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PARTNERSHIP ALLOCATIONS: FLIPPING THROUGH THE SUBSTANTIAL ECONOMIC EFFECT HOOPS

FRANK RAINER

Partnership allocations of profits and losses are determined by the partnership agreement or, in the absence of a provision in the agreement, by the partners' interest in the partnership.[1] One type of allocation provision that is commonly made in partnership agreements is the "flip." A flip is a shift in the allocation of profits and losses upon the happening of a specified event.[2] An example is the case of a limited partnership which has heavy cash contributions from the limited partners and which allocates to the limited partners all of the net cash flow and losses until they have recovered their investment. Once the limited partners have recovered their investment, the allocation of net cash flow and losses is flipped to allow the general partners to share in the partnership allocations. The partners do not, however, have unlimited discretion in determining the nature of the flip. The allocations must meet the substantial economic effect requirement of Internal Revenue Code Section 704(b)(2) or they will be struck down and the profits and losses will be reallocated according to the partners' interests in the partnership.[3]

I. SUBSTANTIAL ECONOMIC EFFECT — CAPITAL ACCOUNT ANALYSIS.

Substantial economic effect is not a new concept. It has been a part of partnership tax law since 1954,[4] but did not emerge as the

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1. *See* I.R.C. § 704 (CCH 1982). Section 704, dealing with the determination of a partner's distributive share, provides in relevant part:

> (a) Effect of partnership 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.
>
> (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.

2. *See* 1 A. WILLIS, J. PENNELL & P. POSTLEWAITE, PARTNERSHIP TAXATION § 46.01, at 46-1 (3d ed. 1983) [hereinafter cited as WILLIS].
3. *See* I.R.C. § 704(b)(2) (CCH 1982).
4. *See* S. REP. No. 1622, 83d Cong., 2d Sess., § 704, *reprinted in* 1954 U.S. CODE CONG. &

principal test for allocations until the Tax Reform Act of 1976.[5] Prior to the Reform Act, the test for determining the substantial economic effect of allocations was whether the allocation's purpose was the "avoidance or evasion of any tax."[6] While the change to the substantial economic effect test may seem to have been a radical change, actually it was not that dramatic.[7] The test had its origins in Treasury Regulation section 1.704-1(b)(2), which was promulgated prior to the Reform Act.[8] The regulation defines substantial economic effect as "whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences."[9] The Senate Finance Committee Report submitted prior to the Reform Act adopted the test as defined in the regulation.[10] Also, as is discussed below, the courts were already using the substantial economic effect test in determining whether an allocation involved the "avoidance or evasion of any tax."[11]

It is generally believed that the way to determine whether the allocation "actually affects" the partners' shares of income or loss is by a capital account analysis.[12] A definition of the capital ac-

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AD. NEWS 4621, 5021.

5. Pub. L. No. 94-455, 90 Stat. 1520 (1976) (codified as amended in scattered sections of 26 U.S.C.) [hereinafter cited as the Reform Act].

6. I.R.C. § 704(b)(2) (1970) *amended by* I.R.C. § 704(b)(2) (CCH 1982). Prior to 1976, allocations were defined as either special or bottom-line. Bottom-line allocations were not considered subject to the substantial economic effect test. *See infra* notes 64-69 and accompanying text. With the passage of the Reform Act, however, the substantial economic effect test was made applicable to both special and bottom-line allocations. *See* S. REP. No. 938, 94th Cong., 2d Sess. 99, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3439, 3535-36; *see also* McKee, *Partnership Allocations: The Need for an Entity Approach,* 32 MAJOR TAX PLAN. ¶ 401.1, at 4-5 (1980).

7. *See* Allison v. United States, 83-1 U.S. Tax Cas. (CCH) ¶ 9241 (Ct. App. Fed. Cir. 1983). The court states "that this change in language [by the Reform Act] had minor substantive effect, at best, on the evaluation given special allocations by the courts which even before 1976 emphasized the existence of substantial economic effect over other factors." *Id.* at 86,567.

8. Treas. Reg. § 1.704-1(b)(2) (1964).

9. *Id.*

10. *See* S. REP. No. 938, *supra* note 6, at 100.

11. *See infra* notes 18-35 and accompanying text.

12. *See* Solomon, *Current Planning for Partnership Startup, Including Special Allocations, Retroactive Allocations and Guaranteed Payments,* 37 INST. ON FED. TAX'N § 13.03[4], at 13-11 (1979); *but cf.* Krane & Sheffield, *Beyond* Orrisch: *An Alternative View of Substantial Economic Effect Under Section 704(b)(2) Where Nonrecourse Debt Is Involved,* 60 TAXES 937, 947 (1982) (suggesting that when nonrecourse debt is involved a percentage ownership analysis should be used instead of a capital account analysis); Weidner, *Partnership Allocations and Tax Reform,* 5 FLA. ST. L. REV. 1, 17 (1977) (notes that other factors are cited in the regulation as determinative of the validity of an allocation).

count analysis was included in the Joint Committee's explanation of the Reform Act, and provides that:

> The determination of whether an allocation may actually affect the dollar amount of the partners' shares of total partnership income or loss, independent of tax consequences, will to a substantial extent involve an examination of how these allocations are treated in the partners' capital accounts for financial (as opposed to tax) accounting purposes; this assumes that these accounts actually reflect the dollar amounts that the partners would have the rights to receive upon the liquidation of the partnership.[13]

Therefore, the essence of the substantial economic effect—capital account analysis is (1) whether the allocation is used to adjust the capital account of the partners, and (2) whether the partnership distributions upon liquidation would be in accordance with the partners' capital accounts.[14]

The landmark case in applying the capital account analysis to determine substantial economic effect is *Orrisch v. Commissioner*.[15] Partners Orrisch and Crisafi had agreed in their partnership agreement to share equally in the profits and losses from two apartment houses. In a subsequent year, they orally agreed to amend the partnership agreement to allocate all of the depreciation deductions to Orrisch. Also, the partners agreed that on the sale of the property the gain would be allocated to Orrisch until he had recouped the amount of depreciation previously charged to him with any additional gain to be divided equally.[16] The Tax Court, in striking down the special allocation, stated the following:

> To find any economic effect of the special allocation agreement aside from its tax consequences, we must, therefore, look to see who is to bear the economic burden of the depreciation if the buildings should be sold for a sum less than their original cost. There is not one syllable of evidence bearing directly on this cru-

The definition of a capital account is: The partner's capital contributions plus the partner's share of partnership income minus [the partner's share of losses plus distributions made to that partner]. *See* Stephenson, *Oil and Gas Operations Inside and Outside the Partnership*, 40 INST. ON FED. TAX'N § 13.03(2)(c), at 13-46 to -47 (1982).

13. STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF TAX REFORM ACT OF 1976, at 95 n.6 (1976), *reprinted in* 2 WILLIS, *supra* note 2, § 86.03, at 86-3.

14. *See* McKee, *supra* note 6, ¶ 401.2, at 4-6 to -7.

15. 55 T.C. 395 (1970), *aff'd per curiam*, 31 A.F.T.R. 2d (P-H) ¶ 73-556 (9th Cir. 1973).

16. *Orrisch*, 55 T.C. at 397.

> cial point. We have noted, however, that when the buildings are fully depreciated, petitioners' capital account will have a deficit, or there will be a disparity in the capital accounts, approximately equal to the undepreciated basis of the buildings as of the beginning of 1966. Under normal accounting procedures, if the building were sold at a gain less than the amount of such disparity petitioners would either be required to contribute to the partnership a sum equal to the remaining deficit in their capital account after the gain on the sale had been added back or would be entitled to receive a proportionately smaller share of the partnership assets on liquidation. Based on the record as a whole, we do not think the partners ever agreed to such an arrangement. On dissolution, we think the partners contemplated an equal division of the partnership assets. . . . That being true, the special allocation does not "actually affect the dollar amount of the partners' share of the total partnership income or loss independently of tax consequences" within the meaning of the regulation.[17]

An important concept which flows from *Orrisch* is that a capital account analysis is risk-oriented.[18] The court looked to a hypothetical liquidation to see how the risk was spread.[19] If the property were to be sold for a gain, a gain charge back provision would apply. This provision would allocate to Orrisch the taxable gain on sale until he equalized his capital account with Crisafi and then they would split the remaining taxable gain equally.[20] Thus, on liquidation, an equal distribution of the proceeds would be in accordance with the capital accounts. This fact was not dispositive to the court. Instead, the court looked at who was to suffer the economic burden if the property was sold at less than the special allocation of depreciation, at a loss, or for neither a gain nor loss, so that the disparity in capital accounts could not be remedied by the gain charge back.[21]

Orrisch requires that when there is a gain charge back provision, it is necessary to determine whether the partner who takes the deduction bears any of the economic loss associated with the deduc-

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17. *Id.* at 403-04 (footnotes omitted); *but cf.* Solomon, *supra* note 12 at 13-13 (criticizing the *Orrisch* decision for concluding that the partners intended to divide the partnership assets equally, where there was no evidence to support such a conclusion).

18. *See* Weidner, *Partnership Allocations and Capital Accounts Analysis*, 42 OHIO ST. L.J. 467, 491 (1981).

19. *Orrisch*, 55 T.C. at 404.

20. *Id.*

21. *Id.* at 403.

tion.[22] A failure to reduce the partners' distribution on liquidation fails the capital account analysis. The partner who was not given an allocation bears the economic loss, but upon liquidation he is compensated by receiving a tax loss. This distinction should not matter since the tax accounting will always result in him getting that loss.[23] The regulations require that the allocation have effect on the actual dollar amount and that the proceeds be allocated in accordance with the tax results.[24] Therefore, the divergence of tax and economic consequences of an allocation for a specific year indicates the lack of substantial economic effect and it is not a defense to say that there will be a reconciliation on liquidation.[25]

As a corollary to the above analysis, if a partner has a negative capital account and any other partner's capital account is positive, then the allocation lacks substantial economic effect unless that partner is required to restore the negative balance on liquidation.[26] Capital accounts are viewed as reflecting unrecovered investment. A negative capital account means that the partner has recovered more than his investment. The negative capital account can no longer be bearing the economic burden of the allocations.[27]

In contrast, *Harris v. Commissioner*[28] is a case in which the Tax Court found substantial economic effect even though the entire loss was allocated to one partner. As part of a plan to liquidate Harris' forty percent partnership interest, the partnership sold a ten percent interest and specially allocated the loss and cash proceeds to Harris. Harris then withdrew from the partnership and received an undivided thirty percent interest in the property, which he also sold.[29] The Tax Court found that there was economic effect because "the loss allocated [to Harris] was applied to reduce his capital account, and his share of the related items of future profits, losses, and proceeds in case of liquidation was reduced proportionately."[30] A decisive factor in the decision was the "exact equivalence between the amount of the loss and the economic ef-

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22. *See* McKee, *Partnership Allocations in Real Estate Ventures:* Crane, Kresser *and* Orrisch, 30 TAX L. REV. 1, 18-20 (1974).

23. *Id.*

24. *See supra* text accompanying note 9.

25. *See*, 1 W. MCKEE, W. NELSON & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, ¶ 10.02[2][c] (1977) [hereinafter cited as PARTNERSHIPS].

26. *Id.*, ¶ 10.02[2][b], at 10-21 to -22. *See also* McKee, *supra* note 22, at 22-23.

27. PARTNERSHIPS, *supra* note 25, ¶ 10.02[2][b] at 10-22.

28. 61 T.C. 770 (1974).

29. *Id.* at 776. The property in question was a shopping center.

30. *Id.* at 786.

fect as among the partners."[31]

The Tax Court again used the capital account analysis in *Magaziner v. Commissioner.*[32] Magaziner and Feldman formed a partnership in which most of the depreciation and interest were allocated to Magaziner in the early years. In later years they were to be equal partners. On the sale of the property, Magaziner received more than fifty percent of the proceeds despite the absence of a special allocation. The court, citing the *Orrisch* decision, looked "to see who is to bear the economic burden of the . . . deductions if the partnership property is sold for a sum less than its original cost and the partnership liquidated."[33] The court strengthened the position of capital account analysis by stating that "if the allocation of an item of income or deduction to a partner is reflected in his capital account and the liquidation proceeds of the entity are distributed in accordance with the capital accounts, the allocation has substantial economic effect."[34] Therefore, *Magaziner* is the first case which explicitly stands for the proposition that substantial economic effect is found by passing the capital account analysis.[35]

While the capital account analysis is firmly entrenched in partnership tax law, it has not gone without criticism. It is claimed that the capital account analysis can give some allocations substantial economic effect which have tax avoidance as their sole motive.[36] The most severe criticism of the capital account analysis is that it fails when nonrecourse debt is involved.[37] It is claimed that nonrecourse debt causes the *Orrisch* analysis to fail on two counts: (1) the risk of loss is borne by the nonrecourse lender and not by the partners,[38] and (2) there will always be a gain on any disposition of property because the nonrecourse debt is included in the

31. *Id.*

32. 37 T.C.M. (CCH) 873 (1978).

33. *Id.* at 875 (citing *Orrisch*, 55 T.C. at 403).

34. *Id.*

35. *See* Weidner, *supra* note 18, at 490.

36. *See* Solomon, *supra* note 12, § 13.03[6], at 13-45.

37. *See* Krane & Sheffield, *supra* note 12, at 945-49. These authors suggest that when nonrecourse debt is involved, a percentage ownership analysis should be applied. This analysis would require calculation of the present value of the partner's economic, nontax interest in the partnership and of the total benefits the partner can expect. The present value of the economic benefits is divided by the present value of the total benefits. If the partner's percentage ownership of the economic benefits is eighty percent of his percentage ownership of total benefits, the allocation has substantial economic effect.

38. *Id.* at 945; *see also* McKee, *supra* note 22 at 3-4.

amount realized.[39] No court, however, has found the above criticisms to be of any significance.[40]

II. *Hamilton v. United States*

Since a flip makes use of the allocation provisions, it must pass muster under the substantial economic effect test. Before *Hamilton v. United States*,[41] the flip had not been subject to judicial scrutiny.[42] *Hamilton* gave the United States Court of Claims[43] an opportunity to test the flip provisions of a partnership agreement, and the court found that the allocations had economic substance.[44] While the tax shelter in *Hamilton* was an oil and gas limited partnership, its flip provisions are similar to those found in most tax shelter partnerships.[45]

The flip provision in *Hamilton* provided basically for the general partners to contribute a five percent capital interest to the partnership with the limited partners contributing the remaining ninety-five percent. There was an allocation of all income, expenses and net cash flow distributions to the partners in proportion to their capital contributions until the limited partners had recovered their ninety-five percent capital contributions. After recoupment by the limited partners of their capital contributions, the allocations were flipped to sixty percent for the limited partners and forty percent for the general partners.[46] Prior to recoupment, the

39. *See* Crane v. Commissioner, 331 U.S. 1 (1947). Crane requires that the nonrecourse debt be included in the amount realized upon sale. *See also*, Krane & Sheffield, *supra* note 12, at 946 n.34.

40. *But see* 48 Fed. Reg. 9871-9886 (1983) (to be codified at 26 C.F.R. § 1) (proposed March 4, 1983). The service has proposed new regulations in which it attempts to address these criticisms as well as other problems. *See infra* notes 81-100 and accompanying text.

41. 687 F.2d 408 (Ct. Cl. 1982).

42. *See, e.g.*, 1 WILLIS, *supra* note 2, § 46.03, at 46-6.

43. The Court of Claims was merged with the Court of Customs and Patent Appeals in October of 1982 to form the Court of Appeals for the Federal Circuit. Federal Courts Improvement Act of 1982, Pub. L. No. 97-164, 96 Stat. 25 (to be codified in scattered sections of 26 U.S.C.).

44. Economic substance is the test for pre-1976 bottom-line allocations, but the court found that the test differs only slightly from the substantial economic effect test. *Hamilton*, 687 F.2d at 414. *See infra* notes 70-79 and accompanying text.

45. *See* Willis, *Special Allocations of Partnership Profits and Losses*, 7 J. REAL EST. TAX'N 356 (1980). Willis discusses the importance of Tech. Advice Memo. 7707260880A (July 26, 1977) to real estate partnerships. The memorandum concerned the same flip provision at issue in *Hamilton*. *See infra* note 46 and accompanying text.

46. *Hamilton*, 687 F.2d at 411. None of the limited partnerships followed these percentages exactly; there were some differences. This statement of facts reflects the basic mechanics of the flip provisions. Tech. Advice Memo. 7707260880A, which the Service issued on the Hamilton partnerships, used the same general percentage figures. *Id.*

general partners could have accelerated the flip by paying the limited partners a specified portion of their unrecovered capital contributions. A liquidation before the capital contribution recovery entitled the general partners to a forty percent interest in the partnership assets, less the limited partners' "[n]et [p]rofits interest."[47] The net profits interest was to come solely out of the partnership assets.

The Hamiltons' first limited partnership was formed in 1956 and was the subject of a favorable 1957 private letter ruling.[48] A 1967 limited partnership was also the subject of a favorable private letter ruling.[49] In 1969 the Hamiltons and other partners exchanged their partnership interests for shares in Hamilton Brothers Petroleum Corporation. The transaction for income tax purposes was reported under section 351 of the Internal Revenue Code with a total exchange value of approximately sixty-five million dollars. In 1977 the Service issued a memorandum[50] which found that the allocation (flip) provisions of the limited partnerships were inconsistent with the economic substance of the arrangements. The Hamiltons then sued for income tax refunds for 1969 claiming that the Service improperly interpreted the partnership agreements.

A. Loan Theory

In contesting the allocation provisions of the partnership, the Service argued a nonrecourse loan theory. The Service contended that, although the general partners had stated their interest in the partnership at five percent, their interest was actually closer to forty percent. Pleading in the alternative, the Service claimed that the additional thirty-five percent interest came either from a nonrecourse loan by the limited partners to the general partners or that the limited partners transferred thirty-five percent of their interests to the general partners in return for an equal amount of nonrecourse debt.[51] The Service pointed to the net profits interest as not "'an interest in the assets of the partnership' which is properly allocable to the limited partners"[52] and that reallocation of the

47. The net profits interest is calculated by taking approximately thirty-five percent of the limited partners' capital contributions less any cash distributions they have received. *Id.* at 421.

48. *Id.* at 410.

49. *Id.*

50. *Id.* at 411 (citing Tech. Advice Memo. 7707260880A (July 26, 1977)).

51. *Id.* at 412.

52. *Id.* at 415.

partnership income would result in additional income to the plaintiffs. In addition, the Service contended that when the partnerships were incorporated the "loans were discharged and plaintiffs recognized a taxable gain to the extent that the outstanding loans exceeded plaintiffs' bases in the partnership interests transferred."[53]

As support for rejecting the Service's nonrecourse loan theory, the court looked to example five of Treasury Regulation section 1.704-1(b)(2) and Revenue Ruling 68-139.[54] Both were found to have a set of facts directly analogous to the present case and both upheld the validity of a shift in the allocation provisions.[55] Fur-

53. *Id.* at 409.

54. *Id.* at 415-16 (citing Treas. Reg. § 1.704-1(b)(2) (ex. 5) (1964); Rev. Rul. 139, 1968-1 C.B. 311.

55. *Id.* at 415-16. Example 5 of Treas. Reg. § 1.704-1(b)(2) (1964) provides the following hypothetical:

> G and H, each of whom is engaged as a sole proprietor in the business of developing and marketing electronic devices, enter into a partnership agreement to develop and market electronic devices. H contributes $2,500 cash and agrees to devote his full-time services to the partnership. G contributes $100,000 cash and agrees to obtain a loan for the partnership of any additional capital needed. The partnership agreement provides that the full amount of any research and experimental expenditures and any interest on partnership loans are to be charged to G. It also provides that G's distributive share is to be 90 percent of partnership income or loss computed without reduction by such research and experimental expenditures and such interest, until all loans have been repaid and G has received through his 90 percent share of income an amount equal to the full amount of such research and experimental expenditures, of such interest, and his share of any partnership operating losses. During this time H's distributive share will be 10 percent. Thereafter, G and H will share profits and losses equally. Since all of the research and experimental expenditures and interest specifically allocated to G are in fact borne by G, the allocation will be recognized in the absence of other circumstances showing that its principal purpose was tax avoidance or evasion.

Rev. Rul. 139 states:

> The parties, *A*, *B*, and *C*, entered into a partnership agreement for the joint exploration of oil and gas in which *B* and *C* were required to contribute 300x dollars, each, to be used for drilling and equipping the first test well for which *B* and *C* each received a 3/32d working interest in the leases for their contributions. *A* retained the remaining 26/32d working interest. The contributions were to be paid, one-half by *B* and one-half by *C*, as follows: (a) 300x dollars upon the first test well reaching 3,500 feet and (b) 300x dollars upon the first test well reaching 7,500 feet or 1,000 feet above the top of a specified formation, or to a depth which encountered commercial production.
>
> Partner *A* commenced drilling the test well and soon thereafter *B* and *C* each contributed their 300x dollars, all of which was expended in 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

ther, the court found that it could not reconcile the Service's loan theory with the absence of any mention of such a theory in these authorities.[56]

Next, the court looked to Revenue Ruling 72-135[57] and found that it was "most damaging to [the Service's] position."[58] The ruling dealt with limited partners receiving a nonrecourse loan from general partners in order to enable the limited partners to invest in the partnership. The ruling determined that the loan is a contribution of capital by the general partners which adds to their bases. From this, the court extrapolated "that when a partner makes a nonrecourse loan to another partner . . . the 'lender's'—not the 'borrower's'—basis in his partnership interest is increased."[59] Therefore, the ruling supported the premise that, even if the limited partners in *Hamilton* did make a nonrecourse loan, a reallocation is not mandated because the loan is considered a contribution of capital by the limited partners.[60]

Finally, the court found that the Service's loan theory "characterize[s] the provisions of [the] agreement in a manner which is

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> agreement, would, to the extent so expended, represent their respective contributions to the intangible drilling and development costs incurred by the partnership. . . .
>
> . . . .
>
> Accordingly, the provisions of the partnership agreement to allocate the intangible drilling and development costs incurred by the partnership will be recognized, if a proper election is made by the partnership under sections 1.703-1(b)(1) and 1.612-4 of the regulations to deduct intangible drilling and development costs, unless examination discloses that the principal purpose of the allocation is the avoidance or evasion of Federal income tax.

Rev. Rul. 139, 1968-1 C.B. 311 (citations omitted).

56. *Hamilton*, 687 F.2d at 416-17.

57. Rev. Rul. 135, 1972-1 C.B. 200 provides the following:

> *ABC, Ltd.*, is a limited partnership engaged in the acquisition, exploration, development and operation of oil and natural gas properties in which *P* is the general partner. The limited partners are those investors who have subscribed to a public offering of limited partnership interests in *ABC*. The limited partnership agreement provides that *P* may loan, on a nonrecourse basis, to limited partners, a portion of their subscription in *ABC*. The agreement further provides that *P* may make loans, on a nonrecourse basis, to the partnership.
>
> *Held*, in the instant case, a nonrecourse "loan" from the general partner to a limited partner or to the partnership is a contribution to the capital of the partnership by the general partner, rather than a loan, and accordingly, the amount thereof shall be added to the basis of the partnership interest of the general partner and not to the basis of the partnership interest of the limited partner.

58. *Hamilton*, 687 F.2d at 417.

59. *Id.*

60. However, the Service's alternate argument that the limited partners transferred thirty-five percent of their interests to the general partners in return for an equal amount of nonrecourse debt is supported by the ruling.

contrary to [its] economic reality."[61] Prior tax opinions did not determine the validity of allocations by characterizing the allocation as a loan; rather, they looked to whether the partner who received the allocation bore the economic burden of the allocation.[62] The court found that by recharacterizing the limited partners' contributions as a nonrecourse debt or a transfer of a portion of their interest in return for a net profits interest, the Service "[did] not alter the fact that the limited partners' contributions to the partnerships equaled their total economic burden."[63]

B. *Substantial Economic Effect v. Economic Substance*

Even though *Hamilton* recognized that the validity of allocations is ascertained by the economic burden of the allocations, it did not feel that the substantial economic effect test was applicable.[64] This is because the challenged allocations are bottom-line allocations[65] and prior to 1976 there was a distinction made between the test of special and bottom-line allocations. Special allocations, which are allocations of a specific item of income, loss, deduction or credit to a partner, are subject to the substantial economic effect test.[66] Bottom-line allocations, which are allocations of net income or loss generated by activities of the partnership, are not tested by the substantial economic effect test but by the economic substance test of *Kresser v. Commissioner,*[67] and *Boynton v. Commissioner.*[68] The *Kresser-Boynton* standard is whether the substance of the agreement reflects the partners' allocations of benefits and burden.[69] However, the *Hamilton* court found that for bottom-line allocations the test "differs only slightly from the standard found in [Internal Revenue Code] section 704(b)(2) and the use of one rather than the other should have little effect on the outcome of this

61. *Hamilton,* 687 F.2d at 417.

62. *See, e.g.,* Holladay v. Commissioner, 72 T.C. 571, 587 (1979), *aff'd,* 649 F.2d 1176 (5th Cir. 1981); Boynton v. Commissioner 72 T.C. 1147, 1159 (1979), *aff'd.* 649 F.2d 1168 (5th Cir. 1981), *cert. denied,* 454 U.S. 1146, (1982); Magaziner v. Commissioner, 37 T.C.M. (CCH) 873, 875 (1978).

63. *Hamilton,* 687 F.2d at 418.

64. *Id.* at 414, 418 (applying the pre-1976 economic substance test).

65. *Id.* at 414.

66. *Id.; see also* Rev. Rul. 187, 1966-2 C.B. 246; *but see* 2 WILLIS, *supra* note 2, § 82.01, at 82-2 (claiming there is no specific meaning of special allocation).

67. 54 T.C. 1621 (1970).

68. 72 T.C. 1147 (1979).

69. *Hamilton,* 687 F.2d at 414.

case."[70]

In determining the economic substance of the allocations the court applied an analysis similar to that of a capital account test. First, the court found that the net cash flow was allocated according to the economic substance of the partners' deal.[71] Important to the court was the fact that prior to the flip the allocation scheme operated to reimburse all the partners at the same time for their capital contributions and according to their initial capital contributions; *i.e.* for every $100 of cash receipts, $95 would be alloted to the limited partners and $5 to the general partners.[72] Another factor of importance was that the flip of the distributions and taxable income occurred at the same time and to the same extent for all the partners.[73]

Second, the court looked at the liquidation provisions of the partnership agreement. The court concentrated on the effect of a liquidation which might occur prior to the flip.[74] In such a liquidation, the limited partners would receive sixty percent of their capital contributions plus a net profits interest. The net profits interest would give the limited partners the remaining thirty-five percent of their capital contributions less any cash distributions they had received.[75] The court found that the "'net profits interest' is an economic interest . . . similar to a royalty."[76] Therefore, throughout the entire term of the partnership, a liquidation would result in the partners recovering their capital contributions in proportion to the economic burden they bore.

Hamilton rightfully rejected the Service's loan theory and instead focused on the economic substance of the partnership agreement. It is unfortunate that the court was not able to apply the substantial economic effect test to the allocations at issue, but it was saddled with the archaic distinction made between special and bottom-line allocations. However, the court seemed to indicate

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70. *Id.* I.R.C. § 704(b)(2) contains the substantial economic effect test. *See supra* note 1.

71. *Hamilton*, 687 F.2d at 418.

72. *Id.*

73. *Id.* Distributions are not taxable to the partners unless the distribution exceeds the basis of the partner's partnership interest. *See* Caruthers, *Real Estate Tax Shelters: Special and Retroactive Allocations Under the Tax Reform Act of 1976*, 4 J. REAL EST. TAX 119, 139 (1977) (explaining how the flip may cause taxable gain to the partners because the flip relieves them of a proportionate share of liabilities); *see also* Seago & Horvitz, *Some Subtle Effects of the Partnership Constructive Distribution Rules*, 58 TAXES 97, 99-100 (1980).

74. *Hamilton*, 687 F.2d at 418, 419.

75. *Id.* at 421 (approximate figures); *see supra* note 46.

76. *Hamilton*, 687 F.2d at 419 (citing Kirby Petroleum Co. v. Commissioner, 326 U.S. 599, 604 (1946)).

that the distinction was without merit.[77] While the court claimed to use the economic substance test of *Kresser* and *Boynton,* the characteristics it examined in determining the validity of the allocations were the same as those that would have been examined if a capital account analysis under the substantial economic effect test had been used. In matter of fact, the court recognized in a footnote that the allocations at issue would have survived the scrutiny of the substantial economic effect-capital account test.[78] Thus the court has relieved much of the uncertainty as to whether a flip is a valid method of allocation by finding the flip at issue to have economic substance.[79]

III. Recent Developments

While case law and practitioners have repeatedly used a capital account analysis to determine the substantial economic effect of allocations, Treasury Regulation section 1.704-1(b)(2) does not include any reference to capital accounts.[80] In order to remedy this omission and to update the regulation, the Service has proposed a new regulation.[81] The proposed regulation spells out at length the rules and applications of the capital account analysis. The following is a brief outline of the concepts in the new regulation.[82]

The proposed substantial economic effect-capital account test is a two pronged test. The first prong requires that the allocation have economic effect. This is based on a risk concept which requires that where "there is an economic benefit or economic burden which corresponds to the allocation, the allocation will actually affect (to the same extent) the dollar amount received by such partner."[83] In order to meet the requirement of economic effect the following factors must be present:

> (a) The allocation is reflected as an appropriate increase or decrease in that partner's capital account . . . and

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77. *Id.* at 414.

78. *Id.* at 419 n.29.

79. The Service has proposed a new Treas. Reg. § 1.704-1(b)(2), and has included several examples where the validity of a flip is upheld under the capital accounts test. *See* 48 Fed. Reg. 9,871, *supra* note 40. *See infra* notes 91-93 and accompanying text.

80. The regulation was first promulgated in 1960 (amended 1964), long before capital account analysis was considered the main test to determine substantial economic effect.

81. 48 Fed. Reg. 9,871, *supra* note 40.

82. The proposed regulation would expand the present one line reference to substantial economic effect to fifteen pages in the Federal Register. *Id.* at 9,872-86.

83. *Id.* at 9,873.

> (b) Liquidation proceeds are, throughout the term of the partnership, to be distributed in accordance with the partners' capital account balances, and
>
> (c) Any partner with a deficit in his capital account following the distribution of liquidation proceeds is required to restore the amount of such deficit to the partnership, which amount shall be distributed to partners in accordance with their positive capital account balances [or] paid to creditors.[84]

The second prong of the test requires substantiality, which is determined by weighing "the likelihood and magnitude of . . . shift[s] in the economic consequences among partners . . . against the shifting of tax consequences resulting from the allocation (or allocations), particularly tax consequences which result from the interaction of the allocation (or allocations) with the partners."[85] There is a rebuttable presumption of lack of substantiality if the shift in tax consequences is disproportionately larger than the changes in economic consequences. Further, substantiality is determined by assuming that the economic benefit or burden will occur without regard to the probability of such occurrence. Therefore, it is not necessary that the allocation of accelerated cost recovery be matched by an equal decline in the value of the property.[86]

Failing both prongs of the substantial economic effect-capital accounts test requires that the allocations be reallocated in accordance with the partners' interest in the partnership. The proposed regulation spells out what is considered to be an interest in the partnership. It starts off with the presumption that the partners all have an equal interest. However, this presumption may be rebutted by proving facts and circumstances otherwise. The proposed regulation finds the following facts relevant:

> (1) The partners' relative contributions to the partnership;
>
> (2) The interests of the partners in economic profits and losses (if different from that in taxable income or loss);
>
> (3) The interests of the partners in cash flow and other distributions; and
>
> (4) The rights of the partners to distributions of capital and other property upon liquidation.[87]

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84. *Id.*
85. *Id.*
86. *Id.* at 9,874.
87. *Id.* at 9,875.

In addition, the proposed regulation would apply restrictive rules for *all* partnerships where the allocations are based on nonrecourse financing.[88] The regulation is structured to police against any allocations in which the creditor bears the economic burden. In order to determine when the creditor bears the burden, a "minimum gain" must be calculated by taking the difference between the unpaid principal and the adjusted basis of the property.[89] The sum of all capital accounts of those partners with negative balances cannot exceed the minimum gain unless those partners with deficits are allocated subsequent income and gain sufficient to "pay back" the deficits.[90]

The proposed regulation provides several examples where the capital account analysis is applied to a flip provision. Example 3[91] of the proposed regulation is the same as Example 5 of the present regulation except that it requires the allocation to conform with the capital account requirements given above. Along with Example 3, Example 2[92] and Example 16[93] deal with flip provisions. All of these examples show that flips can be valid if they follow the requirements of the proposed regulations.

The impact of the proposed regulation appears to be favorable to flips. The examples indicate when the flip is a valid allocation and gives the practitioner some guidance. All of the relevant examples permit a flip which is designed to give certain partners a swift recovery of their initial investment. This is an important marketing tool for partnerships.[94] Without the ability to offer certain partners a guaranteed return on their investment, partnerships would be severely impaired in their ability to generate capital.

In general, the passage of the proposed regulation will help clarify a confused area which long has been in need of reform.[95] The capital account analysis will be recognized as the test for substantial economic effect, and several features of this analysis are simply a restatement of prior law. The requirement that the allocation be reflected in the partner's capital account and that the liquidation proceeds be distributed in accordance with the capital account has

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88. *Id.* at 9,876.
89. *Id.*
90. *Id.*
91. *Id.* at 9,878-79.
92. *Id.* at 9,878.
93. *Id.* at 9,882.
94. *See* 1 WILLIS, *supra* note 2, § 46.01, at 46-1 to -2.
95. *See* Weidner, *supra* note 12, at 64.

always been considered the heart of a capital account test.[96] Also, the requirement of substantiality has been an integral part of the substantial economic effect test from the outset.[97] To the extent the proposed regulation will restate prior law,[98] it will eliminate ambiguities which currently exist.

However, the proposed regulation has some aspects which will only muddy the waters. Most notable is the restriction on allocations which are based on nonrecourse financing. Unlike the economic effect and substantiality tests, the rules for nonrecourse financing are supported by very little authority.[99] No judicial or legislative[100] authorities have ever applied such restrictions on allocations which are possible because of nonrecourse financing. The Service is attempting to do administratively that which both Congress and the judiciary have failed to do.

IV. Conclusion

The fact that flip provisions can have substantial economic effect is finally recognized. *Hamilton,* as the first case to determine the substantial economic effect[101] of a flip, demonstrates as much. Practitioners now have a model of a flip allocation which can pass judicial scrutiny. In addition, the proposed regulation would only reinforce the fact that flips can have substantial economic effect and provide further examples of safe harbors.

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96. *See supra* notes 13-14 and accompanying text.

97. *See supra* notes 22-25 and accompanying text.

98. There is some uncertainty as to whether the liability nature of a negative capital account is a restatement of prior law. The Uniform Partnership Act §§ 18, 40, 6 U.L.A. 213, 469 (1969), seems to indicate that a negative capital account measures the potential liability of the partner to the partnership if the partnership is immediately liquidated. *But see* 2 Willis, *supra* note 2, § 86.05, at 86-9; Partnerships, *supra* note 25, ¶ 10.02[2], at 10-23. However, at present only one court has interpeted these provisions to impose liability on the partner for a negative capital account. *See* Park Cities Corp. v. Byrd, 534 S.W.2d 668, 672 (Tex. 1976).

99. McKee seems to be the only authority for these rules on nonrecourse financing. *See* Partnerships, *supra* note 25, ¶ 10.03[2], at 10-27 to -34.

100. It may be claimed that the I.R.C. § 465 "at risk" rules lend some credence to a finding of a legislative mandate to deal harshly with nonrecourse financing. The applicability of this argument is extremely limited. The "at risk" rules deal only with the initial inclusion of nonrecourse debts in the partners' basis and not the deductibility once included.

101. Actually, *Hamilton* determined that the flip passed the economic substance test. *See supra* notes 64-70 and accompanying text. However, the court recognized that the substantial economic effect test is similar to the economic substance test and that the allocations at issue would pass the substantial economic effect test. *See supra* notes 70-79 and accompanying text.