Fall 1983


Peter Doragh

Follow this and additional works at: http://ir.law.fsu.edu/lr

Part of the Business Organizations Law Commons, and the Taxation-Federal Commons

Recommended Citation
http://ir.law.fsu.edu/lr/vol11/iss3/7

This Note is brought to you for free and open access by Scholarship Repository. It has been accepted for inclusion in Florida State University Law Review by an authorized editor of Scholarship Repository. For more information, please contact bkaplan@law.fsu.edu.

Partners, not partnerships, are subject to federal income taxation, and each partner declares his share of partnership income or loss individually.¹ The partners may set their shares together, or they may be calculated in accord with the partners' interest in the partnership.² The flexible passing of tax consequences has made the partnership a commonly used device to generate and market tax shelters. By virtue of the deferral period which results, the taxpayer in effect receives a forced "loan" from the government for the amount of the tax liability. In addition, a conversion to capital gains may also result in a reduction of the liability.³ Flexible allocations are limited primarily by the requirement that distributions not in accord with partnership interests must have substantial economic effect.⁴

Certain sections of the Internal Revenue Code, such as the intangible drilling costs (IDC) deduction,⁵ are set up by Congress in order to provide loans in the form of reduced tax liabilities to individuals who make certain preferred expenditures. These deductions are also generally available to partnerships.⁶ However, the partnership allocation standards employed to discourage the waste of tax shelters may simultaneously prevent deductions from reaching taxpayers whom Congress intended to encourage.

Allison v. United States⁷ is just such a case. In Allison, the court of appeals reversed the decision of the trial court upholding the deduction of intangible drilling costs passed through the partnership to those who put up the funds. This note will review the two decisions, particularly focusing on how and why the court of appeals ruled as it did.

I. Background

A. Facts of Allison

The case developed from the involvement of taxpayer-plaintiff

---

¹ I.R.C. §§ 701, 702 (CCH 1983).
² I.R.C. § 704 (CCH 1983).
³ See I.R.C. § 1202 (CCH 1983).
⁵ I.R.C. § 263(c) (CCH 1983).
⁶ I.R.C. § 703 (CCH 1983).
James E. Allison through a pyramid of partnerships in an oil and gas drilling venture off the coast of Indonesia. Initially, in September, 1968, the Independent Indonesian American Petroleum Company (IIAPCO) contracted with Pertamina, the state-run oil and gas company of Indonesia, for IIAPCO to drill for oil in an unexplored area off the coast of Sumatra.

In early 1969, Herbert Dillon, Jr., became aware that IIAPCO desired to find individuals to supply eight to ten million dollars for an exploratory drilling program. Negotiations resulted in a letter agreement to form a partnership to conduct the exploration and production of oil in the contract area. Reading and Bates Company was to drill 40,000 feet of hole in the contract area for a 17% interest. The tax deductions for intangible drilling costs (IDC) were to go to the individuals who supplied the cash for the drilling, and Dillon was to provide such individuals.

Dillon formed Indonesian Marine Resources (Indomar), a Texas limited partnership, in order to raise the required funds. Among those investing in this partnership was the R. Ashland Shepherd partnership (Shepherd) which had been formed by Dillon’s attorney (of the same name) in order to invest. Allison, also an attorney...
ney, invested $10,459 in the Shepherd partnership, thus becoming involved in the Indonesian oil drilling.\textsuperscript{15}

In the meantime, Indomar finalized the Southeast Exploration (Souex) partnership agreement with IIAPCO, Carver-Dodge and Warrior. Indomar agreed to contribute $8.75 million, which was earmarked for the costs of the exploratory drilling, and thus receive the IDC resulting from its contribution. Reading and Bates decided to stay outside of Souex, receive the $8.75 million for the drilling work and retain a 4% interest in the Indonesian contract. Souex owned the remaining 96% interest.\textsuperscript{16}

The agreement further provided that if oil or gas of commercial value was discovered by any of the exploratory drilling, or if additional wells were drilled, each partner could decide to invest additional cash in proportion to its partnership interest. If any partner did not contribute, it would lose its interest in the particular well and the surrounding block.\textsuperscript{17} Finally, upon liquidation, each partner would acquire an undivided interest equal to its partnership interest in any partnership asset to which it had not lost its rights by refusing to further invest.\textsuperscript{18}

During 1970, Reading and Bates drilled eight wells under the contract.\textsuperscript{19} No oil or gas was found in the wells. IIAPCO proposed

\textsuperscript{15} Allison, 83-1 U.S. Tax Cas. at 86,564. Allison's investment occurred in 1970, the tax year at issue. Id.

\textsuperscript{16} Id. at 86,565. The decision of Reading and Bates to remain outside the partnership is not explained. The interest of the partners in Souex were set as follows:

<table>
<thead>
<tr>
<th>Partner</th>
<th>Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>IIAPCO</td>
<td>59.0000 percent</td>
</tr>
<tr>
<td>Carver-Dodge</td>
<td>19.6131 percent</td>
</tr>
<tr>
<td>Warrior</td>
<td>7.8452 percent</td>
</tr>
<tr>
<td>Indomar</td>
<td>13.5417 percent</td>
</tr>
</tbody>
</table>

\textit{Id.} Indomar's interest in the partnership secured it a 13% interest in the underlying contract. Souex held 96% of that contract and Indomar therefore acquired 13%. To calculate the percentage, Indomar would require Souex to secure 13 of Souex's 96 points. The formula is as follows:

\[
\frac{13}{96} = \frac{X}{100 (\text{Souex})}
\]

\[X = 1300 \times \frac{1}{96} \quad \text{or} \quad 13.54166\]

The importance of the partnership interests set out is that each partner would share in any taxable income or loss in the same percentage as their interest, except for the IDC and any income or loss attributable to wells in which a partner had not chosen to participate. \textit{Id.} at 86,565-66.

\textsuperscript{17} \textit{Id.}

\textsuperscript{18} \textit{Id.} at 86,566.

\textsuperscript{19} \textit{Id.} Only $8.57 million of the $8.75 million was paid in 1970 and is the subject of this litigation. \textit{Id.} After 1971, Souex liquidated by agreement and the partners continued as joint owners. Allison, 82-1 U.S. Tax Cas. at 83,219.
the drilling of five additional wells. While Indomar was considering continued involvement in Souex, one of the wells hit oil in commercial quantities. Naturally, Indomar chose to remain involved and increased its investment.\(^2\)

Also in 1970, Souex allocated all of its IDC to Indomar. Indomar passed this allocation on to its partners, including Shepherd, which further allocated $10,180.27 to Allison.\(^2\)\(^1\) Thus, Allison claimed a deduction on his 1970 tax return of slightly less than his cash investment for that year.

IIAPCO’s management philosophy encouraged it to minimize financial exposure by seeking outside capital. When Dillon committed himself to find investors, he helped IIAPCO limit the risk it faced in the Indonesian deal. While IIAPCO believed favorable geologic structures and basins might exist in the contract area based on seismic work, the area was totally unexplored. This drilling in the contract area involved all the risks inherent in a “wildcat” area.\(^2\)\(^2\)

The trial court observed that such investment was common in the 1960’s, where risk capital investors received deductions in exchange for accepting the risk.

Mr. Dillon made it clear . . . that in order to be able to raise money from investors, he must be able to offer what was normally offered to investors, i.e., a special allocation of tax deductions for IDC. . . . [T]he risk of total loss of their investment would have to be assumed by investors who provided the money for the drilling of exploratory wells. . . . \(^2\)\(^3\)

Thus, the persons who invested in Indomar were told they would receive the deductions which resulted from the drilling they

\(^{20}\) Allison, 83-1 U.S. Tax Cas. at 86,566. The eight original wells were all abandoned. In fact, Indomar had decided not to continue with Souex, but Dillon had not yet told Souex when the ninth well hit. Allison, 82-1 U.S. Tax Cas. at 83,218-19.

\(^{21}\) Allison, 82-1 U.S. Tax Cas. at 83,218-19. Souex allocated Indomar approximately $9 million in losses, including the $8.57 million in IDC resulting from the initial investment. Indomar allocated approximately $253,000 of the $9 million to Shepherd. The IRS disallowed the IDC-based deduction, claiming the Souex allocation to Indomar improperly exceeded Indomar’s 13.5417\% interest in Souex and was therefore invalid. Id. at 83,219. According to the IRS, the amount of additional tax owed by Allison for 1970 was $7,843 plus interest. Id. at 83,215.

\(^{22}\) Id. at 83,215. The trial court also found that any wells drilled in the area would be wildcat wells, and the prospects of success would be no greater than one in fifteen, or one in twenty. Id. at 83,218. No offshore oil or gas production was occurring in the vicinity of the area, and the closest onshore production had occurred 150 miles distant. Id. at 83,215.

\(^{23}\) Id. at 83,216 (emphasis added).
financed in proportion to their investment. The trial court concluded “that in the absence of such assurances, none of the persons who invested in Indomar would have been willing to provide money for a wildcat drilling program in the Southeast Sumatra Contract area.” All the Souex partners understood that such an allocation would be required, and no reason other than acquiring risk capital was discussed by them in deciding to set aside the IDC deductions for Indomar.

Forming the Souex partnership completed the distribution of interests in the Indonesian contract. Neither the “contract” partners’ nor the “cash” partners’ interests alone would have sufficed. For the long, complicated process of acquiring the “cash” partners to succeed, it was necessary to distribute the IDC to them. IDC was not necessary to encourage the investments of the “contract” partners, who never expected it or bargained to retain it.

B. Section 263(c): Intangible Drilling Costs

The intangible drilling costs deduction which Allison shared, and for which Dillon bargained, is allowed under Internal Revenue Code section 263(c). Basically, the section allows an operator, at his option, to elect to charge intangible drilling and development costs incurred in the development of oil and gas properties to ei-

24. *Id.* at 83,217. While reversing the trial court, the court of appeals stated: “We do not doubt . . . that a special allocation of IDC was in this instance the *sine qua non* for the Indomar partners’ investment in Souex.” *Allison*, 83-1 U.S. Tax Cas. at 86,568.


26. I.R.C. § 263 (CCH 1983) reads as follows:

§ 263. CAPITAL EXPENDITURES

(a) General rule—No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. . . .

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

(c) Intangible drilling and development costs in the case of oil and gas wells and geothermal wells.

Notwithstanding subsection (a), regulations shall be prescribed by the Secretary under this subtitle corresponding to the regulations which granted the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells and which were recognized and approved by the Congress in House Concurrent Resolution 50, Seventy-ninth Congress. . . .

27. “Operator” is defined as “one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights.” Treas. Reg. § 1.612-4(a) (1965).
ther capital or expense. If charged to capital, the expenditures are either recovered by depletion or depreciation, or are claimed as an ordinary loss if incurred in drilling a nonproductive well. Otherwise, the expenditures are deductible as a current expense. If it were not for the special operation of section 263(c), the expenditures would be charges to capital under section 263(a).

Intangible drilling and development costs consist of "all wages, fuel, repairs, hauling, supplies, etc. . . . necessary for the drilling of wells and the preparation of wells for the production of oil or gas." As such, IDC represents an opportunity for a quicker recovery of invested capital through a tax deduction than would be otherwise available under normal circumstances.

The section was originally added to the Code in 1954 by the Senate without any comment as to its purpose. The purpose was discussed, however, while considering, in 1976, a series of limitations on such deductions. A House report stated: "Allowing a current deduction for intangible drilling costs is usually justified on the grounds that it provides an incentive for the discovery of new reserves of oil and gas. For this purpose the deduction for intangibles can be an efficient incentive . . . since it directly encourages new drilling." The related Senate report noted that adverse

28. Id. Treas. Reg. § 1.263(c)-1 (1960) directs the reader to Treas. Reg. § 1.612-4 and contains no other text.
30. See supra note 26. See also F.H.E. Oil Co. v. Commissioner, 147 F.2d 1002 (5th Cir.), reh'g denied, 149 F.2d 238, reh'g denied en banc, 150 F.2d 857 (1945).
31. Treas. Reg. § 1.612-4(a) (1965). The option does not apply to items which have salvage value themselves under the regulations. Id.; see also Harper Oil Co. v. United States, 425 F.2d 1335, 1342-43 (10th Cir. 1970) (court held that in some cases an item may have no salvage value and still fail to qualify for the deduction, particularly tangible goods).
33. The limitations were attempts to restrict deductions to the amount "at risk." For a description of the rules, see A. Willis, J. Pennell & P. Postlewaite, Partnership Taxation §§ 53-58, 60-66 (3d ed. 1983) [hereinafter A. Willis].
34. H.R. Rep. No. 658, 94th Cong., 2d Sess. 54, reprinted in 1976 U.S. Code Cong. & Ad. News 2897, 2948-49 (emphasis added) [hereinafter H.R. Rep. No. 658]. The report continued by noting that such deductions, however, had been marketed by some as a means of reducing taxes on unrelated income. This marketing "solely" for tax advantages was said to distort the marketplace and tempt taxpayers to make unprofitable investments. Id. Allison could not be characterized as this sort of deal.

---

28. Id. Treas. Reg. § 1.263(c)-1 (1960) directs the reader to Treas. Reg. § 1.612-4 and contains no other text.
30. See supra note 26. See also F.H.E. Oil Co. v. Commissioner, 147 F.2d 1002 (5th Cir.), reh'g denied, 149 F.2d 238, reh'g denied en banc, 150 F.2d 857 (1945).
31. Treas. Reg. § 1.612-4(a) (1965). The option does not apply to items which have salvage value themselves under the regulations. Id.; see also Harper Oil Co. v. United States, 425 F.2d 1335, 1342-43 (10th Cir. 1970) (court held that in some cases an item may have no salvage value and still fail to qualify for the deduction, particularly tangible goods).
33. The limitations were attempts to restrict deductions to the amount "at risk." For a description of the rules, see A. Willis, J. Pennell & P. Postlewaite, Partnership Taxation §§ 53-58, 60-66 (3d ed. 1983) [hereinafter A. Willis].
34. H.R. Rep. No. 658, 94th Cong., 2d Sess. 54, reprinted in 1976 U.S. Code Cong. & Ad. News 2897, 2948-49 (emphasis added) [hereinafter H.R. Rep. No. 658]. The report continued by noting that such deductions, however, had been marketed by some as a means of reducing taxes on unrelated income. This marketing "solely" for tax advantages was said to distort the marketplace and tempt taxpayers to make unprofitable investments. Id. Allison could not be characterized as this sort of deal.
economic impact that might result from a limitation on section 263(c) "since we are falling far short of reaching . . . our goal of energy independence." Congress therefore has assigned section 263(c) an important place in the government's efforts to encourage production of energy resources.

The deductibility of Souex's expenses as IDC was not the issue which faced the court in Allison. Yet, the declared purpose and intent of Congress to encourage investment in oil and gas exploration has been affected by the Allison court's conclusion under the partnership tax rules. Despite the understanding of those in Souex that the IDC would be required by investors putting up the cash, in other words, that the IDC would be used exactly as Congress planned, their allocation of the deductions failed to meet the test applied by the court of appeals.

II. Section 704(b)(2): Principal Purpose v. Substantial Economic Effect

A. The Courts' Opinions in Allison

Internal Revenue Code section 704 is the relevant provision addressed in Allison. Subsection (b)(2) at the time provided that if
"the principle purpose of any provision in the partnership agreement with respect to the partner’s distributive share of such item is the avoidance or evasion of any tax," then the partner’s distributive share would be determined by his "share of taxable income or loss of the partnership." Such an allocation by a partnership not in accord with the partner's general interest in the partnership is known as a special allocation. The question faced in Allison concerned the principal purpose of the allocation of 100% of the IDC deduction to Indomar by Souex, while Indomar's general interest in the Souex partnership was only 13.5417%.

The trial court began with the proposition that "the special allocation provision in the Souex partnership agreement was effective . . . unless ‘the principal purpose’ of the provision was tax avoidance." For the purpose of tax avoidance to be "principal," it must be the "most important." Such a standard had been adopted regarding similar Code sections by previous courts.

Clearly, tax avoidance was a purpose of the IDC allocation in Allison. "However, tax avoidance is not reprehensible, or even unpatriotic." In fact, in the case of IDC deductions, tax avoidance is a vehicle of national policy in energy production. The court then considered all the circumstances relating to the allocation provision in the partnership agreement to determine the principal purpose behind it.

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

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


39. I.R.C. § 704(b) (1954) (emphasis added). In a case where the allocation set by the agreement of taxable income and that set for taxable loss were different, this reallocation clause could have unclear results. However, in Allison, the allocation share of Indomar for everything other than IDC was set at 13.5417%. See supra note 16.


41. Allison, 82-1 U.S. Tax Cas. at 83,219. The court noted that there was no suggestion in the evidence of any purpose of tax evasion. Id.

42. Id. at 83,220 (citing Webster's New Collegiate Dictionary, (1977)).

43. Id. Hawaiian Trust Co. v. United States, 291 F.2d 761, 765 (9th Cir. 1961), declared the purpose "must exceed in importance any other purpose." Id. VGS Corp. v. Commissioner, 68 T.C. 563 (1977), restated the principle to require that the purpose "must outrank, or exceed in importance, any other single purpose." 68 T.C. at 595 (citations omitted).

44. Allison, 82-1 U.S. Tax Cas. at 83,220 (citing Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934)).

The court made a finding of fact that the entire $8.75 million Indomar invested in Souex was at risk. It implied that Indomar would either end up with nothing to show for its money or, if the drilling should be successful, enormous rewards "commensurate with the risk."\textsuperscript{46} Should the drilling be unsuccessful, as it was, Indomar’s "only hope" of recovering its investment, would be further investment in future drilling.\textsuperscript{47} Clearly, Indomar could find itself throwing good money after bad in such a risky venture.

For these reasons, the trial court held that it was not the principal purpose of the special allocation to avoid taxation. "[T]he principal motivation behind the inclusion of the provision was the \textit{business objective} of inducing people of means to provide the money needed. . . . None of the companies having legal interests . . . at the time . . . had sufficient funds to finance an exploratory drilling program."\textsuperscript{48} The money could not be raised unless the IDC was offered to reduce the risk of the investment,\textsuperscript{49} since such an offer was customary in the oil and gas business. Because the principal purpose of the allocation was its business purpose, the allocation was valid.\textsuperscript{50}

Secondly, the trial court held that an allocation can be properly given to a partner who bears the economic burden of the expenditure of the deduction allocated.\textsuperscript{51} In this case that burden rested on Indomar since it put up the entire cost creating the IDC deduction. According to the court, the fact that Indomar received its

\begin{itemize}
\item \textsuperscript{46} Allison, 82-1 U.S. Tax Cas. at 83,218.
\item \textsuperscript{47} Id. The court of appeals did not accept the argument that Indomar retained no interest of any value in Souex unless it made further contributions. The court noted that Indomar would retain its 13.5417\% interest in the contract itself on liquidation, or 13\% of the contract. This retained right was not valueless even after the $8.75 million was exhausted. Allison, 83-1 U.S. Tax Cas. at 86,570-71. For calculation of Indomar’s interest in the contract itself, see \textit{supra} note 16.
\item \textsuperscript{48} Allison, 82-1 U.S. Tax Cas. at 83,220 (emphasis added).
\item \textsuperscript{49} Id. The risk of the investment would be reduced by the IDC allocation, since the partners receiving it could apply the deduction to reduce their taxes owed on other income in the same year. Thus, for taxpayers in the highest bracket for 1970, the real dollar value of the deduction is only equal to the highest bracket amount. I.R.C. § 1 (CCH 1969). Since this reduction in taxes was guaranteed to the Indomar investors, the real value of the cash they stood to lose if the investment was a total failure was not their investment amount, but their investment amount reduced by 70\% of their IDC deduction. In Allison’s case, this would be nearly 70\% of his entire investment. See \textit{supra} notes 15 & 21 and accompanying text.
\item \textsuperscript{50} Allison, 82-1 U.S. Tax Cas. at 83,220.
\item \textsuperscript{51} Id. The trial court relied on Lewis v. Commissioner, 65 T.C. 625, 632-33 (1975) and Boynton v. Commissioner, 649 F.2d 1168, 1172 (5th Cir. 1981), \textit{cert. denied}, 454 U.S. 1140 (1982) for its economic burden test. \textit{Id}.
\end{itemize}
partnership interest in Souex in exchange for the funds shifted none of the burden to the other Souex partners since Indomar received no right to any future income without some further investment. If the $8.75 million were lost, the loss would be borne by Indomar alone. Thus, the court held the provision valid because it allocated the deduction to the partner who bore the burden underlying it.\textsuperscript{52}

The court of appeals reversed the trial court,\textsuperscript{53} finding that the trial judge emphasized the wrong standard to validate the special allocation and that the allocation was proscribed under the correct standard. The court ruled that the "'principal purpose' of 'tax avoidance'" provision primarily raised a question of whether the special allocation of the partnership agreement had "substantial economic effect."\textsuperscript{54} While the trial judge had discussed the economic effect of the allocation in discussing the economic burden underlying the allocation, the court of appeals believed the trial judge "did not afford that factor its significant role."\textsuperscript{55}

The Tax Reform Act of 1976 changed the language of the test listed in section 704(b)(2) from the "principal purpose" standard, used by the trial court and applicable to Allison, to require that special allocations have substantial economic effect. The court of appeals relied on the substantial economic effect test since it concluded, from the case law and articles on the subject, that the substantial economic effect test had been adopted by the courts to evaluate "principal purpose" even before 1976.\textsuperscript{56} The court prevented the allocation without questioning either the riskiness of the deal or its necessity for bringing in the cash partner, Indomar.\textsuperscript{57}

\textsuperscript{52} Allison, 82-1 U.S. Tax Cas. at 83,220-21.
\textsuperscript{53} Allison, 83-1 U.S. Tax Cas. at 86,564.
\textsuperscript{54} Id. at 86,567.
\textsuperscript{55} Id. at 86,568.
\textsuperscript{57} Allison, 83-1 U.S. Tax Cas. at 86,568.
B. The Ascendency of Substantial Economic Effect

Initially, substantial economic effect stood in opposition to a purpose of tax avoidance and, as used in the Senate report accompanying the Internal Revenue Code of 1954, it explained the “principal purpose of tax avoidance” test. From that time, it has developed to dominate section 704(b) decisions, so that the court of appeal’s declaration that the 1976 “change in language had minor substantive effect, at best,” may not be far from the truth.

While the 1954 House report did not mention substantial economic effect or any other standard for section 704(b), the Senate report did include one sentence: “Where, however, a provision in a partnership agreement for a special allocation of certain items has substantial economic effect and is not merely a device for reducing the taxes of certain partners without actually affecting their shares of partnership income, then such a provision will be recognized for tax purposes.” Two notions may strike the reader of this brief passage. First, substantial economic effect as herein used only validates a special allocation because it contradicts a conclusion that the allocation is “merely” for tax avoidance purposes. This is important because no reading of the sentence hints that lack of substantial economic effect might be used to invalidate an allocation. Secondly, the threshold for validating an allocation seems fairly low. The sentence implies an allocation will be good unless it is merely a device for avoiding taxes. Thus, methods not mentioned might validate an allocation by demonstrating more than mere tax avoidance. Such a method could be a showing of business purpose.

The second source for the application of substantial economic effect to the principal purpose test is the treasury regulation for section 704, which reads:

Partner's Distributive Share.

(b) Distributive share determined by income or loss ratio.

(2) . . . . In determining whether the principal purpose of

58. Weidner, supra note 56, at 469.
any provision in the partnership agreement for a special allocation is the avoidance or evasion of Federal income tax, the provision must be considered in relation to all the surrounding facts and circumstances. Among the relevant circumstances are the following: Whether the partnership or a partner individually has a business purpose for the allocation; whether the allocation has "substantial economic effect," that is, whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences; whether related items ... from the same source are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocation.48

Clearly, substantial economic effect is listed here as only one of several factors, including business purpose and the range of normal business factors. If all these factors were considered in relation to the surrounding facts and circumstances, the allocation in Allison would appear valid.44 However, case decisions relying on the Senate report and treasury regulations found substantial economic effect to be the dominant of the relevant circumstances.

The first and still most important case considering this question is Orrisch v. Commissioner.45 After citing the Senate report and Treasury Regulation section 1.704-1, the court noted that the Senate language "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. ... [T]he statement is an affirmation that special allocations are ordinarily to be recognized if they have business validity apart from their tax consequences.46

In striking the allocation before it, the court concluded that the allocation "was adopted for a tax-avoidance rather than a business

---

44. The trial judge found that Souex had a valid business purpose and that the allocation accorded with normal business factors in acquiring cash partners in oil and gas deals. See supra text accompanying notes 21-23 & 48-50.
46. Id. at 400-01 (emphasis added) (citation omitted).
purpose.\(^{67}\) Unfortunately, the language of the court set business purpose and tax avoidance as incompatible, rather than coexistent purposes, the principal one of which required discovery by the court. The \textit{Orrisch} decision went on to conclude that the agreement before it did not reflect normal business considerations.\(^{68}\) Before reaching that point in the decision, the court in \textit{Orrisch} had considered two of the six relevant circumstances of the regulations, and found the deal lacking.\(^{69}\)

The \textit{Orrisch} court then moved on to an argument by the taxpayers that because their allocation was reflected in the capital accounts\(^{70}\) of the partners, the allocation had substantial economic effect. Under the regulations this required \textit{some} impact of the allocation upon future dollar shares of the partners. The court, in an analysis of the partnership's capital accounts, found such future impact absent.\(^{71}\) Having tested three separate circumstances recommended by the regulations, the court concluded the principal purpose of the allocation to be tax avoidance.\(^{72}\) The longest discussion, however, was of the final factor considered, that of the economic effect of the allocation as measured by the capital accounts.

In 1974, \textit{Harris v. Commissioner}\(^{73}\) picked up where \textit{Orrisch} left off. Faced again with a challenge to a partnership allocation, the

\begin{itemize}
  \item \textit{Id.} at 401.
  \item \textit{Id.}
  \item These same two factors \textit{were} present in \textit{Allison} according to the trial court's findings. \textit{See supra} note 64.
  \item The capital accounts of a partnership are a record of the total capital burdens and receipts of each partner regarding the partnership. If an account is positive the partner has contributed more to the partnership than he has received from it. If negative, the opposite conclusion is drawn. Because the accounts reflect all movement of capital in the partnership, at the end of the partnership the sum total of all accounts must equal zero (at least in simple arrangements). If each individual partner's account equals zero then no partner has recovered another's investment. The account is generally increased by the amount of cash and adjusted basis of property contributed and the taxable partnership income claimed by the partner. It is debited by the amounts of cash, the adjusted basis of property distributed, and any share of partnership loss claimed by the partner. \textit{See 48 Fed. Reg.} at 9873. (to be codified at 26 C.F.R. pt. 1) (proposed March 4, 1983).
  \item The capital accounts test holds that if:
    \begin{enumerate}
      \item the special allocation is reflected on the capital accounts; and
      \item the capital accounts will control distributions upon liquidation; and
      \item any negative accounts will be regarded as a debt to the partnership,
    \end{enumerate}
    then the partner bears the burden of the special allocation. If gain is not produced to cover a loss taken, for instance, then the partner will give up recovery of capital contributed to the partnership, otherwise receivable, or will replace the loss to the partnership by an additional contribution. \textit{See A. Willis, supra} note 33, at § 86.03; \textit{48 Fed. Reg.} at 9873.
  \item \textit{Orrisch}, 55 T.C. at 402-04.
  \item \textit{Id.} at 404.
  \item 61 T.C. 770 (1974).
\end{itemize}
court looked to the regulations to determine that the disposition was part of a valid business plan. The court found that Congress plainly intended this structuring of tax burdens and stated that, in addition, the allocation had an "obvious economic effect." The court treated economic effect as being of critical significance, since the allocation was reflected on the partnership's capital accounts and would reduce the amount received on liquidation by the taxpayer accordingly. This "sharply" distinguished the case from Orrisch.

The process converting substantial economic effect from a "circumstance" to a replacement "test" for determining the principle purpose of an allocation in pre-1976 cases appears to have been completed by Magaziner v. Commissioner in 1978. Magaziner cited Orrisch for the proposition that "a special allocation will be given effect only if it has business validity apart from its tax consequences," and then cited Harris for the "critical significance" of substantial economic effect. The court then promptly collapsed business validity under substantial economic effect by only considering whether "the allocation [might] actually affect the dollar amount of the partner's shares of total partnership income or loss independently of tax consequences." The conclusion drawn is, of course, only the regulations' definition of substantial economic effect, one of several circumstances mentioned. Magaziner, through utilizing Orrisch and Harris, took the separate circumstances of business purpose, substantial economic effect and normal business factors, as set out by the regulations, and combined them under substantial economic effect. This may have been what was meant by the court in Hamilton v. United States when it held that substantial economic effect is the key factor to be considered in any analysis of the viability of a special allocation. An allocation that lacks "substantial economic effect" will not be saved by meeting the other five factors in the regulation, and it is unlikely that an allocation that has "substantial economic effect" would not also meet the other factors.

74. Id. at 785-86.
75. Id. at 786.
76. 37 T.C.M. (CCH) 873 (1978).
77. Id. at 875 (citations omitted).
78. Id. (citation omitted).
79. 687 F.2d 408 (Ct. Cl. 1982).
80. Id. at 414. Hamilton did not cite Orrisch, Harris or Magaziner when it announced this conclusion. Id.
Neither the *Hamilton* court nor the *Allison* court explained why substantial economic effect necessarily includes or precludes the other five factors listed in the regulations. Nor did they explain how what had been three factors in *Orrisch* became one.

Yet, other authors looking at the question of "principal purpose" have come to the same basic conclusion that substantial economic effect has predominated. One leading partnership taxation manual wrote, while considering the effects of the 1976 section 704(b) language change, that "[b]ecause the Regulations and the courts had established the preeminence of the substantial economic effect test under prior law . . . [the revision] was probably less substantive than it might otherwise seem." 81 In addition, it adds that the other factors listed in the regulations "were given only nominal effect." 82 Other commentators have identified substantial economic effect as clearly "[t]he most important factor," 83 or discerned an emerging consensus that it is a fundamental test. 84

Congress may have encouraged this view when it replaced principal purpose with substantial economic effect in 1976. The Senate report reflected a desire to limit special allocations to those with substantial economic effect, "as presently interpreted by the regulations and case law." 85 The House version had a differing legislative purpose 86 but declared the regulations "focused" on substantial economic effect, while they only "inquired" as to business purpose and other factors. 87 The Senate displayed an additional desire that the other factors be regarded as important in the deter-

---

81. W. McKee, *supra* note 56, at ¶ 10-16. The substantial economic effect test is also referred to as the "litmus" test for determining principal purpose. *Id.* at ¶ 10-11. A similar conclusion was expressed in A. Willis, *supra* note 33, at § 82-4: "Although this . . . change appears to be a substantial one in concept, from a practical standpoint it should result in very little difference." *Id.*


83. Kopple, *supra* note 56, at 638. He also notes that the other factors have received only limited discussion and like *Hamilton* suggests that a finding of substantial economic effect may preclude inquiry into other factors, but he does not suggest that failure to find substantial economic effect should end inquiry without consideration of other factors. *Id.* at 638-39. See also Solomon, *Current Planning for Partnership Startup, Including Special Allocations and Guaranteed Payments*, 37 INST. ON FED. TAX’N § 13.03[2], at 13-8 (1979) [hereinafter Solomon], where he contends that while substantial economic effect became the most important test, it was not the only factor, and so an allocation that had substantial economic effect might be disallowed, while an allocation without it might still be good because of sound business reasons for the allocation.

84. Weidner, *supra* note 56, at 469.


86. See *supra* note 33 and accompanying text.

mination of allocation validity, but did not explain how this would occur, since substantial economic effect was established as the test. One might presume that this also indicated a belief that substantial economic effect always subsumed the other factors and did not merely override them, but some commentators have had difficulty explaining this. Another prominent commentator arrives at this conclusion, stating: "A close analysis of these criteria will show that they can be applied in the determination of whether a special allocation has substantial economic effect," but he does not do any analysis to apply them.

Whatever their strength, these sources support the Allison court's conclusion that the 1976 Act effected little change, even if that conclusion overstates the clarity of prior case law. The Senate report did have an important comment about congressional intent for the rule they were creating: "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." If Congress also intended to encourage partnerships, among others, to invest in oil and gas, then should not the allocation of IDC to the partners who require it for encouragement be regarded fundamentally as a valid business purpose whatever standard of evaluation is used? Remember, in Orrisch, a finding that business purpose was lacking invalidated that deal. By adopting the Hamilton standard, Allison completely ignores business purpose in finding substantial economic effect. Under the court's analysis such effect either exists or it does not; valid business purposes may coexist, but they do not create substantial economic effect. They therefore are clearly outside even

89. McKee uses the Senate language to conclude that the 1976 change had little effect, W. McKee, supra note 56, at 10-11, but could not explain the use of the other factors since they were largely ignored prior to 1976, except to say they might in extreme cases invalidate an allocation with economic effect, but never validate an allocation without it. Id. at 10-25. But see Solomon, supra note 83, at 13-10. He sees no role for the other factors since if Congress changed the law it should have intended that substantial economic effect be the sole requirement, even if this allows allocations whose sole purpose is tax avoidance.
90. A. Willis, supra note 33, at § 82-5.
92. In fact, the court of appeals went so far as to distinguish the valid business purpose standard used in the trial court and mentioned by Congress from the business validity language of Orrisch in order to explain why the trial court standard was incorrect. Allison, 83-1 U.S. Tax Cas. at 86,568 n.5. The text of the note is as follows:
the uncertain intent of Congress.

III. SUBSTANTIAL ECONOMIC EFFECT IN Allison

A. Allison and Capital Accounts Analysis

Having determined that principal purpose should be tested in terms of substantial economic effect, the court of appeals, consulting the regulations, turned to test the economic effect of the Allison allocation. Finding no cases dealing with a full allocation of IDC to a cash partner, the court turned to the cases under section 704(b)(2) dealing with allocations of other items.

The cases upon which the court based its decision were, Orrisch, Magaziner, Harris and Hamilton. Relying on these cases, the court concluded that the Souex allocations of IDC entirely to Indomar lacked any economic effect aside from the tax consequences. It adopted an analysis of the partnership capital accounts, referred to as capital accounts analysis, from the cited cases to reach its conclusion.

In Orrisch, the taxpayers and another couple acting as the second "partner" entered into an oral partnership agreement to purchase and operate two buildings. They agreed to share all expenses, profits, and losses equally, despite disparate initial capital contributions. They operated the partnership and generated net losses for three years. At the beginning of the fourth year, the partners orally agreed that the taxpayers would receive all the depreciation deductions for that and subsequent years, while all else

Whether an allocation has "business validity" is not necessarily the same as whether it was adopted for a "valid business purpose." In assessing the former we must determine the economic effect of the allocation. Dissecting a "valid business purpose," on the other hand, may not call for an analysis of economic effect, although it is not clear that a special allocation—or, for that matter, the business enterprise as a whole—can be considered to have a valid business purpose if the allocation does not also have a substantial economic effect.

While footnote five may have a fair point about the difference between valid business purpose and business validity, when defined in terms of economic effect, it would seem the fault lies not with the valid purpose factor which has been part of the law from the beginning, but with the unexplained, and therefore unwarranted, holdings that substantial economic effect (business validity) is the only relevant factor in Hamilton and Allison.

93. Allison, 83-1 U.S. Tax Cas. at 86,568 (quoting Treas. Reg. § 1.704-1 (1964)).
94. Id. at 86,568.
95. Id. at 86,568-69.
96. Id. at 86,569.
97. Id. at 86,568-69.
98. Orrisch, 55 T.C. at 396.
would continue to be shared evenly. They further agreed that should the partnership property be sold at a gain, the specially allocated depreciation would be "charged back" to the taxpayer's capital account and they would pay the tax burden caused by the depreciation deductions. They proceeded under this agreement for two years, driving the taxpayer's capital account negative while his partner's account remained positive. 99

Looking to the gain charge back provision 100 for gain realized on the sale of the property, the court noted that if the gain realized exceeded the disparity in the capital accounts of the partners, then the remaining gain would be divided equally, along with the proceeds of the sale.

In such circumstances, the only effect of the allocation would be a trade of tax consequences, i.e., the [other partner] would relinquish a current depreciation deduction in exchange for exoneration of all or part of the capital gains tax when the property is sold, and [the taxpayers] would enjoy a larger current depreciation deduction but would assume a larger ultimate capital gains tax liability. Quite clearly, if the property is sold at a gain, the special allocation will affect only the tax liabilities of the partners and will have no other economic effect. 101

To find economic effect, the Orrisch court concluded it must "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," 102 that is, if the gain realized was insufficient to restore to the capital account all the effects of the depreciation. The crucial passage of the court's analysis followed:

Under normal accounting procedures, if the building were sold at a gain less than the amount of such disparity [the taxpayers] 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

99. Id. at 397-98.
100. Id. at 401. The court in Orrisch considered several factors recommended by the regulations before it reached substantial economic effect at the urging of the taxpayers. Id. at 401. The taxpayers argued that their allocation had substantial economic effect solely because it was reflected in the capital accounts. Only in this context did the court analyze the capital accounts to meet the argument, and capital accounts analysis was born. Id. at 402-04.
101. Id. at 403.
102. Id. (emphasis added).
receive a proportionately smaller share of the partnership assets on liquidation.\textsuperscript{103}

Since the partners did not intend that a negative capital account should be a debt to the partnership nor that capital accounts would control the proceeds on liquidation, reflecting the allocation in the capital accounts would not affect the partners' share in total income or loss independent of tax consequences.\textsuperscript{104}

Several points may be made from this discussion. First, reflecting an allocation on the capital accounts of the partnership will only have substantial economic effect if the capital accounts will control liquidation proceeds. Second, if the allocation is such that it may result in a negative capital account, the partner must be required to restore the deficit to achieve substantial economic effect.\textsuperscript{105} Third, capital accounts analysis was not proffered as the only method of finding substantial economic effect. Fourth, a gain charge back provision, in and of itself, cannot create substantial economic effect, and is at best neutral. Finally, the purpose of the exercise is to determine who bears the burden behind the allocation, but the burden need only be potential, and may never come to pass.

\textit{Harris} upheld an allocation because it found both a valid business plan and obvious economic effect.\textsuperscript{106} The entire basis for finding economic effect was the reflection of the allocation on the capital accounts and control of liquidation proceeds by the adjusted

\textsuperscript{103} Id. at 403-04 (emphasis added).

\textsuperscript{104} Id. at 404.

\textsuperscript{105} This results since capital accounts reflect the total contributions and receipts of a partner from a partnership and, as such, ultimately the total of all capital accounts will be zero. If one account is negative, then some other account must be positive, and so some other partner has made the contribution bearing the burden of the deduction creating the negative account. For a more detailed description of the impact of negative capital accounts, see A. Willis, \textit{supra} note 33, at § 86.05; W. McKee, \textit{supra} note 56, at ¶ 10.02[2][b].

Where a negative capital account can result, the implication is that one partner has received greater compensation from the partnership than his investments are responsible for creating. Since the partner was not required to restore the account deficit to the partnership, and his partner's account would therefore remain positive, his partner's investment, and not his own, would be that unrecovered if the sale of the asset resulted in a real economic loss to the partnership. Thus his partner might bear the burden of the depreciation deduction. If depreciation of a building works as an advancement of recovery of capital, the disparity in capital accounts would mean that the recovery of capital had gone to a partner other than the partner responsible for the capital contribution. W. McKee, \textit{supra} note 56, at ¶ 10.02[2][b].

\textsuperscript{106} Harris, 61 T.C. at 785-86.
capital accounts. Magaziner held that the partner who benefits from the special allocation must bear its costs. This case also concerned depreciation of a building, which was disallowed by using capital accounts analysis as in Orrisch. In Hamilton, the court stated plainly that "[t]he validity of an allocation is tested by examining the effect of the allocation on the capital accounts of the partners at liquidation."

The Allison court, using a capital accounts test, took exception with the IDC allocation for two reasons. There was no gain charge back provision, which was not in itself fatal; but critically, there was no provision "entitling Indomar to a proportionately smaller share of liquidation proceeds, calculated according to the adjusted capital accounts."

In pointing to the lack of a gain charge back provision, the court cited Magaziner as holding that such provisions are customary when losses are specially allocated to capital-providing partners. What the court fails to realize is that IDC deductions do not reduce basis in a capital asset. By their nature, the IDC deductions allow expensing of an asset, expressly avoiding the process of charging the cost to capital and later depreciating it. In the case of IDC, unlike normal depreciation, there is no built-in gain realization equated with the deduction amount reflected in reduced basis. Without such gain to charge back, any attempt to allocate the first taxable income earned to Indomar would simply have delayed the time when liquidation would award more proceeds to the other partners in order to equalize the capital accounts. Thus, the Allison deal was not subject to the same cleanup opportunities as existed in the depreciation cases of Orrisch and Magaziner. Gain

107. Id. at 786.
108. Magaziner, 37 T.C.M. at 874.
109. Id. at 875-76.
110. Hamilton, 687 F.2d at 419 n.29. The Hamilton court at least claimed to be evaluating a different question, however, that of economic substance. See Comment, Partnership Allocations: Flipping Through the Substantial Economic Effect Hoops, 11 FLa. St. U.L. Rev. 407, 417-19. They also allowed an allocation despite imperfect capital account results. Hamilton, 687 F.2d at 419 n.29.
111. Allison, 83-1 U.S. Tax Cas. at 86,569.
112. Id. (citing Magaziner, 37 T.C.M. at 876).
114. For more on gain charge backs, see A. Willis, supra note 33, at § 86.04; and W. McKee, supra note 56, at ¶ 10.02 [2][a]. The economic effect of gain charge backs may still be questioned, however, and Congress may have contemplated something at least similar as allowable in 1954. See H.R. Rep. No. 1337, supra note 60, 1954 U.S. Cong. Code & Ad. News at 4092.
charge back could not have worked.

Clearly, however, the capital accounts were not intended to control liquidation proceeds, so the court of appeals is correct in that *Allison* does not meet the capital accounts standard. Indomar was entitled to receive 13.5417% of the proceeds under any circumstance relative to the allocation. Only nonparticipation in some particular well would have reduced that amount.\textsuperscript{116} Therefore, nothing about the allocation reduced the amount of Indomar's share of partnership distributions, at least not after the agreement was reached. But the court of appeals never considered an important distinction between *Orrisch* and *Allison*. The taxpayers in *Orrisch* dreamed up the special allocation three years after the agreement creating the partnership. Thus the allocation had no role in the partners' determination of their distributive shares. In *Allison*, the allocation was subject to negotiation from the beginning, and it could reasonably be expected that had the allocation not been made, the cash partner's distributive share would have required an increase commensurate with the higher risk of loss. Such an effect on the dollar amounts of the partners' distributive shares would be real enough economically, but it would never be reflected on the capital accounts. The court of appeals seems to have never considered this possibility for finding economic effect, but did leave the door open to the potential for some demonstration of economic effect other than capital accounts analysis.\textsuperscript{116}

Unfortunately, congressional approval of capital accounts analysis as the sole arbiter of substantial economic effect\textsuperscript{117} is even less obvious than such approval for substantial economic effect as the sole factor in the principal purpose test. Despite the weaknesses of the analysis,\textsuperscript{118} it appears to be entrenched. The newly proposed regulations for section 704 adopt entirely a capital accounts approach for post-1976 partnership allocations.\textsuperscript{119} However, the true standard for economic effect would seem to be determined by

\textsuperscript{115} Allison, 83-1 U.S. Tax Cas. at 86,569-70.
\textsuperscript{116} Id. at 86,570. The court simply was not persuaded that any such other method applied in Allison's case.
\textsuperscript{117} The only statement on the subject contemplates use of capital accounts, but does not require it or limit the inquiry to capital accounts analysis. See Staff of the Joint Committee on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, 95 n.6 (1976).
\textsuperscript{119} 48 Fed. Reg. at 9871.
which partner is "bearing the burden" of the allocation, and the proposed regulations at least link the concepts.\textsuperscript{121}

B. Bearing the Economic Burden of an Allocation other than through Capital Accounts

Notwithstanding the current hegemony of capital accounts analysis as the sole arbiter of substantial economic effect, the overriding principle of the test has always been measuring the economic burden lying behind any given special allocation. An idea persists that an allocation should be allowed where it reflects in its allocation of tax burden the economic reality underlying the tax item allocated in the real economic deal of the partners.\textsuperscript{122} The conclusion of the court of appeals on this point, that "even if there might be circumstances in which capital accounts analysis would fail to demonstrate an otherwise viable economic effect of an allocation, plaintiff has not persuaded us that this is such a case,"\textsuperscript{123} may offer an opportunity for future holdings that economic effect might exist without meeting the basic capital accounts requirements.

The regulations have defined substantial economic effect as a finding that the allocation "may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences."\textsuperscript{124} The effect sought consists of some future or forward looking consequence on real world economic results, which at least may occur under reasonably foreseeable conditions.

Such a method conforms with the testing principle applied in

\textsuperscript{120} See supra text accompanying note 102.
\textsuperscript{121} 48 Fed. Reg. at 9873.
\textsuperscript{122} The freedom with which partners should be able to pass on individual tax consequences of partnership activity depends on adopting either an aggregate or entity theory of the nature of a partnership. In this longstanding debate, aggregate theorists have maintained that a partnership consists of a collection of individuals working together. Entity theorists have focused instead on the partnership as a thing in itself separate from the individuals. Subchapter K adopts differing points of view with differing sections. From an aggregate point of view allowing each individual to receive tax consequences based on the individual character of his involvement makes perfect sense. Entity analysis, however, will require that each result of partnership activity should be spread throughout the partners' interests without looking behind the entity to determine who caused the occurrence. For federal taxation purposes, the entity theory of partnership predominates. See A. WILLIS, supra note 33, at §§ 2.04-07.
\textsuperscript{123} Allison, 83-1 U.S. Tax Cas. at 86,570 (footnote omitted).
\textsuperscript{124} Treas. Reg. § 1.704-1(b)(2). See also S. REP. No. 938, supra note 35, 1976 U.S. CONG. CODE & AD. NEWS at 3536.
Orrisch and succeeding cases. The Orrisch court declared that "to find any economic effect of the special allocation . . . we must . . . 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 costs." Since the depreciation in that case, caused by application of loans to basis, was sufficient to drive a capital account negative, the court looked to provisions surrounding the accounts to find what economic impact this result would affect. The method of determining a lack of economic burden involved discovering the potential that a negative capital account might be created as a result of the allocation and not correctable later.

Other cases have spoken of the general principle in similar terms. Holladay v. Commissioner stated that "for allocations to be bona fide they must accurately reflect the basis on which the [partners] agreed to share the economic profits and bear the economic losses of the joint venture." Harris spoke of both the need to consider how the allocation is reflected in the capital accounts under a realistic liquidation plan, and the accuracy of the reflection. This approach is unlike Orrisch, where the effect of the depreciation allocation was merely "transitory." Even Magaziner, which used the substantial economic effect test and capital accounts analysis whole-heartedly, did so to measure if "the partner who benefits from a special allocation of tax deductions must bear the entire cost (burden) of such deductions."

Perhaps the best case of all from Allison's point of view is Lewis v. Commissioner, where full allocation of an interest deduction was made to a 50% partner who paid the cash for the interest pay-

126. Orrisch, 55 T.C. at 403.
127. For examples of low capital accounts that might go negative and their impact, see A. Willis, supra note 33, at §§ 86.03, 86.05; W. McKee, supra note 56, at ¶ 10.02[2] -[2][b]; Weidner, supra note 56, at 487. Capital accounts are regarded as reflecting the relative levels of contributions and recoveries of capital to a partnership by a partner. They are increased by costs to him, and decreased by compensations. See supra note 70.
128. Orrisch, 55 T.C. at 397-98.
129. 72 T.C. 571, 588 (1979), aff'd, 649 F.2d 1176 (5th Cir. 1981).
130. See also Boynton v. Commissioner, 72 T.C. 1147, 1158, aff'd 649 F.2d 1168 (5th Cir. 1981), cert. denied, 454 U.S. 1146 (1982), which states: "[T]he partnership agreement [allocations] must be bona fide in the sense that they are genuinely in accord with the actual division of profits and losses inter sese [sic] which the partners have in fact agreed upon among themselves."
131. Harris, 61 T.C. at 785-86.
132. Id. at 786.
133. Magaziner, 37 T.C.M. at 875.
134. 65 T.C. 625 (1975).
The court allowed the allocation because “[a] particular deduction may . . . be specially allocated to the partner who bears the economic burden of the expenditure underlying the deduction.”

The newly proposed regulations agree that the basic purpose of capital accounts analysis is to determine the economic burden of the deduction. The proposed regulations divide the question of substantial economic effect into two parts: economic effect and the substantiality of the effect. Economic effect is defined entirely in terms of capital accounts. The rule requires that the allocation be reflected in the capital accounts, liquidation proceeds are to be distributed in accordance with the adjusted capital accounts balances, and any partner with a deficit account following distribution of liquidation proceeds must restore the amount to the partnership.

The meaning of finding economic effect is set out, however, as follows: “Thus, the partner to whom an allocation is made must receive the economic benefit or bear the economic burden or risk associated with the allocation.” Substantiality is defined as a consideration of: “[T]he likelihood and magnitude of a shift in the economic consequences among [the] partners . . . weighed against the shifting of tax consequences resulting from the allocation, . . . particularly tax consequences which result from the interaction of the allocation . . . with the partners’ nonpartnership tax attributes.” The test for substantiality admits of subjective standards. Its purpose appears to be prevention of low cash investment tax shelters which produce high levels of deduction, such as the deal in Orrisch. The proposed regulations then repeat the other factors found in the current regulations for evaluation of principal purpose, but without explanation as to their use.

The proposed regulations offer one more glimpse of the purpose of capital accounts analysis when discussing nonrecourse debt. Since “allocations of loss or deduction . . . attributable to nonrecourse debt which is secured by partnership property do not have substantial economic effect since the creditor bears the economic

135. Id. at 627-28.
136. Id. at 632-33 (citing Orrisch, 55 T.C. at 633).
137. 48 Fed. Reg. at 9873.
138. Id.
139. Id.
140. Id.
141. Id. at 9874.
142. For a discussion of why capital accounts fail to work adequately to explain special allocations in nonrecourse debt situations, see Krane, supra note 118.
burden of any losses attributable thereto, . . . such allocations must be made in accordance with the partners' interests in the partnership." Notice that the lack of substantial economic effect occurs because the underlying burden lies outside the partnership, not because a special allocation is somehow incapable of reflection on the capital accounts.

This discussion has been intended to demonstrate that economic effect is a function of bearing economic burden, and not capital accounts analysis. The analysis only serves as a tool to discover economic burden, and should only be used where it functions correctly. The possibility remains that some other method of determining economic burden might be effective in cases where capital accounts fail to demonstrate the burden. The emphasis should not be on resolving a mechanical question involving the occurrence of or lack of certain provisions in a partnership agreement. Instead it should be on the real location of the burden (or risk of loss) behind any venture. Risk of loss is the factor which must be accounted for in the formation of any business enterprise. And the risk of loss is the economic reality Congress tried to effect when it offered to take over some portion of intangible drilling costs by means of tax relief.

Two questions must be answered to find economic effect in this way. First, is this an appropriate case for use of some other measure than capital accounts? If so, what other justification or burden may be relied on to supply the basis of the deduction? Such inquiry may take varied paths in varied cases, but a fair guide can be taken from Hamilton: "The key factor behind any analysis of the validity of a partnership allocation is that the allocation must reflect the true economic substance of the partners' deal."

The court of appeals did address the "burden of the allocation" question in closing its opinion. Essentially, it concluded that even looking at the deal itself "fails to explain how the allocation itself could have affected the partners' shares independently of tax

---

143. 48 Fed. Reg. at 9876 (emphasis added). Notice a partner now may have multiple "interests" in the partnership since the regulations recognize complete diversity potentially in the allocation of any items. Id.

144. When Congress agrees not to collect taxes otherwise owed, it enters the marketplace and makes some activity more attractive than it would be otherwise. When such a deduction is purchased by means of an actual cash expenditure, the Congress simply takes over a portion of the purchase price. Here the Congress agreed to finance up to 70% of oil drilling if investors would risk the loss of the other 30%.

145. Hamilton, 687 F.2d at 417.

146. Allison, 83-1 U.S. Tax Cas. at 86,570.
PARTNERSHIP TAXATION

consequences." The court correctly pointed out that even with the complete exhaustion of its $8.75 million investment, Indomar did not lose everything since it remained entitled to a 13% interest in the contract upon liquidation and retained presumably saleable interests in future involvement in the partnership itself. These interests were received in exchange for the cash, and the court's apparent conclusion is that the other Souex partners therefore bore almost 87% of the cash loss in the failed drilling. Thus, in an approach not very different from capital accounts analysis itself, the court found that Indomar did not bear the entire loss behind the deduction, and the allocation could not be supported.

The court failed to consider two points, however. First, where the government offers deductions for a current expense, it subsidizes the activity. Thus, up to 70% of the money paid by Indomar would be recovered in the real value of the tax deductions. The risk that did support this governmental involvement, that is, the only risk which could support the deduction, was the payment of the cash up front, and this risk Indomar bore. By the real economics of the deal, potentially only 30% of the exhaustion of resources would be suffered by members of the Souex partnership. In addition, as a member of the entity, Indomar bore 13.5417% of that 30% risk. Therefore, Indomar bore over 70% of the risk behind the deduction that there existed to bear. What counts is that Indomar's tax result was not truly as divergent from the real risk it agreed to bear as the court of appeals would suggest.

The second difference is that the burden associated with an allocation of IDC fundamentally differs from the depreciation in Orrisch. The IDC deduction can never exceed the actual cash contribution of the partner, at least where, as here, the deduction is traced directly to the contribution source. Orrisch was able to recover deductions in excess of actual cash outlay. But no sane taxpayer would enter a deal where he paid one dollar hard currency in exchange for one dollar in tax deduction. The value of the tax deduction will always be less than the dollar amount required up front. Therefore, this was no tax shelter, but a deal arranged for profit, accepting the encouragement Congress offered with IDC deductions.

147. Id.
148. Id. at 86,570-71.
149. Of course, it was also not exactly as dire as the Court of Claims suggested. However, the Court of Claims and the allocation come much closer than the court of appeals and the forced reallocation to measuring the actual burden.
Another important distinction from Orrisch in this regard comes from the timing of the special allocation decision. The Orrisch style allocation, which is made after formation of general partnership interests, obviously has no effect unless it modifies those interests. But the allocation decision made during negotiation of the original partnership interests has an immediate and permanent effect upon those interests. Indomar took the risk of losing 30% of its money if the contract proved to be valueless. It assumed that risk in return for 13.5417% of potential returns on that investment. If, instead, the Indomar partners faced the potential loss of nearly 87% of their capital, we might safely presume they would desire triple rewards to cover triple risks. Just as a target, such rewards would require a 39% interest in the underlying contract. Thus, the allocation of the IDC deduction did have a real world impact on the economic deal that was substantial and permanent, but which could never appear on the capital accounts.

Before the advent of capital accounts analysis, such an allocation looked to be entirely possible. Example five of Treasury Regulation section 1.704(b)(2) and Revenue Ruling 68-139 both involved transactions where the partner putting up cash resulting in deductions received full allocation of the deductions as passed through by the partnership. Example five concludes: “Since all of the . . . expenditures and interest specially 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.” Similarly, Revenue Ruling 68-139 held that the IDC directed to the cash partners would be upheld unless found to be for avoidance or evasion of tax. One important commentator has seized upon the last phrase to incorporate capital accounts analysis into both. But it would be more reasonable to conclude that the true intention was validation of the allocation without showing the slightest interest in capital accounts. As another key commentator has noted, “its [Revenue Ruling 68-139] purpose is obscure if it was not intended to approve the allocation.”

If it is true that economic burden is the key and may be shown without resort to a pure capital accounts analysis, then that conclusion may be bolstered by the treatise most loyal to capital accounts analysis. The authority noted the trial court’s Allison opin-

152. See W. McKez, supra note 56, at ¶ 10.92[1], 10.05[g].
153. A. Willis, supra note 33, at § 82.13.
ion, concluding: "While the trial judge's analysis is not explicated precisely in terms of capital accounts analysis, it appears consistent with such analysis and embraces the same basic concepts in analyzing the way in which the economic burden of the expenditures would be borne by the partners." 154 The trial court had, of course, found the burden to lie on Indomar.

IV. CONCLUSION

While there may be some opportunity to define substantial economic effect in terms of economic burden measured outside of capital accounts, the current trend does not support this. The Allison decision makes capital accounts analysis applicable both to pre-1976 and post-1976 cases, and finds no other burden to support an allocation. 155 With the proposal of new regulations couched entirely in terms of capital accounts analysis, such analysis would appear to be firmly entrenched as the wave of the future. This appears the case despite a lack of clear congressional intent to use the test exclusively.

The courts should establish some method of upholding allocations to respond to the declared intent of Congress to encourage certain activities. Otherwise such allocations will be frustrated by the same rules designed to restrict use of tax shelters marketing tax savings in excess of capital investment. Such a result is unattractive and would be counterproductive to congressional purpose.

The ability to maintain the burden of a deduction based on the simple contribution of the cash behind the deduction requires

154. W. McKee, supra note 56, at ¶ 10.05[q] (emphasis added).

155. Ironically, the balance of capital accounts sought on liquidation under the capital accounts test would actually be met in Allison despite the failure to provide for control of liquidation proceeds by the accounts in the partnership agreement. All additions and subtractions from the Souex partners' accounts subsequent to the exploratory drilling would be by partnership interest, and would be equal in the end. Ignoring these, Indomar would have a credit on its account equal to its contributed cash, and this would be reduced to zero by the special allocation of a corresponding amount of IDC deduction. The other three partners would have an unrecovered recredit equal to their adjusted basis in the contributed property. See 48 Fed. Reg. at 9874. On distribution to them of their share of the property they should have basis in their partnership interests equal to this unrecovered investment in the property. See I.R.C. § 705 (CCH 1976) for the partner's basis in his interest. The adjusted basis will therefore be reassigned to the property distributed out to those three partners even though they take a lesser share of the contract than they contributed. They will recover their capital subsequently in the same manner basis in an asset is generally recovered. Thus, in this particular case, the mechanics of the partnership rules force all partners' capital accounts to zero. They realized complete recovery of all capital investments and no partner ultimately bore the burden of unrecovered capital for which another partner received a deduction.
breaking down the partnership entity into its partners. This difference in approach has been termed an aggregate approach versus an entity approach.\textsuperscript{156} The Souex partnership agreed to allocate to each partner the tax consequences of its contribution.\textsuperscript{157} If an aggregate approach was allowed, Indomar would receive the current expense deduction attributed to its cash contribution for drilling. The other Souex partners would receive recovery of capital either by depreciation or reduction from the amount received on sale. This would serve to give each partner back his investment with differing tax consequences, rather than the forced shared consequences of the \textit{Allison} decision.

The \textit{Allison} decision as it stands offers little hope of seeing a court-fashioned standard which truly distinguishes legitimate investments with tax elements from wasteful diversions of capital to unproductive tax avoidance enterprises. The oil deal in \textit{Allison} was established to produce wealth while meeting a nationally desired goal. It has been broken by rules created to limit deals designed to lose. It would be beneficial for the courts to begin fashioning rules which distinguish between undesirable tax shelters and tax supplements of rationally declared goals.

\textit{Peter Doragh}

\textsuperscript{156} See Krane, \textit{supra} note 118, for the argument that an aggregate approach is allowed; but see McKee, \textit{Partnership Allocations in Real Estate Ventures} Crane, Kresser and Orrisch, 30 \textit{Tax L. Rev.} (1974), in which the author of the new regulations explains hostility to any aggregate approach.

\textsuperscript{157} \textit{Allison}, 83-1 \textit{U.S. Tax. Cas.} at 86,565.