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Special Allocations of Bottom-Line Profits and Losses in Real Estate Partnerships Under the Final 704(b) Regulations

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SPECIAL ALLOCATIONS OF BOTTOM-LINE PROFITS AND LOSSES IN REAL ESTATE PARTNERSHIPS UNDER THE FINAL 704(b) REGULATIONS

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I. INTRODUCTION***

The Tax Reform Act of 1976 (the 1976 Act)[1] modified section 704(b) of the Internal Revenue Code (Code) making "substantial economic effect" the exclusive test for determining the validity of partnership allocations of income, gain, loss, deduction, or credit. On December 31, 1985, almost a decade after enactment of the 1976 Act, the Treasury Department issued Final Code Section 704(b) Regulations (Final 704(b) Regulations) interpreting the term "substantial economic effect."[2] Prior to the issuance of Final 704(b) Regulations, the interpretation of "substantial economic effect" by taxpayers and practitioners was based upon legislative history of the 1976 Act, case law, prior regulations, and Proposed Code Section 704(b) Regulations (Proposed 704(b) Regulations) published on March 9, 1983.[3] The Final 704(b) Regulations will generally apply to partnership taxable years beginning after April 30, 1986.[4]

This article discusses special allocations of bottom-line profits and losses in real estate partnerships in light of current case law and the newly promulgated Final 704(b) Regulations. Specifically, this article will focus on current law regarding the interpretation of "substantial economic effect" by comparing its development over the past decade in case law, legislative history, and the Proposed 704(b) Regulations with the Final 704(b) Regulations.

II. THE IMPACT OF THE TAX REFORM ACT OF 1986 ON THE FINAL 704(b) REGULATIONS

Tax practitioners have questioned the future significance of the Final 704(b) Regulations in light of the enactment of the Tax Reform Act of 1986 (TRA '86).[5] Many of the significant tax benefits previously available to real estate

*** Unless otherwise provided, all Code references herein are to the Internal Revenue Code of 1954, as amended. The Tax Reform Act of 1986 (TRA '86), Pub. L. No. 99-514, 100 Stat. 2085 (1986), signed by the President on October 22, 1986, substantially modified the Internal Revenue Code of 1954 and provided that in the future references to the Code shall be cited as the Internal Revenue Code of 1986 [hereinafter Int. Rev. Code of 1986]. *See id* § 2.

1. Tax Reform Act of 1976, Pub. L. No. 94-455, § 213(d), 90 Stat. 1520, 1547-49.
2. 50 Fed. Reg. 53,423 (1985) (to be codified at 26 C.F.R. § 1.704-1).
3. Prop. Reg. § 1.704-1(b), 48 Fed. Reg. 9871 (1983).
4. Treas. Reg. § 1.704-1(b)(1)(ii) (1986).
5. Pub. L. No. 99-514, 100 Stat. 2085 (1986).

investors have been eliminated or curtailed by TRA '86.[6] For example, the new tax law: (1) increases the recovery period (i.e., depreciation period) of real property from nineteen years for both residential and commercial property to 27.5 years for residential rental property and 31.5 years for commercial (nonresidential) property;[7] (2) extends the at-risk rules to real estate, in modified form;[8] and (3) limits the deductibility of losses and credits from real estate rental activities through the passive activity loss rules.[9] These provisions are viewed by some tax practitioners as mitigating the need for detailed regulations in the area of loss allocations.

Although the number of instances in which application of the Final 704(b) Regulations may be reduced, the authors believe that because of the effective dates and transitional rules of TRA '86, the Final 704(b) Regulations will continue to play a significant part in the tax analysis of partnership allocations. With respect to the effective dates of the new depreciation rules and the extension of the at-risk rules to real estate, these two provisions will generally apply only to real property placed in service after December 31, 1986.[10] Therefore, these two provisions will not limit the deductibility of future losses from real estate partnerships in operation prior to 1987.

The passive activity loss rules generally are effective for taxable years beginning after December 31, 1986.[11] Therefore, the passive activity loss rules will apply to real estate ventures in operation prior to 1987. The passive activity loss rules, however, contain a phase-in provision for taxpayers who invested in real estate ventures prior to October 22, 1986 (pre-enactment ventures).[12] This phase-in rule provides that losses from pre-enactment ventures may be written off sixty-five percent in 1987, forty percent in 1988, twenty percent in 1989, and ten percent in 1990.[13] The tax losses from these pre-enactment ventures, however, must first have substantial economic effect under the Final 704(b) Regulations before they can qualify for the phase-in rules of the passive activity loss provisions.

The passive activity loss rules are the heart of the new tax law's attack on real estate tax shelters. These rules were designed to end the use of tax shelter losses to offset a taxpayer's other income (*e.g.*, salary and active business income). Generally, passive activity losses may be deducted only against income from passive activities. Because of the mechanics of the passive activity loss rules, real estate promoters are structuring new real estate ventures to generate passive income to offset passive losses. Thus, in addition to analyzing the impact of the Final 704(b) Regulations on special allocations of tax losses from real estate partnerships, tax practitioners may be required in the future to determine

6. *See* TRA '86, Pub. L. No. 99-514, § 509, 100 Stat. 2085 (1986) (extending at-risk rules to real estate); *see also* S. Rep. No. 313, 99th Cong., 2d Sess. 713 (1986) (amending H.R. 3838) (limiting deductibility of losses and credits from passive activities).

7. Int. Rev. Code of 1986 § 168(c).

8. *Id.* § 465.

9. *Id.* § 469.

10. Pub. L. No. 99-514, §§ 203(a)(1)(A), 503(c)(1), 100 Stat. 2085 (1986).

11. *Id.* § 501(c)(1).

12. Int. Rev. Code of 1986 § 469(l).

13. *Id.* § 469(l)(2).

whether special allocations of taxable income from these new real estate ventures have substantial economic effect under the Final 704(b) Regulations.

III. Section 704(b) — Statutory Provisions

Prior to 1976, section 704(b) provided that a partner's distributive share of any item of income, gain, loss, deduction, or credit was to be determined in accordance with his distributive share of taxable income or loss of the partnership for the taxable year if (1) the partnership agreement did not provide for the partner's distributive share of such item, or (2) the principal purpose of any provision in the partnership agreement, with respect to a partner's distributive share of such item, was the avoidance or evasion of federal income tax.[14] Treasury Regulations under section 704(b) prior to the 1976 amendment listed several criteria for determining whether the principal purpose of a particular allocation was avoidance or evasion of federal income tax.[15] These factors included: (1) whether the partnership or a partner individually had a business purpose for the allocation; (2) whether the allocation had "substantial economic effect" — that is, whether the allocation might actually affect the dollar amount of the partner's shares of total partnership income or loss independently of tax consequences; (3) whether related items of income, gain, loss, deductions, or credit from the same source were subject to the same allocations; (4) whether normal business factors were taken into account in determining the allocation of any item and whether such allocation was made only after the amount of the specially allocated item could reasonably be estimated; (5) the duration of the allocation; and (6) overall tax consequences of the allocation.[16]

The only factor considered relevant by the courts, however, was whether the allocation had substantial economic effect.[17] The presence or absence of other factors had little bearing on the outcome of the cases.[18] The definition of substantial economic effect, however, had been unclear for numerous years. Substantial economic effect was first mentioned in a 1954 Senate Finance Committee Report that stated:

> [W]here, however, a provision in a partnership agreement for a special allocation of certain items has substantial economic effect and is not readily a device for reducing the taxes of certain parties without actually affecting their shares of partnership income, then such a provision will be recognized for tax purposes.[19]

Section 704(b), amended in 1976 and effective for tax years beginning after December 31, 1975,[20] gives some indication of the definition of substantial

14. I.R.C. § 704(b) (West 1985).

15. Treas. Reg. § 1.704-1(b) (West 1985).

16. *Id.* The meaning of various factors listed in the Treasury Regulations was not certain. For example, how one could have a non-tax motivated "business" purpose for an allocation of tax consequences was not clear. Further, what factors were to be considered as normal business factors were uncertain.

17. *See infra* § V.B.

18. *Id.*

19. S. Rep. No. 1622, 83d Cong., 2d Sess. 397 (1954).

20. Tax Reform Act of 1976, Pub. L. No. 94-455, § 213(d), 90 Stat. 1520, 1547-49 (1976).

economic effect. Section 704(b), as amended, states that a partner's distributive share of income, gain, loss, deduction, or credit is to be determined in accordance with the partner's interest in the partnership (taking into account all facts and circumstances) if (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof); or (2) the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner under the agreement does not have substantial economic effect.[21] The report of the Staff of the Joint Committee on Taxation, explaining the 1976 amendment, discussed the determination of whether an allocation has substantial economic effect and stated:

> [It] will to a substantial extent involve an examination of how these allocations are treated in the partners' capital accounts for financial (as opposed to tax) accounting purposes; this assumes that these accounts actually reflect the dollar amounts that the partners would have the rights to receive upon the liquidation of the partnership.[22]

The staff report also stated that "other factors that could possibly relate to the determination of the validity of an allocation are set forth under the present regulations."[23]

IV. Case Law Under Section 704(b)

Although the Code and regulations under section 704(b) provided little guidance to the meaning of "substantial economic effect," various judicial decisions discussed the concept of substantial economic effect in relationship to partnership special allocations. The case law, discussed below, indicates that courts generally believe the capital account analysis test is the best means for determining whether allocations have substantial economic effect.[24]

Orrisch v. Commissioner[25] is the landmark case applying the capital account analysis test in determining substantial economic effect of partnership allocation provisions. In this case, partners Orrisch and Crisafi provided in a partnership agreement for equal sharing of profits and losses from two apartment houses.[26] In a subsequent year, the partners orally agreed to amend the partnership agreement to allocate all depreciation deductions to Orrisch.[27] The partners also agreed to allocate any gain upon the sale of the property to Orrisch until he recovered the amount of depreciation previously deducted by him. Any addi-

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21. I.R.C. § 704(b) (West 1977).

22. Staff of the Joint Comm. on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, 95 n.6 (Comm. Print 1976) [hereinafter General Explanation 1976], *reprinted in* 1976-3 (Vol. 2) C.B. 107.

23. *Id.* at 95, 96.

24. *See id.* (Joint Committee staff assertion that capital accounts are basic criterion of substantial economic effect).

25. 55 T.C. 395 (1970), *aff'd*, 31 A.F.T.R.2d (P-H) ¶ 73-556 (9th Cir. 1973) (per curiam).

26. 55 T.C. at 396.

27. *Id.* at 397.

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tional gain would be divided equally.[28] The Tax Court, in disallowing the special allocation of depreciation, stated:

> 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. There is not one syllable of evidence bearing directly on this crucial point. We have noted, however, that when the buildings are fully depreciated, petitioners' capital account will have a deficit, or there will be a disparity in the capital accounts, approximately equal to the undepreciated basis of the buildings as of the beginning of 1966. Under normal accounting procedures, if the building were sold at a gain less than the amount of such disparity petitioners would either be required to contribute to the partnership a sum equal to the remaining deficit in their capital account after the gain on the sale had been added back or would be entitled to receive a proportionately smaller share of the partnership assets on liquidation. Based on the record as a whole, we do not think the partners ever agreed to such an arrangement. On dissolution, we think the partners contemplated an equal division of partnership assets . . . . That being true, the special allocation does not "actually affect the dollar amount of the partners' share of the total partnership income or loss independently of the tax consequences" within the meaning of the regulation.[29]

An important element emphasized in *Orrisch* is that the capital account analysis test examines the economic risk of the allocations.[30] In *Orrisch*, the Tax Court looked to a hypothetical liquidation to determine how economic risk was allocated between the partners.[31] If the property were sold at a gain, a gain charge-back provision in the partnership agreement would apply.[32] This provision would allocate taxable gain on sale to Orrisch until his capital account was equalized with Crisafi's. Remaining taxable gain would be split equally.[33] Thus, in liquidation, equal distribution of proceeds would be in accordance with their respective capital accounts.[34] This, however, was not dispositive to the Tax Court. Instead, the Tax Court examined who was to suffer the economic burden of the allocations if the property were sold at less than the special allocation of depreciation, so a disparity in capital accounts could not be remedied by a gain charge-back provision.[35] The *Orrisch* opinion specifies that the

28. *Id.*

29. *Id.* at 403-04 (footnotes omitted). *But cf.* Solomon, *Current Planning for Partnership Startup, Including Special Allocations, Retroactive Allocations and Guaranteed Payments*, N.Y.U. 37TH INST. ON FED. TAX'N 13-1, 13-13 (1979) (criticizing the *Orrisch* court's conclusion that Orrisch and Crisafi intended to divide partnership assets equally, where partnership agreement did not state such a conclusion).

30. 55 T.C. at 403 ("we must . . . look to see who is to bear the economic burden . . .").

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

35. *Id.*; *see supra* text accompanying note 30.

partner who took the deduction for depreciation should receive a reduced amount upon liquidation.[36]

The Tax Court also used the capital account analysis test in *Magaziner v. Commissioner*,[37] where two individuals formed a partnership to construct an apartment complex. One individual (the Service Partner) was to supervise construction of the project but was not required to make any capital contributions unless costs exceeded a specified amount.[38] The other individual (the Money Partner) contributed $60,000.[39] Pursuant to the partnership agreement, all income, expenses, credits, and distributions were to be allocated equally, subject to a special allocation of interest and depreciation deductions to the Money Partner. The special allocation was to last for seven years, in the following percentages: year one, 100 percent; year two, 100 percent; year three, 90 percent; year four, 80 percent; year five, 70 percent; year six, 60 percent; and year seven, 50 percent.[40] The apartment building was sold in year six and the Money Partner received more than 50 percent of the net proceeds in liquidation of his partnership interest although, according to his capital account, he was entitled to less than that amount.[41]

The Tax Court found that the partnership had disregarded the special allocation of depreciation and interest under the partnership agreement when dividing the proceeds from the sale.[42] Therefore, the special allocation to the Money Partner, for tax purposes, did not have substantial economic effect.[43] Specifically, the Tax Court stated:

> [A] 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.[44]

Although *Magaziner* involved the special allocation of specified deductions, other recent Tax Court cases apply the capital account analysis to special al-

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36. 55 T.C. at 403-04. Correlating to this conclusion, if a partner has a negative capital account and any other partner's capital account is positive, the allocation lacks substantial economic effect, unless the partner with the negative capital account is required to restore such negative capital account balance upon liquidation of the partnership. A negative capital account subsequent to liquidation means the partner has received cash or has been allocated tax losses in excess of his original investment. The negative capital account can no longer be bearing the economic burden of such allocations.

37. 37 T.C.M. (CCH) 873 (1978); *see* Sellers v. Commissioner, 36 T.C.M. (CCH) 305, 317-19 (1977), *aff'd on other grounds*, 592 F.2d 227 (4th Cir. 1979); Moore v. Commissioner, 70 T.C. 1024, 1028-36 (1978).

38. 37 T.C.M. (CCH) at 874.

39. *Id.*

40. *Id.*

41. *Id.* at 874, 875.

42. *Id.* at 876.

43. *Id.*

44. *Id.* at 875.

locations of bottom-line profit and loss.[45] For example, in *Holladay v. Commissioner*,[46] the Tax Court addressed special allocations of bottom-line profit and loss where an individual and a corporation formed a joint venture to complete development of an apartment complex. The corporation contributed a partially constructed apartment building and land to the joint venture.[47] The individual contributed $750,000 in cash and other property and agreed to provide up to $1,000,000 in loans.[48] The joint venture agreement provided for allocation to the individual of all taxable losses of the joint venture during the years 1970 through 1973. Profits and cash were to be allocated and distributed equally, with one minor exception.[49] Pursuant to the joint venture agreement, $2,300,000 of joint venture losses were allocated to the individual for the years 1970 through 1973.[50]

The Internal Revenue Service (Service) contended the allocation of losses to the individual was not a bona fide allocation because it bore no relationship to the individual's distributive share of economic profits and losses from the joint venture.[51] The Service asserted that because economic profits and cash distributions were to be shared almost equally, the individual was entitled to report only one-half of the losses for federal income tax purposes.[52] The individual contended, on the other hand, the allocation was bona fide because it was agreed to by the corporation and was set forth in the joint venture agreement.[53]

The Tax Court agreed with the Service and held the individual was entitled to only one-half of the joint venture as losses for the years 1970 through 1973.[54] In basing its opinion on *Kresser v. Commissioner*,[55] the *Holladay* court stated the allocations were not bona fide for federal tax purposes because the purported

45. *See also* S. Rep. No. 938, 94th Cong., 2d Sess. 99 (Comm. Print 1976) ("The committee believes that an overall allocation of the taxable income or loss for a taxable year (described under Section 702(a)(9)) should be subject to disallowance in the same manner as allocations of an item of income or loss.").

46. 72 T.C. 571 (1979), *aff'd*, 649 F.2d 1176 (5th Cir. 1981).

47. 72 T.C. at 577.

48. *Id.* at 577, 580.

49. *Id.* at 578-79.

50. *Id.* at 585.

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.* at 589-90.

55. 54 T.C. 1621 (1970). In *Kresser*, the dominant partner in two partnerships had a large net operating loss carryover about to expire. *Id.* at 1624-25. In order to take advantage of the carryover, the partners voted to allocate to the dominant partner all partnership income for the current year. The partnership agreement was never modified to reflect this adjustment. *Id.* at 1625. The other partners believed they would not be disadvantaged and the dominant partner would restore to the other partners in subsequent years the shares of partnership income allocated to him. *Id.* The Tax Court held that no bona fide reallocation occurred because the allocation of the entire partnership income to the dominant partner was not reflected in the partnership agreement and did not alter the other partners' rights to distributive shares of partnership cash distributions. *Id.* at 1630-32.

allocation of all losses to the individual for the tax years involved would have no effect whatsoever on cash proceeds he would receive from the joint venture.[56]

The Tax Court has also used the capital account analysis with respect to allocations of partnership bottom-line profit and loss in other cases.[57] In a factual situation similar to *Holladay*, the Tax Court denied special allocation of bottom-line losses to an individual where cash distributions upon liquidation of the partnership were not distributed in accordance with the partners' capital accounts.[58] Further, in recent Tax Court opinions involving special allocations, the Tax Court has stated that a partner's allocation must be reflected in his capital account and, in the event of a partnership liquidation, the liquidation proceeds must be distributed in accordance with his capital account balance.[59] Moreover, where a partner's capital account reflects a deficit, he must be obligated to restore the deficit upon liquidation of the partnership.[60] The Tax Court has stated that absent an obligation to restore a negative capital account, the other partner or partners would bear the economic cost of the special allocations that resulted in the deficit capital account.[61]

In *Goldfine v. Commissioner*,[62] two individuals, Blackard and Goldfine, entered into a joint venture agreement to own and operate an apartment complex. Each contributed one-half the initial capital.[63] Under the terms of their agreement, each shared equally in the proceeds of the sale of joint venture assets and any net proceeds on liquidation.[64] Each taxpayer shared equally certain cash distributions from refinancing.[65] Each was equally liable for cash losses.[66] The agreement, however, allocated to Goldfine all depreciation deductions and allocated to Blackard all net income computed without depreciation.[67] The Tax Court considered whether the principal purpose of the allocations was the avoid-

56. *Holladay*, 72 T.C. at 588.

57. The Service has, in at least one case, used an alternative analysis to the strict capital account analysis. *See* Hamilton v. United States, 687 F.2d 408 (Ct. Cl. 1982). In *Hamilton*, the Service asserted that a special allocation of bottom-line profits and losses to limited partners constituted either a loan repayment or a payment for a partnership interest transferred from the general partner to the limited partners. 687 F.2d at 409, 412. In either event, the Service treated the priority distribution to the limited partners as a return of capital. *Id.* at 412. The court held the government's "loan" theory was not supported by the regulations, revenue rulings, or case law, and the partnership agreements did not contain implicit "loan" or "transfer of interest" provisions. *Id.* at 414-18. Accordingly, the court concluded the allocations of income and losses designated in the partnership agreements had substantial economic effect. *Id.* at 418.

58. Boynton v. Commissioner, 72 T.C. 1147, 1157-61 (1979), *aff'd*, 649 F.2d 1168 (5th Cir. 1981), *cert. denied*, 454 U.S. 1146 (1982).

59. *See, e.g.*, Goldfine v. Commissioner, 80 T.C. 843, 852 (1983).

60. *Id.*

61. *Id.* (citations omitted).

62. 80 T.C. 843 (1983); *see* Allison v. United States, 701 F.2d 933 (Fed. Cir. 1983).

63. 80 T.C. at 845, 849.

64. *Id.* at 846, 849.

65. *Id.*

66. *Id.* at 845, 849.

67. *Id.*

ance or evasion of income taxes.[68] The Tax Court concluded that allocation of depreciation to Goldfine lacked substantial economic effect.[69] Because Goldfine's capital account reflected the special allocation of depreciation and the joint venture agreement did not provide for liability to restore capital account deficits upon liquidation, the agreement did not provide for distribution of assets upon liquidation in accordance with capital account balances.[70] Instead, the agreement called for an equal division of the net proceeds.[71] The Tax Court concluded, therefore, that the joint venture agreement did not meet the capital account analysis test because Goldfine did not bear the economic burden of depreciation deductions allocated to him.[72]

The Tax Court, in *Goldfine*, stated that the most important test for determining whether there is substantial economic effect to a partnership allocation is whether the capital account analysis test is met.[73] If a partner's allocation is reflected in that partner's capital account and liquidation proceeds are distributed in accordance with capital account balances, the allocation has substantial economic effect.[74] Moreover, where a partner's capital account registers a deficit, the partner must be obligated to restore such deficit. Absent such an obligation, the other partner or partners would have to bear part of the economic costs of special allocations that resulted in the deficit capital account.

In *Dibble v. Commissioner*,[75] the Tax Court analyzed special allocations of losses in a real estate partnership and found they had substantial economic effect. In that case, the taxpayer organized UAP, a Wisconsin limited partnership, to acquire certain commercial real estate.[76] Pursuant to the UAP partnership agreement, the general partner contributed an option to purchase real estate improvements, and each limited partner contributed $22,500 in cash and agreed to contribute another $22,500 in cash the following year.[77] The UAP partnership agreement provided that all losses would be allocated among the limited partners on the basis of their capital accounts at the close of each year. Net profits would be allocated fifty percent to the general partner and sixteen and two-thirds percent to each limited partner.[78] The agreement did not provide a specific time when contributions of the general partner and limited partners were to be returned, except that, upon termination or dissolution of UAP, the

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68. *Id.* at 849.
69. *Id.* at 852.
70. *Id.* at 852-53.
71. *Id.* at 853.
72. *Id.*
73. *Id.* at 851.
74. *Id.* at 852 (citation omitted).
75. 49 T.C.M. (CCH) 32 (1984); *see* Ogden v. Commissioner, 84 T.C. 871 (1985); Frink v. Commissioner, 49 T.C.M. (CCH) 386 (1984); Hirsch v. Commissioner, 47 T.C.M. (CCH) 1006 (1984).
76. 49 T.C.M. (CCH) at 33.
77. *Id.* Under the UAP partnership agreement, each partner received an interest designated as a "25% Capital Account" in exchange for his initial capital contribution. *Id.*
78. *Id.* The general partner was excluded from any allocation of the partnership's losses. *Id.*

amount of capital contributions of the limited partners was to be returned and an amount equal to the capital contribution of one limited partner was to be paid to the general partner.[79] During the years at issue, a shopping center owned by UAP was leased to various retail tenants. Residential properties, also owned by UAP, were leased to single family occupants.[80] To fund certain losses, the limited partners made additional capital contributions and assumed liability on certain debts of UAP.[81] UAP reported aggregate losses of approximately $808,000 in years 1977, 1978, and 1979. All losses were allocated to the limited partners in proportion to their capital account balances at year end. The limited partners claimed these losses on their individual income tax returns.[82] The limited partners' capital accounts were all charged with such losses.[83]

The Service argued that special allocations of losses to the limited partners during 1977 through 1979 lacked substantial economic effect.[84] The Tax Court found the special allocations of losses were reflected in the limited partners' capital accounts.[85] The court then set out to determine whether, upon liquidation of the partnership, the proceeds would be distributed in accordance with each partner's capital account.[86] The Tax Court found the partnership agreement provided for liquidations to be made in accordance with capital account balances.[87] The Service argued, however, that the UAP partnership agreement did not contain a provision requiring a partner to restore any deficit in his capital account and, therefore, the liquidation proceeds in certain circumstances would not be distributed in accordance with capital accounts.[88] The Tax Court noted the partnership agreement did not provide for restoration of capital account deficits; however, the Tax Court found the facts and circumstances in the case different from *Orrisch* and *Goldfine* where a partner's capital account registered a deficit.[89] In the instant case, the limited partners' capital accounts never registered a deficit in the years in question. Because the limited partners maintained positive capital account balances, no partner would bear more than his share of the economic costs of the special allocations. The Tax Court found that the absence of an obligation to restore a deficit was not fatal to the special allocations to the limited partners.[90] Thus, the Tax Court found the allocation

79. *Id.* Any excess in assets was to be distributed 50% to the general partner and 16 2/3% to each of the limited partners. *Id.*

80. *Id.*

81. *Id.* at 34.

82. *Id.*

83. *Id.*

84. *Id.* at 35.

85. *Id.* at 36, 37.

86. *Id.* at 37.

87. *Id.*

88. *Id.*

89. *Id.* In *Orrisch* and *Goldfine*, the Tax Court held that where a partner's capital account registers a deficit, he must have the obligation to restore the deficit. *Goldfine*, 80 T.C. at 852; *Orrisch*, 55 T.C. at 403-404.

90. 49 T.C.M. (CCH) at 37.

of losses to the limited partners had substantial economic effect even though no partnership provision required restoration of a negative capital account.[91]

Dibble can be narrowly read as standing for the proposition that special allocations of losses can have substantial economic effect even though the partnership agreement does not contain a deficit restoration provision, provided: (1) the special allocation of losses is reflected in the partner's capital account; (2) the partnership is liquidated in accordance with capital accounts; and (3) none of the partners has a negative capital account. The underpinnings of *Dibble*, however, are premised on a facts and circumstances determination of whether any partner would bear more than his share of the economic costs of the special allocation. The Tax Court's willingness to factually distinguish *Dibble* from *Orrisch* and *Goldfine* creates some uncertainty as to when a partnership agreement must contain a deficit restoration provision in order for a special allocation of losses to have substantial economic effect.

The principles of *Dibble* appear to support a position that a deficit restoration provision is not required in situations where special allocations of losses are attributable to nonrecourse debt and general partner advances and the partnership agreement contains a charge-back provision. If, for example, a partner has a negative capital account because of allocations of losses attributable to nonrecourse debt and general partner advances, and, upon liquidation, property is sold for less than the amount of nonrecourse debt and general partner advances, the partners would recognize gain equal to the difference between the outstanding principal balance of the nonrecourse debt and the adjusted basis of the partnership property,[92] plus cancellation of indebtedness income in the amount of unpaid general partner advances.[93] If such gain is allocated (charged-back) to the partners in accordance with the special allocation of losses, the partners receiving the special allocations would bear their share of economic costs of the special allocation. Accordingly, the principles of *Dibble* appear to

91. *Id.*

92. *See* Tufts v. Commissioner, 70 T.C. 756 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. Unit A July 1981), *rev'd*, 461 U.S. 300 (1983) (where property is sold for less than amount of nonrecourse debt secured by property, gain is recognized in amount equal to the amount by which debt exceeds the adjusted basis of such property); *cf.* Prop. Reg. § 1.704-1(b)(4)(iv), 48 Fed. Reg. 9871, at 9876 (1983) (limited safe harbor for allocations of losses financed by nonrecourse indebtedness). Under the Proposed Regulations, losses are attributable to nonrecourse debt to the extent the principal amount exceeds the partnership's adjusted basis in the collateral securing the debt. *Id.* This difference, termed the "minimum gain" in the Proposed Regulations, is commonly known as "negative basis" or "negative capital." An allocation of losses attributable to nonrecourse debt will be recognized if (1) the allocation does not cause the sum of the deficit capital account balances of partners receiving the allocation to exceed the excess of the outstanding principal balance of the debt over the adjusted basis of the property (that is, the deficit in the partners' capital accounts does not exceed the partnership's "negative basis" in the collateral), and (2) the partnership agreement provides that partners with such deficit capital accounts shall be allocated income or gain in an amount no less than the sum of the deficit capital account balances. *Id.*

93. *See* I.R.C. §§ 61(a)(12), 701, 702(a)(7) (West 1986). *But see* Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 2(a), 94 Stat. 3389, 3391-92 (current version at I.R.C. § 108(c), (d)(4) and (6) (West 1986)) (excluding the "qualified business indebtedness" of a partnership).

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support an argument that, in the foregoing situation, the special allocation of losses to partners with negative capital accounts can have substantial economic effect.

V. Proposed 704(b) Regulations

On March 9, 1983, the Treasury Department published a proposed amendment to Treasury Regulations section 1.704-1(b) (the Proposed 704(b) Treasury Regulations) that further defined the term "substantial economic effect."[94] The Proposed 704(b) Regulations prescribed three ways in which an allocation can have substantial economic effect under section 704(b). First, the Proposed 704(b) Regulations provided a safe harbor[95] under which special allocations would be honored by the Service.[96] Second, the Proposed 704(b) Regulations provided special rules under which certain allocations were deemed to have substantial economic effect.[97] Third, a special allocation had substantial economic effect if the partners showed, taking into account all the facts and circumstances, the allocation was in accordance with the partner's interest in the partnership (facts and circumstances test).[98] Discussion of the Proposed 704(b) Regulations will be limited to the substantial economic effect safe harbor requirements of the regulations.

Generally, the Proposed 704(b) Regulations set forth a two-part test to determine whether an allocation has substantial economic effect: (1) the allocation must have economic effect, and (2) the economic effect must be substantial.[99]

A. *Determination of Allocation's Economic Effect*

In order to demonstrate that a partnership's allocation provisions have economic effect under the Proposed 704(b) Regulations, it was necessary to establish that (1) the partnership agreement provided that partners' capital accounts would be adjusted to reflect allocations; (2) liquidation proceeds of the partnership would to be distributed in accordance with capital account balances of the partners; and (3) a partner was required, under the partnership agreement, to restore any deficit in his capital account following liquidation.[100]

The Proposed 704(b) Regulations contained very specific rules concerning the computation of a partner's capital account, generally applying "tax accounting principles" to the computation of a partner's capital account.[101] The

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94. Prop. Reg. § 1.704-1(b), 48 Fed. Reg. 9871-86 (1983).

95. Prop. Reg. § 1.704-1(b)(1)(i), 48 Fed. Reg. at 9872.

96. *Id.*; *see* Prop. Reg. § 1.704-1(b)(4), 48 Fed. Reg. 9871, 9875-77 (1983).

97. Prop. Reg. § 1.704-1(b)(1)(i), 48 Fed. Reg. at 9872; *see* Prop. Reg. § 1.704-1(b)(2), 48 Fed. Reg. 9871, 9873-75 (1983).

98. Prop. Reg. § 1.704-1(b)(1)(i), 48 Fed. Reg. at 9872; *see* Prop. Reg. § 1.704-1(b)(3), 48 Fed. Reg. 9871, 9875 (1983).

99. Prop. Reg. § 1.704-1(b)(2)(i), 48 Fed. Reg. at 9873.

100. Prop. Reg. § 1.704-1(b)(2)(ii), 48 Fed. Reg. at 9873.

101. Prop. Reg. § 1.704-1(b)(2)(iv), 48 Fed. Reg. 9871, 9874 (1983). Hence, the capital accounts of partners must be credited with the adjusted tax bases of contributed properties rather than fair market values.

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Proposed 704(b) Regulations provided that (1) the cash and adjusted basis of property contributed to the partnership (net of liabilities assumed and liabilities to which contributed property was subject), and the partner's distributive share of partnership income (including income exempt from tax) and gain (or item thereof) generally must be credited to the partner's capital account; and (2) the cash and partnership's adjusted basis of property distributed to the partner (net of liabilities assumed by such partner and liabilities to which distributed property is subject), and his distributive share of partnership loss and deductions must be debited to the partner's capital account.[102]

The Proposed 704(b) Regulations set forth two additional criteria to be met by allocation provisions for them to have economic effect: liquidation is in accordance with a partner's capital account balance, and restoration of a partner's negative capital account balance upon liquidation.[103] The Proposed 704(b) Regulations do not contain detailed rules describing these last two requirements.[104]

The Proposed 704(b) Regulations modified the three-prong test for determining if a partnership's allocation procedures have economic effect where nonrecourse indebtedness is involved.[105] Specifically, the Proposed 704(b) Regulations contained an alternative criterion in lieu of requiring restoration of a partner's capital account balance upon liquidation where losses were financed by nonrecourse debt secured by partnership property. The Proposed 704(b) Regulations provided that losses were attributable to nonrecourse debt to the extent the principal amount of the debt exceeded the partnership's adjusted basis in the collateral securing the debt.[106] The Proposed 704(b) Regulations referred to the difference as "minimum gain" and, depending upon the circumstances, may account for the aggregate negative capital accounts of partners in a partnership.[107] An allocation of losses attributable to nonrecourse debt was recognized if (1) the allocation did not cause the sum of deficit capital account balances of the partners receiving the allocation to exceed the excess of the outstanding principal balance of the debt over the adjusted basis of the property (i.e., the deficit in the partners' capital accounts did not exceed the partnership's "negative basis" or "minimum gain" in the collateral), and (2) the partnership agreement provided that partners with such deficit capital accounts are allocated income or gain in an amount no less than the "minimum gain" and at a time

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102. *Id.* The Final 704(b) Regulations under § 704, discussed *infra* notes 120-258 and accompanying text, substantially revised the rules governing the maintenance of capital accounts. *See, e.g.*, Treas. Reg. § 1.704-1(b)(2)(iv)(*e*)(*1*) (1986) (requiring all contributions of property to or distributions of property from a partnership be reflected in a partner's capital account according to fair market value).

103. Prop. Reg. § 1.704-1(b)(2)(ii)(*b*), (*c*), 48 Fed. Reg. 9871, 9873 (1983).

104. *Cf.* Treas. Reg. § 1.704-1(b)(2)(ii)(*c*) (1986) (subparagraph concerning obligation to restore deficit).

105. *See* Prop. Reg. § 1.704-1(b)(4)(iv), 48 Fed. Reg. 9871, 9876 (1983).

106. *Id.*

107. *Id.*

no later than the time when the "minimum gain" is reduced below the sum of such deficit capital account balances.[108]

The Proposed 704(b) Regulations also included an alternative to the three-prong economic effect test. This test, the capital account equivalence test, provided that if capital accounts were not maintained by the partnership or if capital accounts did not govern distribution of dissolution proceeds, but the partnership allocation provisions in all cases (irrespective of the economic performance of the partnership) produced the same results as if the economic effect test had been met, then the partnership allocations were deemed to have economic effect.[109]

B. *Determination of Substantial Economic Effect*

After an allocation was found to have economic effect under the Proposed 704(b) Regulations, such economic effect must be shown to be substantial.[110] The Proposed 704(b) Regulations provided that:

> In determining whether the economic effect is substantial, the likelihood and magnitude of a shift in the economic consequences among partners must be weighed against the shifting of tax consequences resulting from the allocation (or allocations), particularly tax consequences which result from the interaction of the allocation (or allocations) with the partners' nonpartnership tax attributes.[111]

An allocation did not have substantial economic effect "[i]f at the beginning of the taxable year to which an allocation (or allocations) relates there is a strong likelihood that such allocation (or allocations) would cause a shift in tax consequences that is disproportionately large in relation to the shift in economic consequences . . . ."[112]

Additional factors considered in determining whether the economic effect was substantial were (1) whether the partnership or a partner individually has a non-tax business purpose for the allocation; (2) whether related items of income, gain, loss, deduction, and credit from the same source are subject to

108. *Id.* Notwithstanding the apparent simplicity of the minimum gain rules, application of the rules created numerous problems. For example, whether the computation of "minimum gain" included accrued interest on the nonrecourse indebtedness was unclear. *See* Priv. Ltr. Rul. 8,041,019 (June 30, 1986), IRS - Ltr. Rulings Rep. (CCH) No. 190 (Oct. 22, 1980); Priv. Ltr. Rul. 8,041,017 (June 30, 1980), IRS - Ltr. Rulings Rep. (CCH) No. 190 (Oct. 22, 1980). Further, whether the minimum gain rules are adhered to when both recourse and nonrecourse debt exist in the partnership (the so-called order or "stacking" of the losses allocated to the partners of a partnership) is also unclear.

109. Prop. Reg. § 1.704-1(b)(2)(iv)(*b*), 48 Fed. Reg. 9871, 9874 (1985). The usefulness of this alternative test is questionable. Specifically, the Proposed 704(b) Regulations did not give sufficient detail to explain the mechanics of the test. Unfortunately, the Final 704(b) Regulations do not substantially clarify the scope of this alternative test. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(*i*) (1986).

110. Prop. Reg. § 1.704-1(b)(2)(i), 48 Fed. Reg. 9871, 9873 (1983).

111. Prop. Reg. § 1.704-1(b)(2)(iii)(*a*), 48 Fed. Reg. 9871, 9873 (1983).

112. *Id.*

the same allocation; (3) whether the allocation was made without recognition of normal business factors; (4) whether the allocation was made only after the amount thereof could reasonably be estimated; (5) the duration of the allocation; and (6) the overall tax consequences of the allocation.[113]

In addition, another aspect of the test of substantiality focused on the transitory nature of special allocations to partners.[114] Specifically, examples contained in the Proposed 704(b) Regulations addressed situations where a partner (or class of partners) received a special allocation of loss (or income) in one year for the purpose of reducing that partner's personal tax liability, while in a subsequent year, the partner received an offsetting allocation of income (or loss).[115]

Where allocations failed to meet either the economic effect test or the substantiality test or both, the Proposed 704(b) Regulations required the allocations to be reallocated to the partners in accordance with the partners' interest in the partnership.[116] The Proposed 704(b) Regulations detailed what was considered an interest in the partnership.[117] The Proposed 704(b) Regulations presumed the partners all to have equal interests, but the presumption could be rebutted by proving facts and circumstances otherwise.[118] The Proposed 704(b) Regulations set out the following facts as relevant: (1) the partners' relative contributions to the partnership; (2) the interests of the partners in economic profits and losses (if different from that in taxable income or loss); (3) the interests of the partners in cash flow and other distributions; and (4) the rights of the partners to distributions of capital and other property upon liquidation.[119]

VI. FINAL 704(b) REGULATIONS

On December 31, 1985, the Treasury Department published final regulations under section 704(b) interpreting the term "substantial economic effect."[120] The Final 704(b) Regulations follow the Proposed 704(b) Regulations by providing three ways for a special allocation to have substantial economic effect: (1) the partnership must comply with the detailed economic effect safe harbor rules of the Final 704(b) Regulations; (2) the partnership must meet certain rules that deem allocations to have substantial economic effect (e.g., allocations of tax credits); or (3) the partner must prove that under all facts and circumstances

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113. *Id.* § 1.704-1(b)(2)(iii)(*b*), 48 Fed. Reg. at 9874.

114. *See id.* § 1.704-1(b)(2)(iii)(*a*), 48 Fed. Reg. at 9874.

115. *See id.* § 1.704-1(b)(5) examples 2(ii) & 8(ii), 48 Fed. Reg. 9871, 9878, 9880 (1983). The Final 704(b) Regulations, discussed *infra* § VI, basically contain the same rules concerning substantiality as the Proposed 704(b) Regulations. *Cf.* Treas. Reg. § 1.704-1(b)(2)(iii) (1986).

116. Prop. Reg. § 1.704-1(b)(1)(i), 48 Fed. Reg. 9871, 9873 (1983).

117. *Id.* § 1.704-1(b)(3), 48 Fed. Reg. at 9875.

118. *Id.*

119. *Id.* The Final 704(b) Regulations also contain the concept that, if the partnership allocations do not meet the substantial economic effect test, the allocations will be reallocated in accordance with a partner's interest in the partnership. Treas. Reg. § 1.704-1(b)(1)(i) (1986).

120. Treas. Reg. § 1.704-1 (1986).

the allocation was in accordance with the partner's interest in the partnership (the "facts and circumstances test").[121]

The following discussion will be limited to the detailed rules contained in the Final 704(b) Regulations providing a safe harbor for determining whether a special allocation has substantial economic effect, and certain special rules contained in the Final 704(b) Regulations that deem special allocations to have substantial economic effect. This article will not discuss in detail the facts and circumstances test. It is noted, however, that the facts and circumstances test is an independent means of determining whether a special allocation of losses has substantial economic effect. If a partnership does not meet the detailed requirements of the Final 704(b) Regulations for substantial economic effect, a partner can still prove a special allocation has substantial economic effect by showing the allocation was in accordance with his interest in the partnership.[122]

Although the Final 704(b) Regulations clearly provide that the facts and circumstances test is a viable means for achieving substantial economic effect, there appears to be substantial risk involved in relying solely upon such an amorphous test. At present, it is uncertain whether courts will look to prior case law such as *Dibble* or to the detailed rules of the Final 704(b) Regulations for guidance in deciding whether a partner has proven, under all facts and circumstances, that a special allocation has substantial economic effect. It would appear in the face of such uncertainty that partnerships should prefer the detailed safe harbor provisions of the Final 704(b) Regulations as their primary means of achieving substantial economic effect and rely on the facts and circumstances test as a safety net if they fail to meet the safe harbor standards.

The Final 704(b) Regulations generally adopted the criteria used by the Proposed 704(b) Regulations to determine substantial economic effect. The Final 704(b) Regulations retain the two-part substantial economic effect test consisting of substantiality and economic effect.[123] The substantiality test adopted by the Final 704(b) Regulations is basically unchanged.[124] The economic effect test continues to use the three-prong analysis contained in the Proposed 704(b) Regulations.[125] The majority of the substantive changes drafted into the Final 704(b) Regulations relate to maintenance of partners' capital accounts.[126] While the Final 704(b) Regulations continue to use the concept of the capital account equivalence test, it has been relabeled the "economic effect equivalence test."[127] Moreover, the Final 704(b) Regulations contain detailed rules for determining when a special allocation will have substantial economic effect if the partnership agreement does not have a capital deficit restoration provision. These rules are embodied in a new alternate test, the "qualified income offset test," for eco-

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121. *Id.* § 1.704-1(b)(1)(i).
122. *Id.* § 1.704-1(b)(3).
123. *Id.* § 1.704-1(b)(2)(i).
124. *Id.* § 1.704-1(b)(2)(iii); *see supra* notes 110-19 and accompanying text.
125. Treas. Reg. § 1.704-1(b)(2)(ii) (1986); *see supra* notes 100-09 and accompanying text.
126. Treas. Reg. § 1.704-1(b)(2)(iv) (1986).
127. *Id.* § 1.704-1(b)(2)(ii)(*i*).

nomic effect.[128] Finally, the Final 704(b) Regulations retain but modify the minimum gain rules of the Proposed 704(b) Regulations.[129]

The following discussion will focus on areas relating to the capital account maintenance rules, qualified income offset test, allocations of tax credits, allocations attributable to nonrecourse financing, and effective dates.

A. *Maintenance of Capital Accounts*

1. In General

The Final 704(b) Regulations follow the Proposed 704(b) Regulations by examining the partners' capital accounts, as maintained under the partnership agreement, to determine whether a special allocation has economic effect. A special allocation of income, gain, loss, or deduction will not have economic effect under the Final 704(b) Regulations unless the partners' capital accounts are determined and maintained throughout the full term of the partnership in accordance with the capital accounting rules of the Regulations.[130]

The basic rules of the Final 704(b) Regulations governing maintenance of capital accounts generally require a partner's capital account be increased by (1) the amount of money contributed to the partnership, (2) the fair market value of property contributed to the partnership (net of liabilities secured by such contributed property that the partnership is considered to assume or take subject to under section 752), and (3) allocations to the partner of partnership income and gain (or items thereof), including income and gain exempt from taxation.[131] The partner's capital account is decreased by (1) the amount of money distributed to the partner, (2) the fair market value of property distributed to the partner (net of liability secured by the distributed property that the partner is considered to assume or take subject to under section 752), (3) allocations to the partner of expenditures of the partnership described in section 705(a)(2)(B), and (4) allocations of partnership loss and deductions (or items thereof).[132]

In general, the Final 704(b) Regulations modified some portions of the capital accounting rules under the Proposed 704(b) Regulations and clarified other portions of such rules. Section VI.A.2. of this article will compare the

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128. *Id.* § 1.704-1(b)(2)(ii)(*d*).

129. The Final 704(b) Regulations as originally promulgated on December 31, 1985, reserved the section on allocations attributable to nonrecourse deductions. On August 8, 1986, the Service promulgated the section attributable to nonrecourse deductions. *See* T.D. 8099.

130. Treas. Reg. § 1.704-1(b)(2)(iv)(*a*).

131. *Id.* § 1.704-1(b)(2)(iv)(*b*)(*1*)-(*3*).

132. *Id.* § 1.704-1(b)(2)(iv)(*b*)(*4*)-(*7*); *see id.* § 1.704-1(b)(2)(iv)(*d*)(*2*) (if partner contributes promissory note to partnership, partner's capital account is increased only when the partner makes principal payments on note). Although the Final 704(b) Regulations clearly provide the promissory note will not increase a partner's capital account until payments are made on the note, the Final 704(b) Regulations are silent on whether the promissory note could be used as a substitute for a limited deficit restoration provision.

capital accounting rules of the Proposed 704(b) Regulations and Final 704(b) Regulations, highlighting the changes and modifications.

2. Tax Accounting vs. Financial Accounting

Generally, the Final 704(b) Regulations adopt the rule contained in the Proposed 704(b) Regulations requiring partners' capital accounts to reflect tax accounting principles rather than financial accounting principles.[133] The tax accounting principles, however, have been substantially modified by the Final 704(b) Regulations. Under the Proposed 704(b) Regulations, a partner's capital account was increased by the tax basis of property contributed by him to the partnership, and decreased by the tax basis of property distributed to him by the partnership.[134] The Final 704(b) Regulations, however, require property contributed to and distributed from a partnership to be reflected in a partner's capital account according to fair market value.[135]

This modification of general tax accounting principles appears to be the result of comments on the Proposed 704(b) Regulations that questioned both the validity of the tax accounting principles and the end results achieved by applying such principles.[136] Commentators questioned the authority of the Proposed 704(b) Regulations for using tax accounting principles to determine economic effect. The report of the Staff of the Joint Committee on Taxation stated economic effect should be determined by financial accounting, independently of tax consequences.[137] Commentators also pointed out that crediting a partner's capital account with the basis of contributed property rather than fair market value would distort the economics of a transaction.[138] With respect to unsold partnership property, the Proposed 704(b) Regulations allowed the partnership to elect to adjust capital accounts prior to liquidation to eliminate discrepancies between tax and financial accounting as to such property.[139] In allowing adjustment, the Proposed 704(b) Regulations tacitly acknowledged that maintaining capital accounts according to tax accounting principles could distort the economics of a transaction and thus provided the preliquidation election to adjust capital accounts as a mechanism to correct the distortion. Presumably, all partnerships would make such a preliquidation election. Accordingly, a requirement that capital accounts be credited with the tax basis of contributed property appeared purposeless and was, therefore, omitted from the Final 704(b) Regulations.

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133. *Compare* Treas. Reg. § 1.704-1(b)(2)(iv)(*a*) (1986) *with* Prop. Reg. § 1.704-1(b)(2)(iv)(*a*), 48 Fed. Reg. 9871, 9874 (1983).

134. Prop. Reg. § 1.704-1(b)(2)(iv)(*a*), 48 Fed. Reg. 9871, 9874 (1983).

135. Treas. Reg. § 1.704-1(b)(2)(iv)(*d*)(*1*), (*e*)(*1*) (1986).

136. *See* Cowan, *Treasury Proposes New Rules for Partnership Allocations*, N.Y.U. 42D INST. ON FED. TAX'N 19-1, 19-26 to 19-29 (1984).

137. GENERAL EXPLANATION 1976, *supra* note 22, at 94-95.

138. *See* Cowan, *supra* note 136, at 19-27.

139. Prop. Reg. § 1.704-1(b)(2)(iv)(*c*)(*2*), 48 Fed. Reg. 9871, 9874 (1983).

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In response to comments, the Final 704(b) Regulations excepted from the tax accounting principles all contributions of property to and distributions of property from the partnership.[140] Contributions and distributions must be reflected in capital accounts at fair market value when contributed or distributed (rather than at their adjusted tax basis), and subsequent capital account adjustments with respect to such property must reflect fair market value.[141]

The requirement of the Final 704(b) Regulations that contributions and distributions of property be reflected in capital accounts at fair market value should result in liquidation distributions reflecting the true economic arrangement of the partners when the partnership is liquidated. Although the end results accomplished by this financial accounting requirement of the Final 704(b) Regulations appear to be an improvement over the tax accounting requirement for contributed and distributed property under the Proposed 704(b) Regulations, this requirement could result in more cumbersome bookkeeping requirements for partnerships. In order to properly reconcile the interplay between tax accounting and financial accounting principles of the capital account maintenance rules, partnerships should keep one set of books on a strict tax accounting basis and another set of books on a combined tax and financial accounting basis to ensure capital accounts are maintained in accordance with the Final 704(b) Regulations.

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140. Treas. Reg. § 1.704-1(b)(2)(iv)(*d*), (*e*) (1986).

141. *Id.* Tax practitioners may want to consider using the following definition of capital account in their partnership agreements in order to comply with the requirements of the Final 704(b) Regulations:

> For all purposes of this Partnership Agreement, the "Capital Account" of a partner as of any date is hereby defined to mean the amount of cash and fair market value of any property (net of any associated liabilities of such partner assumed by the partnership and liabilities to which such property is subject) contributed by such partner upon admission to the partnership, increased by:
>
> (1) the amount of cash and/or fair market value of any property (net of any associated liabilities of such partner assumed by the partnership and liabilities to which such property is subject) contributed by such partner subsequent to admission to the partnership; and
>
> (2) such partner's distributive share of partnership income (including income exempt from federal income tax, such as exempt municipal bond interest) and gain;
>
> and decreased by
>
> (3) such partner's distributive share of partnership deductions (including partnership expenses or expenditures not deductible and not required to be capitalized under applicable federal tax accounting principles, such as non-deductible tax penalties) and loss; and
>
> (4) the amount of cash and fair market value of any partnership property (net of partnership liabilities assumed by such partner and any liabilities to which such property is subject) distributed to such partner.
>
> Notwithstanding the definition of capital account stated in the preceding sentence, all partners' capital accounts shall be maintained in accordance with Treasury Regulation 1.704-1(b)(2)(iv). In the event an amendment to such regulation changes the effect of any partnership tax item or transaction upon partnership capital accounts, the provisions of this section shall be deemed properly adjusted as of the effective date of such amendment to comply with the change caused by such amendment.

3. Revaluations of Partnership Property

The Final 704(b) Regulations modified the Proposed 704(b) Regulations regarding revaluations of partnership property to reflect value changes of partnership property, including unrealized appreciation or depreciation on property contributed to or distributed from the partnership.[142] The Final 704(b) Regulations modify the class of cases in which capital accounts may be adjusted to reflect the fair market value of partnership property and still comply with the capital account maintenance rules.[143]

Under the Final 704(b) Regulations, partnership property may be revalued to reflect fair market value in the following situations where revaluations are made principally for a substantial non-tax business purpose: (1) the adjustment is in connection with a contribution of money or other property to the partnership by a new or existing partner as consideration for an interest in the partnership; (2) the adjustment is in connection with a distribution of money or other property by the partnership to a retiring or continuing partner as consideration for an interest in the partnership; or (3) the adjustment is made under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments readily tradable on an established securities market.[144]

Prior to the admission of a new partner or withdrawal (or dilution) of an existing partner, the partners' capital accounts will not reflect any unrealized appreciation or depreciation of partnership assets. The capital accounting rules of the Final 704(b) Regulations, however, require: (1) the capital account of the new partner be increased by the amount of money or fair market value of property contributed to the partnership; or (2) the capital account of the diluted partner be decreased by the amount of money or fair market value of property distributed to such partner.[145] Therefore, without this new rule permitting partnership property revaluation, the capital accounts of the partners would not reflect the true economics of the relationship among the partners upon a subsequent admission of a new partner or withdrawal of an old partner.[146]

Specifically, if a new partner's interest in the partnership is determined by the relationship of his contribution (cash or fair market value of property contributed) to the fair market value of partnership assets, the economic arrangement between the old partners and the new partner will not be reflected in their capital accounts. This is so because the old partners' capital accounts will not be based on fair market values of partnership assets at the time the new

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142. Treas. Reg. § 1.704-1(b)(2)(iv)(*f*) (1986).

143. *Id.*

144. *Id.* § 1.704-1(b)(2)(iv)(*f*)(*5*).

145. *Id.* § 1.704-1(b)(2)(iv)(*f*)(*5*)(*i*)-(*ii*).

146. *Id.* § 1.704-1(b)(2)(iv)(*f*) ("If the capital accounts of the partners are not adjusted to reflect the fair market value of partnership property when an interest in the partnership is acquired from or relinquishes to the partnership . . . potential tax consequences . . . may arise. . . .").

partner is admitted to the partnership.[147] In a similar manner, if an existing partner's interest in the partnership is diluted in proportion to the cash or fair market value of assets that the partner receives from the partnership, his capital account, after such dilution, will not reflect his true percentage ownership interest in the partnership, because the partner's predilution capital account did not reflect any unrealized appreciation or depreciation of partnership assets.[148] The Final 704(b) Regulations apparently recognize that partners may want to adjust their capital accounts to reflect economic reality in the aforementioned situations. Accordingly, the Final 704(b) Regulations permit adjustments to capital accounts to reflect unrealized depreciation or appreciation in partnership property in connection with the acquisition of an interest by a new partner or the disposition of an existing interest to the partnership.[149]

The third category of situations in which the partnership may revalue its assets is where substantially all the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments readily tradable on an established securities market, provided such adjustments are allowed under generally accepted industry accounting practices.[150] This category appears to provide greater flexibility for securities partnerships following "mark to market" financial accounting principles.

In general, revaluations of property to fair market value will be considered made in compliance with the capital account maintenance rules of the Final 704(b) Regulations if: (1) the adjustments are based on fair market value of partnership property; (2) the adjustments reflect the manner in which unrealized income, gain, loss, or deduction inherent in such property would be allocated among the partners if there were a taxable disposition of such property for fair market value on that date; (3) the partnership agreement requires the partners' capital accounts to be adjusted in accordance with the Final 704(b) Regulations for allocations of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property; and (4) the partnership agreement requires the partners' distributive shares of both depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, be determined to take account of the variation between the adjusted tax basis and book value of property in the same manner as under section 704(c).[151]

Although the Final 704(b) Regulations appear to give partnerships the option to revalue their property, the option may not be an option at all but a mandatory requirement of meeting the substantial economic effect test. In order to meet the substantial economic effect test, a partnership must liquidate according to capital accounts.[152] If a partnership does not revalue property upon the admission of a new partner or dilution of an existing partner, the partners'

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147. *See id.* § 1.704-1(b)(5) examples 14 & 18.
148. *Id.*
149. *Id.* § 1.704-1(b)(2)(iv)(*f*).
150. *Id.* § 1.704-1(b)(2)(iv)(*f*)(*5*)(*iii*).
151. *Id.* § 1.704-1(b)(2)(iv)(*f*)(*1*)-(*4*).
152. *Id.* § 1.704-1(b)(2)(ii)(*b*)(*2*).

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capital accounts might not reflect the true economic relationship among the partners after such event. In this situation, the partners will be faced with a decision to liquidate according to capital accounts for substantial economic effect purposes or to liquidate according to their economic arrangement, which might violate the substantial economic effect safe harbor rules. Accordingly, when a new partner is admitted to the partnership or an existing partner's interest is diluted through a distribution of property, the partnership may be forced to revalue property and adjust capital accounts in order to avoid adverse effects upon liquidation of the partnership.

If a partnership decides to revalue its property upon the occurrence of one of the aforementioned events, it should obtain appraisals of its assets to substantiate their fair market values. In certain circumstances, the cost of such appraisals may be offset by tax benefits that revaluation could produce to some of the partners. For example, if a partnership agreement does not contain a deficit make-up provision and some of the partners have negative capital accounts, they cannot receive additional allocations of tax losses and deductions. A book-up of partnership assets, however, could cause negative capital accounts to become positive, thereby allowing additional allocations of tax losses and deductions to these partners.

4. Code Section 704(c)

The Final 704(b) Regulations clarify the relationship between section 704(c) allocations and section 704(b) allocations. Such clarification, however, results more from the amendment of section 704(c) by the Tax Reform Act of 1984[153] than from finalization of the Proposed 704(b) Regulations. On March 9, 1983, the date of issuance of the Proposed 704(b) Regulations, section 704(c) (prior section 704(c))[154] provided two methods of allocating a partner's distributive shares of items of depreciation, gain, or loss attributable to contributed property. Specifically, prior section 704(c)(1) provided that tax items attributable to contributed property were allocated in the same manner as if such property had been purchased by the partnership.[155] Prior section 704(c)(2) allowed a part-

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153. Pub. L. No. 98-369, tit. I, § 71(a), 98 Stat. 494, 589 (1984).

154. Prior to amendment, § 704(c) read in part as follows:

(c) Contributed property. —

(1) General Rule. — In determining a partner's distributive share of items described in section 702(a), depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, except to the extent otherwise provided in paragraph (2) or (3), be allocated among the partners in the same manner as if such property had been purchased by the partnership.

(2) 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 variation between the basis of the property to the partnership and its fair market value at the time of contribution.

I.R.C. § 704(c)(1), (2) (1982).

155. *Id.* § 704(c)(1).

nership to allocate depreciation, depletion, or gain or loss with respect to contributed property so as to take account of the variation between the basis of property to the partnership and its fair market value at the time of contribution.[156] Depending upon the allocation election used for contributed property, partners were thus able to shift tax consequences between them with respect to precontribution gain or loss. For example, if partner *A* contributed nondepreciable property with a fair market value of $100 and a basis of $50, and partner *B* contributed $100 cash to a partnership, and the capital accounts of the partners were set at $100 (the fair market value of their contributions), absent specific allocation of precontribution gain to partner *A*, a subsequent sale of the property for $100 would result in an allocation of $25 of gain to each partner, thereby shifting $25 of the precontribution gain from partner *A* to partner *B*.

Although prior section 704(c) permitted the partnership to choose between two methods of allocating tax items attributable to contributed property, the Proposed 704(b) Regulations required capital accounts to be maintained by allocating tax items to partners to take into account variations between the basis of contributed property to the partnership and its fair market value.[157] Under the Proposed 704(b) Regulations, allocations made under prior section 704(c)(1) were not deemed to have economic effect.[158] Accordingly, the Proposed 704(b) Regulations effectively would have eliminated use of prior section 704(c)(1) allocations of tax items.

The Tax Reform Act of 1984 amended section 704(c) to provide a new rule regarding allocations with respect to property contributed to a partnership that achieves the same results as prior section 704(c)(2).[159] Under new section 704(c), depreciation, depletion, gain, and loss with respect to items of contributed property are to be shared among the partners to take account of the difference between the partner's basis in the property and fair market value of the property at the time of contribution.[160] In the above example, new section 704(c) requires $50 of precontribution gain associated with the contributed property be allocated entirely to partner *A*.

The Final 704(b) Regulations clarify the Proposed 704(b) Regulations by providing that if new section 704(c) determines the partners' distributive shares of tax items (i.e., depreciation, depletion, gain, or loss) with respect to contributed property, such allocations are not subject to the substantial economic effect test of section 704(b).[161] Although section 704(c) governs such allocations for tax purposes, the Final 704(b) Regulations also make clear, with respect to contributed property, the corresponding distributive shares of partners' book

156. *Id.* § 704(c)(2).
157. Prop. Reg. § 1.704-1(b)(2)(iv)(*a*), 48 Fed. Reg. 9871, 9874 (1983).
158. *Id.* § 1.704(b)(4)(i), 48 Fed. Reg. at 9875.
159. Tax Reform Act of 1984, Pub. L. No. 98-369, tit. I, § 71(a), 98 Stat. 494, 589 (1984), *reprinted in* 1984-3 (vol. 1) C.B. 97.
160. I.R.C. § 704(c) (West 1985).
161. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(*d*)(*3*), (*g*)(*1*), (b)(4)(i).

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items are determined under section 704(b) and the Final 704(b) Regulations.[162] When appreciated or depreciated property is contributed to a partnership, the capital accounting rules of the Final 704(b) Regulations appear to require the partnership to maintain separate accounts for tax purposes and book purposes. Allocation of tax items associated with any precontribution appreciation or depreciation of the property should be reflected in a partner's tax account according to principles of section 704(c). Allocations of book items associated with such contributed property, however, should be reflected in a partner's book capital account according to the substantial economic effect principles of the Final 704(b) Regulations.

5. Code Section 705(a)(2)(B) Expenditures

The Final 704(b) Regulations generally follow the Proposed 704(b) Regulations in the area of allocation of section 705(a)(2)(B) expenditures.[163] Specifically, a partner's capital account must be decreased by allocations made to such partner of expenditures described in section 705(a)(2)(B).[164] The Proposed 704(b) Regulations qualified section 705(a)(2)(B) expenditure allocations with a parenthetical stating "which share shall be determined in accordance with the partner's interests in the partnership."[165] Such language appears to preclude a special allocation of section 705(a)(2)(B) items. The Final 704(b) Regulations state, however, that if an allocation of section 705(a)(2)(B) expenditures under the partnership agreement does not have substantial economic effect, such expenditures will be reallocated in accordance with the partners' interests in the partnership.[166] This language appears to sanction special allocations of section 705(a)(2)(B) expenditures, provided such allocations have substantial economic effect.

Section 705(a)(2)(B) expenditures represent an outflow of cash from the partnership but do not produce any tax deductions for the partnership or partners.[167] Such expenditures, therefore, will not be reflected in a partner's capital account when it is adjusted for the partner's allocable share of partnership tax items. Moreover, by statutory definition, such expenditures are not capital expenditures that would increase the value of the partnership.[168] Theoretically, such expenditures should reduce the economic value of the partnership, causing the

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162. *Id.* § 1.704-1(b)(1)(vi).

163. *Compare* Prop. Reg. § 1.704-1(b)(2)(iv)(*a*), 48 Fed. Reg. 9871, 9874 (1983) *with* Treas. Reg. § 1.704(b)(2)(iv)(*b*) (1986).

164. Treas. Reg. § 1.704-1(b)(2)(iv)(*b*)(*6*) (1986); *see* I.R.C. § 705(a)(2)(B) (West 1985) (expenditures of the partnership not deductible in computing taxable income and not properly chargeable to capital account). Examples of such expenditures are charitable contributions, political contributions, and interest on debts incurred or continued to purchase tax exempt bonds under § 265.

165. Prop. Reg. § 1.704-1(b)(2)(iv)(*a*), 48 Fed. Reg. 9871, 9874 (1983).

166. Treas. Reg. § 1.704-1(b)(2)(iv)(*i*)(*1*) (1986).

167. I.R.C. § 705(a)(2)(B) (West 1985).

168. *Id.*

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partnership to have less funds available for distribution to the partners. The Final 704(b) Regulations require capital accounts be reduced by section 705(a)(2)(B) expenditures apparently to reflect economic loss to the partnership caused by such expenditures.

Furthermore, the Final 704(b) Regulations provide additional rules that certain items be treated as section 705(a)(2)(B) expenditures for adjustments to the partners' capital accounts.[169] Such items include (1) amounts paid or incurred to organize a partnership or to promote the sale of an interest in a partnership, except for amounts for which an election is properly made under section 709(b), and (2) a deduction for a loss incurred in connection with the sale or exchange of partnership property disallowed to the partnership under sections 267(a)(1) or 707(b).[170]

The classification of section 709(b) expenditures and sections 267(a)(1) or 707(b) losses as section 705(a)(2)(B) expenditures seems to be in keeping with the theoretical basis of the capital account maintenance rules. Specifically, the general rule under section 709(a) provides that a partnership must capitalize organizational and syndication expenses.[171] If the proper election is made, however, the partnership may amortize its organizational expenses over a five-year period.[172] Any unamortized organizational expenses, and all syndication expenditures, cannot be deducted by the partnership.[173] Such expenses, therefore, will not flow through the partners' capital accounts as tax items. Similarly, because the partnership is not allowed a deduction for losses disallowed by sections 267(a) or 707(b), such losses will not flow through the partners' capital accounts as tax items.[174] Unamortized organizational expenses, syndication expenses, and realized but unrecognized losses under sections 267 and 707 represent a decrease in the value of partnership assets. Thus, the Final 704(b) Regulations require a partner's capital account be reduced for the partner's allocable share of such items by treating them as section 705(a)(2)(B) expenditures.[175]

6. Transfer of Partnership Interests

The Final 704(b) Regulations adopt the general capital account maintenance rule of the Proposed 704(b) Regulations that upon the sale or exchange of a partnership interest, the capital account of the transferor partner carries over

169. Treas. Reg. § 1.704-1(b)(2)(iv)(*i*) (1983).

170. *Id.* § 1.704-1(b)(2)(iv)(*i*)(*2*), (*3*). *See generally* I.R.C. § 709(b) (West 1986) (partnership may elect to amortize organizational expenses over 60 month period); *id.* § 267(a) (no deduction allowed for loss from sale or exchange of property between certain related persons); *id.* § 707(b) (disallowing loss deductions from sales or exchanges of property with respect to controlled partnerships).

171. I.R.C. § 709(a) (West 1986).

172. *Id.* § 709(b)(1).

173. *Id.* § 709(a).

174. Treas. Reg. § 1.704-1(b)(2)(iv)(*i*)(*3*) (1986).

175. *Id.* § 1.704-1(b)(2)(iv)(*i*)(*1*).

to the transferee partner.[176] If the transfer of a partnership interest causes a termination of the partnership under section 708(b)(1)(B), however, the constructive distribution of property to the transferee partner will be governed by capital accounting rules for distributed property.[177] The Final 704(b) Regulations also state that the constructive reformation of the partnership under section 708(b) will be treated as the formation of a new partnership.[178] Thus, in connection with a section 708(b) partnership termination, the Final 704(b) Regulations appear to require: (1) booking up the partnership assets to fair market value prior to the deemed distribution of such assets to the partners; (2) reflecting such book up in the capital accounts of the partners; (3) reducing the partners' capital accounts by the fair market values of the deemed distributed property; and (4) increasing the partners' capital accounts by the fair market value of the deemed contributed property.

In addition to the foregoing, the Final 704(b) Regulations clarify which adjustments are to be made to partners' capital accounts upon a transfer of a partnership interest when the partnership has a section 754 election in effect.[179] In the case of a transfer of all or a part of an interest in a partnership that has a section 754 election in effect,[180] adjustments to the tax basis of partnership property under section 743 are *not* reflected in the capital accounts of the transferee partner or on the books of the partnership.[181] Furthermore, section 743 adjustments are disregarded for subsequent capital account adjustments for distributions of partnership property and depreciation, depletion, amortization, and gain or loss with respect to such property.[182] The disallowance of a capital account adjustment to a transferee partner, to reflect a section 743(b) basis adjustment, appears to be based on the fact that (1) the economic transaction producing such basis adjustment is between the transferor and transferee of the partnership interest, and (2) such transfer does not affect economic arrangements within the partnership.

In the case of a distribution of property by a partnership that has a section 754 election in effect, the partner receiving a distribution giving rise to an

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176. *Id.* § 1.704-1(b)(2)(iv)(*l*); *see* Prop. Reg. § 1.704-1(b)(2)(iv)(*c*)(*1*), 48 Fed. Reg. 9871, 9874 (1983).

177. Treas. Reg. § 1.704-1(b)(2)(iv)(*2*) (1986).

178. *Id.*

179. *Id.* § 1.704-1(b)(2)(iv)(*m*).

180. *See* I.R.C. § 754 (West 1986) (optional adjustment to basis in cases of distribution or transfer of partnership property). In the case of a transfer of partnership interests in a partnership that does not have a § 754 election in effect, any adjustments to tax basis under § 732(d) are treated for capital account purposes in the same manner as § 743 basis adjustments. Treas. Reg. § 1.704-1(b)(2)(iv)(*m*)(*3*) (1986).

181. Treas. Reg. § 1.704-1(b)(2)(iv)(*m*)(*2*) (1986). This paragraph also contains a minor exception to the general rule that § 743 basis adjustments are not reflected in capital accounts. To the extent § 743 adjustments are allocated to the common basis of partnership property under Treas. Reg. § 1.734-2(b)(1), such basis adjustments give rise to adjustments to the capital accounts of the partners. Treas. Reg. § 1.704-1(b)(2)(iv)(*m*)(*2*) (1986).

182. *Id.*

adjustment to the tax basis of partnership property under section 734 makes a corresponding adjustment to his capital account.[183] The Final 704(b) Regulations place a limitation on adjustments made to a partner's capital account in respect to basis adjustments under sections 732, 734, and 743.[184] Such capital account adjustments are limited to the extent that such basis adjustments (1) are permitted to be made to one or more items of partnership property under section 755, and (2) result in an increase or decrease in the amount the property is carried on the partnership's balance sheet, as computed for book purposes.[185] The Final 704(b) Regulations provide the following example of the latter limitation:

> If the book value of partnership property exceeds the adjusted tax basis of such property, a basis adjustment to such property may be reflected in a partner's capital account only to the extent such adjustment exceeds the difference between the book value of such property and the adjusted tax basis of such property prior to such adjustment.[186]

7. Restatement of Capital Accounts

The Final 704(b) Regulations apply to partnership tax years beginning after April 30, 1986.[187] Capital accounting rules of the Final 704(b) Regulations, therefore, will apply to existing partnerships (i.e., partnerships formed prior to May 1, 1986) as well as newly formed partnerships. Moreover, the Final 704(b) Regulations appear to require existing partnerships that have not complied with the new capital accounting rules since their inception to revalue all partnership property and restate the partners' capital accounts for the first partnership taxable year beginning after April 30, 1986.[188] Because the capital accounting provisions of the Final 704(b) Regulations substantially modify the capital accounting rules of the Proposed 704(b) Regulations, it is extremely unlikely that any partnership formed prior to December 31, 1985, the date the Final 704(b) Regulations were published, has complied with every detailed requirement of the Final 704(b) Regulations' capital accounting rules. Therefore, it seems under a literal interpretation of the Final 704(b) Regulations, all existing partnerships are required to restate capital accounts for the partnership tax year beginning after April 30, 1986. For calendar year partnerships, such restatement of capital accounts would be required for taxable years commencing January 1, 1987. Furthermore, the restatement of capital accounts according to the fair market

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183. *Id.* § 1.704-1(b)(2)(iv)(*m*)(*4*).

184. *Id.* § 1.704-1(b)(2)(iv)(*m*)(*5*).

185. *Id.*

186. *Id.* If, for example, a partnership's property has a book value of $80, a tax basis of $70, and a basis adjustment under § 755 of $30, then adjustment to a partner's capital account would be limited to the extent the basis adjustment ($30) exceeds the difference between the book value of the property ($80) and the adjusted tax basis of such property ($70), or $20.

187. *Id.* § 1.704-1(b)(1)(ii).

188. *Id.* § 1.704-1(b)(2)(iv)(*r*).

value rules must comply with revaluation provisions of the Final 704(b) Regulations.[189] Unless capital accounts are restated in accordance with the revaluation provisions of the Final 704(b) Regulations, special allocations of tax items under the partnership agreement, for partnership taxable years beginning after the effective date of the Final 704(b) Regulations, will not qualify for the substantial economic effect safe harbor rules.

B. *Alternative Test for Economic Effect*

The Final 704(b) Regulations create a new test for economic effect applicable to partnership agreements that do not contain a deficit restoration provision.[190] Although this new test has been labeled the "alternate test for economic effect," the Final 704(b) Regulations limit its scope to certain partnerships and further limit the extent to which allocations by such partnerships will be considered to have economic effect. The alternate test, therefore, is a narrow exception to the three-prong economic effect test rather than an independent test for economic effect. A partnership will not qualify for the new test unless four conditions are met: (1) the partnership properly maintains capital accounts; (2) the partnership liquidates in accordance with capital accounts; (3) partners are *not* obligated to restore deficits in their capital accounts; and (4) the partnership agreement contains a "qualified income offset provision."[191] Although general parameters of the alternate test can be simply stated, the application of its principles is quite complex.

1. Special Maintenance of Capital Account Rules

Special allocations are considered to have economic effect under the alternate test to the extent such allocations do not cause (or increase) a deficit balance in a partner's capital account.[192] According to the Final 704(b) Regulations, a determination of whether the allocation causes a deficit in a partner's capital account is made as of the end of the partnership taxable year to which the allocation relates.[193] This portion of the Final 704(b) Regulations simply appears to restate principles of case law that if a partner's capital account never goes negative, a deficit restoration provision is not required for the allocation to have economic effect.[194] In determining whether a special allocation causes a deficit in a partner's capital account, however, the Final 704(b) Regulations seem to go beyond case law by specifically requiring that a partner's capital account be reduced for certain adjustments, allocations, and distributions.

Specifically, the Final 704(b) Regulations state a reduction in a partner's capital account must be made for the following future events: (1) adjustments

189. *See supra* notes 142-52 and accompanying text.
190. Treas. Reg. § 1.704-1(b)(2)(ii)(*d*) (1986).
191. *Id.*
192. *Id.* § 1.704-1(b)(2)(ii)(*d*)(*3*).
193. *Id.*
194. *See supra* note 89 and accompanying text.

reasonably expected to be made to the partner's capital account for certain depletion allowances;[195] (2) certain allocations of losses and deductions reasonably expected to be made to such partner;[196] and (3) distributions reasonably expected to be made to such partner to the extent they exceed offsetting increases to the partner's capital account.[197]

The Final 704(b) Regulations limit the number of future events that are reasonably expected to occur and that must be reflected currently in a partner's capital account. The common thread joining these enumerated future events is that they represent items for which the Service cannot prescribe regulations relating to allocation. For example, the adjustments for depletion and allocations of losses pursuant to section 704(e)(2), section 706(b), and Treasury Regulations section 1.751-1(b)(2)(ii)[198] are allocated to partners pursuant to self-operating provisions of the Code or regulations. The Service, therefore, cannot reallocate such items in future years. Similarly, if a partnership distributes money or property to a partner, the Service cannot allocate such distribution away from the distributee partner.

The current reduction of a partner's capital account for future allocations of losses under section 706(d) and future distributions is of primary concern to real estate partnerships. Section 706(d) requires a partner's distributive share of items of partnership income, gain, loss, deduction, and credit be determined by a method that takes into account the varying interests of the partners (attributable, for example, to the admission of new partners or the transfer of a partnership interest) during the partnership's taxable year.[199] Two general methods are used to calculate each partner's distributive share: (1) the proration method, under which the partnership's profit or loss for the entire year is allocated *pro rata* to each partner in accordance with the number of days he was a partner and according to the percentage of partnership interest held for those days; and (2) the interim-closing-of-the-books method, under which the partnership tax year is divided into segments and each partner is allocated a share of profit or loss incurred during each segment during which he was a partner.[200] Under the Final 704(b) Regulations, if a partner reasonably expects to transfer his partnership interest in a future tax year and reasonably expects to be allocated a loss pursuant to section 706(d), such partner's capital account must be reduced currently to reflect the reasonably anticipated future loss allocation under section 706(d).[201]

As stated above, the Final 704(b) Regulations require a partner's capital account for the year of the special allocation be reduced for certain future distributions (including liquidating distributions) to the extent they exceed off-

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195. Treas. Reg. § 1.704-1(b)(2)(ii)(*d*)(*4*) (1986).
196. *Id.* § 1.704-1(b)(2)(ii)(*d*)(*5*).
197. *Id.* § 1.704-1(b)(2)(ii)(*d*)(*6*).
198. *Id.* § 1.704-1(b)(2)(ii)(*d*)(*5*).
199. I.R.C. § 706(d)(1) (West 1986).
200. *See id.* § 706(d)(2)(A).
201. Treas. Reg. § 1.704-1(b)(2)(ii)(*d*)(*3*), (*5*) (1986).

setting increases to the partner's capital account.[202] The complex language in this regulation becomes clearer when read in conjunction with the examples contained in the regulation. The following example is an attempt to interpret the language of the Final 704(b) Regulations in light of results contained in regulation examples.[203] Assume the partnership is a calendar year partnership and partner *A* receives a special accelerated cost recovery system (ACRS) allocation for taxable year 1986. On December 31, 1986, partner *A* must look to the future and determine whether he reasonably expects to receive a distribution in future years (e.g., the partnership intends to distribute refinancing proceeds in 1990) that will reduce partner *A*'s capital account in 1990. Partner *A* then must determine whether he reasonably expects to receive any allocations of income and gain during the years 1987 through 1990 that will increase his capital account and offset the reasonably expected decrease to his capital account for the refinancing proceeds in 1990. To the extent the refinancing proceeds distribution in 1990 exceeds offsetting increases to his capital account during the period 1987 through 1990, partner *A* must reduce his capital account balance in 1986 by such excess to determine whether the special ACRS allocation in 1986 will cause his capital account to become negative. The special ACRS allocation for 1986, to the extent it causes a deficit in partner *A*'s capital account, will not have economic effect under the alternate test and will be reallocated according to the partners' interests in the partnership.

2. Qualified Income Offset Rules

An allocation under a partnership agreement that does not contain a deficit restoration provision cannot be eligible for the alternate test unless the partnership agreement contains a "qualifed income offset provision."[204] The Final 704(b) Regulations state:

> The partnership agreement contains a qualified income offset if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation or distribution described [under the reasonably expected standard], will be allocated items of income and gain in an amount and manner sufficient to eliminate such deficit balance as quickly as possible.[205]

The qualified income offset will apply only to situations where three conditions are present. First, the event causing a deficit in a partner's capital account must arise from either (1) an adjustment for depletion allowances; (2) allocations of loss or deduction pursuant to section 704(e)(2), section 706(d), or Treasury Regulations section 1.751-1(b)(2)(ii); or (3) distributions to the

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202. *Id.* § 1.704-1(b)(2)(ii)(*d*)(*6*).
203. *See id.* § 1.704-1(b)(5) examples 1(iii)-(vi), (viii)-(x), 15 & 16(ii).
204. *Id.* § 1.704-1(b)(2)(ii)(*d*)(*3*).
205. *Id.* § 1.704-1(b)(2)(ii)(*d*).

extent they exceed offsetting increases to a partner's capital account.[206] These events that trigger the qualified income offset are the same events for which a partner's capital account must be reduced under the reasonably expected standard.

Second, the Final 704(b) Regulations state the event causing a deficit in a partner's capital account must occur unexpectedly.[207] The Final 704(b) Regulations seem to acknowledge that if an adjustment, allocation, or distribution unexpectedly occurs, the partnership was not intentionally trying to circumvent the substantial economic effect test. Therefore, if the other requirements of the qualified income offset are met, the partnership will be given an opportunity to correct the aberration caused by the unexpected event.

Third, in order for the qualifed income offset test to be met, the partnership agreement must provide that any deficit to a partner's capital account caused by such unexpected occurrence be eliminated as quickly as possible through allocation of income and gain to such partner.[208] The Final 704(b) Regulations do not define "as quickly as possible" nor do they contain an example of an unexpected adjustment, allocation, or distribution being eliminated as quickly as possible. Moreover, the regulations are unclear as to which items of income and gain must be allocated to the partner with a deficit in his capital account. Presumably, the Final 704(b) Regulations mean bottom-line allocations of income and gain. They could be interpreted, however, to mean allocations of gross income if there is not sufficient net income to offset the unexpected adjustment allocation or distribution.

Although not explicitly stated in the Final 704(b) Regulations, the language defining a qualified income offset could be reasonably interpreted to provide a limited exception to the general rule that a special allocation cannot have economic effect if it causes a partner's capital account to become negative. Allowing a partner who is not required to restore a deficit in his capital account to receive a special allocation that causes a deficit in his capital account would not violate the principles of the Final 704(b) Regulations provided that (1) the reduction item was unexpected, and (2) the deficit would be eliminated in a short period of time. The requirement that the item reducing the capital account be unexpected would eliminate any possibility of prearranged manipulation of allocations solely for tax purposes. Furthermore, requiring such deficit be eliminated as quickly as possible through allocation of gain to such partner would assure that any tax benefits derived from such allocations were only temporary.

The alternate economic effect test does not appear to be a major alternative to a deficit restoration provision. Its application is limited to certain allowances, deductions, and distributions the Service has no ability to allocate away from a partner. Furthermore, the subjective nature of the alternative test for economic effect creates uncertainty in its application. Practitioners, therefore, should use

206. *Id.*
207. *Id.* (paraphrasing "reasonably are expected" language).
208. *Id.*

caution in relying upon this test for substantial economic effect. On the other hand, in the limited number of situations in which the alternate test is applicable, it can create a safe harbor from a challenge by the Service to reallocations of partnership items among partners. Accordingly, it seems that as a safety measure, practitioners may want to consider drafting a boilerplate qualified income offset provision to insert into partnership agreements that do not contain a deficit restoration provision.[209]

C. *Allocations of Tax Credits*

The Final 704(b) Regulations generally adopt the position of the Proposed 704(b) Regulations that allocations of tax credits[210] and tax credit recapture cannot have economic effect because such allocations are not reflected by adjustments to the partners' capital accounts.[211] Therefore, tax credits and tax credit recapture (other than investment tax credits under section 38) that arise from a partnership expenditure must be allocated in accordance with the partners' interests in the partnership.[212] The partners' interests in the partnership with respect to such credits are the same as the partners' distributive shares of such expenditures. With respect to the investment tax credit, allocations of costs or qualified investments made in accordance with regulations proscribed by the Secretary are deemed to be made in accordance with the partners' interests in the partnership.[213]

Generally, if an investment tax credit is determined under section 46(a) with respect to section 38 property, the basis of the property is reduced by fifty percent of the amount of the credit.[214] In the event there is a recapture of the investment tax credit, the basis of the property is increased by an amount equal to fifty percent of the recapture amount.[215] Furthermore, section 48(q)(6) provides for an equivalent downward or upward adjustment to the aggregate bases

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209. The following language is suggested for a qualified income offset provision:

> Notwithstanding the foregoing allocation provisions, if a partner unexpectedly receives an adjustment, allocation, or distribution described in Treas. Reg. 1.704-1(b)(2)(ii)(*d*)(*4*), (*5*), or (*6*) which causes a deficit balance in such partner's capital account, such partner will be allocated items of partnership income and gain in an amount and manner sufficient to eliminate such deficit balance as quickly as possible.

210. TRA '86 repealed the regular investment tax credit effective for property placed in service after December 31, 1985. *See generally* TRA '86 § 211.

211. Treas. Reg. § 1.704-1(b)(4)(ii) (1986); *see* Prop. Reg. § 1.704-1(b)(4)(ii), 48 Fed. Reg. 9871, 9876 (1983).

212. Treas. Reg. § 1.704-1(b)(4)(ii) (1986). The targeted jobs credit is an example of a tax credit that arises from a partnership expenditure. *See id.* § 1.704-1(b)(5) example 11.

213. *Id.* § 1.704-1(b)(4)(ii); *see* Treas. Reg. § 1.46-3(f)(2) (West 1986) (partner's share of basis or cost of any § 38 property determined by ratio in which partners divide general profits); *id.* § 1.48-8(a)(4)(iv) (where partnership has ownership interest in a qualified film, investment is apportioned *pro rata* among partners based on their percentages of capital at risk in partnership at time film is placed in service).

214. I.R.C. § 48(q)(1) (West 1986).

215. *Id.* § 48(q)(2).

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of partnership interests.[216] The Final 704(b) Regulations expand the Proposed 704(b) Regulations by addressing the proper capital account treatment of such bases adjustments. Any downward adjustment to bases resulting from the investment tax credit is shared among the partners in the same proportion as the adjusted tax basis or cost of such section 38 property is allocated among partners under Treasury Regulations sections 1.46-3(f) or 1.48-8(a)(4)(iv).[217] Conversely, any upward adjustment to the aggregate bases of partnership interests resulting from investment tax credit recapture is allocated among the partners in the same proportion as the investment tax credit is recaptured by the partners under Treasury Regulations section 1.47-6.[218] The capital accounts of the partners will not be considered determined and maintained in accordance with the Final 704(b) Regulations unless they are adjusted by the partners' shares of any upward or downward bases adjustment discussed above.[219]

D. *Allocations Attributable to Nonrecourse Debt*

1. In General

Allocations of tax losses or deductions attributable to nonrecourse debt cannot have substantial economic effect because the nonrecourse lender, and not the partners, bears the economic loss corresponding to tax losses or deductions. Under the Proposed 704(b) Regulations, however, allocations attributable to nonrecourse debt were deemed in accordance with the partners' interests in the partnership if the minimum gain rules were followed.[220]

The minimum gain rules under the Proposed 704(b) Regulations provided that losses and deductions attributable to nonrecourse debt would be deemed in accordance with a partner's interest in the partnership if (1) the partnership maintained capital accounts in accordance with the regulations; (2) the partnership liquidated in accordance with the partners' positive capital account balances; (3) either (i) the partners were obligated to restore deficit balances in their capital accounts upon liquidation of their interests in the partnership, or (ii) the partners' deficit capital account balances attributable to such losses and deductions did not exceed the amount of minimum gain; and (4) the minimum gain was allocated to the partners who received allocations of losses and deductions attributable to nonrecourse debt.

The minimum gain rules of the Proposed 704(b) Regulations were criticized by certain members of the public on conceptual grounds. One of the major concerns of these commentators was that a partner's obligation to bear the tax burden on minimum gain resulting from losses and deductions attributable to nonrecourse debt was not necessarily a good indicator of a partner's interest

216. *Id.* § 48(q)(6).
217. Treas. Reg. § 1.704-1(b)(2)(iv)(*i*) (1986).
218. *Id.*
219. *Id.*
220. Prop. Reg. § 1.704-1(b)(4)(iv), 48 Fed. Reg. 9871, 9876 (1983).

in the partnership. For example, under the Proposed 704(b) Regulations, as long as the partnership agreement contained a minimum gain charge-back provision,[221] one hundred percent of losses and deductions attributable to nonrecourse debt could be allocated to a partner even though his interest in every other partnership item was substantially less than one hundred percent. In order to make special allocations of losses attributable to nonrecourse debt more consistent with a partner's interest in the partnership and to correct certain technical deficiencies in the minimum gain rules of the Proposed 704(b) Regulations, the Final 704(b) Regulations modified the minimum gain rules of the Proposed 704(b) Regulations. The minimum gain rules of the Final 704(b) Regulations provide that four tests must be satisfied for a special allocation attributable to nonrecourse debt to have substantial economic effect.

2. The Minimum Gain Requirements to be Satisfied — The Four-Prong Test

Special allocations of deductions attributable to nonrecourse debt will be deemed in accordance with a partner's interest in the partnership if and only if the partnership satisfies a four-prong test.[222] First, throughout the term of a partnership, the partnership must maintain capital accounts in accordance with the Final 704(b) Regulations, and liquidation distributions must be made in accordance with such capital accounts.[223] Second, beginning in the first taxable year in which there are nonrecourse deductions (as defined below) and thereafter, throughout the full term of the partnership, the partnership agreement must provide for allocations of nonrecourse deductions among the partners in a manner reasonably consistent with allocations, having substantial economic effect, of some other significant partnership item attributable to property securing nonrecourse liabilities of the partnership (other than minimum gain recognized by the partnership).[224] Third, beginning in the first taxable year the partnership has nonrecourse deductions and thereafter throughout the full term of the partnership (i) the partnership agreement must contain a deficit restoration provision, or (ii) the partnership agreement must contain a minimum gain charge-back provision.[225] Finally, all other material allocations and capital account adjustments under the partnership agreement must be in compliance with the Final 704(b) Regulations.[226] If this four-prong test is not satisfied, special allocations of nonrecourse deductions will not have substantial economic effect, and those deductions will be reallocated according to the partners' overall economic interests in the partnership.

221. *See supra* note 108 and accompanying text.
222. Treas. Reg. § 1.704-1(b)(4)(iv)(*d*) (1986).
223. *Id.* § 1.704-1(b)(4)(iv)(*d*)(*1*).
224. *Id.* § 1.704-1(b(4)(iv)(*d*)(*2*).
225. *Id.* § 1.704-1(b)(4)(iv)(*d*)(*3*).
226. *Id.* § 1.704-1(b)(4)(iv)(*d*)(*4*).

3. Nonrecourse Deductions

The minimum gain rules of the Final 704(b) Regulations contain a new concept entitled "nonrecourse deductions."[227] The nonrecourse deductions for a partnership's taxable year consist of depreciation or cost recovery deductions relating to partnership property subject to nonrecourse liabilities, to the extent of the increase in minimum gain (as defined below) attributable to nonrecourse liabilities to which each item of property is subject.[228] The remainder of the nonrecourse deductions, if any, is made up of a pro rata portion of the partnership's other items of deduction, loss and section 705(a)(2)(B)[229] expenditures for that year.[230] If, however, the depreciation or cost recovery deductions exceed the net increase in partnership minimum gain, a proportionate share of each cost recovery or depreciation deduction will constitute a nonrecourse deduction.[231] In addition, if the net increase in partnership minimum gain during a partnership taxable year exceeds the total amount of items of partnership loss, deduction, and section 705(a)(2)(B) expenditures for the year, the amount of the excess minimum gain is carried over to the next succeeding taxable year.[232] This carryover is added to the partnership's net increase in minimum gain for the succeeding tax year to determine the amount of the partnership's nonrecourse deductions for that taxable year.[233]

4. Minimum Gain

As discussed above, the amount of nonrecourse deductions for a partnership's taxable year equals the net increase, if any, in the amount of partnership minimum gain during that year.[234] In order to determine nonrecourse deductions for a partnership year, it is necessary to determine the partnership's minimum gain. The partnership's minimum gain is computed by creating a hypothetical sale of each partnership asset subject to a nonrecourse liability in which the nonrecourse liability is completely satisfied. Gains, if any, from each hypothetical sale are aggregated to determine total partnership minimum gain.[235]

In the event partnership property is subject to more than one liability, the Final 704(b) Regulations provide guidelines for allocating tax basis to the prop-

227. *Id.* § 1.704-1(b)(iv)(4).
228. *Id.* § 1.704-1(b)(iv)(4)(*b*).
229. *See supra* note 164 and accompanying text.
230. Treas. Reg. § 1.704-1(b)(4)(iv)(*b*) (1986).
231. *Id.*
232. *Id.*
233. *Id.*
234. *Id.* In determining the net increase in minimum gain for any partnership taxable year in which the capital accounts of the partners are increased as a result of the revaluation of partnership property subject to one or more nonrecourse liabilities of the partnership, any decrease in partnership minimum gain attributable to the revaluation will be added back to the net decrease or increase in minimum gain. *Id.*
235. *Id.* § 1.704-1(b)(4)(iv)(*c*).

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erty's nonrecourse liabilities for purposes of the hypothetical sale.[236] The adjusted tax basis of property subject to two or more liabilities of equal priority (regardless of whether the liabilities are recourse or nonrecourse) is allocated among the liabilities in proportion to their respective outstanding balances.[237] The adjusted tax basis of property subject to two or more liabilities of unequal priority (regardless of whether the liabilities are recourse or nonrecourse) is allocated on the basis of priority. Basis is first allocated to liabilities with superior priority, in an amount equal to the aggregate outstanding balance of the liabilities of superior priority.[238] The balance of the adjusted tax basis, if any, is allocated to liabilities of inferior priority.[239] Only the portion of the property's adjusted tax basis allocated to nonrecourse liabilities of the partnership is used in computing minimum gain.[240]

If there is a disparity between book value of partnership property and adjusted tax basis, the book value of property rather than its adjusted tax basis is used to calculate minimum gain.[241] For example, if the partnership has appreciated property and a new partner is admitted to the partnership, the partnership may elect to revalue property to fair market value to reduce or eliminate the discrepancy between capital accounts of existing partners and the capital account of the new partner. The effect of the book up would be to reduce the amount of minimum gain.[242]

Once the partnership's minimum gain is determined, the Final 704(b) Regulations provide rules to allocate minimum gain to each partner.[243] Generally, a partner's share of partnership minimum gain is determined at the end of the partnership's taxable year. A partner's share of minimum gain equals the aggregate nonrecourse deductions allocated to such partner from the inception of the partnership minus the partner's share of net decreases in partnership minimum gain from the inception of the partnership.[244] A partner's share of net decrease in partnership minimum gain during a taxable year is calculated by first determining the partner's percentage share of partnership minimum gain at the end of the preceding partnership tax year. The partnership's net decrease in minimum gain for the current taxable year is then multiplied by the partner's percentage share of partnership minimum gain at the end of the preceding partnership tax year to determine the partner's net decrease in minimum gain for the current partnership tax year.[245] In addition, if there is a decrease in partnership minimum gain attributable to the revaluation of partnership prop-

236. *Id.*
237. *Id.*
238. *Id.*
239. *Id.*
240. *Id.*
241. *Id.*
242. *See id.* § 1.704-1(b)(5) example 22.
243. *Id.* § 1.704-1(b)(4)(iv)(*f*).
244. *Id.*
245. *Id.*

erty subject to one or more nonrecourse liabilities, each partner's share of the partnership's minimum gain, as of the time of the revaluation, must be reduced by the amount of the increase to the partner's capital account attributable to the revaluation. Furthermore, reduction in each partner's share of minimum gain attributable to revaluation of partnership property must be made regardless of whether there is a net decrease in partnership minimum gain during the year of revaluation.[246] However, the partners' reduction in minimum gain is limited to the reduction in partnership minimum gain caused by the revaluation.[247]

5. Minimum Gain Chargeback Provision

If a partnership agreement does not contain a deficit restoration provision, the partnership agreement must contain a minimum gain chargeback provision (in addition to the other requirements of the minimum gain rules).[248] The Final 704(b) Regulations state the minimum gain chargeback provision must provide that if there is a net decrease in partnership minimum gain, all partners with deficit capital accounts must be allocated items of income and gain in order to eliminate the deficits as quickly as possible.[249] In determining whether a partner has a deficit capital account for purposes of the minimum gain chargeback provision, the partner's capital account must be reduced for the following future events: (1) adjustments reasonably expected to be made to his capital account for certain depletion allowances; (2) allocations of losses and deductions reasonably expected to be made to the partner pursuant to section 704(e)(2), section 706(d), and Treasury Regulation section 1.751-1(b)(2)(ii); and (3) distributions reasonably expected to be made to the partner to the extent they exceed offsetting increases to his capital account.[250]

Allocations of income and gain made pursuant to the minimum gain chargeback provision take precedence over any other allocations required by section 704(b).[251] Furthermore, these allocations of income and gain are deemed in accordance with the partner's interest in the partnership if the partnership maintains capital accounts in accordance with the Final 704(b) Regulations, and if the partnership agreement requires the partnership to liquidate in accordance with the partner's positive capital account balances.[252]

The Final 704(b) Regulations provide an ordering rule for allocations of income and gain made pursuant to a minimum gain chargeback provision.[253]

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246. *Id.*

247. *Id.* The Final 704(b) Regulations provide that the amount of a partner's share of minimum gain shall be added to the limited dollar amount, if any, of the deficit balance in such partner's capital account that such partner is obligated to restore. *Id.*

248. *Id.* § 1.704-1(b)(4)(iv)(*d*)(*3*).

249. *Id.* § 1.704-1(b)(4)(iv)(*e*).

250. *See supra* notes 195-97 and accompanying text.

251. Treas. Reg. § 1.704-1(b)(4)(iv)(*e*) (1986).

252. *Id.*

253. *Id.*

If the partnership disposes of property subject to a nonrecourse liability, any gain recognized by the partnership, to the extent of the decrease in minimum gain attributable to the disposition, is allocated to the partners to reduce the minimum gain chargeback. The remainder of the minimum gain chargeback, if any, is made up of a pro rata portion of the partnership's other items of income and gain for that year. However, if gains from dispositions of multiple items of partnership property subject to nonrecourse liabilities exceed the amount of the minimum gain chargeback, the minimum gain chargeback is made up of a proportionate share of gain from each disposition.[254]

6. Other Matters Addressed by the Final 704(b) Regulations Nonrecourse Allocation Rules

In addition to the minimum gain chargeback provision safe harbor rules discussed above, the Final 704 Regulations also deal with nonrecourse deductions in other areas of concern. The Final 704(b) Regulations provide that a partner who makes a purported nonrecourse loan to a partnership bears the burden of economic loss of such loan to a partnership.[255] Thus, this partner should be allocated losses or deductions attributable to such nonrecourse loan.[256] The Final 704(b) Regulations, however, have reserved addressing issues pertaining to allocations of partnership items in the case of nonrecourse loans made by persons related to partners.[257]

Finally, the Final 704(b) Regulations clarify that a partner's share of minimum gain shall be treated as a limited deficit makeup obligation for purposes of the alternate economic effect test.[258] In order to combine concepts of the minimum gain provisions and the qualified income offset provisions, a partnership agreement could be drafted to contain a concept of an "adjusted capital account." This adjusted capital account would then be a partner's capital account, as determined under the capital account maintenance rules of the Final 704(b) Regulations, increased by the partner's allocable share of minimum gain. The partnership agreement must also contain a qualified income offset provision requiring an allocation of income and gain as quickly as possible to a partner with a negative capital account.[259]

E. *Effective Dates*

Compliance with the provisions of the Final 704(b) Regulations will be mandatory for all partnership taxable years beginning after April 30, 1986.[260] Partnerships formed on May 1, 1986, or thereafter must comply with the Final

254. *Id.*
255. *Id.* § 1.704-1(b)(4)(iv)(*g*).
256. *Id.*
257. *Id.* § 1.704-1(b)(4)(iv)(*h*).
258. *See supra* § VI.B.; *e.g.*, Treas. Reg. § 1.704-1(b)(5).
259. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(*d*)(*3*) (1986).
260. Treas. Reg. § 1.704-1(b)(1)(ii) (1986).

704(b) Regulations for their first taxable year.[261] An existing partnership, that is, a partnership formed prior to May 1, 1986, will not be required to comply with the Final 704(b) Regulations until its taxable year beginning after April 30, 1986.[262] Existing partnerships on a calendar year, therefore, will not be required to comply with the Final 704(b) Regulations until taxable years beginning on January 1, 1987. The effective date rules provide additional time for existing partnerships not maintaining capital accounts in accordance with the Final 704(b) Regulations to adjust capital account maintenance provisions to comply with the Final 704(b) Regulations. As discussed above, existing partnerships may be required to restate capital accounts in order to comply with the Final 704(b) Regulations.[263] Because restated capital accounts must be adjusted to reflect the fair market value of partnership property, such partnerships may desire to use the additional time to obtain appraisals supporting fair market value determinations.

Although existing partnerships are not required to comply with the Final 704(b) Regulations for taxable years prior to May 1, 1986, the formal effective date of the Final 704(b) Regulations is for partnership taxable years beginning after December 31, 1975.[264] The manner in which the effective date rules of the Final 704(b) Regulations were drafted provides existing partnerships with a choice of law governing special allocations for taxable years beginning after December 31, 1975, but before May 1, 1986. Specifically, the Final 704(b) Regulations provide that special allocations for the aforementioned taxable years not respected under the Final 704(b) Regulations will be respected under section 704(b), provided such allocations have economic effect under relevant case law, legislative history of the 1976 Act, and the prior regulations.[265]

VII. Conclusion

Section 704(b) states that an allocation of tax items under a partnership agreement will be ignored if the tax allocation does not have substantial economic effect. The purpose of substantial economic effect is to create a direct relationship between the economic arrangements and the allocation of tax items among the partners. Congress, the courts, and the Service generally agree that the way to determine whether an allocation of tax items has substantial economic effect is through a capital account analysis test.

The capital account analysis test requires a combination of tax accounting and financial accounting principles. Since the landmark *Orrisch* decision in 1970, courts have been developing general parameters for the capital account analysis test. In 1983, the Service issued Proposed 704(b) Regulations providing detailed rules for establishing the relationship between tax accounting and financial ac-

261. *Id.*
262. *Id.*
263. *See supra* notes 187-89 and accompanying text.
264. Treas. Reg. § 1.704-1(b)(1)(ii) (1986).
265. *Id.*

counting principles in order for a special allocation to have substantial economic effect. On December 31, 1985, the Service published Final 704(b) Regulations following the general pattern of the capital account analysis test under the Proposed 704 Regulations but significantly modifying the capital accounting rules.

The substantial economic effect test of the Final 704(b) Regulations contains detailed rules a partnership must follow in order for a special allocation to comply with such test. If these detailed rules are followed, a safe harbor for the special allocation exists. If a partnership fails to meet the substantial economic effect safe harbor, the special allocation may still be honored if either the allocation is deemed to have substantial economic effect under the Final 704(b) Regulations or the partners can show, under a facts and circumstances test, that the allocation has substantial economic effect.

Although the facts and circumstances test represents a less rigorous standard for substantial economic effect than the detailed rules of the substantial economic effect safe harbor, practitioners should be cautious in relying on the amorphous facts and circumstances test to establish substantial economic effect. Both the facts and circumstances test and the economic effect test safe harbors lead to the same place, a determination of whether an allocation has substantial economic effect. There is a strong possibility, therefore, that courts could rely heavily on the detailed safe harbor rules of the Final 704(b) Regulations to determine whether under the facts and circumstances test a special allocation has substantial economic effect.

Since the substantial economic effect test safe harbor is the only way to assure that partnership allocations will be valid, practitioners should review and revise, if necessary, their clients' partnership agreements to assure compliance with the Final 704(b) Regulations. Furthermore, the Final 704(b) Regulations seem to require all existing partnerships to revalue property and restate partners' capital accounts for the first partnership taxable year beginning after April 30, 1986, in order to begin complying with the Final 704(b) Regulations. For calendar year partnerships, the capital accounting rules of the Final 704(b) Regulations apply to partnership taxable years commencing on January 1, 1987. Moreover, under section 761(c), partnership agreements may be modified for a taxable year up to and including the date for filing the partnership return (not including extensions). Accordingly, any modifications to the partnership agreement of a calendar year partnership to comply with the Final 704(b) Regulations would be timely if a partnership agreement is amended by April 15, 1988.