation, it should be accompanied by a gain charge-back provision that only applies on a subsequent disposition of partnership property.

96. Compare ALI PROPOSALS FOR CHANGES IN THE RULES FOR TAXATION OF PARTNERS, Tent. Draft No. 3 at 132 (March 27, 1979):

(4) When tax losses are attributable to nonrecourse indebtedness, the validity of an allocation of those losses will depend on the following factors:

- (a) relative investment by the partners;
- (b) economic sharing of cash produced from operations;
- (c) economic sharing of proceeds of a sale of partnership assets; and
- (d) economic sharing of distributions from the proceeds of a refinancing of the partnership assets.

* * *

In applying these factors, the likelihood of there being cash from operations, cash from refinancing, etc., in a particular period and the magnitude of such items must also be taken into account.

See also text accompanying notes 97-114 *infra*.

D. *The Basic Flaw: Single-Mindedness*

It is obviously important to analyze capital accounts to determine what economic effect a special allocation might have. But there are those who have made an examination of capital accounts the sole determinant of the permissibility of special allocations.⁹⁷ The basic rationale for doing so is as follows. Prior to the 1976 Act, the Code contained the "principal purpose" limitation. One of the tests under the "principal purpose" Regulations is whether an allocation has substantial economic effect.⁹⁸ The other tests are vaguely aimed at tax avoidance considerations; this is why *Holladay* referred to the principal purpose limitation as a "subjective" test.⁹⁹ The 1976 Act eliminated the principal purpose limitation to make "substantial economic effect" the sole test. Tax avoidance considerations no longer come into play because it was the intent of Congress to add certainty to the law by introducing a purely objective standard. An allocation that does not have substantial economic effect will be disregarded even though there is no tax avoidance behind it. Conversely, an allocation that has substantial economic effect will be upheld even if tax avoidance is its sole purpose.¹⁰⁰ The presence of substantial economic effect is determined solely by an examination of the allocation's impact on and through capital accounts.

An exclusive reliance on capital accounts would on the one hand prohibit some allocations that have been considered perfectly permissible, and on the other hand approve many other allocations, particularly in tax shelter partnerships, that prior to the 1976 Act would have had no chance of being upheld. An example of an area in which a pure capital accounts analysis would be more restrictive than existing law, and unreasonably so, is that of special allocations with respect to contributed property, discussed above in connection with *Holladay*.¹⁰¹ Special allocations of depreciation, depletion, and gain or loss with respect to contributed property are specifically authorized by the Code and are valid independent of a capital accounts analysis. In Example 2,¹⁰² for instance, it is clear that liquidation proceeds are not distributed either in accordance with the partners' capital accounts or in accordance with their basis accounts. Nevertheless, common sense indicates that the special allocations should be upheld. It is perfectly reasonable to allocate the precontribution gain to the partner who contributes the property. It also makes sense to view his cash-contributing partner as having purchased an undivided half-

97. See A. WILLIS, PARTNERSHIP TAXATION § 68.11 (2d ed. 1976).

98. See note 9 *supra*.

99. See text accompanying note 44 *supra*.

100. Solomon, *Current Planning for Partnership Startup, Including Special Allocations, Retroactive Allocations, and Guaranteed Payments*, 37 N.Y.U. INST. FED. TAX. 13-1, 13-45 (1979):

It is possible for a special allocation to have substantial economic effect even though its sole purpose is the avoidance of tax. The pre-1976 TRA law disregarded special allocations made with the purpose of avoiding tax. Under current law, if the substantial economic effect test is satisfied, the special allocation apparently must be respected.

101. See text accompanying notes 50-67 *supra*.

102. See text accompanying notes 62-67 *supra*.

interest in the property and specially allocate him depreciation accordingly, up to the ceiling computation at the partnership level.

Pure capital accounts analysis is also more restrictive than existing law when a partnership with appreciated assets admits a new partner for cash. Present law is permissive not because of an express provision in the statute, but because of reasonable interpretation in the principal purpose Regulations. An exclusive emphasis on capital accounts would invalidate the present reasonable interpretation. Example 4 of the principal purpose Regulations concerns the following situation:

KL is a brokerage partnership with assets consisting of securities with a basis of \$20,000 and a value of \$50,000. *M* makes a \$25,000 cash contribution to the partnership in order to become an equal partner. Subsequently, when the value of the securities has appreciated to \$74,000, they are sold.¹⁰³

Of the \$54,000 gain, \$30,000 is specially allocated entirely to *K* and *L* and the remaining \$24,000 is divided equally among the three partners. Even though the sale proceeds are equally divided independent of the partners' capital accounts, the Regulations conclude the allocation "has substantial economic effect and will be recognized in the absence of other circumstances showing that the principal purpose of the allocation was tax avoidance or evasion."¹⁰⁴

The conclusion that the allocation has substantial economic effect within the meaning of the principal limitation is appropriate even though the allocation has no economic effect. It also indicates that the term "substantial economic effect" has long been used to embrace considerations other than a narrow economic effect. The allocation simply and reasonably permits the parties to allocate a tax bill based on one perception of economic reality.¹⁰⁵ Here, as elsewhere, the special allocation permits the partners to depart from a strict entity analysis and view the partnership as an aggregation of individuals. Under a strict entity approach, the partnership as an entity, and not individual partners acting in concert, owns the securities, both before and after *M* becomes a partner. Under the entity approach, *M* has an interest in the partnership, but no direct interest in its assets.¹⁰⁶ The special allocation in

103. Treas. Reg. § 1.704-1(b)(2), Example (4) (1964).

104. *Id.* At least one capital accounts analyst makes a fine distinction in this situation:

The agreement apparently is that the partners will receive equal amounts of cash because the new partner contributed his share of fair market value. When the appreciated asset is sold, the allocation of gain to the two original partners presumably will bring their capital account balances up to the same level as the incoming partner had when he first entered the partnership. If the distribution of proceeds is based upon capital account balances, the example would appear to be entirely correct. *If, however, there is no agreement for the appropriate accounting and distribution of the cash proceeds from the sale of the asset simply are divided equally without regard to the capital accounts, the allocation probably will fail.*

Freling, *Effects of Partnership Liabilities and Special and Retroactive Allocations*, ABA RESOURCE MATERIALS ON PARTNERSHIPS 301, 309-10 (2d ed. 1980) (emphasis added).

105. Compare Rev. Rul. 75-458, 1975-2 C.B. 258.

106. See UNIFORM PARTNERSHIP ACT § 26:

A partner's interest in the partnership is his share of the profits and surplus, and the same is personal property.

See also *id.*, § 25.

Example 4 permits the partners to recognize the economic reality that *M*, in effect, purchases an undivided one-third interest in the partnership's securities when he is admitted for his cash contribution. When so viewed, it is reasonable to permit *K* and *L* to pay the tax bill on the appreciation in value that took place before *M* became a partner.¹⁰⁷

On the other hand, an analysis that focuses solely on capital accounts is much more permissive than existing law in other situations.¹⁰⁸ Its permissiveness and its restrictiveness both arise out of its mechanical, one-dimensional emphasis on the distribution of liquidation proceeds. Existing law suggests that an allocation will not necessarily be upheld simply because it might in the future have some economic effect. The economic effect might be too distant, either in time or in probability, to rise to the level of "substantial economic effect" within the meaning of the Code. Or, it might be too insubstantial when weighed against tax avoidance considerations.

Example 3 of the principal purpose Regulations illustrates an allocation that would presumably become permissible under a pure capital accounts analysis:

[U]nder an agreement with respect to partnership *CD*, it is provided that *C*'s distributive share of income shall be the first \$10,000 of tax-exempt income and *D*'s distributive share of income shall be the first \$10,000 of dividend income, the balances to be divided equally. Since the principal purpose of this provision is to allocate tax-exempt interest to *C*, who is in a higher income tax bracket than *D*, it will be disregarded.¹⁰⁹

Example 3 is extremely significant because it strikes down an allocation that initially appears to have economic effect. *C* and *D* presumably bear the economic risk that their respective types of income will not be realized, or will be realized only after great delay. Under present law, an allocation will not necessarily have "substantial economic effect" simply because it may have some economic effect. As stated in *Orrisch*, an allocation will be disregarded if it does not "reflect normal business considerations but [is] designed primarily to minimize the overall tax liabilities of the partners."¹¹⁰ Presumably,

107. See also ALI PROPOSALS FOR CHANGES IN THE RULES FOR TAXATION OF PARTNERS, Tent. Draft No. 3, at 133 (March 27, 1979):

When the parties choose a generally applicable allocation of profit and loss, which reflects the substance of their economic agreement, that allocation should be sustained even though there may be a more appropriate allocation for a specific item.

108. See note 100 *supra*.

109. Treas. Reg. § 1.704-1(b)(2), Example (3) (1964). The result would be different if the partners bore all potential gain and risk of economic unprofitability of the underlying securities.

Example (3). Rather than impair the credit standing of the AB partnership by a distribution, the partners agree to invest surplus partnership funds in an equal dollar amount of municipal bonds and corporate stock. The partners further agree that A is to receive all the interest income and gain or loss from tax-exempt bonds and B is to receive all the dividend income and gain or loss from corporate stock. Such allocation has substantial economic effect and will be recognized in the absence of other circumstances showing that the principal purpose was tax avoidance or evasion.

Id. Note that even in this situation the Regulations hold open the possibility that the allocation might be disregarded if the prohibited principal purpose were shown by "other circumstances."

110. 55 T.C. 395, 401 (1970).

under a strict capital accounts analysis, the allocation would be upheld if it caused disparities in capital accounts that might affect liquidation proceeds. Has tax avoidance been purged from consideration by the 1976 Act?

It is hard to understand how the detached observer could read the 1976 Act history and conclude that a major liberalization of the law of partnership allocations was intended.¹¹¹ When the 1954 Code was enacted, "principal purpose" was in the statute and "substantial economic effect" appeared only in the Senate Report. *Orrisch* said the Senate's "substantial economic effect" language meant only that "special allocations are *ordinarily* to be recognized if they have business validity apart from their tax consequences."¹¹² Under the 1976 Act, it was the tax avoidance language that was relegated to the legislative history. The "substantial economic effect" language was elevated to the text of the statute by the Senate when it rejected the revision of section 704(b) that had been passed by the House. The House Bill contained tax avoidance language in the text, and the Senate indicated that its approach was "essentially" the same as the House approach. The House Bill would have replaced the principal purpose limitation with a two-pronged test. The House Bill disregards any allocation that is either without "a business purpose" or that results in a "significant avoidance or evasion of any tax."¹¹³ The Senate Report states that the substantial economic effect requirement has "essentially" the same intent as the two-pronged test in the House Bill, and unequivocally reaffirms the continued importance of tax avoidance considerations:

While there is a difference in language, the intent of the committee amendment and the House Bill are essentially the same—both versions seek to prevent the use of special allocations for tax avoidance purposes, while allowing their use for bona fide business purposes.¹¹⁴

The history of the 1976 Act also indicates that the distribution of capital on liquidation of the partnership is only one factor to be considered in determining a "partner's interest in the partnership," which can be viewed as the norm for the allocation of tax benefits:

In determining a "partner's interest in the partnership," all facts and circumstances are to be taken into account. Among the relevant factors to be taken into account are the interests of the respective partners in profits and losses (if different from that of taxable income or loss), cash flow; and their rights to distributions of capital upon liquidation.¹¹⁵

111. See generally Weidner, *Partnership Allocations and Tax Reform*, 5 FLA. ST. U.L. REV. 1, 52-63 (1977).

112. 55 T.C. 395, 401 (1970).

113. H.R. 10612, 94th Cong., 1st Sess., 121 CONG. REC. 38, 605 (1975), § 210(d) provided that the reallocation mechanism shall not be applied to allocations agreed upon by the partners if "the partner receiving the allocation can establish both that there is a business purpose for this allocation and that no significant avoidance or evasion of any tax imposed by this subtitle results from such allocation."

114. S. REP. NO. 94-938, 94th Cong., 2d Sess. 100 (1976).

115. *Id.*

It would therefore frustrate congressional intent to evaluate special allocations solely in terms of their impact on liquidation proceeds through capital accounts. Neither other economic factors nor tax avoidance considerations should be ignored.

The American Law Institute has recommended "substantial economic effect" Regulations as part of its Federal Income Tax Project. Draft 3 treats the 1976 Act allocation changes as merely changes of emphasis. It recommends what the 1976 Act history requires: that tax avoidance continue to be considered in the interpretation of the substantial economic effect requirement. It considers a situation that would pass muster under a pure capital accounts analysis:

Example (5). A and B are 50-50 partners in Partnership AB. AB owns a building which is rented on a net lease and earns an approximately constant amount each year.

In a year in which A has an expiring net operating loss carryforward he agrees with B that he will get all that year's income and B will get all the next year's income. After the second year they will return to their 50-50 arrangement.¹¹⁶

Under pure capital accounts analysis, this allocation is good if it affects capital accounts and through them distributions on liquidation. If the tenant goes bankrupt in the second year and pays no more rent, the special allocation of the preceding year will have an adverse economic impact on B. But what if the lease is a net lease to a triple-A tenant? Draft 3 concludes that, in some situations, "the economic effect may be inadequate to offset the tax effect."¹¹⁷ Draft 3 provides that the "most useful way to take tax motivation into account is to consider the tax-saving effect of an allocation as one factor to be balanced against the economic factors."¹¹⁸ It sets up the following as a "Guiding Principle:"

If an allocation may have a substantial economic effect it will be recognized for tax purposes. In determining whether an allocation may have a substantial economic effect, the likelihood and the magnitude of the economic effect must be weighed against the shifting of tax consequences resulting from the allocation.¹¹⁹

The "10-5-3" proposal presently before Congress raises some interesting questions about the "likelihood and magnitude of the economic effect" required to support a capital accounts analysis. Consider if Congress decides that all new buildings may be depreciated over a ten-year period. That is, assume Congress adopts a depreciation allowance that obviously and severely overstates economic depreciation in all but the most unusual situation. If the buildings are sold when they are written off, gain charge-back provisions will operate ineluctably to eliminate disparities in capital accounts. The transitory disparities in capital accounts never will have any economic effect.

116. ALI PROPOSALS FOR CHANGES IN THE RULES FOR TAXATION OF PARTNERS, Tent. Draft No. 3, at 108 (March 27, 1979).

117. *Id.* at 131.

118. *Id.*

119. *Id.* at 131-32.

The remoteness of the possibility of a loss is readily seen under existing law without the statement of an extreme situation. It is no secret that depreciation deductions are frequently generous when no economic depreciation at all is taking place.¹²⁰ Consider the following hypothetical:

A and B are practicing attorneys who have for several years owned a very profitable apartment house as equal partners. In a year in which A wins a large contingent fee and B loses a large contingent fee, the partnership agreement is amended to allocate all depreciation deductions to A. The agreement provides that the deductions decrease A's capital account, that liquidation proceeds will be distributed in accordance with capital accounts, and that any negative capital account will be treated as a debt to the partnership. The agreement also contains a gain charge-back provision.

In this situation, even if with recourse financing is involved, it is hard to believe the allocation would be sustained. It is so unlikely that the apartment house will be sold for less than its original cost that A is willing to agree, as a "throw-away" to uphold his allocation of depreciation, that it will reduce his distribution if the apartment house is sold for less than its cost.¹²¹ In the situation that both A and B expect without question—a sale for at least original cost—the gain charge-back provision¹²² equalizes capital accounts and prevents the allocation of depreciation from having any economic effect. It is clear that the "business purpose" aspect of the substantial economic effect requirement, which was reiterated by Congress when it passed the 1976 Act, has not been satisfied. Stated differently, to the extent an overstatement of economic depreciation clearly exists, a court might be persuaded that risk-oriented capital accounts analysis is a bit too self-serving a taxpayer argument, or might simply break new ground on how remote the possibility of an economic effect can be before it ceases to be "substantial."¹²³ If the sub-

120. For example, a classic study concludes that on the average, the decline in the market value of apartment houses from 1951 to 1965 was negligible. P. TAUBMAN & R. RASCHE, *TAX INCENTIVES* 113-142 (1971).

121. See A. WILLIS, *PARTNERSHIP TAXATION* § 68.11 (2d ed. 1976). Willis discusses the situation in which the special allocation is made only after the partnership property has doubled in value. He also points out that the partnership might not continue with the same partners until the property is sold and that the partnership agreement might otherwise be amended years after the special allocation is first made. What happens if the partnership agreement is amended 10 or 20 years later to provide some other allocation of sale proceeds? What if the property is not sold by the partnership but transferred years in the future to a corporation in an I.R.C. § 351 transaction?

122. Compare ALI PROPOSALS FOR CHANGES IN THE RULES FOR TAXATION OF PARTNERS, Tent. Draft No. 3, at 110 n.** (March 27, 1979):

In real estate transactions, particularly tax shelters, it is common for taxable gain on a sale of property to be allocated to the partners who are allocated the tax losses. This gain often does not result in any cash distribution but instead occurs because the mortgage balance exceeds the tax basis of the property at the time of sale. Should this allocation of gain be supported on the ground that, . . . it reaches the right tax result even though the allocation has no economic effect?

123. Compare *Jasionowski v. Commissioner*, 66 T.C. 312 (1976), in which the Service relied on I.R.C. § 183, the "hobby loss" provision, to deny a doctor tax losses from a house he was leasing to an elderly invalid who was a long-time patient and family friend. The Service relied on the fact that the rent being charged was nowhere near what the rental market would bear. The doctor replied that he would charge more rent on the

stantial economic effect requirement is not applied flexibly to embrace the full range of economic and avoidance considerations, the Service and the courts can be expected to follow the lead of cases such as *Holladay* and ignore the partnership rules and disregard allocations on broad notions of insufficiency of economic substance¹²⁴ or assignment of income.¹²⁵

V. CONCLUSION

The Treasury Department has under way the task of drafting proposals for new regulations on permissible partnership allocations. That task should be guided by the realization that capital accounts analysis has become fashionable among many segments of the legal and accounting professions. There appear to be a great many practitioners who unqualifiedly view capital accounts analysis as a "safe harbor" for allocations. Because it is a risk-oriented analysis as applied, with gain charge-back provisions, it has not been forcefully stated in nonrecourse situations. Even when financing is with recourse, there are many situations in which it appears unwise to rely exclusively on a capital accounts analysis. Because of its single-minded focus on some potential effect on the distribution of liquidation proceeds, it unrealistically ignores avoidance considerations and other economic variables that may be much more significant. On the other hand, the need for some safe-harbors in this area of considerable uncertainty is both understandable and reasonable. The Treasury will provide a valuable service if its new regulations indicate with some specificity a variety of situations in which capital accounts analysis provides a safe harbor and others in which it represents a trap for the unwary or the avaricious.

expiration of her lease and that he would eventually reap capital gains on the sale of the house. Nevertheless, the Tax Court held there is no time like the present when the search is on for profit motive:

[W]e do not think that any profit motive [the doctor] may have harbored for the period following the lease's expiration can be substituted for [his] intentions during the actual term of the lease.

Id. at 323. Might a court not hold that there is no time like the present when the search is on for the economic effect of an allocation of depreciation? Compare Judge Tannenwald's concurring opinion in *Holladay*, 72 T.C. 571, 591 (1979):

[T]he majority opinion seems to do no more than say that the divergence between the allocation of "bottom line" profits and losses and the actual division of funds during the taxable years in question is, in and of itself, sufficient to sustain [the Service's] position. But . . . this appears simply to make the test of "economic substance" or "economic effect" the same as that embodied in section 704(b)(2).

124. In *Boynton v. Commissioner*, 72 T.C. 1147 (1979), the Tax Court followed *Holladay* and disregarded an allocation of tax losses without relying on § 704(b)(2). Instead, it relied on

another and more sweeping limitation, namely, that the purported allocation of income and losses nominally in the partnership agreement must be bona fide in the sense that they are genuinely in accord with the actual division of profits and losses inter sese which the partners have in fact agreed upon among themselves.

Id. at 1158.

125. See *Rodman v. Commissioner*, 542 F.2d 845, 857-59 (2d Cir. 1976); *Moore v. Commissioner*, 70 T.C. 1024, 1032-35 (1978).