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Report No. 1502
October 10, 2024

The Honorable Aviva Aron-Dine
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Daniel I. Werfel
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Marjorie A. Rollinson
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

Re: NYSBA Tax Section Report No. 1502 - Report on Section 704(b)

Dear Mses. Aron-Dine and Rollinson, and Mr. Werfel:

Please see attached Report No. 1502 of the Tax Section of the New York State Bar Association, which discusses the allocation of partnership tax items among partners under Section 704(a) and (b).

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Jiyeon Lee-Lim
Chair

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Enclosure

cc:

Shelley de Alth Leonard
Acting Deputy Assistant Secretary (Tax Policy)
Department of the Treasury

Krishna Vallabhaneni
Tax Legislative Counsel
Department of the Treasury

Sarah Haradon
Attorney Advisor (Office of the Tax Legislative Counsel)
Department of Treasury

William M. Paul
Principal Deputy Chief Counsel and Deputy Chief Counsel (Technical)
Internal Revenue Service

Holly A. Porter
Associate Chief Counsel (Passthroughs & Special Industries)
Internal Revenue Service

Clifford M. Warren
Special Level Counsel, Office of Associate Chief Counsel (Passthroughs & Special Industries)
Internal Revenue Service

Report No. 1502

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON SECTION 704(B)

October 10, 2024

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I. Introduction

This report (the "Report")[1] discusses the allocation of partnership tax items among partners under section 704(a) and (b).[2] Generally, a partnership may allocate to a partner its distributive share of income, gain, loss, deduction, or credit (or item thereof) in one of two manners: First, the partnership may decide on a specific allocation for such item if the partnership agreement provides for such allocation and such allocation has "substantial economic effect" ("SEE"). Second, in all other cases, the item must be allocated in accordance with a "partner's interest in the partnership" ("PIP").[3]

These rules are complex. Section 704(b) in its current form was enacted in 1976 and has not been amended since then. The implementing Treasury regulations were promulgated in 1985 and have not been significantly modified since then. The Treasury regulations prescribe detailed rules governing when an allocation will have SEE but include very little guidance on PIP, which is inherently a facts and circumstances analysis.

The New York State Bar Association Tax Section has written several reports addressing various aspects of section 704(b), including in particular a report in 2010 addressing the use of so-called "targeted allocations."[4] There are several reasons for writing this new Report. First, as practitioners, it is our experience that several issues with the SEE rules have led most partnerships (other than tax sensitive partnerships, including tax equity partnerships and partnerships that seek to comply with the fractions rule)[5] to rely on PIP rather than on the SEE rules, and PIP is under-developed. Second, and relatedly, economic arrangements between partners have only become

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[1] The principal authors of this Report are Matt Donnelly, Meyer Fedida, Jennifer Ray, and Kendra Simpson, with substantial assistance from Adriana De Bartolo and Michael Sims. Helpful contributions were made by Jennifer Alexander, Kimberly S. Blanchard, Robert Cassanos, Peter Connors, Edward E. Gonzalez, John Hynes, Bob Kane, Stephen Land, Jiyeon Lee-Lim, Mark Lubin, James Manzione, Richard M. Nugent, Elliot Pisem, Yaron Z. Reich, Stuart Rosow, Michael L. Schler, David H. Schnabel, Vikram Sharma, Eric B. Sloan, Joseph Tootle, Shun Tosaka, and Libin Zhang. This Report reflects solely the views of the New York State Bar Association Tax Section and not those of the New York State Bar Association's Executive Committee or its House of Delegates.

[2] This Report uses the word "partnership" to mean entities classified as partnerships for federal income tax purposes regardless of their legal form.

Any reference to "section" in this Report is a reference to a section of the Internal Revenue Code of 1986, as amended (the "Code"), and any reference to "Treasury regulations" is a reference to a section of the regulations promulgated under the Code (the "regulations") by the U.S. Department of the Treasury ("Treasury," including as applicable, the Internal Revenue Service (the "IRS")).

[3] The regulations provide further that if a partnership agreement provides for an allocation to a partner, the allocation will be respected under the section 704(b) regulations if (i) such allocation has substantial economic effect under Treasury regulations section 1.704-1(b)(2) (SEE), (ii) such allocation is in accordance with partners' interest in the partnership under Treasury regulations section 1.704-1(b)(3) (PIP), or (iii) such allocation is deemed to be accordance with PIP under a set of special rules prescribed in Treasury regulations section 1.704-1(b)(4). *See* generally Treasury regulations section 1.704-1(b)(1)(i).

[4] New York State Bar Association Tax Section, Report No. 1219, *Report on Partnership Target Allocations* (Sep. 23, 2010) (the "2010 Report").

[5] *See* section 514(c)(9)(E); Treasury regulations section 1.514(c)-(2); Prop. Treasury regulations section 1.514(c)-(2) and New York State Bar Association Tax Section, Report No. 1368, *Proposed Regulations Under Section 514(c)(9)(E)* (March 29, 2017).

more complex, raising more questions on the application of the SEE rules and of PIP to relatively common fact patterns. Third, Treasury and the IRS have expressed their intent to focus more resources on partnerships. Finally, the partnership audit regime was significantly overhauled by the Bipartisan Budget Act of 2015, now requiring (among other matters) computational assumptions for the imputed underpayment that can result in very significant taxes when income is reallocated from one partner to another. Against this background, we believe that more regulatory clarity on PIP and the SEE rules could save significant enforcement resources while also providing more certainty to taxpayers.

Before we delve in the discussion of these rules, it is important to note what this Report does not address. First, this Report discusses common business arrangements among third parties and thus does not address issues that may arise in related-party arrangements. Second, Senate Finance Committee Chair Ron Wyden has proposed many significant changes to partnership taxation, including a number that would impact partnership tax allocations and provide that all allocations of partnership items follow PIP (other than with respect to certain controlled partnerships that would be subject to a flat percentage method).[6] This Report does not discuss these proposals, although they underscore the importance that PIP has taken on.

This Report is organized in five parts. Part II summarizes our recommendations for Treasury and the IRS to provide guidance on PIP, as well as approaches to revising the SEE rules. Part III provides a summary of the legislative history behind section 704(b) and Treasury regulations section 1.704-1, leading up to present day and the practical issues with the current SEE regime. Part IV discusses the PIP regime and several underlying principles that we believe guide the proper application of PIP. We then apply these principles to some common business arrangements and propose recommendations for issuing further guidance on how to apply PIP in these scenarios. Part V discusses the SEE rules and provides suggestions for improvement.

II. Summary of Recommendations

A. General PIP Guidance. We encourage Treasury and the IRS to provide more guidance on the application of PIP. This includes:

1. Reiterating that the SEE rules (as defined below) are a safe harbor and thus do not determine what is permitted under PIP.

2. Confirming that, in partnerships in which the economic arrangements are driven by cash distributions (particularly partnerships with a term), allocations should be made to maximize the likelihood that income is allocated to the partner who will ultimately receive the economic benefit associated with that income, rather than relying on other provisions of subchapter K to tax a cash distribution.

[6] *See* Wyden Pass-through Reform Discussion Draft (released Sept. 10, 2021), available at https://www.finance.senate.gov/imo/media/doc/Wyden%20Pass-through%20Reform%20Section%20by%20Section.pdf.

3. Providing a clearer articulation of whether tax reduction is relevant to the determination of PIP and if so, how. We offer some thoughts in this respect.

4. Confirming that (i) for a single set of facts and circumstances, there may be multiple allocation approaches that satisfy the standard prescribed in Treasury regulations section 1.704-1(b)(3), and (ii) the method adopted by the partnership will be respected so long as it satisfies the standard prescribed in Treasury regulations section 1.704-1(b)(3) even if the IRS proposes an alternative allocation that also satisfies the standard prescribed in Treasury regulations section 1.704-1(b)(3).

5. Confirming that a factor in determining whether an allocation approach satisfies the standard prescribed in Treasury regulations section 1.704-1(b)(3) is whether the allocation is consistent with the allocation approach previously used by the partnership and, if it is not consistent, the reason for the change.

6. Confirming that (i) the PIP allocation methodology should be tested at the time it is first agreed upon (similar to the substantiality prong of the SEE rules, which tests any allocation "at the time the allocation becomes part of the partnership agreement"),[7] (ii) if there is a material and unexpected change in facts such that the original methodology is unreasonable, the partnership should be required to change its method so that its allocations are in accordance with PIP, and (iii) absent a material change in facts, any material change in a taxpayer's PIP allocation methods should be subject to re-testing and to a higher burden of proof (and disclosure in the partnership's tax return).

7. Reiterating that PIP determinations for certain economic arrangements include the taxpayer's reasonable expectations of reasonably possible outcomes at the time an allocation is made.

8. Valuation.

   (a) If a reliable, regular, fair market valuation that is produced for non-tax reasons is available for a particular asset (as discussed in more detailed in this Report below), it generally must be taken into account for measuring PIP with two exceptions:

      (i) First, if the partnership reasonably believes that there is another more accurate measure of value, taking into account all of the facts and circumstances (*e.g.*, the property is subject to lockup), in which case we believe that the

[7] Treasury regulations section 1.704-1(b)(2)(iii)(a).

partnership should be required to disclose and justify such other value.

(ii) Second, a partnership that uses a "typical" targeted allocation methodology should be permitted to use section 704(b) book value.

In addition, we would recommend that with respect to property that is depreciable or amortizable for federal income tax purposes (or the section 704(b) book value of which otherwise changes without regard to a revaluation, sale, or exchange of the property), certain simplifying conventions apply (as discussed in Part IV.B.3).

(b) If a non-tax valuation is not regularly available for an asset, the partnership generally should be able to assume the asset value equals its section 704(b) book value. Such section 704(b) book values could be rebutted by the partnership or the IRS if they lead to materially inaccurate results. However, if the partnership seeks to use another measure of value, it would need to provide explicit disclosure in its tax return that it has relied on a valuation that was not used for non-tax purposes.

9. Confirming that a targeted allocation mechanism that is adopted at the beginning of the partnership's life and consistently implemented is consistent with PIP. In addition, if the targeted allocation mechanism includes a so-called "flex" provision allowing the partnership to depart from the targeted allocation, we believe that the exercise of flex would properly be subject to re-testing when used for reasonableness and genuineness, as well as indicia of tax avoidance principal purpose.

B. Specific Guidance under PIP. We recommend that Treasury and the IRS provide guidance (including by way of examples) illustrating the application of PIP to certain common, but complex, fact patterns, including:

1. Preferred Returns and Net Profit Participations. We recommend that Treasury and the IRS confirm that, under PIP, both targeted allocations and "anticipatory allocations" (as described below) may be used to account for preferred returns (that are not guaranteed payments) and net profit participations.

For this purpose, an anticipatory allocation would need (i) to be based on the partnership's reasonable expectations at the time the allocations are made; (ii) in the case of a preferred return accrual, to be based on a prescribed reasonable period of time (we recommend no more than five years absent specific facts); and (iii) once adopted, to be consistently followed (and any change, including any exercise of "flex" allocations, would be subject to scrutiny).

In addition, we recommend that the IRS include in its guidance examples that illustrate the application of PIP to various common waterfalls. This Report suggests a few examples.

2. Noneconomic income. We recommend that Treasury and the IRS confirm that allocations of noneconomic items (*i.e.*, section 704(b) items of income, gain, loss, or deduction that are not matched by corresponding appreciation or depreciation in value) will be respected so long as (i) they are made in a manner that is reasonable and consistent with the allocation of one or more significant items of income, gain, loss, or deduction (as applicable, depending on the type of noneconomic item) of the partnership, and (ii) the allocation mechanics result in a matching of any corresponding item (*e.g.*, where the initial noneconomic item is an item of income or gain, a subsequent noneconomic item of loss or reduction in gain) to the same partner. We would further recommend a requirement that the partnership disclose its method for allocating noneconomic items on its tax return in the year of allocation.

3. Partial Rollover/Tracing. In a situation in which a partnership has assets with the same relevant attributes (*e.g.*, character and long-term or short-term holding period) and distributes a portion of those assets to some partners while selling another portion, we recommend that the IRS confirm that it is consistent with PIP for the partnership to allocate the revaluation gain with respect to the distributed portion to the distributees and to allocate the taxable income or gain with respect to the portion that is sold in accordance with the sharing ratio for the cash.[8] Not only does this kind of allocation appropriately link the different kinds of allocations with the partners receiving the particular property, but it also minimizes the creation of disparities between a partner's basis in its partnership interest (outside basis) and the partner's share of basis in partnership assets (inside basis).

C. Form of Guidance. Much of the PIP guidance recommended in Part II.A and Part II.B above reflects a request for further articulation of current law or a demonstration of the application of a statutory facts-and-circumstances determination. We acknowledge throughout this Report that the law concerning PIP is under-articulated, and therefore we do not recommend Treasury and the IRS attempt a complete restatement of the PIP regulations (nor do we believe that it would be necessary). Instead, we believe most of the guidance requested under PIP could be addressed by way of some additional regulatory examples of the application of PIP in common scenarios—a practical approach to such fact-dependent law that we ourselves have taken here and which is heavily relied upon in the SEE regulations.

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[8] As this recommendation involves allocation of gain under section 704(b), and section 704(c) is generally outside the scope of this Report, we do not discuss so-called "section 704(c) stuffing" allocations (or section 704(b) "fill up" allocations) in situations other than the partial rollover/tracing.

D. SEE Rules. We believe it would be in both the government's and taxpayers' interest to have more taxpayers follow the SEE rules: it would be beneficial for the government because these rules are mechanical, require less judgment than PIP, and therefore would allow for increased compliance and more efficient audits. It would also be beneficial for the taxpayers to be able to rely on the SEE rules because it would provide more simplicity and certainty. We suggest some improvements that could be made to the SEE rules to encourage taxpayers to rely on these rules instead of PIP.

1. We recommend removing the "full term" requirement from the SEE rules to allow partnerships to come into compliance with the SEE rules. If a partnership wishes to come into compliance with the SEE rules, we recommend that Treasury and the IRS provide for a procedure that would allow the partnership to do a catch-up allocation to reverse known past errors, as compared to the allocations that would have been made as if all past items were allocated correctly.

2. While we do not propose a complete removal of the requirement that liquidations be made in accordance with positive capital account balances, in order to make the SEE rules more relevant and practical, we would propose modifying them to provide additional safe harbors for certain arrangements that do not require liquidation in accordance with positive capital account balances.

   We recommend that the SEE rules be amended to specifically provide for "targeted allocations" to be covered by the SEE safe harbor. We recommend for this purpose that:

   (a) "noneconomic items" would be outside of the targeted allocations and the partnership be permitted to allocate "noneconomic" items in a reasonable manner consistent with the allocation of items of the same sign to one or more partners, with an allocation of the corresponding opposite sign item to the same partner, in each case outside of the "target."

   (b) for assets that are subject to regular non-tax valuations, the safe harbor allow partnerships to use either section 704(b) book value or fair market value for those assets. If this recommendation is not accepted, we recommend that targeted allocations be treated as presumptively satisfying PIP.

   (c) a regulatory safe harbor allow use of net profit or loss, and also allow allocation of gross items if necessary, when there is insufficient net profit, to account for preferred returns. The partnership agreement should provide a consistent method for determining whether it is necessary to allocate gross items and how they will be allocated for its entire life.

(d) if a targeted allocation provision allows more general flexibility for the partnership to exercise discretion in making allocations in a manner that more consistently reflects the economic arrangement, such provision would not cause allocations to fall outside of the safe harbor unless and until such discretion is actually exercised. If and when the discretion is exercised, (i) the allocations could still be consistent with the PIP test depending on the facts and circumstances, and (ii) the partnership should be required to disclose departing from SEE. In addition, exercising such flexibility with respect to "noneconomic items" (*i.e.*, in accordance with recommendation D.2(a) above) would not cause the partnership to fall outside the safe harbor (since these deductions would not be through the targeted allocations).

In addition, we recommend that targeted allocations described in the 2010 Report (*i.e.*, that reach the "Safe Harbor Result" as the term was used in that report) or that meet the requirements of the additional safe harbor recommended in this Report also be deemed to have economic effect for the purposes of section 168(h)(6) and section 514(c)(9)(E).

3. Revaluations.

(a) We recommend that the proposed regulations adding recapitalizations as a permissible revaluation event be finalized.[9]

(b) Given the extreme complexity that revaluations can generate, we recommend that they remain discretionary.

(c) Finally, revaluations may result in inside-outside basis disparities when the allocation of a revaluation gain does not align with how the assets are ultimately distributed. In this situation, we recommend allowing the partners to reallocate or exchange reverse section 704(c) amounts on property with the same character and holding period to prevent or mitigate creation of inside-outside basis disparities. While section 704(c) is generally outside the scope of this Report, we recommend that Treasury and the IRS amend the section 704(c) regulations to permit such a reallocation.

4. DROs and QIOs.

(a) We recommend that the SEE rules be amended to allow a partner with a deficit restoration obligation ("DRO") to repay until the later of (i) the date that the partnership is required to file (or, if earlier,

[9] Prop. Treasury regulations section1.704-1(b)(2)(iv)(*f*)(*5*)(*v*). In the preamble to the proposed regulations, Treasury and the IRS noted that they agree that recapitalizations should be added as a permissible event in order to preserve each partner's share of unrealized built-in gain or loss, absent an addition of a special allocation of unrealized gain or loss in the partnership agreement. REG–151416–06, 79 Fed. Reg. 65151 (Nov. 3, 2014).

actually files) its final tax return, and (ii) 180 days after the date of liquidation.

(b) We recommend that the SEE rules be amended to provide that the QIO mechanism applies to any deficit capital account, including if the partner's capital account becomes negative as a result of an expected distribution.

III. History

This Part IIIIII starts our discussion of section 704(b) and the regulations promulgated thereunder by providing a brief overview of their history.

A. 1954 Code

The Code and each of its predecessor codes and revenue acts have had rules stating that partners (and, generally, not the partnership) are subject to tax on their "divided" or "distributive" shares of their partnership's income, regardless of whether or not actually distributed.[10] However, no revenue act, predecessor tax code, or regulations attempted to define "divided" or "distributive" share until the 1954 code. Pre-1954 caselaw and regulatory and sub-regulatory guidance was sparse but recognized the need for flexibility in the partnership form subject to limitations on tax avoidance.[11] Articulating this standard has been a challenge ever since.

Sections 704(a)-(b) of the 1954 code (which Congress observed in the 1954 legislative history were "new" but "substantially in accord with existing practice"[12]) attempted to define the "distributive share" of a partner by providing that an allocation of a partnership item had to follow the allocation of its non-separately stated income (under section 702(a)(9) of the 1954 code) *unless* the partnership agreement provided otherwise *and* such provision did not have as the principal purpose the avoidance or evasion of federal income tax.[13]

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[10] Partnerships were subject to an excess profits tax under the War Revenue Act of 1917, and for taxable years after 2017, can be assessed an imputed underpayment on audit under the rules of subchapter C of Chapter 63 of the Code.

[11] *See* Jacob Rabkin & Mark H. Johnson, *The Partnership under the Federal Tax Laws*, 55 HARV. L. REV. 909 (1942); Paul Little, FEDERAL INCOME TAXATION OF PARTNERSHIPS, 399-408 (1952); Arthur Willis, HANDBOOK OF PARTNERSHIP TAXATION, 138-139 (1957); Matt Donnelly, *The Imperfect Approach*, 102 TAXES 25, 26-29 (March 2024).

[12] S. Rep. No. 83-1622, at 379 (1954).

[13] Section 704 of the 1954 code read as follows:

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

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

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

In discussing the "principal purpose" test, the Senate Finance Committee report on the 1954 code coined the "substantial economic effect" phrase and observed that "[w]here … a provision in a partnership agreement for a special allocation of certain items has substantial economic effect and is not merely a device for reducing the taxes of certain partners without actually affecting their shares of partnership income, then such a provision will be recognized for tax purposes."[14] It added that, for example, a partnership agreement can provide that one partner receives all of the partnership's tax-exempt interest while another partner receives all of the partnership's dividend income, unless it is "a device for the allocation of the interest exemption without any real economic effect on either partner's share of the total partnership income."[15]

The Treasury regulations under section 704(b) of the 1954 code provided further context on the principal purpose test:

> In determining whether the principal purpose of any provision in the partnership agreement for a special allocation is the avoidance or evasion of Federal income tax, the provision must be considered in relation to all the surrounding facts and circumstances. Among the relevant circumstances are the following: whether the partnership or a partner individually has a business purpose for the allocation; whether the allocation has "substantial economic effect," that is, whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences; whether related items of income, gain, loss, deduction, or credit from the same source are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocation.[16]

After the enactment of the 1954 code and the promulgation of the 1956 regulations, there was little caselaw or guidance with respect to section 704(b). However, contemporary commentary from the era and three important cases yield two observations about the 1954 code and related guidance. First, notwithstanding the multi-pronged facts-and-circumstances test in the 1956 Treasury regulations, the "substantial economic effect" prong was widely understood as the principal indicator that a special allocation of an item did not have tax avoidance or evasion as its principal purpose.[17] Second, the specific wording of section 704 of the 1954 code provided that an allocation of a partnership "item" that was not respected under the principal purpose test was to be allocated in the same manner as the partnership's non-separately stated income. That

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

[14] *Id.*

[15] *Id.*

[16] T.D. 6175, 19 Fed. Reg. 3,500 (May 25, 1956).

[17] *See, e.g.*, Martin B. Cowan, PARTNERSHIP—DISTRIBUTIVE SHARES—DISALLOWANCE OF SPECIAL ALLOCATIONS, BNA TAX MGMT PORTFOLIO 283 (1973), at A-5-6; William S. McKee, William F. Nelson & Robert L. Whitmire, *The Tax Reform Act of 1976: Changes Affecting the Taxation of Partnerships and Partners*, 33 TAX L. REV. 485, 499 (1978).

statutory construct led to the interpretation that only special allocations of partnership items, but not "bottom line" allocations of net income or loss, were subject to the statute's "principal purpose" limitation.[18]

B. The Emergence of PIP

In the Tax Reform of 1976, Congress amended section 704(b) of the 1954 code to address both of these issues by codifying the substantial economic effect rules and introducing the concept of a "partner's interest in the partnership." The resulting language remains the language of section 704(b) today.[19]

In particular, the Tax Reform of 1976 made three key changes to section 704: First, it revised section 704(b) such that it applied to *all* allocations of income (*i.e.*, "bottom line" allocations of net income or loss as well as allocations of individual items of income, gain, loss, and deduction). Second, it replaced the 1954 "principal purpose … of tax avoidance or evasion" standard in section 704(b)(2) with the "substantial economic effect" prong from the 1956 regulations. Third, to avoid circularity and to create a default allocation for a partnership allocation that did not fall within the substantial economic effect prong, it introduced the statutory term a "partner's interest in the partnership."

The legislative history is not as detailed as one would hope, but it does provide a few helpful clarifications with respect to these changes.

First, it is clear from the legislative history that PIP was not intended as a straight-up, flat percentage of the partnership's income, but rather as a more nuanced analysis that respected all the facts and circumstances and the flexibility that partnerships afford. Thus, the Senate Finance Committee Report noted:

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18 *Kresser v. Commissioner*, 54 T.C. 1621 (1970); *Orrisch v. Commissioner*, 55 T.C. 395 (1970), aff'd per curiam, 31 A.F.T.R.2d 1069 (9th Cir. 1973); *Harris v. Commissioner*, 61 T.C. 770 (1974); *see also* Sherwin Kamin, *Partnership Income and Loss Allocations before and after the Tax Reform Act of 1976*, 30 TAX LAW. 667 (1977).

Kresser in particular included this important footnote:

> We do not here pass upon the Government's argument that sec. 704(b)(2) is fatal to the petitioners' position in this case. While we are fully prepared to accept the contention that the principal purpose of the alleged modifications was the "avoidance or evasion" of tax … within the meaning to sec. 704(b)(2), we are faced with the petitioners' troublesome argument that sec. 704(b)(2) applies only to "items" of income, etc., dealt with in pars. (1) through (8) of sec. 702(a) and does not govern par. (9) relating to the composite of all of the partnership's income (sometimes referred to as its "ordinary income") which is here involved. The point is not without difficulty. Although there is general language in *Smith v. Commissioner*, 331 F. 2d 298, 301 (C.A. 7), in accord with the Government's argument, the structure of the statute itself and language in the legislative history would seem to give support to petitioners' position. *See* S. Rept. No. 1622, 83d Cong., 2d Sess., p. 379. However, in view of our conclusion that there was not in fact a bona fide reallocation of income among the partners, we do not reach the question whether sec. 704(b)(2) is applicable to sec. 702(a)(9).

Kresser, at 1631, n. 5.

19 Tax Reform Act of 1976, Pub. L. No. 94-455, § 213(f), 90 Stat. 1520, 1548 (1976).

> If an allocation made by the partnership is set aside, a partner's share of the income, gain, loss, deduction or credit (or item thereof) will be determined in accordance with his interest in the partnership, taking into account all facts and circumstances.
>
> In determining a "partner's interest in the partnership", all the facts and circumstances are to be taken into account. Among the relevant factors to be taken into account are the interests of the respective partners in profits and losses (if different from that of taxable income or loss), cash flow; and their rights to distributions of capital upon liquidation.[20]

Second, the "substantial economic effect" standard generally requires the use of capital accounts and was intended to build upon the 1956 regulations.[21] The Joint Committee Report noted:

> The determination of whether an allocation may actually affect the dollar amount of the partners' share of total partnership income or loss, independent of tax consequences, will to a substantial extent involve an examination of how these allocations are treated in the partners' capital accounts for financial (as opposed to tax) accounting purposes: this assumes that these accounts actually reflect the dollar amounts that the partners would have the rights to receive upon the liquidation of the partnership.[22]

C. The Current State of Affairs

Regulations under the amended section 704(b) were proposed in 1983 and finalized in 1985. While there have been numerous conforming updates and a handful of amendments in the intervening years, the structure and material provisions of the 1985 regulations remain, without meaningful change, the law today.

The principal focus of the 1985 regulations was the "substantial economic effect" requirement of section 704(b)(2) (which we refer to as the "SEE rules" in this Report). The 1985 regulations fashion the "substantial economic effect" requirement into a safe harbor that can be satisfied only by allocations that comport with (or have the exact same effect as comporting with) the accounting and economic strictures of the 1985 regulations.[23] We discuss the SEE rules in more detail in Part V below, but, at a high level, the test for substantial economic effect is a two-part analysis. First, the purported allocation must have economic effect, which generally requires,

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[20] S. Rep. 94-938 (1976), at 100.

[21] Numerous commentators before 1976 advocated reliance on partnership capital accounts to demonstrate "substantial economic effect." *See, e.g.*, Donald McDonald, *New Partnership Regulations*, 9 MAJOR TAX PLAN. 171, 179 (1957).

[22] Staff of J. Comm. on Tax'n, General Explanation of the Tax Reform Act of 1976, JCS 33-76, at 95 n.6 (1976).

The Joint Committee also observed, in its explanation of section 704(b), that "other factors that could possibly relate to the determination of the validity of an allocation are set forth under the present regulations" and cited the 1956 regulations. *Id.* at 94-95.

[23] *See, e.g.*, Alan Gunn, *The Character of a Partner's Distributive Share under the Substantial Economic Effect Regulations*, 40 TAX LAW. 121, 123 (1986).

for the full term of the partnership, (i) the proper maintenance of capital accounts, (ii) liquidation of the partnership in accordance with positive capital account balances by the end of the taxable year of liquidation or, if later, within 90 days after liquidation, and (iii) a qualified income offset or deficit restoration obligation.[24] Second, that economic effect must be substantial. Although the substantiality rules are complex, an allocation will be substantial if "there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences." PIP is the benchmark against which the after-tax consequences of the purported allocation must be tested.[25]

By contrast, the 1985 regulations provide sparse guidance on PIP. They emphasize that PIP is a facts-and-circumstances analysis and define PIP as "the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated."[26] The regulations go on to note that, except with respect to partnership items that cannot have economic effect (such as nonrecourse deductions of the partnership), this sharing arrangement may or may not correspond to the overall economic arrangement of the partners. The regulations then cite, as a non-exhaustive list of factors, the factors cited in the Senate Finance Committee Report, that is: (i) the partners' relative contributions to the partnership, (ii) the interests of the partners in economic profits and losses (if different than that in taxable income or loss), (iii) the interests of the partners in cash flow and other non-liquidating distributions, and (iv) the rights of the partners to distributions of capital upon liquidation.[27]

The regulations include 40 examples, the vast majority of which are focused on the SEE rules. Notwithstanding the acknowledgement in the regulations that the sharing arrangement under PIP may or may not be the overall economic arrangement of the partners, all examples address situations in which the PIP analysis results in a pro-rata, straight-up bottom-line allocation of income or loss.

Furthermore, post-1985 caselaw and sub-regulatory guidance interpreting both the SEE rules and PIP have also been limited and, in the case of PIP, not necessarily uniform in approach or application.[28] For example, the IRS will not issue a ruling or determination letter regarding whether an allocation to a partner is in accordance with PIP or the SEE rules.[29]

At the same time, contemporary commentary and institutional memory support the observation that the amendments made in the Tax Reform of 1976 and the 1985 regulations were adopted in an era when partnerships were deployed in limited circumstances—largely professional services firms, family partnerships, real estate ventures, and tax shelter arrangements. In addition, by forcing the regulations' accounting mechanisms to take precedence over any other economic

[24] Treasury regulations section 1.704-1(b)(2).

[25] Treasury regulations section 1.704-1(b)(2)(iii)(a).

[26] Treasury regulations section 1.704-1(b)(3)(i).

[27] Treasury regulations section 1.704-1(b)(3)(ii).

[28] *See, e.g.*, Paul Carman, *In Search of Partner's Interest in the Partnership: The Alternative of Substantial Economic Effect*, J. of Tax'n (Oct. 2007).

[29] Rev. Proc. 2024-3, 2024-1 IRB 143.

arrangement upon liquidation, the SEE rules are, in most instances, suitable only for transactions that are more focused on assuring the parties' after-tax outcomes than their pre-tax outcomes (for example, tax equity arrangements).[30] These rules are not particularly attuned to the practice of many commercial businesses and investment vehicles operating today as partnerships, which have complex ownership arrangements and cash-distribution waterfalls that evolved to accommodate complex business arrangements and market requirements.

Looking at the period since 1985, it is hard to overstate the increase in the use of partnerships in commercial transactions. Partnerships are ubiquitous and are found in all corners of the business world: joint ventures, securitization vehicles, investment funds, real estate projects, and oil and gas partnerships. This is due to many factors, including the final repeal of the *General Utilities* doctrine in 1986, the reduction in personal income tax rates relative to corporate income tax rates, the widespread adoption of limited liability company statutes throughout the 1990s (and the IRS's confirmation that such entities could be classified as partnerships), and the substantial flexibility that partnerships and limited liability companies provide in tailoring business arrangements between parties (as compared to common shares and preferred shares arrangements in a corporation).[31] To take one example among many, a July 2023 report from the Governmental Accountability Office stated that, between 2002 and 2019, the number of large partnerships—those with over $100 million in assets and 100 or more partners—increased almost 600 percent.[32] Likewise, the latest IRS Statistics of Income (SOI) Division Partnership Returns OneSheet indicates that partnerships filed more than 4 million returns for Tax Year 2021, representing more than 30.6 million partners.[33]

D. Practical Issues with the SEE Rules

Before we discuss the PIP regime, it is important to note that, in our experience, most modern partnerships do not liquidate in accordance with capital accounts as required under the SEE rules. Indeed, partnerships liquidate in accordance with the capital accounts (and otherwise follow the strict SEE rules) only in partnerships in which the tax allocations are an essential aspect of the business arrangement (*e.g.*, tax credit structures or partnerships that need to comply with the fractions rule).[34]

We discuss the current challenges raised by the SEE rules in Part V, below, and provide recommendations for certain changes, but at a high level the main reasons for this state of affairs are:

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[30] *See* Thomas W. Henning & William M. Ruddy, *Partnership Allocations—Drafting the Partnership Agreement to Meet the Safe Harbor and Fit the Economic Deal*, 41 MAJ. TAX PLANNING ¶ 2205.1 (1989).

[31] *See* Susan Pace Hammill, *The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure*, in BUSINESS TAX STORIES 295 (2005); Rev. Rul. 88-76, 1988-2 C.B. 360.

[32] Gov't Accountability Office, *Tax Enforcement: IRS Audit Processes Can Be Strengthened to Address a Growing Number of Large, Complex Partnerships* (July 27, 2023), available at https://www.gao.gov/products/gao-23-106020.

[33] IRS Publication 5338 (Rev. 4–2024), available at https://www.irs.gov/pub/irs-pdf/p5338.pdf.

[34] *See*, *e.g.*, Rev. Proc. 2020-12, 2020-11 IRB; Rev. Proc. 2007-65, 2007-2 CB 967.

- Liquidation in accordance with capital accounts. The SEE rules require that a partnership liquidate in accordance with positive capital accounts. This is the most significant issue with the SEE rules. Business parties need to have a clear understanding of the economics of the transaction and cannot accept that the economics would ultimately depend on tax rules. Stated differently, the capital accounting rules are complex and cannot be understood by non-tax experts (and, in some cases, non-partnership tax experts). In addition, even for partnership tax experts, there has been an exponential increase in complexity of economic arrangements between partners, making it very difficult to draft an allocation of profits and losses that will always reach the intended economic result.

- Full-term compliance. Capital accounts must have been maintained correctly for the entire duration of the partnership. There is, however, uncertainty in how to maintain capital accounts in some common business transactions, including recapitalizations or redemptions.

- Revaluations. Under the SEE rules, a partnership may need to revalue its assets to reflect the economic arrangement between the partners. Revaluations introduce additional complexity, such as new section 704(c) layers on each asset, and there is potential for multiple revaluations every year. This is, in practice, an extremely complex system to operate.[35] Furthermore, revaluations can create inside-outside basis disparities if revaluation gain is allocated to partners who do not end up receiving a distribution of the revalued asset or sharing the proceeds from disposition of that asset.

- Substantiality. The substantiality test compares the results of the allocations under the partnership agreement with the results under PIP. As discussed in this Report, PIP is under-articulated, which makes any substantiality testing under the SEE rules confusing. In addition, the test is challenging to apply when dealing with large partnerships (or partnerships in which the parties are not related) because the test requires the partnership to take into account the after-tax impact of the allocations on each partner and, if a partner is a look-through entity, on the partner's owners.

IV. PIP Regime

This Part IV discusses some aspects of the PIP regime. We begin by articulating in Part IV.A some principles that we believe inform PIP determinations under current law. Some of these principles date from the promulgation of the current regulations in 1985, while others have informed the determination of partnership allocations for over a century. While we would encourage Treasury and the IRS to communicate these principles formally to taxpayers and agents in the interest of providing certainty and reducing transaction costs, we believe that, in all cases, these principles (however under-articulated) reflect the proper application of section 704(b). Part

[35] Revaluations can also be relevant in partnerships with PIP arrangements and similarly can create complexity. However, because those partnerships generally liquidate in accordance with an agreed cash waterfall, revaluations for section 704 purposes are not necessary to ensure that partners receive their economic entitlements.

IV.B then discusses our experience and views on applying PIP to certain common business arrangements and provides recommendations for guidance.

Much of the PIP guidance recommended in this Part IV reflects a request for further articulation of current law or a demonstration of the application of a statutory facts-and-circumstances determination. As noted in this Report, we acknowledge that the law concerning PIP is under-articulated, and therefore we do not recommend Treasury and the IRS attempt a complete restatement of the PIP regulations (nor do we believe that this would be necessary). Instead, we believe most of the guidance requested under PIP could be addressed by way of some additional regulatory examples of the application of PIP in common scenarios—a practical approach to such fact-dependent law that this Report itself takes and which is heavily relied upon in the SEE regulations.

A. Principles

1. PIP and the SEE Safe Harbor

As an initial observation that is almost self-evident, we note that the SEE rules are a safe harbor and are not determinative of PIP. This is clear from the text of section 704(b), the structure of Treasury regulations section 1.704-1(b) (which states that "there are three ways in which such allocation will be respected under section 704(b)…," only one of which is the SEE rules),[36] and the history of section 704(b) (discussed in Part III, above). Nevertheless, we are aware that IRS agents have on occasion asserted that determinations under PIP must conform to the allocations that would result under the SEE rules, which is why we are reiterating this principle.[37]

Naturally, we understand the inclination of certain taxpayers to approach compliance with section 704(b) by initial reference to the SEE rules. After all, Treasury regulations section 1.704-1(b)(2) is ordered first in the regulation, is thousands of words longer than the PIP regulations, and is explained by dozens of regulatory examples, whereas the portions dealing with PIP are short and under-articulated. We agree that, in some cases, the SEE rules may help inform PIP determinations: for instance, the widely-used targeted allocation method (discussed in Part IV.A.5 below) that has been endorsed in multiple reports of the New York State Bar Association Tax Section (including in this Report) is based on the capital account maintenance rules of Treasury regulations section 1.704-1(b)(2)(iv), even if it does not technically fit within the SEE rules.[38] As a result, many partnership agreements that rely on PIP are replete with cross-references to the SEE rules and even maintain capital accounts in partial compliance with the SEE rules for purposes of applying the targeted allocation method (as well for purposes of applying section 704(c) and Treasury regulations section 1.704-2).

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36 Treasury regulations section 1.704-1(b)(1) (emphasis added).

37 The fact that the SEE rules are not explicitly labeled as a safe harbor seems to be a simple quirk of history, as the regulations were published in the wake of Congress's brief experiment with "safe harbor leasing." John Pierson, *Treasury to Tighten Section 704(b) Partnership Regulations*, 20 Tax Notes Fed. (TA) 491 (Aug. 8, 1983) ("'[S]afe harbor' is a sufficiently powerful curse these days to give the Treasury pause.").

38 *See* 2010 Report and Part IV.A.5, below for a discussion of targeted allocations.

That said, the SEE rules are a safe harbor, like any other, and therefore are not determinative of the broader facts-and-circumstances test (here, PIP) from which it provides protection to taxpayers. As a result, allocations under PIP do not need to (where even possible) also satisfy the SEE rules to be respected.

2. Proper Reflection of Income

Partnerships allow for a seemingly endless variety of business arrangements between their partners both from a legal and tax perspective. We believe that, in economic arrangements that are driven by cash distributions (particularly partnerships with a term), PIP must be implemented in order to maximize the likelihood that income is allocated to the partner who will ultimately receive the economic benefit from that income, rather than relying on other provisions of subchapter K to tax a cash distribution. In addition, we believe that the nature of the PIP determination is such that it does not sanction allocations that have tax avoidance as their principal purpose: while this aspect of PIP is difficult to articulate precisely in light of the limited legislative history of the PIP standard, we include some thoughts on its operation in Part IV.A.2(b), below.

(a) Aligning Income and Cash Flows

The key principle of subchapter K as enunciated by its very first section (section 701) is that a partnership is not subject to tax. Rather, the partnership's income is allocated to its partners, and the partners pay their taxes on such income. This means both that income derived through a partnership cannot be subject to double taxation (as would be the case in subchapter C) but also that it must be included in income at least once.[39] Subchapter K ensures that this is true by measuring income at the partnership level and by allocating it to its partners (who are then subject to tax on the income so allocated). A series of provisions, including section 731(a) and section 732, then operate to ensure that no income or distribution escapes taxation by taxing distributions of cash that exceeds the partner's basis in its partnership interest and by preserving the built-in gain or loss in property that can be distributed tax-free.

While these adjustment mechanics work well to preserve the total quantum of gain or loss and subchapter K works to preserve character in some cases, a key goal of subchapter K is to ensure a proper reflection of income.[40] Section 704(b) determinations are the better mechanism to accomplish this goal than sections 731 and 732. A very simple example illustrates the issue, as well as several principles we believe govern section 704(b).

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[39] Of course, inclusion in income does not necessarily mean taxed if, for example, a partner is not subject to tax on a particular item by virtue of the partner's own tax status.

[40] *See*, *e.g.*, Treasury regulations section 1.701-2(a)(3). ("[T]he tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, proper reflection of income)" unless "clearly contemplated" by another provision or provisions of subchapter K and the Treasury regulation that "were adopted to promote administrative convenience and other policy objectives.").

Example 1 A and B form a partnership, PRS,[41] by each contributing $10. In 2024, PRS earns $100 of ordinary income matched by an equivalent cash receipt. Under the terms of the PRS partnership agreement, that cash will be distributed in 2028 based on the performance of an external uncontrolled index in 2028. In 2024, A and B expect all $100 of that cash to be distributed (in 2028) to A. Accordingly, in 2024, PRS allocates the $100 of income to A based on the parties' expectation at the time the 2024 return is filed as to how they will ultimately share the cash.

In 2028, contrary to the previous expectations of the partners, the performance of the index favors Partner B, and the $100 of cash earned in 2024 is distributed to Partner B.

In 2029, PRS liquidates, and each of A and B receives its $10 back.

Because of the $100 allocation of income to A in 2024, A's outside basis increases from $10 to $110 under section 705(a). In 2028, B would have $90 of long-term capital gain under section 731(a)(1) (being the difference between the $100 of cash received and B's $10 of basis in PRS). Ultimately, when PRS liquidates, A has $100 of capital loss (equal to the difference between the $10 of cash received and its $110 basis in PRS), and B has $10 of long-term capital gain (equal to the difference between $10 received and its $0 basis in PRS).

The net effect of this arrangement is that A has been subject to tax on ordinary income in 2024 and obtained a non-offsetting capital loss in 2029. By contrast, B recognizes $90 of capital gain in 2028 and $10 of capital gain in 2029. The proper amount of income (*i.e.*, $100) is subject to tax, but, in hindsight, the character and timing consequences do not clearly reflect the partners' economic income.[42]

Relying on section 731(a) or the other provisions of subchapter K to tax the income generated by the partnership should therefore be seen as a "last resort," and the purpose of an allocation under PIP should be to align the income allocations and economic entitlements. This is consistent with the Treasury regulations that define PIP as the "manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated."[43] Indeed, the four main factors specifically articulated in Treasury regulations section 1.704-1(b)(3)(ii) (relative contributions to partnerships, interests in economic profits and losses, interest in cash flow and other non-liquidating distributions, and interest in liquidating distributions) all would be the key elements to take into account in determining the taxation of a distribution to a partner.

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[41] In this example, PRS has no other income or loss; has no other assets, activities, or debt; and makes no other distributions during the period.

[42] If the partnership has other assets, section 734(b) or (d) may operate to mitigate this result by adjusting the partnership's basis in its other property, thereby accelerating the recognition of the built-in gain by B and the deduction by A to a disposition event or to the cost recovery of such property. Nevertheless, since this mechanism depends on the attributes of the other property, it does not guarantee that the proper character is preserved. *See* Howard Abrams, *The Section 734(b) Basis Adjustment Needs Repair*, 57 TAX LAW. 343, 345-351 (2004).

[43] Treasury regulations section 1.704-1(b)(3).

This Part IV.A.2(a) recommends that particular weight be given to cash distributions in determining whether an allocation is properly made in accordance with PIP. We believe this is especially true in finite-term partnerships in which cash distributions (and their timing) are particularly important to the parties' arrangement. We acknowledge that PIP is ultimately a facts-and-circumstances test and the distributions (liquidating and non-liquidating) are just two of the factors listed in Treasury regulations section 1.704-1(b)(3). Nevertheless, in commercial transactions in which the parties' fundamental economic arrangement is based on how and when partnership cash or other property will be distributed to the partners (and particularly if the partnership has a term),[44] we believe distribution waterfalls are particularly indicative of PIP. By contrast, the economic deal in a commercial joint venture that is intended to be a permanent vehicle and is entered into to develop and exploit a resource or technology may be principally based on the parties' relative contributions of funds, know-how or other property, and, therefore, those contributions may be more appropriately indicative of PIP.[45]

(b) Substantiality

PIP, like the SEE rules, recognizes the flexibility allowed to partners in structuring commercial arrangements. In our experience, in arrangements that are entered into among unrelated parties and are struck on pre-tax terms, there is ordinarily no reason not to respect the terms of the business arrangement, and tax items should be allocated accordingly under PIP.[46] In these pre-tax arrangements, each party's tax consequences resulting from the partnership's section 704(b) allocations generally are understood to be each party's own issue (outside the purview of the transaction), and the parties' course of dealing and partnership agreement typically do not reflect any assurance of any party's after-tax outcome under section 704(b) or otherwise.[47] If anything, when it comes to agreeing on the tax allocations in such transactions, we find that parties are most interested in having as much certainty as tax advisors can provide that their allocation will not materially deviate from the cash or property to which they are entitled under the terms of their partnership agreement.

Having said this, we appreciate the potential difficulty of trying to determine whether an agreement has been struck on pre-tax terms. The presence of tax-indifferent or tax-benefited partners (*e.g.*, partners who are tax-exempt entities, partners in different tax brackets or eligible for preferential tax rates, or partners with expiring tax attributes eligible to offset partnership income or gain) may in some cases raise a question of whether the partners have agreed to a "pre-tax economic deal" that would not have been agreed to but for the partner's tax benefits. Under

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[44] For this purpose, a partnership can have a term either measured in specific reasonable number of years or based on the accomplishment of a specific project (*e.g.*, the partnership liquidates after it builds and sells a building).

[45] *See, e.g.*, *PNRC Limited Partnership v. Commissioner*, T.C. Memo 1993-335 (reallocating under PIP in accordance with capital contributions); *Tobias v. Commissioner*, T.C. Memo 2001-37 (same); *Harrell v. Commissioner*, T.C. Memo 1978-211 (same); IRS Field Serv. Adv. 200131013 (Aug. 3, 2001) (respecting apparent PIP allocation in accordance with capital contributions).

[46] As noted in Part I, this Report does not discuss the application of PIP in the context of related parties, as we acknowledge that assessing the true nature of a partner's interest in the partnership in this context can be uniquely challenging.

[47] By contrast, unrelated parties often negotiate over after-tax allocation outcomes when agreeing to section 704(c) methods.

the SEE rules, the substantiality prong aims to limit the allowable partner-level tax savings resulting from allocations that depart from a pre-tax economic deal but do so only after finding an impermissible tax reduction as compared to the taxes that would be payable based on the allocations under PIP. In other words, the SEE rules themselves assume that the true pre-tax economic deal (the "baseline") can be determined based on an assessment of all of the facts and circumstances.

The substantiality prong of the SEE rules does not apply to allocations under PIP. In addition, none of the factors enumerated in the regulations to determine what PIP is reference the tax impact of the purported allocation. Nonetheless, we believe that PIP itself includes an inquiry into the partners' purported economic arrangements that takes into account federal tax effects. This inquiry (and specifically, the time and manner in which such tax effects are taken into account) has not been consistently or meaningfully articulated by Congress, the courts, or the IRS. That it exists, however, can be gleaned from the history of section 704(b) and the regulations thereunder.

This inquiry inherent in PIP arguably pre-dates subchapter K itself. We have discussed the history of section 704(b) in Part IIIIII, above. As noted there, when sections 704(a)-(b) were initially enacted as part of the 1954 code, they were intended as a codification of pre-1954 law and provided that special allocations of items were not respected if their "principal purpose … [was] the avoidance or evasion of any [federal income] tax."[48] In discussing the principal purpose test from the 1954 code, the Senate Finance Committee effectively defined an allocation with a substantial economic effect as an allocation that is "not merely a device for reducing the taxes of certain partners without affecting their shares of partnership income."[49]

The Senate Finance Committee went on to give an example of a partnership that specially allocates tax-exempt interest to one partner and taxable dividend income to another partner, observing that such an allocation would be respected "unless it is a device for an allocation of the interest exemption without any real economic effect on either partner's share of total partnership income."[50] As subsequently noted by in an important 1956 study by the American Law Institute, the Senate Finance Committee's barebones example lacked two important facts necessary to establish actual tax avoidance and that are critical to understanding the scope of the "principal purpose" concern that was reflected in the 1954 code and we believe survived in the 1976 amendment to section 704(b). Importantly, both facts were subsequently addressed in regulations.

The missing facts are perhaps obvious but worth unpacking to understand the core of Congress's concern. First, the partners in the example needed to be subject to tax at different effective rates (due to entity classification, marginal tax bracket, attributes, etc.) for the arrangement to have actually reduced overall taxes. The allocation of the interest exemption was not itself the source of any tax avoidance because such an allocation would be inoffensive among similarly situated taxpayers. Rather, tax avoidance resided in the overall impact of the

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48 1954 Internal Revenue Code, section 704.

49 S. Rep. No. 83-1622, at 379 (1954).

50 The example served as the basis for an example in the 1956 and current regulations. *See infra* note 54 and accompanying text.

arrangement—that is, the shifting, in effect, of the economic benefit of partner-specific inalienable tax attributes (exemption, bracket headroom, expiring loss carryovers, etc.) from one partner to another. Second, implicit in the Committee's reference to an impermissible arrangement constituting a "device" was that such an outcome was indeed intended by (or the "principal purpose" of) the parties. These two facts (economic transfer of attributes; purpose) could be readily inferred from the arrangement if the parties either performed the allocation after the income had been earned (but before the relevant year's tax return was filed) or if the parties had a sufficiently clear expectation as to the income of the partnership.

The Senate Finance Committee's examples were refined in the 1955 proposed regulations and the 1956 final regulations to address the "missing" facts from the Senate Finance Committee's simplified example.[51] Those regulations also explained that a special allocation would have to be considered in relation to all of the surrounding facts and circumstances, including whether there was a business purpose for the allocation and whether the allocation may affect the partners' share of partnership income or loss independent of tax consequences.[52]

The 1985 regulations (which followed the amendment to section 704(b) in 1976) moved away from a facts-and-circumstances test for SEE and instead aimed to make the test more prescriptive.[53] An allocation that has economic effect and satisfies the SEE rules' substantiality prong is respected under the SEE safe harbor. An allocation that does not satisfy substantiality is tested under PIP, which is determined by taking into account all the facts and circumstances "relating to the economic arrangement of the partners." Although none of the factors specifically enumerated to determine PIP references the particular tax circumstances of the partners, we believe the various factors that have been considered relevant since 1954 are relevant in determining PIP. Those factors include (i) whether a particular allocation or distribution right affects the partners' share of expected partnership income or loss independent of tax considerations, (ii) whether there is a business purpose for that right, (iii) whether the same consequences could have been achieved if the property were owned or payment were made outside the partnership (and such ownership or payment outside of the partnership would be consistent with the overall economic arrangement), and (iv) whether a special allocation (or distribution provision) is designed and expected to reduce materially the total tax of the partners when there is another allocation (or distribution provision) that is equally consistent with the partners' economic arrangement but would not be expected to reduce materially the total tax of the partners. In many transactions between unrelated parties, these questions will be easy to answer. But, as noted above, the presence of tax-indifferent or

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51 Example 3 of the 1956 regulations dropped reference to "a device for the allocation of tax-exempt interest," referring instead broadly to the presence of "tax avoidance or evasion." The 1956 example also further emphasized the critical importance of objectively predictable income to such a scheme by adding in the potentially permissive version of the facts that each partner was not only allocated the interest or dividends (as applicable) but also all gain or loss from the bonds and stock, respectively. Such gain or loss (which is typically materially less predictable than interest or dividend income) presumably offers a stronger indication that a disguised exchange of tax attributes cannot be inferred from the arrangement.

52 *See* Treasury regulations section 1.704-1(b)(2) (1956).

53 For example, there is no "business purpose" prong of substantiality. However, because substantiality uses PIP as a baseline, and because PIP depends on the facts and circumstances (presumably including business purpose), it is not clear that the Treasury regulations have succeeded in making substantiality a more prescriptive test.

tax-benefited partners (including indirect partners) may call a particular allocation (or distribution provision meant to attract an allocation) into question.

To be clear, we do not think this determination requires inquiry into the interior motives of the partners: this would be, practically speaking, very challenging because partnerships are almost always intended to be tax-efficient. Instead, we believe that such an inquiry must be based on objective facts and circumstances, including those above.

Consider the following example, based on Example 7 of the section 704(b) regulations[54] (which has its origins in the incomplete example from the 1954 legislative history discussed above and revised in the 1956 regulations):[55]

> **Example 2** M and N are partners in the MN partnership. Generally, income, gain, loss, and deduction from the MN business are allocated equally between M and N.
>
> In order to enhance the credit standing of the partnership, M and N contribute equal amounts to the partnership and agree to invest in equal dollar amounts of tax-exempt bonds and corporate stock for the partnership's first three taxable years. M is expected to be in a higher marginal tax bracket than N during those three years. M and N generally agree to share income and sale proceeds from the stock and bonds equally, except that in the first year, M will be allocated 90 percent and N 10 percent of the interest income from the tax-exempt bonds, and N will be allocated 90 percent and M 10 percent of the income from the corporate stock, in each case up to the first $10,000 of income from each. M and N will share the cash in the same manner. At the time they make this agreement, there is a strong likelihood that the partnership will earn more than $10,000 of taxable dividends and more than $10,000 of tax-exempt interest in its first year.
>
> The example concludes that, under the SEE test, the special allocation of the first $10,000 is not substantial because there is a strong likelihood that the two allocations will offset, and the total taxes of the partners will be reduced as a result of the allocations.

In the context of the SEE rules, an allocation fails the substantiality test if it is not expected to affect the dollar amounts to be received by the partners (independent of tax consequences) and if it reduces the aggregate amount of income tax payable by the partners. To determine whether an allocation reduces tax, it must be compared to the PIP result as a baseline. In the example above, the contributions were all made in a 50-50 proportion. All distributions were also expected to be made 50-50. Although the partners had agreed to a different economic sharing of the first $10,000 of two different kinds of income, there was a strong likelihood that the partnership would have more than that amount of each kind of income. Thus, it was anticipated that all distributions

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[54] Treasury regulations section 1.704-1(b)(6), Example 7. Under the example in the regulations, MN maintains capital accounts, liquidating distributions are made in accordance with positive capital account balances, and both partners agree to a DRO.

[55] S. Rep. No. 83-1622, at 379 (1954) and Treasury regulations section 1.704-1(b)(2), Example 3 (1956).

would, in fact, be made 50-50. There is no indication that the parties had a non-tax substantial business purpose for the special allocation of income, which decreased the aggregate tax liability of the partners (in effect, the facts make it readily inferable that the parties' purpose was to transfer the economic benefit of a portion of the headroom in N's lower tax bracket to M). Therefore, it seems relatively straightforward to conclude (as the regulations do) that the allocation was made principally to avoid tax and that PIP in this example was a 50-50 sharing of all items of the partnership even if the partnership agreement provided for distributions to be in accordance with a stated waterfall (including the special distributions of cash attributable to the first $10,000 of each kind of income).

But PIP may respect allocations that are not permitted under the SEE rules. For instance, in some situations, an allocation may be respected under PIP even if the overall economics would not be affected by the allocation (or by the special sharing of distributions). Consider the same example as above but assume that it is illegal for M to receive any of the cash attributable to the dividend income. Therefore, the parties agree that M will receive all of the tax-exempt income and N will receive all of the dividend income. At the time they agree to this allocation, assume that there is a strong likelihood that the partnership will earn equal amounts of the two kinds of income. Here, although it is an unusual case, it seems clear that the parties would have agreed to this special sharing without regard to their tax attributes (*i.e.*, its purpose was clearly to save M from the consequences of receiving illegal income, not to transfer a portion of the headroom in N's lower tax bracket to M), such that the allocation was not made with the principal purpose of tax avoidance. Therefore, PIP should respect the special allocations of income.[56]

Furthermore, an allocation that affects economics may be respected under PIP even if it results in a tax savings. Assume, for instance, that M and N agreed to a different economic arrangement such that M and N share in the profits (other than the profits and losses generated by the specific tax-exempt bond and corporate stock) equally, but because M prefers the relative safety of a bond investment over a stock investment, the parties decide that M is allocated (and bears economically) all profits and losses (*i.e.*, interest as well as gains and losses) from the tax-exempt bond, and N is allocated (and bears economically) all profits and losses from the corporate stock (dividends, gains and losses). The stock and bond are ordinarily fundamentally different

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[56] Another example of a PIP allocation that may be respected even if it would not be permitted under the SEE rules can arise in the context of allocation of losses in partnerships with "qualified income offsets." As discussed below in Part V, under the SEE rules, a partnership agreement that does not have an unlimited "deficit restoration obligation" in place can satisfy the "alternate test" for economic effect by including a "qualified income offset" that reallocates income or gain in the event a partner incurs certain specific unanticipated adjustments, allocations or distributions listed in Treasury regulations section 1.704-1(b)(2)(ii)(*d*)(*4*)-(*6*) that drive the partner's capital account downward (and cannot themselves be reallocated under section 704(b)). Under these rules, regular allocations to such a partner are deemed to have economic effect, and income or gain reallocated to the partner under the "qualified income offset" is deemed to satisfy PIP.

However, such "qualified income offsets" are often drafted broadly to address any capital account deficit (and not just an "adjusted capital account deficit" that technically triggers a "qualified income offset" under the SEE rules). In the event such a partnership were to allocate an item of deduction or loss to a partner that was not described in Treasury regulations section 1.704-1(b)(2)(ii)(*d*)(*4*)-(*6*) and caused the partner's capital account to go negative in an amount in excess of the amount of the partner is (or is deemed) obligated to restore, the allocation would not be respected under the SEE rules. However, if there is an expected allocation of income to that partner in subsequent years that will be allocated to such partner pursuant to the partnership agreement and erase the deficit, the allocation may still satisfy PIP.

investments and cannot be expected to perform identically. The facts lack the necessary objective indication that the parties' principal purpose was to transfer N's tax attribute to M; indeed, the arrangement is practically akin to the ownership of the stocks and bonds by the partners outside the partnership. Indeed, the fact that the arrangement could be achieved outside subchapter K would seem all but determinative of whether subchapter K should respect it.[57] We see no reason why this allocation, which will affect cash flows, would not be respected under PIP, even if, as a result, M is allocated tax-exempt income and therefore the total tax liability of the partners is lower than if everything had been allocated proportionately to each partner.[58]

Finally, in other situations, the SEE rules may permit allocations that would not be respected under PIP. For instance, consider a variation on Example 2 in which M and N generally agree to share income and sale proceeds from the stock and bonds equally, except that in the first year, N (the lower-bracket taxpayer) will be allocated 90 percent and M (the higher-bracket taxpayer) 10 percent of the interest income from the tax-exempt bonds, and M will be allocated 90 percent and N 10 percent of the income from the corporate stock, in each case up to the first $10,000 of income from each. If these allocations had economic effect, it appears that they would satisfy substantiality, as they do not result in a reduction in the partners' aggregate tax liability. We do not believe they would satisfy PIP, however, because they are not consistent with the actual economic sharing of the items of income.

We recommend a clearer articulation of these principles under section 704(b), both for the proper and efficient administration of the tax law and to provide certainty and reduce transaction costs in the types of commercial arrangements discussed in Part IV.B below, especially because many tax-exempt entities (*e.g.*, state or private pension funds, university endowments, and sovereign wealth funds) are significant economic actors. That said, we would anticipate that allocations that are consistent with common business arrangements that have meaningful non-tax economic impacts and that were not put in place with the principal purpose of tax avoidance (in particular in the section 704(b) context, no principal purpose of effecting the transfer of tax attributes between partners) would be respected.

3. Principles for Applying PIP

There are three additional principles that we believe inform PIP and that are implicit in its "facts and circumstances" framework and the "principal purpose" inquiry discussed above: first, there can be multiple reasonable ways of determining PIP from a common set of "facts and

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[57] We do not suggest the application of such a principle be extended to segregate the arrangement into multiple partnership or undivided ownership arrangements because subchapter K has clearly and definitively respected such special allocations within single partnerships since at least 1954. *See* Rev. Rul. 57-138, 1957-1 C.B. 543, *revoking* Rev. Rul. 56-134, C.B. 1956-1, 649, and *distinguishing* O.D. 140, C.B. 1, 174 (1919).

[58] *See also infra* note 51. Of course, we believe on these facts that the SEE rules would reach the same result since the benchmark for the substantiality test is the result under PIP.

Similarly, if MN were to invest in two bonds with different yields and different credit profiles—one tax exempt bond that is investment grade (with a lower return reflecting both the tax-exempt nature and the creditworthiness of the issuer) and one taxable bond that is not investment grade (with a higher return reflecting both the fact that the yield is taxable and the riskiness of the investment), and M preferred to bear the profits and losses of the tax-exempt bond while N bears the profits and losses of the taxable bond, we believe the allocation would be respected under PIP.

circumstances"; second, "tax avoidance" purposes should not be inferred from a partnership arrangement to the extent that overall tax savings at issue result from subsequent and unforeseen changes in facts and that a partnership allocation for which no such impermissible tax savings were reasonably foreseeable upon adoption of the original scheme should continue to be respected (provided that such scheme is consistently maintained); and third, PIP determinations for certain economic arrangements are based on the partnership's reasonable expectations of reasonably possible outcomes at the time an allocation is made.

PIP is defined by the regulations as the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated.[59] This is a determination based on all the facts and circumstances. Partnership arrangements often involve complex economic sharing of certain items of income, gain, loss, deduction, or credit over the course of many years. Indeed, partnerships are often used precisely because they allow for such complex sharing from a legal and tax perspective. As a result, and as with any facts-and-circumstances determination, different parties can often reasonably draw different conclusions from the same facts and circumstances at the time an allocation must be made. (For instance, it is entirely possible that the partner who will receive the benefit of an item of income cannot be determined with certainty at the time an allocation must be made (*see* Part IV.B, below). In this situation, different parties may reasonably have different expectations as to which partner will get such benefit.) In addition, Treasury regulations section 1.704-1(b)(3)(ii) lists different factors relevant to the parties' economic arrangement that can themselves be given different weight by different parties. Finally, Treasury regulations section 1.704-1(b)(3)(ii) is explicit that the factors it lists in determining whether an allocation is in accordance with the PIP standard are not an exhaustive list (stating "the following factors are among those that will be considered…"). Thus, for example, in addition to current economic indicators, PIP is also implicitly informed by the historic performance of the partnership and can take into account historic allocations of partnership income, gain, loss, and deduction in the interest of achieving a clear reflection of the partners' income. In light of all these factors, an attempt to determine a single "true" PIP allocation in every situation would, in our view, be futile. Indeed, it is evident that Congress and the drafters of the regulations believed and were comfortable with the fact that there will often be multiple ways of allocating the same partnership items that are equally valid. We provide various examples of such situations in Part IV.B, below.

In addition, PIP (and section 704(b) more generally) takes into account the entire life of a partnership and the allocation of each item in each year must be respected as in accordance with PIP. "Tax avoidance" outcomes via partnership allocations can in some instances be achieved by varying allocations over the course of multiple tax years, for example, via so-called "transitory allocations" that are subject to special principles in the SEE rules.[60] Therefore, it is appropriate for the IRS to scrutinize the effect of partnership allocations under PIP over multiple years for indications of impermissible tax attribute shifting by partners. By the same token, however, a finding of impermissible "tax avoidance" should continue to require some external indicia of a negotiated understanding among the partners—as noted above, either an allocation adopted *ex post facto* or one adopted in advance but with the benefit of a predictable stream of tax items around

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[59] Treasury regulations section 1.704-1(b)(3)(i).

[60] *See* Treasury regulations 1.704-1(b)(2)(iii)(c).

which to construct a "tax avoidance" transaction. Where, upon adoption of the relevant allocations, no such impermissible tax savings was reasonably foreseeable, a subsequent change in facts resulting in mere tax savings should not permit a "tax avoidance" motive to be imputed with hindsight. In Example 2 above, in which partners M and N agree to specially allocate tax-exempt interest and taxable dividend income among themselves, no "tax avoidance" purpose would be inferable at adoption of the allocations were M and N instead in the same tax bracket (and there were no other facts indicating an exchange of partner tax attributes); however, were M to win the lottery in year 3 and as a result find herself in a higher tax bracket going forward, that mere change in facts should not retroactively imbue their arrangement with a different purpose (even if its effect is now overall tax savings).

For taxpayers to demonstrate this, however, it is critical for an allocation approach to be applied consistently throughout the life of the partnership. Varying approaches over time runs the risk of tax-motivated decisions as to the allocations. As a result, we believe that (i) the PIP allocation methodology should be tested for "tax avoidance" purposes at the time it is first agreed upon (similar to the substantiality prong of the SEE rules, which tests any allocation "at the time the allocation becomes part of the partnership agreement"),[61] (ii) if there is a material and unexpected change in facts such that the original methodology is unreasonable (without impermissible use of hindsight to impute nonexistent original purposes, as noted in the example above), the partnership should be required to change its method so that its allocations are in accordance with PIP, and (iii) absent a material change in facts, any material change in a taxpayer's PIP allocation method should be subject to re-testing for "tax avoidance" purposes and to a higher burden of proof of the bona fide of such allocation method. The IRS could require that any material change of allocation method be disclosed in the partnership's tax return.

Finally, although Treasury regulations section 1.704-1(b)(3) does not itself contain explicit reference to "reasonable expectations" or "reasonable possibilities," we believe that PIP requires the partnership, at the time of the allocation (or, if a formulaic approach is used, when the methodology becomes a part of the partnership agreement), to make a reasonable assessment of the future performance of the partnership. Reasonable expectations also inform the parties' expected after-tax consequences for purposes of assessing the presence or absence of "tax avoidance" purposes.[62] This is implicit in determinations under current law because PIP requires an assessment of the partners' interest in liquidating and non-liquidating cash flows. This observation is also based on our actual practice, which routinely involves making determinations of PIP and section 704(b) allocations based on both historic partnership performance and also forward-looking projections or assumptions. We believe that this reasonableness standard is appropriate because the very terms of "reasonableness" are a readily judiciable standard that is routinely employed in the Code, subchapter K guidance and by the courts in analogous contexts.[63]

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[61] Treasury regulations section 1.704-1(b)(2)(iii)(a).

[62] In the immediately preceding example, M and N reasonably anticipate being in the same tax bracket for the life of the arrangement; by contrast, if M did not win the lottery in year 3 but instead came into the same fortune by inheritance from a deceased relative who was terminally ill at the time the partnership was formed, the reasonableness of those same expectations among the parties may warrant greater skepticism.

[63] *See, e.g.*, Treasury regulations sections 1.707-1(c), 1.752-2(k), and 1.752-3(a)(3). Two areas are particularly analogous and inform our comfort with such a standard. Regulatory guidance under section 704(c) answered Congress's call that Treasury and the IRS prescribe regulations to take account of the variation between the basis

Indeed, the SEE rules' substantiality tests in Treasury regulations section 1.704-1(b)(2)(iii) are keyed off determinations of "reasonable possibilities," the "strong likelihood" of events, and present value calculations.

4. Valuation Issues

Valuation is another important issue that is embedded in PIP determinations. Valuation can be relevant in a variety of contexts in which the economic entitlements of the parties depend on the valuation of the property, some of which are discussed in this Report. This is the case, for instance, for preferred returns or carried interest arrangements that are discussed in Part IV.B, below (including in Examples 6-9). That would also be relevant for determining in some cases whether an item of income, gain, deduction or loss is noneconomic (*see* Example 10). More generally, PIP determinations based on reasonable expectations of future performance will often require a determination of the current (and possibly, expected future) value of the partnership's property.

At the start of this discussion, we acknowledge that valuation issues are particularly challenging and time-consuming to audit. The SEE rules resolve this issue rather bluntly by requiring taxpayers to assume that the value of partnership property is its book basis (except in the case of contributions and distributions of property or upon elective revaluations) and use tax cost recovery methods and conventions.[64] Although this assumption is important in the context of a safe harbor (which is intended to promote certainty and administrability), the resulting section 704(b) balance sheet (like GAAP balance sheets) often bears no realistic relationship to actual values, which in turn necessitates a further presumption that such basis is in fact the value for purposes of the substantiality prong of the SEE rules.[65] This can lead to the somewhat bizarre result that a partnership formed for the very purpose of investing in property and selling it at a gain (*e.g.*, an investment partnership) is presumed never to succeed.[66]

PIP allocations, by contrast, generally must accord with the actual facts and circumstances of the economic arrangement (including reasonable expectations of the future economics). A discussion of administrable principles for determining fair market values in all circumstances is

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of contributed property and its fair market value by requiring taxpayers use a "reasonable method" that is "consistent" with the purposes of section 704(c). Treasury regulations section 1.704-3(a). Further, section 7701(o)(2)(A) defines the "profit potential" standard for the economic substance doctrine by reference to "reasonably expected" pre-tax profits and tax benefits.

[64] Treasury regulations section 1.704-1(b)(2)(iii)(c).

[65] Commentators have noted that the "value equals basis" presumption may have been based on and enacted to further administrative convenience, as described in Treasury regulations section 1.701-2(a)(3), which states: "However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income." *See* Karen T. Lohnes, John Schmalz, and Craig Gerson, *Value Equals Basis and Partners' Distributive Share: Stuffing, Fill-Ups, and Waterfalls,* 105 J. Tax'n (Aug. 2006).

[66] For a further discussion of this value equals basis "conundrum," *see* Gregory J. Marich, *Substantial Economic Effect and the Value Equals Basis Conundrum*, 42 Tax L. Rev. 509 (1987).

beyond the scope of this Report, but we offer several observations based on our experiences with section 704(b) that we believe would be helpful to articulate in guidance.

When it comes to determining whether there is a reliable fair market valuation, we believe as a general matter that a degree of deference should be given in PIP determinations to valuations that have material non-tax significance—*e.g.*, values that are reasonably agreed to among the partners in arm's-length negotiations where the partners have sufficiently adverse interests (such as, for instance, valuations used in "applicable financial statements" as described in section 451(b)(3)). Due to the inherent limitations in obtaining such valuations on an asset-by-asset basis, such valuations are most likely in practice to be available for non-operating assets (*e.g.*, investment assets such as stocks and bonds) and lower-tier partnership interests and real estate. We note that the SEE rules already defer to such non-tax valuations to a certain extent because they permit use of valuations and revaluations upon the occurrence of events that presumably would include implied external indications of value (*e.g.*, property contributions and distributions or in revaluation events such as when new interests are issued).[67]

Accordingly, we believe that guidance should be issued providing that, when a reliable fair market valuation that is produced for non-tax reasons is regularly available to the partnership, it generally must be taken into account for measuring PIP (to the extent valuation is relevant to the allocation at issue) subject to the exceptions listed below. We note that for property that is depreciable or amortizable for federal income tax purposes (or the section 704(b) book value of which otherwise changes without regard to a revaluation, sale, or exchange of the property), certain simplifications are appropriate. We discuss these in more detail in Part IV.B.3, below. The IRS may naturally disagree with the valuation methodology used by the partnership, but we recommend that there be a (rebuttable) presumption that a valuation used for a material non-tax purpose is correct.[68] (We discuss further the use of fair market values and PIP in the context of allocations for investment partnerships in Part IV.B.2(b), below.)

We recommend two exceptions to this rule: First, in some cases, a non-tax fair market valuation may not be the more accurate measure of value, taking into account future events that would be relevant under PIP. For example, an investment fund may own an interest in a portfolio company subject to a lockup. For financial statement and LP reporting purposes, it may value that interest without regard to the lockup. However, the lockup is a relevant factor to consider under PIP, especially if the partnership has an outstanding preferred interest with an accreting coupon. Therefore, we recommend that, if a partnership reasonably believes that there is another more accurate measure of value, taking into account all of the circumstances, the partnership should be

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[67] Treasury regulations sections 1.704-1(b)(2)(iv)(d)-(f).

[68] Because this approach is based on the view that non-tax valuations that are disclosed to third party would not be made with tax considerations in mind, we think that it less likely applicable in "closely held" partnerships. Accordingly, a "closely-held" partnership that wants to rely on valuations provided to its owners would need to disclose such fact on its return and would not benefit from such presumption of correctness.

For this purpose, a "closely held" partnership could be defined by analogy to the personal holding company rules of section 542(a)(2), *i.e.*, a partnership where 50 percent or more of the capital of the partnership is owned directly or indirectly by five or fewer individuals. This definition could be further expanded to also cover partnerships where 50 percent or more of the capital of the partnership is owned by an affiliated group of corporations.

able to use that other value, as long as the partnership discloses and justifies such modified value. In such case, the IRS would be permitted to challenge the modified value used by the partnership.

Second, as discussed in Part 5IV.A.5 immediately below (and as previously discussed in our 2010 Report), we believe that if the SEE rules are not modified to approve "targeted allocations," so-called "targeted allocations" should be permitted under PIP. Because that methodology generally follows the capital accounting principles of the SEE rules, we would not propose that a partnership that chooses to use targeted allocations be required to use fair market valuations for purposes of determining its targeted capital accounts (although it could if it so chooses); rather, the partnership should be allowed to use the section 704(b) valuations as long as such method is consistently applied during the life of the partnership.

This discussion so far has addressed the use of fair market value when there is a reliable, non-tax fair market valuation that is regularly available to the partnership. Partnerships that do not perform non-tax valuations should generally be permitted to avoid costly regular valuations merely for tax compliance purposes and should therefore be permitted to use the section 704(b) book valuation rules that are used for maintaining capital accounts in the SEE rules. Such section 704(b) book values could be rebutted by partnership or the IRS if they lead to materially inaccurate results. In order to prevent tax avoidance, in cases where a taxpayer (rather than the IRS) seeks to rebut such presumption by relying on an alternative valuation methodology, then either (1) the taxpayer's alternative valuation methodology would need generally to be reasonably expected to result in the same or a higher aggregate tax liability for the partners or (2) the partnership would need to provide explicit disclosure in its tax return that it has relied on a valuation that does not meet the standards of the prior paragraph. In both cases, the partnership would then need to follow the valuation approach consistently.

5. Targeted Allocations

In our 2010 Report, we described the "targeted allocation" method and recommended that Treasury and the IRS issue guidance confirming that such allocations generally be respected under PIP if they reach the same result as the SEE rules.[69]

Under the targeted allocation method, each partner is allocated an amount of income or loss necessary to cause the partner's capital account balance to equal such partner's economic entitlements in a hypothetical liquidation. In other words, the partnership does not liquidate in accordance with the capital accounts, but the capital accounts are maintained such that each partner's capital account is equal to such partner's entitlement on liquidation.

To accomplish this, the targeted allocation method first compares 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 the end of the relevant period followed by a repayment of creditors and liquidating distribution of the net proceeds (*i.e.*, the "target" capital account) and then "plug" the difference between opening and closing amounts with allocations of income or loss recognized for section 704(b) purposes during

[69] *See* 2010 Report.

the period.[70] As discussed below in Part V.C., in some cases an allocation of the partnership's net profit or loss for the year is insufficient to cause the partners' capital accounts to equal the hypothetical liquidation amounts. In that case, often a partnership agreement will provide for allocation of gross items "as necessary" to achieve that result. By explicitly linking allocations of income and loss to the cash-distribution waterfall in each year, targeted 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 section 704(b) regulations. That is, targeted allocations are not used to minimize or avoid tax or to shift income or loss among partners.[71]

In our experience, targeted allocations (with some modifications discussed below) are used in most partnerships that have been formed in the past two decades, with the notable exception of tax credit partnerships or fractions rule-compliant structures that rely on the SEE rules. Given how ubiquitous this mechanism has become, it is unfortunate that it is not addressed in any guidance under section 704(b). As such, we continue to recommend that Treasury and the IRS issue the guidance recommended in our prior report, broadened as discussed in Part V.C, below. In addition, as discussed in Part V, below, as part of our broader recommendations for an update to the SEE rules, we recommend that the SEE rules explicitly provide a safe harbor for certain targeted allocation arrangements.[72] Finally, unless and until the IRS issues such guidance and given the prevalence of targeted allocations in the market, we would recommend that, at a minimum, Treasury and the IRS confirm (for example, through a Revenue Ruling or an example in the regulations) that a targeted allocation mechanism (as described in our 2010 Report and as further described in Part V.C, below) that is adopted at the start of the partnership's life and consistently implemented satisfies PIP.

As noted in our 2010 Report,[73] support for this approach can be found in Treasury regulations section 1.704-1(b)(3)(iii) (the so-called "Comparative PIP Test"). Under the Comparative PIP Test, an allocation that lacks economic effect under the SEE rules because it does

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70 The targeted allocation generally will carve out certain regulatory items, such as items attributable to nonrecourse liabilities as defined in Treasury regulations section 1.704-2, so that the regulatory items can be allocated first and separately from the rest of the profit or loss under the target. Certain regulatory allocations do not have economic effect, but allocation of these items is generally respected as long as the allocation meets the rules of Treasury regulations section 1.704-2 or Treasury regulations section 1.704-1(b)(4) ("Deemed PIP Rules").

For purposes of allocating all other partnership items, each partner's share of partner minimum gain and minimum gain is added back to the partner's capital account balance. In addition, for purposes of determining the hypothetical amount to be distributed upon liquidation of the partnership, it is assumed 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 at least equals the excess of such debt over the asset's adjusted tax basis. These adjustments allow nonrecourse deductions to be allocated separately in a manner that would be allowed by the Deemed PIP Rules if the partnership agreement met the test for economic effect. *See* 2010 Report at 24-25 (providing example).

71 We discuss further various ways to implement targeted allocations in Part V.C, below.

72 In addition to the benefits of relying on a safe harbor rather than PIP, it is important to confirm that targeted allocations satisfy the SEE rules given the importance of meeting the SEE test to allocations of nonrecourse deductions (under Treasury regulations section 1.704-2), to the application of section 704(c), and to other tax rules (*e.g.*, the fractions rule and section 168(h)(6)).

73 2010 Report at 26-27.

not have a "deficit restoration obligation" or "qualified income offset"[74] (but that otherwise maintains capital accounts in accordance with the SEE rules, liquidates in accordance with positive account balances of capital accounts and makes allocations that are substantial) will be in accordance with PIP if its allocations are determined generally by comparing the manner in which distributions (and contributions) 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 the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the prior taxable year. That is essentially the same approach as that of the targeted capital accounts.

Further, we also regularly encounter partnership agreements that include explicit language that allows the parties to allocate income, gain, loss, deduction, and credit in a manner that departs from the strictures of the targeted allocation language to the extent necessary or advisable to more closely conform to PIP as determined by the parties. This construct is necessary for instance in the situations discussed in Part IV.B, immediately below, and is often referred to as "targeted allocations with flex."[75]

Exercising such "flex" introduces the possibility that the partnership's allocations are "becoming part of the partnership agreement" annually (if not more frequently), and *post hoc*, may create inconsistency issues (*see* Part IV.A.3, above). As such, we believe that the exercise of flex to depart from a plain targeted allocation mechanism would properly be subject to re-testing for reasonableness and genuineness, as well as indicia of tax avoidance principal purpose.[76] Nevertheless, for the reasons discussed in Part IV.B, immediately below, we would not expect the exercise of such "flex" to be controversial in the various fact patterns described below.

B. Common Fact Patterns/Issues Involving Application of PIP

This Part IV.B now turns to four fact patterns that arise in the context of common business arrangements and for which it would be helpful to taxpayers and the government to have more guidance on the application of PIP. Most of these fact patterns fundamentally deal with situations in which it is not known, at the time when income must be allocated, which partner is entitled to the economic benefits associated with the income.

The first two fact patterns (preferred returns and net profit participations, discussed in Parts IV.B.1 and IV.B.2, below) deal with business arrangements that are common in partnerships in

[74] Both concepts are explained in depth below in V.

[75] There are many variations of such language. An example of such language would include, for instance, a provision in the partnership agreement indicating that the partnership may "make appropriate amendments to the allocations of items pursuant to [the targeted allocation provision] if necessary or desirable in order to comply with section 704 of the Code or applicable Treasury regulations thereunder and to conform to the economic provisions of the agreement."

[76] Similar considerations apply in the context of allocations based on a more open-ended PIP formulation (*e.g.*, "allocations in a manner that as closely as possible give effect to the economic entitlements of the partners" or "allocations in accordance with PIP"). By contrast, an allocation mechanism that is consistently applied throughout the life of the partnership (*e.g.*, a classic targeted allocation mechanism) would not be subject to retesting.

which a partner's economic entitlements are measured based on the net effects of transactions that span multiple years. As such, there is uncertainty as to which partner has ultimately earned income at the end of a particular year. Nevertheless, because the "annual accounting" concept requires that income be measured and allocated annually, the income must be allocated before such uncertainty is resolved.[77]

The third fact pattern (noneconomic income, discussed in Part 0, below) addresses situations in which a partnership recognizes income, gain, loss, or deduction that is noneconomic under the factors in Treasury regulations section 1.704-1(b)(3) and thus does not fit neatly into the PIP determination.

Finally, the fourth fact pattern (discussed in Part IV.B.4, below) deals with an in-kind distribution of securities to some partners that wish to retain a specific investment made by a partnership when other partners wish to sell, which we believe is a situation that is increasingly common in the marketplace.

1. Preferred Return

It is common for a partner to have a priority entitlement to a portion of all net profits derived by the partnership. In such a case, although the total income and cash flows earned by the partnership during a specific year are known, the partnership may not be able to reasonably ascertain its future income and losses or whether such future income or cash flows will be sufficient to pay the preferred return partner its priority entitlement or when such distributions will be made. As a result, without the benefit of hindsight, any allocation of annual income may not correspond with the ultimate economics.[78]

This uncertainty is inherent in most preferred returns arrangements, and neither the SEE rules nor the PIP rules provide guidance on how to address it. The SEE rules are silent, and as discussed, PIP focuses on the manner in which the partners have agreed to share the economic benefit or burden, but it may not be possible at the end of the tax year to determine what a partner's allocable share is (taking into account the life of the partnership). As a result, there are at least two ways (albeit imperfect) to try to allocate the partnership's annual income:

- Targeted Allocations: One option would be to use targeted allocations, which, as discussed in Part IV.A.5, above, we believe generally satisfy PIP. In the examples

[77] *See* section 441(a); Treasury regulations section 1.441-1(a)(1). This annual accounting concept was first articulated by the U.S. Supreme Court in *Burnet v. Sanford & Brooks*, where the Court emphasized that tax must be imposed on the net result of all events occurring within each year, even if related events producing a different aggregate result (*e.g.*, a loss) might occur in a later year ("A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss." *Burnet v. Sanford & Brooks Co*, 282 US 359, 363-365 (1931)).

[78] This Report addresses preferred returns that are allocations of income under section 704(b). For a discussion of the interaction between guaranteed payments and preferred returns, please *see* New York State Bar Association Report No. 1357, *Report on Guaranteed Payments and Preferred Returns* (Nov. 14, 2016) (the "2016 Report").

below, we assume targeted allocations are done using section 704(b) book values as of the end of the tax year for which the allocation needs to be made (although as noted, there are other options). As discussed in the examples provided in this Part IV.B, by focusing on a hypothetical liquidation at year end, these tax allocations may end up deviating significantly from the manner in which the corresponding economic items are ultimately shared.

- Anticipatory Allocations: Another approach, so-called "anticipatory allocations," allocates the taxable items of income, gain, loss, or deduction based on the partnership's reasonable expectations as to the outcome of a contingency. Anticipatory allocations, in contrast to targeted allocations, do not focus on a hypothetical (and generally unlikely) liquidation at year end, but rather seek to ensure that the partners' allocations will more approximately track the amounts to which the partners would be entitled in the later year, had the partnership liquidated in that later year based on the partnership's expected outcome of the contingency.

As discussed in more detail below, in cases in which the partnership's relevant expectation is reasonable and consistently applied, this Report recommends that the partnership's anticipatory allocation be respected as consistent with PIP.[79] Of course, like all PIP determinations, the analysis of whether the partnership has a reasonable expectation is an analysis that depends on the particular facts and circumstances. Moreover, in order to demonstrate the reasonableness of the partnership's expectation, it may be advisable for the partnership to document (even informally) the factors it considered in making its determination (and the IRS could reasonably decide, on a prospective basis, to require the partnership to maintain such documentation).[80]

Example 3 A and B form a partnership, AB, with each contributing $1,000. AB has a ten-year term.

AB does not generate effectively connected income and A is a non-U.S. investor that qualifies for an exemption from U.S. withholding tax from most FDAP income under an applicable tax treaty. B is a U.S. taxpayer.

The partners agree that distributions will be made according to the following waterfall: First, to A, up to its $1,000 contribution. Second, to B, up to its $1,000 contribution. Third, to A, up to an 8% annual non-compounded preferred return on A's unreturned capital (*i.e.*, $80/year for years when A's $1,000 capital contribution is wholly unreturned). Fourth, any remaining cash is distributed 30% to A and 70% to B. At the time the business arrangement is agreed, it is not possible to predict the economic performance of AB. Thus, there is a reasonable possibility that A and

[79] For a further description of anticipatory allocations and rationale for respecting them under PIP, *see* James R. Brown, Catherine Harrington and Carlos Schmidt, *A Framework for Evaluating Anticipatory Allocations*, THE PARTNERSHIP TAX PRACTICE SERIES 2023.

[80] Examples of documentation that could support such expectations could include communications as to the expected holding period of an asset that are made to investors, co-investors or lenders, or internal assessments based on the performance to date of an asset, as well as the macro-economic environment.

B will receive significantly different amounts of distributions, even after taking into account the after-tax economics.

Assume further that AB uses the contributed $2,000 to acquire two non-depreciable assets: Asset 1, for $400, and Asset 2, for $1,600. Neither asset generates current income. At the end of the partnership's year 1, AB sells Asset 1 for $500, recognizing gain of $100. Under the waterfall, all of the cash from the sale of Asset 1 (*i.e.*, $500) is distributed to A as a return of its capital contribution.

Finally, on September 15 of year 2, the date on which AB files its federal income tax return for year 1, AB has not generated any income for year 2 and the partnership does not expect to conduct any activity for the remainder of year 2. Asset 2 has not appreciated in value. There is no expectation that AB will liquidate in the foreseeable future.

In Example 3, there are at least two ways for AB to allocate the $100 of recognized gain from the sale of Asset 1 in year 1:

First, under the targeted allocation approach, AB would determine the amount that would be distributed to each partner if AB sold its assets and liquidated. At the end of year 1, AB had total asset value of $1,600. If AB liquidated, it would distribute $586 to A and $1,014 to B.[81] Taking into account the year 1 distributions, A's capital account immediately before the allocation is $500, and B's is $1,000. Therefore, AB would allocate the $100 of gain: $86 to A and $14 to B. If AB ultimately does not generate sufficient profits for A to be allocated additional income (*e.g.*, if Asset 2 is ultimately sold at the end of year 3 for its cost basis, or $1,600), then A will receive a cash distribution in excess of its basis, taxable under section 731(a), and B will have been allocated income without the corresponding receipt of cash and thus will recognize a capital loss under section 731(a).[82]

Second, under an anticipatory allocation approach: because the partnership does not expect that there will be profits in year 2 to allocate to A with respect to its preferred return, the partnership would take into account A's year 2 preferred return for year 2 in allocating the year 1 gain. Assuming sufficient profits, A is owed $80 of preferred return with respect to year 1 and A will also be owed $40 of preferred return (or 8% x $500 of unreturned capital) with respect to year 2

[81] For A, this is A's $1,000 capital contribution, plus $80 preferred return, plus $6 share of remaining partnership profit (or 30% of the remaining $20 of profits), minus the $500 distribution to A. For B, this is B's $1,000 capital plus $14 share of remaining partnership profit (or 70% of the remaining $20 of profits).

[82] This is because under the waterfall, the $1,600 of proceeds will be distributed as follows: A will be entitled to the first $500 (for the return of its remaining capital), then B will be entitled to $1,000. In the third stage, A will be entitled to the full $100 (because it has an aggregate preferred return entitlement of $160, which is $80 for the first year where the 8% applied to the entire $1,000 of unreturned capital and then $40 for two years where the 8% applied to the $500 of unreturned capital). Because A has been allocated only $86 of income in year 1, it will receive cash ($600, *i.e.*, $500 return of capital plus $100) in year 3 in excess of its basis of $586 ($1000 minus $500 of cash distribution in year 1 plus $86 of income allocated), thereby recognizing capital gain under section 731. By contrast, B's basis in AB ($1000 plus $14 of income allocated in year 1) will exceed the cash received in year 3 ($1,000) and thus ultimately yield a loss.

(*i.e.,* a total of $120).[83] Under this approach, the partnership would allocate all $100 of gain to A. If AB does not earn any income in year 2, then AB's aggregate profits will have been $100 all distributable to A and therefore the allocation of income will have matched the economics and both A's and B's cash entitlements at the end of year 3 ($600 and $1,000 respectively) will align with their basis in AB. By contrast, if AB ultimately generates sufficient profits in subsequent years that exceed A's preferred return, then B will be allocated profits in subsequent years.

We believe that based on these facts, both approaches are reasonable. We observe that the targeted allocation mechanism in this example is likely to result in a greater amount of taxes paid on a present value basis because the targeted allocation method allocates income to B, the taxable investor, in year 1. In addition, the tax liability might be greater on an absolute value basis when comparing the character of the allocated partnership income to the character of the gain ultimately resulting under section 731(a), but we do not believe that this is determinative. As discussed above, it is not possible to predict the performance of AB's assets, and thus it is entirely possible (and, under the facts of this Example 3, likely) that the targeted allocations will not reflect the manner in which the partners in fact share the resulting income and will result in incorrect allocations. This is not a matter of the taxpayer choosing between two different allocations with respect to the same projected economic result (one of which yields a lower tax liability), but rather of trying to determine with imperfect information the allocations most consistent with a single economic arrangement. Absent a crystal ball, it is not possible to know which one is correct, and there is no reason to assume one result is inappropriate (or even abusive) just because one approach may result in a higher tax liability.

Whether an anticipatory allocation approach is in fact reasonable depends on the particular facts and circumstances, as illustrated by Example 4 to Example 6, below.

> **<u>Example 4</u>** Same facts as Example 3, except that sometime in year 2 before AB files its tax return for year 1, AB enters into substantial negotiations to sell Asset 2 for $1,650, which would result in AB's recognizing gain of $50. AB reasonably expects that Asset 2 will in fact be sold for that price before the end of year 2. AB intends to use the cash received from the sale to acquire Asset 3. Asset 3 is expected to generate current income of more than $100 a year.

Based on these facts, there is a reasonable expectation, at the time the tax returns are filed, that AB will have income in year 2 in excess of the $40 of preferred return that will be owed to A for year 2 (and in addition, a strong likelihood that AB will have sufficient income in future years to pay the preferred return). Accordingly, on these facts, it would not be reasonable for AB to allocate an additional $20 of its year 1 gain to A with respect to A's year 2 preferred return.

> **<u>Example 5</u>** Same facts as Example 3, except that Asset 2 is a minority investment in a private company that is subject to significant transfer restrictions. Based on these restrictions, AB reasonably expects that it will not be able to dispose

[83] If Asset 2 had appreciated in value it may also be reasonable to conclude that the preferred return would be funded from the appreciation in Asset 2 and thus to allocate a portion of the year 1 income to B. On the other hand, depending on the facts, AB may also reasonably conclude that it should still allocate $100 of gain to A because regardless of whether it is able to sell Asset 2 at a gain in the future, A will be entitled to at least $100 on account of its preferred return.

of Asset 2 until year 7 (by which time, A will be entitled to a $280 preferred return under AB's agreement).[84] At the time the allocations have to be made with respect to year 1, Asset 2 is still worth $1,600.

In Example 5, as in Example 3, there are at least two ways for AB to allocate its recognized gain of $100 from the sale of Asset 1. Here, again, we believe that both approaches are reasonable.

First, under the targeted allocation approach, AB would determine the amount that would be distributed to each partner if AB sold its assets and liquidated. At the end of year 1, AB had total asset value of $1,600 that would be distributed $586 to A and $1,014 to B if AB liquidated. Taking into account the distributions in year 1, A's capital account immediately before the allocation is $500, and B's is $1,000. Therefore, AB would allocate $86 to A and $14 to B. Similar to our discussion of Example 3, if, as reasonably expected by AB, Asset 1 is not sold until year 6, then there is the risk that there will not be sufficient profits in AB to allocate to A and that A will receive cash in excess of its basis in AB (with the concomitant capital gain for A and capital loss for B). On the other hand, if, contrary to AB's expectations (and the terms of its partnership agreement), AB were to liquidate shortly after the end of year 1 (with Asset 2 still worth $1,600) such that A would only be entitled to $80, then the allocations under this approach would match the economic entitlement of the parties in a hypothetical liquidation.

Second, under an anticipatory allocation approach: allocate the entire $100 of gain generated from the sale of Asset 1 to A, given that (i) Asset 2 has not appreciated in value,[85] (ii) A is entitled to an 8% annual non-compounded preferred return and, (iii) based on the reasonable expectations of AB, AB will need to generate an additional $180 ($280 of preferred return to A less $100 gain on the sale of Asset 1) of profits before B can share in the profits.[86] Similar to our discussions in Example 3, if AB sells Asset 2 as it expects at the end of year 6 at cost or at a small gain, then the allocations will have matched the economic entitlements of the parties. It is possible that at that time, B will become entitled to profits (*i.e.*, if Asset 2 is sold for more than $1,780 (its original cost of $1,600, plus the additional $180)). However, (i) AB will have sufficient profits at the time of the sale to allocate to B, and (ii) there is no deferral at play here: B has not received (nor was reasonably expected to receive) cash before year 7 and B's right to any return is subordinate to A receiving its preferred return first. Additionally, while it is true that if AB partnership were to liquidate at the end of year 1, A would have been allocated too much income and B would be entitled to a cash distribution ($20) that exceeded its basis, such a liquidation is not the reasonable expectation of the parties. Thus, we believe that the anticipatory allocation approach (if applied appropriately) properly reflects the income of the parties at least as well, and perhaps better, as the targeted allocation approach in dealing with this situation.

Because the anticipatory allocation must be based on the partnership's reasonable expectations, it must be based on a reasonable period of time based on the specific facts and circumstances. Accordingly, we believe that anticipatory allocations that look at more than a five-

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[84] That preferred return is equal to the $80 preference for year 1 (when none of A's capital had been returned) and a $40 preference for each of the following five years (based on the $500 of unreturned capital).

[85] *See* Part IV.A.4 for a discussion of valuation of assets subject to lockups.

[86] *See* note 84.

year period should not be respected unless the facts and circumstances clearly establish otherwise (for example, the lockup applicable to a minority position, as mentioned in Example 5). Naturally, the choice of a five-year period is somewhat arbitrary, but we believe that it is a reasonable horizon for projections and note that the SEE rules assume that projections over five years are reliable enough to measure the substantiality of an offsetting allocation.[87]

As these examples emphasize, anticipatory allocations in the context of a preferred return require some judgment as to the partnership's holding period of its assets, the partner's holding period of the preferred interest and the partnership's future income. If the holder of the preferred interest is tax-exempt or otherwise subject to a materially lower tax burden than the holder of the common interest, there is a risk that the parties would take the position that the asset would be held for as long as possible thereby allocating as much income as possible to the preferred return holder and increasing the risk that the common interest holder receives a distribution in excess of basis at the time of distribution. We believe the safeguards mentioned in this discussion should mitigate these risks, but the IRS could also decide on a prospective basis to require partnerships to communicate their expectations as to holding period to their owners (which, in case of non-closely held vehicles, would serve as a natural check of the business expectations of the parties).

2. Net Profit Participation

Another common form of contingent return is a net profit participation based on multi-year cash flows generated by a partnership. For instance, in a typical private investment fund, the general partner's share of the fund's profits (the so-called "carried interest") takes the form of a participation in the net profits (most often 20 percent) generated by the fund over its life. As a result, allocations of income to the general partner are inherently complex and speculative—taxable income must be allocated annually, even though not all investments have been disposed of yet and even though it is unclear whether the general partner will actually be entitled to distributions in respect of its carried interest.

(a) Why is carried interest challenging?

In many ways, every fund agreement reflects a bespoke arrangement between the sponsor (or general partner)[88] and the capital investors (or limited partners). Nonetheless, there are broadly two types of distribution waterfalls that provide for carried interest: so-called American waterfalls and European waterfalls.

American waterfalls generally determine distributions on an investment-by-investment basis. Thus, after an investment is disposed of, the partnership agreement typically provides that limited partners have priority to receive an amount equal to their capital contributed towards such investment plus unrecovered capital from investments that were previously disposed of (for instance, if a prior investment was disposed of at a loss), as well as expenses allocable to such investments and a preferred return on the foregoing. The general partner then receives a catch-up

87 Treasury regulations section 1.704-1(b)(2)(iii)(c).

88 For ease of reference, this Report refers to the owner of the carried interest as the general partner or GP, but the sponsor can at times hold a limited liability interest (*e.g.*, managing member interest in a limited liability company).

distribution to account for the preferred return distribution such that all profits to date have been distributed in accordance with the profit-sharing ratio (which we will assume in this Report is 20% for simplicity) and any remaining cash is distributed 80% to the limited partners and 20% to the general partner. Importantly, the distribution generally does not take into account the profits inherent in other unrealized investments. Many funds with an American waterfall do, however, take into account write-downs on unrealized investments, either on an investment-by-investment basis or in the aggregate (*i.e.*, if unrealized losses exceed unrealized gains) to ensure the GP is "in carry."

By contrast, in European waterfalls, the fund generally distributes amounts to the general partner only after the limited partners have recovered all their capital contributed to the fund plus their preferred return. Thus, after an investment is sold, the partnership agreement typically provides that limited partners have a priority right to receive first all of their unreturned capital and a preferred return on all unreturned capital to date. The general partner then receives a catch-up distribution to account for the preferred return distribution such that it receives 20% of all profits to date. Finally, any remaining cash is distributed 80% to the limited partners and 20% to the general partner.

Accordingly, the American waterfall provides for cash distributions to the general partner earlier in the life of the fund compared to the European waterfall and, as a result, creates a higher risk that the general partner will receive distributions that represent more than its appropriate share of the net profits (because, for example, subsequent investments may be disposed of at a loss).[89] To address this issue, many agreements provide for clawback mechanisms—that is, if the general partner receives more than 20% of the aggregate profits (or the limited partners did not receive their preferred return), the general partner must return such excess funds to the partnership.

These arrangements are complex to describe and even more so to implement, given the seemingly endless variety of fact patterns that arise. Because the carried interest is based on the performance of all of the partnership's assets, the general partner's interest in the profits generated by any specific investment can vary from 0 to 100% and thus in many cases (particularly in a European waterfall, where no distribution is made to the general partner until all the capital contributed has been returned) cannot be determined with certainty until the end of the life of the fund. There are many reasons for which the general partner's profit share may be less than 20%: For instance, if a partnership has previously sold an asset at a loss, part or all of the profits generated by the sale of a subsequent asset would be allocated to the limited partners to "make up" for their unreturned capital and thus reduce the share of profits that are allocable to the general partner. But it also can be the case in a European waterfall if a partnership disposes of a successful investment first (before all invested capital has been returned) and subsequently disposes of investments at a loss: the subsequent loss would reduce the general partner's entitlement to a distribution from the fund. Similarly, the general partner's share of the profits from an investment can be reduced because of the preferred return that keeps accruing on other assets that have not been disposed of yet. On the other hand, the general partner can also have more than a 20% interest in the profits from an investment if by the time the investment is disposed of, the preferred return

[89] While more unusual, this situation can also arise in the context of European waterfalls, for instance, if investments are disposed of early in the fund's life and before all the capital has been deployed.

has been paid to the limited partners such that the general partner has reached the catch-up stage of the waterfall.

(b) Valuations

From a business perspective (and long before looking at tax implications), a general partner that causes a fund to dispose of a specific investment at a gain will ask two questions to understand its ability to get carried interest: (i) "What will be the value of the remaining assets when sold?", and (ii) "When will the partnership be able to sell them ?" (because the longer they are held, the higher the preferred return due to the limited partners). The limited partners also ask themselves these same questions as they consider what net returns to expect from their investment in the fund. As a result, the financial statements provided by the fund to its limited partners will often include valuations of the unrealized investments.

When considering the accuracy of these valuations, it is important to keep in mind that, in a typical fund, the general partner does not have an incentive to undervalue the assets. First, because, as noted, in some cases the American waterfall will take into account losses on unrealized investments. Second, because these valuations allow limited partners to monitor the performance of the fund and thus could result in limited partner's discontent and tensions if the fund shows losses. Third, because the performance of existing funds is a key factor that limited partners look at when they consider investing in successor funds—and the marketing materials generally would include the valuations of all the funds' assets, whether realized or unrealized. To mitigate the impact of any resulting incentive to overstate the value of the fund's assets, the valuations generally are based on a valuation policy and the sponsor frequently assisted by third-party valuation firms in preparing them. If the sponsor is an investment adviser registered under the Advisers Act, it must maintain a record of its valuation policy and practices that are subject to SEC inspection, and it is also subject to fiduciary obligations when preparing these valuations.[90]

For the tax practitioner, questions that are similar to the anticipatory allocations discussed in Part IV.B.1, above, arise here. That is, it seems logical that, because the allocations are based on all the applicable facts and circumstances, as dictated by section 704(b), and because the ultimate sales price of unrealized assets is a key driver of the economic arrangement, fair market value (based on the principles discussed above in Part IV.A.4) and reasonable expectations should be taken into account for this purpose.

(c) Examples

We now turn to examples to illustrate the possible application of various PIP methodologies to carried interest allocations.

In all these examples, the general partner (GP) and limited partners (LPs) form PRS, a limited partnership. LPs contribute $600 on day 1, and the GP receives a profits interest (carry) in PRS. GP is a partnership that is owned by individuals who are resident of the United States. PRS is not closely held and some of the LPs are tax-exempt organizations. For simplicity, we refer to

[90] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), Title IV, entitled the "Private Fund Investment Advisers Registration Act of 2010."

the LPs, collectively, as one LP. PRS provides audited financial statements that includes a valuation of unrealized investments. PRS's management company is a registered investment advisor. No Treasury regulations section 1.704-1(b)(2)(iv)(f) revaluation event occurs.

Example 6 European Waterfall. Net Loss.

PRS has a European waterfall. As such, LP must be distributed amounts equal to its contributed capital ($600) plus a non-compounding 5% annual preferred return on its unreturned capital first. Then, GP is distributed 100% of the profits until GP has received 20% of the profits generated to date. Finally, all remaining distributions are 80% to LP and 20% to GP.

In year 1, PRS acquires Asset A for $200, Asset B for $200, and Asset C for $200. There is no income or loss in year 1.

At the end of year 2, Asset A is sold for $300, Asset B declines in value to $50, and Asset C remains worth $200 (*i.e.*, total fair market value of assets in the partnership of $550).

At the end of year 3, Asset B is sold for $50 (*i.e.*, at $150 loss) and Asset C is sold for $200 (*i.e.*, no gain or loss). The partnership has total proceeds of $250.

Economics:

In year 2, all $300 of proceeds from the sale of Asset A are distributed to LP, all of which represent a return of capital (with LP having an unreturned capital of $300 = $600 of capital contribution minus $300 returned in year 2).

In year 3, all $250 proceeds from the sale of Assets B and C are distributed to LP as a return of capital.

The net result is that LP has received only $550 of its $600 of capital (*i.e.*, it has incurred a $50 loss) and GP receives nothing.

Distribution Waterfall			
		LP	**GP**
Year 2			
$300			
	Capital	$ 300	$ -
Year 3			
$250			
	Capital	$ 250	$ -
		$ 550	$ -

Tax Allocations:

PRS has generated $100 of gain in Year 2 and a $150 loss in year 3. There are multiple ways of allocating the gain and loss that we believe are in accordance with PIP. These include at least the following:

Targeted Allocation Using Section 704(b) Book Value:

In year 2, there is $100 of taxable gain from the sale of Asset A. PRS allocates the $100 of taxable gain among LP and GP based on a hypothetical liquidation (based on section 704(b) book values) at the end of year 2. Because the section 704(b) books show $700 of capital (*i.e.*, $300 from sale of Asset A, $200 for Asset B, and $200 for Asset C) reflecting $100 of gain, the LP is owed its preferred return of 5% per annum or $60 at the end of year 2 (*i.e.*, $600 x 5% x 2 years), the GP is entitled to a catch-up (of $15) and the remaining $25 of profits are shared based on the 80/20 ratio (*i.e.*, $20 to LP and $5 to GP). As a result, after taking into account the distributions for the year, the targeted capital accounts are $380 and $20 for the LP and GP, respectively. After the distribution to the LP, but before any income is allocated, the LP's capital account is $300, and the GP's capital account is $0. Therefore, PRS allocates $80 to the LP and $20 to the GP.

In year 3, there is a $150 loss (and $250 of cash in PRS). The total section 704(b) book value of the assets at the end of year 3 is $250: The targeted capital accounts based on economic entitlements are $250 for the LP and $0 for the GP. The year 3 starting capital accounts are $380 and $20, respectively. Therefore, PRS allocates the $150 of loss to cause the partners' capital accounts to equal the targeted capital accounts, $130 to the LP and $20 to the GP. As a result, the LP's net income allocation between year 2 and 3 is a $50 loss (*i.e.*, $80 gain in year 2 minus $130 loss in year 3), and the GP's net income allocation is $0 ($20 of gain in year 2 minus $20 of loss in year 3).

Alternative PIP Allocation:

In year 2, there is $100 of gain. Taking into account the $300 cash and the combined value of Asset B and Asset C at the time the allocation is made (*i.e.*, $550 total, which is less than the $660 that is due to LP at the end of year 2), PRS allocates all of the $100 of taxable gain from the sale of Asset A to LP.

In year 3, PRS has $150 of loss, which is allocated to LP in its entirety. In total (across both years), $50 of gain is allocated to the LP and no income or loss is allocated to the GP.

The results of both approaches can be summarized as follows:

Targeted Allocations Capital Accounts		
	LP	**GP**
1/1/Y2	$ 600	$ -
Year 2 Gain	$ 80	$ 20
Distribution	$ (300)	$ -
12/31/Y2	$ 380	$ 20
1/1/Y3	$ 380	$ 20
Loss Year 3	$ (130)	$ (20)
Distribution	$ (250)	$ -
12/31/Y3	$ -	$ -

Alternative PIP Capital Accounts		
	LP	**GP**
1/1/Y2	$ 600	$ -
Year 2 Gain	$ 100	$ -
Distribution	$ (300)	$ -
12/31/Y2	$ 400	$ -
1/1/Y3	$ 400	$ -
Loss Year 3	$ (150)	$ -
Distribution	$ (250)	$ -
12/31/Y3	$ -	$ -

We believe that both the targeted allocation and the alternative PIP allocation would accord with PIP on these facts. It is true that, assuming GP is taxable and LP is a tax exempt or a non-U.S. taxpayer (a relatively common fact pattern), the alternative PIP allocation would result in a lower amount of tax collected on a present-value basis, but we do not think that this is dispositive for a few reasons. First, as discussed in Part IV.A.2, this allocation is intended to properly reflect the income of a common, non-tax motivated arrangement and as such should be respected. There is no tax avoidance or deferral by GP: GP receives nothing from the partnership. Second, as discussed above, at the time the allocations are adopted, it is not possible to know the general partner's share of any investment, and even if the alternative allocation is adopted in year 2 via exercise of "flex" language in the PRS partnership agreement, the "flex" is not used with a purpose of tax avoidance but rather to clearly reflect the parties' updated reasonable expectation of how the income will be shared.[91] Indeed, the targeted allocation mechanism can also be said to be wrong by assuming that GP earned 20% of the income from Asset A when the economic deal for the fund is that GP is not entitled to any distribution at this stage. Finally, as discussed in Part III.C, the PIP analysis takes into account a variety of factors: the partners' relative contributions, the interest of each partner in economic profits and losses, the interest of each partner in cash flow and other nonliquidating distributions, and the rights of the partners to distribution of capital upon liquidation.[92] In this context, we believe the entitlement to cash distributions would be the key factor to the analysis—and GP is receiving nothing in year 2 (nor is it reasonably expected to).

To be clear, this does not mean that such allocations would be appropriate under all facts and circumstances —rather, the key facts here are that the GP receives no cash and the fund's valuation of its assets at the time of the allocation shows that it will not be entitled to any cash. Of

[91] As discussed in Part IV.A.3, above, by exercising "flex" and effectively adopting a new allocation scheme, the partnership should be subject to a reassessment of the reasonableness and genuineness of its updated expectations.

[92] Treasury regulations section 1.704-1(b)(3)(ii).

course, if based on the fund's valuations, the GP would be entitled to a distribution, even in later years, the allocation described above may well not be appropriate under PIP.

Example 7 European Waterfall. Profits.

Same facts as Example 6, except that, at the end of year 2, Asset A is sold for $300, and PRS reasonably believes that Asset B and C are worth $200 each (total asset value at that stage of $700). GP reasonably expects that Asset B and Asset C will be sold for at least $200 each in Year 3.

At the end of year 3, Asset B is sold for $300 (*i.e.*, gain of $100) and Asset C is sold for $200 (*i.e.*, no gain or loss) for total proceeds of $500.

Economics:

In year 2, all $300 of proceeds from the sale of Asset A are distributed to LP, all of which represent a return of capital (with LP still having unreturned capital of $300, *i.e.*, $600 of capital contribution minus $300 returned in year 2).

In year 3, the first $300 are distributed to LP as return of capital. LP also has a preferred return of $75 (that is $60 for the first two years and $300 x 5%, or $15, of preferred return for year 3). After taking into account the GP catch up (approximately $19), the remaining $106 is distributed based on the 80/20 sharing ratio, so LP is distributed an additional $85 and GP is distributed $21. The net result is that LP has received $760 of proceeds ($600 of return of capital, $75 of preferred return, and $85 of additional profits) and GP has received $40 of proceeds.

Distribution Waterfall			
		LP	**GP**
Year 2			
$300			
	Capital	$ 300	$ -
Year 3			
$250			
	Capital	$ 300	$ -
	Preferred Return	$ 75	$ -
	GP Catch-up	$ -	$ 19
	Profit	$ 85	$ 21
		$ 760	$ 40

Tax Allocations:

PRS has generated \$100 of gain in year 2 and \$100 of gain in year 3. There are multiple ways of allocating the gain and loss that we believe are in accordance with PIP. These include at least the following:

Targeted Allocation Using Section 704(b) Book Value:

In year 2, there is \$100 of gain from the sale of Asset A to allocate, just as in Example 6. PRS allocates the \$100 of taxable gain between LP and GP based on a hypothetical liquidation (based on section 704(b) book values) at the end of year 2. The section 704(b) books show \$700 of capital (*i.e.*, \$300 cash from the sale of Asset A, \$200 for Asset B, and \$200 for Asset C) reflecting \$100 of gain. LP is owed its preferred return of 5% per annum or \$60 at the end of year 2 (*i.e.*, \$600 x 5% x 2 years), GP is entitled to a catch-up of \$15, and the remaining \$25 of profit are shared based on the 80/20 ratio (*i.e.*, \$20 to LP and \$5 to GP). As a result, after taking into account the distribution for the year, the targeted capital accounts are \$380 and \$20 for the LP and GP, respectively. After the distribution to the LP, but before any income is allocated, the LP's capital account is \$300, and the GP's capital account is \$0. Therefore, PRS allocates \$80 to LP and \$20 to GP.

In year 3, there is \$100 gain to allocate: at this stage, PRS has disposed of all its assets, and therefore the section 704(b) book values are equal to the cash proceeds of \$500, reflecting \$100 of gain. The year 3 starting capital accounts are \$380 and \$20, respectively. At the end of year 3, LP is entitled to \$460 and GP to \$40. Therefore, PRS allocates the \$100 of gain to cause the partners' capital accounts to equal the targets, \$80 to LP and \$20 to GP.

Alternative PIP Allocation:

In year 2, there is \$100 of gain. Taking into account the expected holding period for Assets B and C (until year 3) and the fair market value of PRS's assets (*i.e.*, \$700, which is more than the \$675 of capital plus preferred return to which the LP would be entitled by the end of year 3 when the GP reasonably expects the assets to be sold), the profits are allocated as follows: First, \$75 are allocated to the LP on account of its preferred return (based on a holding period of three years, that is \$60 for the first two years and \$300 x 5%, or \$15, of preferred return for year 3). Second, the GP is allocated its catch-up (~\$19). Third, the remaining \$6 of profits are allocated between the LP and the GP based on the 80/20 sharing ratio, or (~\$5 for LP and ~\$1 for GP). The net effect is therefore an allocation of \$80 to LP and \$20 to GP.

In year 3, \$100 of gain. Since the preferred return (\$75 for three years) and catch up have been satisfied with the allocations made in year 2, the profits are allocated 80/20 with the LP being allocated \$80 and the GP being allocated \$20.

The results of both approaches can be summarized as follows:

Targeted Allocations Capital Accounts		
	LP	**GP**
1/1/Y2	$ 600	$ -
Year 2 Gain	$ 80	$ 20
Distribution	$ (300)	$ -
12/31/Y2	$ 380	$ 20
1/1/Y3	$ 380	$ 20
Year 3 Gain	$ 80	$ 20
Distribution	$ (460)	$ (40)
12/31/Y3	$ -	$ -

Alternative PIP Capital Accounts		
	LP	**GP**
1/1/Y2	$ 600	$ -
Year 2 Gain	$ 80	$ 20
Distribution	$ (300)	$ -
12/31/Y2	$ 380	$ 20
1/1/Y3	$ 380	$ 20
Year 3 Gain	$ 80	$ 20
Distribution	$ (460)	$ (40)
12/31/Y3	$ -	$ -

In this case, both approaches reach the same result, and for the reasons discussed above, we believe that both approaches would be reasonable.

<u>Example 8</u> American Waterfall.

Same facts as in Example 6, except that PRS has an American waterfall that entitles GP to a distribution of 20% of the profit upon the sale of *each* Asset (after taking into account the preferred return with respect to the assets sold to date), but GP has a clawback obligation in the event that, upon liquidation, B has been distributed more than 20% of the net profits of PRS.

<u>Economics:</u>

In year 2, there are $300 of sales proceeds. LP is entitled to and receives a distribution of $280 and GP is entitled to and receives a distribution of $20 computed as follows: First, LP is entitled to its capital ($200) back with respect to the investment in Asset A. Second, LP is entitled to a preferred return of $20 (5% x $200) for the two years for which the $200 were invested. Third, the GP then gets a catch-up of for the preferred return of $5 (so that it gets 20% of the $25 distributed up to this stage). Finally, the remaining $75 is distributed based on the 80/20 sharing ratio.

In year 3, there is $250 of sales proceeds, all of which is distributed to LP. Between the $280 distributed in year 2 and the $250 distributed in year 3, PRS has returned to LP $530, which is less than its $600 of capital. As a result, GP returns the $20 distributed in year 2 pursuant to its

clawback obligation with PRS,[93] and PRS distributes it to LP, yielding a total distribution to LP of $270 in year 3.

The net effect is that, as in Example 5, the LP receives $550 (representing a $50 loss) and the GP receives $0.

Distribution Waterfall			
		LP	**GP**
Year 2			
$300			
	Capital	$ 200	$ -
	Preferred Return	$ 20	$ -
	GP Catch-up	$ -	$ 5
	Gain	$ 60	$ 15
		$ 280	$ 20
Year 3			
$250			
	Capital	$ 250	$ -
	GP clawback	$ 20	$ (20)
		$ 550	$ -

Tax Allocations:

There is $100 of income to allocate in year 2 and a $150 loss to allocate in year 3.

Targeted Allocation Using Section 704(b) Book Value:

In year 2, there is $100 of gain. As in Example 6, PRS allocates the $100 of taxable gain between LP and GP based on a hypothetical liquidation (based on section 704(b) book values) at the end of year 2. Since the books show $700 of capital (*i.e.*, $300 cash from sale of Asset A, $200 for Asset B, and $200 for Asset C) reflecting $100 of gain, LP is owed its preferred return of 5% per annum or $60 at the end of year 2 (*i.e.*, $600 x 5% x 2 years), the GP is entitled its catch-up of $15, and the remaining $25 of profits are shared based on the 80/20 ratio (*i.e.*, $20 to LP and $5 to GP). As a result, after taking into account the $300 of distribution for the year, the targeted capital accounts are $400 and $0 for the LP and GP, respectively. After the distribution, but before any income is allocated, the LP's capital account is $320, and the GP's capital account is $0. Therefore, PRS allocates $80 to LP and $20 to GP (even though GP is economically in clawback given the expected value of PRS's remaining assets).

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[93] This assumes for simplicity that the GP clawback obligation is on a pre-tax basis and the GP returns the entire $20. We note, however, that GP clawback obligations are often done on an after-tax basis.

In year 3, there is a $150 loss and GP has to make a clawback contribution of $20, which is distributed to LP. PRS allocates the $150 of loss to the partners in a manner that causes their capital accounts to equal their liquidating entitlements, so $20 loss is allocated to GP to bring its capital account balance down to $0, and the remaining $130 loss is allocated to LP (such that LP's net income allocation between year 2 and 3 is a $50 loss: a profit allocation of $80 in year 2 and a loss allocation of $130 in year 3).

Alternative PIP allocation:

In year 2, there is $100 of gain to allocate: PRS allocates $80 to LP and $20 to GP. Although PRS believes there has been a decline in value of Asset B, unlike in Example 6, GP is in fact receiving a distribution of $20. We believe this would be an important factor to take into account in the PIP analysis, particularly because ignoring this distribution and allocating the income to LP (as is done in Example 6) would result in a taxable distribution of $20 to the GP under section 731(a) and thus an immediate misalignment of the cash and taxable income in the year of allocation, which we believe PIP allocations should avoid where possible (*see* Part IV.A.2, above).

In year 3, there is a $150 loss and GP has to make a clawback contribution of $20, which is distributed to LP. The loss is allocated $20 to GP and $130 to LP to reverse the prior allocation of profits.

As such, the targeted allocation and the alternative PIP approach would yield the same result in such case.

The results of both approaches can be summarized as follows:

Targeted Allocations Capital Accounts		
	LP	**GP**
1/1/Y2	$ 600	$ -
Year 2 Gain	$ 80	$ 20
(Distribution)/Clawback	$ (280)	$ (20)
12/31/Y2	$ 400	$ -
1/1/Y3	$ 400	$ -
Loss Year 3	$ (130)	$ (20)
(Distribution)/Clawback	$ (270)	$ 20
12/31/Y3	$ -	$ -

Alternative PIP Capital Accounts		
	LP	**GP**
1/1/Y2	$ 600	$ -
Year 2 Gain	$ 80	$ 20
Distribution	$ (280)	$ (20)
12/31/Y2	$ 400	$ -
1/1/Y3	$ 400	$ -
Loss Year 3	$ (130)	$ (20)
(Distribution)/Clawback	$ (270)	$ 20
12/31/Y3	$ -	$ -

One implication of this approach of using anticipatory allocations in a partnership with a European waterfall is that the income allocations are likely to be more consistent with cash flows (that is, LPs who receive the cash in the early stages are likely to be allocated income, and the GP is likely to be allocated income closer in time to an actual distribution of carry than it would have

under the targeted allocation approach). This is because the fund's assets may be less likely to be appreciated early in the fund's life. That is not an improper result (again, there is no deferral here), but it is conceivable that by the time GP is entitled to a distribution, there will be less taxable income to allocate than cash to distribute, as illustrated in Example 9, immediately below.[94] To be clear though, this would only arise if (i) PRS concludes that, because of the reasonably expected values and hold periods for a distressed asset, income in the early years needs to be allocated to the LP, (ii) the economics subsequently improve such that the asset is disposed at a gain (or more quickly than anticipated) such that the GP is now entitled to a carry distribution, *but* (iii) the sale of the asset does not generate income in an amount equal to the carry to be distributed to the GP.

Example 9 European Waterfall. Carry Distribution. No Profits in PRS.

Same facts as Example 6, except that we assume (for simplicity) LP is not entitled to a preferred return (and therefore there is also no GP catch-up).

As in Example 6, at the end of year 2, Asset A is sold for $300, Asset B declines in value to $50, and Asset C remains worth $200 (*i.e.*, total fair market value of assets in the partnership of $550).

In year 3, Asset B recovers in value and is sold for $200, all of which is distributed to LP. No gain or loss is realized. In Year 4, Asset C is sold for cost of $200.

Economics:

In year 2, there is $300 to distribute. Just as in Example 6, all $300 of proceeds from the sale of Asset A are distributed to LP, which represents a return of capital (with LP still having $300 of unreturned capital: $600 of capital contributions minus $300 of distribution in year 2).

In year 3, there is $200 to distribute. All $200 of proceeds are distributed to LP, all of which represent a return of capital (with LP still having $100 of unreturned capital: $600 of capital contributions, minus $300 of distribution in year 2, minus $200 of distribution in year 3).

In year 4, there is $200 to distribute: the proceeds are distributed $180 to LP and $20 to GP computed as follows: LP receives $100 as a return of capital and the remaining $100 is distributed based on the 80/20 sharing ratio: $80 to LP and $20 to GP.

The net result is that LP received $680 (representing $600 of capital and $80 of profits) and GP received $20.

[94] One other implication is that income from assets that have been held for less than three years (and thus would not be eligible for long-term capital gain treatment for the GP under section 1061) is more likely to be allocated to LPs than to the GP under this approach than under a targeted allocation approach. As the European waterfall generally requires the GP to have held its interest in the fund for a longer period before being entitled to any distribution and the carried interest is based on the cumulative impact of all disposition of assets until the carry distribution is actually made, we do not believe that this result is inappropriate as a policy matter.

Distribution Waterfall			
		LP	**GP**
Year 2			
$300			
	Capital	$ 300	$ -
Year 3			
$200			
	Capital	$ 200	$ -
Year 4			
$200			
	Capital	$ 100	$ -
	Profit	$ 80	$ 20
		$ 680	$ 20

Tax Allocations:

Targeted Allocation Using Section 704(b) Book Value:

In year 2, there is $100 of gain. PRS allocates the $100 of taxable gain from the sale of Asset A among LP and GP based on a hypothetical liquidation (based on section 704(b) book values) at the end of year 2. Since the books show $700 of capital (*i.e.*, $300 cash from sale of Asset A, $200 for Asset B and $200 for Asset C) reflecting $100 of gain, LP is allocated $80, and GP is allocated $20. As a result, after taking into account the distribution for the year, the targeted capital accounts are $380 and $20 for the LP and GP, respectively. After the distribution to the LP, but before any income is allocated, the LP's capital account is $300, and the GP's capital account is $0. Therefore, PRS allocates $80 to LP and $20 to GP.

In years 3 and 4, there is no income (or loss) to allocate.

Alternative PIP Allocation: Same approach as Example 6:

- in year 2, all of the gain ($100) is allocated to LP.
- in year 3, no gain (asset sold at cost).
- in year 4, no gain (asset sold at cost).

The results of both approaches can be summarized as follows:

Targeted Allocations Capital Accounts		
	LP	**GP**
1/1/Y2	$ 600	$ -
Year 2 Gain	$ 80	$ 20
Distribution	$ (300)	$ -
12/31/Y2	$ 380	$ 20
1/1/Y3	$ 380	$ 20
Year 3 Gain	$ -	$ -
Distribution	$ (200)	$ -
12/31/Y3	$ 180	$ 20
1/1/Y4	$ 180	$ 20
Year 4 Gain	$ -	$ -
Distribution	$ (180)	$ (20)
12/31/Y4	$ -	$ -

Alternative PIP Capital Accounts		
	LP	**GP**
1/1/Y2	$ 600	$ -
Year 2 Gain	$ 100	$ -
Distribution	$ (300)	$ -
12/31/Y2	$ 400	$ -
1/1/Y3	$ 400	$ -
Year 3 Gain	$ -	$ -
Distribution	$ (200)	$ -
12/31/Y3	$ 200	$ -
1/1/Y4	$ 200	$ -
Year 4 Gain	$ -	$ -
Distribution	$ (180)	$ (20)
12/31/Y4	$ 20	$ (20)

At this stage, under the alternative PIP allocation there are two potential ways to align income and cash flows: (i) relying on section 731(a) to tax GP (and to provide an offsetting loss to the LP who receives $20 less than it was allocated in year 1), or (ii) relying on reverse 704(c) allocations and principles similar to the remedial allocations, as explained further below. Before we do so, however, it is important to note that this issue is not created by this proposed PIP approach—rather it is a result of the inability to predict GP's stake in any specific investment. Similar issues can arise for instance under the targeted allocations method if an asset is disposed of in early years and income is allocated to the GP (similar to what is done in this Example 9 under the targeted allocation approach), but because of the preferred return the economic ownership of the profits shifts over time to the LP, thereby resulting in a cash distribution to the LP that has not been matched by a section 704(b) allocation of income.

Under the first approach, if the cash distributions do not match with the GP's expectations in year 2, then GP would be taxed under section 731(a). Here, we observe that the timing of GP's income under section 731(a) is, potentially, elective if the GP was then able to defer the distribution while somehow in substance securing the economic benefit of the accrued cash.[95] However, this would not be a common fact pattern for a closed-end fund since funds are generally required to distribute the proceeds shortly after receipt and to liquidate at term.

Under the second approach, PRS would book down its assets at the end of year 2 as a result of the distribution to LP. LP is allocated $50 of net section 704(b) loss, including $100 of gain on

[95] There could also be character conversion aspects if the gain from Asset A would be ordinary income or short-term capital gain and the GP receives a distribution that results in long term capital gain under section 731(a) (*see* Example 3 in Part IV.A.2(a), above).

Asset A and $150 of revaluation loss on Asset B. When Asset B's value increases such that such built-in loss is eliminated in year 3 when the asset is sold for $200, the book gain of $150 would be allocated $20 to the GP (matching the cash to be distributed to the GP) and $130 to LP. Applying an approach similar to the remedial method, GP would be allocated matching remedial gain of $20 and LP would be allocated a remedial loss of $20. We do not favor this method: while technically pure, it would create extreme complexity when, as discussed in Part V.D, partnerships are already struggling with the complexity of the capital account rules and revaluations (and the potential need to track multiple layers of revaluations over multiple assets would be very difficult to operate in practice). In any case, because we believe there are proper safeguards in place (as discussed above) to avoid improper deferral by the GP, we would not support mandatory revaluations or remedial allocations.

Recommendation:

We recommend that Treasury and the IRS confirm that, under PIP, both targeted allocations based on current-year liquidation as well as anticipatory allocations may be used to account for preferred returns (that are not guaranteed payments) and for net profit sharing arrangement (such as carried interest).

As noted, for this purpose, an anticipatory allocation would need (i) to be based on the partnership's reasonable expectations at the time the allocations are made; (ii) in the case of preferred return accrual, to be based on a prescribed reasonable period of time, we recommend not more than five years absent specific facts (for example, a lockup applicable to a minority position); and (iii) once adopted, to be consistently followed (and any change, including any exercise of "flex" allocations, would be subject to scrutiny).

3. Noneconomic Items

A different fact pattern that also commonly arises when dealing with section 704(b) allocations and for which guidance would be helpful relates to the allocation of items of noneconomic income and loss, *i.e.*, situations in which the Code determines that the partnership must recognize an item of income, gain, loss, or deduction even though there has been no corresponding economic impact at the partnership level. The regulations require that, "[e]xcept with respect to partnership items that cannot have economic effect (such as nonrecourse deductions of the partnership)," an allocation under PIP "may or may not correspond to the overall economic arrangement of the partners."[96] Although it is not clear what if any general guidance is being provided with respect to noneconomic items, it appears that the rules provided in the regulations regarding specific types of noneconomic items apply for purposes of PIP.[97] Consistent with those rules, where a noneconomic item is related to an economic item, we would expect that the sharing of the noneconomic item would need to be consistent with the sharing of the related economic

[96] Treasury regulations section 1.704-1(b)(3)(i).

[97] *See, e.g.,* Treasury regulations sections 1.704-1(b)(4)(i) (revaluations), (ii) (credits), (iii) (excess percentage depletion), (iv) (nonrecourse liabilities), (viii) (creditable foreign tax expenditures), (ix) (noncompensatory options).

item even if the sharing of the related economic item does not correspond to any "overall" economic arrangement.

The following example illustrates one instance of the issue:

> **Example 10** GP, LP1, and LP2 form Partnership PRS. LP1 and LP2 each contribute $50. GP contributes no capital but has a profits interest that entitles it to 20% of the profits generated over the term of PRS.
>
> In Year 1, PRS acquires all of the stock of a corporate portfolio company (PC) for $100. At the time of the purchase, PC has $50 of earnings and profits. No section 338 election is made. Later during the same year, when PC has not increased in value, PC takes advantage of improved financing conditions and borrows $20 and distributes the cash to PRS. PC's equity value has decreased by the amount of the borrowing, to $80.

The value of PRS's assets has not changed because of this distribution: PRS owned shares of PC worth $100 before the transaction, and after the distribution owns shares of PC worth $80 and $20 of cash. Nevertheless, the distribution by PC is treated as a dividend under section 301(c)(1). There is no decrease in the basis of the PC shares held by PRS such that there is now a built-in loss of $20 in the shares of PC.

Applying the targeted allocation approach using section 704(b) book values: if the value of the shares of PC are not marked down to reflect their fair market value, PRS's section 704(b) books will reflect $120 of assets and GP would be allocated 20% of the $20 of income or $4 (with LP1 and LP2 being allocated the remaining 80% equally or $8 each). If PRS's assets do not increase in value and PRS ultimately sells the shares of PC for $80 (with a resulting loss of $20) such that the GP is not entitled to any return from PRS, the GP will be allocated 20% of the loss to bring its capital account down to $0.

Alternatively, PRS could reasonably conclude at the end of year 1 that because there is no economic profit (taking into account PRS's reasonable assessment of PC's value), GP (which only participates in profits) has no economic entitlement to that distribution and thus should not be allocated any income. Rather the LPs should be allocated the $20 of income in year 1 and thus each of LP1 and LP2 would be allocated $10 of income (and each of them derive the benefit of the built-in loss in the shares of PC when the partnership sells the shares of PC).

It would not be reasonable on the other hand for PRS to treat LP1 and LP2 differently here (and thus for instance to allocate all the dividend income to LP1 and none to LP2) when the economic terms of their participation in PRS are identical.

Fundamentally, the two approaches are reasonable because the dividend is not an item of income that has economic significance for the partners. In that case, the nonrecourse deductions rules of Treasury regulations section 1.704-2 provide a useful analogy. Nonrecourse deductions are deductions that are attributable to partnership nonrecourse debt that cannot have economic

effect because the creditor alone bears the economic burden that corresponds to these allocations.[98] Because no partner bears the economic risk of loss with respect to such debt and related deduction, the Treasury regulations allow the partnership to allocate the deduction in a manner that is reasonably consistent with allocations of some other significant partnership item attributable to the property securing the nonrecourse liabilities that have substantial economic effect (and then require the partnership to allocate the resulting "minimum gain" between the partners who benefited from such deductions).[99]

We believe that a similar approach should hold true for other types of noneconomic income. Thus, in Example 10, PRS should be free to allocate the income between GP and LP so long as (i) the allocation is reasonable and consistent with the allocation of a significant item of the partnership, [100] and (ii) the related benefit that results from the built-in loss in the PC shares is allocated to the same partners to which the income was allocated.[101] Because this income does not have economic significance there is no partner that is the true owner of the income, and the fact that one allocation could result in more taxes collected than the other is not relevant to the analysis.[102]

A related question arises in the context of certain items of deductions or income the timing (or amount) of which does not match the economic timing (or amount) of the realization of income or deduction. For instance, the Code often allows taxpayers to depreciate the cost basis of an asset at an accelerated pace that does not correlate with the speed at which the asset's fair market value declines.[103] More generally, depreciation and amortization deductions are benefits granted by Congress to an asset's owner and the deductions may or may not correlate with a reduction in the underlying asset's value. If the partnership follows fair market valuations under PIP (*see* Part IV.A.4, above), the tax depreciation and amortization deductions may not have economic effect.[104]

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98 Treasury regulations section 1.704-2(b)(1).

99 Treasury regulations section 1.704-2(g).

100 In the case a noneconomic income that relates to an item of economic income, the allocation should be consistent with the allocation of the related economic item.

101 Naturally, the value of PC may increase over time such that there is no built-in loss at the time PRS disposes of the shares of PC, but we would expect that in such a case there would be less gain than if the PC had not distributed the $20 (*i.e.*, there is still a related benefit allocated to the partners that were previously allocated the dividend income).

102 A similar issue can arise with tiered partnerships. In some situations, gain or loss recognized by a lower-tier partnership is "noneconomic" from the perspective of an upper-tier partnership. This can occur, for example, if the lower-tier partnership interest has been contributed to an upper-tier partnership at a time when the assets of the lower-tier partnership are appreciated or depreciated, the lower-tier assets are sold, and the section 704(c) regulations do not require an allocation of the gain or loss existing in the lower-tier assets back to the partner that contributed the lower-tier partnership interest to the upper-tier partnership. This is a situation that we believe would be more appropriately addressed through changes to the section 704(c) regulations, which are outside the scope of this Report. Unless and until those changes are made, we believe that an allocation of such gain by the upper-tier partnership back to the contributing partner satisfies PIP.

103 *See, e.g.*, section 168(k).

104 The issue can also arise under the SEE rules, if the partnership revalues its assets. In such a case, the regulations provide that the items of tax deduction that do not have economic effect (because they are not reflected in the book basis) are to be allocated based on PIP (unless governed by section 704(c)). The regulations go on to note that these tax items must be shared among the partners in a manner that takes account of the variation between

In addition, as a practical matter, most partnerships do not value each item of depreciable or amortizable property separately, and therefore it would not be practicable or feasible to require a partnership to test the economic effect of each item of depreciation or amortization deduction.[105] It would also be very time consuming for the IRS to audit.

Accordingly, we recommend that as a rule of administrative convenience, a partnership that applies PIP using fair market valuation should be able to determine the amount of depreciation and amortization deductions in respect of its assets for capital account and tax purposes using the initial 704(b) book value and adjusted tax basis of those assets, respectively and allocating any noneconomic tax deductions in the same manner as the related book deductions. As in the case of the other deductions discussed in this section, any offsetting gain, for book and tax purposes, should be allocated to the same partners to which the depreciation and amortization deductions were allocated. Also, under this rule of convenience, the partnership would need to take account of the rules for nonrecourse deductions and minimum gain chargeback, if and to the extent relevant.[106]

Recommendation:

We recommend that guidance confirm that allocations of noneconomic items will be respected so long as (i) the allocation is reasonable and consistent with the allocation of a significant item of income, gain, deduction or loss of the partnership, and (ii) the allocation mechanics result in a matching of any corresponding item (*e.g.*, where the initial noneconomic item is an item of income or gain, a subsequent noneconomic item of loss or reduction in gain) to the same partner. We would recommend a requirement that the partnership disclose its method for allocating noneconomic items on its tax return in the year of allocation.

4. Partial Rollover-Tracing

In the sale of a partnership's business, some partners may "roll" their equity into the buyer's structure. Often the partnership will distribute a portion of its business assets (or stock if the

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the adjusted tax basis of such property and its book value in the same manner as variations between the adjusted tax basis and fair market value of property contributed to the partnership are taken into account in determining the partners' shares of tax items under section 704(c). Treasury regulations section 1.704-1(b)(i).

[105] *See* preceding footnote. The same would be true for an upper-tier partnership that owns an equity interest in a lower-tier partnership and gets allocated depreciation deductions from such lower-tier partnership. While the upper-tier partnership may have a valuation for its lower-tier partnership interest, it would not ordinarily have valuations of each depreciable asset of the lower-tier partnership.

[106] For example, assume partnership PRS that applies PIP using annual fair market valuations has an initial fair market value of $1,000, including a depreciable asset with an initial book basis of $50 and a 5-year depreciation period. LP contributes the capital and GP has a 10% profits interest. For year 1, PRS allocates a $10 depreciation deduction to LP, reducing LP's capital account and adjusted basis to $990. If at the end of year 1, PRS' fair market valuation remains at $1,000 (or, alternatively, increases to $1,200), the parties expect that the LP would be allocated $10 for book purposes to offset the depreciation deduction (if and when the asset is sold). Similarly, in the alternative scenario the parties expect that the $200 (economic) gain would be allocated $180 to LP and $20 to GP. Upon a realization event with respect to the asset, any taxable gain would first be allocated to LP to offset prior allocations of depreciation deductions.

partnership owns shares in a corporation) in kind to its partners who are rolling over and will sell the rest to the buyer, with the proceeds distributed.

As a result of the partial sale and partial rollover, if the partnership's business assets have changed in value, the partnership will have taxable gain or loss from the sale that must be allocated. If the parties who are rolling over are not fully redeemed, there is some uncertainty over how the partnership should allocate its section 704(b) gain or loss from this transaction. With respect to the distributed assets, the partnership will realize section 704(b) book gain or loss based on the difference between the property's section 704(b) book value and its fair market value at the time of distribution. With respect to the property that is sold, the partnership will either realize section 704(b) gain from a permissive revaluation of that property (as a result of the disproportionate distribution to the rolling partners) followed by tax gain from the sale of the property, or will simply recognize tax gain from the sale. Generally, it should be consistent with PIP for the partnership to allocate the section 704(b) gain with respect to the distributed property to the distributee partners, and to allocate the section 704(b) gain with respect to the sold property to the partners in accordance with how they receive cash. This is also consistent with the factors described in Treasury regulations section 1.704-1(b)(3)(ii), which includes "the interests of the partners in cash flow" as a factor considered when allocating in accordance with PIP.

> **<u>Example 11</u>** X and Y each contribute $300 for a 50 percent interest in PRS, which uses the $600 to acquire stock in corporation A for $600.
>
> Several years later, when the section 704(b) book value and tax basis of the stock is still $600 but the stock is worth $1,000, X, Y, PRS, and a buyer reach an agreement in which PRS will dispose of all of the stock of A. However, X wishes to retain some of its indirect interest in A.
>
> The transaction is structured as a partial rollover and partial sale in which X will first receive an in-kind distribution of $200 worth of stock of A, which X will then contribute to an entity in the buyer's structure in a transaction in which gain is not recognized and X's basis in the stock carries over to its basis in the buyer equity.
>
> The distribution reduces X's interest in the partnership to 37.5 percent (($500-$200)/$800). Next, PRS will sell its remaining stock to a buyer entity for $800. The $800 will be distributed $300 to X and $500 to Y.
>
> PRS will remain in existence for some time after the sale to collect escrow and earnout payments and satisfy its obligations under the purchase and sale agreement. Assume no other income in PRS throughout its existence such that before the sale of the shares of A each of X and Y have a $300 basis in their PRS interest.

Before considering how the gain should be allocated, it is worth considering three baseline alternatives. First, what would the result be if PRS simply sold all of its stock of A for $1,000 and distributed the resulting cash to X and Y? The partnership would recognize gain of $400 ($1,000 amount realized minus $600 of basis), which would be allocated $200 each to X and Y. Thus, before any transaction, each partner's share of gain in partnership assets is $200.

Second, what would the result be if instead PRS liquidated, distributing the stock to X and Y, and X and Y transacted directly with buyer? First, the liquidation would be tax-free, and each of X and Y would receive shares of A with a basis of $300 (reflecting X's and Y's outside basis in PRS).[107] Second, Y would sell all $500 of its stock to buyer, recognizing gain of $200. Third, X would sell $300 worth of stock of A to buyer, recognizing a gain of $120 ($300 value minus $180 tax basis).[108] X would then contribute its remaining shares (with a $80 of built-in gain ($200 value of contributed stock minus $120 tax basis)) to buyer's affiliate in a tax-deferred transaction and obtain a carry-over basis in the equity of buyer's affiliate. Thus, X's total gain (both recognized and deferred) would be $200.

Third, what would happen if the buyer bought interests in PRS? Y would sell its entire interest and recognize gain of $200. X would sell 60% of its interest in PRS for $300 (with basis of $180) and recognize gain of $120. X would retain an interest in PRS worth $200 with basis of $120 (built-in gain of $80).

In any of these three baselines, each partner's share of gain before and after the transaction (including X's remaining gain of $80 in the buyer equity) is $200.

In the fact pattern in Example 11 (a distribution of some stock and sale by the partnership of the rest), there are generally two ways that the partnership could allocate the gain. These might be called a "tracing" approach and a "proportionate" approach.

A tracing approach will make allocations consistent with the assets each partner actually receives and attempts to preserve each partner's share of gain. Under this approach, the partnership would allocate section 704(b) book gain from the distributed shares entirely to the distributee (X) and section 704(b) and tax gain from the sold shares to the partners in accordance with their post-distribution percentages.

- Stock Distributed: The stock of A that is distributed to X has a section 704(b) book value of $120 before the distribution[109] and fair market value of $200. When the stock is distributed, PRS revalues it for purposes of section 704(b) and allocates the $80 of revaluation gain to X.

- Stock Sold: The stock sold has a section 704(b) book value and tax basis of $480 ($800/$1,000 x $600) and a fair market value of $800. Thus, PRS recognizes $320 of section 704(b) and tax gain on the sale. It allocates that gain in accordance with the partners' sharing percentages *immediately after* the distribution, that is, 37.5 percent to X ($120) and 62.5 percent to Y ($200).

[107] Section 732(b).

[108] The tax basis would be computed as the $300 of aggregate basis in A stock x $300 (FMV of shares sold)/$500 (total FMV).

[109] That is computed as $200 (FMV of shares distributed)/$1,000 (aggregate FMV) x $600 of section 704(b) book value for all the shares.

This results in the following capital accounts and tax attributes before any distribution of cash to X and Y:

	X		Y	
Starting section 704(b) capital	$	300	$	300
Allocation of section 704(b) revaluation gain on distributed shares	$	80	$	-
Distribution of shares	$	(200)	$	-
Allocation of section 704(b) gain on sold shares	$	120	$	200
Section 704(b) capital immediately before cash distribution	$	300	$	500
Tax basis in partnership interest before cash distribution	$	300	$	500

As a result of these allocations, X and Y maintain their pre-transaction shares of gain of $200, and neither recognizes gain or loss when the cash is distributed. If the cash were not distributed, X and Y both would have no built-in gain or loss in their partnership interests and no share of built-in gain or loss in partnership assets (because the partnership only holds cash).

These allocations are entirely consistent with the economics of the transaction. After the transaction, X owns buyer equity with all of the built-in gain attributable to the distributed shares. Thus, it is consistent with the economics to allocate to X the revaluation gain with respect to those shares. Similarly, after the distribution, X and Y share the remaining shares in a new manner (37.5 percent and 62.5 percent, respectively), and it is consistent with the economics to allocate the gain from sale in that manner.[110]

Importantly, this approach is consistent with essential elements of PIP, which requires the partnership to look at all the facts and circumstances, including the interests of the partners in cash flow and other non-liquidating distributions, and the rights of the partners to distributions of capital upon liquidation.[111] In the transaction, X has received a distribution in kind of stock of A which is fundamentally different from the cash distribution received by X and Y. This approach respects the significance of that economic difference. In addition, after the stock distribution, X's and Y's relative remaining contributions to PRS are 37.5 percent and 62.5 percent, respectively. Because PRS allocates its profits and losses based on percentage interests, X's and Y's interests in economic profits and losses, interest in cash flow and other non-liquidating distributions, and interest in liquidating distributions are also equal to 37.5 percent and 62.5 percent, respectively.

By contrast, under a proportionate approach, PRS would allocate the section 704(b) gain and tax gain to X and Y in accordance with their pre-distribution sharing percentages (50-50) immediately before the distribution of stock to X.[112] This allocation yields the same final capital

[110] Notably, the shares in this example all have the same character and holding period, so using a tracing approach does not cause a shift in any partner's share of ordinary, capital, short-term, or long-term property.

[111] This is also consistent with the "merger buyout rule" in Treasury regulations section 1.708-1(c)(4), which allows for differential treatment of partners where some wish to sell their interest and some wish to continue in the new partnership.

[112] Although the percentage interests are 62.5 and 37.5 at the time the stock is sold, in a proportionate approach both the revaluation gain and taxable gain are allocated in accordance with pre-transaction percentage interests (50-50). If the revaluation gain were allocated in accordance with the percentages before the distribution (50-50) and

accounts as a tracing approach but creates an inappropriate a difference in the amount of gain recognized by the partners, as compared to any of the three baseline alternatives and the tracing approach:

	X		Y	
Starting section 704(b) capital	$	300	$	300
Allocation of section 704(b) revaluation gain on distributed shares	$	40	$	40
Distribution of shares	$	(200)	$	-
Allocation of section 704(b) gain on sold shares	$	160	$	160
Section 704(b) capital immediately before cash distribution	$	300	$	500
Tax basis in partnership interest before cash distribution	$	340	$	460

While this approach may seem simpler, it yields odd results by overtaxing the partners on a current and future basis. If PRS makes allocations under this approach, X's share of partnership taxable gain will increase by $40 (until PRS liquidates, at which point the loss on liquidation may or may not be able to offset the taxable gain allocated at the time of the sale of the A shares). That is because X is allocated taxable gain of $160 with respect to the shares that are sold and only half of the revaluation gain on the distributed shares even though X inherits *all* of the built-in gain on those shares when they are distributed to X (and ultimately owns buyer equity with built-in gain of $80). Conversely, Y's share of partnership taxable gain would decrease by $40 until it receives the $200 of cash from PRS or PRS liquidates. That is because even though Y's share of gain before the transaction was $200, Y would only be allocated $160 of taxable gain.[113]

Recommendation:

In a situation in which a partnership has assets with the same tax attributes (*i.e.*, character and holding period) and distributes a portion of those assets while selling another portion, it should be in accord with PIP for the partnership to allocate the revaluation gain with respect to the distributed portion to the distributee and to allocate the gain with respect to the portion that is sold in accordance with the sharing ratio for the cash.[114] Not only does this kind of allocation appropriately link the allocations of different items with the partners receiving the particular

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the sale gain were allocated in accordance with the percentages after the distribution (62.5-37.5), the partners' section 704(b) capital accounts immediately before the cash distribution would be $260 (X) and $540 (Y), not equal to the amount of cash the partners are entitled to ($300 for X and $500 for Y).

[113] The proportionate approach could be viewed as taxing X on a deemed exchange of a portion of the distributed shares for a portion of the shares left in the partnership. This would be inconsistent with the general operation of sections 721 and 731, in which contributions to and distributions from partnership generally do not result in a deemed exchange of assets (with limited exceptions explicitly provided by other Code sections, such as sections 751(b), 707(a), 737, and 704(c)(1)(B)). In Example 11, a proportionate approach is also inconsistent with section 1036, pursuant to which X and Y could have exchanged shares of stock without recognition of gain.

[114] *See also* Jennifer Ray, *Dividing the Indivisible: Identifying the "Property" in Partnership Transactions*, 100 TAXES 95, 131 (March 2022). In situations in which the partnership property had previously been revalued, we previously reiterated our support for amending Treasury regulations section 1.704-3(a)(6) to allow a reallocation of the revaluation gain, or a "swapping" of reverse section 704(c) amounts on property with the same tax attributes, as between the distributee and remaining partners, *See* discussion of Example 16 below.

property, but it also minimizes the creation of disparities between a partner's basis in its partnership interest (outside basis) and the partner's share of basis in partnership assets (inside basis).

V. Suggestions for Improving SEE Rules

This Part V now turns to the SEE rules. As discussed, there are significant practical constraints presented with the applications of the SEE rules, leading taxpayers to satisfy those rules only in limited circumstances. We believe it would be in both the government's and taxpayers' interest to have more taxpayers follow the SEE rules: it would be beneficial for the government because the rules are mechanical, typically require less judgment than PIP, and therefore would allow for increased compliance and more efficient audits. Likewise, it would be beneficial for the taxpayers to be able to rely on the SEE rules because it would provide more simplicity and certainty.

As such, this Part V focuses on some improvements that could be made to the SEE rules to encourage taxpayers to rely on those rules rather than PIP. As discussed in Part III.C, above, the section 704(b) regulations provide, in general, that a partnership allocation will be respected if it satisfies the SEE rules. Treasury regulations section 1.704–1(b)(2)(i), in turn, articulates a two-part test for determining whether an allocation satisfies the SEE rules: (i) an allocation must have economic effect, and (ii) the economic effect must be substantial, in each case as determined at the end of the taxable year to which the allocation relates. Our recommendations below focus on the requirements for an allocation to have economic effect and the practical issues faced under those rules. Although there are many practical issues with the substantiality rules, we do not provide recommendations regarding potential amendments to those rules in this Report but reiterate the prior recommendation made in prior reports.[115]

A. Economic Effect in General

The Treasury regulations begin by articulating a fundamental principle necessary for an allocation to have economic effect:

> In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.[116]

The Regulations then go on to identify three different tests for satisfying the economic effect requirement: (i) a primary test, (ii) an alternate test, and (iii) an economic effect equivalence ("EEE") test.

Under the primary test, for a partnership's allocations to have economic effect, the partnership agreement, throughout the full term of the partnership, must provide for (1) the proper

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[115] We previously made recommendations with respect to the "look through rules" in New York State Bar Association Tax Section, Report No. 1256, *Report on Proposed Regulations Withdrawing the De Minimis Exception from the Section 704(b) Regulations* (Jan. 23, 2012).

[116] Treasury regulations section 1.704-1(b)(2)(ii)(a).

determination and maintenance of capital accounts, (2) liquidation of the partnership in accordance with positive capital account balances by the end of the taxable year of liquidation or, if later, within 90 days after liquidation, and (3) a deficit restoration obligation ("DRO") for all partners. A DRO is an agreement providing that if a partner has a deficit balance in its capital account following liquidation of the partner's interest in the partnership and after taking into account all capital account adjustments for the year of liquidation, the partner is unconditionally obligated to restore the amount of the deficit to the partnership by the end of the taxable year of liquidation or, if later, within 90 days after liquidation. The amount contributed is then paid to creditors of the partnership or distributed to other partners with positive capital account balances.[117]

As discussed further below, there is often reluctance for the parties to agree to a DRO. If there is no DRO, or if there is a limited DRO (*e.g.*, an agreement to contribute additional amounts pursuant to a partnership agreement up to a cap), but the first two requirements of the primary test are otherwise met (*i.e.*, the partnership properly maintains capital accounts and the agreement provides for liquidating distributions in accordance with positive capital account balances), the alternate test may apply. The alternate test requires that the partnership limit allocation of losses and that the agreement contain a qualified income offset (a "QIO"). Specifically, the agreement must prohibit an allocation of loss or deduction to the extent the allocation would cause increase a deficit balance in the partner's capital account (in excess of any limited obligation to restore) as of the end of the partnership taxable year to which the allocation relates, but taking into account certain capital account adjustments and allocations of deduction and loss, and distributions that reasonably are expected to be made with respect to such partner in future taxable years. A QIO is a backstop to the stop-loss rule and generally provides that if a partner unexpectedly receives such an adjustment, allocation, or distribution that would have been taken into account under the general stop-loss rules if it were expected and that causes the partner to have a deficit capital account (after taking into account the anticipated adjustments, allocations, and distributions noted above) in excess of the amount the partner is obligated or deemed obligated to restore, the partner will be allocated items of income and gain in an amount and manner sufficient to eliminate such deficit balance as quickly as possible.

If neither the primary nor the alternate test is satisfied, it is possible for allocations to have economic effect if they satisfy the EEE test. Under that test, generally allocations that do not otherwise have economic effect are deemed to have economic effect, "provided 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 results to the partners as would occur" if the three requirements of the primary test for economic effect were met.[118]

Below we discuss some practical issues associated with the economic effect test that may preclude reliance on the SEE safe harbor and provide some recommendations for guidance.

B. Maintenance of Capital Accounts

One of the requirements of both the primary and alternate test for economic effect is that the partnership agreement provide for the determination and maintenance of capital accounts in

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[117] Treasury regulations section 1.704-1(b)(2)(ii).

[118] Treasury regulations section 1.704-1(b)(2)(ii)(i).

accordance with the rules of Treasury regulations section 1.704-1(b)(2)(iv) for the full term of the partnership.[119] It is common, however, especially in smaller partnerships, for capital accounts to be incorrectly maintained at some point in the life of a partnership, even if the partnership agreement contains the requirement to maintain capital accounts. It is not clear from the regulations to what extent failure to determine or maintain capital accounts correctly prevents future allocations from qualifying for either the primary test or alternate test for economic effect.[120]

Furthermore, there is often uncertainty in how to maintain capital accounts in some common business transactions. For example, the partnership may need to raise funds, and an investor may be willing to contribute cash only if it acquires units at a discount to net asset value. This is analogous to a bargain purchase and generally does not result in income to the investor.[121] The capital account maintenance rules do not explicitly address this situation, and it is not clear whether the investor's starting capital account should equal the amount of cash contributed or the liquidation value (fair market value) of the interest at the time of acquisition.

> **Example 12** An operating partnership needs to raise money to make additional investments. The partnership is currently worth $100. An investor is willing to contribute $20 for a preferred interest entitling it to an accreting preferred return and one fourth of the net aggregate value (worth $30 after the investment). There is no current expectation that the partnership will liquidate.

In an SEE-compliant agreement, arguably the investor should start with a section 704(b) capital account of $30, reflecting the investor's right to proceeds on a hypothetical liquidation immediately after the investment. The Treasury regulations, however, provide that a partner's capital account is increased only by the amount of cash contributed by the investor ($20).[122] If the investor begins with a capital account of $20, the partnership may be forced to allocate the first $10 of net profit (or even gross income) to the investor to cause the investor's capital account to equal $30. The effect of an immediate income allocation is to tax the investor on a bargain purchase, contrary to the general treatment of bargain purchases.

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[119] Treasury regulations section 1.704-1(b)(2)(iv)(*a*).

[120] This uncertainty has been increased by Tax Court's decision in *Clark Raymond & Co. v. Commissioner*, T.C. Memo 2022-105, which implies that the partnership's failure to allocate revaluation gain with respect to distributed assets caused the SEE safe harbor not to apply at all.

[121] *See, e.g., Palmer v. Commissioner*, 302 U.S. 63 (1937) ("Profit, if any, accrues to him only upon sale or disposition, and the taxable income is the difference between the amount thus realized and its cost, less allowed deductions. It follows that one does not subject himself to income tax by the mere purchase of property, even if at less than its true value, and that taxable gain does not accrue to him before he sells or otherwise disposes of it."); *Hunley v. Commissioner*, T.C. Memo 1966-66 (denying to apply the broader standard of "accession to wealth" from *Commissioner v. Glenshaw Glass Co*., 348 U.S. 426 (1955) "It is enough that the Federal fisc will be entitled to claim its share as income tax when and if petitioner disposes of his stock at a profit."); *Pellar v. Commissioner*, 25 T.C. 299 (1955) (citing *Palmer v. Commissioner* and finding that a purchase below value is not a realization event). *Cf. Lowndes v. United States*, 384 F.2d 635 (4th Cir. 1967) ("From the circumstances shown, the conclusion is inescapable that the $7,000 profit was nothing other than compensation for the taxpayer's service to Bethlehem. Although the sale was bona fide, the result was a fee realized at the time of the transaction even though not reduced to cash until a later date.").

[122] Treasury regulations section 1.704-1(b)(2)(iv)(*b*)(*1*).

Recommendation:

We recommend that guidance clearly address the consequences of failure to comply with the capital account maintenance rules, in particular in circumstances in which the failure is ultimately the result of reasonable (albeit errant) efforts to comply or the absence of complete guidance.[123]

We further recommend removing the "full term" requirement from the SEE rules to allow partnerships to come into compliance with SEE (even if the allocations would otherwise be valid under PIP). If a partnership has not maintained capital accounts in accordance with the SEE rules and wishes to come into compliance with the SEE rules, we recommend that Treasury and the IRS provide for a procedure that would allow the partnership to do a catch-up allocation to reverse known past errors, as compared to the allocations that would have been made as if all past items were allocated correctly.[124]

C. Liquidation in Accordance with Positive Capital Account Balances

The biggest hurdle to compliance with either the primary test or alternate test for economic effect is that liquidation in accordance with positive capital account balances generally is not acceptable as a commercial matter. In our experience, when partners are negotiating a partnership agreement, they want a clear understanding of how current and liquidating distributions will be made. If liquidating distributions are made in accordance with positive capital account balances, the economic outcome is driven by allocations of profits and losses and maintenance of capital accounts in accordance with the SEE rules. These rules are complex and most investors do not (and are not willing to commit the time necessary to) understand them.

For this reason, for at least two decades, partnership agreements have commonly used "cash-driven" distributions for both current and liquidating distributions, because this approach ensures that each partner will receive what it bargained for on a pre-tax basis. 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 distributions are clearer, simpler, and thus less prone to drafting error (at least less prone to an error introduced because of tax reasons) because they unequivocally state the intended business arrangement. In these agreements, section 704(b) allocations do not determine the economic entitlements, but rather the economic entitlements drive the allocations.

One such arrangement uses a "targeted allocation" mechanic as discussed in Part IV.A.5, above. As discussed in various portions of this Report and in our 2010 Report, we believe that targeted allocations are consistent with PIP. We also believe that they are consistent with the economic effect rules and, given their prevalence in the market, if the government's goal is to have

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[123] Moreover, guidance should also address the relevant regulatory gaps themselves, such as situations in which a partnership interest is purchased at a discount in an arm's-length transaction.

[124] In order to implement this mechanism, the IRS could consider a mechanism based on section 6226, the four-year adjustment period of section 481 or the corrective allocation mechanism of Treasury regulations section 1.704-1(b)(4)(x).

more partnerships follow the SEE rules, the SEE rules must address these types of allocation provisions explicitly.

Targeted allocations are discussed extensively in the 2010 Report. In that report, we recommended that Treasury and the IRS add a safe harbor for targeted allocation provisions that would reach the same result as would have been produced if the partnership were instead following the primary or alternate test for economic effect (the "Safe Harbor Result"). We continue to recommend such a safe harbor, but we would recommend expanding it so that the safe harbor covers a targeted allocation that (i) provides a mechanism for allocation of noneconomic items separately from the target, (ii) provides for a hypothetical liquidation at fair market value in certain conditions (in addition to section 704(b) book value), and (iii) allows use of net profit or loss, or gross items if necessary.[125] As discussed below, we also recommend that the safe harbor include a targeted allocation provision that allows the partnership to deviate from the targeted allocation methodology set forth in the agreement and allocate items in a different way, if such other allocation is more consistent with PIP.[126] However, we recommend that to the extent such discretion is used, the discretionary allocation method would need to be disclosed on the partnership's return for the year, and the separately allocated items would be subject to testing under PIP.

1. Noneconomic items

As discussed above in Part IV.B.3, a partnership might recognize an item of income, gain, loss, or deduction even though there has been no corresponding economic impact at the partnership level. In our discussion of PIP above we recommend that guidance confirm that allocations of noneconomic items will be respected so long as (i) the allocation is consistent with the allocation of a significant item of income, gain, deduction or loss (as applicable, depending on the type of noneconomic item) of the partnership, and (ii) the allocation mechanics result in a matching of any

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[125] Among other things, the 2010 Report also asked for confirmation that targeted allocations that reach the Safe Harbor Result also satisfy the safe harbor rules for allocating nonrecourse deductions under regulation section 1.704-2(e) and residual nonrecourse liabilities under regulation section 1.752-3(a)(3), and would be deemed to have economic effect for purposes of section 514(c)(9). 2010 Report at 2. We would recommend that targeted allocations that fall within the safe harbor requested in this Report be similarly treated.

Other commentators have requested a rule providing that a pro rata partnership is deemed to satisfy the SEE Rules. A partnership would be considered a pro rata partnership if all contributions are cash; all items of partnership income, gain, loss, deduction, and credit are allocated pro rata based on the partners' relative contributions; all partnership liabilities are shared pro rata based on the partners' relative contributions; and all partnership distributions are made pro rata based on the partners' relative contributions. *See* American Institute of Certified Public Accountants*, Comments on Proposed Regulations Withdrawing the Section 704(b) De Minimis Exception on Partner's Distributive Share* (Nov. 12, 2012). Although we do not object, we do not think such a safe harbor is necessary, because there should be no question that pro rata allocations in a purely pro rata partnership either satisfy the SEE rules (by virtue of satisfying EEE) or PIP.

[126] The current safe harbor rules already do this in certain instances. For example, the Comparative PIP Test of Treasury regulations section 1.704-1(b)(3)(iii) might cause a particular loss allocation to be allocated under PIP while the remaining partnership items are allocated under the SEE safe harbor. Similarly, a QIO causes certain items of income and gain to be allocated under PIP while the remaining partnership items are allocated under SEE.

corresponding item (*e.g.*, where the initial noneconomic item is an item of income or gain, a subsequent noneconomic item of loss or reduction in gain) to the same partner.

Partnership flexibility in allocating noneconomic items is not inconsistent with a targeted allocation approach. We recommend that a safe harbor for targeted allocations also allow the same options in allocating noneconomic items (and their corresponding opposite sign items). Although both items would affect the section 704(b) capital accounts, for purposes of determining the targeted capital accounts, the opposite sign item would be added back. For example, in Example 10 above, if the dividend income is allocated to the LPs, their section 704(b) capital accounts (based on book values) will be $120. For purposes of determining their targeted capital accounts, however, the corresponding opposite sign item (the section 704(b) loss in the corporate stock) will be added back, such that their targeted capital accounts (before any distribution) are only $100 as shown in the table below. Without this addback, the targeted capital account mechanism would automatically reverse the allocation of the $20 noneconomic income with other items, but we believe it is more properly offset by the loss in the PC stock.

Capital contribution	$ 100
Noneconomic dividend income	$ 20
Corresponding PC stock loss	$ (20)
Targeted capital account	$ 100

A similar mechanism is used in nearly all targeted capital accounts for nonrecourse deductions and the minimum gain chargeback.

2. <u>Hypothetical liquidation value</u>

There are variations in the way that targeted allocation provisions are written. Most require the hypothetical liquidation to be done using section 704(b) book values, and those partnerships generally maintain capital accounts in accordance with the SEE rules. However, as discussed in this Part V.C.2, we do not think the use of section 704(b) book values is necessary to the integrity of the system and believe that fair market values could be used instead, subject to the valuation principles we recommend for PIP (*see* Part IV.A.4, above).

We start this discussion by illustrating in Example 13 the operation of a targeted allocation provision based on section 704(b) book value. As demonstrated in this example, even if one uses book values, different allocations are possible depending on whether the partnership revalues its assets or not. In other words, the SEE rules already provide for the use of fair market values in certain scenarios.

> <u>**Example 13**</u> An investment fund has limited partner investors ("LPs"). The general partner (GP) receives a profits interest for services performed to or for the benefit of the partnership.
>
> The general economic agreement governing distributions follows a European waterfall, and, as such, (a) LPs first receive back their contributed capital, then (b) LPs receive an annual non-compounding preferred return of 10 percent on their unreturned capital, then (c) the GP receives a distribution of an amount necessary

to cause the GP to have received 20 percent of the total amount distributed pursuant to clauses (b) and (c) (the "catch-up"), and finally (d) the residual is distributed 80 percent to the LPs and 20 percent to the GP.

At the beginning of Year 1, the LPs contribute $450, and the fund purchases stock in Corporation A for $100, stock in Corporation B for $150, and stock in Corporation C for $200.

At the end of Year 4, the fund sells the stock of Corporation A for $300 (recognizing book and tax gain of $200) and distributes the $300 of proceeds to the LPs. At this point, the LPs have accrued $180 of preferred return ($450 x 10 percent x 4 years). If the partnership were to sell Corporation B and Corporation C for their section 704(b) book values (purchase price), the GP would be entitled to a catch-up distribution of $20.[127]

If the partnership had an SEE compliant agreement and did not revalue its capital accounts, the allocations and capital accounts would be as follows:

	LPs	GP
Starting section 704(b) capital	$ 450	$ -
Year 4 gain allocation	$ 180	$ 20
Ending section 704(b) capital (before any distributions)	$ 630	$ 20

If instead the partnership agreement provided for a distribution waterfall and typical targeted allocations, the same allocations would result. Instead of allocating gain to drive the capital accounts to match the expected economics, the fund would calculate the expected liquidating (or targeted) distributions based on section 704(b) book value and would allocate the gain to cause each partner's capital account to equal the target. In this example, the section 704(b) book value of the partnership's assets is $650 at the end of year 4, and the targeted capital accounts would be $630 for the LPs and $20 for the GP. For the reasons discussed in the 2010 Report and in this Report, we believe this targeted allocation would be in accordance with PIP.

Alternatively, assume the partnership is SEE compliant and experiences an event in year 4 that permits it to revalue the partners' capital accounts. At the end of year 4, Corporation B is now worth $200 (a $50 gain) but Corporation C is now worth $120 (an $80 loss). As a result, the fund's total section 704(b) profit in year 4 is $170 ($200 gain from sale of Corporation A, plus $50 book gain on Corporation B less $80 book loss on Corporation C). This $170 of section 704(b) profit

[127] The maximum catch-up distribution at this point would be $45 ($180/.8 - $180), but the fund only has $20 of excess profit ($200 profit minus $180 owed to LPs as preferred return).

is less than the $180 of preferred return that the LPs have accrued[128] and would be allocated entirely to the LPs. The same would hold true under a targeted allocation approach.[129]

	LPs		GP	
Starting section 704(b) capital	$	450	$	-
Year 4 gain allocation	$	170	$	-
Ending section 704(b) capital (before any distributions)	$	620	$	-

Thus, the use of a targeted allocation based on section 704(b) book values can generally achieve the same allocations that would have been made in a SEE-compliant agreement. In both cases, the result of the allocation depends on whether the partnership revalues its assets in year 4, or not.

As noted above, we also believe it would be consistent with PIP for the targeted allocation provision to provide instead for a hypothetical liquidation based on fair market value of fund investments at the end of the applicable taxable year, subject to the same valuation principles discussed in Part IV, above. Using the fair market value of assets may give rise to items that are recognized for federal income tax purposes but raise similar issues as "noneconomic" items because they are offset by other unrealized items. Example 14 illustrates these issues.

> **Example 14** The facts are the same as Example 13, above, but assume that at the end of year 4, the fund reports to its investors that Corporation B is now worth $200 (a $50 gain) but Corporation C is now worth $120 (a $80 loss). Taking into account the sale of Corporation A for $300, the fund assets are worth $620 at the end of year 4.
>
> If the fund liquidated at the end of year 4, this entire amount would be distributed to the LPs, because the profit to date would be less than the accrued preferred return. Thus, if the partnership agreement provides for targeted allocations based on a hypothetical liquidation at fair market value, the fair market value targeted capital accounts would be $620 for the LPs (this is the lesser of (i) $450 contributed capital plus $180 preferred return and (ii) the actual $620 value available for distribution) and $0 for the GP.
>
> It is clear that at least $170 of gain from the sale of Corporation A should be allocated to the LPs. Such an allocation would cause the LPs to have a capital account of $620, equal to their fair market value targeted capital account. The GP would have a capital account of $0. It is less clear how to allocate the remaining $30 of gain from the sale, as this gain is economically matched by unrecognized loss in the remaining fund assets ($50 gain with respect to Corporation B and $80

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128 Although this $170 is less than the preferred return that has accrued, and many targeted allocation provisions provide for allocation of gross items "if necessary," in this example, a gross allocation of gain to the LPs would result in an allocation of loss to the GP, an inappropriate result as the GP does not have a capital account balance.

129 The tax gain would follow allocation of the section 704(b) gain. Because the LPs are allocated all $200 of section 704(b) gain from the sale of Corporation A (in addition to a net $30 section 704(b) loss on the other assets), they are also allocated the $170 of tax gain.

loss with respect to Corporation C). Consistent with our recommendations with respect to noneconomic items generally, we believe it would be reasonable to allocate the remaining $30 of gain to the LPs here, because the GP would not be entitled to any distributions if the fund were to liquidate. As proposed for noneconomic items, allocating the $30 of noneconomic gain to A is consistent with the allocation to A of all $170 of economic gain resulting from the sale. Furthermore, it is also consistent with the economics to allocate the $30 loss "chargeback" to A when recognized, because it represents a loss of A's capital. To the extent possible, the LPs would later be allocated $30 of the corresponding section 704(b) loss in Corporation C.[130] This would result in the following allocations and capital accounts:

	LPs	GP
Starting section 704(b) capital	$ 450	$ -
Year 4 gain allocation	$ 200	$ -
Ending section 704(b) capital (before any distributions)	$ 650	$ -
Unbooked loss	$ (30)	$ -

In this scenario, the gain from sale of Corporation A is allocated the same way (entirely to the LPs) whether the targeted allocation used fair market values or used section 704(b) book values with a revaluation of assets.

We recommend that a safe harbor for targeted allocations allow partnerships to specify use of section 704(b) book values or fair market values in accordance with the standards discussed in Part IV.A.4 and Part IV.B.2(b), above. If the partnership uses fair market value for this purpose, it would be required to allocate any resulting "noneconomic" items in the manner described in Part IV.B.3 above. In order to qualify for the safe harbor, the partnership would be required to consistently apply the same value approach for its targeted allocations each year.

If this recommendation is not accepted, we recommend that targeted allocations using fair market values be treated as presumptively satisfying PIP.

3. Allocation of gross items

In many common business transactions, especially the issuance of a partnership interest with an accreting preferred coupon, it is not possible to guarantee that the partnership will have sufficient section 704(b) profit every year to allocate with respect to the coupon. In the case of an operating partnership, the partnership may be starting a business and expect losses in the early years, or the partnership may be earning income but may have depreciation and amortization deductions, causing it to incur a net loss. In the case of a partnership that owns only stock in one or more corporations, the stock may be increasing in value, but the partnership may not expect the

[130] Corporation C may increase in value before its disposition such that there is no built-in loss at the time the fund disposes of the shares of Corporation C. In such a case, the GP would be able to participate in the proceeds from the sale of Corporation C without any corresponding income to allocate to the GP, as we discussed in Example 9, in Part IV.B.2(c) above.

corporation to pay a dividend and may not expect a sale for several years. In our experience, in most cash-driven partnership agreements, the preferred return accrues regardless of whether the partnership ever has profit.[131] Generally, however, when a partnership issues a preferred interest, the parties expect that the partnership will eventually have sufficient profit to pay the coupon so that it is not paid from other partners' capital.[132]

Some targeted allocation provisions require allocation only of net section 704(b) profit or loss. In this situation, even if the capital accounts do not equal the partners' hypothetical liquidating entitlements at the end of each year, the expectation is generally that future allocations will adjust the capital accounts so that they reach the Safe Harbor Result by the year of liquidation.

We believe that this approach is reasonable provided that the partnership reasonably expects there to be sufficient profits in the future to satisfy the accrued but unallocated preferred return, and the preferred return is not distributed in advance of the associated income allocation. For example, at the beginning of the life of a partnership, an operating partnership may incur losses as it begins its business. At that time, presumably the partnership is not distributing cash and the preferred partner cannot force the partnership to liquidate to satisfy the preferred return. Accordingly, it arguably would be inconsistent with the economics to allocate gross income to the preferred partner in the early years just to match an accreting return that is hypothetical until paid, when the parties expect the return in fact to be paid out of future profits.

Other targeted allocation provisions provide for the allocation of gross items "if necessary" in order to increase the likelihood that partners' capital accounts will equal the Safe Harbor Result at the end of each year. If net items are insufficient, items of gross income would be allocated to the partner with the preferred interest to cause its capital account to equal its hypothetical liquidating entitlement. This results in a loss (or larger loss) for the remaining partners. Partnership agreements rarely specify how gross items would be allocated, and there are multiple approaches as discussed in the following example.

> **Example 15** X and Y each contribute $100 to an LLC. X holds a preferred interest with an accreting coupon of $10 each year. Y has a common interest and receives all profits above the preferred return. Economic losses are borne first by Y to the extent of its capital. In year 1, the partnership has $100 of operating income, $80 of deductible expenses, and $11 of nondeductible expenses, for a total of $9 of section 704(b) profit.

First, assume that the LLC agreement provides a targeted allocation of net section 704(b) profit only. All $9 of section 704(b) income (including a net $20 of taxable income and $11 of nondeductible expenses) is allocated to X. As a result, X's capital account at the end of year 1 is

[131] In some cases, a partner's preferred return could also reasonably be viewed as a guaranteed payment. As discussed in note 78, for purposes of this Report, we will assume that a partner's preferred return is treated as a distribution that will at some time be matched by a corresponding income allocation, and not a guaranteed payment.

[132] *See* 2016 Report at 21 ("[T]he partner's preferred return is expected to be paid out of partnership income—it may be paid out of the other partners' capital, but only if (i) there is insufficient income and (ii) losses or more senior claims do not eliminate that capital first.").

$109, less than X's hypothetical liquidating entitlement of $110. X's total taxable income is $20, even though it was only allocated $9 of section 704(b) income, and its coupon is only $10.

Instead, assume that the partnership agreement provides for allocation of gross items if necessary. As noted in our 2016 Report,[133] there are several ways that this could be done, including the following:

- Option A: One possibility is to allocate gross deduction to the partner with the subordinated common capital (Y) and the remaining items to the partner with the preferred interest (X). Here, $1 of section 704(b) deduction would be allocated to Y such that "adjusted net income" equals $10, the amount of X's accrued coupon. As a result, X would be allocated total section 704(b) profit of $10, comprising $100 of operating income and $90 of deductions. X's total taxable income will depend on whether the partnership allocates $1 of deductible expenses, $1 of nondeductible expenses, or a proportionate amount of each, but would range from $20 (if $1 of nondeductible expense is reallocated to Y) to $21 (if $1 of deductible expense is reallocated to Y).

- Option B: A second possibility is to allocate gross income to the partner with the accreting preferred coupon (X) and the remaining items to the partner with the common interest (Y). Here, $10 of gross income would be allocated to X, and the rest of the items (a total section 704(b) loss of $1) would be allocated to Y. In this scenario, X would have taxable income of $10 and Y would have taxable income of $9 (income of $90 minus deductible expenses of $80).

- Option C: A third possibility is to allocate gross income to each partner to cause their capital accounts to equal the hypothetical liquidating targeted accounts, and then to allocate the remaining items between them. Here, $10 of gross income would be allocated to X and $1 of gross deduction would be allocated to Y, which would leave $90 of gross income and $90 of gross expense, for total remaining section 704(b) profit of $0. The $0 (with its underlying items) would be allocated proportionately to the partners in some manner.

Each of these approaches is consistent with the SEE rules, but will have dramatically different results to the partners.

We recommend that a regulatory safe harbor allow use of net profit or loss, or gross items when required, to account for preferred returns. For this purpose, allocation of gross items should, in our view, be required when the partnership does not reasonably anticipate sufficient net profits to satisfy the preferred return. Also, as a condition for such safe harbor treatment, the partnership agreement should be required to provide a consistent method for determining whether it is necessary to allocate gross items and how they will be allocated over the partnership's entire life (or for the period during which the preferred interest is outstanding). If, at the time the preferred investor receives a distribution with respect to its coupon, the investor has not been allocated a

[133] 2016 Report at 26 n. 64.

corresponding amount of net profit (or items of income or gain), the payment of the preferred return would be treated as a guaranteed payment.

In either case, we believe that such a safe harbor should be available only where the method to be used is clearly specified in the partnership agreement prior to making any allocations and is consistently applied from year to year thereafter when there is insufficient net income to satisfy the preferred return.

4. Flex language

Because a formulaic targeted allocation provision sometimes leads to results that are inconsistent with the partners' economic entitlements (as discussed in various portions of this Report), it has become increasingly common in our experience for practitioners to include "flex" language permitting allocations of profit and loss (or items thereof) among the partners in another way if that other allocation is more consistent with the partners' economic interests in the partnership.

This flexibility can be used for many reasons. For instance, it can be used to avoid overallocation to a partner with a profits interest when the value changes (*see* Examples 6-9 in Part IV.B.2(c) above).

For the same reason, the partnership might also want the ability to change its method of allocation if it has income or gain in the current year, has an outstanding preferred interest, and is not anticipating having sufficient income or gain in the following year to allocate an amount with respect to the accreting coupon in that year, similar to the facts discussed in Example 3 above.

Partnerships also use the flex language when the facts or asset values change shortly after the year for which allocations are being done. For example, many investment funds running a hypothetical liquidating waterfall (based on actual fair market values) when they were preparing the tax returns on March 31, 2020, or June 30, 2020, would likely have gotten significantly different answers than the hypothetical liquidating waterfall on December 31, 2019.

Because it is not possible to predict every scenario, a partnership often will want to include more general "flex" language allowing deviation from the formulaic targeted allocation method set forth in the agreement, to allow it to react to unforeseen circumstances.[134] In such a case, we would recommend that the partnership be viewed as complying with the SEE safe harbor for targeted allocations as long as it follows the specific approach articulated in its partnership agreement and does not use discretion under the general flex language. To the extent that flexibility is used to exercise discretion solely to allocate a noneconomic item in accordance with recommendation 2.(a) above, the partnership's other allocations would still benefit from the safe harbor. To the extent the partnership uses the general flex language to allocate economic items, the "flex" allocations would no longer fall within the safe harbor, though they could still be

[134] For example, a partnership might use the flex language when it recognizes noneconomic income, such as the dividend described in Example 10, or has $0 net section 704(b) income comprising offsetting gross items of income and loss. The use of flex solely to allocate a noneconomic item should not remove the partnership's other (economic) allocations from the safe harbor since, under the SEE rules, noneconomic items are addressed under PIP.

consistent with PIP depending on the facts and circumstances. We recommend that once the partnership exercises its flexibility, it would be required to disclose the special allocations on its return for the year.

Recommendation:

In order to make the SEE rules more relevant and practical we propose modifying them to provide additional safe harbors for certain arrangements that do not require liquidation in accordance with positive capital account balances.

We recommend that Treasury and the IRS allow certain targeted allocation provisions to satisfy the SEE safe harbor. In addition to a safe harbor for the type of targeted allocation provision discussed in the 2010 Report, we recommend that a safe harbor cover targeted allocation provisions that (i) provide a mechanism for allocation of noneconomic items separately from the target allocation, (ii) provide for a hypothetical liquidation at fair market value in certain conditions (in addition to section 704(b) book value), and (iii) allows use of net profit or loss, or gross items if necessary. In addition, we recommend that targeted allocations described in the 2010 Report (*i.e.*, that reach the "Safe Harbor Result" as the term was used in that report) or that meet the requirements of the additional safe harbor recommend in this Report also be deemed to have economic effect for the purposes of section 168(h)(6) and section 514(c)(9)(E). We also recommend that the safe harbor include a targeted allocation provision that allows the partnership to deviate from the targeted allocation methodology set forth in the agreement and allocate items in a different way, if such other allocation is more consistent with the partners' interest in the partnership. However, we recommend that to the extent such discretion is used, the discretionary allocation method would need to be disclosed on the partnership's return for the year, and the separately allocated items would be subject to testing under PIP.

D. Revaluations

A partnership that liquidates in accordance with positive capital account balances may need to revalue its property and capital accounts frequently (for example, each time a disproportionate distribution or contribution is made) to ensure that capital accounts reflect the intended economic arrangement.[135] The need to revalue assets is another reason that partners may not want liquidating distributions to be in accordance with positive capital account balances.

It is unclear whether a partnership may revalue its property upon a recapitalization or restructuring of the equity. The section 704(b) regulations provide an exclusive list of situations in which a partnership may revalue its property and allocate the resulting section 704(b) gain or loss to the partners.[136] The list includes, among other things, certain disproportionate contributions and distributions, and issuances of partnership interests for services. Partnership recapitalizations are not included on the list, even though recapitalizations, like the other listed events, are generally situations in which partners are negotiating about the value of partnership property and in which it may be sensible to revalue capital accounts to reflect the capital value and built-in gain or loss

[135] Treasury regulations section 1.704-1(b)(2)(iv)(*f*).

[136] Treasury regulations section 1.704-1(b)(2)(iv)(*f*).

belonging to each partner at the time of the recapitalization.[137] Many partnerships do revalue when a recapitalization occurs. Under current law, it is not clear whether those partnerships are incorrectly maintaining capital accounts and excluded from satisfying the SEE rules.

We recommend that the proposed regulations adding recapitalizations as a permissible revaluation event be finalized.[138]

In addition, in some cases, revaluation events can occur multiple times per year if multiple investors are investing in or being redeemed from the partnership. Each time a partnership revalues its assets, however, a new section 704(c) layer is created on each asset (if the value or basis of the asset has changed since the last revaluation). The partnership is generally required to track each layer and allocate depreciation, amortization, and gain or loss from sale of the asset in accordance with section 704(c) principles. For partnerships with thousands of assets, whether operating assets or investment securities, tracking multiple section 704(c) layers for each asset and each partner can be enormously complicated and expensive.[139] For this reason, we recommend that revaluations remain discretionary.

Finally, revaluations may result in inside-outside basis disparities when the allocation of a revaluation gain does not align with how the assets are ultimately distributed. In this situation, we recommend allowing the partners to reallocate previously allocated section 704(b) revaluation amounts (together with the corresponding reverse section 704(c) gain) on property with the same relevant tax attributes to prevent creation of inside-outside basis disparities.

> **<u>Example 16</u>** Partners X and Y contribute $4,000 and $6,000, respectively, to a partnership that uses the $10,000 to buy 100 shares of stock.
>
> Several years later, the stock is worth $30,000 in total, and each share is worth $300. The partnership grants a profits interest to a service provider and revalues it stock immediately before the grant. Each share is booked up by $200, of which $80 is allocated to X and $120 is allocated to Y. Later, when the stock value has not changed, 20 shares (worth $6,000) are distributed to X (in partial redemption of X's

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137 The proposed section 704(b) regulations that were included in the proposed section 751(b) regulation package would provide that a partnership may also revalue its assets in connection with an agreement to make a non-de minimis change in the manner in which the partners share any item or class of items of income, gain, loss, deduction, or credit of the partnership under the partnership agreement. Prop. Treasury regulations section 1.704-1(b)(2)(iv)(f)(5)(v), REG-151416-06, 79 Fed. Reg. 65,151 (Nov. 3, 2014). The effective date of the proposed section 704(b) regulations is unclear.

138 Prop. Treasury regulations section 1.704-1(b)(2)(iv)(*f*)(*5*)(*v*). In the preamble to the proposed regulations, Treasury and the IRS noted that they agree that recapitalizations should be added as a permissible event in order to preserve each partner's share of unrealized built-in gain or loss, absent an addition of a special allocation of unrealized gain or loss in the partnership agreement. REG–151416–06, 79 Fed. Reg. 65151 (Nov. 3, 2014).

139 Many of these complexities have been addressed in comments to IRS Notice 2009-70. *See, e.g.,* New York State Bar Association Tax Section, Report No. 1202, *Report on the Request for Comments on Section 704(c) Layers Relating to Partnership Mergers, Divisions and Tiered Partnerships* (Jan. 16, 2010); New York State Bar Association Tax Section, Report No. 1220, *Report on Aggregation Issues Facing Securities Partnerships Under Subchapter K* (Sept. 29, 2010).

interest, such that X only owns 25 percent of the capital after such distribution). The capital accounts are as follows:

	X	Y	Profits interest holder
Starting section 704(b) capital account	$ 4,000	$ 6,000	$ -
Allocation of revaluation gain	$ 8,000	$ 12,000	$ -
Distribution of shares	$ (6,000)	$ -	$ -
Ending section 704(b) capital account	$ 6,000	$ 18,000	$ -

The capital accounts at this point accurately reflect each partner's economic share of the partnership assets. X now has a 25 percent interest in the partnership.[140]

It might be expected that X would be allocated 25 percent of the gain if the remaining shares were sold for $24,000. This is not the case under a literal application of Treasury regulations section 1.704-3: The partnership has 80 shares, each of which has a section 704(b) and fair market value of $300, and a tax basis of $100. Under Treasury regulations section 1.704-3 as typically applied by many tax practitioners, the built-in gain of $200 in each share would be allocated in the same manner that the revaluation gain was allocated, that is $80 to X and $120 to Y, regardless of the fact that X has reduced its interest (and Y increased its interest) in the partnership.

Therefore, if the shares were sold for $24,000, X would be allocated 40 percent of the gain (or a total of $6,400) even though it owns only 25 percent of the partnership and owns 20 shares of the corporation with built-in gain of $2,400. Similarly, Y would be allocated 60 percent (for a total of $9,600) of tax gain. Upon distribution of the proceeds, X would recognize a loss of $2,400,[141] and Y would recognize a gain of $2,400.[142]

The reason for this result is that the shares distributed to X had reverse section 704(c) gain attributable to Y of $2,400. In effect, the distribution in kind of the shares caused X to take over $2,400 of Y's built-in gain in the shares.

This type of disparity resulting from revaluations can lead to negative and unexpected consequences for X and/or deferral for Y and is another reason that partnerships may not want to revalue their assets. The result in the example above could be avoided if X and Y were permitted (or required), in effect, to exchange their reverse section 704(c) gain with respect to the distributed and retained shares. If such an exchange were permitted, X's share of reverse section 704(c) gain

[140] This is because X owned a 40% interest in the partnership's assets before the distribution (since the value of the property did not increase since the profits interest was granted) worth $12,000 (40% x $30,000) and X received 20 shares worth, in the aggregate, $6,000. As such, X's interest is now ($12,000 - $6,000)/$24,000 or 25%.

[141] This is X's original basis of $4,000, minus the $2,000 basis in the shares distributed to X, plus the $6,400 of gain allocated to X, minus the $6,000 distributed to X.

[142] This is Y's original basis of $6,000, plus the $9,600 of gain allocated to Y, minus the $18,000 distributed to Y. The $2,400 built-in gain in Y's partnership interest is equal to Y's share of section 704(c) gain on the shares distributed to X ($120 times 20).

on the distributed shares would be increased by $2,400 from $1,600 to $4,000 (reflecting the total built-in gain X actually takes in the shares), and X's share of reverse section 704(c) gain in the remaining shares would be reduced (and Y's share increased) by a corresponding $2,400.[143]

While section 704(c) is generally outside the scope of this Report, we recommend that the Treasury and the IRS amend the section 704(c) regulations to permit such an exchange of reverse section 704(c) gain on assets with the same relevant tax attributes.

E. DROs

A DRO is an agreement pursuant to which, if a partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs, the partner is unconditionally obligated to restore the amount of the deficit balance to the partnership by the end of the partnership taxable year or, if later, within 90 days after liquidation.[144] Unless the partner has unlimited liability as a matter of law (*e.g.*, general partner in a limited partnership), DROs are rarely used in non-tax-driven commercial transactions because partners generally do not agree to share in downside beyond contributed capital unless a significant benefit can be obtained with compliance (*e.g.*, tax equity deals). Even if a DRO is available, it is not clear what benefit the 90-day period is intended to accomplish: in our experience, it is quite short and by the time a DRO would need to be restored under the SEE rules, the parties may not have concluded the final accounting.

Recommendation:

We recommend that the period to restore a deficit capital account for partners in partnerships with agreements that contain DROs be extended, as 90 days may be too short in practice. In order to allow partnerships to finalize their accountings (and partners who have positive DRO to have sufficient time to arrange for payment of the amount due), we recommend that the obligation to restore a deficit be allowable until the later of (i) the date that the partnership is required to file (or, if earlier, actually files) its final tax return, and (ii) 180 days after the date of liquidation.

[143] A similar procedure has been suggested in earlier reports and by other commentators in connection with section 751(b). The application of section 751(b) could be narrowed if a partner receiving a distribution of hot assets could increase the partner's reverse section 704(c) gain in the distributed assets (up to the total reverse section 704(c) gain inherent in the distributed assets) and correspondingly reduce the partner's share of reverse section 704(c) gain in retained partnership assets. In that case, no partner's share of hot assets would be changed by the distribution. *See* New York State Bar Association Tax Section, Report. No. 1329, *Proposed Regulations Under Code Sec. 751(b)* (Sept. 9, 2015) at 46-49. *See also* American Bar Association Tax Section, *Comments Concerning Notice 2006-14, 2006-1 C.B. 498* (Apr. 27, 2007) at 30-31; New York State Bar Association Tax Section, Report No. 1122, *Report Responding to Notice 2006-14, 2006-1 C.B. 498 Relating to the Treatment of Partnership Distributions Under Code Sect. 751(b)* (Nov. 28, 2006) at 26-27; Preamble to Prop. Treasury regulations section 1.751-1(b), REG-151416-06, 79 Fed. Reg. 65,151 (Nov. 3, 2014) (requesting comments on this suggestion).

[144] Treasury regulations section 1.704-1(b)(2)(ii)(*b*)(*3*).

F. QIOs

Under the alternate test for economic effect, a DRO is not required if a partnership agreement limits loss allocations and contains a QIO. Specifically, an allocation of a loss will be considered to have economic effect to the extent such allocation does not cause or increase a deficit balance in the partner's capital account (in excess of any limited deficit restoration obligation) as of the end of the partnership taxable year to which the allocation relates. Regarding the QIO, the partnership agreement must provide that if a partner has been allocated losses and later has a certain unexpected adjustment, allocation, or distribution that causes the partner to have a deficit capital account (adjusted downward, as a first step, for certain such reasonably anticipated adjustments, allocations, and distributions), the partner must be allocated items of income and gain to restore such deficit capital account as quickly as possible.[145] As the regulation is drafted, a QIO would not apply when a partner's capital account goes negative as a result of an *expected* distribution, even if no losses have been allocated.[146] Outside of the specific situation covered by the QIO, it is not clear if allocations to restore a negative capital account would have economic effect or would be deemed to be in accordance with PIP.

> **Example 17** A partnership agreement meets the first two requirements of the primary test for economic effect (provides for maintenance of capital accounts and liquidating distributions in accordance with positive capital account balances) and contains a QIO instead of a DRO.
>
> At the beginning of Year 1, X has a capital account balance of $100. The partnership does not expect to make any adjustments, allocations, or distributions to X in the future that would reduce X's capital account balance. At the end of year 1, the partnership allocates X a loss of $80, reducing X's capital account balance to $20.
>
> In year 4, when X's capital account balance is still $20 (and X is not otherwise expected to be allocated income in year 4) the partnership unexpectedly distributes $50 to X, reducing X's capital account balance to ($30).[147]

Under the QIO, the partnership must allocate $30 of gross income and gain to X as quickly as possible to restore X's capital account balance to $0.

> **Example 18** The facts are the same as Example 17, but X is not allocated any losses in year 1.
>
> Under the partnership agreement, X is entitled to a share of the increase in partnership assets. In year 4, when the partnership assets have increased in value but have not been revalued for purposes of section 704(b), the partnership

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[145] Treasury regulations section 1.704-1(b)(2)(ii)(*d*)(*6*) (flush language).

[146] *But see Clark Raymond & Co. v. Commissioner*, T.C. Memo 2022-105 (suggesting to the contrary).

[147] The partnership has liabilities and pursuant to the Treasury regulations prescribed under section 752, X has a sufficient share of those liabilities, such that the distribution does not cause X to recognize gain under section 731(a).

distributes $130 to X pursuant to the partnership agreement, reducing X's capital account balance to ($30).

It appears that the QIO does not apply to the situation in this Example 18, both because the distribution to X is expected and because the QIO is drafted as a backstop to previous loss allocations, and here no losses were allocated. An allocation of income or gain of $30 to X may not have economic effect, because it will merely increase X's capital account from ($30) to $0, and in either case X would not be entitled to anything. (If the QIO provision does not apply, it is not clear whether an allocation of $30 of partnership income or gain would be deemed to be in accordance with PIP. Nevertheless, many practitioners believe that it would be in accordance with PIP to allocate income or gain to X in this situation.)

Recommendation:

In our experience, most partnership agreements that are drafted to comply with the SEE safe harbor do not contain a DRO but do have provisions limiting loss allocations and provide for a QIO. In some cases, the QIO provision is drafted more broadly than the regulations require and requires an allocation of gross income or gain to a partner to the extent of a partner's deficit capital account (in excess of any limited obligation to restore a deficit balance that the partner may have and in excess of the partner's share of minimum gain). As discussed above, it is not clear whether an allocation of income or gain to a partner with a deficit capital account satisfies the primary or alternate test for alternate effect. We recommend that Treasury and the IRS clarify the regulations to provide that a QIO applies to any deficit capital account. The QIO should not apply, however, to the extent a partner has a share of minimum gain.[148]

[148] Under current law, the QIO does not apply to the extent a partner has a share of minimum gain. Treasury regulations section 1.704-2(g)(1).