

A photograph of two men in business suits shaking hands. The man on the right is wearing a dark suit, a white shirt, and a blue tie. The man on the left is wearing a dark suit. They are standing in an office with a wooden floor and a blurred background.

Allocations Made in Accordance With Partners' Interests in the Partnership

Prepared by:
Bradley T. Borden
Brooklyn Law School

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ALLOCATIONS MADE IN ACCORDANCE WITH PARTNERS' INTERESTS IN THE PARTNERSHIP*

Bradley T. Borden*

Despite the universal importance of making allocations in accordance with partner's interests in a partnership, the tax law does not do a good job of defining these interests. Allocations made in accordance with partners' interests in the partnership are important in three situations.¹ First, if a partnership agreement allocates tax items that have economic effect, tax law tests the substantiality of those allocations by comparing them to allocations made in accordance with partners' interests in the partnership.² Second, if a partnership agreement allocates tax items but the allocations lack substantial economic effect, tax law reallocates those tax items in accordance with the partners' interests in the partnership.³ Third, if a partnership agreement does not allocate tax items, tax law allocates the tax items in accordance with partners' interests in the partnership.⁴ Thus, allocations made in accordance with partners' interests in the partnership are the standard against which tax law tests allocations that have economic effect. They are also the default allocations if the partnership agreement is silent regarding tax-item allocations or if partner-directed tax-item allocations lack substantial

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* Bradley T. Borden is an associate professor of law at Washburn University School of Law in Topeka, Kansas. © 2009 Bradley T. Borden.

¹ The regulations use the terms "partners' interest in the partnership," "partner's interest in the partnership," and "partner's interest in a partnership" interchangeably, as appropriate, to refer to the same concept. This article adopts the same usage.

² See Reg. 1.704-1(b)(2)(iii)(a).

³ See Section 704(b)(2).

⁴ See Section 704(b)(1).

economic effect. All of this suggests that if a partnership agreement allocates tax items in accordance with partners' interests in the partnership, tax law should respect such allocations, even if the allocations do not satisfy the test for substantial economic effect.⁵

Allocations made in accordance with partners' interests in a partnership are relevant to all partnerships. They are relevant to partnerships that have valid tax-item allocations (i.e., allocations that have substantial economic effect), partnerships that have invalid tax-item allocations (i.e., allocations that lack substantial economic effect), partnerships that lack partner-directed tax-item allocations, and partnerships that allocate tax items in accordance with partners' interests in the partnership.

Despite the universal importance of allocations made in accordance with partners' interests in a partnership, the tax law does not do a good job of defining the partners' interests in the partnership. This article explores the important role that concept plays in tax law, identifies some of its shortcomings, and offers a modest recommendation to make it more workable.

Economic Items

Exploring these issues requires an understanding of the difference between a partnership's economic and tax items. Partnerships are economic arrangements that pose difficult tax-item-allocation problems. As a general matter, parties create partnerships for economic gain. Partners contribute property, services, or both to partnerships, and the partnerships allocate their economic items to the partners. Those economic items may include: profits and losses from the partnership's operations; gains and losses from the sale of partnership property; and rents, royalties, interest, and other income from partnership property.

⁵ See Section 704(b)(2) (providing that if a partnership agreement allocates tax items but those allocations lack substantial economic effect, the tax items must be determined in accordance with the partners' interests in the partnership).

Partners may do nothing to allocate economic items among themselves. In that case, state default rules allocate the economic items.⁶ They may, however, use allocation formulae of varying levels of sophistication to allocate the economic items to the partners. For example, partners might allocate partnership operating profits and losses using one allocation formula and allocate gain or loss from the sale of partnership property using another allocation formula. Often, they will make such allocations for nontax business or economic reasons. For example, one partner may manage the partnership operations and the other partners may agree to allocate a larger share of the operating profits and losses to the manager to motivate that partner to increase the partnership's profits and, consequently, the amount each partner takes from the partnership. Partners may make these economic allocations with little thought of the allocations' tax consequences.

Tax Items

In addition to generating economic items, partnerships generate tax items. Tax items include gross income, rental deductions, depreciation deductions, capital gains and losses, depreciation recapture, and tax credits. Some of those tax items will correspond to economic items; some will not. Because partnerships do not pay income tax, tax law must allocate partnership tax items to the partners. Tax law allows taxpayers to allocate tax items if the allocations have substantial economic effect or are in accordance with the partners' interests in the partnership.⁷ Partner-directed tax-item allocations that have substantial economic effect not only determine the allocation of tax items, they also direct the allocation of economic items. The effect tax-item allocations can have on economic-item allocations might surprise some taxpayers.

⁶ See Unif. Partnership Act, section 401(a), (b); Unif. Ltd. Partnership Act, section 503 and comment; and Unif. Ltd. Liab. Co. Act, section 404 and comment. The limited partnership and limited liability company acts do not provide for allocations, but their distribution formulae would require the allocation of economic items. See Borden, "Partners Interests in a Partnership," available at http://works.bepress.com/brad_borden/26/.

⁷ See Section 704(b).

To avoid surprises, some partners may prefer to allocate tax items in accordance with their interests in the partnership to avoid the negative economic consequences of tax-item allocations that have substantial economic effect. The ambiguity of the concept of partners' interests in the partnership appears to provide partners significant latitude to allocate tax items. It also may create opportunities for the IRS to arbitrarily challenge tax-item allocations that do not come with the economic effect safe harbor.

Economic-Item Versus Tax-Item Allocations

A simple partnership illustrates the distinction between economic-item allocations and tax-item allocations, the effect some tax-item allocations have on economic-item allocations, and the opportunities for abuse available under the current rules.

Rob and Bert form RobBert Partnership. Rob contributes \$40,000 and Bert contributes \$60,000 to the partnership. RobBert Partnership uses that money to acquire used equipment, enter into a lease for a sandwich shop, acquire a franchise, and fund the first few months of operation. Rob and Bert each have other money-making activities and plan to work at the sandwich shop part time, so they agree to divide the ownership and management responsibilities of the partnership. They agree that Rob will manage the sandwich shop operations and supervise employees. Bert will handle the accounting, deal with vendors and the landlord, oversee the marketing, and arrange all other legal and business aspects of the shop. The partnership pays \$30,000 for the franchise and \$25,000 for the equipment.

During the first year, the shop has \$250,000 of gross receipts. The lease agreement provides for \$15,000 annual rentals for five years. The partnership employs six employees and has a payroll of \$110,000 in the first year. The partnership pays \$60,000 for materials and supplies in the first year. During the first year, the value of the franchise increases \$3,500 and

the equipment value decreases \$4,000. Those are the partnership's economic items. Some of the items will undoubtedly fluctuate from year to year. The discussion below suggests that such fluctuations will complicate the determination of the partners' interests in the partnership.

RobBert Partnership will also have tax items—those items that it must include in gross income or that it may deduct. The gross receipts will equal the partnership's gross income.⁸ The amount paid to lease the shop and compensate employees will be deductible business expenses.⁹ The partnership will also be able to deduct the cost of the materials and supplies each year.¹⁰ All of those tax items correspond to economic items. The partnership will also be able to take \$2,000 each year, for 15 years, as an amortization deduction for the franchise and \$2,500 each year, for 10 years, as a depreciation deduction for the equipment.¹¹ Those tax items are independent tax items because they do not correspond to any economic items.

Finally, at the end of the first year, the partnership will have \$5,500 of unrealized gain on the franchise and \$1,500 of unrealized loss on the equipment.¹² Those items correspond in part to the respective property change in value, but the amortization and depreciation deductions make the unrealized amounts different from the economic items (i.e., the actual changes in value). Thus, the unrealized amounts are hybrid tax items. Exhibit 1 summarizes RobBert Partnership's economic and tax items.

EXHIBIT 1

SUMMARY OF ROBBERT PARTNERSHIP'S ECONOMIC AND TAX ITEMS

⁸ See Section 61(a)(2).

⁹ See Section 162(a).

¹⁰ See Reg. 1.162-3. This analysis assumes that the partnership consumes the materials and supplies as it acquires them.

¹¹ See Sections 197(a), 167(a), and 168. This assumes the equipment is ten-year property.

¹² The unrealized gain and loss represent the difference between each property's tax basis and fair market value. See Section 1001(a).

Economic Items	Tax Items
Gross Receipts: \$250,000	Gross Income: \$250,000
Rent Expenditure: (\$15,000)	Rental Deduction: (\$15,000)
Wages Expenditure: (\$110,000)	Compensation Deduction: (\$110,000)
Materials Expenditure: (\$60,000)	Materials Deduction: (\$60,000)
	Amortization Deduction: (\$2,000)
Fluctuations in Value of Franchise: \$3,500	Unrealized gain: \$5,500
	Depreciation Deduction: (\$2,500)
Fluctuations in Value of Equipment: (\$4,000)	Unrealized loss: (\$1,500)

Allocation of economic items. The allocation of the economic items directly affects the partners' economic interests in the partnership. For example, if the partnership equally allocates the gross receipts to the partners, each partner's rights to partnership assets would increase by half of the gross receipts or \$125,000. Their rights derive from the partnership distribution rules as expressed in the partnership agreement or state law. Allocations of expenditures could offset those rights. For example, the partnership agreement may provide for immediate distribution of net receipts (i.e., excess of gross receipts over expenditures). Under such an agreement, the partners would receive their shares of net receipts as the partnership receives them. If the partnership does not immediately distribute net receipts, it should credit the equivalent of the partners' shares of the net receipts to their accounts. The partners should be entitled to receive

the balance of their accounts upon liquidation.¹³ The amount a partner is entitled to receive on liquidation represents the partner's residual risk or economic interest in the partnership. An economic interest in a partnership appears to be different from the Section 704(b) concept of partner's interest in the partnership.

Allocations of tax items. The allocations of the tax items should not affect a partner's economic interest in the partnership, but they often will affect the partner's economic situation outside the partnership. For example, if the partnership equally allocates the gross income to the partners, their respective tax liabilities will increase by an amount equal to the allocation multiplied by their respective tax rates.¹⁴ Thus, if both partners have a 10% tax rate, the allocation of gross income would increase their respective tax liabilities by \$12,500. The increased tax liabilities arising from the allocations affect each partner's economic situation because they must pay \$12,500 of taxes. Because of such effects, the allocation of tax items is important to the partners. The current rules may, however, also affect the partners' economic interests in the partnership.

Tax Partnerships. Tax partnerships present unique tax-item allocation challenges. Tax law generally has no difficulty allocating tax items to individuals. If an individual has an economic item, only that individual can recognize the associated tax item. For example, if an individual performs services and the service recipient pays for those services, the service provider must recognize compensation income on receipt of payment for those services.¹⁵ If an individual owns property that produces income, the individual property owner must recognize

¹³ See Unif. Partnership Act, section 807(b); Unif. Ltd. Partnership Act, section 503; and Unif. Ltd. Liab. Co. Act, section 404.

¹⁴ To illustrate the effect tax items may have on partners' economic situations, this hypothetical assumes that the partners have positive taxable income before the allocation of the gross income and that the gross income is the only item the partnership allocates to the partners.

¹⁵ See *Lucas v. Earl*, 281 U.S. 111, 8 AFTR 10287 (1930) (requiring the allocation of tax income to the person who earned the corresponding economic income).

any income from that property.¹⁶ If tax law allows a depreciation deduction for property, only the owner of the property may claim the depreciation deduction. Similarly, if a C corporation owns property or provides services that generate income, the corporation must recognize that income. Only that corporation can claim the depreciation deduction for property it owns. Simply put, the tax law has settled, and fairly definite, rules for taxing single owners of property and services.

Tax partnerships complicate tax-item allocations because tax partnerships do not pay income tax. Rather, the partnership must allocate all tax items to the partners, who report those items and pay tax on them.¹⁷ No tax items should be lost in the allocation process. In other words, the partners should report all the tax items the partnership would report if it paid income taxes. The allocation of a partnership tax item is not always intuitive. Intuition may suggest that tax items should follow economic items. Some tax items, like depreciation and amortization deductions do not correspond to economic items, so they cannot simply follow economic-item allocations. Nonetheless, tax law must provide for the allocation of independent tax items. As the law currently stands, partners may allocate tax items as they please if the allocations have substantial economic effect.

Substantial Economic Effect

The following discussion illustrates that if a tax-item allocation has substantial economic effect, economic items will follow the tax-item allocations. If the tax item is an independent tax item, tax law creates a fictitious economic item to follow it. Thus, tax law defies intuition and causes economic items to follow tax items and creates fictitious economic items to follow independent tax items.

¹⁶ See *Helvering v. Horst*, 311 U.S. 112, 24 AFTR 1058 (1940) (holding that the person who owns property must recognize income from that property).

¹⁷ See Sections 701 and 702.

Test for Economic Effect. The test for economic effect provides that if a partnership allocates a tax item to a partner, the economic item corresponding to that tax item must follow the tax item.¹⁸ Thus, if RobBert Partnership allocates 50% of gross income (a tax item) to Rob, it must also allocate 50% of gross receipts (the corresponding economic item) to Rob (?). The heart of the test for economic effect is the Section 704(b) capital account maintenance rules that comprise the safe harbor test for economic effect. Those rules provide that a tax-item allocation will have economic effect if a partnership maintains Section 704(b) capital accounts, liquidates in accordance with those capital accounts, and requires partners to restore deficit capital account balances.¹⁹ A partnership that adopts Section 704(b) capital accounts uses tax-item allocations to allocate economic items. Tax-item allocation and Section 704(b) capital accounts supplant the state default allocation rules. By adopting Section 704(b) capital accounts, the partners agree that the tax-item allocations will direct economic-item allocations. The result of these allocations may surprise some partners.

Deal-Centric Allocations. State law allows partners to establish in their partnership agreement how they will allocate economic items.²⁰ For example, Rob and Bert could specify in their partnership agreement that they will allocate 70% of the cost of materials and wages and the changes in value of the equipment to Rob and the remaining 30% to Bert. They could also specify that they will allocate 70% of the rent and fluctuations in the value of the franchise to

¹⁸ See Reg. 1.704-1(b)(2)(ii)(a) (“This means that in the event there is an economic benefit or burden [i.e., an economic item] that corresponds to [a tax-item] allocation, the partner to whom the [tax-item] allocation is made must receive such economic benefit or bear such economic burden.”).

¹⁹ See Reg. 1.704-1(b)(2)(ii)(b). Partners can also satisfy the test for economic effect under the alternative test for economic effect and the economic-effect-equivalence test. See Reg. 1.704-1(b)(2)(ii)(d) and (i). The alternative test for economic effect requires the partnership to maintain section 704(b) capital accounts and to make liquidating distributions in accordance with positive capital account balances. The economic-effect-equivalence test requires that allocations produce the same result that the safe harbor test for economic effect produces. Partners seeking economic effect of allocations will undoubtedly arrange their affairs to come within the safe harbor or alternative test for economic effect.

²⁰ See Unif. Partnership Act, section 103(a); Unif. Ltd. Partnership Act, section 110(a); Unif. Ltd. Liab. Co. Act, section 110(a).

Bert and the remaining 30% to Rob. They may agree to allocate the gross receipts and changes in the equipment value equally between themselves. The reasons for such allocations would appear to be purely economic. Perhaps, Rob and Bert allocate more of the cost of materials and wages to Rob because he manages the store operations. The allocation may motivate Rob to preserve materials and closely manage the employees. They may allocate more of the rent and franchise value to Bert to motivate him to negotiate aggressively for favorable lease terms and also to market the shop well. State law would respect those economic-item allocations.

Tax-Centric Allocations. Instead of focusing on economic-item allocations, Rob and Bert could focus on tax-item allocations. If Rob and Bert adopt Section 704(b) capital accounts, they would indirectly allocate economic items by allocating tax items. For example, Rob and Bert may decide to allocate 70% of the materials and compensation deductions to Rob and the remainder to Bert. They may allocate 70% of the rental deduction to Bert and the remainder to Rob. They may allocate the gross income equally and gain or loss from the sale of equipment between themselves. Those allocations largely correspond to the economic items that they might allocate.

Because the partnership maintains Section 704(b) capital accounts, the allocations of the corresponding and hybrid tax items will influence the allocations of the economic items. Thus, their reasons for making those allocations would appear to be the same as the reasons that motivated the direct allocations of the corresponding economic items. The reasons would appear to be purely economic, assuming the partners understand the economic consequences of tax-item allocations in a partnership with Section 704(b) capital accounts.

Independent Tax Items. The remaining tax items—the amortization and depreciation deductions—do not have corresponding economic items. Consequently, the partners might

allocate those tax items to obtain indirect economic benefit. The indirect economic benefit would be a reduction in tax liabilities equal to the amount of the allocated deduction multiplied by the partner's tax rate. The depreciation and amortization deductions do not necessarily correspond with an economic item. For example, the franchise increases in value over the first year, even though the partnership has \$2,000 amortization deduction. Similarly, the equipment may increase in value or decrease in value at a rate that differs from the depreciation rate. During the first year, the value of the equipment decreases by \$4,000, but the partnership takes a \$2,500 depreciation deduction.

Even though independent tax items do not correspond to economic items, the Section 704(b) capital account maintenance rules require the partners to adjust capital accounts to reflect the allocation of the amortization and depreciation deductions. Those adjustments directly affect the partners' economic interests in the partnership. Contrast this result with the result an individual taxpayer obtains. Tax items normally would not directly affect the economic situation of an individual property owner. Tax items indirectly affect individual property owners by affecting their tax liabilities. Independent tax items may, however, directly affect a partner's economic situation by altering the partner's economic interest in a partnership. Partners must consider both the direct and indirect economic consequences when they allocate independent tax items.

Partners may not, however, realize the direct economic consequences that an independent-tax-item allocation might have. Consequently, the partners may allocate those items for the indirect benefit they provide. For instance, Rob and Bert may agree to allocate 80% of the amortization and depreciation deductions to Rob and the remaining 20% to Bert. Their decision to allocate in that manner may depend on the tax benefit the allocation provides to

Rob.²¹ Assuming they have adopted the Section 704(b) capital account maintenance rules, the allocations should have economic effect and decrease each partner's capital account balance.²²

Because the partnership will liquidate according to positive capital account balances, the allocation of the amortization and depreciation deductions may affect the partners' rights to distributions on liquidation of the partnership, (i.e., their economic interests in the partnership).

The effect independent-tax-item allocations have on the partners' for economic interests in the partnership depends upon numerous factors. For example, the fluctuations of property value with respect to depreciation and the allocation of depreciation recapture can influence the effect of independent-tax-item allocations. Over time, the effect can become more severe as property values deviate from the independent tax items. Partners can measure the direct effect of independent-tax-item allocations by examining their liquidation rights with and without the independent-tax-item allocations. If the partners only allocate economic items, their liquidation interests in the partnership will reflect their original contributions and economic-item allocations.²³ Exhibit 2 summarizes the effect of economic-item allocations.²⁴

²¹ The allocation could satisfy the test for substantiality, even if it provides a tax benefit to Rob. For example, the parties may be in the same tax bracket but allocate the tax items disproportionately as consideration for some transaction between Rob and Bert. See, e.g., Borden, "Partnership Tax Allocations and the Internalization of Tax-Item Transactions", 59 S.C. L. Rev. 297, 338–40 (Winter 2008).

²² See Reg. 1.704-1(b)(2)(ii)(b).

²³ All of the examples in this article assume that the partnership computes residual value by adding contributions to the partners' accounts and adjusting the accounts as appropriate for economic items the partnership allocates to the partners. A forthcoming article refers to the partners' rights to that type of residual value as allocation-dependent residual risk. See Borden, "Residual-Risk Model for Classifying Business Arrangements", 37 Fla. St. U. L. Rev. XX (2010), available at ssrn.com/abstract=1365933. That article distinguishes business arrangements with allocation-dependent residual risk (traditional partnerships) from those with distribution-dependent residual risk (corporations and partnerships with target allocations), and it suggests that business arrangements with distribution-dependent residual risk should not come within the definition of tax partnership. This article does not analyze business arrangements, such as partnerships with target allocations, that have distribution-dependent residual risk. For a discussion of the members' interests in such arrangements, see Borden, *supra* note 6.

²⁴ Tax laws are somewhat restricted because they cannot require taxpayers to use perfect information. Consequently, tax laws rely upon historical cost of assets as a substitute for the value of the partnership's assets. See e.g., Reg. 1.704-1(b)(3)(iii) (using book value to determine the partners' interests in the partners with respect to a portion of an allocation that lacks economic effect). For the sake of illustration, this article generally assumes that the partners know the value of the partnership assets. To demonstrate the partners' economic interests in the

EXHIBIT 2

EFFECT OF ECONOMIC-ITEM ALLOCATIONS

	Rob	Bert
Contribution: \$100,000	\$40,000	\$60,000
Gross Receipts: \$250,000	50%: \$125,000	50%: \$125,000
Rent Expenditure: (\$15,000)	20%: (\$3,000)	80%: (\$12,000)
Wages Expenditure: (\$110,000)	55%: (\$60,500)	45%: (\$49,500)
Materials Expenditure: (\$60,000)	70%: (\$42,000)	30%: (\$18,000)
Change in Franchise Value: \$3,500	25%: \$875	75%: \$2,625
Change in Equipment Value: (\$4,000)	50%: (\$2,000)	50%: (\$2,000)
Residual Value: \$164,500	35%: \$58,375	65%: \$106,125

Economic Consequences of Tax-Item Allocations

Exhibit 2 suggests that Rob's economic interest in the partnership would be 35% and Bert's would be 65% if the partners do not use Section 704(b) capital accounts. The allocations of the amortization and depreciation deductions change the partners' economic interests in the

partnership, the partners' economic interests will always reflect their interests in the actual value of items, even if the partners do not know that value.

partnership.²⁵ The partners must reduce their capital accounts to reflect the allocations. Those reductions alter the amounts each partner would receive on liquidation at the end of the first year.

Consequences of Allocating Independent Tax Items

Exhibit 3 illustrates how the allocation of independent tax items may affect the partners' economic interests in the partnership. The amortization and depreciation allocations affect the partners' economic interests in the partnership because those allocations differ from the allocations of gain and loss.

EXHIBIT 3

EFFECT OF TAX-ITEM ALLOCATIONS UNDER SECTION 704(B) CAPITAL ACCOUNT RULES

	Rob	Bert
Contribution: \$100,000	\$40,000	\$60,000
Gross Receipts: \$250,000	50%: \$125,000	50%: \$125,000
Rent Expenditure: (\$15,000)	20%: (\$3,000)	80%: (\$12,000)
Wages Expenditure: (\$110,000)	55%: (\$60,500)	45%: (\$49,500)
Materials Expenditure: (\$60,000)	70%: (\$42,000)	30%: (\$18,000)
Amortization Deduction: (\$2,000)	80%: (\$1,600)	20%: (\$400)
Gain on Sale of Franchise:	25%: \$1,375	75%: \$4,125

²⁵ This is a simple example with small numbers, so the difference is not significant in absolute dollars. In a more complicated scenario with more dollars of economic items at stake, the partners would be able to affect the economic situation to a greater extent.

	Rob	Bert
\$5,500		
Depreciation Deduction: (\$2,500)	80%: (\$2,000)	20%: (\$500)
Loss on Sale of Equipment: (\$1,500)	50%: (\$750)	50%: (\$750)
Residual Value: \$164,500	34%: \$56,525	66%: \$107,975

A comparison of Exhibits 2 and 3 reveals that the allocations of the amortization and depreciation deductions reduce Rob's economic interest in the partnership by more than one percentage point and increases Bert's by more than one percentage point. The difference is about \$2,000 for each partner. That amount could become more significant and over time as the deductions and property values diverge. Many partners may not realize that the allocation of tax items can affect their economic interests in the partnership. Consequently, the amounts they receive on liquidation may surprise them. Partners who take disproportionate allocations of independent tax items should consider whether the tax benefit they receive exceeds the direct economic consequence of the allocation. The \$2,000 decrease in his economic interest in the partnership may exceed the tax benefit Rob received from the disproportionate allocation of the independent tax items.

Sophisticated or well-advised partners may recognize that independent-tax-item allocations made pursuant to the Section 704(b) capital account rules will affect their economic interests in the partnership, and, therefore, they may prefer not to use Section 704(b) capital accounts or use them strategically to improve their overall economic situations. Because

partners cannot anticipate every consequence that independent-tax-item allocations may cause, they may prefer to avoid all tax-item allocations that have direct economic consequences and allocate tax items in accordance with the partners' interests in the partnership. Tax items allocated in accordance with partners' interests in the partnership should not affect allocations of economic items. Or, perhaps, partners can separate partnership tax items from partnership economic items by using different allocation formulae for each type of item. If so, they could avoid the direct economic consequences of tax-item allocations while reaping the indirect economic consequences of these allocations.

Allocating Tax Items in Accordance with Partners' Interests in the Partnership

The rules governing allocations made in accordance with partners' interests in a partnership are vague. The regulations define partners' interests in the partnership,²⁶ but the definition leaves much to be desired. The deficiencies of that definition are the source of many of the problems that derive from the requirement to allocate tax items in accordance with partners' interests in the partnership. Considering the example above helps illustrate this point. Exhibit 4 summarizes the manner in which the partnership would allocate economic items pursuant to the partnership agreement.

EXHIBIT 4

ALLOCATIONS OF ECONOMIC ITEMS

Economic Item	Allocation to Rob	Allocation to Bert
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²⁶ See Reg. 1.704-1(b)(3).

Economic Item	Allocation to Rob	Allocation to Bert
Gross Receipts: \$250,000	50%: \$125,000	50%: \$125,000
Rent Expenditure: (\$15,000)	20%: (\$3,000)	80%: (\$12,000)
Wages Expenditure: (\$110,000)	55%: (\$60,500)	45%: (\$49,500)
Materials Expenditure: (\$60,000)	70%: (\$42,000)	30%: (\$18,000)
Change in Franchise Value: \$3,500	25%: \$875	75%: \$2,625
Change in Equipment Value: (\$4,000)	50%: (\$2,000)	50%: (\$2,000)

If the partnership agreement is silent regarding the allocation of tax items, the partnership must allocate the tax items to the partners in accordance with their interests in the partnership. The partners' interests in RobBert Partnership are not obvious. Section 704(b) provides little insight into the concept. The regulations provide some guidance for determining partners' interests in the partnership, which guidance Rob and Bert would likely consider to allocate tax items. If Rob and Bert wish to strictly adhere to the letter of the law in allocating the tax items, they may be sadly disappointed as they attempt to apply the regulations to determine their interests in the partnership. If, however, Rob and Bert wish to aggressively allocate tax items, the rules defining their interests in the partnership appear to give them significant latitude to do so.

Overall interest in partnership versus interest in specific items. As a preliminary matter, Rob and Bert must decide whether “partners’ interests in a partnership” refers to overall interests in the partnership or to interests in specific items. The term, as used in Section 704(b), suggests that the concept refers to a partner’s overall interest in the partnership. The regulations provide, however, that partners’ interests in a partnership “signify 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 . . . that is allocated. . . . [T]his sharing arrangement may or may not correspond to the overall economic arrangement of the partners.”²⁷ That provision appears to suggest that the partners should determine the partners’ interests in specific economic items and allocate the tax items according to the allocation of specific economic items. The same paragraph recognizes that “a partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in a particular item of income or deduction.” Thus, the regulation refers to both overall interest and interests in specific items. Taken together, these provisions do not conclusively establish the parameters of partners’ interests in the partnership.

Factors used to determine partners’ interest in partnership. Other provisions appear to support an overall view of partners’ interests in the partnership. The regulations provide four factors to consider in determining partners’ interests in the partnership.²⁸ The regulations present the factors as though they help establish the overall interests the partners have in the partnership. The factors are filled with ambiguous terms, however, and they appear to overlap and do not return consistent values. Thus, they will be of little help to Rob and Bert as they work to determine their interests in RobBert Partnership.

²⁷ See Reg. 1.704-1(b)(3)(i).

²⁸ See Reg. 1.704-1(b)(3)(ii).

Relative contributions. The first factor is the partners' relative contributions.²⁹ Rob contributed \$40,000 and Bert contributed \$60,000 to the partnership. In addition, Rob and Bert both contributed services to the partnership. The regulations do not specify whether "relative contributions" refers only to capital contributions or whether it includes contributions of services. If the factor only refers to capital contributions, Rob's relative contribution is 40% of the total contributions and Bert's is 60%. If the factor also includes contributions of services, Rob and Bert must determine the value of each other's contributed services. That task will most likely prove impossible.

The partners have allocated economic items to the partners to affect each other's performance, but those allocations do not necessarily reflect the fair value of the services. The allocations appear to include a motivational component—the partners allocate economic items to affect each other's behavior. As a result, the allocations probably do not reflect the value of the services.

The partners could attempt to use the partners' opportunity costs as the value of the services or they could look to the amount paid to non-partners for similar services. In another alternative, the partners could attempt to determine the value the services add to the partnership in the form of cost-savings or revenue generation. Each of those different techniques could return a different value for the services. Thus, the partners will have a difficult time determining the partners' relative contributions to the partnership, if they must include partner services in that determination. The regulations do not indicate how they should resolve that issue.

²⁹ See Reg. 1.704-1(b)(3)(ii)(a). Note: The analysis in this article assumes that the first factor refers only to capital contributions. That assumption helps illustrate that even if, contrary to fact, the individual factors were not ambiguous, taken together they are still deficient.

Partners' interests in economic profits and losses. The second factor is the partners' interests in the economic profits and losses of the partnership.³⁰ The factor uses the term “economic profits,” which is not a technical tax term. In fact, the term “profits” does not appear to have an accepted definition in any discipline.³¹ That ambiguity makes applying the factor difficult. If the partners assume that “economic profits” refers to gross receipts minus expenditures, they would determine that RobBert Partnership had \$65,000 of economic profit in year one.³² Their interests in that profit are a function of the manner in which they allocated the components of the economic profit. Even though they do not uniformly allocate the components of economic profit, they can determine their overall interests in the partnership's assumed economic profit. Exhibit 5 reveals that Rob's and Bert's overall interests in the partnership's assumed economic profits are 30% and 70%, respectively.

EXHIBIT 5

PARTNERS' INTERESTS IN THE PARTNERSHIP'S ECONOMIC PROFITS

Economic Item	Rob's Interest	Bert's Interest
Gross Receipts: \$250,000	50%: \$125,000	50%: \$125,000
Rent Expenditure: (\$15,000)	20%: (\$3,000)	80%: (\$12,000)
Wages Expenditure:	55%: (\$60,500)	45%: (\$49,500)

³⁰ See Reg. 1.704-1(b)(3)(ii)(b).

³¹ For example, in *Madison Gas & Electric Co.*, 633 F.2d 512, (CA-7, 1980), the court held that cost savings derived from sharing economies of scale is profit. For an in-depth criticism of the Seventh Circuit's definition of profit and possible definitions of profit, see Borden, “Taxing Shared Economies of Scale”, 61 *Baylor L. Rev.* XX (forthcoming 2009), available at <http://papers.ssrn.com/paper=1462384>.

³² The partnership had \$250,000 of gross receipts and \$185,000 of expenditures (rent of \$15,000, wages of \$110,000, and materials \$60,000).

(\$110,000)		
Materials Expenditure: (\$60,000)	70%: (\$42,000)	30%: (\$18,000)
Economic Profits: \$65,000	30%: \$19,500	70%: \$45,500

Those overall interests in assumed economic profits do not reflect the interests the partners have in any specific economic item. In fact, the partners do not have the same interests in any of the components that constitute partnership's assumed economic profits. If the factor refers to overall interests and requires allocations pursuant to overall interests, the partners would allocate the specific tax items in a manner that varies from the allocation of the specific economic items. Thus, even though the partners allocate 20% of the rent expenditure to Rob, this factor appears to suggest that it should allocate 30% of the rental deduction to Rob. The partners should also know that because their interest in specific items are not uniform, their interests in partnership economic profits will like vary from year to year as the gross receipts and expenditures increase or decrease at different rates.

This factor's ambiguity further complicates matters. Perhaps Rob and Bert's assumption is correct, and economic profits also include fluctuations in the value of the property. If that were the case, Rob's interest in the partnership's economic profits would be approximately 28% and Bert's would be approximately 72%.³³ The definition of economic profits that the partners use will affect the partners' interests in those profits. The change does not appear to significantly alter Rob's and Bert's interests, but if property were a more significant part of the partnership, the changes in the property's value could significantly affect the partners' interests in the

³³ If the partnership's economic profits include the changes in the property's value, the economic profit would become \$64,500. Based on the parties' economic-item allocation agreement, Rob's share of the economic profits would be \$18,375 and Bert's would be \$46,125.

partnership. Treasury must resolve the ambiguity if this factor is to be an effective part of a multi-factor definition of partners' interests in the partnership.

Partners' interest in cash flow. The third factor is the partners' interests in cash flow and other non-liquidating distributions.³⁴ This factor is difficult to apply because it does not clearly provide whether it refers only to distributions the partnership makes during the current year or to the partners' broader interests in all partnership cash flow. The partners hold the residual interests in the partnership assets. Even if the partnership does not distribute its cash flow in the current year, the partners have an interest in it. They will receive undistributed cash flow on liquidation of the partnership.³⁵ Rob and Bert cannot individually force distributions, but they may be able to access the value of their interests in undistributed partnership property by selling interests in the partnership (if they are not subject to transfer restrictions) or by pledging the interests as collateral for a loan. Thus, the partners have interests in partnership cash flow, even if the partnership does not make current distributions.

The regulations do not sufficiently describe whether the third factor refers only to the partners' interests in distributed cash flow or to their interests in all partnership cash flow. Assuming the factor refers to the partners' interests in all partnership cash flow, Rob and Bert could look to the manner in which they allocate economic items that represent cash flow to determine a value for this factor. Based on allocations of the items of partnership cash flow, represented in Exhibit 6, Rob's interest in partnership cash flow would be 30% and Bert's would be 70%.

EXHIBIT 6

³⁴ See Reg. 1.704-1(b)(3)(ii)(c).

³⁵ See Unif. Partnership Act, section 807(b); Unif. Ltd. Partnership Act, section 503; and Unif. Ltd. Liab. Co. Act, section 404.

PARTNER'S SHARE OF UNDISTRIBUTED PARTNERSHIP CASH FLOW

Cash-Flow Item	Allocation to Rob	Allocation to Bert
Gross Receipts: \$250,000	50%: \$125,000	50%: \$125,000
Rent Expenditure: (\$15,000)	20%: (\$3,000)	80%: (\$12,000)
Wages Expenditure: (\$110,000)	55%: (\$60,500)	45%: (\$49,500)
Materials Expenditure: (\$60,000)	70%: (\$42,000)	30%: (\$18,000)
Total Cash Flow: \$65,000	30%: \$19,500	70%: \$45,500

Notice that the results based on the assumptions used for this factor are the same as the results under the first assumptions used for the second factor. If the assumptions are correct, the factors are redundant. That redundancy suggests that the assumptions might not be correct. Unfortunately, the regulations provide no guidance that would help resolve the redundancy. The partners can change assumptions used for one factor or the assumptions used for both factors to eliminate the redundancy. With no guidance, however, the partners cannot know how to proceed to resolve this issue.

Partners' rights to capital on liquidation. The fourth factor is the partners' rights to capital on liquidation of the partnership.³⁶ Here again, the partners will be at a loss to determine a specific value for the factor. Capital is not a technical tax term, so the partners cannot know

³⁶ See Reg. 1.704-1(b)(3)(ii)(d).

with exactness what they should consider in determining the value to assign to this factor. Capital could simply mean amounts contributed to the partnership. It could also include the entire equity portion of the partnership's balance sheet, which would encompass contributions and the results of the partnership's operations. If capital is the entire equity portion of the partnership's balance sheet, this factor would appear to be similar to the partners' economic interests in the partnership, which considers the partners' contributions, the partners' interests in economic profits, and the partners' interests in partnership cash flow.³⁷ If that interpretation is correct, the fourth factor significantly overlaps the other factors. Counting the same items in multiple factors merges the factors, diminishing their individual significance. Despite the problems such an assumption presents, this analysis assumes the factor refers to all property available for distribution.

The partners' rights to capital on liquidation will depend on the value of the partnership's property at the time of liquidation. To determine those rights prior to liquidation, the partners would have to know the value of the partnership's property, which may be difficult, if not impossible, to determine. The partners' rights extend beyond the historical cost of the partnership's property, so if the partners look only to the historical cost of assets to apply this factor, they will likely come up with a result that differs from the actual rights the partners have in the capital of the partnership. Because the rights depend on the allocation of economic items, the partners cannot know the specific percentages of their respective rights without considering the allocations of all economic items, including changes in property values. Furthermore, their rights to capital generally will not be fixed percentages throughout the life of the partnership.³⁸ Thus, the partners would have to determine the value of the partnership's property at the end of

³⁷ See Exhibit 2.

³⁸ The partners could adopt target allocations, in which case their rights to capital on distribution would depend on the distribution formula, not allocations.

each year to know their distribution rights. In this hypothetical, the partners know the actual values of the partnership's property, so they can consider what their rights might be.

As illustrated above, if the partners rely upon actual values of partnership property and include all economic items in the computation of partnership residual value, Rob would have the right to receive \$58,375 of the partnership's \$164,500 at the end of the first year and Bert would have the right to receive \$106,125 of that amount. Converting those amounts to percentages of the total residual value, Rob would have a right to 35% and Bert would have a right to 65% of the partnership's residual value.³⁹ These amounts could represent their rights to capital on liquidation.

If the partnership used historical cost (adjusted for amortization and depreciation) Exhibit 7 suggests the partnership's residual value at the end of the first year would be \$160,500. Rob's right to that on hypothetical liquidation at historical costs would be \$55,900 and Bert's would be \$104,600. Their relative rights would not change significantly—Rob's rights appear to be 35% of the capital and Bert's appear to be 65%. Over time, however, as the property fluctuates in value at a rate that differs from the depreciation and amortization deductions, their rights determined using historical costs will most likely be different from their rights determined using actual values.

EXHIBIT 7

PARTNER'S RIGHTS TO CAPITAL BASED ON A HYPOTHETICAL LIQUIDATION USING HISTORICAL COSTS

³⁹ See Exhibit 2.

	Rob	Bert
Contribution: \$100,000	40%: \$40,000	60%: \$60,000
Gross Receipts: \$250,000	50%: \$125,000	50%: \$125,000
Rent Expenditure: (\$15,000)	20%: (\$3,000)	80%: (\$12,000)
Wages Expenditure: (\$110,000)	55%: (\$60,500)	45%: (\$49,500)
Materials Expenditure: (\$60,000)	70%: (\$42,000)	30%: (\$18,000)
Amortization Deduction: (\$2,000)	80%: (\$1,600)	20%: (\$400)
Depreciation Deduction: (\$2,500)	80%: (\$2,000)	20%: (\$500)
Residual Value: \$160,500	35%: \$55,900	65%: \$104,600

Deficiencies with the factors. This discussion illustrates deficiencies with each of the factors. All of the factors have an element of ambiguity that makes applying them difficult. In fact, no factor returns a definitive answer. The analysis made assumptions to obtain values for each factor. If all of those assumptions are correct, the partners will still have difficulty deriving their overall interests in the partnership. Based on the summary in Exhibit 8, the factors suggest that Rob's interest in the partnership is somewhere between 30% and 40% and Bert's interests is somewhere between 60% and 70%. Taken together, the factors do not provide definitive insight

into the partners' overall interests in the partnerships. Thus, the factors appear to be largely unhelpful in determining the partners' interests in the partnership with any degree of exactness.

Exhibit 8

SUMMARY OF FACTORS (BASED ON STATED ASSUMPTIONS)

Factor	Rob's Interest	Bert's Interest
Relative Contributions	40%	60%
Interests in Economic Profits	30%	70%
Interests in Cash Flow and Non-Liquidating Distributions	30%	70%
Rights to Capital	35%	65%

Inexact Rules may Allow Greater Latitude in Allocating Tax Items

The lack of exactness in these rules may provide the partners greater latitude in allocating tax items than they find under the Section 704(b) capital account rules. The partners may argue that Rob's interest in the partnership is any amount between 30% and 40%, and Bert's interest is any amount between 60% and 70%. The partners might attempt to allocate tax items within those parameters, without regard to the allocation of corresponding individual economic items. If the partners were to allocate tax items to the partners in a ratio that came between those limits, the IRS may not be able to successfully challenge the allocations. Perhaps the partners could also allocate different tax items in different ratios, as long as each allocation comes within the upper and lower limits established by the four factors. For example, the rules may allow the

partners to allocate 40% of the gross income and 30% of the deductions to Rob and allocate the remainder of each tax item to Bert.

If the rules are that lenient, Rob and Bert can separate the allocation of the tax items from the allocation of the economic items. They could allocate economic items to obtain direct economic results and allocate the tax items for purely indirect economic results. That outcome violates the principles of fairness because it allows partners to do things that individuals cannot do. It would also allow partners to allocate tax items to the partners to minimize the partners' overall tax liability. Because allocations that are in accordance with partners' interests in the partnership are valid, according to the statutory language of Section 704(b), the IRS may not be able to challenge allocations that derive from the factors Treasury promulgated in the regulations. Even under anti-abuse rules or case law, the IRS may have difficulty challenging tax-item allocations that come within the regulations' definition of partners' interests in a partnership.⁴⁰ An equally troubling aspect of the definition is that the ambiguous rules may allow the IRS to arbitrarily challenge tax-item allocations. All of this illustrates the current rules are woefully deficient.

Solving this problem would likely require congressional action. Congress could modify Section 704(b) to provide that partnerships must allocate tax items in accordance with a manner in which they allocate economic items. This rule would eliminate the Section 704(b) capital account rules. Instead, partners would look to the allocation of economic items to allocate tax items.

⁴⁰ For example, the IRS could look to a case such as *Orrisch*, 55 TC 395, (1970). The difficulty the IRS may face, however, is the plain language of the statute, which allows allocations to be made in accordance with the partners' interests in the partnership. If the partners rely upon the rules in regulations promulgated by Treasury, the IRS may have difficulty convincing a court that the allocation should be something other than what the taxpayer has adopted.

Under this rule, RobBert Partnership would have to allocate the gross income equally to Rob and Bert because it allocates gross receipts equally to them. It would allocate the rent deduction 20% to Rob and 80% to Bert, the compensation deduction 55% to Rob and 45% to Bert, and the materials deduction 70% to Rob and 30% to Bert. Those tax-item allocations correspond to the partners' economic-item allocations. The partnership would still be left to allocate the independent tax items—depreciation and amortization deductions. Because those tax items do not correspond to economic items, the partnership cannot merely allocate them in the same manner it allocates economic items. The tax law must develop new standards to govern the allocation of independent tax items.

Partnership tax law could look to general principles of taxation to allocate independent tax items. Items such as the amortization and depreciation deductions are available only to owners of property. Partnerships, not partners, own partnership property.⁴¹ Thus, partnership tax law must adapt the general tax principles to allocate the amortization and depreciation deductions to the partners. It can, however, consider the partners' indirect ownership in the partnership property and allocate the amortization and depreciation deductions accordingly. Determining the partners' indirect interests in partnership property could be as difficult as determining their overall interests in the partnership. Perhaps new rules could allow the partners to establish indirect interests in partnership property. The rules should honor partner-established indirect interests, as long as the established indirect interests are reasonable. Furthermore, the rules should require partners who change the partnership ownership structure to alter the established interests. Otherwise, the partners would have to adhere to the established indirect interests.

⁴¹ See Unif. Partnership Act, section 203.

With items like depreciation deductions, the law should require the partner to whom the partnership allocates a depreciation deduction to recognize any depreciation recapture recognized by the partnership on disposition of the property. That would help minimize the abusive use of the depreciation deduction. Such a rule may complicate tax accounting, especially if partnership interests change hands, but partnership tax already addresses similar problems with the built-in gain and loss rules in Section 704(c). Treasury could create such rules for allocating independent tax items that would be in accord with a new statute that required item-by-item allocations.

Conclusion

Lawmakers must revisit the partnership tax allocation rules. If not, partnership tax-item allocations will simply provide revenue-reducing opportunities for partners as they look for ways to minimize their overall tax liabilities by exploiting the ambiguities in the current allocation rules. The current rules allow the partners to opt into allocations that have economic effect. Such allocations are tax centric as the economic items follow the tax-item allocations. Those rules may produce economic results that surprise some taxpayers.

Partners who do not opt into those rules appear to have significant leeway to allocate tax items in accordance with their interests in the partnership because the definition of partners' interests in a partnership is ambiguous. A move to item-specific allocations that require tax items to follow the allocation of economic items will convert the rules from their current tax-centric status to economic- or deal-centric rules. Such rules would help eliminate taxpayer game-playing and grant the partners discretion only with respect to independent items, which discretion they must exercise within reason and consistently throughout the life of the partnership.

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