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PARTNERSHIP ALLOCATIONS*

DONALD J. WEIDNER

I. Introduction

The basic rules of partnership allocations can be stated simply. In general, partners are free to determine in their partnership agreement how the various economic and tax consequences of partnership operations will be allocated.¹ The partnership agreement includes any amendments made up until the time for filing the partnership return.² Prior to the Tax Reform Act of 1976,³ allocations in the partnership agreement were respected unless they were for the "principal purpose" of tax avoidance or evasion.⁴ Allocations that violated the principal purpose limitation were disregarded and reallocated according to the partners' ratio for sharing the "taxable income or loss of the partnership, as described in section 702(a)(9)."⁵ The 1976 Act makes several changes in the provisions governing partnership allocations; most basically, it removes the provisions just quoted. It replaces the "principal purpose" limitation with the requirement that allocations have "substantial economic effect."⁶ Allocations that lack substantial economic effect will be reallocated according to each partner's "interest in the partnership (determined by taking into account all facts and circumstances)."⁷ An examination of prior law will make clear that the 1976 Act makes little, if any, change in the law of partnership allocations. Prior authority, therefore, retains its vitality, and it continues to be important to understand how the Service and the courts have applied the principal purpose limitation.

II. Prior to the Tax Reform Act

A. The Orrisch Case.

The most striking aspect of the principal purpose limitation is that it is an extremely undeveloped concept. There is relatively little authority to explain its precise application in the wide variety

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¹ Int. Rev. Code of 1954, as amended immediately prior to the passage of the *Tax Reform Act of 1976*, § 704(a) [hereinafter "Code"]. Unless otherwise indicated herein, the Code partnership provisions under discussion are not changed by the *Tax Reform Act of 1976*.

² Code § 761(c).

³ The *Tax Reform Act of 1976*, H.R. 10612, Pub. L. No. 94-455 [hereinafter sometimes referred to as the "1976 Act"].

⁴ Code § 704(b)(2).

⁵ Code § 704(b).

⁶ 1976 Act § 213(d), amending Code §§ 704 (a) and (b), effective for taxable years of the partnership beginning after December 31, 1975.

⁷ *Id.*

of situations in which it can be called into play. The difficulty it has presented to practitioners has been compounded by the refusal of the Service to issue advance rulings on whether it will be satisfied in a proposed transaction.⁸ The legislative history of the provision indicates little more than that partners were to have substantial leeway to determine allocations among themselves and that they were to be permitted to share income in a different manner than they share in losses.⁹ Perhaps the most frequently quoted indication of legislative intent is the language in the Senate Finance Committee Report that explained the principal purpose limitation as follows:

Where, however, a provision in a partnership agreement for a special allocation of certain items has a 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.¹⁰

The Regulations state that an allocation must be considered "in relation to all the surrounding facts and circumstances" to determine whether the principal purpose limitation has been violated, and list several factors to be considered. Perhaps because of the Senate Report language just quoted, there appears to have emerged a general sentiment that the most important of the factors identified in the Regulations is "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."¹¹ Surprisingly little attention has been given to the admonition in the Regula-

⁸ Rev. Proc. 74-22, 1974-2 Cum. Bull. 476.

⁹ Both the House and Senate Reports contain the following statement:

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

H. R. Rep. No. 1337, 223 and S. Rep. No. 1622, 379, 83d Cong., 2d Sess., (1954), (to accompany H.R. 8300, Pub. L. No. 591).

¹⁰ S. Rep. No. 1622 at 379.

¹¹ The Regulations state the following are among the relevant circumstances in determining whether the principal purpose of an allocation in a partnership agreement is for the avoidance or evasion of federal income tax:

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

tions to consider whether "the partnership or a partner individually has a business purpose for the allocation" and whether "related items of income, gain, loss, deduction, or credit from the same source are subject to the same allocation."¹²

Perhaps because of the preoccupation with "substantial economic effect," practitioners frequently assume that the principal purpose limitation is satisfied if the allocation in question bears some immediate relation to any economic dimension of the partnership. Whether this is or will remain the truth is the subject of my presentation today. What I would like to address at the outset is the unfortunate tendency to assume that an allocation will have some economic effect if it has impact on the partnership's capital accounts. Such a notion should not have survived *Stanley C. Orrisch*,¹³ the leading case on partnership allocations. *Orrisch* illustrates one critical point that cannot be overemphasized: a partnership's capital accounts may have *no economic significance*.¹⁴

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

the amount of the specially allocated item could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocations.

Treas. Reg. § 1.704-1(b)(2)(1964).

The examples in the Regulations that illustrate the application of these tests indicate that an allocation will not be disregarded simply because it results in a tax savings to all partners. On the other hand, the fact the parties would not have entered a transaction without a particular allocation does not mean it will be found to have substantial economic effect apart from tax consequences. The tests are best viewed as interrelated avenues of inquiry to determine all of the economic consequences of a particular allocation.

¹² *Id.*

¹³ 55 T.C. 395 (1970), *aff'd per curiam*, ¶ 73-556, 31 P-H Am. Fed. Tax Rep. 1069 (9th Cir. 1973).

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

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

Orrisches' capital account was lowered by the amount of the depreciation deductions allocated to them, with the result that their capital account was reduced far below that of the Crisafis.

The court found that the Orrisches had agreed to pay tax on any gain that might occur on the sale of partnership property to the extent they had been specially allocated what otherwise would have been the Crisafis' half of the depreciation deductions. However, the court also found that the charges of depreciation against the Orrisches' capital account had no economic significance. Operating profits and losses, computed without regard to depreciation, continued to be divided equally. Similarly, the proceeds of any sale of partnership property would still be divided equally. Under normal accounting principles, the court said, the disparity in capital accounts caused by the special allocation of depreciation would be treated as a debt to the partnership *or* would affect the division of proceeds in the event of sale of the partnership assets. However, it found no indication that the parties intended normal accounting principles to control the significance of their capital accounts. No debt was intended and the proceeds of any sale of partnership property would continue to be divided equally.¹⁵ In short, the only significance of the charge of specially allocated depreciation against the Orrisches' capital account was that it reflected the extent to which the Orrisches would absorb the Crisafis' tax bill in the event the property were sold at a gain.

It is therefore clear that the special allocation of depreciation failed, in the words of the Regulations, to "actually affect the dollar amount of the partners' shares of the total partnership income and loss independently of tax consequences." However, the court went beyond a recitation of the tests in the Regulations and attempted to clarify the basic meaning of the principal purpose limitation. It explained the "substantial economic effect" language in the Senate Report as follows:

This reference to "substantial economic effect" did not appear in the House Ways and Means Committee report

¹⁵ *Orrisch* is strikingly similar to Treas. Reg. § 1.704-1(b)(2), Example (1)(1964):

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

The only major difference is that the Crisafis did not immediately receive deductions of a different character (they did not appear to need deductions of any character for the years in question), but were to be relieved of tax burden on the sale of the property at a gain to the extent the Orrisches had been specially allocated depreciation.

. . . and was apparently added in the Senate Finance Committee to allay fears that special allocations of income or deductions would be denied effect in every case where the allocation resulted in a reduction in the income tax liabilities of one or more of the partners. The statement is an affirmation that special allocations are ordinarily to be recognized if they have a business validity apart from their tax consequences.¹⁶

The court said the special allocation to the Orrisches "was adopted for a tax avoidance rather than a business purpose" and "did not reflect normal business considerations but was designed primarily to minimize the overall tax liabilities of the partners."¹⁷ The depreciation was therefore reallocated according to "taxable income or loss of the partnership, as described in section 702(a)(9)," that is, according to the partners' 50-50 ratio for sharing general profits or losses.¹⁸

The court's emphasis on business purpose is somewhat clouded because of its roundabout response to the Orrisches' assertion that the purpose of the special allocation of depreciation was to compensate them for their greater economic investment in the enterprise. The court stated that the evidence did not support the "contention" that the special allocation had been adopted "in order to equalize the capital accounts of the partners." Its reasoning was simple: equalization of capital accounts could not have been the goal because the special allocation of depreciation sent the capital account of the Orrisches further below the capital account of the Crisafis than it previously had been above it. The court's discussion of the increased disparity in capital accounts is confusing because the Orrisches did not argue that their goal was to equalize capital accounts *per se*.¹⁹ Their argument was one that would have to be refuted by something more than simple subtraction.

¹⁶ 55 T.C. at 400-01 (citations omitted).

¹⁷ *Id.* at 401.

¹⁸ The application of the reallocation mechanism is slightly more complicated in the case of certain "bottom-line" allocations. *See infra*, text accompanying notes 65 to 75.

¹⁹ The capital accounts in *Orrisch* did not accurately reflect current economic investment in the partnership, nor did they accurately reflect tax basis, nor were they the basis for any allocation ratios. They reflected all cash contributions, withdrawals and distributions, all items of partnership taxable income and loss, but did not include partners' shares of partnership liabilities. There is no uniform rule on the composition of capital accounts, and the computation used in *Orrisch* is not uncommon, particularly among partnerships that have no allocation ratios based on capital accounts. Such a computation produces a figure that does not reflect accurately tax basis because the partners' shares of partnership liabilities are not included. Actual economic investment is not reflected because tax losses are deducted. For example, under the *Orrisch* system, if partner A were to contribute \$100 additional cash to the partnership, his capital account would be increased by \$100, as would his actual economic investment in the enterprise. If he were then to receive a "pass-through" of \$100 of partnership tax losses his capital account would be lowered by \$100, not merely by the actual dollar amount

Recall that the Orrisches had initially contributed twice the amount of cash that had been contributed by the Crisafis. The Orrisches' real argument was that the special allocation of depreciation was an attempt to equalize the capital *investments* of the partners, not their capital *accounts*.²⁰ The two are not necessarily the same. Capital accounts often involve a strange mixture of apples and oranges, at least from an investor's point of view. Consider, for example, the taxpayer in the 50 percent bracket who contributes \$100 in cash and receives in return a \$100 credit on his capital account. If he subsequently is allocated a \$100 depreciation deduction, his capital account (at least under the system used in *Orrisch*), is reduced to zero. But he would not consider that his entire capital investment has been returned to him. Rather, he would consider that his investment has been returned only to the extent of the \$50 savings on his tax bill that resulted from the depreciation deduction. So, too, with the Orrisches. Although their capital account was lowered by the full amount of depreciation allocated to them, their cash investment was returned in only a fraction of that amount, depending on their tax bracket. Indeed, the total amount of depreciation specially allocated to the Orrisches in the years in question would not have been sufficient to return them their excess capital investment had they been in the 50 percent bracket. Therefore, the increased disparity in capital accounts did not negate an intention to equalize economic investment, and the question remained whether the approach adopted was permissible.

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

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

the loss would save him on his tax bill, which is the true measure of the reduction of his actual economic investment in the partnership. Therefore, the Orrisches had no reason to equalize capital accounts *per se*.

²⁰ Brief for Appellant at 9, *Orrisch v. Commissioner*, 31 P-H Am. Fed. Tax Rep. 1069 (9th Cir. 1973):

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

investment, and it is apparent that the economic burden of the depreciation (which is reflected by the allowance for depreciation) was not intended to be the medium used.²¹

The court, therefore, admitted that the increased disparity in capital accounts did not negate the possibility that equalization of investment was the goal of the special allocation. More importantly, it held that equalization of investment could not be accomplished in the manner attempted.

Orrisch therefore contains a strong suggestion that initial contribution to capital is not an appropriate determinant of the allocation of depreciation deductions if initial capital contributions do not also control the allocation of any of the economic benefits or burdens of the partnership. Stated differently, depreciation deductions may not be allocated according to the ratio of what the partners *put in* to the partnership unless that ratio also determines the allocation of some economic incident of what the partners *pull out* of the partnership. More specifically, it is not persuasive to assert that the substantial business purpose of an allocation of depreciation is to compensate selected partners for their greater cash investment if the allocations of partnership cash benefits fail to reflect a similar purpose. This analysis need not be confined to allocations of depreciation deductions. It would appear to be equally applicable to allocations of overall partnership loss. Consider, for example, the fairly common situation of the partnership that has a positive cash flow yet reports a tax loss that is entirely due to depreciation deductions.²² It would seem that the same princi-

²¹ 55 T.C. at 402 n. 5.

²² In an investment in depreciable real estate, taxable income will be less than net cash flow in any year in which the depreciation deduction claimed exceeds the amount of cash spent to retire the principal on outstanding indebtedness. Stated differently, taxable income will be less than the net amount of cash actually produced whenever the deduction for the non-cash expense of depreciation exceeds the amount of money actually spent to amortize indebtedness, a cash expense for which there is no corresponding deduction. The essential point is that there is a gap between actual cash expenditures for which there is no current deduction and fictional deductions that are available without actual cash expenditures. An investment in depreciable real estate produces tax losses notwithstanding net cash flow whenever the depreciation deduction is greater than the sum of net cash flow plus the amount of principal paid on indebtedness—when, after the depreciation deduction is applied to “shelter” from tax net cash flow and debt amortization, surplus depreciation deductions remain. Consider, for example, an apartment house that, in a given year, has \$10,000 in rent receipts, \$500 in real estate taxes, \$400 in maintenance expenses, \$900 repayment of principal on indebtedness, \$8,000 payment of interest on indebtedness, and a \$1,200 depreciation deduction. The net cash flow of the property is as follows:

$$\begin{array}{rcccccc} \text{N.C.F.} & \text{R.R.} & \text{R.T.} & \text{M.E.} & & (\text{P} + \text{I}) \\ & =\$10,000 & - 500 & - 400 & & (900 + 8,000) \\ \text{N.C.F.} & =\$200 & & & & \end{array}$$

The taxable income or loss of the property can be stated in terms of net cash flow as follows:

ples should apply as apply to the allocation of depreciation itself.²³ Stated differently, there is nothing about the *Orrisch* opinion that suggests that it applies only to naked allocations of depreciation and not to allocations of tax losses that represent the surplus depreciation that remains after depreciation has first been applied to shelter net cash flow and debt amortization from tax.

If this interpretation is correct and not simply the product of pathological conservatism, the next question is what must be done to the special allocation of depreciation, or to the allocation of overall partnership loss, to enable it to pass muster under the principal purpose limitation. Is it sufficient to correlate it either with net cash flow, with proceeds of refinancing, or with proceeds in the event of sale of partnership property? Or is one of these economic incidents more important than the other, depending on the situation? There is no clear answer to these questions,²⁴ but the court in *Orrisch* suggested that the allocation would have been upheld if it had had some impact on the distribution of proceeds in the event of sale of partnership property:

To find any economic effect of the special allocation agreement aside from its tax consequences, we must, therefore, look to see who is to bear the economic burden of the depreciation if the buildings should be sold for a sum less than their original cost.²⁵

If this is a general rule, does it apply in the case of an highly leveraged property? The fact that the buildings in *Orrisch* were heavily encumbered may indicate that the answer is yes.²⁶ If so,

T.I.	N.C.F.	D	+	P
	\$200	-1,200	+	900
T.I.	(\$100)			

The two adjustments made to net cash flow to arrive at the \$100 tax loss are necessary because of the conversion from a cash dimension to a tax dimension. Net cash flow is, most simply, cash in minus cash out. Monies spent to repay principal on indebtedness constitute cash out and hence are subtracted in the computation of net cash flow. However, principal repayment is a cash expense for which there is not deduction, and hence must be added back on to net cash flow when converting net cash flow to taxable income or loss. Conversely, depreciation deductions do not enter into the computation of net cash flow because they have no current cash reality. They do, however, have tax reality and must be subtracted from net cash flow when converting net cash flow to taxable income or loss.

²³ *But see* F.C. McDougal, 62 T.C. 720 (1974), which constitutes at least some authority for the proposition that a partner may be allocated the entire amount of his partnership's overall tax loss when he could not properly be allocated the entire partnership depreciation deduction.

²⁴ *See* the discussion of the new reallocation mechanism in the 1976 Act, text accompanying notes 98-111, *infra*.

²⁵ 55 T.C. at 403.

²⁶ *See* McGuire, *When Will A Special Allocation Among Partners Be Recognized?*, 37 J. Tax. 74 (1972), for the opinion of a very able commentator to the effect that an

the allocation of net cash flow could continue independent of the allocation of depreciation or overall loss.

On the other hand, reliance on the *Orrisch* dictum may be misplaced. There are two basic ways in which an allocation of depreciation can be grounded on proceeds of sale of partnership property. First, special allocations of depreciation may be applied to reduce the extent to which the recipients of the depreciation share in sale proceeds. He who receives \$100 of depreciation shall have his share of sale proceeds reduced by \$100. This is the general approach suggested by the *Orrisch* dictum. On the one hand, it appears initially to have economic effect. On the other, it does not appear to have a business purpose. It is difficult to argue that a special allocation of depreciation is a reward for greater capital contribution if the allocation has the effect of reducing the recipient's share of sale proceeds. Second, the allocation of sale proceeds may be made in accordance with the allocation of depreciation. He who receives 80% of the depreciation deductions shall receive 80% of sale proceeds. The "reward" argument is more persuasive in this second type of arrangement. However, under either approach, the realities of an highly-leveraged real estate partnership may suggest that tax avoidance eclipses business purpose if the allocation of depreciation or overall loss is correlated only with proceeds of sale. Most, if not all, of sale proceeds may be applied to retire outstanding mortgage financing. In such a situation, the allocation of sale proceeds may be little more than a paper allocation. Similarly, substantial debt service requirements may render net cash flow minimal or nonexistent. Therefore, the true interest in cash benefits would lie in the partners' ratio for sharing refinancing proceeds. In conclusion, the safest possible approach is to correlate the allocation of depreciation or overall loss in accordance with at least some portion of what will be, in the partnership in question, a meaningful measure of anticipated cash benefits.

B. "Soft Money" Allocations.

Special allocations of "soft money" items are extremely common. "Soft" money or dollars are those applied to expenses that are currently deductible. The issue is whether the partnership may allocate the deduction generated to particular partners on the ground that their contributions were used to meet the expenditures. If, for example, our much-maligned 50-percent bracket investor can have his entire cash contribution applied upon his admission to a deductible expenditure and be allocated the entire corresponding deduction, the result is an immediate return to him of half his cash investment in the form of savings on his tax bill. The overall

alteration in the allocation of proceeds of refinancing or sale would have been sufficient to support the special allocation of all the depreciation to the *Orrisches*.

desirability of such an allocation is enhanced if his fellow partners have no need for the deduction.

As is true in other areas of partnership allocations, there is relatively little authority on soft money allocations. Perhaps the most frequently cited is Example 5 of the principal purpose Regulations,²⁷ which concerns a partnership formed by G and H to develop and market electronic devices. H contributed \$2,500 in cash and his full-time services and G contributed \$100,000 in cash and the promise to obtain a loan for the partnership of any additional funds needed. Their agreement provides that all research expenditures and interest on partnership loans are to be charged to G. It also allocates to G 90 percent of partnership income or loss, computed without reduction by such research and interest expenditures, until all loans have been repaid and G has been returned all research and interest expenditures, plus his share of any partnership operating losses. Thereafter, G and H are to share profits and losses equally.

Example 5 permits all research expense and interest deductions to be allocated to G because those expenses "are in fact borne by G." It is significant that G's priority on return until his recovery of expenses did not prevent the allocation to him of all deductions generated by those expenses. The rationale, presumably, is that G bears the economic risk that partnership operations will not be successful enough to reimburse him. In this connection, Example 5 requires a broad word of caution. Construed most narrowly, it concerns only the classic combination of the service partner and the money partner who bears almost all of the cash investment risk of the enterprise and receives a special allocation of the deductions for categories of expenses he alone shoulders. It does not authorize money partners to freely trace their contributions to whatever expenditures comport with their individual tax pictures and claim the particular deductions, gains, losses, or increase in bases that result.²⁸

Example 5 also requires a note of caution in connection with limited partnerships that own leveraged depreciable property. The use of an initial high sharing ratio to return a greater cash contribution of some sort is frequently referred to as a "pay-back period." Pay-back periods are often used to allocate high percentages of early years' tax losses to limited partners. Perhaps most typically, limited partners are allocated an extremely high percentage of partnership taxable income or loss until they have been returned a specified percentage of their initial capital contributions. Although the allocation may be stated in terms of taxable income or loss in the alternative, the early years of the partnership will most commonly produce tax losses, not taxable income. Indeed,

²⁷ Treas. Reg. § 1.704-1(b)(2), Example 5 (1964).

²⁸ See Treas. Reg. § 1.704-1(b)(2), Example 3 (1964).

partnership tax losses in early years are likely to far exceed those in later years because accelerated depreciation methods will bunch deductions in early years and because only a small portion of debt service in those years will be attributable to the non-deductible expense of repayment of principal.

The result can be contrasted with the situation in Example 5. The latter concerned a special allocation of deductions in the amount of actual cash expenditures by the partner who made them. The losses allocated to the limited partners during the pay-back period, on the other hand, are likely to be far in excess of partnership cash expenditures, because of depreciation deductions, and far in excess of the dollar amount of the initial capital contributions of the limited partners. The reason is, of course, that depreciation is computed on the basis of total acquisition cost, even if the property is acquired entirely with borrowed funds.²⁹ The limited partners may deduct losses in excess of their actual cash investment to the extent they share in the partnership's non-recourse liabilities.³⁰ Indeed, it is not uncommon for limited partners to be allocated losses in excess of their actual cash investment in the first two years of the partnership.³¹ It is true that the losses may in part reflect actual cash expenditures, such as interest payments, but those expenses, especially after the partnership's initial year, will typically be made from partnership gross receipts and not traceable to the contributions of the limited partners. This situation shall be considered more extensively in the discussion below of bottom-line allocations.³² The short of it for the moment is that the priority on partnership losses should conservatively be correlated with something more than the initial capital contributions of the limited partners. As a practical matter, this may be required in any event. For example, Blue Sky Commissioners may insist on a pay-back period that gives the limited partners a priority on net cash flow that corresponds with their priority on partnership losses.³³

²⁹ Crane v. Commissioner, 331 U.S. 1 (1947); Manuel Mayerson, 47 T.C. 340 (1966).

³⁰ Code §§ 704(d) and 725(a); Treas. Reg. § 1.725-1(e) (1960).

³¹ See, e.g., Rev. Proc. 74-17, 1974-1 Cum. Bull. 438, in which the Service refused to issue advance Rulings on tax classification unless:

The aggregate deductions to be claimed by the partners as their distributive shares of partnership losses for the first two years of operation of the limited partnership will not exceed the amount of equity capital invested in the limited partnership.

³² See *infra*, text accompanying notes 53 to 75.

³³ See, e.g., Midwest Securities Commissioners Association, Statement of Policy Regarding Real Estate Programs IV E (July 22, 1975):

E. *Promotional Interest.* An interest in the limited partnership will be allowed as a promotional interest and partnership management fee, provided the amount or percentage of such interest is reasonable. Such an interest will be considered presumptively reasonable if it is within the limitations expressed in either subparagraph 1 or 2 below:

Revenue Ruling 66-187³⁴ is relevant to soft money allocations even though it involved an allocation of tax-preferred income rather than expense deductions. It concerned a partnership formed to acquire and distribute a single issue of tax-exempt municipal bonds. Each partner subscribed for a portion of the bond issue and was obligated to pay for its proportionate share of any bonds remaining unsold on termination of the syndicate. However, the funds advanced by the partners to enable the syndicate to acquire the bonds, which they treated as contributions to capital and not as loans, were not in proportion to their participation.³⁵ Upon termination of the syndicate, net profit or loss was allocated among the members in proportion to their participation, but the tax-exempt interest that accrued on the bonds during the existence of the syndicate was allocated among the members who advanced the funds to acquire the bonds. The Ruling upheld the allocation, stating that it had "substantial economic effect" because it allocated "the bond interest to those members who in fact provided the funds to purchase the bond issues."³⁶

The Ruling can be interpreted as additional support for soft money allocations because it permitted the partners, each of whom could have been required under their agreement to contribute his pro-rata share of the front money, to decide among themselves who would actually supply the front money and receive the tax-exempt income. Because the partners actually received the cash benefit of that income, it would have been difficult to state under the facts given that the allocation lacked business purpose or substantial economic effect and should be disregarded. On the other hand, if it were shown that the allocation of the profit or loss on the resale of the bonds was amended to reflect the earlier allocation of tax-exempt income, the arrangement would presumably

1. An interest equal to 25% in the undistributed cash amounts remaining after payment to investors of an amount equal to 100% of capital contribution; or

2. An interest equal to:

(i) 10% of distributions from cash available for distribution; and

(ii) 15% of cash distributions to investors from the proceeds remaining from the sale or refinancing of properties after payment to investors of an amount equal to 100% of capital contributions, plus an amount equal to 6% of capital contributions per annum cumulative, less the sum of prior distributions to investors from cash available for distribution.

3. For purposes of this Section, the capital contribution of the investors shall only be reduced by a cash distribution to investors of the proceeds from the sale or refinancing of properties.

³⁴ 1966-2 Cum. Bull. 246.

³⁵ Although the syndicate manager could require members to contribute their proportionate shares of any deposits that had to be made on the bonds and any amounts necessary to carry them, he had discretion to raise the necessary funds however he wished, subject to the right of each partner to furnish its proportionate share.

³⁶ 1966-2 Cum. Bull. at 248.

be held to involve an impermissible juggling of tax consequences without the requisite business purpose or economic effect.³⁷

The greatest significance of the Ruling may lie in its use of the term "special allocation." It proceeded from the partners' characterization of the voluntary advances as capital contributions to describe the allocation of tax-exempt income based thereon as a "special allocation." To emphasize: even though the allocation was based on the partners' initial capital contributions it was treated as a special allocation, that is, an allocation that is subject to the principal purpose limitation. It was special because it was not in accordance with the partners' overall sharing ratio. The Ruling, therefore, echoes the note of warning sounded in *Orrisch* to the effect that an allocation of tax benefits may be subject to being disregarded under the principal purpose limitation even though it runs in favor of partners who had made greater initial contributions to capital.

Revenue Ruling 68-139³⁸ involved a soft money allocation of the entire contribution of two partners. The ABC partnership was formed when B and C each received a portion of A's working interest in oil and gas leases for their promise to contribute equal amounts to drill and equip the partnership's first test well. The partnership elected to expense intangible drilling and development costs³⁹ and B and C made their contributions as various stages of completion were reached. Their entire contribution was spent drilling the well and was sufficient to complete it.

The partnership agreement provided that all items of cost were to be allocated to the partners in accordance with their portion of the contributions to the respective items of cost. In determining contributions to intangible drilling and development costs, the initial payments of B and C made pursuant to the partnership agreement, would, to the extent so expended, represent their respective contributions to the intangible drilling and development costs incurred by the partnership.⁴⁰

The Ruling said that allocation of the intangible drilling and development costs to B and C would be recognized "unless examination discloses that the principal purpose of the allocation is the avoidance or evasion of Federal income tax."⁴¹

The Ruling may not constitute as strong authority in support of soft money allocations as it initially appears. Its scope is vague because so few facts are presented. One is left to wonder what further facts might be revealed that would indicate a viola-

³⁷ Compare Treas. Reg. § 1.704-1(b)(2), Example 3 (1964).

³⁸ 1968-1 Cum. Bull. 311.

³⁹ See Treas. Reg. §§ 1.612-4(a)(1965) and 1.703-1(b)(1)(1974).

⁴⁰ 1968-1 Cum. Bull. at 311.

⁴¹ 1968-1 Cum. Bull. at 312. Compare Treas. Reg. § 1.704-1(b)(2) Example 3 (1964).

tion of the principal purpose limitation. For example, the Ruling does not specify whether A's capital investment was prior to or contemporaneous with the admission of B and C.⁴² It did state that B and C each received a 3/32 working interest and that A "retained the remaining 26/32 working interest." Therefore, there is a suggestion that A's investment was prior to that of B and C and that A was in need of funds to complete the test well. This may explain why the Ruling referred to the "business purpose" test in upholding the allocation. On the other hand, it also fails to identify the relative tax pictures of the partners. The point of peering down the mouth of this gift-horse Ruling is to suggest that the Service might not reach the same decision if it were clear that the contributions of the partners were contemporaneous and that A was allocating the soft money items to high-bracket investors when he had little or no need for the deductions.

*S. Rex Lewis*⁴³ is perhaps the most recent and the most striking victory for soft-money allocations. Taxpayer Lewis was a practicing attorney who also had a one-half interest in Howard and Lewis Investments ("HLI"), a partnership organized to invest in real estate. HLI became an equal participant with Anchorage in the ownership of an apartment complex.

As a precondition to HLI's participation in the . . . project, it was agreed that [Lewis] and Howard would pay the first \$80,000 of interest to accrue on the construction loan.⁴⁴

At a December 28 loan closing, \$80,000 of interest was prepaid with funds produced by Lewis and Howard. The entire deduction for this expense was allocated to HLI, that is, to Lewis and Howard.

The Service persuaded the Tax Court that HLI and Anchorage were, for federal income tax purposes, not mere coowners but partners whose sharing ratio was 50-50. The Service had fought for this result to apply the principal purpose limitation to the allocation of the entire prepaid interest deduction to HLI.

The record discloses that HLI's relationship with Anchorage entailed considerably more than the simple coownership of property. Anchorage was responsible for the management of the [project] and was compensated for its services out of the gross rents realized on the complex. In the management of the complex by Anchorage we perceive sufficient business activity to support the conclusion that a partnership did exist in which HLI's distributive share was 50 percent.⁴⁵

⁴² Indeed, it did not specify that A had made any capital investment.

⁴³ 65 T. C. 625 (1975).

⁴⁴ 65 T. C. at 633.

⁴⁵ 65 T. C. at 632. There are too few facts in the opinion to support an attempt to

The Service's victory on the classification issue was somewhat pyrrhic because the court went on to hold that the principal purpose limitation had not been violated. It sustained the allocation to HLI of the prepaid interest deductions "because the economic burden of them was borne by [Lewis] and Howard."⁴⁶

Lewis is striking because a large portion of the prepayment of interest had clearly been made for tax purposes and not for business purposes. Only \$36,000 of the \$80,000 prepayment of interest made at the December 28 closing was required by the lender to be made at that time. The remaining \$44,000 was a voluntary prepayment by HLI of the bulk of the interest that would accrue the following year.⁴⁷ Furthermore, the entire \$80,000 prepayment was made with funds borrowed by Lewis and Howard. Most significantly, the court found that "no advantages were secured by prepaying \$44,000 of interest."⁴⁸ The court treated these facts as of no consequence once it determined that the deduction itself would not be disallowed as a material distortion of income or on other grounds.⁴⁹ In short, even though the \$44,000 soft money payment had been made entirely for tax advantage, once the deduction itself passed muster it was appropriate to allocate it to the partners who bore the expense. It did appear that Anchorage needed and insisted on HLI's contribution of \$80,000 for interest payments. A different result might be reached if one of several money partners insists that his entire contribution be traced to the soft money items.

The facts in *Lewis* suggest the additional point that soft money allocations often include payments to partners. It is common, for example, for the contributions of limited partners to be applied to salaries or fees to general partners. The Code provides that payments to a partner for services or for the use of capital may be treated as payments to an outsider to the extent they are "determined without regard to the income of the partnership."⁵⁰ This so-called "guaranteed payment" provision has been abused because

reconcile *Lewis* with Rev. Rul. 75-374, 1975-2 Cum. Bull. 261, which stated that co-owners of an apartment project can provide customary services without being deemed a partnership for tax purposes.

⁴⁶ 65 T.C. at 633.

⁴⁷ The \$44,000 was deductible only to the extent it was not refundable.

⁴⁸ 65 T.C. at 631. Compare James A. Collins, 54 T.C. 1656 (1970).

⁴⁹ For a discussion of *Lewis* as a prepaid interest case, see Weary and Wilbert, *How Does Tax Court's Retreat on Prepaid Interest Deduction Affect Taxpayers?*, 44 J. Tax 258 (1976). See also Section 208 of the 1976 Act. In Bernard Resnik, 66 T.C. No. 10 (May 12, 1976), the court held that the material distortion of income test would first be applied at the partnership level. It declined to state whether a deduction of prepaid interest that passed muster at the partnership level might be examined for distortion at the partner level.

⁵⁰ Code § 707(c) provides as follows:

(c) Guaranteed Payments.—To the extent determined without regard to the income of the partnership, payments to a partner for services or the use

some have reported on the assumption that payments that fall within its description are automatically deductible. Recent authority highlights what should have been clear all along: guaranteed payments can not be used to convert capital expenditures into immediately deductible items. If the payment must be capitalized if made to an outsider, it must be capitalized if made to a partner.⁵¹

The "without regard to income" requirement for guaranteed payment treatment merits a strong word of caution. Recall that, in *Lewis*, Anchorage received a management fee of a percentage of the gross rentals derived from the project. Until very recently it was generally assumed that payments to a partner for services based on a percentage of gross receipts satisfied the "without regard to income" requirement. It was also assumed, on the other hand, that payments to a partner for services based on a percentage of *net* receipts would violate the requirement. If the payment is deemed to be based on income, it will be treated not as a guaranteed payment but as a distribution of partnership income, which does not result in a deduction to the partnership. The recent case of *Edward T. Pratt*⁵² rejected rather summarily the distinction between payments based on gross receipts and payments based on net receipts. It held that payments to a partner for managing a shopping center based on gross rent receipts did not qualify as guaranteed payments because they were "based on income." *Pratt* is currently on appeal to the Fifth Circuit and should be followed carefully by planners making allocations through guaranteed payments.

C. "Bottom-Line" Allocations.

A partnership's taxable income or loss is known as its "bottom-line." In short, it is the total of all items of partnership income and deduction other than those that have been specially allocated.⁵³ A bottom-line allocation is the ratio by which partners share in the overall taxable income or loss of the partnership. In many partnerships, the bottom-line allocation determines not just the overall taxable income or loss of the partnership but also all of the economic consequences of partnership operations. Each partner has one, overall sharing ratio that determines his allocation of cash flow, capital gains or losses, taxable income or loss, *etc.* At the other extreme from this all-controlling bottom-line allocation is what can be referred to as a "pure" bottom-line allocation: one that

of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses).

⁵¹ Stated differently, a payment that otherwise qualifies under § 707(c) will not result in a current deduction if it constitutes a capital expense. *Jackson E. Cagle, Jr.*, 63 T.C. 86 (1974) and Rev. Rul. 75-214, 1975-1 Cum. Bull. 185.

⁵² 64 T.C. 203 (1975).

⁵³ Code § 702(a)(9).

apportions the partnership's taxable income or loss without also allocating the economic consequences of partnership operations. Pure bottom-line allocations arise when additional ratios are used to allocate the cash consequences of partnership operations.

Pure bottom-line allocations have been particularly common in real estate tax shelters because they enable cash benefits to be allocated quite differently than tax losses. It is fairly common for the partnership agreement to provide different ratios for sharing net cash flow, proceeds in the event of any refinancing or sale of partnership property, and partnership taxable income or loss. The allocation of taxable income or loss under such an arrangement is a pure bottom-line allocation that controls only tax consequences because different allocation ratios are used to allocate the various cash benefits. The following hypothetical summarizes the provisions in a partnership agreement that would effect such an arrangement:

A limited partnership is formed with general partner G and limited partners A and B. The partnership agreement provides that net cash flow will be allocated 50% to G and 25% each to A and B; that the proceeds of any refinancing or sale of the partnership assets will be allocated 60% to G and 20% each to A and B; and that the partnership's taxable income or loss shall be allocated among the partners in proportion to their initial contributions to capital. G makes no initial contribution to capital and A and B each make an initial contribution to capital of \$5,000. An apartment house is acquired for \$100,000, paid for with the initial contributions to capital and the proceeds of a \$90,000 non-recourse loan.

The three different allocation ratios, all or none of which might be brought into play in a particular year, depending on the results of partnership operations, may be summarized as follows:

	Net Cash Flow	Proceeds of Refinancing or Sale	Taxable Income or Loss
G	50%	60%	0%
A	25	20	50
B	25	20	50

The attractiveness of this type of arrangement to a promoter who wants to retain a substantial interest in cash benefits and pass the bulk of tax benefits to his high-bracket investor-partners is clear. Although the bottom-line allocation is stated in terms of income or loss in the alternative, the typical tax shelter partner-

ship will produce only tax losses, not taxable income, at least in the early years. Indeed, if substantial amounts of taxable income are ever expected, the partnership agreement may provide that the bottom-line allocation change, or "flip-flop," before that occurs. The change may be couched in terms of the completion of the type of "pay-back" period discussed above. In short, by allocating tax losses according to initial contribution to capital, and by disclaiming any initial contribution to capital on his own part, G has established a fixed ratio that passes to the limited partners the benefit of all depreciation and other deductions beyond those necessary to shelter from tax the net cash flow and debt amortization of the partnership. That is, the limited partners receive all surplus deductions.

The basic arrangement described above is usually modified in two ways.⁵⁴ First, the general partner is usually given at least some portion of the partnership's bottom line. This has been particularly true since Revenue Procedure 74-17,⁵⁵ in which the Service refused to rule on tax classification unless the combined interest of all the general partners in each item of partnership income, gain, loss, deduction or credit is at least one percent throughout the life of the partnership. Thus in the hypothetical transaction just described, G would credit himself with at least a small initial contribution to capital so he would receive some portion of the partnership's taxable income or loss. Second, the general partner typically receives a substantial portion of annual cash benefits in addition to his allocable share of the partnership's net cash flow. These additional cash benefits take the form of guaranteed payments, which are deducted by the partnership in the computation of net cash flow available for distribution.⁵⁶

There are three tax reasons why general partners are frequently allocated substantial cash benefits in the form of guaranteed payments rather than through larger distributive shares of net cash

⁵⁴ Net cash flow, proceeds of refinancing or sale, and taxable income or loss are the three basic dimensions of partnership operations and discussion is cast in those terms for the sake of clarity of presentation. In practice, the partnership agreement may contain much more elaborate allocation provisions than the basic model under discussion. First, the classes of items subject to separate allocations may be more numerous. There may be, for example, separate allocations of: ordinary income; ordinary loss; capital gains; capital loss; net cash flow; proceeds of refinancing; and proceeds of sale. Indeed, if the partnership holds more than one property, there may be different sharing ratios for each property. Second, the allocation ratios may apply only to particular slices of each category. Thus, for example, partners A and B may share the first ten thousand dollars of annual cash flow on a 50-50 basis, the second ten thousand on a 60-40 basis, *etc.* Third, the allocation ratios, within each slice of each category, may change over time. Thus, for example, A may be entitled to 50 percent of the first ten thousand dollars of annual cash flow only until he has recovered the amount by which his capital contribution exceeded that of B.

⁵⁵ 1974-1 Cum. Bull. 438.

⁵⁶ See *supra*, text accompanying notes 50-52.

flow. The first is to increase the amount of partnership tax losses generated for distribution to the investor-partners through the bottom-line allocation.⁵⁷ If guaranteed payment treatment is appropriate, the partnership will receive a deduction it otherwise would not have, and the general partner will have to include the amount of the payment in income. If he has surplus losses from other sources, the deduction is generated at no additional cost to anyone other than the Treasury.

Second, the general partner may be allocated a substantial portion of his cash benefits in the form of guaranteed payments in order to increase the amount of losses that may be deducted by the limited partners. Limited partners may not deduct losses in excess of their bases in their partnership interests.⁵⁸ Each limited partner has a basis in his partnership interest that includes his cash contribution plus his share of partnership liabilities.⁵⁹ Limited partners share in partnership liabilities for basis purposes only if those liabilities are fully non-recourse.⁶⁰ There is no discretion to allocate liabilities for basis purposes: limited partners automatically share in non-recourse liabilities in the same proportion as they share in partnership *profits*.⁶¹ Assume that the partners' interest in net cash flow is their interest in profits.⁶² If the limited partners were to receive a relatively small interest in net cash flow they would automatically receive only a small amount

⁵⁷ Code § 707(c) and Treas. Reg. § 1.707-1(c)(1958).

⁵⁸ Code § 704(d). Treas. Reg. § 1.704-1(d)(1)(1964):

A partner's share of loss in excess of his adjusted basis at the end of the partnership taxable year will not be allowed for that year. However, any loss so disallowed shall be allowed as a deduction at the end of the first succeeding partnership taxable year, and subsequent partnership taxable years, to the extent that the partner's adjusted basis for his partnership interest at the end of any such year exceeds zero. . . .

⁵⁹ Code §§ 722 and 752(a).

⁶⁰ Treas. Reg. § 1.752-1(e)(1956).

⁶¹ *Id.*

⁶² There is no generally agreed-upon definition of the term "profits." Many discuss the term as the partners' overall ratio for sharing "profits or losses," that is, as the partnership's bottom-line. See, e.g., Pennell, *Tax Considerations in Organizing a Partnership*, 25 U.S.C. Tax Inst. 333, 376. What is the interest in profits in the case of a pure bottom-line allocation? It is submitted that the answer to this question is the same as the answer to the question what is the Code's reallocation mechanism. That is, the profits interest is the measure by which the partners share in the economic benefits of partnership operations. This could be their ratio for sharing net cash flow, the proceeds of refinancing, or the proceeds of sale. It could be viewed as a combination of all three that should also take into account the extent to which cash distributions are made in the form of guaranteed payments. The 1976 Act legislative history makes clear that the profits interest in a particular partnership is not necessarily either the partnership's bottom-line or the interest in net cash flow. The Senate Report explains the new reallocation mechanism, in part, as follows:

In determining a "partner's interest in the partnership", all the facts and circumstances are to be taken into account. Among the relevant factors . . . are the interests of respective partners in profits and losses (if different from

of partnership liabilities for basis purposes. To avoid this result, cash is siphoned off to the promoter in the form of guaranteed payments to enable the limited partners to claim a larger proportionate interest in net cash flow, that is, in profits. They therefore claim a larger share of partnership liabilities to increase their bases and, hence, the amount of tax losses they can deduct.

A final reason to allocate cash benefits to the general partner in the form of guaranteed payments is to give the partnership's bottom-line allocation economic substance. As we have just seen, if the general partner is allocated a substantial portion of his expected cash benefits in the form of guaranteed payments, the limited partners can be allocated a larger proportion of the partnership's net cash flow. In short, the allocation of net cash flow can be made to coincide with the allocation of the partnership's taxable income or loss. If the ratio that allocates taxable income or loss also allocates net cash flow, a pure bottom-line allocation has been avoided.

Pure bottom-line allocations should be avoided whenever possible. Contrast their use to pass surplus deductions to high-bracket investors with Example 3 of the principal purpose Regulations:

[U]nder an agreement with respect to partnership CD, it is provided that C's distributive share of income shall be the first \$10,000 of tax-exempt income, and D's distributive share of income shall be the first \$10,000 of dividend income, the balances to be divided equally. Since the principal purpose of this provision is to allocate tax-exempt interest to C, who is in a higher income tax bracket than D, it will be disregarded.⁶³

Example 3 is extremely significant because it strikes down an allocation that initially appears to have substantial economic effect. C and D presumably bear the economic risk that their respective

that of taxable income or loss), cash flow; and their rights to distributions of capital upon liquidation.

S. Rep. No. 94-938 at 100. See, also, text accompanying notes 124-129, *infra*.

⁶³ Treas. Reg. § 1.704-1(b)(2), Example 3 (1964). The result would be different if the partner receive all potential gain and risk of economic unprofitability of the underlying securities:

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

Id. Note that even in this situation the Regulations hold open the possibility that the allocation might be disregarded if the prohibited principal purpose were shown by "other circumstances." One is left to wonder what those other circumstances might be.

types of income will not be realized, or will be realized only after great delay. However, an allocation will not necessarily have "substantial economic effect" simply because it is made to correlate with some economic reality. As stated by the court in *Orrisch*, the "substantial economic effect" test is violated if the allocation in question does "not reflect normal business considerations but [is] designed primarily to minimize the overall tax liabilities of the partners."⁶⁴

The pure bottom-line allocation in the basic hypothetical under discussion reflects the common practice of grounding allocations of taxable income or loss on initial contributions to capital. Does a pure bottom-line allocation satisfy the principal purpose limitation because it is correlated with initial contribution to capital? At first blush, it seems reasonable to allocate the partnership's taxable income or loss in accordance with the capital contributions of its members, and such an arrangement appears to have substantial economic effect. On the other hand, we have seen that it is a simple matter for a general partner to eschew an initial credit for his contribution of services or property. He may receive substantial sums in salary, fees, or other distributions, even though he is credited with no initial contribution. We have also seen that *Orrisch* supports the inference that initial contributions to capital cannot be rewarded with depreciation deductions unless they are similarly rewarded from the economic benefits of partnership operations. Bottom-line allocations are essentially distributions of all surplus depreciation deductions that remain after cash flow and debt amortization have been sheltered from tax. Therefore, one might expect the *Orrisch* principle to apply to bottom-line allocations as well as to naked allocations of depreciation deductions.⁶⁵ For these reasons, it is prudent to avoid a pure bottom-line allocation, even one that is based on initial contributions to capital. "Business validity" should be given to the ratio that allocates partnership taxable income or loss by making it control also the allocation of some economic component of partnership distributions.

There are those who have argued that bottom-line allocations are not subject to the principal purpose limitation. The argument is based on the fact that the principal purpose limitation, by its terms, applies only to allocations of "any item." The theory is that "taxable income or loss" is a composite that is not an "item" within the meaning of this provision. Proponents stress dictum in *Jean V. Kresser*⁶⁶ that indicates sympathy with the position that allocations of taxable income or loss are not subject to the principal purpose limitation. *Kresser* involved two real estate partner-

⁶⁴ 55 T.C. at 401.

⁶⁵ But see F.C. McDougal, *supra* n. 23.

⁶⁶ 54 T.C. 1621 (1970).

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

The court acknowledged that the principal purpose limitation would have been violated if it were applicable. However, it specifically declined to decide whether the principal purpose limitation applies "to the composite of all of the partnership's income."⁶⁷ Instead, it relied on two other grounds to disregard the allocation. First, it said there was no proof that the partnership agreement had been amended in a manner sufficient to effect the allocation. Section 761(c) provides that a partnership agreement may be amended until the time required for filing the partnership return by consent of all the partners or by any other manner provided in the partnership agreement.⁶⁸ The court was not persuaded that all partners had agreed to the allocation nor did it find that partnership allocations could be changed without the consent of all the partners.

⁶⁷ 54 T.C. at 1631 n 5:

While we are fully prepared to accept the contention that the principal purpose of the alleged modifications was the "avoidance or evasion" of tax on Appleton within the meaning of sec. 704(b)(2), we are faced with the petitioners' troublesome argument that sec. 704(b)(2) applies only to "items" of income, etc., dealt with in pars. (1) through (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.

⁶⁸ Code § 761(c):

(c) Partnership Agreement.—For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.

Second, the court found that the alleged reallocation of income to Appleton was a "paper transaction having no consequences of substance" that "did not in reality shift the 1965 income from the other partners to him."⁶⁹ The likelihood that Appleton "personally guaranteed that the amounts allocated to him would be restored to the other partners regardless of the success or failure of the enterprises"⁷⁰ indicated that the transaction was in the nature of a loan. On the other hand, said the court, the fact that Appleton's withdrawals were far less than the amount of income allocated to him suggested that not even so much as a loan had occurred.

In short, *Kresser* is not very strong authority for the proposition that bottom-line allocations are free from the principal purpose limitation. It certainly does not even suggest that pure bottom-line allocations are exempt. The allocation allegedly involved in *Kresser* was the opposite of a pure bottom-line allocation: it was an all-controlling bottom-line allocation. Finally, whatever comfort might be drawn from the dictum that the principal purpose limitation may not apply is taken away by the court's decision to disregard an allocation of taxable income or loss on economic reality grounds.

Bottom-line allocations have been less obviously vulnerable than naked allocations of depreciation because of the wording of the Code's reallocation mechanism. Recall that Code § 704(b) provides that if an allocation does not pass muster under the principal purpose limitation it will be disregarded and reallocated according to the partners' ratio for sharing "taxable income or loss of the partnership, as described in section 702(a)(9)." Two questions immediately present themselves. First, is the reallocation mechanism the partnership's bottom-line? If the answer is yes, it would be pointless to apply the principal purpose limitation to a bottom-line allocation. If the answer is no, the question becomes how to reallocate a bottom-line allocation that violates the principal purpose limitation.

The answer to both questions lies in the fact that the reallocation mechanism, the norm of "taxable income or loss, as described in section 702(a)(9)," was intended to be the partners' ratio for sharing the overall *economic* profits and losses of the enterprise. Thus, the Regulations consider the effect of an allocation on "income or loss *independently* of tax consequences."⁷¹ More precisely on point, they provide that in the application of the reallocation mechanism:

the manner in which the *net profit or loss* (computed after excluding any item subject to a recognized special alloca-

⁶⁹ 54 T.C. at 1631.

⁷⁰ *Id.*

⁷¹ Treas. Reg. § 1.704-2(b)(2)(1964) (emphasis added).

tion) is actually credited on the partnership books to the accounts of the partners *will generally determine each partner's share* of taxable income or loss as described in section 702(a)(9).⁷²

In short, the Regulations,⁷³ The Tax Court⁷⁴ and the commentators⁷⁵ have consistently described the reallocation mechanism as the partners' overall ratio for sharing "profits or losses." Therefore, if an allocation of taxable income or loss is disregarded because it controls tax losses and nothing more and is for the principal purpose of tax avoidance or evasion, the losses should be reallocated according to the partners' shares in the economic consequences of the enterprise. This could be reflected in their share of net cash flow, determined by taking into consideration guaranteed payments to promoters; their share of proceeds of refinancing; their share of proceeds of sale; or a combination thereof, depending on the nature of the partnership, its assets and their financing.

D. Retroactive Allocations.

The term "retroactive allocations" has been used in a broad sense to refer to ratios established to allocate items of income or loss previously accrued. A retroactive allocation in this broad sense is present if, for example, partners wait until the end of the year to decide how to divide the results of the year's operations. The term is more commonly used in a much more narrow sense to identify allocations to partners of gain or loss incurred prior to their admission. The retroactivity that is at issue is not that of the partnership allocation provision itself. The issue is whether a new partner may share in tax consequences incurred prior to his admission. Thus, the retroactivity issue is present even if there is no amendment to the partnership agreement. For example, some partnership agreements allocate taxable income or loss in accordance with the partners' capital accounts at the close of the year. Although the allocation provision itself remains unchanged, its effect is to allocate preadmission gain or loss to partners admitted late in the year. The issue has become controversial because tax shelter partnerships frequently admit limited partners at the end of the year and allocate them losses as if they had been members for the entire year.⁷⁶ The permissibility of retroactive allocations in this more narrow sense has been unclear and doubtful.

⁷² Treas. Reg. § 1.704-1(b)(1)(1964) (emphasis added).

⁷³ Treas. Reg. §§ 1.704(b)(1) and (2)(1964).

⁷⁴ Stanley C. Orrisch, 55 T.C. 395, 399-400 (1970).

⁷⁵ See, e.g., Jackson *et al*, *The Internal Revenue Code of 1954: Partnerships*, 54 Colum. L. Rev. 1183, 1187 (1954).

⁷⁶ In an highly-leveraged partnership, the amount of losses allocated to the year-end admittee may exceed the dollar amount of his investment. In order to obtain an advance

(1) *The Arguments Against Retroactive Allocations*

The basic argument against retroactive allocations of preadmission losses has been that the Code requires proration when a partner is admitted during the year. The provisions that require proration differ depending on the manner in which the new partner acquires his interest. If he purchases the entire interest of an existing partner, the proration mechanism is the partnership's taxable year, which closes with respect to a partner who sells his entire interest.⁷⁷ The selling partner must claim his distributive share of all items of partnership income, gain, loss, deduction or credit up until the point he transfers his partnership interest.⁷⁸ Strict observance of this approach would require an interim closing of the partnership books. To avoid this result, the Regulations provide a less onerous procedure for determining the selling partner's allocable share:

In order to avoid an interim closing of the partnership books, such partner's distributive share of items described in section 702(a) may, by agreement among the partners, be estimated by taking his pro rata part of the amount of such items he would have included in his taxable income had he remained a partner until the end of the partnership taxable year. The proration may be based on the portion of the taxable year that has elapsed prior to the sale, exchange, or liquidation, or may be determined under any other method that is reasonable.⁷⁹

The transferee must, according to the same proration computation used by the transferor, report the balance.⁸⁰

If the year-end admittee purchases only a portion of the interest of an existing partner, proration is also required, but the mechanism is not the closing of the partnership's taxable year. Section 706(c)(2)(B) provides:

The taxable year of a partnership shall not close . . . with respect to a partner who sells or exchanges less than his entire interest in the partnership or with respect to a partner whose interest is reduced, but such partner's distributive share of items described in section 702(a)

ruling on partnership classification, it must now be shown that the aggregate deductions to be claimed by the partners as their distributive shares of partnership losses for the first two years of operation of the limited partnership will not exceed the amount of equity capital invested in the limited partnership.

Rev. Proc. 74-17, 1974-1 Cum. Bull. 438, 439.

⁷⁷ Code § 706(c)(2)(A)(i).

⁷⁸ Treas. Reg. § 1.706-1(c)(2)(ii)(1973). He must also include any guaranteed payments made to him up until that point. *Id.*

⁷⁹ Treas. Reg. § 1.706-1(c)(2)(ii)(1973).

⁸⁰ *Id.*

shall be determined by taking into account his varying interests in the partnership during the taxable year.⁸¹

This provision is known as the "varying interests rule." The Regulations thereunder do not specify how to compute the proration it requires, and it would appear that the same options are available as if the proration mechanism were the partnership's taxable year.

Many year-end admittees, however, do not purchase part or all of the interest of an existing partner. Instead, they acquire their interests directly from the partnership. One reason for this approach is to avoid the automatic termination of the partnership for tax purposes that would result if there were a sale or exchange of 50 percent or more of the total interest in partnership capital and profits within a twelve-month period.⁸² The Regulations state that a contribution of property is not a sale or exchange for purpose of the termination rule,⁸³ and a recent Ruling holds that the admission of new partners for cash contributions does not result in termination, even if the new partners receive more than 50 percent of the total interest in partnership capital and profits.⁸⁴ The Regulations caution that an "exchange" of a partnership interest may be found if a contribution to a partnership is preceded or followed "within a short period" by a distribution.⁸⁵ An argument can be made that there is a "turnaround distribution" to existing partners when new admittees are automatically allocated shares in partnership liabilities.⁸⁶ There is, however, no authority that a constructive distribution caused by a shift in partnership liabilities is sufficient to classify the admission of a new partner as an exchange of a partnership interest for termination purposes.⁸⁷

⁸¹ Code § 706(c)(2)(B).

⁸² Code § 708(b)(1)(B). If there were such a termination, not only would the retroactive allocation be impossible because the year-end admittees would be members of a "new" partnership rather than the one that incurred the losses, but also accelerated depreciation methods available only to first users would be unavailable.

⁸³ Treas. Reg. § 1.708-1(b)(1)(ii)(1956).

⁸⁴ Rev. Rul. 75-423, 1975-2 Cum. Bull. 260.

⁸⁵ Treas. Reg. §§ 1.708-1(b)(1)(ii) and 1.731-1(c)(3)(1956).

⁸⁶ A new member of a general partnership automatically shares in partnership liabilities according to his proportionate share of partnership losses, and a new limited partner automatically shares in partnership nonrecourse liabilities according to his proportionate share of partnership profits. Treas. Reg. § 1.752-1(e)(1956). Any decrease in an existing partner's share of partnership liabilities, whether caused by a transfer of those liabilities to a new partner or otherwise, is treated as a distribution of cash to him by the partnership. Code § 752(b).

⁸⁷ *Compare* Sol Diamond, 56 T.C. 530, 546 (1971), *aff'd* 492 F.2d 286 (7th Cir. 1974) (emphasis added):

Regardless of whether there may be some kind of equitable justification for giving the parenthetical clause [in the section 721 nonrecognition Regulations] some limited form of affirmative operation scope, as *perhaps where there is a readjustment of partners' shares to reflect services being per-*

The basic argument that proration is required when the year-end admittee acquires his interest directly from the partnership is based on the varying interests rule. It applies not just to a partner who "sells or exchanges" a portion of his interest, but also to a partner whose interest is "reduced." The total interest of the existing partners is reduced as new members are allocated shares in profits, losses, liabilities for basis purposes, *etc.* Therefore, the varying interests rule clearly supports a proration requirement in the case of a partner who acquires his interest directly from the partnership. The general policy against "trafficking" in tax losses supports an argument that any ambiguity should be resolved in favor of the proration requirement.

(2) *The Arguments in Support of Retroactive Allocations.*

There are various arguments in support of retroactive allocations of preadmission losses. The basic position is that the proration requirement of the varying interests rule is overridden by other provisions of Subchapter K. Specifically, section 704(a) permits allocations to be determined by partnership agreement and section 761(c) states that the partnership agreement includes changes made until the time required for filing the partnership return. Thus, the agreement can allocate to new members as if they had been partners for the entire year. Under this approach, the only limitation on allocations of preadmission losses is not the varying interests rule but the principal purpose limitation. This, it is argued, is satisfied because the admission of the year-end partner has the substantial economic effect of placing his capital contribution at risk on account of partnership losses and partnership liabilities incurred prior to his admission.⁸⁸ On the other hand, proponents may argue that not even the principal purpose limitation applies if the preadmission losses are allocated through a bottom-line allocation. The theory is the one discussed above that the principal purpose limitation does not apply to allocations of overall partnership taxable income or loss.⁸⁹

Two additional arguments apply if the varying interests rule is not overridden by the broad authority of partners to allocate freely by an agreement amended before the time for filing. The first is that the words "or with respect to a partner whose interest is reduced" were intended to apply to partial liquidations

formed by one of the partners, we cannot believe that the regulations were ever intended to bring section 721 into play in a situation like the one before us.

⁸⁸ The effect of this argument is to place a substantial premium on the partnership form. The shareholders of a Subchapter S corporation are required to prorate their losses on a daily basis. Code § 1374(c). Consider also that a purchaser of property from another individual may not deduct part or all of his purchase price on the ground that it was applied to meet expenses incurred by the seller. Rev. Rul. 75-304, 1975-2 Cum. Bull. 94.

⁸⁹ See text accompanying notes 65 to 75, *supra*.

and not to the admission of new partners.⁹⁰ The second is that what must be "reduced" to bring the varying interests rule into play is the value of the interests of the existing partners, not merely their sharing ratios. Under this approach, the interest of the existing partners is not "reduced" if the contributions of the new partners are equal to the value of the interests they acquire.⁹¹

(3) *The Rodman Decision.*

The most recent authority in the controversy about preadmission loss allocations is the Second Circuit's decision in *Rodman v. Commissioner*.⁹² *Rodman* involved a partnership engaged primarily in trading publicly the stock of a Canadian company. There were originally four equal partners, Norman and Robert Rodman, Sidney Newman and Walter Ornstein. On November 2, 1956, Ornstein sold his entire interest to the others. Three days later, Martin Rodman acquired one-ninth interests from Norman and Robert. From then on, Newman had a one-third interest and Norman, Robert and Martin Rodman each had a two-ninth's interest. The partnership initially reported a loss for 1956 and allocated Martin a share of the loss based on the partnership's entire taxable year. When, however, the Service determined that there was gain rather than loss, Martin asserted that he should not be taxed on income that accrued prior to his admission. The Service persuaded the Tax Court to hold Martin liable for gains based on the entire year. On appeal, the Service reversed its position on the retroactivity issue and conceded that Martin could not share in income or losses incurred prior to his admission.

The Second Circuit gave three reasons in support of its conclusion that Martin could not share in income or loss incurred prior to his admission.⁹³ It said that the retroactive allocation to Martin violated both the general prohibition against assignments of income and the principal purpose limitation.

⁹⁰ Nims, *Partnership Retroactive Allocations*, 1976-13 BNA Tax Man. Mem. at 3: It seems logical to surmise that the legislative draftsmen of Sec. 706(c)(2)(B) were contemplating partial liquidations when they utilized the phrase "a partner whose interest is reduced." This would provide symmetry with the concept of sale, exchange or liquidation of the entire interest under Sec. 706(c)(2)(A). It is self-evident that liquidation or partial liquidation entails taking something out of the partnership.

⁹¹ *Contra*, I A. Willis, *Partnership Taxation* 286 (2d ed. 1976):

It is hard to accept the theory that the reduction in interest refers to anything other than a reduction in proportionate interest. To say that when the pie is increased enough to offset the reduction in proportionate interest there is no reduction in interest is an unconvincing exercise in subtle semantics. Further, adoption of the "size of the pie theory" would require valuations of the partnership equity before the contribution and of the contribution made by the end of the year admittee.

⁹² 76-2 U.S.T.C. 85,258 (2d Cir. Sept. 17, 1976), *reversing and remanding* Norman Rodman, 32 CCH Tax Ct. Mem. 1307 (1973).

⁹³ The Second Circuit's reversal of the Tax Court's decision on the retroactivity issue

In essence, the present case is no more than an assignment by Robert and Norman of a percentage of their interests in the income earned by them as partners prior to Martin's having joined the partnership. As such, not only does the retroactive allocation of income to a new partner violate the *Helvering v. Horst* general assignment of income prohibition, it necessarily follows . . . that such an attempted assignment in the partnership agreement also falls within 704(b)(2)'s caveat that a term in a partnership agreement cannot be controlling for tax purposes where its principal purpose is the evasion of taxes. Consequently, where a new partner is involved in the sale or exchange of a partnership interest, we must disagree with the tax court's conclusion that the intent of the parties . . . is the controlling factor as to whether or not income or losses which accrued prior to the partner's joining may be re-allocated to him retroactively.⁹⁴

Finally, it said that the varying interests rule applied when Robert and Norman each transferred a portion of their interest to Martin.

Consequently, because Robert and Norman are required to take into account their varying interests during the partnership taxable year, it is only logical that Martin must do the same. During the partnership year prior to November 6, 1956, Martin had no interest in the partnership. The only logical conclusion to be drawn from the Code's provisions dealing with the amounts of a partnership's income and losses attributable to the parties involved in the sale or exchange of a partnership interest is that *Martin had a two-ninth's interest in only those items that accrued after he entered the partnership.* To allow partners by modification of the partnership agreement to rearrange their interests over periods of time when no interests in fact existed would be to disregard the provisions of the Code designed specifically to deal with

comes as no surprise. Commentators had noted that the issue was poorly litigated before the Tax Court and that its decision should not be relied upon. McGuire, *Retroactive Allocations Among Partners: The Rodman Decision*, 52 *Taxes* 325 (1974); Weidner, *Yearend Sales of Losses in Real Estate Partnerships*, 1974 U. Ill. L. F. 533, 545-46.

⁹⁴ 76-2 U.S.T.C. at 85,267 (citations omitted). This portion of the opinion cited "Treas. Reg. § 1.708-1(e)(1)(i)." There is no such Regulation. The Court presumably intended to cite Treas. Reg. § 1.704-1(e)(1)(i)(1964):

The production of income by a partnership is attributable to the capital or services, or both, contributed by the partners. The provisions of subchapter K are to be read in the light of their relationship to section 61, which requires, inter alia, that income be taxed to the person who earns it through his own labor and skill and the utilization of his own capital.

the allocation of partnership income and losses when partnership interests are transferred.⁹⁵

Accordingly, the Court reversed and remanded for an allocation to Martin of a share of partnership income "based upon the limited time that he in fact had an interest in the partnership."⁹⁶

Some commentators will no doubt emphasize that *Rodman* did not involve a partner who acquired his interest directly from the partnership; that it involved the less difficult case of a partner who received partial transfers from less than all of the existing partners. They may also stress that the Court's articulation of all three theories is couched in terms of "sale or exchange" and remind us once again that the admission of new partners for cash contributions does not constitute a sale or exchange. Finally, they may stress that the Court did not discuss whether the interest of existing partners is "reduced" when a new member is admitted upon contribution.

The critical significance of the case should not be obscured by hopeful speculation that a different result might have been reached if Martin had acquired his interest directly from the partnership and the interests of all existing partners had been reduced equally. The opinion makes clear that the varying interests rule can not be overridden by contrary provisions in the partnership agreement. It also found a violation of the principal purpose limitation and assignment of income principles even though Martin's admission as a new general partner exposed him to unlimited personal liability for partnership obligations. Perhaps the most striking aspect of the opinion is the Court's suggestion that assignment of income principles might prevent the partners from computing proration under the short-cut method provided in the Regulations.⁹⁷

III. The Tax Reform Act of 1976

A. Retroactive Allocations.

The 1976 Act amends the varying interests rule to clearly require proration when a new member acquires his interest directly from the partnership:

The taxable year of a partnership shall not close . . . with respect to a partner who sells or exchanges less than his entire interest in the partnership or with respect to a partner whose interest is reduced (*whether by entry of a new partner, partial liquidation of a partner's interest, gift, or otherwise*), but such partner's distributive share of items described in section 702(a) shall be determined by

⁹⁵ 76-2 U.S.T.C. at 85,267-68 (emphasis added).

⁹⁶ *Id.* at 85,268.

⁹⁷ See text accompanying notes 106-111, *infra*.

taking into account his varying interests in the partnership during the taxable year.⁹⁸

The amendment applies to partnership taxable years that begin after December 31, 1975.⁹⁹ However, the legislative history leaves unanswered the question whether this provision is a new rule or simply a clarification of existing law.¹⁰⁰

The draftsmen had little sympathy for the argument that new partners should be allowed to share in deductions incurred prior to their admission.¹⁰¹ They therefore included three supplemental amendments to make clear that the varying interests rule can not be avoided by provisions in the partnership agreement. Unfortunately, this intent is more clearly expressed in the legislative history than in the three amendments themselves. Section 704(a) is amended somewhat vaguely to reflect that section 704 is not the exclusive limitation of the partners' authority to determine partnership allocations by agreement:

A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this *chapter*, be determined by the partnership agreement.¹⁰²

⁹⁸ 1976 Act § 213(c)(1), *amending* Code § 706(c)(2)(B). Italicized portions of quotations from the Code as amended by the 1976 Act indicate the changes made by the 1976 Act unless it is otherwise stated that the quoted section is new or substantially rewritten.

⁹⁹ 1976 Act § 213(f)(1).

¹⁰⁰ Both the House and Senate Reports contain the following statement:

These provisions are effective for taxable years of partnerships that begin after December 31, 1975. The committee does not intend that any inference be drawn as to the propriety or impropriety of a retroactive allocation under present law.

H.R.Rep. No. 94-658, 125, 94th Cong., 1st Sess. (1975) and S.Rep. No. 94-938, 98, 94th Cong., 2d Sess. (1976), (to accompany H.R. 10612, Pub. L. No. 94-455).

¹⁰¹ S. Rep. No. 94-938 at 97:

In essence, the consequence of allowing retroactive allocations is that new partners investing in the partnership towards the close of the taxable year are allowed to deduct expenses which were incurred prior to their entry into the partnership. Some argue that these retroactive allocations are proper because the funds invested by the new partners serve to reimburse the original partners for their expenditures and that, as an economic matter, the new partners have incurred the costs for which they are claiming deductions. However, this argument loses its persuasiveness when the new partner in a partnership situation is compared to that of an investor who directly purchases property which had previously generated tax losses during the taxable year. It is clear that in the latter case the investor would not be entitled to deduct the losses incurred prior to his ownership of the property, notwithstanding the fact that he may, in effect, be reimbursing the seller of property for losses already incurred.

¹⁰² 1976 Act § 213(c)(2), *amending* Code § 704(a).

Somewhat more specifically, a new subsection 704(f) directs the reader to the varying interests rule.¹⁰³ Finally, section 761, which permits partners to amend their agreement until the time for filing their partnership return, is graced with a similar reference to the varying interests rule and a reference to section 704(b).¹⁰⁴

The legislative history indicates that proration is required both as to particular items of deduction and as to overall partnership income or loss.

The conference agreement provides that income or losses will be allocable to a partner only for the portion of the year that he is a member of a partnership and not retroactively to periods prior to entry.¹⁰⁵

The history precludes any argument that the year-end admittee can share in depreciation deductions or the resulting losses on the basis of the entire year if the partnership does not charge depreciation on its books until the end of the taxable year. On the other hand, the legislative history does indicate that partners are to be given substantial leeway to compute the required proration:

In determining the income, loss or special item allocable to an incoming partner, the partnership will either allocate on a daily basis or separate the partnership year into two (or more) segments and allocate income, loss or special items in each segment among the persons who were partners during that segment.¹⁰⁶

Once again, the legislative history makes clear what the Act does not: partners are to have the same flexibility to compute proration that they presently have under existing Regulations concerning the sale by a partner of his entire interest in the partnership.¹⁰⁷

¹⁰³ 1976 Act § 213(c)(3)(A), amending Code § 704:

(f) Cross Reference.—

For rules in the case of the sale, exchange, liquidation, or reduction of a partner's interest, see section 706(c)(2).

¹⁰⁴ 1976 Act § 210(c)(3)(B), amending Code § 761:

(e) Cross Reference.—

For rules in the case of the sale, exchange, liquidation, or reduction of a partner's interest, see sections 704(b) and 706(c)(2).

¹⁰⁵ Committee on Ways and Means, Summary of the Conference Agreement on the Tax Reform Act of 1976 (H.R. 10612) 9 (1976).

¹⁰⁶ *Id.*

¹⁰⁷ S. Rep. No. 94-938 at 98:

[R]egulations are to apply the same alternative methods of computing allocations of income and loss to situations falling under section 706(c)(2)(B) as those now applicable to section 706(c)(2)(A) situations (sale or liquidation or an entire interest).

The drafters understood that the computation alternatives in the Regulations soften the impact of the proration requirement:

These rules will permit a partnership to choose the easier method of prorating items according to the portion of the year for which a partner was a partner or *the more precise method of an interim closing of books* (as if the year had closed) which, *in some instances, will be more advantageous where most of the deductible expenses were paid or incurred upon or subsequent to the entry of the new partners* to the partnership.¹⁰⁸

Conversely, the percentage-of-the-year approach would be preferable to the new member if most deductible expenses had been paid or accrued prior to his admission.

The drafters probably did not understand that, within a few days after the completion of their efforts, the Second Circuit would opine in *Rodman* that the alternative computation methods in the Regulations could result in an impermissible assignment of income:

Both Martin and the Commissioner contend that on remand the share attributable to Martin should be computed simply by multiplying the pro-rata portion of the year during which he owned his interest (57/366) by his two-ninth's interest. See Treas. Reg. 1.706-1(c)(2). We note, however, that such a simple pro-rata allocation could in many instances result in a prohibited income assignment to Martin if, for example, the substantial portion of the partnership's income accrued prior to [his admission]. The record on appeal does not indicate whether or not such is the case, and we leave to the tax court to determine whether or not a simple pro rata allocation is appropriate in this case.¹⁰⁹

As stated earlier in its opinion,¹¹⁰ a violation of the principal purpose limitation (now the substantial economic effect requirement) follows from the assignment of income conclusion. Given that the computation alternatives in the Regulations can be disregarded, it seems clear that other strategies to soften the impact of the proration requirement are also subject to challenge. Consider, for example, whether the partners can simply refrain from paying for or accruing expenses until new members are admitted. Such a strategy, although suggested by the proration Regulations and the legislative history of the 1976 Act, is an indirect allocation that presumably must pass muster under 704(b). The essential question

¹⁰⁸ *Id.* (emphasis added)

¹⁰⁹ 76-2 U.S.T.C. at 85,268 n. 19.

¹¹⁰ 76-2 U.S.T.C. at 85,267.

will be the extent to which the timing of the expenditure represents business purpose or practice rather than tax evasion. An attempt to trace the contribution of a year-end admittee to a year-end expenditure to allocate him the resulting deduction will be subject to the limitations on "soft money" allocations discussed earlier.¹¹¹

B. The Basic Allocation Rules.

The 1976 Act completely rewrites the basic allocation provision, subsection 704(b):

(b) Determination of Distributive Share.—A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if—

(1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or

(2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.¹¹²

¹¹¹ See text accompanying notes 27-52, *supra*.

¹¹² 1976 Act § 213(d), amending Code § 704(b). The 1976 Act makes several other changes in subchapter K that do not deal directly with partnership allocations but should be mentioned because they are related restrictions on tax shelter partnerships. The most significant is 1976 Act § 213(e), which provides that, except in the case of realty partnerships, a limited partner's basis in his partnership interest is not increased by nonrecourse liabilities. The rule is incorporated by amending section 704(d) to provide as follows:

(d) Limitation on Allowance of Losses.—A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred.

* * *

For purposes of this subsection, the adjusted basis of any partner's interest in the partnership shall not include any portion of any partnership liability with respect to which the partner has no personal liability. The preceding sentence shall not apply with respect to any activity to the extent that section 465 (relating to limiting deductions to amounts at risk in case of certain activities) applies, nor shall it apply to any partnership the principal activity of which is investing in real property (other than mineral property).

This new restriction applies to liabilities incurred after December 31, 1976. 1976 Act § 213(f)(2). The source of this rule was a floor amendment in the Senate, and the Conference Committee Report explains its relationship to the new "at risk" provisions as follows:

The effect of this provision is to limit deductions which may be passed through to a limited partner to the amount of investment which he actually has and will have at risk in the partnership. It is intended that in determining whether a partner has personal liability with respect to any partnership

The new 704(b) applies to partnership taxable years that begin after December 31, 1975.¹¹³ However, to the extent it merely clarifies existing law, it applies to all prior taxable years.

One fundamental question about the new 704(b) is whether the insertion of the "substantial economic effect" requirement to replace the "principal purpose" limitation was intended to change existing law. Surely no clarification results from replacing "principal purpose" with "substantial economic effect." As explained earlier,¹¹⁴ it has most commonly been assumed that the essential test for determining whether an allocation satisfies the principal purpose

liability, the rules of section 465 (relating to the limitation on deductions to amounts at risk in case of certain activities) will apply. This provision will not apply to any activity to which section 465 (relating to the limitation on deductions to amounts at risk in case of certain activities) [sic.] nor will it apply to any partnership the principal activity of which involves real property (other than mineral property).

Conference Committee Report at 9.

1976 Act § 213(b)(3) amends Code § 707(c) to emphasize the existing rule that guaranteed payments may not be used to transform capital expenditures into currently deductible items. The new section 707(c) is as follows:

(c) Guaranteed Payments.—To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, *subject to section 263*, for purposes of section 162(a) (relating to trade or business expenses). (emphasis added)

A similar change, albeit one that does more than reiterate existing law, is effected by 1976 Act § 213(b)(1), which adds a new section to subchapter K, section 709:

SEC. 709. TREATMENT OF ORGANIZATION AND SYNDICATION FEES.

(a) General Rule.—Except as provided in subsection (b), no deduction shall be allowed under this chapter to the partnership or to any partner for any amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such partnership.

(b) Amortization of Organization Fees.—

(1) Deduction.—Amounts paid or incurred to organize a partnership may, at the election of the partnership, (made in accordance with regulations prescribed by the Secretary), be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the partnership (beginning with the month in which the partnership begins business), or if the partnership is liquidated before the end of such 60-month period, such deferred expenses (to the extent not deducted under this section) may be deducted to the extent provided in section 165.

(2) Organizational expenses defined.—The organizational expenses to which paragraph (1) applies, are expenditures which—

(A) are incident to the creation of the partnership;

(B) are chargeable to capital account; and

(C) are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would be amortized over such life.

¹¹³ 1976 Act § 213(f)(1).

¹¹⁴ See text accompanying notes 10-17, *supra*.

limitation is whether it has substantial economic effect. On the other hand, this assumed equivalence also indicates that no change was intended. Indeed, the legislative history contains numerous references to existing law for the determination of what constitutes substantial economic effect.¹¹⁵

Can it be, then, that the addition of "substantial economic effect" to replace "principal purpose" was intended neither to change nor clarify existing law? Has the legislature committed a useless act? The substantial economic effect language was added by the Senate when it scrapped the revision of 704(b) that was passed by the House. The House Bill clearly reflected an intent to diminish the ability of partners to allocate freely. It would have replaced the principal purpose limitation with a two-pronged test. The House Bill would have disregarded any allocation that is either without "a business purpose" or that results in a "significant avoidance or evasion of any tax."¹¹⁶ The Senate Report states that the substantial economic effect requirement has "essentially" the same intent as the two-pronged test in the House Bill:

While there is a difference in language, the intent of the committee amendment and the House bill are essentially the same—both versions seek to prevent the use of special allocations for tax avoidance purposes, while allowing their use for bona fide business purposes.¹¹⁷

In a footnote, the Senate Committee explained its reason for the change:¹¹⁸

¹¹⁵ Consider, for example, the following statement in the Senate Report:

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

S. Rep. No. 94-938 at 99-100.

¹¹⁶ H.R. 10612 § 210(d) provided that the reallocation mechanism shall not be applied to allocations agreed upon by the partners if:

the partner receiving the allocation can establish both that there is a business purpose for this allocation and that no significant avoidance or evasion of any tax imposed by this subtitle results from such allocation.

¹¹⁷ S. Rep. No. 94-938 at 100.

¹¹⁸ The Senate also scrapped the two-step reallocation mechanism in the House bill:

(b) Determination of Distributive Share.—

(1) Rule for allocations.—A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined—

(A) in accordance with the partnership's permanent method of allocating the taxable income referred to in section 702(a)(9), if there is such a method, or

(B) in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances) if the partnership has no permanent method of allocating such taxable income.

H.R. 10612 § 210(d). The Senate retained the "interest in the partnership" feature of

Because of the use of the phrase “significant avoidance or evasion of any tax . . . results” (emphasis supplied) under the House bill, a conceivable interpretation might cause the disallowance of a special allocation to a high-bracket taxpayer, notwithstanding that the allocation had a business purpose and economic substance.¹¹⁹

Thus, the Senate Report appears to adopt the House Report’s emphasis on the need for a business purpose to support a special allocation. This will be viewed as a tightening of existing law by those who did not interpret *Orrisch* to emphasize business purpose as the prime determinant of the presence of substantial economic effect.¹²⁰

One additional point in the legislative history merits consideration in connection with the issue of intent to change the basic rules of partnership allocations. Both the House and the Senate Reports contain the following statement:

Under the partnership provisions, a limited (or a general) partnership agreement may allocate income, gain, loss, deduction, or credit (or items thereof) among the partners in a manner that is disproportionate to the capital contributions of such partners (see 704(a), (b)(1)). These are sometimes referred to as “special allocations”. . . .¹²¹

This statement is striking because the term “special allocation” is the shorthand term that has been used to refer to allocations that are subject to the principal purpose limitation. Presumably, the term will be used in the future to refer to allocations that

the reallocation mechanism but dropped the “permanent method” test. It offered the following explanation for the drop:

The House bill provided a two-step method of reallocation which includes the provision described above in the [Senate] committee amendment but also provided for the allocation to be determined in accordance with the partner’s “permanent method of allocating” the taxable income or loss (described under section 702(a)(9)), if there is such a method. The committee amendment deletes this alternative because of the difficulty in defining “permanent method of allocating” the items.

S. Rep. No. 94-938 at 100. However, it would appear that the “permanent method” concept was abandoned because the House had based it in part on its two-step replacement for the principal purpose limitation, which the Senate also abandoned:

A partnership will ordinarily be considered to have a “permanent method” of allocating taxable income or loss if (1) it has consistently applied such method over a number of years, and (2) it meets both the business purpose and significant tax avoidance tests provided under the amended section 704(b).

H.R. Rep. No. 94-658 at 127.

¹¹⁹ S. Rep. No. 94-938 at 100 n. 11.

¹²⁰ See text accompanying notes 13-26, *supra*.

¹²¹ H. Rep. No. 94-658 at 125, S. Rep. No. 94-938 at 98.

will be subject to the substantial economic effect requirement. The question can be put simply: does the statement just quoted imply that allocations based on capital contribution are not special allocations subject to the substantial economic effect requirement? Stated differently, does the quoted language indicate that any allocation based on capital contribution will, by virtue of the correlation, be deemed to have substantial economic effect?

It is submitted that the answer to this question is *no*: allocations based on capital contributions should continue to be subject to the substantial economic effect requirement. To hold otherwise would convert an artless sentence in the legislative history into a major liberalization of the law of partnership allocations, particularly as it applies to tax shelters, without any other indication that a liberalization was intended. It is clear that it would constitute a liberalization to insulate allocations correlated with capital contributions from challenge. We have seen that *Orrisch* strongly suggests that depreciation deductions cannot be allocated on the basis of initial capital contribution unless initial contribution also controls some economic component of what the partners pull out of the partnership. We have also considered a Revenue Ruling that refers to an allocation based on initial capital contribution as a "special allocation" and subjects it to the principal purpose limitation.¹²² Finally, initial capital contributions can be very easily manipulated. We have seen, for example, that to allocate substantial amounts of losses to high-bracket investors, promoters of tax shelters frequently credit themselves with little or no initial capital contribution.¹²³ To forego the credit costs nothing whenever allocations of cash benefits are made independently of initial contribution. In short, any interpretation of the statute or legislative history that would place allocations based on capital contributions beyond the substantial economic effect requirement would constitute a retreat in the law because it would provide a safe harbor into which the most extreme allocation arrangements could easily be drafted. Indeed, it would insure promoters of tax shelter partnerships that they will be free from challenge if they structure their allocation arrangements in precisely the way they would prefer to structure them. Not only does such an interpretation grant promoters a safe harbor they have not had under prior authority, it also clashes directly with the inescapable purpose of the 1976 Act to subject bottom-line allocations to the substantial economic effect requirement.

The primary purpose of the new section 704(b) is to make clear that bottom-line allocations are subject to the same limitations as allocations of individual items. The new provision changes two features of 704(b) that have supported arguments that bottom-line

¹²² Rev. Rul. 66-187, *supra* n. 34.

¹²³ See text accompanying notes 53-62, *supra*.

allocations are not subject to limitation. First, recall that the principal purpose limitation, by its terms, applies to allocations of any "item." It has been argued that the partnership's bottom-line is not subject to the principal purpose limitation because it is a "composite" rather than an "item."¹²⁴ The new 704(b) makes it inescapable that the new substantial economic effect requirement applies to allocations of composites because it includes in every subsection the disjunctive parenthetical "(or item thereof)." Second, recall that it has been argued that it is pointless to disregard an allocation of taxable income or loss only to subject it to the re-allocation mechanism of "taxable income or loss of the partnership, as described in section 702(a)(9)."¹²⁵ The new reallocation mechanism of "the partner's interest in the partnership (determined by taking into account all facts and circumstances)" applies as easily to bottom-line allocations as it does to allocations of individual items. Both these changes, it is submitted, do nothing more than clarify existing law.¹²⁶

Nevertheless, the clarifications may be the beginning of a new stage in the development of the law of partnership taxation. Many fundamental concepts in the area of partnership tax are extremely undeveloped. A major reason for the lack of development is that the provisions of subchapter K are both complex and obtuse. The Tax Court itself has strongly protested their obscurity:

The distressingly complex and confusing nature of the provisions of subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field. * * * Surely, a statute has not achieved "simplicity" when its complex provisions may confidently be dealt with by at most only a comparatively small number of specialists who have been initiated into its mysteries.¹²⁷

On too many important issues, the cases, Regulations and rulings fail to give guidance as to the meaning of the statute. The controversy concerning bottom-line allocations is illustrative. Perhaps it is neither surprising nor indicative of professional incompetence that many accountants and attorneys have assumed that whatever constitutes "taxable income or loss" in a partnership agreement also constitutes "taxable income or loss, as described in section

¹²⁴ See text accompanying notes 66-70, *supra*.

¹²⁵ See text accompanying notes 70-75, *supra*.

¹²⁶ See text accompanying notes 53-75, *supra*, and Weidner, *Passing Depreciation to Investor-Partners*, 25 S.C.L.Rev. 215 (1973).

¹²⁷ David A. Foxman, 41 T.C. 535, 551 n. 9 (1964) (citations omitted).

702(a)(9)” within the meaning of the statute. True, counsel in other substantive areas are often quickly and properly denounced for espousing the “plain meaning” of a statute without first divining its purpose.¹²⁸ True, also, that there is no legislative history that even suggests an intent to give carte-blanche approval to pure bottom-line allocations that separate tax losses from cash benefits and deliver them to high-bracket limited partners. The prevalence of the assumption that bottom-line allocations have been free from limitation is based in part on the fact that the assumption is made in an area of the law in which it is often considered quite an achievement for the non-specialist to divine any meaning, “plain” or otherwise, from a subchapter calculated more to frustrate than inform. Its prevalence is also based in part on the fact that neither legislative history, judicial decisions, Regulations nor rulings have offered any clear refutation of the assumption. The absence of any clear authority affects the staff of the Service in much the same way as it affects private practitioners, and may therefore also explain why the assumption has been a safe one on which to rely.

The new 704(b) precludes continued reliance on the “plain meaning” of the allocation rules by stripping them of any plain meaning. The legislative history makes clear that the new re-allocation mechanism is a flexible standard whose meaning will depend upon the partnership under consideration:

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 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.¹²⁹

¹²⁸ See, e.g., Heydon’s Case, 30 Co. 7a, 76 Eng. Rep. 637 (Exch. 1584):

And it was resolved by them [the judges] that for the sure and true interpretation of all statutes in general (be they penal or beneficial, restrictive or enlarging of the common law), four things are to be discerned and considered:—

1st. What was the common law before the making of the Act.

2nd. What was the mischief and defect for which the common law did not provide.

3rd. What remedy the Parliament hath resolved and appointed to cure the disease of the commonwealth.

And 4th. The true reason of the remedy; and then the office of all the Judges is always to make such construction as shall suppress the mischief, and advance the remedy, and to suppress subtle inventions and evasions for continuance of the mischief, and *pro privato commodo*, and to add force and life to the cure and remedy, according to the true intent of the makers of the Act, *pro bono publico*.

¹²⁹ S.Rep. No. 94-938 at 100.

With this particular clarification comes uncertainty. There is a change from a rule that had been viewed by many as a fixed standard with a plain meaning to a rule that appears almost perfectly elastic.

Regulations are needed to clarify the application of the flexible reallocation mechanism and its impact on related concepts. Consider limited partnership GAB that owns an highly-leveraged apartment building, whose members are general partner G and limited partners A and B. Assume that the partnership agreement initially provides four different ratios—one contribution ratio and three allocation ratios:

	Initial Capital Contribution	Net Cash Flow	Proceeds of Refinancing or Sale	Taxable Income or Loss
G	0%	50%	60%	10%
A	50	25	20	45
B	50	25	20	45

Assume that the partners adhere to this allocation arrangement during years one through four and then deviate from it in year five as follows: (1) the entire partnership depreciation deduction for year five is allocated to B and taxable income or loss, computed without regard to depreciation, is allocated according to the original taxable income or loss ratio; (2) in year five, B was in need of deductions whereas G and A were not because they experienced surplus losses from other sources; and (3) the allocation had no substantial economic effect because it, like the special allocation of depreciation in *Orrisch*, had no effect on any of the non-tax arrangements of the partners. How does the new reallocation mechanism apply to reallocate the depreciation in year five?

Each of the partnership's four ratios could be considered to reflect some dimension of a "partner's interest in the partnership." Consider first the factors the Senate Report states should be taken into account:

- (1) the interests of respective partners in profits and losses (if different from that of taxable income or loss),
- (2) cash flow;
- (3) their rights to distributions of capital upon liquidation.

Does the fact that capital contribution is not one of the factors listed suggest that the partners' contribution ratio is not to be considered in the determination of a "partner's interest in the

partnership?" The Senate Report is subject to interpretation on this point, because its language is illustrative rather than exclusive. However, it is noteworthy that it does define the "partner's interest in the partnership" solely in terms of measures of what the partners pull *out* of the partnership and not in terms of what they put *in*. As suggested above, this seems to be the appropriate approach, particularly when dealing with the deduction for depreciation.

Consider, then, which of the other ratios should control, whether some sort of weighted average of the ratios should control, or whether additional factors should also be considered. Note first that there is nothing to suggest that the depreciation should be returned to the partnership's bottom-line only to be reallocated according to the partners' ratio for sharing taxable income or loss. Indeed, if the 1976 Act does anything, it makes clear that the allocation of taxable income or loss used in the hypothetical in years one through four may also be disregarded because it is as subject to the substantial economic effect requirement as is the naked allocation of depreciation in year five. If the thesis of this paper is correct, the disregarded allocation of depreciation will be reallocated in accordance with one or more of the meaningful measures of anticipated cash benefits, which will vary from partnership to partnership. For example, if net cash flow is the only meaningful measure of anticipated cash benefits, other allocation ratios need not be considered in making the reallocation. To the extent the Service identifies the application of the reallocation mechanism, it will be establishing norms against which proposed allocations can be evaluated.

The Regulations that clarify how the substantial economic effect requirement and new reallocation mechanism apply to various allocation arrangements should be coordinated with the Regulations under the new rule that prohibits partners from increasing their bases by nonrecourse liabilities. Real estate partnerships are excepted from this rule, and an important unanswered question is whether limited partners in real estate partnerships will continue to share in nonrecourse liabilities in the same proportion they share in "profits." If the answer is yes, Regulations should clarify what constitutes a profits interest in different situations. The legislative history of the reallocation mechanism makes clear that a partner's profits interest is a flexible concept that, for example, may be different from his interest in taxable income and different from his interest in net cash flow.

IV. Conclusion

There is an urgent need for Regulations that clarify the meaning and importance of several concepts central to the law of partnership taxation. The need is caused by the interrelationships of two

basic realities of current use of the partnership form. First, it is extremely common for partnerships to have several ratios for sharing the different dimensions of partnership assets and activities. This is true of partnerships in numerous industries and activities, and of partnerships of all sizes. Second, it is extremely common for partners to attempt to allocate tax benefits and burdens differently than they allocate cash benefits and burdens. This tends to be and will continue to be particularly true of real estate partnerships, which survive relatively unscathed as a viable tax shelter. Depreciation deductions and the tax losses they produce are viewed as commodities to be bartered among partners, as are the deductions stemming from particular cash expenditures, whether the partnership be a nationwide public syndication or a handful of local businessmen. However large or small the cast of characters, it almost invariably consists of investors in need of tax losses who combine with promoters or investors who have little or no need for tax losses or who, indeed, because of surplus losses from other sources, are in a position to "eat" the taxable income of high-bracket investors willing to affiliate themselves as general or limited partners.

Most basically, Regulations should explain when tax benefits can be allocated in accordance with what partners contribute to a partnership and when tax benefits must be allocated in accordance with the partners' meaningful measure for sharing the anticipated cash benefits of partnership assets and activities. The new Regulations should inform attorneys and accountants, who have scant authority to guide them, when, if ever, it is appropriate to allocate depreciation deductions, or the bottom-line losses that result, on the basis of capital contribution or liability exposure rather than in accordance with one or all of the ratios for sharing anticipated cash benefits. Similarly, the new "at risk" rules, together with the new rule that prohibits partners in other than real estate partnerships from increasing their bases by nonrecourse liabilities, will require new Regulations concerning the manner in which partners share in liabilities for basis purposes. If limited partners in real estate partnerships will continue to share in nonrecourse liabilities in the same proportion as they share in "profits," the identity of the profits interest in various situations must be clarified. Finally, guidance should be given about the extent to which partners may trace their capital contributions to soft money expenditures and claim the corresponding deductions.

The fundamental thesis of this paper is that the basic content of the new reallocation mechanism, which should be viewed as the general norm for allocations, and the basic content of the profits concept are the same: the meaningful measure of anticipated cash benefits of the partnership in question. This approach is particularly appropriate when the issue is the allocation of depreciation deductions or the bottom-line losses they create. A different approach is

appropriate, however, when certain partners are allocated the deductions for actual cash expenditures they alone shoulder. In general, soft money allocations are appropriate when the burden is traced to particular partners because of normal business considerations but inappropriate when traced because of an attempt by partners to allocate among themselves the deductions, credits, or increase in bases that most comport with their individual tax pictures.