NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

PARTNERSHIP TARGET ALLOCATIONS

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Report No. 1219

Report on Partnership Target Allocations

I. Introduction

This report[1] discusses the growing use of "target allocations" in modern partnership agreements as an alternative method for allocating a partnership's items of income and loss among its partners. Partnerships using target allocations generally tie all allocations of income and loss to the general distribution provisions of the partnership agreement such that liquidating distributions do not depend upon capital accounts. To accomplish this, target allocations first compare each partner's capital account balance at the beginning of the relevant period to the amount distributable to such partner under the agreement's distribution provisions assuming a hypothetical sale of assets at book value at the end of the relevant period followed by a liquidating distribution of the proceeds (i.e., the "target" capital account) and then "plug" the difference in these amounts with allocations of income or loss realized during the period.

The report first describes how and why partnerships typically use target allocations and some common variations on their use. It then discusses the treatment of this method under the Section 704(b)[2] regulations (the "704(b) Regulations") and focuses on whether the allocations have "economic effect" under the "economic effect equivalence" test (the "EEE Test") set forth in Treas. Reg. § 1.704-1(b)(2)(ii)(i) or are in accordance with the "partners interest in the partnership" ("PIP") under Treas. Reg. § 1.704-1(b)(3) (the "PIP Rules"). In connection with this discussion, it recommends improvements to how the 704(b) Regulations should be applied to target allocations.

Very generally, an allocation will be respected under the 704(b) Regulations if it has "substantial economic effect" under Treas. Reg. § 1.704-1(b)(2) (the "SEE Standard"), is made in accordance with PIP or, if it cannot have "economic effect" (e.g., deductions attributable to nonrecourse liabilities), is deemed to be in accordance with PIP under Treas. Reg. § 1.704-1(b)(4) or Treas. Reg. § 1.704-2 (the "Deemed PIP Rules"). To meet the SEE Standard, an allocation must first be treated as having "economic effect" and will be so treated if it meets the EEE Test, the safe harbor requirements under Treas. Reg. § 1.704-1(b)(2)(ii)(b) (the "Primary Requirements") or the "alternate" test under Treas. Reg. § 1.704-1(b)(2)(ii)(d) (the "Alternate Test," together with the Primary Requirements, the "Safe Harbor"). Significantly, the Safe Harbor cannot be met unless (among other things) the partnership's liquidating distributions are made in accordance with the partners' capital account balances (the "Liquidation

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1 This report was prepared by an ad hoc committee consisting of and James R. Brown, who was the principal drafter of the report, Joel Scharfstein, Eric Sloan, Andrew Needham, David Mayo and Peter Blessing, with significant assistance from Amanda Granacher, Meredith Levy and D.J. Stauber. Helpful comments were provided by Andrew Berg, Kimberly Blanchard, Peter Canellos, Peter Connors, Stephen Foley, Marcy Geller, Dan Kusnetz, Stephen Land, Richard Reinhold, Michael Schler, David Schnabel, David Sicular, Diana Wollman.

2 All references to "Section", "Sections" or "§" in this report are to sections of the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder.

Requirement").[3] In general, a partnership's allocations for a year will meet the EEE Test only if the allocations at the end of that year and each future year would produce the same economic result on liquidation of the partnership as would have been obtained had the Primary Requirements been met regardless of the economic performance of the partnership.

Most partnerships that use target allocations violate the Liquidation Requirement because they make liquidating distributions in accordance with the same provisions of the partnership agreement that govern non-liquidating distributions (e.g., by relative percentage interests) rather than in accordance with relative capital account balances. Even though target allocations may fail the Safe Harbor, they still define the amount of income or loss allocable to each partner by reference to his pre-tax economic entitlements to cash distributions over the life of the partnership. If drafted properly, therefore, target allocations will almost invariably produce the same allocation of income or loss to each partner as would have been produced under the Safe Harbor (as defined more precisely below, the "Safe Harbor Result").

This report focuses on when those allocations, which do not meet the Safe Harbor, should be respected under PIP or the EEE Test.[4]

II. Recommendations

It is increasingly common for partnerships to use target allocations and not to liquidate in accordance with capital account balances. Many of these partnerships look to PIP or the EEE Test for assurance that their allocations will be respected. In that regard, the report makes several recommendations as to how the PIP and EEE Test might be clarified and improved to accommodate this approach. Those recommendations are:

1. Guidance be issued confirming that target allocations will generally be respected under PIP if they reach the Safe Harbor Result.

2. Guidance be issued providing that target allocations that reach the Safe Harbor Result also satisfy the safe harbor rules for allocating nonrecourse deductions under Treas. Reg. § 1.704-2(e) and residual nonrecourse liabilities under Treas. Reg. § 1.752-3(a)(3).

3. Guidance be issued providing that target allocations that reach the Safe Harbor Result also will be deemed to have economic effect for purposes of Section 514(c)(9).

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[3] A complete discussion of the requirements necessary to meet the Safe Harbor is included in Part V of this report.

[4] This report does not discuss either the definition of "guaranteed payments" under Section 707 or when the interaction of a partnership's distribution provisions and allocation provisions might result in a distribution (or a right to a distribution) being treated as a guaranteed payment. Nor does this report discuss the extent to which the 704(b) Regulations implicitly support such a characterization.

4. The EEE Test be clarified to provide that its satisfaction requires reaching the Safe Harbor Result only in all fact patterns reasonably likely to occur (and for this purpose, a partner's capital account will not be treated as being negative to the extent not in excess of his share of minimum gain and partner minimum gain as defined in the 704(b) Regulations).

5. Treas. Reg. § 1.704-2(e) be extended to apply to allocations of nonrecourse deductions of a partnership that satisfies the EEE Test.

6. Partnerships using target allocations that satisfy the EEE Test (as revised) be permitted to allocate residual nonrecourse liabilities under Treas. Reg. § 1.752-3(a)(3) in accordance with fixed percentages that are reasonably consistent with expected allocations of profit based on the target method being used by the partnership.

III. What Are "Target Allocations" and Why They Are Popular

Target allocations[5] and their popularity cannot be understood without understanding why so many partnerships choose to violate the Liquidation Requirement in the first place. Today, partnership agreements commonly use "cash-driven" distributions for both current and liquidating distributions for the simple reason that this model will ensure that each partner will receive what it bargained for on a pre-tax basis. By explicitly linking allocations of income and loss to the liquidating cash-distribution waterfall in each and every year, target allocations are generally thought to conform to the partners' pre-tax economic arrangement at least as precisely as any other allocation method available to partnerships under the 704(b) Regulations.

A. What Are Cash-Driven Liquidating Distributions and Why Are They Preferred

In our experiences, investors and business people overwhelmingly prefer their partnership agreements to require liquidating distributions in accordance with the cash-driven distribution priorities of the agreement rather than in accordance with capital accounts. These cash-driven provisions define the amount distributable to each partner by reference to objective criteria such as outstanding units, "percentage interest" or some other "waterfall" of distribution priorities. As compared to capital account-based distributions, cash-driven liquidating

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[5] Allocations with these attributes are also commonly referred to as "forced" allocations or "targeted" allocations. *See, e.g.,* Cavanagh, *Targeted Allocations or "Why I don't Liquidate Partnerships in Accordance With Capital Accounts (Much) Anymore" and Other Real World Partnership Tax Allocation Matters,* Tax Forum No. 615 (March 2, 2009); Golub, *Target Allocations: The Swiss Army Knife of Drafting (Good for Most Situations-But Don't Bet Your Life On It),* TAXES - THE TAX MAGAZINE, March 2009, at 157; Cuff, *Several Thoughts On Drafting Target Allocation Provisions,* TAXES - THE TAX MAGAZINE, March 2009 ("Cuff 2009"), at 171; Cuff, *Working With Target Allocations--Idiot-Proof or Drafting for Idiots*?, J. R.E. Tax'n (2d quarter, 2008); Cuff, *Working With Target Allocations--Drafting in Wonderland,* J' R.E. Tax'n (3d quarter, 2008); O'Connor & Schneider, *Capital Account Based Liquidations: Gone With the Wind, or Here to Stay?,* 102 J. Tax'n 21 (January 2005); Lenz, *Using the Targeted Capital Account Approach to Allocate Income and Loss--Is it Better than the Traditional Layered Approach?* 5 J. Pass-Through Entities 25 (March/April 2002); Kean, *A Partner's Interest in the Partnership for Purposes of Section 704(b),* 807 P.L.I. 825 (2008).

distributions are clearer, simpler and thus less prone to drafting error because they unequivocally state the intended business arrangement. For purposes of this report, references to "cash-driven distributions" or "cash-driven liquidations" mean liquidating distributions that are made based on a waterfall of cash distribution priorities rather than capital account balances.

Few business people (and others not well-versed in partnership taxation) can read the allocation provisions of a typical partnership agreement and know with any confidence that the resulting capital account balances will reflect their expected distributions on a pre-tax basis during each and every year. Even tax specialists knowledgeable in partnership taxation often lack confidence that they can translate a complicated economic arrangement into a set of allocation provisions that in all cases will exactly match the parties' pre-tax economic expectations.

This potential for confusion and ambiguity exists because, in an agreement with capital account-based distributions, understanding the amount distributable to each partner requires dissecting the layers of complexity that constitute capital accounts. Each of the components of the capital account balances must be carefully defined so that their ultimate balances reflect the intended economic result. Those components include both the measure of credits and debits to the capital accounts and how those credits and debits are made.

Even the most basic agreement using capital account-based distributions must specify (i) that capital accounts are credited with contributions and income and debited with distributions and losses, (ii) how each of those amounts is measured and (iii) how income and losses are allocated among the partners for this purpose. Each of these components of the capital account is subject to error and later interpretative dispute. This last component -- how items are allocated among the partners -- can be particularly challenging to draft correctly (and understand), requiring a "layer cake" of allocation rules, even in the simplest economic arrangement.

> Layer Cake Example. Assume Investor and Manager form a partnership in which Investor provides all the capital and Manager provides all the services and assume they agree that, on the sale of the partnership, Investor first receives its money back and any remaining proceeds are shared 70% to the Investor and 30% to Manager.
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> In an agreement that provides for liquidating distributions in accordance with capital account balances, the drafter must carefully define each credit and debit to the capital accounts, not only to ensure the validity of the allocation, but to correctly reflect the agreed business deal. Even the most pared down allocation provisions based on this relatively simple business deal would be complicated and likely look something like the following:
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> - Losses would be allocated (i) 30% to Manager and 70% to the Investor to the extent of income previously allocated in those ratios under clause (c) below, (ii) to the Investor to the extent of the Investor's capital account balance and (iii) 30% to the Manager and 70% to the Investor.
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> - Income would be allocated (a) to reverse prior allocations of losses under clause (iii) above, (b) to reverse prior allocations in clause (ii) above so that the

Investor's capital account is fully restored to its balance prior to such losses and (c) 30% to the Manager and 70% to the Investor.

Whether Investor and Manager would in fact share distributions in accordance with the business deal described above would depend upon whether the relative capital account balances that result from these allocations were consistent with that deal. By contrast, in an agreement with cash-driven distributions, this business arrangement would be expressed by simply providing that both current and liquidating distributions be made first to the Investor to the extent of its contributed capital and then 70% to the Investor and 30% to the Manager. In other words, the distribution provisions would be a concise statement of the partners' economic deal.

Capital account-based liquidating distributions are most strongly resisted by investors that are tax exempt (or relatively insensitive to taxes). These investors generally have little interest in whether the allocations meet the Safe Harbor, which requires capital account-based liquidating distributions.[6] For these investors, capital account-based distributions have only detriment, in the form of complication and confusion. Partly in deference to these investors, which control significant pools of capital, partnership agreements in many asset classes very rarely use capital account-based distributions.

The other important reason for preferring cash-driven liquidating distributions is that in many economic deals capital accounts will not in all possible scenarios match the amounts that the parties have agreed that they should receive. This mismatch arises most commonly when there are insufficient allocable items available to cause the capital account balances of each partner to equal expected distributions, at least if the shortfall is not treated as a guaranteed payment. Partnerships providing one or more partners with a "preferred return" illustrate this possibility most simply.[7]

Preferred Return Example. Assume A and B form a partnership with each contributing $500 and agree that distributions will go first to A to the extent of A's contribution plus a 10% annual non-compounded preferred return, then to B to the extent of B's capital contribution and thereafter 30% to A and 70% to B. Assume that the partnership engages in two transactions as its only economic activity: at the end of year 1, it sells an asset with an adjusted basis of $500 for $650 and reinvests the proceeds; at the end of year 2, it sells all of its remaining assets for their tax basis of $1150 and liquidates. Under any allocation method, the first $50 of $150 of year 1 gain would be allocated to A and the remaining $100 of gain would be allocated $30 to A and $70 to B,

6 As discussed below, tax-exempt investors in real estate partnerships must often accept fully-compliant allocations in order to avoid the application of Section 514 to any debt-financed real property of the partnership. This is because the "fractions rule" of Section 514(c)(9), which provides limited relief from Section 514, generally requires all of the partnership's allocations to satisfy the SEE Standard.

7 However this mismatch could always be avoided by treating the preferred return as a guaranteed payment, which would effectively create an item of partnership deduction and result in the payee partner receiving the correct amount of distribution, as discussed below, and would result in both partners having capital account balances equal to their distribution entitlements after taking into account the guaranteed payment.

resulting in capital accounts of $580 to A and $570 to B. With no profit or loss in year 2 to allocate, however, the partnership cannot adjust the capital account balances to reflect the preferred return. Accordingly, although the relative amounts distributable to A and B under the agreed economic arrangement are $615 ($500 plus $100 of preferred return plus $15 of residual proceeds) and $535 ($500 plus $35 of residual proceeds) respectively, the relative capital account balances are different:

	Capital Accounts			Distribution Formula	
	A	B		A	B
Capital	500	500	Capital	500	500
Year 1 Preferred Return	50	–	Total Preferred Return	100	–
Year 1 Remaining Profit	30	70	Remaining Proceeds	15	35
	$ 580	$ 570		$ 615	$ 535

This preferred return example should be contrasted with agreements that give one or more partners a share of income in priority over other partners' share of income. So long as the priority is not funded from other partners' capital, it should not raise the question as to whether the priority should be treated as a guaranteed payment. This type of arrangement is common in the case of investment partnerships, particularly private equity funds, where the priority is colloquially referred to as a "hurdle" to denote that after profits to exceed a minimum threshold the priority ceases to operate.[8]

Private Equity Example. Assume A and B form a partnership with A contributing $1000 for a limited partnership interest. B is the general partner and will manage the partnership's investments. A and B agree that distributions will be made first to A to the extent of A's contribution, then to A until A has received an 8% annual non-compounded preferred return and then to B until B has received an amount equal to 20% of the partnership's total profit distributions. Thereafter, distributions will be made 80% to A and 20% to B. As in the preferred return example above, assume that the only economic activity is that, at the end of year 1, the partnership sells an asset with an adjusted basis of $500 for $650.[9]

	Capital Accounts			Distribution Formula	
	A	B		A	B

8 In order to be considered a guaranteed payment under Section 707(c), the payment must be determined without regard to the income of the partnership. In the case of the private equity example below, only B's right to profit is subordinate to A's entitlement to a priority distribution, which is dependent on partnership income.

9 If the economic arrangement is that the priority applies over the life of the fund (which, for example, is often the case if failure to meet the hurdle can result in a "clawback" of distributions previously made to the general partner), it can result in an overallocation of profit to B from early investments because the preferred return can continue to accumulate, in which case the capital account balance resulting from the over allocation would be subordinated to the priority return to A. For example, assume that the year one proceeds are reinvested, and at the end of year 2, the partnership sells all of its assets for their tax basis of $1150 and liquidates. There is no profit or loss in year 2 thus no change to the capital accounts. However, under the agreed economic deal, all $1150 ($1000 return of capital plus $150 preferred return) should be distributed to A.

Capital	1,000	–	Capital	1,000	–
Year 1 Preferred Return	80	–	Total Preferred Return	80	–
Year 1 Catch-Up	–	20	Catch-Up	–	20
Year 1 Remaining Profit	40	10	Remaining Proceeds	40	10
	$1,120	$ 30		$1,120	$ 30

B. How Target Allocations Fit with Cash-Driven Distributions

As discussed above, partnerships with cash-driven distributions typically tie allocations of income and loss to the general distribution provisions of the agreement such that liquidating distributions do not depend upon capital accounts. To accomplish this, target allocations first compare each partner's capital account balance at the beginning of the relevant period to the amount distributable to such partner under the agreement's distribution provisions assuming a hypothetical liquidation at Book Value (as defined below) at the end of the relevant period (i.e., the "target" capital account) and then "plug" the difference in these amounts with allocations of income or loss realized during the period.

In short, the "target" allocation to each partner is the amount of income or loss necessary to establish a capital account balance equal to such partner's economic entitlements in a hypothetical liquidation. In this respect, target allocations generally produce the same allocation result as layer-cake allocations. Both are designed to produce capital account balances that match the partner's distribution entitlements upon liquidation. The difference between these allocation methods is thus not substantive but rather how each approach mechanically achieves the same objective.

Target vs. Layer Cake Example: Using the same facts described in the Layer Cake Example above, assume Investor contributed $100 to the partnership, the partnership generated $50 of depreciation in year 1 (with no other income/loss), and then the partnership's asset was sold for $500 at the beginning of year 2, resulting in gain of $450.

- In an agreement providing for layer cake allocations, the year 1 loss would be allocated to 100% to Investor and the year 2 gain would first reverse the year 1 loss then the remaining gain would be split 70% to the Investor and 30% to Manager.

	Capital Accounts		Distributions	
	Investor	Manager	Investor	Manager
Capital	100	-	100	-
Year 1 Loss/Excess Proceeds	(50)	-	-	-
Year 2 Gain/Excess Proceeds	330	120	280	120
	380	120	380	120

- An agreement providing for target allocations would, under these facts, reach the same result. In year 1, the partnership capital declined by $50, leaving only $50 of remaining capital, which under the distribution waterfall would all go to the Investor if the partnership was liquidated at that time. Therefore, to cause the Investor's capital account to equal its distributable amount, all of the loss would be allocated to the Investor. In year 2, the distributable amount is $500 and under the distribution waterfall the Investor is entitled to $380 and Manager $120. To cause their capital accounts to equal those amounts, the year 2 gain would be allocated $330 to the Investor and $120 to the Manager.

	Capital Accounts		Liquidation Amounts	
	Investor	Manager	Investor	Manager
Capital	100	-		
Year 1 Target Allocation	(50)	-		
	50	-	50	-
Year 2 Target Allocation	330	120		
	380	120	380	120

When drafted to maximize the likelihood of being respected, target allocations aim to produce an allocation result that would be obtained if the partnership met the Safe Harbor (including the Liquidation Requirement) and liquidated in the year of allocation in accordance with the partnership's cash-driven liquidation provisions and assuming that the value of the partnership's assets equal the value used for purposes of maintaining capital accounts under the Safe Harbor. This allocation method, when actually achieved, is referred to by this report as the "Safe Harbor Result."[10]

To produce the Safe Harbor Result, target allocations typically look to the rules under the Safe Harbor to define (i) the amounts to be allocated ("Book Income/Loss")[11], (ii) the capital account balances resulting from such allocation and other debits and credits ("Safe Harbor Capital Accounts") and (iii) the amounts distributable upon a hypothetical liquidation of the partnership (the "Deemed Liquidation Amounts"), which is the amount distributable to the partners if the partnership were to sell all of its assets for their carrying value as used for purposes of maintaining Safe Harbor Capital Accounts ("Book Value"). Exactly how and why target allocations incorporate the Safe Harbor to try to achieve the Safe Harbor Result is discussed in more detail in Part V of the report. For now, it is important only to understand that Book Income/Loss is allocated so that the resulting Safe Harbor Capital Account balance of each partner equals as nearly as possible that partner's share of the Deemed Liquidation Amount based on the partnership's cash-driven liquidation provisions. This mechanic is the core of the target allocation method.

C. Why Target Allocations Are Preferred When Cash-Driven Distributions Are Used

Target allocations are appealing mostly because they seek to achieve the Safe Harbor Result without actually requiring that capital accounts govern liquidating distributions. Although

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10 Many agreements contain an allocation provision that simply provides that allocations are to be made in accordance with the partners' interests in the partnership as determined by a designated partner, without specifying the mechanics as to how that is to be done. In many cases, the designated partner will integrate and apply this provision to reach the Safe Harbor Result, though it gives the partner significant flexibility to reach a different result. In this respect, this type of allocation provision is not what is meant by "target allocations."

11 Book Income/Loss is referred to as "Book Income" when positive and "Book Loss" when negative.

other allocations methods may also reach that result, they tend either to risk altering the pre-tax economic deal or to reach the Safe Harbor Result in a narrower range of circumstances. Among the allocation methods that could be used when the Liquidation Requirement is not met, target allocations are thought to stand the best chance of being respected. The basis for respecting target allocations is discussed in Part V below.

D. Target Allocations Are Not Used for Tax Avoidance

We are not aware of target allocations ever being used for the purpose of avoiding or minimizing tax by shifting income or loss among taxpayers. In fact, they are ill-suited for achieving the type of tax-motivated shifting targeted by the 704(b) Regulations, since they generally aim to produce the Safe Harbor Result.

The Safe Harbor was developed principally in response to partnership tax shelters, i.e., transactions with respect to which the economics are primarily based upon after-tax, rather than pre-tax, returns.[12] A rule permitting special allocations of items of partnership income, gain, loss, deduction or credit -- provided the principal purpose of such allocations was not tax avoidance or evasion -- first appeared in the House bill in 1954[13] and was codified as Section 704(b)(2).[14] In 1976, the tax avoidance or evasion test in former Section 704(b)(2) was replaced with the substantial economic effect test in order to codify principles developed by the courts and Treasury in applying the prior test.[15] The legislative history clarifies that this change was not

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12 The 704(b) Regulations are the product of years of effort by Treasury and the tax bar. Treasury published the 704(b) Regulations in draft form in 1983, Prop. Reg. § 1.704-1(b), 48 Fed. Reg. 9871 (1983), and in final form on the last day of 1985, 50 Fed. Reg. 53423 (1985). The 704(b) Regulations incorporate many of the American Law Institute ("ALI") proposals, which were published as a tentative draft in 1979. *ALI Federal Income Tax Project, Subchapter K* (Tent. Draft No. 3, 1979).

13 H.R. 8300, 83d Cong. 2d Sess. § 704(b) (1954).

14 Prior to 1954, when the rules of partnership tax were rudimentary, special allocations were generally not accepted as appropriate under general partnership tax principles. *See* O.D. 140 1 C.B. 174 (1919) (special allocation of foreign source income to a foreign partner forbidden because "[i]ncome from a particular source can not be allocated to one partner of a partnership for income tax purposes, but must be divided pro rata among the several partners"); Rev. Rul. 56-134, 1956-1 C.B. 649, 650 (reiterating this "fundamental proposition" and adding that "[d]ifferent items of income of a single partnership cannot be divided differently between the partners depending upon the source any more than can various items of property held by the partnership be conceived as being held in different ratios or being owned in different ratios by different partners"); *but see* Rev. Rul. 57-138, 1957-1 C.B. 543, 544 (special allocations are permissible under the 1939 Code). *See generally*, Berger & Wiedenbeck, *Cases and Materials on Partnership Taxation,* 300-01, 302 n.24 (1989). Special allocations were also not among the 1954 proposals of the ALI, which were the basis of much of subchapter K. *See* Jackson, Johnson, Surrey & Warren, *A Proposed Revision of the Federal Income Tax Treatment of Partnership and Partners--American Law Institute Draft*, 9 Tax L. Rev. 109, 116, 174-174 (1954) (allowing special allocations only when appreciated property was contributed to the partnership). *See generally* Gergen, *Reforming Subchapter K: Special Allocations,* 46 Tax L. Rev. 1, 9-10 (1991).

15 Committee Reports on P.L. 94-455 (TRA of 1976) at 1976-3 C.B. (Vol. 2) 814 and 1976-3 C.B. (Vol. 3) 133, 825 (substantial economic effect of Section 704(b)(2) is to be understood by reference to regulations and case law). *See also, e.g.,* Treas. Reg. § 1.704-1(b)(1)(ii)(a) (for taxable years beginning before May 1, 1986, allocations will be respected under Section 704(b) if such allocation has substantial economic effect as interpreted under the relevant case law, legislative history, and prior regulations); *Carberry's Est. v. Comm'r*,

intended to replace the focus on tax avoidance; to the contrary, the rule that allocations must have substantial economic effect was intended "to prevent the use of special allocations for tax avoidance purposes."[16] The 704(b) Regulations themselves also explicitly implicate tax shelter considerations by providing that "an allocation of loss or deduction to a partner that is respected under Section 704(b) and this paragraph may not be deductible by such partner if the partner lacks the requisite motive for economic gain...."[17]

The classic tax shelter investments targeted by Congress typically involved passive investments through syndicated limited partnerships in businesses that required very little time commitment, were capital intensive, and were heavily leveraged, with the depreciation and interest deductions attributable to these investments used as an offset to income from other sources.[18] Many of these ventures were not economically viable investments apart from the tax savings realized from the deductions against the investors' other income, and the tax attributions were a fundamental part of the negotiated economic deal among the investments.[19] In addition, partnership tax shelters typically involved the allocation of income or loss to partners who did not economically bear the loss.[20]

In contrast, the use of target allocations should not give rise to partnership tax shelters or other tax avoidance because target allocations do not present the opportunity to shift tax items

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933 F.2d 1124 (2d Cir. 1991) (applying substantial economic effect test in case arising under pre-1976 law); *Allison v. U.S.*, 701 F.2d 933 (Fed. Cir. 1983) (special allocation of intangible drilling and development costs to partners who supplied money for those costs disregarded under 1954–1976 law; tax avoidance purpose proved by lack of economic effect); *Goldfine v. Comm'r*, 80 T.C. 843, 850 (1983) (the "tax avoidance test did not differ significantly from the 'substantial economic effect' test that was adopted in '76 . . . . Both before and after '76, an allocation . . . must likewise have economic substance in the sense that it reflects the actual division of income or loss among the partners when viewed from the standpoint of economic, rather than tax, consequences"). *See also Ogden v. Comm'r*, 84 T.C. 871 (1985*), aff'd per curiam*, 788 F.2d 252 (5th Cir. 1986) (capital account analysis of pre-1976 case law followed for taxable years governed by 1976 amendment of Section 704(b)).

16 Committee Reports on P.L. 94-455, *supra* note 10.

17 Treas. Reg. § 1.704-1(b)(1)(iii).

18 *See generally,* Staff of Joint Comm. on Tax'n, 99th Cong., *General Explanation of the Tax Reform Act of 1986*, 209-14 (Comm. Print 1987).

19 For illustrations and analyses of the economics of tax shelter investments, *see*, McKee, *The Real Estate Tax Shelter: A Computerized Exposé*, 57 Va. L. Rev. 521 (1971); McMahon, Jr., *Applied Tax Finance Analysis of Real Estate Tax Shelter Investments,* 27 B.C.L. Rev. 721 (1986); McMahon, Jr., *Reforming Cost Recovery Allowances for Debt Financed Depreciable Property,* 29 St. Louis U.L.J. 1029 (1985).

20 *E.g., Kresser*, 54 T.C. 1621 (1970) (allocation of all of a partnership's income and loss to one partner); s*ee generally,* Staff of Joint Comm. on Tax'n, *General Explanation of the Tax Reform Act of 1976*, 94th Cong. 2d. Sess., 95. Note that despite the attempt to limit the use of such partnership tax shelters through the 704(b) Regulations, it was not until the passive activity loss limitation under section 469 was enacted that tax shelter investing was effectively ended for taxpayers subject to the limitation. *See generally,* Bittker, McMahon & Zelenak, A *Whirlwind Tour of the Internal Revenue Code's At-Risk and Passive Activity Loss Rules*, 36 Real Prop., Prob. & Tr. J. 673 (2002).

among the individual partners of a partnership; rather, they are by definition intended to allocate such items in the manner in which the partners participate in them economically. Properly drafted target allocations aim to achieve the Safe Harbor Result. Thus, target allocations are fully consistent with the purpose of the SEE Standard, which was enacted "in response to the widespread practice of allocating deductions among partners in accordance with their agreement as to tax consequences, as opposed to their economic participation in the partnership."[21]

IV. Common Variations on Target Allocations

All target allocations use the same basic mechanic of allocating income and loss based on the difference between opening capital account balances and the Deemed Liquidation Amounts. However, there are a number of common variations on this basic mechanic. Before the report discusses in Part V the treatment of target allocations under the 704(b) Regulations, this Part IV of the report describes these common variations in how target allocations are done.

A. Target Allocations with Supplemental Guaranteed Payments

In the case of a partnership that provides for a preferred return to the capital-providing partners, rather than using target allocations to allocate items of partnership income to fill up the preferred return, some partnership agreements treat the preferred return as a guaranteed payment under Section 707(c). Treating the preferred return as a guaranteed payment avoids the problem highlighted in the "Preferred Return Example" above where the partnership does not have enough income each year (or, alternatively, over the life of the partnership) to cover the preferred return. This is because the guaranteed payment will be treated under Section 707(c) as ordinary income to the recipient partner that is earned outside the partnership and will result in an offsetting deduction at the partnership level.[22]

Alternatively, some partnerships liquidate in accordance with capital accounts but provide for a guaranteed payment to the extent necessary to make the partners' capital account balances equal the amount such partners would receive if the partnership liquidated in accordance with a hypothetical waterfall of cash distribution priorities set forth in the general distribution provisions of the partnership agreement. Under this approach, a partner entitled to a preferred return will be treated as receiving a guaranteed payment only to the extent the partnership does not have enough income over the life of the partnership to cover the preferred return.[23] Agreements drafted in this fashion arguably satisfy the Liquidation Requirement, since they literally provide that liquidating distributions must be made in accordance with capital accounts and ensure that these distributions achieve the intended economic result by simply

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[21] NYSBA Tax Section, Report on Proposed Treasury Regulations Under Internal Revenue Code section 704(b) (May 12, 1983).

[22] Some practitioners argue that a preferred return should be treated as a guaranteed payment, regardless of whether the agreement specifically refers to the preferred return as a guaranteed payment.

[23] It has also been suggested that the creation of a right to such a payment is itself a guaranteed payment. Golub, *supra* note 3 at 168.

"fixing" those balances to equal the amount each partner is entitled to under the cash distribution waterfall immediately prior to such liquidation.[24]

Although beyond the scope of this report, the use of guaranteed payments to support the payment of preferred returns raises a number of issues. For example, in the case of accrual basis partnerships, it is uncertain whether the guaranteed payment must be accrued on a current basis or included in income by the recipient partner only when paid.[25] In addition, it is unclear whether a preferred return should be treated as a guaranteed payment only to the extent the partnership does not have sufficient income to make the payment. More fundamentally, it is also unclear whether agreements with preferred returns payable to one partner out of another partner's capital to the extent of insufficient items of income should be treated as guaranteed payments to that extent if not so designated in the agreement.

B. Target Allocations Based on Hypothetical Cash-Driven Liquidations

While many investors significantly prefer cash-driven distributions to capital account-based distributions, it is important for some agreements to clearly fit within the Safe Harbor. To satisfy the Safe Harbor these agreements liquidate in accordance with capital accounts but are sometimes drafted with target allocations based on hypothetical cash-driven liquidations. This allocation method is not the focus of this report, since it should be respected as having economic effect under the Safe Harbor.

To improve the likelihood that these distributions will actually produce the intended economic result, these agreements typically provide more flexibility in exactly how the target allocations are made. Because these agreements meet the Liquidation Requirement (along with the other Safe Harbor conditions), adding this flexibility does not affect whether the allocations will be respected as having "economic effect" (though it may affect whether the allocations have "substantiality" under the SEE Standard).

For example, if a partner is entitled to a preferred return and there is concern about whether in later years the partnership will recognize sufficient items of Book Income/Loss to fill up that preference, the agreement may allow for allocations of additional amounts to the preferred partner in earlier years even though doing so may cause that partner's resulting Safe Harbor Capital Account to exceed the amount distributable to the partner under a hypothetical cash-driven liquidation occurring in the year of allocation. This "anticipatory" allocation better ensures that the partner's Safe Harbor Capital Account will equal the amount to which the

24 For example, the partnership agreement may include an allocation provision that looks something like the following: If the balance of any partner's capital account differs from the balance of its target capital account (defined by reference to the amount a partner would receive under a hypothetical cash-driven liquidation), then the partner with an excess or deficit balance, as the case may be, shall be specially allocated items of income, gain, loss or deduction and, if necessary, any remaining excess shall be treated as a guaranteed payment under Section 707(c) to those partners with such excess and a corresponding deduction to the other partners so as to cause all partners' capital accounts to equal their target capital account.

25 *See* Lewis Steinberg, *Fun and Games with Guaranteed Payments*, 57 Tax Law. 533 (Winter 2004).

partner is entitled in the later year under a hypothetical cash-driven liquidation occurring in that later year.

Similarly, if an allocation of Book Income/Loss would be different if other items not yet includable in Book Income/Loss were includable in the same year as the amounts realized, the agreement might allow for the realized items to be allocated in the manner that they would have been allocated had both the realized and unrealized items been realized in the same year. As a result, when the unrealized items are realized in the subsequent year, they would be allocated so that their allocations, together with the allocation of the previously recognized items, result in Safe Harbor Capital Accounts that match the hypothetical cash-driven liquidation in that subsequent year. Making this "anticipatory" allocation would typically arise when there are unrealized gains or losses (or income or expense) that have not been taken into account as part of Book Income/Loss because there has not been an event that allows for an adjustment to the Book Value of the partnership's assets.

> Hypothetical Cash-Driven Liquidation Example. Using the same facts described in the Preferred Return Example above, assume that the partnership agreement provides that it will liquidate in accordance with capital accounts and that allocations are made so as to cause capital accounts to equal the amounts distributable under a hypothetical cash-driven liquidation that requires distributions to be made first to A to the extent of A's contribution plus a 10% annual non-compounded preferred return, then to B to the extent of B's capital contribution and, thereafter, 30% to A and 70% to B. Further assume, however, that the agreement permits the hypothetical cash-driven liquidation amounts to be adjusted to include the preferred return for future years in which there is not expected to be sufficient income to fill up the preferred return in such future year. As such, when the partnership sells an asset with an adjusted basis of $500 for $650 in year 1, $100 of the gain would first be allocated to A with the remaining $50 being allocated $15 to A and $35 to B if it is expected that in year 2 there will be too little income to fill up the preferred return for the year. Assuming such expectation as to year 2, A's Safe Harbor Capital Account will equal $615 and therefore exceed the amount that would be distributed to A under the hypothetical cash-driven liquidation in year 1 ($500 plus $50 of preferred return plus $30 residual profit). However, in year 2 when the partnership sells its assets and liquidates, the partners' Safe Harbor Capital Accounts will equal the amounts they would receive under the hypothetical cash-driven liquidation (A would be entitled to $615 ($500 plus $100 preferred return plus $15 residual profit) and B would be entitled to $535 ($500 plus $35 residual profit).

C. Gross versus Net Target Allocations

Many partnership agreements using target allocations provide for the allocation of gross items of Book Income/Loss to the extent necessary to force the partners' capital account balances to equal the Deemed Liquidation Amount. Doing so provides greater certainty that each year sufficient items will be available so that the target allocations will reach the Safe Harbor Result for that year. Other target allocation provisions provide only for the allocation of net Book Income/Loss on the theory that the capital accounts do not need to equal the Deemed Liquidation Amount each year because future allocations will adjust the capital accounts such that they produce the Safe Harbor Result.

Target allocations that provide for allocations of gross items can be used to account for preferred returns and other distribution preferences where there is insufficient net income to allocate to the preference partner. Under this approach, items of gross income would be allocated to the preference partner to cause its capital account to equal the Deemed Liquidation Amount while offsetting items of gross loss would be allocated to the other partner. This use of gross allocations is similar to the guaranteed payment approach discussed above. However, a target allocation of gross items, if respected, preserves the character of the underlying items in the hands of the preference partner whereas guaranteed payments are always treated as ordinary income.

There can be, however, significant differences in the character of income recognized by the partners depending on whether net or gross allocations are used and, if gross allocations are used, how they are allocated. If gross allocations are used, there are at least two different methods typically used (the "One-Step Process" and the "Two-Step Process" respectively).

In a One-Step Process, net Book Income/Loss is allocated under the target allocation mechanism, with gross allocations used to the extent (but only to the extent) necessary to achieve the Safe Harbor Result, with each gross item being allocated in the same proportions as the net items. In the Two-Step Process, each gross item of income and deduction is allocated sequentially, in each case per the target allocation mechanism. In some cases, where the overall gross income items and the overall gross deduction items have different characters, the differences between a One-Step Process and the Two-Step Process can be significant.

> <u>Gross/Net Example 1</u>: A and B are partners in partnership AB. A has a preferred interest of 100, entitling it to a preferred return of 10 each year, B has a common interest of 100 and receives all profits above the preferred return. Economic losses are borne first by B to the extent of its 100 of capital. Assume in year 1, AB has net income of 10 consisting of 110 of operating income (taxable) and 100 of fines (non-deductible expense taken into account in computing net income and net loss).
>
> - One-Step Process: A would be allocated the 10 of net income and associated items, so it would be allocated 110 of taxable income and 100 of non-deductible expense.
>
> - Two-Step Process: First, A would be allocated 10 of operating income and B would be allocated 100 of operating income. Second, B would be allocated the 100 of non-deductible expense. Overall, A would be allocated only 10 of taxable income (vs. 110 in the One-Step Process) and B would be allocated 100 of taxable income (vs. 0 in the One-Step Process).

In a One-Step Process a small dollar difference in gross income or deduction can have many times that effect on the allocation of taxable income.

> <u>Gross/Net Example 2</u>: Assume the same facts as above, except that in year 1, operating income was only 99 (vs. 110). This thus results in a net loss of 1.

- One-Step Process: A would be allocated 10 of gross operating income and B would be allocated the resulting net loss of 11, including all the component items. Thus, A would have taxable income 10 and B would have 89 of taxable income and 100 of non-deductible expense allocated to it. In a one step process, the 11 dollar reduction in operating income results in A's taxable income allocation being reduced from 110 to 10 (a reduction of 100).

- Two-Step Process: The 11 reduction would result in no change to A and an 11 change to B (i.e., in step 1, A would first be allocated 10 of gross income items and B 89, and in step 2, B would be allocated 100 of gross deduction items). So overall, there is no difference to A and only an 11 reduction in the gross income to B corresponding to the 11 reduction in AB operating income.

D. Varying Participation in Different Items of Book Income/Loss

Many partnerships provide that different types of economic income are shared differently among the partners. This is most commonly true in the case of partnerships with partners that contribute different amounts of services and capital.

For example, many of these partnerships provide that service partners participate in a fixed percentage of operating income but participate in income recognized (including for book purposes) from capital events in a manner that differs from their participation in operating income. Those differences might be based on return hurdles for the capital partners or other benchmarks being met. These agreements might also provide that service partners forfeit their participation in capital events on a termination of their services.

To accommodate these bifurcated economic arrangements, target allocations in these partnerships are typically also bifurcated. Items of Book Income/Loss are allocated using the target allocation mechanic but only by reference to the distribution and liquidation provisions providing for the sharing of cash associated with those items.

Doing this requires careful consideration of how book items are associated with different categories of differently shared cash flows. For example, if cash distributions to the service partners from operations do not take account of depreciation, then book depreciation (and thus tax depreciation) should not be allocated to them.

> Bifurcation Example: Partner A contributes $100 to the partnership which is used to buy a depreciable asset. Partner B is a service partner and makes no capital contribution. The overall business agreement is that B will receive one-third of the profits from the business. The partnership agreement provides that operating cash will be distributed 2/3 to A and 1/3 to B. Upon a capital event, distributions will be made first to A until A has been distributed an amount of the capital proceeds equal to its capital contribution. Next, distributions will be made to B until B has received an amount equal to 1/3 of the aggregate amounts distributed to A and B from the capital proceeds. Thereafter, the proceeds will be distributed 2/3 to A and 1/3 to B.

Now assume the business generates $300 of both operating cash and operating income (which is taxable income measured before depreciation) and $10 of depreciation and is then sold for $600 (resulting in $510 of gain). The operating income is distributed on a current basis.

- Operating Income: Under the distributions provisions, A is entitled to a distribution of $200 of the operating income and B is entitled to a distribution of $100. Because only A bears the economic loss associated with the depreciation, all $10 of the depreciation would be allocated to A. Accordingly, the Deemed Liquidation Amounts would equal a total of $390 ($300 operating cash + $90 Book Value of depreciable asset), with A being entitled to $290 ($200 operating cash + $90 capital) and B entitled to $100. The target allocation would then result in an allocation of $200 of the operating income to A and $100 to B.

	Safe Harbor Capital Accounts		Deemed Liquidation Amounts	
	A	B	A	B
Capital	100	-		
Depreciation	(10)	-		
Target Allocation	200	100		
	290	100	290	100

- Capital Event: The Deemed Liquidation Amounts would equal a total of $600 ($600 cash sales proceeds). Under the distribution provisions, A is entitled to receive an amount equal to the $100 A contributed to the partnership. B is then entitled to receive the next $50 such that he has been distributed 1/3 (50/150) of the proceeds. The remaining $450 is to be distributed $300 to A and $150 to B. As such, A would be entitled to $400 of the Deemed Liquidation Amount and B would be entitled to $200. The target allocation would then result in an allocation of $310 of the gain recognized on the sale of the business to A and $200 to B.

	Safe Harbor Capital Accounts		Deemed Liquidation Amounts	
	A	B	A	B
Capital	100	-		
Depreciation	(10)	-		
Operating Income	200	100		
Distributions	(200)	(100)		
Target Allocation	310	200		
	400	200	400	200

V. The Basis for Respecting Target Allocations

When the Liquidation Requirement is not met, the only basis for respecting targets is PIP (including the Deemed PIP Rules) or the EEE Test. Targets should generally satisfy PIP (at least if they are properly drafted to achieve the Safe Harbor Result) and may also meet the EEE Test depending on the particular facts. This part of the report discusses these tests as a basis for respecting target allocations.

A. Overview of the 704(b) Regulations

In general, the 704(b) Regulations provide that an allocation will be respected if it meets the SEE Standard, is made in accordance with PIP (as determined by reference to all the facts and circumstances) or is deemed to be in accordance with PIP.[26] Allocations not respected are adjusted so as to conform to PIP.

1. The SEE Standard

To meet the SEE Standard, an allocation must have economic effect and the economic effect must be substantial.[27] Substantiality is discussed generally in section 1(C) below, but is not the focus of this report. Accordingly, for purposes of this report we have assumed that allocations that are treated as having economic effect will also be substantial. In general, to have economic effect, an allocation must be consistent with the underlying economic arrangement agreed to by the partners so that the economic benefit or burden corresponding to an allocation is borne by the partner receiving the allocation.[28] As indicated above, allocations meeting either the Safe Harbor or the EEE Test are treated as having economic effect.

a. The Safe Harbor

Under the Safe Harbor, an allocation will have economic effect if either the Primary Requirements or the Alternate Test (including the requirements that the partnership have a QIO Provision as defined below and that the allocation does not result in a deficit "adjusted" capital account as described below) is met. To meet the Primary Requirements, a partnership must, in addition to liquidating in accordance with capital accounts, maintain capital accounts as prescribed by Treas. Reg. § 1.704-1(b)(2)(iv) (i.e., Safe Harbor Capital Accounts)[29] and provide for a "deficit restoration obligation" (a "DRO"), which generally means partners with deficit capital accounts balances must be obligated to restore such deficits on liquidation.[30] Under the

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[26] Treas. Reg. § 1.704-1(b)(1)(i).

[27] Treas. Reg. § 1.704-1(b)(2)(i).

[28] Treas. Reg. § 1.704-1(b)(2)(ii)(a).

[29] This generally means that a partner's capital account is (i) credited with the amount of money and the fair market value of property contributed by the partner to the partnership, the amount of liabilities assumed by the partner from the partnership and the partner's share of the partnership's income and gain (including any increase in the value of the partner's share of the partnership assets at such time as the partnership appropriately takes into account such increase) and (ii) debited by the money and fair market value of property distributed to the partner, the amount of liabilities assumed by the partnership from the partner and its share of loss and deduction (including any decrease in the value of the partner's share of the partnership assets at such time as the partnership appropriately takes into account such decrease).

[30] Treas. Reg. §§ 1.704-1(b)(2)(ii)(b)(3), 1.704-1(b)(2)(ii)(c).

Alternate Test, if the partnership does not contain a DRO (or limits the partners' DRO) but meets the Liquidation Requirement and maintains Safe Harbor Capital Accounts, the allocation will be treated as meeting the Safe Harbor only if the partnership contains a "qualified income offset" provision (a "QIO Provision") and the allocation does not create or increase a deficit adjusted capital account balance in excess of any DRO.[31] In determining whether an allocation creates or increases a deficit adjusted capital account balance, a partner's capital account must be adjusted to account for certain debits that are expected to be made to the partner's capital account as provided in paragraphs (4), (5) and (6) of Treas. Reg. § 1.704-1(b)(2)(ii)(d) ("Adjusted Capital Accounts").[32] Very generally, under a QIO Provision, allocations must be made so as to avoid deficit Adjusted Capital Account balances in excess of the DRO and unexpected capital account debits that, had they been expected, would have been reflected in the Adjusted Capital Account (e.g., distributions), must be reversed with priority income allocations of gross income (thus effectively minimizing the actual or potential deficit in excess of the DRO).[33] Where the Liquidation Requirement is satisfied, the Alternate Test is particularly important because so many partnerships today are organized as limited liability companies in which no member has liability beyond its contributions to the partnership.

b. The EEE Test

Under the EEE Test, allocations that do not otherwise meet the Safe Harbor will be deemed to have economic effect if at the end of that year and each future year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic result to the partners as would occur if all of the Primary Requirements had been satisfied, regardless of the economic performance of the partnership (the "EEE Result").[34] This test does not require liquidations to be made in accordance with capital accounts or that Safe Harbor Capital Accounts be maintained (though applying the test requires a determination of what the Safe Harbor Capital Account balances would have been if they were maintained).[35]

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[31] Treas. Reg. § 1.704-1(b)(2)(ii)(d).

[32] Treas. Reg. § 1.704-1(b)(2)(ii)(d). In addition, these balances are also adjusted for certain debits attributable to nonrecourse liabilities. Treas. Reg. §§ 1.704-2(g)(1) and 1.704-2(i)(5).

[33] Treas. Reg. § 1.704-1(b)(2)(ii)(d).

[34] Treas. Reg. § 1.704-1(b)(2)(ii)(i).

[35] These conclusions are confirmed by example 4(ii) in Treas. Reg. § 1.704-1(b)(5), which provides that the EEE Test is met even though "the partnership maintains no capital accounts". In this example, G and H contribute $75 and $25, respectively, to the GH partnership. The partnership agreement states that all income, gain, loss, and deductions will be allocated 75% to G and 25% to H, and that all distributions to partners, including distributions in liquidation, will be shared in the same proportions. No capital accounts are kept, and the agreement does not provide for a DRO. However, taking into account local law contribution rights, G and H are ultimately liable for 75% and 25%, respectively, of any partnership debts. Although the allocations under the agreement fail the Primary Requirements, the allocations are valid under the EEE Test because the results are the same as if the Primary Requirements were met.

c. Substantiality

In general, an allocation that has economic effect nevertheless lacks substantiality if it is likely to be offset by another allocation that will neutralize the economic effect of the first allocation.[36] There are four tests for substantiality: the general test, the "after tax" test, the "shifting" test and the "transitory" test. Under the general test, the economic effect of an allocation is substantial if there is a reasonable possibility that it will affect substantially the dollar amounts to be received by the partners independent of tax consequences. Under the "after tax" test, the economic effect of an allocation generally is not substantial if the after-tax economic consequences of at least one partner may, in present value terms, be enhanced as a result of the allocation, and there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished as a result of the allocation. Under the "shifting" test, substantiality generally is lacking if, as a result of the allocation, there is a strong likelihood that the net capital account debits and credits would not differ substantially and the total tax liability of the partners is lower as a result of the allocation. Under the "transitory" test, substantiality is tested over time similarly as provided under the shifting test.

2. PIP and the Comparative PIP Test

If an allocation does not meet the SEE Standard, the allocation will nevertheless be respected if the allocation is substantial and is in accordance with PIP. PIP is generally determined by the manner in which the partners have agreed to share the economic benefit or burden corresponding to the income, gain, loss, deduction or credit (or item thereof) being allocated.[37] This sharing arrangement may or may not correspond to the overall economic arrangement of the partners.[38] In determining PIP, all facts and circumstances related to the economic arrangement of the partners are taken into account, including (i) the partners' contributions to the partnership, (ii) the interest of the partners in economic profits and losses (if different from that in taxable income or loss), (iii) the interest of the partners in cash flow and other non-liquidating distributions and (iv) the rights of the partners to distributions of capital upon liquidation.[39]

For partnerships that meet the Liquidation Requirement and maintain Safe Harbor Capital Accounts, PIP is generally determined with respect to allocations that do not have (but are eligible to have) economic effect by comparing (i) the manner in which distributions would be made if all partnership property were sold at Book Value and the partnership were liquidated immediately following the end of the taxable year to which the allocation relates with (ii) the manner in which distributions would be made if all partnership property were sold at Book Value and liquidated immediately following the end of the prior taxable year (the "Comparative PIP

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36 Treas. Reg. § 1.704-1(b)(2)(iii). A discussion of substantiality is beyond the scope of this report.

37 Treas. Reg. § 1.704-1(b)(3)(i).

38 *Id.*

39 Treas. Reg. § 1.704-1(b)(3)(ii).

Test").[40] For purposes of applying the Comparative PIP Test, the amounts distributed in the hypothetical liquidations must be reduced by the same adjustments mandated under the Alternate Test to determine a partner's Adjusted Capital Account. These adjustments will have the effect of minimizing the possibility that a lack of a DRO will have economic significance.

The Comparative PIP Test applies to a very narrow range of circumstances when a partnership meets the requirements of the Alternate Test. That is, it only applies to allocations of loss or deduction that cause a negative balance in a partner's Adjusted Capital Account to exceed its DRO obligation.[41] However, if the partnership meets all the requirements of the Alternate Test except that it does not contain a QIO, then the Comparative PIP Test would apply to all of its allocations since none of them would meet the Safe Harbor. As a result, in a case where a partnership meets the Liquidation Requirement and maintains Safe Harbor Capital Accounts, the Comparative PIP Test is, in effect, elective depending on whether or not a QIO is included.

As a practical matter, however, the Comparative PIP Test is not often available because partnerships rarely meet the Liquidation Requirement.

3. Regulatory Allocations under Deemed PIP

While the Safe Harbor provides that allocations made in accordance with the Primary Requirements or Alternate Test are treated as having economic effect, the 704(b) Regulations also provide that allocations of certain items of Book Income/Loss cannot have economic effect (the "Regulatory Allocations").[42] These allocations will nevertheless be respected if they meet the Deemed PIP Rules.

Regulatory Allocations principally include allocations of certain items attributable to nonrecourse liabilities as described in Treas. Reg. § 1.704-2. A classic example of such an item would be the depreciation deduction for an asset secured by nonrecourse debt to the extent that the deduction results in or increases an excess of the amount of the liability over the asset's Book Value.[43] The excess is very generally referred to as "minimum gain" in the regulations, and the allocation of the deduction giving rise to such minimum gain is treated as without economic effect because it potentially represents loss to the lender (as opposed to the partnership) to the

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40 Treas. Reg. § 1.704-1(b)(3)(iii)

41 *See* Treas. Reg. § 1.704-1(b)(5) ex. 15(ii).

42 Items allocated under section 704(c) are also excluded from Book Income/Loss. These allocation may also be referred to as regulatory allocations because they are made pursuant to Treas. Reg. § 1.704-3 and are made separately from other allocations of Book Income/Loss. Although adjustments to the Book Value affect target allocations and are made to enable proper Section 704(c) allocations, allocations made under section 704(c) are not relevant to a discussion of target allocations because they do not affect Safe Harbor Capital Account balances (although allocations of book depreciation or amortization, including as done under the target method, can affect how the 704(c) allocations are made). *See* Treas. Reg. § 1.704-1(b)(1)(vi).

43 Treas. Reg. § 1.704-2(b)(1).

extent not recovered from subsequent gain.[44] Similarly, to the extent of a subsequent decrease in such minimum gain (resulting, for example, from a reduction in the liability, which reduces the excess of the liability over the Book Value), the regulations treat subsequent income as without economic effect because such decrease in minimum gain merely reduces the amount of the lender's loss (as opposed to being accretive to the equity of the partnership).[45]

Another example of Regulatory Allocations includes allocations related to nonrecourse liabilities for which a partner or related person bears the economic risk of loss under Treas. Reg. § 1.752-2 ("Partner Nonrecourse Debt") because, for example, the partner is the creditor or guarantor. While deductions related to Partner Nonrecourse Debt, to the extent they result in adjusted tax basis below the amount of such debt, do not affect how the equity of the partnership is shared (because they affect only the lender, as is the case for other nonrecourse deductions resulting in minimum gain), they obviously economically affect the partner creditor/guarantor in his capacity as creditor/guarantor.

The Deemed PIP Rules under Treas. Reg. § 1.704-2 address when these Regulatory Allocations will be respected under the 704(b) Regulations even though they cannot have economic effect. For example, for allocations of deductions attributable to Partner Nonrecourse Debt to meet the Deemed PIP Rules, they must be allocated to the partner bearing the economic risk of loss with respect to the liability (resulting in "partner minimum gain" to that partner), and when that risk of loss is reduced (e.g., by reductions in the liability, which then reduce the partner's partner minimum gain), subsequent allocations of income must be allocated in a manner that reverses the prior deductions.[46] Other allocations of deductions attributable to nonrecourse liabilities that give rise to minimum gain can generally be allocated in a more flexible manner so long as they are similarly reversed when there is subsequent income.[47] Very generally, to satisfy the Deemed PIP Rules, these allocations of items without economic effect must be made so that deductions (or distributions supported by nonrecourse liabilities) offset

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44 To illustrate, assume a partnership finances the purchase of, its single asset, a $100,000 building by borrowing $85,000 on a nonrecourse basis and with $15,000 cash. The first $15,000 of depreciation can be allocated in the way the partners will bear the loss if the building declines in value by $15,000, but if no principal is paid on the mortgage, the economic burden of further declines in the property's value falls on the mortgage lender because the mortgage is without partner liability. Thus, if the partnership's cost recovery deduction is $5,000 in year 1 and $10,000 in each of years 2, 3, 4 and 5, no allocation of the deductions for any of years 3, 4 and 5 has substantial economic effect because if the property declines in value by more than $15,000 the partnership could default on the loan and the lender would sustain the economic loss.

45 Treas. Reg. § 1.704-2(f)(1). Using the facts assumed in the prior footnote as an illustration, if in the beginning of year 4 the building is foreclosed upon without the receipt of any cash, the partnership would realize taxable gain of $10,000 ($85,000 debt relief less $75,000 adjusted basis). Because that taxable gain merely reflects a corresponding $10,000 net decrease in partnership minimum gain (since the partnership no longer holds property with minimum gain potential), the $10,000 of taxable gain does not have economic effect.

46 Treas. Reg. § 1.704-2(i)(1), (4).

47 Treas. Reg. § 1.704-2(e)(3).

subsequent income in the same manner and to the same extent as the deductions.[48] This offset mechanic is generally referred to as a "minimum gain chargeback" provision.

B. How the Safe Harbor Frames the Mechanics of Target Allocations

Failing to liquidate in accordance with capital accounts necessarily precludes partnerships with target allocations from meeting the Primary Requirements or the Alternate Test (since both incorporate the Liquidation Requirement). However, partnership agreements with target allocations aiming to reach the Safe Harbor Result typically do so by attempting to adhere to the Primary Requirements relating to the maintenance of Safe Harbor Capital Accounts. They define Book Income/Loss and Book Value in accordance with the 704(b) Regulations and they make allocations of Book Income/Loss to as closely as possible replicate in the Safe Harbor Capital Accounts the amounts that would be distributed to each partner if the partnership sold all of its property at Book Value and liquidated in accordance with the partnership's liquidating distribution waterfall. The mechanics of accomplishing this usually work as follows:

- The partnership maintains Safe Harbor Capital Accounts and defines the amounts to be allocated for this purpose (i.e., Book Income/Loss) in accordance with the 704(b) Regulations.

- More specifically, consistent with the rules for maintaining Safe Harbor Capital Accounts, the partnership agreement generally defines Book Income/Loss as taxable income or loss with certain adjustments,[49] such as increases for tax exempt income and decreases for expenditures that are neither deductible nor added to Safe Harbor Capital Accounts, and with depreciation and amortization being determined based on the Book Value of the assets. For this purpose, the Book Value of an asset is generally its tax basis as adjusted to its fair market value upon certain events and as adjusted for amortization and depreciation based on such Book Value. The partnership agreement will generally require or allow (where elective) the partnership to revalue its assets and make corresponding adjustments to their Book Value (or "book up") in accordance with the rules applicable to maintaining Safe Harbor Capital Accounts. These rules generally provide for revaluations of partnership assets

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[48] Distributions attributable to nonrecourse debt that create or increase an excess of nonrecourse liability over basis increases the distributee partner's share of the partnership's minimum gain (but not his or her share of nonrecourse deductions) because "the distributee partner enjoys the economic benefit of the immediate use of the proceeds but does not bear the economic risk of loss if the partnership cannot pay the debt." T.D. 8385, 1992-1 CB 199, 201. Accordingly, the amount of distributed loan proceeds is included in the partner's share of partnership minimum gain, so that any gain subsequently realized by the partnership is allocated in the same proportions as the partners shared the corresponding economic benefits through the borrowing and distributions. Treas. Reg. § 1.704-2(g)(1)(i), (h)(1).

[49] Book Income/Loss is also generally defined to treat as an item of gain or loss, as the case may be, any increase or decrease in the Book Value of an asset and the difference, if any, between the fair market value and the Book Value of any property distributed by the partnership. In addition, Book Income/Loss is generally defined to exclude any items that are specially allocated under the Regulatory Allocations described below as well as tax items that reflect book/tax differences, such as those allocated as provided in Section 704(c).

(and corresponding adjustments to Safe Harbor Capital Accounts) upon certain events such as a contribution or distribution of an asset to or from the partnership or upon certain changes in the partners' relative interests in such asset.[50] It is important that partnerships using target allocations provide for revaluations (or book ups) in accordance with these rules and include such adjustments in Book Income/Loss as permitted by the 704(b) Regulations because they result in adjustments to the Safe Harbor Capital Accounts which serve as the baseline for testing target allocations against the Safe Harbor Result.

- The partnership agreement allocates Book Income/Loss so that each partner's Safe Harbor Capital Account balance (after being adjusted for all contributions and distributions through the end of the allocation period) matches, as closely as possible, the amounts that the partner would receive if the partnership's assets were sold for their Book Value and its liabilities satisfied and the remaining assets (i.e., the Deemed Liquidation Amount) distributed in accordance with the partnership's liquidation provision; provided, however, that before these allocations are made, (i) the Safe Harbor Capital Accounts are adjusted by contributions partners would be obligated to make or would receive upon the partnership's liquidation (which is effectively treated as a limited DRO),[51] and (ii) assuming partners have no or a limited DRO and would have to rely on the Alternate Test to meet the Safe Harbor (if the partnership meets the Liquidation Requirement), the partnership agreement would contain a QIO Provision and require items of book gross income to be allocated first in accordance with that provision.[52]

- Finally, if it is anticipated that any items of Book Income/Loss might be ineligible for treatment as having economic effect, as discussed immediately below, the partnership agreement would provide for these items to be allocated separately as Regulatory Allocations and for certain adjustments to be made to the Safe Harbor Capital Accounts and Deemed Liquidation Amounts so as to insulate the regular target allocations from the effect of these special allocations.

As indicated above, Regulatory Allocations cannot meet the Deemed PIP Rules if the partnership does not meet the Liquidation Requirement, which is generally the case when target allocations are used. Nevertheless, target allocations typically attempt to maximize the likelihood of the Regulatory Allocations being respected by carving them out and allocating

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[50] *See* Treas. Reg. § 1.704-1(b)(2)(iv)(f). In a securities partnership, Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(iv) provides that such revaluations may be done annually.

[51] This adjustment is necessary in order to avoid over-allocating Book Income (or under-allocating Book Loss) to the partners with such an obligation and under-allocating Book Income (or over-allocating Book Loss) to those partners that do not have (or benefit from) such an obligation.

[52] A partnership agreement that provides for target allocations (and lacks a DRO) will generally include a separate QIO Provision so that the allocations are consistent with the Alternate Test and the requirements provided in Treas. Reg. § 1.704-2(e) for respecting allocations of nonrecourse deductions.

them as prescribed by the Deemed PIP Rules.[53] In other words, just as target allocations aim to reach the Safe Harbor Result with respect to allocations eligible to be treated as having economic effect, target allocations aim to allocate other items (i.e., make Regulatory Allocations) in a manner that (i) would be respected under the Deemed PIP Rules if the Liquidation Requirement were met and (ii) do not affect how allocations eligible to have economic effect are made.

To achieve those objectives, target allocations provide for (i) these Regulatory Allocations to be made before the regular target allocations and (ii) each partner's share of partner minimum gain and minimum gain to be added back to the partner's opening Safe Harbor Capital Account balance that is used for purposes of allocating the remaining Book Income/Loss.[54] In addition, for purposes of making the regular target allocations, the partnership's aggregate Deemed Liquidation Amount is determined by assuming that assets subject to nonrecourse debt giving rise to such minimum gain and partner minimum gain are valued at no less than the amount of such debt, since any discharge of the debt would result in income or gain that is no less than the excess of such debt over its adjusted tax basis.[55] These adjustments to opening Safe Harbor Capital Accounts and Deemed Liquidation Amount thus allow non-recourse deductions to be allocated separately (and in a manner that would be allowed by the Deemed PIP Rules if Liquidation Requirement were met) without affecting how other items of Book Income/Loss are allocated so that each partner's resulting Safe Harbor Capital Accounts matches the partner's share of the Deemed Liquidation Amount (as measured by the Book Value of assets actually available for distribution after the discharge of partnership liabilities).

> Regulatory Allocations Example: Assume A and B form a partnership with each contributing $10,000 and agree that distributions will go first to A to the extent of A's contribution then to B to the extent of B's capital contribution and thereafter 40% to A and 60% to B. Assume that the partnership purchases a building for $100,000 using the $20,000 cash contributed by A and B and an $80,000 non-recourse loan. Further assume that the building generates $9000 of gross operating income and cash (none of which will be distributed until liquidation) and $10,000 of depreciation each year (resulting in a taxable loss of $1000 each

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53 An additional reason why partnership agreements will typically track the partners' respective shares of partnership minimum gain is to ensure that basis adjustments resulting from an increase or decrease in a partner's share of the partnership's liabilities (or from the assumption by a partner of partnership liabilities, or vice versa) under Sections 705 and 752 will match the corresponding nonrecourse deductions and/or distributions relating to those liabilities.

54 Consistent with the logic of this approach to making target allocations, the Deemed PIP Rules provide that, for purposes of the Alternate Test, a partner's share of minimum gain and partner minimum gain limits the amount of the partner's deficit balance in determining the partner's DRO if there is a minimum gain chargeback provision. Treas. Reg. § 1.704-2(g)(1) and -2(i)(5). In effect, the Deemed PIP Rules confirm that any deficit balance attributable to capital account debits reflected in a partner's share of minimum gain and partner minimum gain should not be included in the partner's DRO because those items will be reversed when the minimum gain or partner minimum gain is recognized (and also because the associated liabilities are, by definition, nonrecourse).

55 *See Crane*, 331 U.S. 1 (1947); *Tufts*, 461 U.S. 300 (1983); Treas. Reg. § 1.1001-2.

year), and the partners have agreed to share nonrecourse deductions 40% to A and 60% to B (i.e., the same ratio as overall profits are allocated). Finally, assume that at the beginning of year 4 the building is sold for $80,000 and the partnership liquidated, with the $27,000 of cash distributed $12,800 to A and $14,200 to B.[56]

- At the end of year 1, the Deemed Liquidation Amounts will equal $19,000 ($9000 of cash + $90,000 Book Value of building - $80,000 loan) and would be distributed $10,000 to A and the remaining $9000 to B. Thus all of the $1000 of Book Loss for the year would be allocated to B to bring their closing Safe Harbor Capital Accounts to $10,000 and $9000 respectively.

- At the end of year 2, the Deemed Liquidation Amounts will equal $18,000 ($18,000 of cash + $80,000 Book Value of building - $80,000 loan) and would be distributed $10,000 to A and the remaining $8000 to B. Thus all of the $1000 of Book Loss for the year would be allocated to B to bring the closing Safe Harbor Capital Accounts to $10,000 for A and $8000 for B.

- At the end of year 3, the $10,000 of depreciation in year 3 causes the nonrecourse loan to exceed the building's basis by an equivalent amount ($80,000 loan - $70,000 basis), thus increasing net aggregate minimum gain by $10,000. Prior to making other allocations, this nonrecourse deduction would be allocated $4000 to A and $6000 to B.[57] For purposes of allocating the balance of the partnership's items (i.e., $9000 of gross income), Safe Harbor Capital Accounts would be increased by the partners' share of minimum gain ($4000 to A and $6000 to B), resulting in "adjusted" opening balances equal to $10,000 and $8000 respectively. The Deemed Liquidation Amount would be $27,000 ($27,000 of cash + $80,000 adjusted Book Value of building - $80,000 loan) and would be distributed $12,800 to A and $14,200 to B. Thus the $9000 of gross income would be allocated $2800 to A and $6200 to B to bring their "adjusted" ending Safe Harbor Capital Accounts to $12,800 and $14,200 respectively. The actual Safe Harbor Capital Accounts (which reflect the debits from the nonrecourse deductions), however, would be $8800 and $8200 respectively (together equaling $17,000, which is the amount equal to $27,000 of cash + $70,000 Book Value of building - $80,000 loan).

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56 The facts in this example are unusual in that cash is retained and does not secure the loan, however, we wanted to provide a simple example to illustrate how Regulatory Allocations are made in the context of target allocations. In addition, to simplify the arithmetic, this example assumes that the loan is non-interest bearing.

57 Treas. Reg. § 1.704-2(e). The allocation of nonrecourse deductions in this example is made so as to be consistent with the general allocation of Book Income/Loss in accordance with the distribution waterfall.

- At the beginning of year 4, when the building is sold $80,000 and loan repaid, the partnership's net minimum gain would decrease by $10,000 (to zero since there would no longer be nonrecourse debt in excess of the secured assets Book Value), requiring the reversal of the prior nonrecourse deductions under the minimum gain chargeback rules. The $10,000 gain resulting from the building sale would thus be allocated $4000 to A and $6000 to B, resulting in Safe Harbor Capital Accounts of $12,800 and $14,200 respectively. If these nonrecourse deductions had not been isolated as outline above, they could not have been allocated in a manner that resulted in both (i) their reversal in proportion to their initial allocation (which is required by a minimum gain charge back provisions of the Deemed PIP Rules) and (ii) Safe Harbor Capital Account balances to equal the amounts distributable to the partners.[58]

	Safe Harbor Capital Accounts		Deemed Liquidation Amounts	
	A	B	A	B
Capital Contributions	10,000	10,000		
Year 1 Target Allocation	-	(1,000)		
Year 1 Safe Harbor Capital Account	10,000	9,000	10,000	9,000
Year 2 Target Allocation	-	(1,000)		
Year 2 Safe Harbor Capital Account	10,000	8,000	10,000	8,000
Year 3 Nonrecourse Deduction	(4,000)	(6,000)		
Year 3 Minimun Gain Adjustment	4,000	6,000		
Year 3 Target Allocation	2,800	6,200		
Year 3 Adj. Safe Harbor Cap. Accts	12,800	14,200	12,800	14,200
Year 3 Actual Safe Harbor Cap. Accts	8,800	8,200		
Year 4 Minimum Gain Chargeback	4,000	6,000		
Pre-Distribution Actual Safe Harbor Cap Accts	12,800	14,200	12,800	14,200

C. Analyzing Target Allocations under PIP and Recommended Guidance for Respecting Target Allocations under PIP

Because target allocations generally do not meet the Safe Harbor, they are typically analyzed under PIP. When they reach the Safe Harbor Result, many practitioners believe that they should be respected under PIP by analogy to the Comparative PIP Test (even if that test does not technically apply because the Liquidation Requirement is not met).

In reaching the Safe Harbor Result, target allocations and the Comparative PIP Test assume a hypothetical liquidation based on a sale of assets at Book Value. This preserves the annual accounting concept used in Subchapter K, which takes account of only recognized items and any other "book" items included in Book Income/Loss as a result of an adjustment to the

[58] For example, if the year 3 nonrecourse deductions were not carved out and specially allocated as described (but were instead allocated just as any other item under the regular target allocation mechanic), those year 3 nonrecourse deductions would be allocated 100% to B but the gain reversing that allocation would be allocated partially to A and partially to B.

Book Value of assets as required (or permitted) in maintaining Safe Harbor Capital Accounts. This approach also avoids the need for annual appraisals of a partnership's assets. Both target allocations (which are drafted to reach the Safe Harbor Result) and the Comparative PIP Test use this same basic framework.

The Comparative PIP Test effectively says that allocations not meeting the Safe Harbor will be respected under PIP if they reach the Safe Harbor Result assuming certain adjustments as required under the Alternate Test. While reliance on this test requires the Liquidation Requirement be met, we believe that whether the Liquidation Requirement is actually met generally should not be relevant in the context of target allocations if the Safe Harbor Result is reached -- i.e., the target allocation is the same allocation that generally would have been drafted into the partnership agreement to as closely as possible assure the intended economic result (consistent with a partnership cash waterfall distribution scheme) in a case where the Safe Harbor is satisfied and the Liquidation Requirement is met. Given that the Comparative PIP Test requires adjustments as prescribed by the Alternate Test, for this purpose these same adjustments should be made in implementing target allocations.

For the foregoing reasons, we therefore recommend that guidance be issued confirming that target allocations reaching the Safe Harbor Result (as so defined) will generally be respected under PIP.

D. Analyzing Target Allocations under the EEE Test and Recommendations for Clarifying the EEE Test with Respect to Target Allocations

Satisfying the EEE Test means that, if there is substantiality, the SEE Standard will be met. Meeting the SEE Standard is important for partnerships desiring to fit within certain safe harbors as discussed below. However, there is significant uncertainty as to when target allocations will be treated as satisfying the EEE Test.[59]

1. Obtaining the Safe Harbor Result "Regardless of Economic Performance"

The EEE Test requires that, as of the end of each partnership taxable year, a liquidation of the partnership "at the end of such year or at the end of any future year" would produce the same economic result as allocations that meet the Primary Requirements "regardless of the economic performance of the partnership."

One area of uncertainty is whether this requires allocations to be tested under facts and circumstances (not just performance standards) that were not expected at the time an allocation was included in the partnership agreement or the year with respect to which the allocation is being tested. In addition, it is unclear to what extent the EEE Test can be satisfied with respect to a given year if it was failed in a prior year.

For example, consider a partnership formed to acquire on an unleveraged basis the stock of a domestic C-corporation and that does not anticipate acquiring any other assets. To satisfy

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[59] Cuff 2009, *supra* note 3, at 191.

the EEE Test, must the partnership's allocations be able to meet the EEE standard on the assumption that it might acquire leveraged real estate or depletable property (even though in the year for which compliance is tested no such investments have been acquired or are anticipated)? What about the possibility of unanticipated future leveraging? What about potential divergences from the EEE standards for performance that is not reasonably anticipated at the time for testing? For example, assume that a partnership makes a leveraged investment in stock with recourse borrowing, but it is considered highly unlikely that any partner will have a negative capital account as a result of the partnerships allocations and operations. If the partnership does not have a DRO might the partnership's allocations nevertheless qualify under the EEE Test? Under a literal wording it appears they could not.

Practitioners disagree on the answer to these questions under the current EEE Test. However, there is widespread agreement that as a matter of tax policy the test should be applied in a manner such that possible but unexpected divergences from the Safe Harbor Result should not preclude reliance on the test until those divergences actually occur, and if unexpected divergences actually occur but are not expected to persist, then it should be possible to rely on the test in future periods in which there are no such divergences. In the case of a partnership that satisfies the Primary Requirements, upon liquidation the partners must receive the amounts reflected in their capital accounts, but with respect to a year in which the partnership is not expected to liquidate, comparing the economic result of a deemed liquidation in such year with the Safe Harbor Result is not meaningful. Provided a partnership's allocations are expected to produce the Safe Harbor Result in all scenarios in which an actual liquidation of the partnership might occur, unexpected divergences from the Safe Harbor Result prior to liquidation should not prevent the partnership from satisfying the EEE Test. Clarifying or modifying the EEE Test to confirm this interpretation would be helpful. We note that in the regulations under Section 514(c)(9)(E) addressing the "fractions rule" for partnership allocations, certain "unlikely" events are permitted to be disregarded in determining compliance with the rule.

2. The Relevance of the DRO Requirement

Under the EEE Test, the Safe Harbor Result must be obtained assuming there is a DRO because the test requires obtaining the same result as would have occurred if all the Primary Requirements (including the requirement of a DRO) had been satisfied. It is unclear, therefore, when partnerships without a DRO can satisfy the EEE Test, if ever.[60] The resolution to this issue is particularly important, however, because partnerships are commonly organized as limited liability companies in which no partner has any obligation to make contributions to the partnership on its liquidation (or otherwise, in the case of many partnerships).

In our view, if a partnership agreement does not contain a DRO, meeting the EEE Test depends on whether there is only a remote possibility that the agreement's allocation method would not produce a Safe Harbor Result independently of there being a DRO. Moreover, for

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[60] As noted above, in the only guidance that the 704(b) Regulations offer on this question an example provides that a partnership agreement which did not contain a DRO could satisfy the EEE test where the partners were under a state law obligation to contribute any debts of the partnership in proportion to their shares of partnership profits. Treas. Reg. § 1.704-1(b)(5), Example 4(ii).

partnership agreements without a DRO provision, this should always be achievable with target allocations so long as it is not possible for aggregate negative adjustments to the partners' Safe Harbor Capital Accounts (from distributions and losses) to exceed the aggregate amount of the partners' capital contributions, income allocations and share of minimum gain and partner minimum gain. This is because in these agreements the economic arrangement of the partners would not require them to make contributions beyond a specified amount (or, perhaps, at all) and the allocations -- if properly drafted in accordance with the Deemed PIP Rules -- would be made in a manner that fully reflects that economic arrangement.

Nor is the absence of a DRO relevant to any negative capital account balance associated with prior Regulatory Allocations. Recall that minimum gain and partner minimum gain merely represent the aggregate debits to a partner's capital account that must reverse upon a future sale of the partnership's assets since the amount realized by the partnership in such a sale will at least equal the nonrecourse debt that produced these debits in the first place (even if the property is worthless).[61] In other words, to the extent an otherwise negative capital account balance is attributable to those amounts, the negative balance will be reversed on a sale of the partnership's assets secured by the nonrecourse debt that gives rise to such negative balance, assuming those debits and credits are made in accordance with the Deemed PIP Rules, which require such reversal.

This means that, provided that minimum gain and partner minimum gain are properly tracked and allocated, using target allocations should always avoid driving any partner's Safe Harbor Capital Account negative by more than the partner's share of minimum gain and partner minimum gain, and the absence of a DRO would have no effect on the Safe Harbor Result.[62] In this case, therefore, the absence of the DRO also should have no effect on the satisfaction of the EEE Test. The Deemed PIP Rules effectively confirm this analysis by providing that these amounts (i.e., a partner's share of minimum gain and partner minimum gain) are added back in reducing a DRO for purposes of applying the Alternate Test – i.e., they imply that such amounts do not constitute a deficit at all.[63] For these reasons, we believe that the absence of a DRO should generally not preclude reliance on the EEE Test, provided that the Deemed PIP Rules are properly applied. We recommend that the EEE Test be clarified or modified to provide that a partnership's allocations need satisfy the Safe Harbor Result only under those fact patterns reasonably likely to occur. For this purpose, a partner's capital account would not be treated as being negative to the extent not in excess of its share of minimum gain and partner minimum gain as defined in the 704(b) Regulations.

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[61] *See* note 48, *supra*.

[62] The exception to this would arise where an anticipatory allocation is made (or not made) based on an adjustment required under the Alternate Test that is incorrect. For example, suppose a loss is allocated to partner A to avoid a negative capital account to partner B as a result of an anticipated distribution to partner B, but then the distribution is made instead to partner A, driving partner A's capital account negative.

[63] Treas. Reg. § 1.704-2(g)(1) and -2(i)(5).

Minimum Gain Reduces DRO Example:[64] Assume A and B form a partnership. A contributes $20,000 and B contributes $180,000. The partnership then takes out an $800,000 nonrecourse loan to purchase a building for $1,000,000. The partnership agreement provides that distributions will be made 10% to A and 90% to B, and that nonrecourse deductions will be allocated on the same basis.

Each year, the partnership is entitled to a depreciation deduction of $90,000 on the building. Assume that the partnership breaks even on an operating basis and makes no distributions over the next three years. The capital accounts of A and B will be adjusted as follows:

	Safe Harbor Capital Accounts Target Allocations		Deemed Liquidation Amounts	
	A	B	A	B
Capital account at inception	20,000	180,000		
$90,000 deduction in year 1	(9,000)	(81,000)		
	11,000	99,000	11,000	99,000
$90,000 deduction in year 2	(9,000)	(81,000)		
	2,000	18,000	2,000	18,000
$70,000 NR deduction in year 3	(7,000)	(63,000)	-	-
$20,000 addt'l deduction year 3	(2,000)	(18,000)	(7,000)	(63,000)
Ending Capital account balance	(7,000)	(63,000)	(7,000)	(63,000)

If the partnership were to sell the building at the beginning of year 4 for $800,000 (in full satisfaction of the nonrecourse loan), the partnership would have $70,000 of minimum gain chargeback, which would then be allocated between the partners in the same way that the nonrecourse deductions were allocated such that the negative balance in each partner's capital account is eliminated. The absence of a DRO is therefore irrelevant to obtaining the Safe Harbor Result.

	Safe Harbor Capital Accounts Target Allocations		Deemed Liquidation Amounts	
	A	B	A	B
Capital account balance	(7,000)	(63,000)		
$70,000 minimum gain chargeback	7,000	63,000		
Ending Capital account balance	-	-	-	-

If it is conceivably possible (even if unlikely) that having a DRO would produce a different result, then it would seem doubtful that the EEE Test can be satisfied in the absence of a DRO. Given the possibility of unpredictable events (resulting in unanticipated allocations), it is hard to conclude that a DRO would never make a difference. As discussed below, we recommend that the EEE Test be liberalized to require taking into account only all reasonably expected events.

[64] *See* Treas. Reg. § 1.704-2(m), Example 1(i).

If an agreement contains a DRO, target allocations will necessarily take account of the DRO and will necessarily produce the Safe Harbor Result required under the EEE Test, at least if settlement of the DRO and liquidation are assumed to occur within the time frame prescribed by the regulations governing DROs.[65] Some have suggested, however, that if settlement of the DRO is not required in the full range of circumstances in which liquidation of the partnership is deemed to occur under the 704(b) Regulations,[66] the EEE Test might arguably not be met because such potential gap means that one or more of the types of hypothetical liquidations under the 704(b) Regulations might not produce the same economic result as would be produced in an actual liquidation that actually triggered the DRO (or triggered it at a slightly different time because of the application of state law).[67] In our view, this interpretation of the Primary Requirements is unnecessarily narrow, as confirmed by the regulatory example of the EEE Test, which contemplates a DRO imposed by state law without specifying whether such requirement meets the time requirements of the DRO rules.[68] Again, we would suggest clarifying the EEE Test to confirm this interpretation.

3. Obtaining the EEE Result with Gross Allocations or Guaranteed Payments

Provided there are enough items available to allocate, target allocations should be able to obtain the Safe Harbor Result in all cases, and thus should meet the EEE Test. Allocating gross items of Book Income/Loss separately can materially improve the likelihood that sufficient items will be available for such allocations.

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65 Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3). This regulation states that if a partner has a DRO he must restore the deficit before the end of the taxable year in which the partner's interest in the partnership is liquidated or, if later, within 90 days of liquidation of his interest.

66 Under the 704(b) Regulations, "a liquidation of a partner's interest in the partnership occurs upon the earlier of (1) the date upon which there is a liquidation of the partnership, or (2) the date upon which there is a liquidation of the partner's interest in the partnership under paragraph (d) of § 1.761-1. For purposes of this paragraph, the liquidation of a partnership occurs upon the earlier of (3) the date upon which the partnership is terminated under section 708(b)(1), or (4) the date upon which the partnership ceases to be a going concern (even though it may continue in existence for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its partners. Requirements (2) and (3) of paragraph (b)(2)(ii)(b) of this section will be considered unsatisfied if the liquidation of a partner's interest in the partnership is delayed after its primary business activities have been terminated (for example, by continuing to engage in a relatively minor amount of business activity, if such actions themselves do not cause the partnership to terminate pursuant to section 708(b) (1)) for a principal purpose of deferring any distribution pursuant to requirement (2) of paragraph (b)(2)(ii)(b) of this section or deferring any partner's obligations under requirement (3) of paragraph (b)(2)(ii)(b) of this section." Treas. Reg. § 1.704-1(b)(2)(ii)(g).

67 The possibility of a more expansive version of this argument is set forth in Cuff 2009, *supra* note 3, at 190.

68 Treas. Reg. § 1.704-1(b)(5), Example 4(ii). The example describes a partnership agreement that does not contain a DRO but each partner is ultimately liable under a state law right of contribution for its share of the partnership's liabilities and concludes that the allocations have economic effect under the EEE Test without any discussion as to when the state law contribution would be required, whether such contribution would be required in all cases in which the partnership is deemed to liquidate under the 704(b) Regulations, or whether the contribution would satisfy the time periods for a DRO under the 704(b) Regulations.

For this reason, some believe that target allocations must allow for gross items to be broken out and allocated for the allocations to meet the EEE Test if meeting the test depends on there being sufficient items. Not allowing this, they argue, would narrow the range of circumstances in which the Safe Harbor Result could be reliably obtained, thus jeopardizing whether it would be obtained in all conceivable (or expected) events. This would typically be the case, for example, when one or more partners is entitled to a preferred rate of return that, when paid, is payable from the other partners' capital if there is otherwise insufficient income.

Others disagree with this conclusion and argue that such distribution right should be treated as a guaranteed payment and thus, when recognized, would result in an item of deduction available such that target allocations would meet the Safe Harbor Result.[69] Presumably, however, relying on guaranteed payments to fill gaps in reaching the Safe Harbor Result requires specifying such amounts as guaranteed payments, raising the question as to when they must be recognized, which generally is in accordance with the partnership's regular method of accounting.[70]

If there is a requirement that gross allocations be used to the extent necessary to meet the targeted allocation amounts, it would be helpful to clarify the regulations in that respect and to specify whether the One-Step or Two-Step Process (or some other method) should be used to make those allocations.[71] We note, however, that this question directly goes to the issue of "substantiality" as opposed to "economic effect." In addition, the regulations should specify whether these methods must be used consistently from year to year and to what extent changed circumstances or expectations might justify a change in method.

4. Fair Market Value Deemed Liquidations

It is clear that under the Safe Harbor, maintaining Safe Harbor Capital Accounts limits the circumstances in which Book Value can be adjusted to reflect fair market value of the partnership's assets.[72] For this reason, to meet the Safe Harbor, Book Income/Loss can include changes in Book Value only when a "book up" event occurs, including a liquidation.

The EEE Test, however, requires allocations be made so as to reach the Safe Harbor Result if a liquidation occurred in the year of allocation, and unlike the Comparative PIP Test (which assumes a liquidation at Book Value), the EEE Test does not specify what value should be used for purposes of determining this Deemed Liquidation Amount. Since maintaining Safe Harbor Capital Accounts requires asset values to be adjusted to fair market value on a liquidation of the partnership, it could be argued that the EEE Test allows (or perhaps even requires) adjusting the assets to their fair market value to measure Book Income/Loss and determining the

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69 See Golub, *supra* note 3, at 168-169.

70 Treas. Reg. § 1.707-1(c).

71 See the discussion of gross versus net income allocations in Section C of Part IV above.

72 Treas. Reg. § 1.704-1(b)(2)(iv)(f).

Safe Harbor Result for purposes of evaluating whether the EEE Result is (or will always be) met; after all, if in any year the partnership were to liquidate, the Safe Harbor Result would clearly be based on the fair market value of the assets at the time of liquidation. We believe that the better interpretation of the EEE Test is that the Safe Harbor Result is determined based on a Deemed Liquidation Amount using Book Value and not fair market value (except where Book Value is adjusted to fair market value for purposes of maintaining Safe Harbor Capital Accounts).

5. Relevance of the EEE Test to the Deemed PIP Rules

As discussed above, allocations of nonrecourse deductions are respected under the Deemed PIP Rules only if the partnership meets the Safe Harbor (i.e., it maintains Safe Harbor Capital Accounts, satisfies the Liquidation Requirement and provides for a DRO or a QIO Provision).[73] As such, Treas. Reg. § 1.704-2(e) technically does not apply to allocations that meet the EEE Test but not the Safe Harbor. At best, this leaves uncertain whether partnerships using target allocations can specially allocate nonrecourse deductions and, if not, how such deductions would be re-allocated under PIP.

In our view, the 704(b) Regulations should not generally favor allocations made by partnerships satisfying the Safe Harbor over those that reach the same result and thereby meet the EEE Test. We therefore recommend that Treas. Reg. § 1.704-2(e) be extended to apply to allocations of nonrecourse deductions by a partnership that satisfies the EEE Test. Adopting this recommendation should require minimal changes to the Deemed PIP Rules, since for target allocations to meet the EEE Test, these deductions would have to be carved out of the target methodology and made (and offset) in the manner outlined by those rules.

6. Benefits of Clarifying the Treatment of Target Allocations under the EEE Test

Given the widespread (probably dominant) use of cash-driven distributions and target allocations, the usefulness of the 704(b) Regulations to taxpayers and the government is materially diminished because the treatment of target allocations under the EEE Test is unclear. We believe, therefore, that clarifying the EEE Test as outlined above would materially improve these regulations and benefit both taxpayers and the government.[74]

Even if our recommendation regarding guidance providing that target allocations will generally be respected under PIP is accepted, making these clarifications with respect to the EEE Test are necessary to clarify when allocations of residual nonrecourse deductions will be respected under Treas. Reg. § 1.752-3(a)(3) in partnerships where the Safe Harbor is not met. This section generally requires residual nonrecourse liabilities of a partnership to be allocated in accordance with the partners' shares of partnership profits, provided that allocations of some item of profit in that manner would meet the SEE Standard. Therefore, clarifying the treatment

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[73] Treas. Reg. § 1.704-2(e)(1).

[74] A comprehensive summary of our recommendations is provided in Part II of the report.

of target allocations under the EEE Test will also clarify permitted allocations of residual nonrecourse liabilities for partnerships using target allocations.

As to Treas. Reg. § 1.752-3(a)(3), we further recommend, however, that partnerships using target allocations be permitted to allocate their residual nonrecourse liability in accordance with fixed percentages that are reasonably consistent with expected allocations of profit based on the target method being used. This is because the target method of allocating Book Income/Loss is by definition not based on a fixed percentage with respect to any particular item. Such allocations can vary from year to year based on changing liquidation rights (for example, because of an accruing preferred rate of return). Therefore, for target allocations to be used as a reference point for allocating these liabilities, taxpayers need to be able to adopt a percentage that is reasonably consistent with the expected target allocations.

Finally, clarifying the EEE Test as it applies to target allocations would also help clarify their treatment under Section 514(c)(9)(E). This Section sets forth a requirement (the fractions rule) that must be satisfied so that indebtedness incurred by a partnership with respect to the purchase or improvement of real property does not constitute acquisition indebtedness for purposes of the unrelated business income tax, where the partnership has both exempt and non-exempt partners. One of the requirements that must be met to satisfy the fractions rule is that the partnership's allocations must meet the SEE Standard. Therefore, clarifying the treatment of target allocations under the EEE Test will also clarify the range of permitted allocations under Section 514(c)(9). Today, many taxpayers investing in real estate partnerships would significantly prefer to use target allocations but do not do so because they are concerned that the allocations would violate Section 514(c)(9).

GLOSSARY OF DEFINED TERMS

- "704(b) Regulations" means the Treasury Regulations issued under Section 704(b) of the Internal Revenue Code of 1986, as amended, with respect to the allocation of partnership income, gain, loss, deduction or credit (or item thereof).

- "Adjusted Capital Accounts" means capital accounts as adjusted for certain debits that are expected to be made to the partners' capital accounts as provided in paragraphs (4), (5) and (6) of Treas. Reg. § 1.704-1(b)(2)(ii)(d).

- "Alternate Test" means the test for economic effect provided in Treas. Reg. §1.704-1(b)(2)(ii)(d) pursuant to which the allocations of a partnership that does not contain a DRO but meets the Liquidation Requirement and maintains Safe Harbor Capital Accounts will be treated as meeting the Safe Harbor, which very generally requires that the partnership agreement contain a QIO Provision and avoid allocations that would create or increase a deficit Adjusted Capital Account balance in excess of any DRO (including by making adjustments to take account of anticipated distributions and allocations).

- "Book Income/Loss" means the amount of income, gain, loss and deduction (or items thereof) allocable for purposes of maintaining Safe Harbor Capital Accounts. Such amount is referred to as "Book Income" when such amount is positive and "Book Loss" when such amount is negative.

- "Book Value" means the value of the partnership assets as carried on the partnership's books for purposes of maintaining Safe Harbor Capital Accounts. The Book Value a partnership asset is generally its tax basis as adjusted to its fair market value on certain events and as adjusted for amortization and depreciation based on such Book Value.

- "Comparative PIP Test" means the test under Treas. Reg. § 1.704-1(b)(3)(iii) pursuant to which PIP is determined with respect allocations that do not have (but are eligible to have) economic effect very generally by comparing (i) the manner in which distributions would be made if all partnership property were sold at Book Value and the partnership were liquidated immediately following the end of the taxable year to which the allocation relates with (ii) the manner in which distributions would be made if all partnership property were sold at Book Value and liquidated immediately following the end of the prior taxable year.

- "Deemed Liquidation Amount" means the amounts distributable to the partners if, upon a hypothetical liquidation of the partnership, all of the partnership's assets were sold for their Book Value.

- "Deemed PIP Rules" means the rules under Treas. Reg. § 1.704-1(b)(4) and Treas. Reg. § 1.704-2 addressing when allocations will be deemed to be in accordance with PIP even though such allocations cannot have economic effect.

- "DRO" means the obligation of a partner with a deficit capital account balances to restore such deficit upon liquidation of the partnership. A DRO is required under Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3) in order for a partnership to comply with the Primary Requirements.

- "EEE Result" means for any year the allocation result that would occur if the partnership were to satisfy all of the Primary Requirements and liquidate at the end of that year.

- "EEE Test" means the test under Treas. Reg. § 1.704-1(b)(2)(ii)(i) pursuant to which allocations that do not otherwise meet the Safe Harbor will be deemed to have economic effect if at the end of that year and each future year a liquidation of the partnership at the end of such year or at the end of any future year would produce the EEE Result, regardless of the economic performance of the partnership.

- "Liquidation Requirement" means the requirement under Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2) that, in order to comply with the Primary Requirements, the partnership's liquidating distributions must be made in accordance with the partners' capital account balances.

- "One-Step Process" refers to the method of allocating gross items of Book Income/Loss to force the partners' capital account balances to equal the Deemed Liquidation Amount under which net Book Income/Loss is allocated under the target allocation mechanism, with gross allocations used to the extent (and only to the extent) necessary to achieve the Safe Harbor Result and with each gross item allocated in the same proportions as the net items.

- "Partner Nonrecourse Debt" means nonrecourse liabilities of the partnership for which a partner or related person bears the economic risk of loss under Treas. Reg. § 1.752-2.

- "PIP" refers to a partner's interest in the partnership, or the partners' interests in the partnership, and means the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to an allocation of partnership income, gain, loss, deduction, or credit (or item thereof), as determined under the PIP Rules.

- "PIP Rules" means the rules under Treas. Reg. § 1.704-1(b)(3) for determining PIP.

- "Primary Requirements" means the safe harbor requirements for economic effect provided in Treas. Reg. § 1.704-1(b)(2)(ii)(b). To satisfy the Primary Requirements, a partnership must maintain Safe Harbor Capital Accounts, (ii) satisfy the Liquidation Requirement and (iii) have a DRO.

- "QIO Provision" means a provision in the partnership agreement requiring that any partner who has a deficit balance in its Adjusted Capital Account as a result of unexpectedly receiving an adjustment, allocation or distribution described in paragraphs (4), (5) and (6) of Treas. Reg. § 1.704-1(b)(2)(ii)(d), be allocated items of future income or gain in an amount and manner sufficient to eliminate such deficit balance as quickly as possible.

- "Regulatory Allocations" means allocations of certain items of Book Income/Loss which cannot have economic effect.

- "Safe Harbor" means the rules under Treas. Reg. § 1.704-1(b)(2)(ii)(b) and (d) which treat an allocation as having economic effect if either the Primary Requirements or the Alternate Test is met.

- "Safe Harbor Capital Accounts" means capital accounts maintained under the rules prescribed by Treas. Reg. § 1.704-1(b)(2)(iv).

- "Safe Harbor Result" means the allocation result that would have been obtained had the partnership met the Safe Harbor (including the Liquidation Requirement) and liquidated in the year of allocation in accordance with the partnership's cash-driven liquidation provisions and assuming that the value of the partnership's assets equal the value used for purposes of maintaining Safe Harbor Capital Accounts.

- "SEE Standard" means the substantial economic effect standard pursuant to which an allocation of partnership income, gain, loss, deduction or credit (or item thereof) will be respected only if it is considered to have substantial economic effect under Treas. Reg. § 1.704-1(b)(2).

- "Two-Step Process" refers to the method of allocating gross items of Book Income/Loss to force the partners' capital account balances to equal the Deemed Liquidation Amount under which each gross item of income and deduction is allocated sequentially, in each case per the target allocation mechanism.