

## PARTNERS' INTERESTS IN A PARTNERSHIP

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### ABSTRACT

Entities taxed as partnerships (e.g., partnerships, limited liability companies, and limited partnerships) have management flexibility and benefit from favorable tax rules. Consequently, such entities are very popular among business owners. They are also complex structures that often present complicated tax, legal, and economic issues. The state and tax laws that govern them are intertwined, so actions partners take for *legal* or *economic* purposes may affect the partners' tax consequences. Actions partners take for *tax* purposes may affect the partners' economic and legal situations. State and tax laws have related but subtly different concepts that may work in tandem, or at odds, with the partners' intent. For example, *state law* focuses on the partnership's *economic items* and determines the *partners' economic interests in the partnership*. *Tax law* does not impose a tax on partnership income, so the partners' legal and economic interests in the partnership should influence the allocation of *tax items*. Tax law governs the allocation of partnership *tax items* and generally allows partners to direct the allocation of those items. Tax law uses the *partners' interests in the partnership* to test partner-directed tax-item allocations or to otherwise allocate tax items to the partners. Partner-directed tax-item allocations may, however, affect the partners' economic interests in the partnership. This Article illustrates that state and tax laws are each at work in partnerships but do not adequately correlate the various concepts. Such failure causes ambiguity and may generate unintended negative legal and economic consequences. That ambiguity allows sophisticated business owners to exploit the interaction of the respective laws, and the unintended consequences may ensnare unsuspecting and ill-advised business owners. This Article recommends the law should change to correlate state law and tax law, eliminate ambiguity, check the actions of tax game-players, and protect unsophisticated business owners from legal traps.

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## I. INTRODUCTION

Commentators observe with fascination the proliferation of unincorporated legal entities over the last several years.<sup>1</sup> The popularity of unincorporated entities derives from the flexible legal and management alternatives they present and the generally favorable treatment tax law affords them. Unincorporated entities include partnerships, limited liability companies, and limited partnerships, all of which are generally subject to the flow-through tax regime and come within the federal definition of tax partnership. Consequently, those entities often fall within the partnership rubric and their members are considered partners for the sake of discussion and analysis. Despite the growing popularity of partnerships, the laws

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1. See, e.g., Larry E. Ribstein, *Uncorporating the Large Firm*, 34 (Ill. L. & Econ. Res. Paper Series, Research Paper No. LE08-016, 2008), available at [http://papers.ssrn.com/pape.tar?abstract\\_id=1003790](http://papers.ssrn.com/pape.tar?abstract_id=1003790) (examining the use of unincorporated entities as vehicles for equity funds and large publicly traded ventures); Robert J. Rhee, *Bonding Limited Liability*, (forthcoming, on file with author) (illustrating that the number of limited liability company filings in three major states for the five-year period ended in 2008 increased by 10.6%, while the number of corporate filings decreased by 1.2% during the same period and suggesting states should require such entities to post bond to do business in the states).

governing such arrangements are often malformed, underdeveloped, or not coordinated. For example, tax law uses the concept of “partners’ interests in a partnership” to regulate partnership flow-through taxation.<sup>2</sup> Even though that concept fills an important and fundamental role in tax law, its interaction with state law makes it ambiguous, often creating a domino effect of negative consequences.

The central role “partners’ interests in a partnership” plays in both state and tax laws makes it a lynchpin of the two laws. To explore the concept this Article introduces three correlatives, each of which has legal, tax, and economic significance that affects the others. The three correlatives, as depicted in Table 1, are: *state law* and *tax law*; *economic items* and *tax items*; and *partners’ economic interests in a partnership* and *partners’ interests in a partnership*.

TABLE 1  
PARTNERSHIP LEGAL AND ECONOMIC CORRELATIVES

<b>Legal/Economic Concept</b>	<b>Correlative Tax Concept</b>
State Law	Tax Law
Economic Items	Tax Items
Partners’ Economic Interests	Partners’ Interests

In a somewhat circular, almost dance-like, process, the correlatives interact to establish partners’ economic, legal, and tax effects. The circle begins with state law. The legal structure of a partnership affects the partners’ rights and obligations related to the economic performance of a partnership. For example, state law and the partnership agreement grant partners’ rights to distributions and management and obligations to contribute to the partnership. After determining those rights, the process turns to tax law. Tax law taxes partners, not the partnership, on their “distributive shares” of partnership tax items, such as income and deductions.<sup>3</sup> Tax law generally allows partners to determine their distributive shares of partnership tax items through allocation agreements.<sup>4</sup> Partner-directed tax-item allocations can affect the partners’ legal and economic interests in the partnership. The process thus circles back to state law to consider the legal and economic effect of partner-directed tax-item allocations. The process also must verify partner-directed tax-item

2. See I.R.C. §704(b) (2006).

3. See I.R.C. §§ 701, 702(a) (2006).

4. See I.R.C. § 704(b) (2006) (respecting partner-directed tax-item allocations that have substantial economic effect or are in accordance with the partners’ interests in the partnership); *infra* Part III.C. (discussing the test for substantial economic effect).

allocations by comparing them to tax-item allocations made in accordance with the partners' interests in the partnership, which requires state law consideration. Furthermore, in the absence of self-directed tax-item allocations, tax law allocates tax items to the partners in accordance with the partners' interests in the partnership. Thus, state law and tax law intertwine, each potentially affecting the other.

The distinction between economic items and tax items helps elucidate the interworking of state and tax laws. Before considering those interworking in the partnership context, consider the relationship between economic items and tax items in the simpler individual context. In the individual context, tax law examines the economic activity of an individual and assesses taxes accordingly. An individual has both economic items and tax items. Economic items are metrics that express the individual's economic performance. For example, wages paid to an individual represent an increase in the individual's consumption power and are an economic item. In the case of wages, tax law requires the individual to report a corresponding tax item—compensation income. Thus, an individual taxpayer has both economic and tax items; tax law allocates the corresponding tax item to the individual based upon the economic item, which is generally simple.

Allocating economic and tax items in the partnership context is more difficult. State law or the partnership agreement allocates the economic items. For example, partners may agree how they will share rental income from partnership property (an economic item). Rental income (also a tax item) corresponds to the partnership's economic item. Because tax law does not tax partnerships, it requires the partners to report the partnership's tax item on their individual tax returns through allocations. Thus, the partners must collectively report the partnership's rental income on their tax returns. Intuition suggests that the partnership tax items should follow the partnership economic items, but tax law is not that simple.

Tax law allows partners to allocate tax items among themselves as they please, subject to some limitations. If partners fail to allocate tax items in their partnership agreement, or if partner-directed tax-item allocations are invalid, tax law allocates the items in accordance with the partners' interests in the partnership. Thus, "partners' interests in a partnership" is a very important concept.<sup>5</sup> "Partners' interests in a partnership" is also a technical tax-law term. Its technical meaning appears

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5. The concept of partners' interests in the partnership is a significant part of the partnership tax allocation rules. The term "partners' interests in the partnership" appears 23 times, "partner's interest in a partnership" appears 1 time, and "partner's interest in the partnership" appears 16 times in the partnership tax allocation rules. Such frequent use would appear to add gravity to the related terms. Section 1.704-1(b)(3)(i) provides that the "determination of a partner's interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners."

to differ from partners' *legal* and *economic* interests in a partnership, a distinction that is important in the analysis.

Partners' *legal* interests in a partnership signify that the person is a member of a partnership. Partners' legal interests in a partnership grant rights and impose obligations.<sup>6</sup> For example, the legal interests may grant the partners the right to manage the partnership and dispose of partnership property on the partnership's behalf. A partner's legal interests in a partnership include "the partner's transferable interest and all management and other rights."<sup>7</sup> Subject to restrictions in the partnership agreement, partners can transfer the economic interests (i.e., rights to partnership profits and distributions) they hold in the partnership.<sup>8</sup> Partners may not, however, transfer the management and other rights, without the approval of the other partners.<sup>9</sup> Thus, partners have economic rights, which they can transfer, and other rights as partners, which they cannot transfer. The transferee of economic rights would hold economic interests, but may not be a partner, to the extent that management and other rights make a party a partner.<sup>10</sup> The transferability of rights helps distinguish partners' legal interests from their economic interests.

Partners' *economic* interests in a partnership refer specifically to partners' rights in the partnership's economic items. Partners' economic rights and obligations include their rights to distributions from a partnership and their obligations to make contributions to the partnership.<sup>11</sup> The partners may establish by agreement the timing and manner in which a partnership will make distributions.<sup>12</sup> The partners may also enter into agreements regarding contributions, and state law may require

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6. See UNIF. P'SHIP ACT Art. 4 (amended 1997), 6 U.L.A. 133 *et seq.* (2001) (enumerating partners' rights and duties).

7. See UNIF. P'SHIP ACT § 101(9), 6 U.L.A. 61.

8. See UNIF. P'SHIP ACT § 502, 6 U.L.A. 155.

9. See UNIF. P'SHIP ACT § 503(a)(3), 6 U.L.A. 157.

10. Similar rules apply to other arrangements, such as limited liability companies and limited partnerships, which can be subject to partnership taxation. See *infra* Part III.B. (reviewing aspects of state law that apply to the various noncorporate arrangements discussed in this Article); Treas. Reg. § 301.7701-2 (as amended in 2008) and -3 (as amended in 2006) (governing tax entity classification). This article refers to partnerships, but the concepts should apply equally to limited liability companies and limited partnerships, unless stated otherwise. Tax law also recognizes partners' legal interests in a partnership. Tax law provides that a partner may have a basis in a partnership interest, see I.R.C. § 722 (2006) a partner may sell the interest in the partnership, I.R.C. § 741 (2006) and the partnership may liquidate a partner's interest in a partnership. See I.R.C. §§ 731(a)(2), 732(b) (2006). These references are to the general legal phenomenon of being a member of a partnership.

11. A distribution is a transfer of money or property to a partner from a partnership. A contribution is a transfer of money or property from a partner to a partnership.

12. See UNIF. P'SHIP ACT § 103(a), 6 U.L.A. 73 (giving partnership agreements primacy over most state default rules). In the absence of such an agreement, state law governs distributions from the partnership. See § 402, 6 U.L.A. 139 (restricting in-kind distributions, absent a relevant partnership agreement); § 801(b), 6 U.L.A. 206 (governing liquidating distributions in the absence of a relevant partnership agreement).

contributions upon the occurrence of certain events.<sup>13</sup> The workings of partners' obligations to make contributions and the partners' rights to distributions define the partners' economic interests in the partnership. For example, the partnership may make equal distributions to the partners of all partnership economic items. That would appear to give each partner an equal interest in the partnership's economic items and would affect their economic interests in the partnership.

The partners' interests in economic items should affect the allocation of tax items. Just as tax law requires individuals to report tax items that correspond to economic items, it should require partners to report tax items that correspond with economic items. In that undertaking, tax law falls short. Tax law's rules governing self-directed tax-item allocations require partnership economic items to follow the partners' allocation of partnership tax items. As a consequence, partner-directed tax-item allocations may affect the partners' economic interests in the partnership. The effect on partners' economic interests may surprise many unsuspecting partners.

Tax law uses the concept of partners' interests in a partnership to test the validity of partner-directed tax-item allocations and to allocate tax items otherwise.<sup>14</sup> Nonetheless, tax law's explanation of partners' interests in a partnership fails to adequately incorporate state law, relies upon ambiguous factors, and consequently falls short of being useful.<sup>15</sup> That failure opens the door of opportunity for conniving taxpayers to use the partnership tax allocation rules to shift their tax burdens to others. With some modest alterations, tax law could close the loopholes and protect unsuspecting business owners. The growing demand for partnerships suggests that now is the time for change.

This Article begins the analysis of partners' interests in a partnership by examining existing allocation rules. Both state law and tax law have allocation rules. Part II reviews those rules and illustrates how state law's allocation of economic items and tax law's allocation of tax items can affect partners' interests and economic interests in the partnership. Part III accepts the task of presenting tax law's concept of partners' interests in a partnership. Despite the concept's importance, tax law's description of it is inept. Leaving Part III clearly aware of the need for improvement, the Article precedes in Part IV to examine alternative solutions, ultimately recommending an item-specific allocation regime. Part V concludes.

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13. See, e.g., UNIF. P'SHIP ACT § 807(b), 6 U.L.A. 206 (requiring contributions upon winding up of a partnership in certain situations).

14. See I.R.C. § 704(b) (2006).

15. See *infra* Part III (illustrating shortcomings of the explanation in the regulations).

## II. ALLOCATION RULES

Both state law and tax law adopt partnership allocation rules. State law governs the allocation of economic items. Tax law governs the allocation of tax items. The two bodies of law often overlap, however, and affect the allocation of both tax and economic items. The following simple fact pattern helps illustrate concepts throughout the Article. Sam and Claire form Samaire Partnership on January 1, Year 1. Sam contributes \$800,000 and Claire contributes \$200,000 to the partnership. The partnership immediately uses the money to purchase an office building. The annual tax depreciation on the depreciable portion of the office building is \$20,000. Table 2 illustrates the partnership's economic performance over the first three years of the partnership's existence.<sup>16</sup> The partnership's accumulated profit equals its cash receipts minus its cash expenditures. The value of the property reflects the changes in the property's market value over the years. The residual value reflects the amount that would be available for distribution at the end of each year, assuming the partnership makes no distributions. The partnership's profits and the changes in its property's value represent the partnership's economic performance.

TABLE 2  
PERFORMANCE OF HYPOTHETICAL PARTNERSHIP

Year	Accumulated Profit	Property Value	Residual Value
<b>Formation</b>		1,000,000	1,000,000
<b>1</b>	100,000	930,000	1,030,000
<b>2</b>	206,000	999,000	1,205,000
<b>3</b>	310,000	1,088,000	1,397,000

The economic performance generates tax and economic items that state and tax law must allocate to the partners. State law or the partnership

16. The table randomly assigns a value to the change in profit. It uses a lognormal distribution to determine the property's appreciation, based upon a separately assigned random change in value. The performance is something that is very possible in an actual partnership.

<u>Year</u>	<u>Profit</u>	<u>% Profit Increase</u>	<u>Accum'd Profits</u>	<u>Property Apprec.</u>	<u>% Value Increase</u>	<u>Property Value</u>	<u>Residual Value</u>	<u>Book Value</u>
						1,000,000		
1	100,000		100,000	(69,529)	-7.21%	930,471	1,030,471	1,100,000
2	106,304	6.30%	206,304	68,930	7.15%	999,401	1,205,705	1,206,304
3	103,575	-2.73%	309,880	88,170	8.45%	1,087,571	1,397,451	1,309,880

agreement determines the allocation of the economic items. The allocation of economic items generally establishes the partners' interests in the partnership's residual value, i.e., the partner's economic interests. For example, if the partnership were to liquidate at the end of Year 1, Sam and Claire would each have a claim to a portion of the partnership's \$1,030,000 residual value. Their claims to the residual value would depend upon their contributions and the allocations of partnership's economic items—profit and the change in the property's value—in Year 1.<sup>17</sup>

The allocation of partnership tax items establishes the partners' responsibility for the tax owed on those tax items. The tax items of Samaire Partnership include tax income, a depreciation deduction, and the gain or loss the partnership would recognize upon the sale of the property.<sup>18</sup> The partnership must allocate the \$100,000 of tax income and the \$20,000 of depreciation deduction to the partners in Year 1. The partners will report those items on their individual tax returns based upon the tax-item allocations.<sup>19</sup> Table 3 lists the economic items and tax items for each of Samaire's first three years.

TABLE 3  
ECONOMIC AND TAX ITEMS

<b>Year</b>	<b>Economic Items</b>	<b>Tax Items</b>
<b>1</b>	\$100,000 Profit \$70,000 Lost Value	\$100,000 Income \$50,000 Unrealized Loss <sup>20</sup> \$20,000 Depreciation
<b>2</b>	\$106,000 Profit \$69,000 Appreciation	\$106,000 Income \$39,000 Unrealized Gain <sup>21</sup> \$20,000 Depreciation

17. Some partnerships determine the partners' claims to residual value using a distribution formula similar to those common in corporations. See Bradley T. Borden, *Residual-Risk Model for Classifying Business Arrangements*, 37 FLA. ST. L. REV. \_\_\_\_ (forthcoming 2010), available at [ssrn.com/paper=1365933](http://ssrn.com/paper=1365933).

18. Tax items generally include all income, gain, loss, deductions, and credits. See I.R.C. §702(b) (2006). This Article uses the nontechnical term "tax income" to refer to gross income minus all tax deductions, other than the depreciation deductions.

19. See I.R.C. §§701, 702(a) (2006).

20. The unrealized loss equals the excess of the property's adjusted tax basis at the end of Year 1 (\$980,000) over the property's value (\$930,000). The adjusted tax basis is the cost of the property minus the depreciation deduction. See I.R.C. §§ 1011(a), 1012(a), 1016(a)(2) (2006).

21. The unrealized gain equals the excess of the property's value (\$999,000) over the property's adjusted tax basis (\$960,000).

Year	Economic Items	Tax Items
3	\$104,000 Profit \$88,000 Appreciation	\$104,000 Income \$148,000 Unrealized Gain <sup>22</sup> \$20,000 Depreciation

Often, tax items correspond to economic items. For example, Samaire Partnership owns an office building. The tenants of that building pay rent to the partnership. The rent is an economic item of income; a tax item, rental income, corresponds to the economic rent.<sup>23</sup> The partnership will likely pay someone to maintain the common areas of the office building. Such payments would be an economic expense; they would have a corresponding tax deduction.<sup>24</sup> The tax items that correspond to an economic item are “corresponding tax items.”

Some tax items do not correspond with an economic item. For example, tax law allows a depreciation deduction for property held for business use that is subject to wear and tear.<sup>25</sup> Tax law’s depreciation allowance does not necessarily correspond to the economic performance of a depreciable asset.<sup>26</sup> For example, Samaire Partnership has a \$20,000 tax depreciation deduction in each of its first three years of operation.<sup>27</sup> Those deductions do not correspond with changes in the property’s value. In Year 1 the property’s value decreases by \$70,000, and it increases in value by \$70,000 and \$90,000 in Year 2 and Year 3, respectively.<sup>28</sup> Thus, the depreciation deduction does not follow the property’s fluctuation in value. It also does not follow fluctuations in the partnership’s profit, which fluctuates from \$100,000 in Year 1 to \$106,000 in Year 2, and to \$104,000 in Year 3. Because the tax depreciation deduction does not correspond to an economic item, it is an “independent tax item.”

Unrealized gain or loss is also a tax item. It represents the fair market value of the property over the property’s adjusted basis. That is the amount of taxable gain the partnership would recognize if it sold the property in a taxable transaction.<sup>29</sup> Unrealized gain or loss roughly corresponds to the property’s change in value. The difference between the unrecognized gain

22. The unrealized gain equals the excess of the property’s value (\$1,088,000) over its adjusted tax basis (\$940,000).

23. See I.R.C. §61(a)(5) (2006).

24. See I.R.C. §162(a)(1) (2006).

25. See I.R.C. § 167(a) (2006).

26. See *Simon v. Comm’r*, 103 T.C. 247, 261–62 (9914), *aff’d* 68 F.2d 41 (2d Cir. 1995) (providing that property’s change in value does not affect whether property is eligible for the depreciation deduction).

27. See *supra* Table 3.

28. See *supra* Table 3.

29. See I.R.C. §1001(a) (2006).

or loss and the property's change in value is the cumulative depreciation deductions. Thus, unrealized gain or loss is a function of both a corresponding tax item (amount realized) and an independent tax item (depreciation deduction). Unrealized gain or loss is therefore a "hybrid tax item." Because realized gain and recognized gain are also functions of corresponding and independent tax items, they too are hybrid tax items.

#### A. Relationship between Tax- and Economic-Item Allocations

The relationship between economic-item allocations and tax-item allocation is important. The tax allocation rules help determine the limits within which partners may allocate the tax items. Consider how the partners may allocate the economic items and tax items in Year 1, absent rules governing the allocations. Assume Sam and Claire allocate the economic items equally—\$50,000 of profit and \$35,000 of lost property value to each partner.<sup>30</sup> The economic consequence to each partner would be a net positive allocation of \$15,000 of economic items (the difference between the \$50,000 allocated profit and the \$35,000 allocated lost value). The partners' economic interests in the partnership, following those allocations would equal their contributions plus the allocations. Sam's interest would therefore be \$815,000 and Claire's would be \$215,000. The sum of their interests (\$1,030,000) equals the partnership's residual value.<sup>31</sup>

The partners must also allocate the \$100,000 of tax income and the \$20,000 tax depreciation. Tax law does not permit the allocation of unrealized loss,<sup>32</sup> so the partners will not allocate that tax item in Year 1. The allocation of the tax item often will affect after-tax economic benefit.<sup>33</sup> Allocations of partnership tax items can similarly have economic significance to the partners. The economic significance of a tax item is the extent to which it affects a taxpayer's tax liability. An example illustrates how partnership tax items have economic significance to the partners. Assume Sam has \$100,000 of taxable income from sources other than Samaire Partnership and is subject to a 20% tax rate. Thus, she would owe \$20,000 of tax on her \$100,000 of taxable income.<sup>34</sup> After she pays the \$20,000 tax, she would have an \$80,000.

Recall that the partnership allocated a net \$15,000 of economic items to Sam. That allocation provides her a before-tax economic benefit of

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30. In Year 1, the Samaire has \$100,000 of profit, half of which is \$50,000, and \$70,000 of lost property value, half of which is \$35,000.

31. See *supra* Table 2.

32. See I.R.C. § 1001(a) (2006) (requiring a sale or other disposition to trigger gain or loss recognition).

33 The \$80,000 after-tax economic benefit represents the \$100,000 of income minus the \$20,000 of tax.

34. See I.R.C. §1(a)-(d) (2006) (imposing a tax on individuals equal to their taxable income multiplied by a tax rate).

\$15,000. Her after-tax economic benefit depends upon the manner in which the partners allocate the tax items. If the partnership allocates the tax items equally to the partners, Sam will report \$50,000 of tax income and \$10,000 of depreciation deduction or a net tax income of \$40,000.<sup>35</sup> Taxed at 20%, Sam would owe \$8,000 on that allocated amount. Thus, the after-tax economic benefit of the partnership items allocated to Sam is \$7,000 (\$15,000 economic items minus \$8,000 of tax). If tax law did not restrict the manner in which partners allocate tax items, perhaps Claire could agree to allocate only \$40,000 of tax income to Sam without adjusting the allocation of the partnership's economic items. That would give Sam a net tax income from the partnership of \$30,000 instead of \$40,000.<sup>36</sup> Thus, she would owe \$6,000 (\$30,000 of net tax income allocated to her times her 20% tax rate) instead of \$8,000 on her share of partnership tax items, leaving her after-tax economic benefit at \$9,000 instead of \$7,000.<sup>37</sup> The allocation of tax items therefore has economic consequences.

Several factors could prompt the parties to enter into an arrangement that separates the tax-item allocation from the economic-item allocation. For example, the parties may use the allocation as a form of compensation or consideration. By agreeing to allocate 40% of the tax income to Sam instead of 50%, Claire in effect agrees to pay the government \$2,000 on Sam's behalf.<sup>38</sup> That \$2,000 payment on Sam's behalf would ordinarily be income to Sam.<sup>39</sup> Claire probably would not make the payment unless she received something from Sam in return.<sup>40</sup> Tax law does not appear to require Sam to include in her gross income the benefit she receives from a tax-item allocation. Thus, the absence of tax-item allocation rules would allow partners to keep from the fisc the tax owed on the tax-item transaction, i.e., Sam's exchange of something for Claire's agreeing to report an extra \$10,000 of partnership tax income. The allocation also

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35. The net economic items allocated to Sam do not equal the net tax items allocated to Sam because tax law does not recognize the changes in the property's value. Often the partners will not know the value of property at the end of each year, so they will not know the amount of all the economic items the partnership allocates. Nonetheless, the partners' economic interests reflect the changes in the value of partnership property, whether known or not.

36. The new net tax income derives from the allocation of \$40,000 tax income and \$10,000 of depreciation deduction the partners allocate to Sam.

37. Sam's after-tax economic benefit is the \$15,000 of net partnership economic items allocated to her, minus the \$6,000 tax she owes on net partnership tax items allocated to her.

38. The allocation that reduces Sam's tax liability is economically equivalent to Claire paying Sam \$2,000 and Sam using those proceeds to pay her tax liability. *See Old Colony Trust Co. v. Comm'r*, 279 U.S. 716, 729 (1929) (recognizing that the payment of tax on behalf of another is equivalent to receipt of cash by the person taxed).

39. *See id.* at 731.

40. Even if Claire owed no tax on the extra income allocated to her, she might ask for something in return for helping Sam improve her economic situation.

appears to violate a sense of fairness. Sam obtained the economic benefit of the \$15,000 of net economic items allocated to her but did not pay the tax a non-partner with a similar economic benefit would pay. Fairness appears to require the person who obtains an economic benefit to pay tax on it. Partnerships should not become a vehicle for avoiding such principles. Tax law allocation rules should help thwart such potential abuse. The current allocation rules fall short of that ideal.

Although requiring corresponding tax items to follow the relevant economic items appears to be intuitive, but tax law does not always track such intuition.<sup>41</sup> The allocation of independent tax items lacks intuitive connections to economic items. Nonetheless, allocations of independent tax items have economic consequences. Before considering the economic significance of partnerships' allocations of independent tax items, consider the economic significance independent tax items have for individuals. If an individual takes a deduction for depreciation, the amount reduces the individual's taxable income.<sup>42</sup> That reduction provides a tax benefit to the individual equal to the amount by which the deduction reduces the individual's tax liability. The reduction of tax liability equals the amount of the deduction multiplied by the individual's tax rate. Thus, a \$20,000 tax deduction for a person with a 20% tax rate will provide a \$4,000 economic benefit to the individual.

The depreciation deduction provides an economic benefit that is independent of the property's economic performance. Whether the property produces no income for the individual or increases or decreases in value is irrelevant. The individual receives the same depreciation deduction and the tax benefit. The depreciation deduction affects the individual's tax liability but not the economic interest the individual has in the property. Later, if the individual disposes of the property tax law requires the individual to recapture that depreciation deduction as ordinary income or section 1250 gain.<sup>43</sup> That recapture rate thus affects the character of gain the individual recognizes on the disposition of the property.

Now consider a partnerships' depreciation deduction. In Year 1, Samaire Partnership's depreciation deduction was \$20,000, but the property's value declined \$70,000. In Year 2, the depreciation deduction was again \$20,000, but the property's value increased by \$69,000. In Year 3, the property's value increased by \$90,000, but the depreciation deduction remained constant. Thus, over a three-year period, the property's value increased by about \$90,000, but the partnership had

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41. See *infra* Part II.A.

42. See I.R.C. §§ 63(a) (2006) (defining taxable income as gross income minus deductions); 167(a) (allowing a deduction for depreciation).

43. See I.R.C. §§1245(a), 1(h)(1)(D) (2006).

\$60,000 of depreciation deductions. This illustrates that the depreciation deduction is independent of the partnership's economic situation. Because partners share the economic performance of partnership property, the depreciation deduction may provide independent economic benefit to the partners.

Over the first three years, if the partners allocate the partnership's depreciation deduction equally to the partners (a total of \$30,000 to each), Sam's tax benefit from the allocation would be \$6,000 and Claire's (who has a 30% tax rate) would be \$9,000.<sup>44</sup> If tax law does not restrict the allocation of independent tax items, Sam and Claire could use them to reduce their tax liabilities. One way to do that would be to use the tax-item allocation as consideration. Assume that Claire transfers a \$9,000 piece of property to Sam, and Sam agrees to pay Claire \$9,000 for the property. That transaction would have tax consequences to Claire.<sup>45</sup> Instead of paying \$9,000 to Claire, however, Sam could agree to allocate all of the depreciation deduction to Claire. The allocation of an additional \$30,000 of depreciation to Claire would provide her with an additional \$9,000 tax benefit. The additional tax benefit would be like Claire receiving \$9,000 of cash from Sam.<sup>46</sup>

These examples illustrate that if tax law allows partners discretion to allocate tax items as they please, two negative consequences may flow from such leniency. First, partners would be able to enter into transactions that tax law may not tax. Current law may not treat the allocation of partnership tax items in exchange for property as a taxable event.<sup>47</sup> Exempting such transactions from taxation would reduce tax revenue and treat members of partnership differently from other taxpayers. Second, the allocation reduces the overall taxes paid by the difference between the economic benefit one partner gives up and the economic benefit another partner obtains. For example, Sam gave up \$6,000 economic benefit by agreeing to allocate more depreciation deduction to Claire, and Claire obtained a \$9,000 benefit from the allocation. Consequently, the government loses \$3,000 of tax revenue on the transaction. Thus, unregulated allocations provide room for taxpayer game-playing, which often will have negative effects on tax revenue. Tax law does not leave such allocations unregulated, but their regulation should depend to a more

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44. Sam's economic benefit will equal her 20% tax rate multiplied by her \$30,000 share of the \$60,000 of depreciation deduction. Claire's economic benefit will equal her 30% tax rate multiplied by her \$30,000 share of the depreciation deduction.

45. See I.R.C. §61(a)(3) (2006) (including gains from sale in gross income); I.R.C. §1001(a) (defining gain and loss from the sale or disposition of property).

46. This is the same result that obtains if the partners allocate corresponding tax items as consideration. See *supra* text accompanying notes 38–40.

47. See Bradley T. Borden, *Partnership Tax Allocations and the Internalization of Tax-Item Allocations*, 59 S.C.L. REV. 297, 338–40 (2008) (describing a partnership tax-item transaction).

significant extent upon the allocation of economic items, which state law governs.

#### B. Allocation of Economic Items under State Law

State law allows partners to agree upon the manner in which they will allocate the entity's economic items.<sup>48</sup> The variations of partner-directed allocations of economic items are unlimited. The discussion in Part III illustrates a few possible allocation formulae. In the event partners do not use the partnership agreement to allocate partnership economic items, state default rules govern the allocation of the economic items. The state law default allocation rules vary depending on the type of legal entity the partners use. Because the default allocation rules affect the partners' rights to distributions, they affect the partners' interests in the partnerships' residual value. Thus, the partners' decision to organize as a partnership, limited partnership, or limited liability company may affect the partners' economic interests in the partnership. Although state law allocation rules may vary from state to state, this Article uses the rules in the Uniform Acts to illustrate possible default allocation rules for the various entities. Those rules illustrate the concept of state default rules and the possible variability of such rules depending on the type of entity.

*Partnerships.* In the absence of allocation provisions in the partnership agreement, state law deems partners to have accounts, which represent the partners' economic interests in the partnership. State law credits (i.e., increases) partner accounts with partner contributions and the partners' shares of partnership profits and charges (i.e., decreases) them for distributions and shares of partnership losses.<sup>49</sup> State default rules also provide that partnerships divide partnership profits and losses equally among the partners.<sup>50</sup> Upon liquidation, the partnership distributes assets the partners in accordance with those accounts.<sup>51</sup> State law does not precisely define profits and losses, which can be a source of confusion.<sup>52</sup> For purpose of this discussion, a simple definition of profits will illustrate

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48. See UNIF. P'SHIP ACT §103(a) (amended 1997), 6 U.L.A. 73 (2001); UNIF. LTD. P'SHIP ACT §110(a) (2001), 6A U.L.A. 378 (2008); UNIF. LTD. LIAB. CO. ACT § 110(a) (2006), 6B U.L.A. 442 (2008).

49. See UNIF. P'SHIP ACT § 401(a), 6 U.L.A. 133.

50. See UNIF. P'SHIP ACT §401(b), 6 U.L.A. 133.

51. See UNIF. P'SHIP ACT § 807(b), 6 U.L.A. 206 (requiring the partnership to distribute the excess of credits over charges in partners accounts to the partners and requiring partners to contribute the excess of charges over credits in the accounts).

52. See ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP, §2.07(b)(4) (2007); see *infra* Part III.A. (discussing possible different definitions of "profit").

the state law allocation rules. Assume state law defines profits and losses to include the difference between revenue and expenditures, including any changes in the property's value (state law profit). The hypothetical Samaire Partnership has perfect information the partners can use to determine their shares of partnership profits and losses each year. With that information, they can determine their economic interests in the partnership at the end of each year.

Sam contributed \$800,000 to the partnership, so the partnership will credit her account with that amount. The partnership will also credit her account with one-half or \$50,000 of the Year 1 profit and charge it with one-half or \$35,000 of the property's lost value in Year 1, or a net of \$15,000.<sup>53</sup> At the end of Year 1, Sam's account would therefore have \$815,000 in it. The partnership will credit Claire's account with her \$200,000 contribution and 50% of the partnership's profit and lost value, so her account will have \$215,000 in it at the end of Year 1. Notice that the sum of the partners' accounts (\$1,030,000) equals the partnership's residual value at the end of Year 1.<sup>54</sup> Sam's economic interest at the end of Year 1 appears to be 79% of the partnership's residual value, and Claire appears to be the remaining 21% of the value.<sup>55</sup> The balance of the partners' accounts thus represents their shares of the partnership's residual value and reflects their interests in the partnership.

Based on the state law formula, Sam's account balance will be \$902,500 at the end of Year 2 and \$998,500 at the end of Year 3.<sup>56</sup> Claire's account balance will be \$302,500 in Year 2 and \$398,500 in Year 3.<sup>57</sup> Sam's economic interest in the partnership, based on her percentage of residual value, will range from 80% on formation, 79% at the end of Year 1, 75% at the end of Year 2, to 71% at the end of Year 3.<sup>58</sup> Claire's economic interest will reflect the remaining portion of the residual value,

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53. Even though the partnership does not recognize the fluctuation in its property's value, the changes in value affect the partners' economic interest. With the information about the property's value available in this hypothetical, the Article uses the value to analyze the partners' interests in the partnership.

54. See *supra* Table 2 presenting the partnership's residual value.

55. Sam's economic interest is \$815,000/\$1,030,000 and Claire's economic interest is \$215,000/\$1,030,000.

56. The Year 2 state law profit is \$106,000 and change in property value is \$69,000, see *supra* Table 3, and 50% of that amount is \$87,500, which increases Sam's account to \$902,500. The Year 3 state law profit is \$104,000 and the change in value is \$88,000, see *id.*, and 50% of that amount is \$96,000, which increases Sam's amount to \$998,500.

57. In Year 2, her account, like Sam's, will increase \$87,500 to \$302,500 and in Year 3, it will increase \$96,000 to \$398,500.

58. At the time of formation, Sam's economic interest will be \$800,000 of the total residual value of \$1,000,000. At the end of Year 1, Sam's economic interest will be \$815,000 of the total residual value of \$1,030,000. At the end of Year 2, Sam's economic interest will be \$902,500 of the total residual value of \$1,206,000. At the end of Year 3, Sam's economic interest will be \$998,500 of the total residual value of \$1,397,000.

so her economic interest as a percentage of residual value on the date of formation will be 20%.<sup>59</sup> It will be 21% at the end of Year 1, 25% at the end of Year 2, and 29% at the end of Year 3.<sup>60</sup> The partners' economic interests in the partnership, determined as a percentage of the partnership's residual value, thus fluctuates over the years. The fluctuation results because state law allocates partnership profits and losses in a ratio that differs from the ratio of each partner's contributions. Under the state law default rules, the partners' economic interests would equalize (i.e., move closer to 50%) over time, if the partnership is profitable, because the profits become a more significant part of the partnership's residual value.

*Limited Partnerships.* State law does not specifically allocate the profits and losses of a limited partnership.<sup>61</sup> Instead, it assumes that “[n]early all limited partnerships will choose to allocate profits and losses in order to comply with applicable tax, accounting and other regulatory requirements. Those requirements, rather than [the limited partnership act], are the proper source of guidance for that profit and loss allocation.”<sup>62</sup> That assumption is somewhat misguided because tax, accounting, and other regulatory requirements may dictate the allocation of economic items. Tax provisions can dictate the allocation of economic items only if partners include tax-item allocation provisions in the partnership agreement. Not all limited partnerships include tax-item allocation provisions.<sup>63</sup> Additionally, accounting principles do not determine partners' legal rights to partnership property; they direct the provision of information about an arrangement's economic performance.<sup>64</sup> The allocation of economic items is a legal concept that the partners must address in the partnership agreement. If the partnership agreement is silent, state law must allocate the economic items.

Because state law does not expressly direct the allocation of economic items, the partners must derive the allocations from the state law distribution rules. State law provides that limited partnerships shall make

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59. At the time of formation, Claire's economic interest will be \$200,000 of the total residual value of \$1,000,000.

60. At the end of Year 1, Claire's economic interest will be \$215,000 of the total residual value of \$1,030,000. At the end of Year 2, Claire's economic interest will be \$302,500 of the total residual value of \$1,206,000. At the end of Year 3, Claire's economic interest will be \$398,500 of the total residual value of \$1,397,000.

61. See UNIF. LTD. P'SHIP ACT § 503, comment (2001), 6A U.L.A. 444 (2008).

62. *Id.*

63. See *infra* Part III (illustrating various partnership allocation alternatives, some which do not include tax-item allocation provisions).

64. See Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises*, ¶ 9 (1978) (“Financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions—for making reasoned choices among alternative uses of scarce resources in the conduct of business and economic activities.”).

distributions based upon the value of contributed property.<sup>65</sup> Mandating distributions based on contributions appears to require the limited partnership to make distributions in proportion to the value contributed by the partners. For a limited partnership to make distributions in proportion to the value of contributed property, it would have to allocate the economic items in proportion to the contributions.

An example illustrates how partners can derive economic-item allocation rules from state limited partnership distribution rules. If Samaire Partnership were to make a liquidating distribution at the end of Year 1, state law would require it to distribute the assets based upon the partners' contributions. Sam contributed 80% of the total partner contributions and Claire contributed the other 20%. Thus, the partnership would distribute 80% of the partnership assets to Sam and 20% to Claire upon liquidation. At the end of Year 1, Samaire Partnership's residual value is \$1,030,000. If the partnership were to liquidate at the end of Year 1, Sam's distribution would be 80% of the residual value, or \$824,000. That is \$24,000 more than she contributed, so in effect, the partnership must allocate that \$24,000 to Sam. The \$24,000 is 80% of the partnership's \$30,000 state law profit.<sup>66</sup> Claire's 20% distribution (\$206,000) would similarly require an effective allocation of 20% of the partnership's profit in Year 1. To ensure future distributions will be in proportion to contributions, the partnership would make the same proportionate allocations of its economic items in each of the following years. Thus, Sam's and Claire's economic interests would remain 80% and 20% throughout the life of the partnership.<sup>67</sup>

*Limited Liability Companies.* As with limited partnerships, state law provides rules for making distributions to the members of limited liability companies, but it does not provide for profit and loss sharing.<sup>68</sup> State law provides, however, that limited liability companies must make pro rata non-liquidating distributions.<sup>69</sup> Consequently, prior to liquidation, limited liability companies must distribute property equally to the members, under the default rules. Upon liquidation, limited liability companies make distributions first to return contributions.<sup>70</sup> They then distribute any remaining property to the members in equal shares.<sup>71</sup> These rules

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65. See UNIF. LTD. P'SHIP ACT § 503, 6A U.L.A. 444.

66. The partnership had \$100,000 of profits in Year 1 from operations, and the property decreased in value \$70,000. Thus, its state law profit was \$30,000.

67. This assumes no other contributions or distributions in a proportion different from the 80%/20% split. Disproportionate contributions or distributions would alter the partners' economic interests in the partnership.

68. See UNIF. LTD. LIAB. CO. ACT §404, comment (2006), 6B U.L.A. 480–81.

69. See UNIF. LTD. LIAB. CO. ACT §404(a), 6B U.L.A. 480.

70. See UNIF. LTD. LIAB. CO. ACT §708(b)(1), 6B U.L.A. 514.

71. See UNIF. LTD. LIAB. CO. ACT §708(b)(2), 6B U.L.A. 514.

effectively allocate economic items equally to the members of the limited liability company.<sup>72</sup> For example, assume Samaire Partnership is a limited liability company and distributes \$120,000 to the members at the end of Year 1. Because state law requires pro rata non-liquidating distributions, the partnership would distribute \$60,000 each to Sam and Claire. The distribution would appear to consist of \$30,000 of state law profits and \$90,000 (the difference between the \$120,000 distribution and \$30,000 of state law profit) of contributed property, or \$120,000. The partnership would divide that amount equally between the partners. Each partner's distribution would consist in part, of state law profit and in part, of partnership capital. Thus, the partnership would distribute \$15,000 of profits (half of the partnership's \$30,000 state law profits) to each partner and would return \$45,000 of each partners' original contribution. Sam's remaining account would be \$755,000 and Claire's would be \$155,000.

Assume the limited liability company then liquidates at the end of Year 2. The partnership would distribute \$755,000 to Sam and \$155,000 to Claire to return their undistributed contributions.<sup>73</sup> That would leave \$225,000 to distribute equally to Sam and Claire, so Sam's total liquidating distribution would equal \$867,500.<sup>74</sup> Over the two-year period, Samaire's total distributions to Sam would equal \$902,500.<sup>75</sup> As a result of these rules, Sam would receive her original \$800,000 contribution plus one-half of the partnership's \$205,000 of state law profits.<sup>76</sup> Claire would similarly receive her contribution plus one-half of the partnership's state law profits. Because the rules effectively divide the profits equally among the partners, their economic interests would appear to be the same as their interests under the partnership default rules.<sup>77</sup>

These examples illustrate that the state default allocation rules. They apply if partners fail to provide for economic-item allocations in the partnership agreement. The reasons for neglecting to include such

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72. To simplify the analysis, the Article does not consider the consequences of an unprofitable limited liability company.

73. Recall that Sam had contributed \$800,000 and the partnership distributed \$45,000 to her at the end of Year 1 as a return of her contribution. Claire had contributed \$200,000 and the partnership distributed \$45,000 to her at the end of Year 1 as a return of her contribution. Thus, Sam's and Claire's undistributed contributions at the end of Year 1 were \$755,000 and \$155,000, respectively.

74. That amount equals the \$755,000 return of her remaining contribution plus her \$112,500 share of the \$225,000 remaining after the distribution of contributed property.

75. Sam's Year 1 distribution was \$60,000 and her Year 2 distribution was \$867,500, so her total distribution was \$902,500.

76. Year 1 profits were \$100,000 and Year 2 Profits were \$106,000, *see supra* Table 3, and the property was worth \$1,000 less at the end of Year 2 than it was when the partnership purchased it on the date of formation. *See supra* Table 2. Thus, total state law profits for the first two years would be \$205,000.

77. *See supra* text accompanying note 49–58.

provisions are undoubtedly numerous.<sup>78</sup> Perhaps the partners lack the sophistication required to include such provisions. Some partners may not realize they are forming a partnership when they enter into an agreement and consequently do not consider economic-item allocation.<sup>79</sup> Or, some partners who realize they are forming a partnership and are sophisticated believe the state default allocation rules would provide them the economic benefit they seek. For any such reason, partnership agreements may not provide for tax-item allocations. Thus, state law remains important and will determine the partners' interests in economic items in numerous arrangements.

State law anticipates, however, that members of unincorporated entities will often create their own allocation formulae, often for tax purposes.<sup>80</sup> Other partners will allocate economic items for specific purposes, but may fail to allocate tax items. For example, partners may allocate economic items to help reduce agency costs.<sup>81</sup> If one partner performs a particular function, the other partners may agree to allocate a larger portion of the profits from that function to the partner. Such an allocation may encourage the partner to perform the function more efficiently. Partners could also allocate a larger portion of certain costs or the change in value of partnership property to a partner who oversees the use of resources. Such allocation should encourage the partner to carefully manage the resources. Thus, the allocation of partnership economic items fills an important role in many partnerships. The allocation of economic items also affects the partners' economic interests in the partnership, which should be relevant to tax-item allocation rules.

Tax practitioners are generally aware that the tax tail should not wag the business dog. Business participants should generally focus first on the business arrangement and the allocation of economic items. After that, they should consider tax items. Nonetheless, the partnership's allocation of

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78. See Manuel A. Utset, *A Theory of Self-Control Problems and Incomplete Contracting: The Case of Shareholder Contracts*, 2003 UTAH L. REV. 1329, 1348 (2003) (proposing that members of close business arrangements may not formalize agreements because they choose to rely upon mutual trustworthiness and fear undermining fragile trust that exists at the beginning for a venture); Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1805 (2001) (suggesting that failure to contract in close business arrangements may be a symptom of the parties' "ignorance, lack of imagination, or poor legal advice"); Dennis S. Karjala, *Planning Problems in the Limited Liability Company*, 73 WASH. U. L.Q. 455, 477 (1995) (observing that many small businesses will not incur the cost to negotiate and draft a carefully worded agreement).

79. See BROMBERG & RIBSTEIN, *supra* note 52 at § 201(a).

80. See *supra* note 62 and accompanying text; *supra* note 68.

81. See Bradley T. Borden, *Aggregate-Plus Theory of Partnership Taxation*, 43 GA. L. REV. 717, 752–61 (2009) (providing examples of possible uses of partnership economic-item allocations to reduce agency costs); Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 786 (1972) (observing that members of partnerships may use profit-sharing to self-police and help reduce shirking).

tax items in the partnership agreement may inadvertently affect the partners' economic interests in the partnership. Some partners may be surprised to learn that the allocation of tax items can affect their economic interests in the partnership. The following discussion illustrates how partner-directed tax-item allocations can affect the allocation of economic items. It all begins with the partnership tax allocation rules.

### C. Allocation of Tax Items under Tax Law

Partnership tax law exists because partnerships present challenges that are too complex to address with traditional tax rules.<sup>82</sup> Partnerships need rules that determine the extent to which each partner will report the partnership's tax-items. The partnership tax-item allocation rules serve that purpose and are the heart of partnership taxation. Other partnership tax rules (such as basis rules, partnership tax years, and liability allocation rules) support the tax-item allocation rules.<sup>83</sup> Thus, by understanding the tax-item allocation rules, one understands a significant portion of partnership taxation. The allocation rules must serve both sophisticated and unsophisticated partnerships. Consequently, they bear a significant burden.

The tax-item allocation rules generally grant partners significant discretion in allocating the partnership's tax items.<sup>84</sup> To be valid under tax law, however, partner-directed tax-item allocations must have "substantial economic effect," a technical term discussed *infra*, or be in accordance with the partners' interests in the partnership.<sup>85</sup> Partners' efforts to give partner-directed tax-item allocations substantial economic effect can alter the allocation of economic items. Therefore, the allocation of tax items can affect the partners' economic interests in the partnership. Nonetheless, the partners must know their interests in the partnership to test the validity of partner-directed tax-item allocations. The interaction of tax-item allocations and economic-item allocations create the circular analysis, which tax law should eliminate.

If the partnership agreement does not allocate tax items, tax law requires the partnership to allocate them "in accordance with the partner's interest in the partnership."<sup>86</sup> If the partnership agreement allocates tax items, but those allocations do not have substantial economic effect, tax law allocates the items in accordance with the partners' interests in the

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82. See Borden, *supra* note 17 at Part IV.A.

83. For example, the rules regarding partnership formation, inside and outside basis maintenance, and partnership distributions and dissolutions all exist because tax law must recognize partnerships to address the allocations problems they present.

84. See I.R.C. § 704(a) (2006).

85. See I.R.C. § 704(b) (2006); *infra* text accompanying notes 89–102.

86. See I.R.C. § 704(b) (2006).

partnership.<sup>87</sup> Stated differently, tax law requires the partnership to allocate tax items in accordance with the partners' interests in the partnership unless the partnership agreement allocates the tax items and those allocations have substantial economic effect. Partners' interest in the partnership also is the standard against which tax law tests the validity of partner-directed tax-item allocations. The technical tax concept of partners' interests in a partnership applies in each of those cases. The examination of the concept below reveals its complexity and shortcomings.<sup>88</sup>

Before examining tax law's concept of partners' interests in a partnership, consider how partner-directed tax-item allocations may affect the partners' economic interests in the partnership. Often partners who choose to allocate tax items make an effort to satisfy the test for substantial economic effect. The test for substantial economic effect has two conjunctive parts: (1) economic effect and (2) substantiality. To satisfy that test, all allocations in a partnership agreement must have economic effect.<sup>89</sup> The term "economic effect" is a term of art, providing that the benefit or burden of an economic item must follow the allocation of the corresponding tax item.<sup>90</sup> On its face, this language appears to apply only to corresponding tax items and their related economic items. As demonstrated below, however, the requirement also applies to independent tax items. As a consequence, the rule creates fictitious economic items.

To satisfy the test for economic effect, partners may draft their partnership agreement to come within the economic effect safe harbor. To come within the economic effect safe harbor, the partnership must satisfy three requirements (the section 704(b) capital account rules): (1) maintain section 704(b) capital accounts, (2) liquidate in accordance with positive capital account balances, and (3) require partners to restore deficit capital account balances on liquidation.<sup>91</sup> The confluence of tax-item allocations, section 704(b) capital account maintenance, and the requirement to liquidate the partnership in accordance to the section 704(b) capital accounts establishes the partners' economic rights in the partnership. The maintenance of section 704(b) capital accounts supplants the state default partnership rules and dictates the allocation of economic items. Thus,

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87. *See id.*

88. *See infra* Part III.

89. *See* Treas. Reg. § 1.704-1(b)(2)(i) (as amended in 2008).

90. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(a) (as amended in 2008).

91. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(b) (as amended in 2008) (requiring the partnership agreement to include provisions that satisfy those requirements). An allocation can also have economic effect, if the partnership satisfies the first two requirements of the safe harbor, has a limited deficit restoration obligation, and includes a qualified income offset (this is the alternative test for economic effect). *See* Treas. Reg. § 1.704-1(b)(2)(ii)(d) (as amended in 2008). Finally, an allocation has economic effect if the end result of the allocation is the same as the result obtained under the safe harbor or alternative test. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(i) (as amended in 2008).

provisions that the partners include in the partnership agreement for tax purposes establish the partners' economic interests in the partnership.

An example illustrates the legal and economic significance of coming within the economic effect safe harbor and demonstrates how tax-item allocation can create fictitious economic items. Assume Sam and Claire focus solely on allocating tax items. They agree to allocate all tax items, except the depreciation deduction, equally. They agree to allocate the depreciation deduction 60% to Sam and 40% to Claire. They structure their partnership agreement to come within the economic effect safe harbor. They do not include any other allocation provisions in their partnership agreement. The tax-item allocations nonetheless affect the allocation of the partnership's economic items.

The section 704(b) capital account maintenance rules require the partners to increase their section 704(b) capital accounts by the amount of money contributed to the partnership.<sup>92</sup> Consequently, Sam's beginning capital account balance will be \$800,000 and Claire's will be \$200,000. Over the first three years, the partnership allocates the \$310,000 of tax income equally to Sam and Claire. It allocates the \$60,000 of depreciation deduction \$36,000 (60%) to Sam and \$24,000 (40%) to Claire. The section 704(b) capital account maintenance rules require the partnership to increase the section 704(b) capital accounts by the amount of tax income allocated to the partners,<sup>93</sup> and decrease the section 704(b) capital accounts by the amount of loss or deduction allocated to the partners.<sup>94</sup> The partnership will therefore increase Sam's and Claire's capital accounts each by \$155,000, their shares of partnership tax income. The partnership will decrease Sam's capital account by \$36,000 and Claire's by \$24,000 to reflect the allocation of the depreciation deduction. After those adjustments, Sam's capital account balance will be \$919,000 and Claire's will be \$331,000.

Recognize that although the depreciation deduction is an independent tax item, the section 704(b) capital account maintenance rules require the partnership to adjust the partners' capital accounts to reflect the tax-item allocation.<sup>95</sup> Because the partnership liquidates in accordance with section 704(b) capital accounts, the capital account reduction affects the partners' economic interests in the partnership. To consider the effect of the rules, assume Samaire Partnership liquidates at the end of Year 3 by selling its property and distributing all of its cash. At the end of Year 3, Samaire would sell the property for its \$1,088,000 fair market value and recognize

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92. See Treas. Reg. §1.704-1(b)(2)(iv)(b)(1)(2) (as amended in 2008).

93. See Treas. Reg. §1.704-1(b)(2)(iv)(b)(3) (as amended in 2008).

94. See Treas. Reg. §1.704-1(b)(2)(iv)(b)(7) (as amended in 2008).

95. See Treas. Reg. §1.704-1(b)(5), *Example (1)* (as amended in 2008) (reducing the partners' capital accounts by the amount of depreciation allocated to the partners).

\$148,000 of taxable gain.<sup>96</sup> Pursuant to the partnership agreement, Samaire would allocate that gain equally to Sam and Claire and adjust their capital accounts accordingly.<sup>97</sup> Thus, Sam's capital account would become \$993,000 and Claire's would become \$405,000. The partnership would distribute the \$1,398,000 of cash to the partners in those respective amounts.

Those distributions vary from the amounts the partnership would distribute to the partners if the state default rules applied. If the state default rules applied, the partnership would allocate profit and losses equally to the partners.<sup>98</sup> Over the three years, the partnership has \$310,000 of profit from operations, and the property appreciates \$88,000. The partnership would therefore allocate \$199,000 (one half the \$398,000 total increase) of economic increase to each of Sam and Claire. After those allocations, Sam's account would be \$999,000 and Claire's would be \$399,000. The allocation of the tax item therefore decreased Sam's interest by \$6,000 over three years. The allocation of the tax item created a fictitious economic item, which did not reflect the economic performance of the partnership. Thus, the allocation of the independent tax item altered the partners' economic interests in the partnership.

Notice that the tax-item allocation rules affected Sam's and Claire's economic interests in the partnership. Their adoption of the section 704(b) capital account maintenance rules altered the amounts they received on liquidation. If the partners had not allocated the tax depreciation 60% to Sam and 40% to Claire, state law would have established their economic interests. The allocation of tax items (even independent tax items) under the section 704(b) capital account maintenance rules can affect the partners' economic interests in the partnership by adopting the section 704(b) capital account maintenance rules. If the partners are not aware of that potential, they could inadvertently alter their economic interests in the partnership. Such alteration could occur in particular if the partners simply adopted boiler plate tax language to satisfy the test for economic effect. The adoption of the section 704(b) capital accounts may also have unintended consequences for partners who carefully consider potential outcomes but inadvertently overlook some potentialities. For this reason,

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96. At the end of Year 3, the property's adjusted bases would be the original \$1,000,000 basis reduced by the \$60,000 of depreciation or \$940,000. *See* I.R.C. §1011(a)(2006). The difference between the \$1,088,000 received on the sale and the \$940,000 adjusted basis produces the \$148,000 of gain recognized. *See* I.R.C. §1001(a), (c)(2006).

97. Sam and Claire could have agreed to allocate the depreciation recapture in the same proportion in which they allocated the depreciation. *See* Treas. Reg. §1.704-1(b) (as amended in 2008). If they had done so, the allocation would have not altered the economic interests they would have had under state law. The deviation with respect to the independent tax item alters their economic interests in the partnership.

98. *See supra* note 50, and accompanying text.

some partners may prefer to avoid the economic effect regime and allocate in accordance with their interests in the partnership.

The second part of the test for substantial economic effect requires allocations to be substantial.<sup>99</sup> The test for substantiality is designed to prevent abusive tax-item allocations, such as those that may improve the after-tax economic consequences of one partner but not diminish another partners' after-tax situations.<sup>100</sup> The test appears to require a comparison of the after-tax economic results of allocations that have economic effect to the after-tax economic results of allocations made in accordance with the partners' interests in the partnership.<sup>101</sup> Consequently, to test the validity of allocations in the partnership agreement that have economic effect, the partners must know the partners' interests in the partnership. If an allocation lacks substantiality, tax law reallocates tax items in accordance with the partners' interests in the partnership.<sup>102</sup>

In addition to the significant shortcomings of tax law's definition of partners' interests in a partnership,<sup>103</sup> using the concept as a baseline for the substantiality test is problematic. An allocation that has economic effect is part of the partnership agreement and helps establish the partners' economic interests in the partnership, supplanting the state default rules.<sup>104</sup> For example, Sam's and Claire's allocations of depreciation deductions helped establish their economic interests in the partnership.<sup>105</sup> The test for substantiality appears to require them to consider allocations that would occur if the depreciation deduction allocations were not in the partnership agreement. That appears simple enough because the state default rules apply, but for that allocation provision. The test for substantiality therefore appears to require a comparison of the consequences under the state default rules to the consequence with the depreciation deduction allocation. That interpretation of the rule is, however, problematic. The state default rules do not apply because the partners have supplanted them with the section 704(b) capital accounts. The default rules do not affect the partners' interests in the partnership. Thus, state law defers to the partnership agreement, which includes the allocation provision. Thus, the test would

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99. See Treas. Reg. § 1.704-1(b)(2)(i) (as amended in 2008).

100. See Treas. Reg. § 1.704-1(b)(2)(iii)(a) (as amended in 2008). For example, an allocation of a depreciation deduction from one partner (who has no taxable income outside the partnership) to a partner (who has significant taxable income outside the partnership) may benefit one partner with but not diminish the economic situation of the other partner. See Treas. Reg. § 1.704-1(b)(5), *Example 5* (as amended in 2008).

101. See Treas. Reg. § 1.704-1(b)(2)(iii) (as amended in 2008).

102. See Treas. Reg. § 1.704-1(b)(1)(i) (as amended in 2008).

103. See *infra* Part III.

104. See *supra* text accompanying note 91–98.

105. See *id.*

appear to compare the consequences of identical allocations, making the test for substantiality illusory.

To review, if the partnership agreement is silent about tax-item allocations, tax law allocates those items in accordance with the partners' interests in the partnership. If the partnership agreement includes tax-item allocations that have economic effect, tax law tests the validity of those allocations by comparing them to allocations made in accordance with partners' interests in the partnership. Because tax-item allocations can affect the partner's economic interests in the partnership, that test may be circular and illusory. Third, if tax-item allocations do not have substantial economic effect, tax law reallocates the tax items in accordance with the partners' interests in the partnership. Fourth, tax-item allocations that do not have substantial economic effect will be valid, if they are made in accordance with the partners' interests in the partnership. Despite the universal importance of tax-item allocations and the integral role the concept of partners' interests in a partnership plays in tax-item allocations, tax law does not provide a sufficiently lucid definition of the concept. The following section illustrates the concept's deficiencies.

### III. PARTNERS' INTERESTS IN A PARTNERSHIP

The Internal Revenue Code does not define partners' interests in a partnership. The regulations contain a short description of the concept, which raises more questions than it answers.<sup>106</sup> The description raises the question of whether the concept refers to partners' economic interests in the partnership, the partners' interests in specific economic items of the partnership, or to some other interest. The description also raises many other, more specific, questions. The regulations provide that the partners' interests in a partnership "signify the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated."<sup>107</sup> That sentence appears to indicate that to determine the partners' interest in the partnership, the partners should look to the economic items of the partnership that correspond to the tax items. The next sentence states that the arrangement to share specific economic items may not correspond with the overall economic arrangement of the partners.<sup>108</sup> Taken together, those two sentences appear to imply that the

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106. See Treas. Reg. §1.704-1(b)(3) (as amended in 2008).

107. See Treas. Reg. § 1.704-1(b)(3)(i) (as amended in 2008). The language of the provision appears to be tax centric, i.e., it appears to suggest that the economic benefit or burden follows the tax item that is allocated. Because the question is the proper allocation of the tax item, the tax item should follow the corresponding economic item. That concept would be more clearly expressed if the sentence finished, "credit (or item thereof), that must be allocated."

108. See *id.*

term “partners’ interests in a partnership” refers to an item-specific concept, and is not the same as the partners’ economic interests in the partnership.

The regulations use an example to illustrate that the sharing of economic benefits and burdens may not correspond to the partners’ overall economic arrangement. The example provides that a partner may have a 50% overall interest in the partnership but have a 90% interest in a particular item.<sup>109</sup> That example contrasts overall interests and item-specific interests. The example is, however, very narrow and does not appear to support item-specific determinations generally.<sup>110</sup> Nonetheless, the reference to specific items indicates that the regulations do not refer to partners’ economic interests in the partnership (i.e., interests in the partnership’s residual assets). The concept in the regulations thus appears to be something other than the partners’ economic interests in the partnership and to refer to something other than interests in specific economic items. This Article demonstrates, however, that a unitary concept is not workable.

The regulations provide further that the determination of the partners’ interests in the partnership “shall be made by taking into account all of the facts and circumstances relating to the economic arrangement of the partners.”<sup>111</sup> This is further evidence that the rules contemplate universal interests in the partnership. Finally, the regulations list four factors that should help define the partners’ interests in a partnership: (1) the partners’ relative contributions to the partnership; (2) the partners’ interests in the partnership’s economic profits and losses (if different than that in taxable income or loss); (3) the partners’ interests in cash flow and other non-liquidating distributions; and (4) the partners’ rights to distributions of capital upon liquidation.<sup>112</sup>

The non-technical language in those factors and their significant overlap indicates Treasury intended to create a universal concept of partners’ interests in a partnership. The fourth factor is similar to the partners’ economic interest in the partnership, indicating that tax law does not adopt partners’ economic interests in the partnership as the general test. Instead, it merely becomes part of the larger tax concept of partners’ interests in a partnership. The following discussion illustrates, however, that the four factors do not reveal the true nature of the concept of partners’ interests in a partnership. In particular, the factors adopt ambiguous terms

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109. *See id.*

110. Based upon the parenthetical in that provision, the regulations appear to refer to a qualified income offset as defined in Treas. Reg. § 1.704-1(b)(2)(ii)(d) (as amended in 2008).

111. *See* Treas. Reg. § 1.704-1(b)(3)(i) (as amended in 2008).

112. *See* Treas. Reg. § 1.704-1(b)(3)(ii) (as amended in 2008).

to overlap significantly, suffer from a lack of sufficient information and are difficult to apply.

#### A. Factor Ambiguity and Overlap

Treasury's decision to populate the four factors with non-technical terminology makes the factors ambiguous. The regulations also fail to weight the several factors. The several factors may each return a unique result. In such a situation, the rules do not provide a method for resolving the differences results reached among the several factors and for making a determination with respect to specific tax items. Finally, perhaps because of the non-technical language in the regulations, the factors appear to overlap significantly. A closer examination illuminates the factors' shortcomings.

*Partners' Relative Contributions.* The first factor is the partners' relative contributions to the partnership. Tax law uses the term "contribution" in numerous contexts, to mean a transfer of something by a partner to a partnership.<sup>113</sup> Tax law recognizes that partners can contribute both property (including cash) and services.<sup>114</sup> This factor does not specify whether it refers to contributions of both property and services. If it refers to contributions of services, it provides no guidance respecting the method for determining the amounts of contributed services. The parties can generally determine the relative amount of contributed property, but they will have significant difficulty determining the relative amount of the contributed services.

Contributed services could have two possible values: (1) the market value, as expressed by the opportunity cost of the services or (2) the extent to which the services contribute to the partnership's success. The services may have an identifiable market value, but, as part of the partnership, the services represent a source of income. The parties probably cannot determine the extent to which the various services contribute to the income. The regulations do not indicate whether the first factor comprehends services, nor does it specify how to value contributed services. As this discussion indicates, if the first factor includes contributed services, it will be almost impossible to apply.

If opportunity cost is not the best measure of the service's value, the partners may consider the extent to which contributed services benefit the partnership. The inability to establish the extent to which services benefit the partnership is one of the difficulties partnerships present, and it is the

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113. See, e.g., I.R.C. §§ 721(a), 722, 724, 752(a) (2006).

114. See Treas. Reg. § 1.721-1(b) (as amended in 1996).

fundamental justification for partnership taxation.<sup>115</sup> Many resources contribute to a partnership's economic performance. Even simple partnerships often derive benefits from contributed property and services. In most situations the partners cannot determine the extent to which the property and the partners' services generate the partnership output.<sup>116</sup> Thus, they cannot determine the extent to which the services benefit the partnership. That is one reason valuing contributed services is difficult.

Some commentators may suggest economic-item allocations indicate the value of contributed services. To consider the value the parties place on contributed services, the partners need a baseline with which they can compare economic-item allocations. If the partners do not specially provide for allocations, state law will allocate the economic items equally to the partners. If the partners agree to some other allocation ratio, the question is whether the parties moved away from an equal allocation, moved from some other allocation, or moved at all. If the parties moved away from an equal allocation, then the services would appear to be worth the difference between the equal allocation and the actual allocation. That conclusion is, however, problematic on two counts. First, the state default rules do not necessarily represent the allocation formula the partners would have adopted absent service contributions. Perhaps the partners would have adopted an allocation ratio that tracked the value of contributed property. If such a ratio would have been something other than an equal allocation, the comparison should be between that other ratio and the ratio of the actual allocation. Knowing whether the ratio would have been something other than the actual allocation may be impossible.

Second, an allocation for services may reflect more than the partners' understanding of the value of the services. The allocation could represent the partners' understanding of the extent to which the services will contribute to the partnership's success. For example, the partners may believe that the services increase the partnership's operating income by a certain amount and decide to allocate extra income to the service provider in recognition of that effect. The allocation could, however, represent an economic incentive provided by one partner to another to improve the partnership's overall performance, and may not reflect the value of the services or their effect on partnership performance.<sup>117</sup> The non-service-providing partner may allocate more of specific economic items to the service-providing partner to motivate the service-providing partner to exert

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115. See *Campbell v. Comm'r*, 943 F.2d 815, 823 (8th Cir. 1991) (holding that the value of a profits-only partnership interest received in exchange for services is too speculative to include in gross income); Bradley T. Borden, *Profits-Only Partnership Interests*, 74 BROOK. L. REV. \_\_\_\_ (forthcoming 2009) (describing the economic theory for partnership taxation, its application to profits-only interests received in exchange for services, and the difficulty determining the value of contributed services).

116. See Borden, *supra* note 115.

117. See Borden, *supra* note 81 at 754–59.

extra effort. Extra effort by the service-providing partner may increase the partnership's overall performance and consequently increase the total economic items allocated to the non-service-providing partner.<sup>118</sup>

The first factor leaves open the possibility that partner contributions include contributions of services. Partners will have significant difficulty determining the value of contributed services. That difficulty will often prevent them from determining their relative contributions, suggesting that the first factor should not include contributed services. Unfortunately, the factor's ambiguity does not settle that issue.

*Partners' Interests in Economic Profits and Losses.* The second factor is the partners' interests in the partnership's economic profits and losses (if different from their interests in the partnership's taxable income or loss). "Profit" is not a technical tax term, so it does not have a clear definition for tax purposes. In fact, the term profit can have various and broad definitions and lacks technical significance in various other contexts.<sup>119</sup> Several disciplines use the term profit, but none of them appear to have an established definition. Accounting uses the term sparingly, in a general sense, but does not give it technical significance or define it specifically.<sup>120</sup> Economists also use the term, but they have long debated the definition of profit.<sup>121</sup> Finally, state law uses the term to help establish the partners' economic rights to partnership resources.<sup>122</sup> State law does not, however, provide a universal definition of profits as used in that context.<sup>123</sup> Thus, there is no single place to turn for a definition of profits and losses.

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118. See *id.* (describing the possible effect of allocations on the amount of total partnership output).

119. See Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, ¶ 16, n. 9 (1985) ("Profit is used in this and the following paragraphs in a broad descriptive sense to refer to an enterprise's successful performance during a period. It is not intended to have a technical accounting meaning or to imply resolution of classification and display matters that are beyond the scope of this Statement, and no specific relation between *profit* and either *comprehensive income* or *earnings* . . . is implied. *Loss* as in *profit or loss* (in contrast to *gain or loss*) is also used in a broad descriptive sense to refer to negative profit or unsuccessful performance and is not intended to have a technical accounting meaning.") (emphasis in original); NEEDLES, FINANCIAL ACCOUNTING 113 (4th ed. 1992) ("Profit has many meanings. One definition is the increase in owners' equity resulting from business operations. However, even this definition can be interpreted differently by economists, lawyers, business people, and the public. Because the word *profit* has more than one meaning, accountants prefer to use the term *net income*, which has a precise definition from an accounting point of view.") (emphasis in original); Borden, *The Federal Definition of Tax Partnership*, 43 HOUS. L. REV. 925, 972 (2006) (discussing the accounting, balance sheet, and dictionary definitions of profit).

120. See *Elements of Financial Statements*, *supra* note 119.

121. See FRANK H. KNIGHT, RISK, UNCERTAINTY AND PROFIT, 19–38 (Dodo Press 2009) (presenting various interpretations of profit).

122. See UNIF. P'SHIP ACT § 401(a)(1) (amended 1997), 6 U.L.A. 133 (2001).

123. See BROMBERG & RIBSTEIN, § 2.07(b)(4).

For the sake of discussion, assume the terms “profits” and “losses” refer to the difference between revenue and expenses. That raises the question of whether the terms refer only to profits and losses from operations or also to profits and losses from property transactions. If the factor only concerns profits from operations, then the partners’ interests in operating profit would represent the second factor. If partnership profits also include gains and losses from partnership property, then the second factor would be some amalgam of the partners’ interests in the operating profits and the partners’ interests in the gain and loss from the sale of property.<sup>124</sup> State law appears to include gains and losses from sales of partnership assets in its definition of profits.<sup>125</sup> The regulations do not, however, indicate that state law definition applies to the factor. Thus, state law may not be an appropriate reference for this factor. This illustrates one shortcoming of the second factor.

Part of the confusion regarding the appropriate interpretation of this factor is a lack of general guidance regarding its specific purpose. It is one of several factors that help determine the partners’ interests in the partnership. As such, Treasury may not have intended for it to return a specific value. Instead, Treasury may have intended that the several factors considered together should determine the partners’ interests in the partnership. To be valuable as part of a general structure, the factors should return a specific value. Other factors appear to include the appreciation of property, so perhaps profits and losses should not include such amounts. If that is the correct interpretation, the second factor only considers the partners’ interests in the partnership’s operating profits and losses. The lack of clarity and potential interpretations make this factor difficult to apply.

*Partners’ Interests in Cash Flow and Non-Liquidating Distributions.* The third factor is the partners’ interests in cash flow and other non-liquidating distributions. Once again, the regulations fail to define the key terms—“cash flow or other non-liquidating distribution”. The regulations appear to present cash flow a concept that is different from non-liquidating

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124. For example, the net of income and change in value of the property is \$30,000 in Year 1. The partnership allocates \$55,000 of income to Claire and \$24,500 of decrease in property to her. Her net allocation is \$30,500, which is more than 100% of the profit, if it includes changes in the value of the property. Sam’s net would be the \$45,000 share of income and \$45,500 of decrease in value. Thus, Sam would have a net loss of \$500. Her interest in the net amount would be less than 0%.

125. See UNIF. P’SHIP ACT. § 807(b) (requiring the partnership to credit partners’ accounts with their shares of partnership profit from the sale of partnership assets upon liquidation).

distributions. Apparently the reference to cash flow is to the partnership's cash flow, not the partners'.<sup>126</sup>

State law or the partnership agreement, would establish the partners' interests in the partnership cash flow. State law provides generally that property acquired by the partnership is the partnership's property and not the property of partners individually.<sup>127</sup> Thus, the question to consider is what interests the partners have in the partnership cash flow. The partnership's cash flow would appear to include cash receipts and cash payments, a common definition of cash flow.<sup>128</sup> If the partnership uses the cash method of accounting, its profits might be similar to its cash flow.<sup>129</sup> Therefore, in the example above, the partnership's cash flow would probably equal \$100,000 in Year 1. State law provides that partnerships credit partners' accounts with their shares of partnership profit.<sup>130</sup> Partners have rights to profits credited to their accounts. They may not be able to access those funds through a distribution prior to liquidation,<sup>131</sup> but they could sell their rights to the funds by selling their economic interests in the partnership.<sup>132</sup> Thus, they would appear to have economic access to the profits credited to their accounts. The partners' rights to cash flow could refer to their economic interests in cash flow as represented by the partnership crediting profits to their accounts. If that interpretation is correct, this factor appears to overlap the second factor.

Non-liquidating distributions would appear to include any distribution to a partner that the partnership makes other than in liquidation.<sup>133</sup> State

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126. The language in the regulations does not specifically provide that cash flow refers to partnership cash flow, but flows of cash and property between partners and the partnership generally take either the contribution or distribution label.

127. See UNIF. P'SHIP ACT §203 (amended 1997), 6 U.L.A. 96 (2001).

128. See Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, ¶¶ 52-54 (describing the statement of cash flows as representing cash receipts and cash payments).

129. See DONALD E. KIESO & JERRY J. WEYGANDT, *INTERMEDIATE ACCOUNTING*, 94 (7th ed.) ("Under the strict cash basis of accounting, revenue is recorded only when the cash is received and expenses are recorded only when cash is paid."). Items such as depreciation would, however, distinguish cash flow from taxable income of a strict cash method taxpayer. See *id.* at 213 (showing adjustments to statements of cash flows to account for the depreciation deduction).

130. See UNIF. P'SHIP ACT § 401(a)(1), 6 U.L.A. 133.

131. See UNIF. P'SHIP ACT § 501, comment, 6 U.L.A. 155 ("[A] partner who misappropriates partnership property is guilty of embezzlement . . .").

132. See UNIF. P'SHIP ACT § 501, 6 U.L.A. 156 ("The only transferable interest of a partner in the partnership is the partner's share of the profits and losses of the partnership and the partner's right to receive distributions.").

133. The regulations do not define non-liquidating distributions, but they distinguish this factor from the fourth factor (rights to distributions of capital upon liquidation. See Treas. Reg. § 1.704-1(b)(3)(ii)(d) (as amended in 2008)). Treasury therefore appears to limit non-liquidating distributions to distributions made other than in liquidation of the partnership. Another distinguishing interpretation would treat any distributions of cash flow as non-liquidating distributions. Unfortunately, the regulations provide no further guidance about the use of the term in this context. Thus, this Article

law is silent regarding non-liquidating distributions.<sup>134</sup> Consequently, partners may withdraw property from the partnership, only if the partnership agreement allows withdrawals.<sup>135</sup> Because state law does not grant individual partners power to unilaterally withdraw partnership property, partners may not be able to access partnership cash flow through distributions. Perhaps this factor distinguishes between cash flow, which may include all of the partnership's cash flow, and non-liquidating distributions, which may include only amounts of cash flow the partnership distributes to the partners, other than liquidation.

Perhaps, however, the regulations treat cash flow as being equivalent to non-liquidating distributions. Some partnerships may maintain "drawing accounts" that reflect the partners' rights to withdraw cash flow from the partnership under the partnership agreement.<sup>136</sup> Any portion of cash not represented in a drawing account should go to the partners' accounts.<sup>137</sup> Unless the amount credited to the drawing accounts alters the portion of cash flow to which each partner would otherwise be entitled to upon liquidation, the drawing accounts would only alter the timing of the distributions. For example, if the partnership credits \$25,000 each to Sam's and Claire's drawing accounts in Year 1, it should credit \$25,000 to each partner's account. As a result, each partner would have economic interest in \$50,000 of the partnership's cash flow, \$25,000 of which they can access immediately out of their drawing accounts. They would receive the remaining \$25,000 in their accounts only if they agreed to distribute it, or the partnership liquidated. Thus, non-liquidating distributions and interests in cash could be synonymous. The regulations leave such matters unresolved.

*Partners' Rights to Capital upon Liquidation.* The fourth factor is the partners' rights to distributions of capital upon liquidation. After examining the first three factors, it is no surprise that the regulations do not define partnership capital. Capital could include any assets in the partnership that are available for distribution upon liquidation. If that is the correct interpretation, capital would include partnership cash flow, and the third and fourth factor would overlap. If the factors are exclusive, partnership capital should not include items included in other factors. Unfortunately, the regulations do not indicate whether the factors are

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assumes, for the sake of analysis, that "non-liquidating distributions" refers to distributions made other than in liquidation of the partnership.

134. See BROMBERG & RIBSTEIN, *supra* note 52 at ¶6.02(b)(2); UNIF. P'SHIP ACT §807(b), 6 U.L.A. 206 (governing liquidating distributions).

135. *See id.*

136. *See id.*

137. *See id.*

exclusive, and capital does not have a technical definition in tax law or across the disciplines. Thus, multiple interpretations are possible.

Accountants use the term capital to refer to the equity portion of a balance sheet.<sup>138</sup> Used in that manner, capital includes both the partners' contributions and the partnership's retained earnings. In fact, accounting may divide capital into two categories: (1) paid-in-capital and (2) earned capital.<sup>139</sup> The fourth factor could refer to the non-debt portion on the right-hand side of the partnership's balance sheet, i.e., the partners' equity. If that were the case, partnership capital would include partner contributions, undistributed partnership cash flow, and increases in the value of partnership property. That interpretation would include items from each of the other three factors. Such an interpretation would appear to make the first three factors superfluous, as the fourth factor subsumes them all. Thus, such a broad interpretation does not appear accurate.

The broad interpretation appears, however, to be consistent with the state-law liquidation rules. State law provides that the "partnership shall make a distribution to a partner in an amount equal to any excess of the credits over the charges in the partner's account."<sup>140</sup> Total credits to a partner's account equal the partner's contributions plus the partner's share of profits, and charges equal distributions to the partner and the partner's share of losses.<sup>141</sup> Upon liquidation, the partnership would sell its assets and allocate profit or loss from the sale of those assets to the partners.<sup>142</sup> The partners' right to distributions of capital upon liquidation would therefore equal their contributions plus, their shares of profits and losses, plus their shares of increase or decrease in the value of the partnership property.<sup>143</sup>

The multiple possible interpretations of the fourth factor make it difficult to apply. If partnership capital is broad enough to include all the property available for distribution on liquidation, the fourth factor appears to refer to the partnership's residual value. If that is the case, the fourth factor merely considers the partners' economic interests in the partnership. Because such a broad interpretation subsumes all of the other factors, the test for partners' interests in the partnership would merely test for the partners' economic interests in the partnership. To apply such a test, the partners would have to know the value of all of the assets.

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138. See KIESO & WEYGANT, *supra* note 129 at 753.

139. See *id.*

140. See UNIF. P'SHIP ACT § 807(b) (amended 1997), 6 U.L.A. 206 (2001).

141. See UNIF. P'SHIP ACT § 401(a), 6 U.L.A. 133.

142. See UNIF. P'SHIP ACT § 807(b), 6 U.L.A. 206.

143. See UNIF. P'SHIP ACT § 401(b), 6 U.L.A. 133.

## B. Asset Valuation

The examples above used perfect information about the value of partnership assets to illustrate the concept of partners' economic interests in a partnership.<sup>144</sup> Generally, such information is unavailable or difficult to obtain. Consequently, tax law relies upon historical cost to determine such matters as partners' rights to capital upon liquidation. For example, if an allocated tax item lacks economic effect, the regulations use the historic cost to re-allocate the item in accordance with the partners' interests in the partnership.<sup>145</sup> For the purpose of reallocating such an item, the regulations require two hypothetical liquidations of the partnership, pursuant to which the partnership sells all of its assets at book value and distributes the proceeds.<sup>146</sup> The regulations determine the partners' interests in the partnership by comparing the results of the two hypothetical liquidations and allocating the tax item accordingly.<sup>147</sup> Thus, for the purpose of reallocating some tax items, the regulations use historical cost to determine the partners' interests in the partnership. The use of historical value instead of market value will often affect the determination of the partners' interests in a partnership.

Recall from above that if Samaire Partnership is subject to the state default rules, Sam's economic interests in the partnership at the end of Year 1 will be 79% and Claire's will be 21%.<sup>148</sup> That example used the actual value of the partnership assets to determine the partners' interest. If the example relied upon historical cost, at the end of Year 1, the book value of the partnership assets would be \$1,100,000.<sup>149</sup> Sam's share of that amount would be \$850,000 or 77%.<sup>150</sup> Claire's share would be \$250,000 or 23%. Thus, the partners' interests in the partnership could vary depending upon the value used to compute those interests.

This example illustrates that the use of historical cost of partnership property to determine partners' interests in a partnership, produces a result that differs from the partners' economic interests in the partnership. The difference in results can be material. If the tax item in question was the \$20,000 depreciation deduction, the amount allocated to Sam using perfect

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144. See *supra* text accompanying notes Part II.B.

145. See Treas. Reg. § 1.704-1(b)(3)(iii) (as amended in 2008).

146. See *id.*

147. See *id.*

148. See *supra* text accompanying note 54.

149. To simplify the illustration, this example disregards the depreciation deduction, which tax law would normally take into account in determining the book value of partnership assets. See Treas. Reg. § 1.704-3(b)(2), *Example 1*(ii) (as amended in 2005) (illustrating the reduction in book value for depreciation to illustrate allocations made with respect to property with built-in gain).

150. Sam's share would be her \$800,000 contribution plus her 50% share of the partnership's profit for Year 1. As a percentage of total book value, it would be 77% (\$850,000/\$1,100,000).

information would be \$15,800.<sup>151</sup> If the partners use the historical cost, the allocation to Sam would be \$15,400.<sup>152</sup> The allocation based on historical cost is roughly 2.5% less than the allocation based on market value.<sup>153</sup> If the book value and market value diverge over time, the difference would increase. Thus, the lack of perfect information can significantly affect the amount determined to be the partners' interests in the partnership.

The lack of perfect information and the inability to accurately value partnership assets frustrates attempts to adopt a universal concept of partners' interests in a partnership. Such frustrated efforts coupled with the factor ambiguity make the current partnership allocation rules largely unworkable. The following discussion attempts to apply the rules to simple hypothetical partnerships. The futility of such efforts, further illustrates the concept's deficiencies.

### C. Application Difficulties

Partners can employ different levels of sophistication to create partnerships and partnership agreements. Even in basic arrangements, determining the partners' interests in the partnership using the four factors can be difficult. In particular, any attempt to apply a universal concept of partners' interest in a partnership will often prove futile. The examples also demonstrate that the law's shortcomings provide taxpayers the opportunity to allocate tax items to reduce their tax burden.

#### 1. Partnership with Minimalist Partnership Agreement

Assume Sam and Claire trust each other and therefore fear using a formal agreement because an agreement may imply a lack of trust. Or, they may not realize the importance and relevance of having a partnership agreement. Whatever the reason, assume Sam and Claire fail to agree how they will allocate their economic and tax items. In addition to contributing the cash indicated above,<sup>154</sup> Sam agrees that she will maintain the partnership's office building, and Claire agrees to manage it.<sup>155</sup> They each withdraw money from the partnership as needed. Sam withdraws \$25,000 in Year 1, \$33,000 in Year 2, and \$20,000 in Year 3. Claire withdraws

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151. The allocation derives from multiplying the \$20,000 depreciation deduction by Sam's 79% interest based on actual value.

152. That allocation derives from multiplying the \$20,000 depreciation deduction by Sam's 77% interest based on historic cost.

153. The percentage difference is the \$400 difference divided by \$15,800.

154. See *supra* text accompanying note 16.

155. Property maintenance refers to painting, infrastructural repairs, and capital improvements. Property management refers to negotiating lease terms, handling tenant concerns, arranging garbage disposal, and cleaning.

\$30,000 in Year 1, \$27,000 in Year 2, and \$32,000 in Year 3. At the end of Year 1, Sam and Claire must prepare a partnership tax return and allocate the tax items to each other. Because the partnership agreement does not allocate tax items, they must allocate the tax items in accordance with their interests in the partnership.<sup>156</sup> They turn to the factors in the regulations to determine their interests in the partnership.

*Partners' Relative Contributions.* Sam and Claire must decide what to include as contributions to determine their relative contributions. Sam contributed \$800,000, and Claire contributed \$200,000. If that is all the factor includes, Sam contributed 80% and Claire contributed 20% of the total contributions. If the factor also includes services, the task of determining relative contributions is more difficult. The parties cannot determine the extent to which the separate services and property contributed to the partnership's operating profit and the property's fluctuation in value.<sup>157</sup> Because Sam and Claire cannot determine the extent to which the various resources contribute to the partnership's profit and the property's change in value, they will arguably have difficulty determining their relative contributions. Focusing solely on the value of the contributed property will neglect the contributed services. Merely relying upon the market value of the services may fail to accurately reflect the extent to which the services contribute to the partnership's economic performance.<sup>158</sup> Consequently, the partners cannot definitively identify their relative contributions. If they neglect the contribution of services, the relative contributions appear to be 80% by Sam and 20% by Claire.

*Partners' Interests in Economic Profits and Losses.* Because Sam and Claire do not provide for the allocation of profits and losses in their partnership agreement, state law will allocate those items. Under state law "each partner is entitled to an equal share of the partnership profits and is chargeable with a share of the partnership losses in proportion to the partner's share of the profits."<sup>159</sup> Because Sam and Claire do not provide otherwise in a partnership agreement, they will share equally in the partnership's economic profits and losses, assuming the arrangement is a partnership or limited liability company. If the arrangement had been a limited partnership, however, state law would allocate the items differently.<sup>160</sup> Because state law allocates profits and losses equally to Sam

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156. See I.R.C. §704(b) (2006); *supra* text accompanying notes 86.

157. See *supra* text accompanying notes 114–118.

158. See *id.*

159. See UNIF. P'SHIP ACT. § 401(b) (amended 1997), 6 U.L.A. 133 (2001).

160. See UNIF. LTD. P'SHIP ACT § 503 (2001), 6A U.L.A. 444; *supra* text accompanying notes 61–67.

and Claire, the result in this factor appears to differ from the result in the first factor. The partners each appear to have a 50% interest in the partnership's economic profits and losses.

*Partners' Interests in Cash Flow and Non-Liquidating Distributions.* Sam and Claire's partnership agreement does not appear to be completely silent regarding the third factor. Sam and Claire allow each other to withdraw funds from the partnership as needed. The amount each withdraws varied from year to year. Assume the partnership did not agree to compensate the partners for their services, so the withdrawals would have been partnership distributions.<sup>161</sup> The partners did not, however, specify the partners' specific interests in the cash flow or non-liquidating distributions, and the regulations do not specify how the partners should determine their interests in the partnership cash flow.<sup>162</sup> Thus, the partners are left to speculate what the regulations mean with respect to this issue.

Consider three different alternatives for determining the partners' interests in cash flow. First, the partners could consider their interests in cash flow as a percent of total distributions each of the three years. Sam's withdrawals as a percent of total distributions varied from about 38% to 55% of the total annual distributions over the three-year period, and Claire's varied from about 45% to 62%.<sup>163</sup> Second, the partners could consider their interest in cash flow by comparing their distributions to total partnership cash flow. The partnership's cash flow over the three-year period (accumulated profit, in Table 2) was \$310,000. Sam's yearly distribution as percentage of total partnership cash flow ranged from approximately 19% to 31%, and Claire's ranged from approximately 25% to 31%.<sup>164</sup>

Third, the partners could determine their interests in partnership cash flow by considering the portion in which they have an economic interest. The partners' economic interests should equal the amount of cash flow they would receive upon liquidation of the partnership, minus any non-liquidating distributions the partners received. If cash flow is the same as profits, the partners should receive an equal share of cash flow as a total of non-liquidating and liquidating distributions. If this is the correct

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161. See UNIF. P'SHIP ACT § 401(h), 6 U.L.A. 133.

162. See *supra* text accompanying notes 126–135.

163. Sam received the following proportions of total non-liquidating distributions in each year: Year 1 \$25,000/\$55,000 = 45%; Year 2 \$33,000/\$60,000 = 55%; and Year 3 \$20,000/\$52,000 = 38%. Claire received the following proportions of total non-liquidating distribution in each year: Year 1 \$30,000/\$55,000 = 55%; Year 2 \$27,000/\$60,000 = 45%; and Year 3 \$32,000/\$52,000 = 38%.

164. Sam received the following proportions of total partnership cash each year: Year 1 \$25,000/\$100,000 = 25%; Year 2 \$33,000/\$106,000 = 31%; and Year 3 \$20,000/\$104,000 = 19%. Claire received the following proportions of total cash flow each year: Year 1 \$30,000/\$100,000 = 30%; Year 2 \$27,000/\$106,000 = 25%; and Year 3 \$33,000/\$104,000 = 31%.

interpretation, the partners' interests in cash flow and non-liquidating distributions would appear to be equal. Thus, each of the three methods returns a different result.

With no specific guidance, the partners are left to decide which of the various alternatives they will use to determine the partners' interests in cash flow and other non-liquidating distributions. The conjunctive expression ("cash flow and other non-liquidating distributions") of this factor indicates that the second alternative might be appropriate because it considers their non-liquidating distributions in light of total cash flow. The first alternative does not consider total cash flow, focusing solely on non-liquidating distributions. The third alternative merely considers the partners' interests in the partnership's cash flow. If, however, non-liquidating distributions are merely a subset of cash flow, the third alternative would be appropriate. None of those possible interpretations appear unreasonable. With no specific guidance, the partners appear to have some leeway in stating values for this factor.

*Partners' Rights to Capital upon Liquidation.* To accurately apply the fourth factor at any time other than liquidation, the partners would need perfect information about the value of partnership assets, which likely would be unavailable.<sup>165</sup> Because this factor incorporates the other factors, the result obtained in this factor may vary from the results found in the other factors. For example, state law determines the balance of the partners' accounts, which are a function of contributions, allocations of profit and losses, and distributions.<sup>166</sup> If those items are not all made in the same proportion, the rights upon distribution cannot be in the same proportion as all other factors.<sup>167</sup> For instance, if Sam contributed 80% of partnership capital and the partnership allocates 50% of the profits to her, she would not have a right to either 80% or 50% of the partnership capital upon liquidation.<sup>168</sup> Her rights to capital would be somewhere between those amounts. Furthermore, the partners' rights to capital distributions vary from year to year, depending upon the allocation of economic items.<sup>169</sup> Upon forming the partnership as a state law general partnership, Sam's and Claire's rights to capital would equal their contributions. Assuming distributions are equal over time, their rights to capital would move toward 50%, but never reach it.<sup>170</sup>

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165. See *supra* text accompanying notes 144–153.

166. See UNIF. P'SHIP ACT § 401(a) (amended 1997), 6 U.L.A. 133 (2001); *supra* Part II.B.

167. See *supra* text accompanying notes 68–77.

168. This assumes the partnership has not previously distributed all of the profits.

169. See *supra* Part II.B. (discussing the rules that determine the partners' rights to distributions).

170. See *supra* text accompanying notes 58, 77. This assumes the partnership retains a material amount of profits.

Table 4 summarizes the findings for each of the four factors used to determine partners' interests in a partnership. The table reveals that the four factors do not conclusively establish the partners' interests in the partnership. Based upon the four factors, Sam's interest appears to vary from 25% to 80% and Claire's from 20% to 62%.

TABLE 4  
FACTORS SUMMARY:  
PARTNERSHIP WITH MINIMALIST PARTNERSHIP AGREEMENT

<b>Factor</b>	<b>Sam</b>	<b>Claire</b>
<b>Relative Contributions</b>	\$800,000 and maintenance services	\$200,000 and management services
<b>Interests in Profits and Losses</b>	50%	50%
<b>Interests in Cash Flow</b>	50% or 25-55%	50% or 29-62%
<b>Rights to Capital upon Liquidation</b>	50-80%	20-50%

At the end of Year 1, Sam and Claire must report the \$100,000 of partnership tax income and \$20,000 depreciation deduction.<sup>171</sup> Because Sam and Claire's partnership agreement does not include partner-directed tax-item allocations, they must allocate the tax items in accordance with their interests in the partnership.<sup>172</sup> They can begin the tax-item allocations by considering the corresponding tax item (the \$100,000 of tax income) because it should be easier than the independent tax item to allocate. Tax income appears to correspond with the partnership profit. Under state law, the partners have an equal interest in the profit. They therefore may consider allocating tax income equally, in accordance with their interests in the profit.

Suppose, however, that Sam and Claire decide that they prefer something other than an equal allocation of tax income. They may prefer to allocate less tax income to Sam because she withdrew less from the partnership. Consequently, they may consider allocating the tax income 45% to Sam and 55% to Claire to reflect their understanding of their interests in cash distributions for the year.<sup>173</sup> Those percentages are close to the equal allocations that represent the parties' interests in the profits of the partnership. Perhaps the IRS would not question whether the 45% -

171. See I.R.C. §702(a) (2006).

172. See I.R.C. §704(b) (2006).

173. The total distributions in Year 1 were \$55,000, and Sam received \$25,000 or roughly 45% of the total distributions and Claire received \$30,000 or roughly 55%. See *supra* note 163

55% allocations are in accordance with the partners' interests in the partnership.

Sam and Claire may, however, decide to allocate the tax income 80% to Sam and 20% to Claire. That allocation is similar to their relative contributions. That allocation is consistent with one of the factors, and represents an action (contributing property) that the parties took. Their interests' in profits is the same default rule. The application of the default rule may be evidence that they did not consider profit allocations, so they may argue that less emphasis should be on that factor. They may argue that the law should focus on the factor that reflects their actions. Apparently, Sam and Claire have some flexibility in allocating the corresponding tax item.

Realizing that they have significant leeway in allocating the corresponding tax item, Sam and Claire may anticipate they will have at least as much freedom in allocating the depreciation deduction (an independent tax item). Sam and Claire begin to discuss the tax consequences of various allocations. They contemplate allocations of the depreciation deductions that cover the full range of values in Table 4. They consider the low end of that range 25% for Sam and 20% for Claire. The high end of the range is 80% for Sam and 62% for Claire. With this apparent leeway they consider the economic consequences the allocations will have and begin negotiating for the allocations of the respective items.

The lack of a definitive answer regarding the allocation of tax depreciation is significant. Claire may have an insignificant amount of taxable income outside the partnership, and Sam could have a significant taxable income outside the partnership. Therefore, Claire may agree to allocate 80% of the depreciation to Sam. The allocation appears to provide an economic benefit to Sam without diminishing Claire's economic situation. Thus, it appears it would lack substantiality, if subject to that test.<sup>174</sup> But, if the allocation is in accordance with the partners' interests in the partnership, which it appears to be, it is valid and the test for substantiality is irrelevant.<sup>175</sup> If that is the case, the IRS would have difficulty challenging the allocation, which may motivate Sam and Claire to use the default tax allocation rules instead of the section 704(b) safe harbor.<sup>176</sup>

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174. See Treas. Reg. §1.704-1(b)(2)(iii)(a) (providing that an allocation lacks substantiality if it enhances the after-tax economic consequences of one partner without diminishing the after-tax economic consequences of any partner).

175. See I.R.C. §704(b) (2006).

176. Perhaps the IRS could challenge the allocation under the general partnership anti-abuse rules. See Treas. Reg. § 1.701-2 (as amended in 1995). The IRS does not, however, appear to use that provision to challenge partnership allocations. Under prior law, the IRS may have challenged some allocations as serving a tax avoidance purpose. See *Orrisch v. Comm'r*, 55 T.C. 395, 404 (1970). The IRS may have more difficulty challenging an allocation under current law because partners may be able

This simple example illustrates that the most basic partnerships raise serious questions regarding allocations made in accordance with partners' interests in a partnership. A partnership that chooses to allocate tax items in accordance with partners' interests in the partnership would appear to have considerable flexibility in making the allocations. That freedom appears to provide them the opportunity to enter into tax-item transactions or other tax-minimizing arrangements. The allocation of the tax items would not affect the partners' rights to profits and losses of the partnership, their interests in cash flow, or their rights to distributions of capital on the liquidation of the partnership. State law would govern the allocation of those economic items. State law does not appear to recognize the agreements to allocate tax items if the partners do not tie the economic-item allocations to the tax item allocations. The partners would not be subject to the section 704(b) capital account rules because they did not adopt section 704(b) capital accounts. Thus, even though Sam obtains the economic benefit of a large tax depreciation deduction, the deduction does not affect her right to partnership assets. The deficient tax allocation rules allow Sam and Claire to separate the allocation of economic items and tax items in a simple partnership. The IRS has limited recourse in such situations.

## 2. Partnership with Uniform Economic-Item Allocations

Instead of forming a default partnership, Sam and Claire may decide to allocate economic items in a manner that reflects their relative capital contributions. Therefore, they may agree to allocate all economic items of profit and loss 80% to Sam and 20% to Claire to reflect their understanding of their relative contributions. Because the partnership agreement includes profit and loss allocations, it will determine each partner's interest in the partnership's economic items. In such an arrangement, they do not, however allocate tax items. They must determine their interests in the partnership to allocate the tax items. The factors for determining partners' interests in the partnership should have a greater degree of uniformity, under these modified facts.

*Partners' Relative Contributions.* The partners' relative Contributions do not change with the change of facts. Sam and Claire each contribute the same amount of capital and provide the same services to the partnership. Thus, the result of the first factor should remain the same.

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to successfully argue that the allocations are in accordance with the partners' interests in the partnership, which the statute allows. See I.R.C. §704(b)(2006).

*Partners' Interests in Economic Profits and Losses.* In this scenario, Sam and Claire agree that the partnership will allocate 80% of the profits and losses to Sam and 20% of them to Claire. That appears to reflect their interests in profits and losses.

*Partners' Interests in Cash Flow and Non-Liquidating Distributions.* The new partnership agreement does not help Sam and Claire determine the partners' interests in cash flow, assuming they withdraw the same amounts, during the first three years as they did in the prior example.<sup>177</sup> Their legal rights to partnership property do, however, change. If the term "interests in cash flow" refers to legal rights, then the partners' interests would be the 80%-20% split they have in the profits under their agreement. If interests in cash flow refers to some percentage of cash flow the partnership distributes to the partners, their interests will vary from 25% to 62%, as they did in the example of the default partnership. As with the earlier scenario, the partners' interests in cash flow are not obvious.

*Partners' Rights to Capital upon Liquidation.* The partners' right to capital appears to reflect their capital contributions and profit-sharing agreement. This is not unexpected because partnership capital without cash flow is merely the partners' contributions and changes in the value of the partnership property. Sam and Claire therefore respectively appear to have 80%-20% shares in the rights to capital upon liquidation.

Table 5 summarizes the four factors. The four factors are closer to uniform under this scenario, but still not perfectly uniform. The lack of clarity regarding the third factor may leave some room for manipulation. The non-uniform results obtained in the third factor may provide an opportunity for Sam and Claire to separate the economic-item allocations and tax-item allocations. They may have more difficulty under this scenario convincing a judge that their interests in the partnership were not 80% and 20%, but the four factors do not definitively establish the partners' interests in the partnership. Thus, a window of opportunity for abuse remains open.

TABLE 5  
FACTORS SUMMARY:  
PARTNERSHIP WITH UNIFORM ALLOCATIONS

<b>Factor</b>	<b>Sam</b>	<b>Claire</b>
<b>Relative Contributions</b>	\$800,000 and maintenance services	\$200,000 and management services

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<sup>177.</sup> See *supra* text accompanying notes 155–156.

<b>Factor</b>	<b>Sam</b>	<b>Claire</b>
<b>Interests in Profits and Losses</b>	80%	20%
<b>Interests in Cash Flow</b>	80% or 25-47%	20% or 29-53%
<b>Rights to Capital upon Liquidation</b>	80%	20%

### 3. Partnership with Specially Allocated Economic Items

Determining partners' interests in a partnership becomes even more difficult as the partnership becomes more complicated. Sam and Claire may decide to use specific economic items to encourage particular behavior. For example, to help motivate Claire to provide excellent management services, Sam may agree to allocate a larger portion of the partnership profit (operating revenue minus operating expenses) to Claire. Sam and Claire may also believe that superior maintenance will affect the long-term value of the property.

Claire may therefore agree to allocate a larger portion of the property's increase or decrease in value to Sam. Thus, they may allocate 55% of the profit to Claire (with the balance going to Sam) and 65% of the change in property value to Sam (with the balance going to Claire). Assume the partners make the allocations of those economic items a part of the partnership agreement, but they do not provide for the allocation of tax items. The partners therefore must allocate the tax items in accordance with the partners' interests in the partnership. They turn to the four factors, but once again the four factors provide little guidance.

*Partners' Relative Contributions.* At first blush, partner-directed economic-item allocations do not appear to affect the partners' relative contributions. A tendency may be to use the allocations to determine the value of contributed services. Efforts to impute value to the contributed services based upon the economic-item allocations will likely prove futile. Sam would be willing to grant Claire a greater percentage of the profits, if it will motivate Claire to provide services that increase profits, so long as Sam's economic benefit increases. Assume, for example, that the profit from the partnership would be \$90,000 if Claire shirked under an equal allocation of the profits. Sam's equal share of that profit would be \$45,000. If the disproportionate sharing of profits motivated Claire to work and increase profits to \$110,000, Sam's 45% in interest in the increased profits would be \$49,500. Sam would therefore be willing to accept less

than half of the partnership's total profit, if her total dollar value of allocations increased.

If profits increased from \$90,000 to \$110,000 and the partners shifted from equal allocations to disproportionate allocations, Claire's share of profit would increase from \$45,000 to \$60,500. Claire's services under disproportionate sharing appear to be worth \$20,000 because that is the extent to which the profits increase. If that analysis is accurate, Claire's contribution of services may equal \$20,000 and her total contribution could equal \$220,000, instead of the \$200,000 of property she contributed. Unless the parties can assess the partnership profits without the special allocation, however, they cannot determine the value of the contributed services. The partners could alternatively treat the value of her services contribution as her portion of the profits, which would be \$60,500. The problem with that analysis is that the profits derive only in part from Claire's services—Sam's services and the property also contribute to the partnership's profits.<sup>178</sup> Perhaps the property would have generated a portion of that profit even without Claire's services. The parties cannot determine the extent to which each of the partnership's resources contribute to the partnership's profit, so they probably cannot accurately measure Claire's contribution of services in dollar-denominated units.

An analysis will similarly fail to determine the dollar-denominated value of Sam's contributed services. Sam's share of appreciation in property is 65%, instead of the 50% default amount. Claire agreed to that allocation to motivate Sam to maintain the property in such a manner that the property's value increases. Sam's efforts alone will not, however, increase the value of the property. Factors such as the surrounding environment, the real estate market, the location of the property, the credit market, and numerous other factors can affect the value of the property. The parties feel, however, that her services will also affect the value of the property, so they allocate a disproportionately large percentage of the property's change in value to Sam. As with the disproportionate allocation to Claire of profits, the allocation of the property's change in value may not reflect the value of Sam's services, but instead may reflect the amount Claire is willing to allocate to help motivate Sam to work to increase the value of the property. Claire stands to gain even if Sam receives more under the allocation formula than her services are worth, as long as Claire ends up with a larger total amount.

The disproportionate allocations of profit and change in property value do not appear to help determine the partners' relative contributions to the partnership. The value of the property contributions is certain in this example because both parties contribute cash. As with the other examples, they remain unable to determine the value of the contributed services. The

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178. See Borden, *supra* note 115.

partners will likely have to rely upon property contributions only to determine the amounts under the first factor. Therefore, the use of partner-directed economic-item allocations does not appear to change the analysis of the relative contributions.

*Partners' Interests in Economic Profits and Losses.* To accurately apply this factor, Sam and Claire must know the breadth of profits and losses, as used in the regulations. If this factor distinguishes between partnership operating profits and appreciation in the property's value, the analysis is fairly straight forward. The parties have agreed that the partnership shall allocate 55% of the profits to Claire and 45% to Sam. The ambiguity of the terms "profits and losses" complicates the determination of this factor. If the terms' definition includes changes in value of partnership property, Sam and Claire may not be able to determine a value for this factor. To do so, they would need to know the property's change in value each year. That is the only way they could determine the partners' interests in profits and losses on an annual basis, if the definition is broad enough to include changes in the property's value. Even if the factor only includes operation profits, the factors do not provide a definitive answer. Assuming the simplest interpretation of this factor, the analysis still reveals the inadequacy of the multi-factor test in this scenario.

*Partners' Interests in Cash Flow and Other Non-Liquidating Distributions.* Sam and Claire make the same withdrawals in this scenario that made in the earlier scenarios, so the question is whether interests in cash flow refers to the partnership's distributions to partners or some other amount. The answer to that question will help the parties determine their interests in the partnership's cash flow. Perhaps their interests in cash flow and non-liquidating distributions are the same as their allocations of profit, i.e., 45% for Sam and 55% for Claire. Perhaps, however, their interests in cash flow and non-liquidating distributions depend upon the amount each party withdrew from the partnership. In which case, their interests could vary significantly, as discussed above.<sup>179</sup> Unfortunately, the law is unclear about the definition of cash flow, so the parties cannot answer that question with any greater certainty in this scenario.

*Partners' Rights to Capital upon Liquidation.* In addition to difficulties encountered in the other scenarios, Sam and Claire will have difficulties in applying the fourth factor to the modified facts. The allocations of economic items will affect the parties' rights to capital upon liquidation. Because the partnership does not equally allocate economic items to the partners, the rights to capital upon liquidation may not equalize over time.

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<sup>179</sup> See *supra* text accompanying notes 161–164.

If the property appreciates at a greater rate than the profits accumulate, Claire's rights to capital should increase disproportionately faster than Sam's. With fluctuations in profit and property value, the partners' rights to capital upon liquidation will often change from year to year. The partners will lack the relevant information to determine their actual rights in the partnership capital. Therefore, this factor will be of little value in determining the partners' interests in the partnership.

Table 6 summarizes the findings for each factor in the case of a partnership with specially allocated economic items. As with the default partnership, Sam and Claire will have difficulty deriving their interest in the partnership using the four factors. The different results in each factor, and the uncertainty with several of the factors does not provide a clear answer regarding the partners' interests in the partnership.

TABLE 6  
FACTORS SUMMARY:  
PARTNERSHIP WITH SPECIALLY ALLOCATED ECONOMIC ITEMS

<b>Factor</b>	<b>Sam</b>	<b>Claire</b>
<b>Relative Contributions</b>	\$800,000 and maintenance services	\$200,000 and management services
<b>Interests in Profits and Losses</b>	45%	55%
<b>Interests in Cash Flow</b>	45% or 25-47%	55% or 29-53%
<b>Rights to Capital upon Liquidation</b>	Vary from year to year.	Vary from year to year.

The lack of a clear answer would appear to provide Sam and Claire with tax avoidance opportunities. They have to allocate the tax items in accordance with their interests in the partnership, but cannot determine those interests. Because tax income correlates to profits logic dictates that they should allocate the tax income 45% to Sam and 55% to Claire. Nonetheless, the regulations imply that partner's interests in the partnership is a unitary concept, so Sam and Claire may not be bound by their economic-item allocations, even with respect to corresponding tax items. They may be able to separate tax-item allocations from the economic-item allocations. That is a significant flaw of the current allocation rules.

#### 4. Partnership with Allocated Tax Items

Assume now that Sam and Claire include tax-item allocations in their partnership agreement. Assume that they have agreed to allocate

partnership tax income 55% to Claire and 45% to Sam and to allocate the taxable gain or loss from the sale of the property 65% to Sam and 35% to Claire. Based on those allocations, the general economic arrangement appears to be the same as the arrangement with specially allocated economic items. The parties agree, however, that they will allocate the tax depreciation 75% to Sam and 25% to Claire. Assume for now that the partners do not maintain section 704(b) capital accounts. Thus, the partnership would allocate the economic items using the state default rules. To be valid, the tax-item allocations would have to be in accordance with the partners' interests in the partnership. Those interests should be the same as the interests considered above for the minimalist partnership with no allocations, which was also subject to the state default allocation rules. Because the tax-item allocations come within the ranges in Table 4, Sam and Claire might successfully argue that the allocations are in accordance with their interests in the partnership.<sup>180</sup>

Assume now that Sam and Claire include in their partnership agreement the provisions required to satisfy the economic effect safe harbor. Accordingly, they agree to maintain section 704(b) capital accounts, make liquidating distributions in accordance with positive balances in those capital accounts and restore deficit balances in those capital accounts.<sup>181</sup> As a consequence, the partner-directed tax-item allocations will establish the allocations of the partnership's economic items. To test the allocations for substantiality, the parties will have to compare them to allocations made in accordance with the partners' interests in the partnership. Doing that comparison is difficult because state law and tax law intertwine partnerships that adopt 704(b) capital accounts.

To test the substantiality of a partner-directed tax-item allocation, the partners must imagine the tax-item allocation is not in the partnership agreement.<sup>182</sup> The trouble with imagining the partnership without the allocation is that the tax-item allocations determine the partners' economic consequences.<sup>183</sup> If so, the imagined partnership will be different from the partnership with the tax-item allocation. Without the allocation, the partnership would be a default partnership similar to the minimalist partnership considered above.<sup>184</sup> With no guidance to resolve this dilemma, partners are left to themselves to determine the most feasible

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180. See *supra* text accompanying notes 171–176.

181. See Treas. Reg. § 1.704-1(b)(2)(ii)(b) (as amended in 2008); *supra* text accompanying note 91.

182. See Treas. Reg. § 1.704-1(b)(2)(iii)(a) (as amended in 2008).

183. See *supra* text accompanying notes 92–105.

184. See *supra* text accompanying notes 154–176.

interpretation of the rule. That independence provides opportunities to avoid taxes.

With respect to allocations of corresponding tax items, a feasible interpretation is that the analysis should retain the economic effect of the tax-item allocations. The section 704(b) capital accounts give tax-item allocations legal and economic effect. The allocations therefore determine the partners' economic interests in the partnership. Imagining a partnership without those allocations would completely confuse the task because the imaginary partnership would have no economic or legal resemblance to the actual partnership. Consequently, the analysis would compare the actual partnership comprised of the economic attributes established in the partnership agreement to a fictitious partnership with no economic resemblance to the actual partnership. Such a comparison would be nonsensical.

The analysis of independent tax items would similarly be flawed if it compared the actual partnership to an imaginary state default partnership. As shown above, the allocation of independent tax items using section 704(b) capital accounts affects the partners' economic interests in the partnership.<sup>185</sup> If the partnership follows the section 704(b) capital account maintenance rules, the test for substantiality cannot ignore the effect tax-item allocations have on the partners' economic interests in the partnership. The Treasury regulations provide an example of a partnership that allocates tax-exempt income to partners differently than it allocates taxable income.<sup>186</sup> The example in the regulations provides that the allocations lack substantiality because the partners expect to be in different tax brackets and the allocations will benefit one partner without hurting the other.<sup>187</sup> The example then requires the partners to reallocate the items in accordance with the partners' interests in the partnership. The tax-item allocations affect the partners' interests in economic items of the partnership.<sup>188</sup> Thus, the example in the regulations ignores the partners' economic interests to determine the partners' interests in the partnership. This Article rejects that analysis because it disregards the economic significance of tax-item allocations made pursuant to the section 704(b) capital account maintenance rules. Tax law must consider the economic consequences of the section 704(b) capital accounts when determining the partners' interests in the partnership. Consider the application of the four factors if the partnership adopts section 704(b) capital accounts.

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185. See *supra* text accompanying notes 91–99.

186. See Treas. Reg. §1.704-1(b)(5), *Example 5(i)* (as amended in 2008).

187. See *id.*

188. See *supra* text accompanying notes 82–105.

*Partners' Relative Contributions.* Sam's and Claire's relative contributions do not appear to change from the original example in this scenario.

*Partners' Interests in Economic Profits and Losses.* The legal consequences of the partners' self-directed tax-item allocation should determine the partners' interests in the partnership's profits and losses. The allocation of depreciation deductions appears to differentiate this scenario from the other scenarios. When the partners use section 704(b) capital accounts, the allocation of tax depreciation affects the partners' economic interests in the partnership,<sup>189</sup> but it does not appear to affect their interests in partnership profits and losses. The partners' interests in the partnership's profits and losses would therefore equal their allocable share of tax income (i.e., the \$100,000 profit in Year 1 with no adjustment for depreciation). Thus, Sam's interest will be 45% and Claire's will be 55%.

*Partners' Interests in Cash Flow and Non-Liquidating Distributions.* This new scenario presents the same difficulties that the other scenarios present with respect to the partners' interests in cash flow. The partner-directed allocation of depreciation using section 704(b) capital accounts does not appear to affect the result of this analysis.

*Partners' Rights to Capital upon Liquidation.* The section 704(b) capital accounts determine the partners' rights to capital upon liquidation. The allocation of the depreciation deduction affects the partners' rights to capital upon liquidation.<sup>190</sup> Even though the allocation of the depreciation deduction affects the partners' rights to capital upon liquidation, the partners will still have considerable difficulty determining those rights. They still face the daunting task of determining the value of the partnership assets, and they must determine the definition of capital. The interests would also generally vary from year to year as profits and changes in property value change. Table 7 summarizes the factors.

TABLE 7  
FACTORS SUMMARY:  
PARTNERSHIP WITH SPECIALLY ALLOCATED ECONOMIC ITEMS

<b>Factor</b>	<b>Sam</b>	<b>Claire</b>
<b>Relative Contributions</b>	\$800,000 and maintenance services	\$200,000 and management services

189. See Treas. Reg. §1.704-1(b)(2)(iv)(b)(7) (as amended in 2008); *supra* text accompanying notes 91–99.

190. See *supra* text accompanying note 91–99.

<b>Factor</b>	<b>Sam</b>	<b>Claire</b>
<b>Interests in Profits and Losses</b>	45%	55%
<b>Interests in Cash Flow</b>	45% or 25-47%	55% or 29-53%
<b>Rights to Capital upon Liquidation</b>	Varies from year to year	Varies from year to year

As Table 7 illustrates, the task of determining partners' interests in a partnership is often no easier when a partnership adopts section 704(b) capital accounts. Consequently, partners, the IRS, and courts will often have significant difficulty testing the substantiality of tax-item allocations in such partnerships.

#### 5. Partnership with Target Allocations

Target allocations have become popular with partnerships in recent years.<sup>191</sup> Sam and Claire may decide to use target allocations in their partnership agreement. Target allocations create distribution-dependent residual risk.<sup>192</sup> Instead of using allocations to determine their rights in partnership assets, partners who adopt target allocations use a distribution formula to determine their rights in partnership assets.<sup>193</sup> They then allocate partnership tax items in accordance with their rights, as determined under the formulae.<sup>194</sup> The structure is fraught with problems that partnership tax law is not equipped to address.

Target allocation-provisions generally use a multi-tier distribution structure to determine the partners' rights to partnership assets. The partnership agreement then requires tax allocations to follow the tiered distribution structure. To illustrate, assume Sam and Claire adopt a three-tier structure. Tier One requires the partnership to make distributions of available cash to partners who contribute property in a manner that provides the contributing partners an 8% return on their contributions. If the partnership does not have sufficient funds to make all of the distributions under Tier One, it can make distributions in proportion to the distributions it would make with sufficient funds. Tier Two requires the partnership to distribute any funds remaining after the Tier One distributions in proportion to contributed capital. Tier Three requires the

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191. See Terrance Floyd Cuff, Terrence Floyd Cuff, *Working with Target Allocations—Idiot-Proofing or Drafting for Idiots*, 35 REAL EST. TAX'N 116, 116 (2d Quarter 2008).

192. See Borden, *supra* note 17.

193. See Cuff, *supra* note 191 at 126–28.

194. See *id.* at 126.

partnership to distribute equally any funds remaining following the Tier One and Tier Two distributions.

A partnership with target allocations may use section 704(b) capital accounts. The partnership agreement may also require the partnership to allocate tax items to the section 704(b) capital accounts in a manner that reflects the partners' rights to distributions under the tiered structure.<sup>195</sup> On an annual basis, ongoing partnerships will encounter significant difficulty in attempting to make such allocations. The partners' rights to allocations depend upon the value of the partnership's property which often will be indeterminable, or available only at significant cost. Without sufficient information about the value of the partnership's property, the partners may be unable to determine their distribution rights. Consequently, they will be unable to accurately allocate tax items in accordance with their rights to distributions under the tiered structure.

The general nature of the tiered structure also does not help with the allocation of specific tax items. Assume the partners can determine the value of partnership assets and their proportionate rights to those assets. The target allocations probably do not provide whether the partners allocate all tax items to the partners in the same proportion. Perhaps the partners will decide to allocate the tax items in different proportions. For example, they may allocate tax income and the depreciation in different deduction proportions. To test the substantiality of tax-item allocations, the partners will have to determine their interest in the partnership. Without knowledge of the value of the partnership assets, that determination will be impossible. Consider the application of the four factors to a partnership with target allocations.

*Partners' Relative Contributions.* Sam's and Claire's relative contributions would not change if they adopted target allocations.

*Partners' Interests in Economic Profits and Losses.* The partners will have difficulty determining their interests in partnership economic profits and losses. The interests depend upon the portion of profits and losses the partnership would distribute to the partners if it were to liquidate. To determine how the partnership would liquidate, the partners must know the value of the partnership property. The variations in profit and changes in value of partnership property each year will change the partners' interests in profits each year. Therefore, as a practical matter, the partners probably cannot determine their interests in partnership profits and losses if they use target allocations.

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195. See *id.*

*Partners' Interests in Cash Flow and Non-Liquidating Distributions.* The partners' interests in cash flow and non-liquidating distributions will depend upon the value of the partnership assets. If the partnership assets are sufficient to cover only the first two tiers, their interests will reflect their relative contributions. If the assets are sufficient to cover all three tiers, the partners' interests in cash flow will begin to equalize as the value of partnership assets increase because Tier Three requires equal distributions.<sup>196</sup> Without knowledge about the value of the partnership's assets, the partners cannot accurately determine their rights in cash flow and other non-liquidating distributions.

*Partners' Rights to Capital upon Liquidation.* The tiered distributions establish the partners' rights to capital upon liquidation. Their rights to liquidating distributions should be similar to their rights to cash flow and non-liquidating distributions. Those rights will depend upon the value of the partnership assets, which the partners probably cannot determine.

This analysis illustrates that, if a partnership adopts target allocations, all but the first factor depends upon the partners' distribution rights. Generally, the partners will be unable to assess those rights without perfect information. Consequently, they will be unable to assign values to the other three factors, and they will not be able to determine the partners' interests in the partnership. Allocating tax items in a partnership with target allocations will thus be extremely difficult. Testing the validity of those allocations by comparing them to allocations made in accordance with the partners' interests in a partnership will be equally difficult. That difficulty may encourage mischievous taxpayers to use tax-item allocations to shift tax burdens. The IRS will be hard-pressed to challenge the validity of the allocations.

In fact, economic theory of entity classification suggests that tax law should not treat partnerships with target allocations as tax partnerships.<sup>197</sup> Economically, a partnership with target allocations is like a corporation with multiple classes of stock.<sup>198</sup> Corporations with complex capital structures cannot trace the income of the corporation to a specific shareholder and therefore require the corporate tax regime.<sup>199</sup> Because partnerships with target allocations face a similar problem, tax law should treat partnerships with target allocations as tax corporations.<sup>200</sup> Nonetheless, the current definition of tax corporation does not include

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196. This tendency to equalize is similar to the tendency in a default partnership described above. See *supra* text accompanying notes 49–58.

197. See Borden, *supra* note 17.

198. See *id.* Part III.C.

199. See *id.*

200. See *id.* at IV.B.

partnerships that make target allocations.<sup>201</sup> An attempt to allocate tax items to Sam and Claire in their partnership with target allocations reveals that problem.

This short review of several different types of partnerships illustrates the challenges tax law faces in allocating tax items in accordance with the partners in a partnership. The examples also illustrate that partners will have difficulty determining their interests in even simple partnerships. Tax law's definition of partners' interests in a partnership does not provide sufficient guidance to be useful in that endeavor. Tax law needs something better. Among several possible alternatives, item-specific-allocations appear to be the best alternative for allocating tax items.

#### IV. MOVING TOWARD A WORKABLE MODEL

The above analysis illustrates the significance of tax-item and economic-item allocations. It also illustrates that tax law and state law are intertwined under the current tax-item allocation rules. In particular, the current tax-item allocation rules have legal and economic consequences. A partnership that adopts the section 704(b) capital accounts establishes the partners' economic rights and obligations through those accounts. Tax law also relies upon state law to determine partners' interests in a partnership. It relies upon that concept to test tax-item allocations, reallocate tax items, and allocate tax-items if the partners fail to do so. Nonetheless, the rules are deficient, and call for repair. Such repair must contemplate the three correlative identified above.<sup>202</sup> New rules must better contemplate the relationship between tax law and state law. They must explicitly recognize the difference between economic items and tax items. The allocation of tax-items should not affect the allocation of economic items. The rules should abandon the ambiguous concept of partners' interests in a partnership and consider partners' interests in specific partnership economic items. Finally, they should not give partners the discretion they currently enjoy.

Commentators often argue that rules restricting the partners' ability to allocate tax items are inefficient because they limit the economic transactions that will attract partners.<sup>203</sup> Recall from the discussion above that partners allocate economic items for various reasons, including

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201. A partnership may, however, elect to be a tax corporation. See Treas. Reg. §301.7701-3(a) (as amended in 2006). Assuming the partners are rational, a partnership would make that election only if it provided the partners a tax advantage.

202. See *supra* Table 1.

203. See, e.g., Darryll K. Jones, *Towards Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047, 1078-93 (2006) (discussing and referencing different arguments for and against flexibility in partnership allocations).

reducing agency costs.<sup>204</sup> For example, to help reduce agency costs, Sam and Claire may decide to allocate partnership operating profit using one ratio and allocate gains or losses from the disposition of property using a different ratio.<sup>205</sup> A tax law that alters their decision to allocate the economic items in that manner could be inefficient because it may distort the partners' behavior.<sup>206</sup> Distorted behavior is a negative consequence that derives from regulating the allocation of economic items. Tax policy does not suggest, however, that the partners should be able to allocate tax items freely. Here, the distinction between tax items and economic items is important. Tax law should attempt to match tax-item allocations to economic-item allocations whenever possible. Tax law should regulate tax-item allocations to help accomplish that purpose. Imposing definite rules on the allocations of tax items will help bring partnership tax accounting in line with other tax laws. The following discussion considers alternative partnership tax-item allocation rules that come to mind when considering reform of the existing inadequate rules.

#### A. Mandatory Use of Section 704(b) Capital Accounts

One alternative is to require all partnerships to follow the section 704(b) capital account rules.<sup>207</sup> This alternative would be attractive to many in the tax bar and tax academy because they are familiar with the section 704(b) capital account rules. Requiring all partnerships to adopt section 704(b) capital accounts would create uniformity and provide rules with which a significant portion of the bar is familiar. Nonetheless, the costs of mandatory section 704(b) capital accounts would exceed any benefit such a rule may bestow.

First, default partnerships will not include section 704(b) capital accounts. Two or more persons may join together in a profit-seeking activity and not realize they have formed a partnership.<sup>208</sup> As shown above, even a simple default partnership can raise tax accounting complexities that require sophisticated partnership tax-item allocation rules. If the partners did not realize that they were forming a partnership, certainly they would not have included the section 704(b) capital account a partnership agreement. Similarly taxpayers who knowingly form a

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204. See *supra* note 81 and accompanying text.

205. See *id.*

206. See HARVEY S. ROSEN & TED GAYER, *PUBLIC FINANCE* 331 (8th ed. 2008) (defining inefficiency as a distortion in economic behavior caused a tax that creates a loss of welfare above and beyond the tax revenues collected).

207. See *supra* text accompanying notes 91–99 (discussing the section 704(b) capital account rules).

208. See BROMBERG & RIBSTEIN, *supra* note 52 at §2.02 (discussing different contexts in which the question of partnership status arises).

partnership may not possess the tax sophistication required to include section 704(b) capital accounts in their partnership agreement. Many partners may simply fail to recognize the application of mandatory section 704(b) capital accounts. Penalizing unsophisticated taxpayers for that oversight would be draconian.

Second, sophisticated taxpayers may prefer not to use section 704(b) capital accounts. Because the section 704(b) capital account rules allocate economic items based upon the allocation of tax items, the partners may fear the unintended consequences of such allocations. For example, the partners may not realize that the allocation of tax depreciation, which often will not correspond to the economic performance of the partnership, may alter the partners' economic arrangement.<sup>209</sup> Even sophisticated taxpayers cannot predict all of the economic consequences that will proceed from using the section 704(b) capital account rules. Therefore, many partners may choose not to use section 704(b) capital accounts. Forcing sophisticated taxpayers to adopt the rules would impose an unduly harsh requirement on them.

Third, because the section 704(b) capital account rules are tax centric (i.e., economic items follow tax-items allocations), they may misrepresent the partners' preferred economic arrangement. In particular, independent tax items have no corresponding economic item, so tax law employs fictitious economic items to adjust capital accounts.<sup>210</sup> Mandatory use of the rules could distort behavior as partners attempt to obtain their desired economic arrangement while working with rules that do not accurately portray the economic arrangement. For example, if adjustments to capital accounts for the depreciation deduction alter the partners' economic arrangement, the partners may allocate other tax items to offset the depreciation deduction allocation and equalize the economic arrangement. For instance, the partners may adjust allocations of tax income to offset allocations of depreciation deductions. Such offsetting allocations could be similar to the complex allocations of the built-in gain or loss of contributed property.<sup>211</sup> Requiring partners to use tax-centric allocation rules imposes unneeded complexity on arrangements that partners would otherwise manage more simply.

Fourth, if tax law could overcome all of those shortcomings, the mandatory use of section 704(b) capital accounts would still face the problems raised by the test for substantiality. If all partnerships adopt the

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209. See *supra* text accompanying notes 92–99 (illustrating this effect).

210. See Treas. Reg. §1.704-1(b)(5), *Example 1* (as amended in 2008); *supra* text accompanying notes 92–99.

211. See I.R.C. § 704(c) (2006); Treas. Reg. § 1.704-3 (as amended in 2005); Andrea Monroe, *Saving Subchapter K: Substance, Shattered Ceilings and the Problem of Contributed Property*, 47 BROOK. L. REV. \_\_\_\_ (forthcoming 2009) (discussing the rules governing the allocation of built-in gain and loss).

section 704(b) capital account rules, their allocations would have economic effect, but the allocations may not be valid. As discussed above, partners must test the validity of their tax-item allocations by comparing those allocations to allocations that would be made in accordance with partners' interests in the partnership.<sup>212</sup> Thus, if the law adopted mandatory use of the section 704(b) capital account rules, it would still have to resolve the current ambiguity of the concept of partners' interests in the partnership. Clarifying that concept will be difficult.

Finally, because state law does not require partnerships to allocate tax items, tax law cannot force all partnerships to abide by rules that allocate economic items. Ultimately, state law governs the allocation of the partnership's economic items, and determines the partners' economic interests in the partnership. Tax law could impose penalties for failure to use capital accounts, but it would still be left with the task of allocating tax items for unsophisticated partners. The penalties also would create economic inefficiency as partners would have to alter their economic arrangement to avoid the penalties. As a consequence, tax law will always have the task of considering the validity of agreed-upon allocations and of allocating tax items for partnerships that do not include relevant allocation provisions. Mandating section 704(b) capital accounts will not resolve those problems. Thus, mandatory section 704(b) capital accounts do not appear to be a viable alternative for allocating tax items.

#### B. Universal Concept of Partners' Interests in a Partnership

Another alternative is to modify the current rules and develop a formula for determining a universal concept of partners' interests in a partnership. For example, some may consider a multiple integral formula. Such an undertaking would be extremely difficult and would likely prove futile. To develop a universal concept using the four factors, for example, the law would have to accurately define key terms of each factor, resolve the problem of factor overlap, and weight the factors. Each of those tasks would present a significant challenge. Just imagining the complexity of such a task is mind-boggling.

To accurately determine the partners' interests in the partnership, the partners would also need accurate information about the value of the partnership's assets. The examples above that illustrate the partners' economic interests in the partnership demonstrate the need for perfect information.<sup>213</sup> Often perfect information regarding the value of partnership assets is not available and would be costly to obtain. To make allocations on an annual basis, the partners would have to gather

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212. See *supra* text accompanying notes 99–105.

213. See *supra* Part II.B.

information each year. If the partnership was somewhat complicated with multiple assets, obtaining such information may be impossible and would not prove cost efficient.

Finally, a universal concept of the partners' interests in a partnership may not accurately reflect the partners' economic arrangement. Partnerships generally have allocation-dependent residual risk, meaning the partners determine their residual claims in the partnership by considering the allocations of partnership economic items.<sup>214</sup> Partnerships may allocate different economic items to different partners in different ratios. Merely considering the partners' residual claims in the partnership assets (i.e., their economic interests in the partnership) will not accurately reflect the character of specific economic items allocated to the partners. For example, if the partners allocate profit and changes in the value of partnership property differently, a universal concept of partners' interests in the partnership will not capture that distinction.<sup>215</sup> Thus, allocating tax items using a universal ratio, may not match tax items with economic-item allocations.

The example above of the partnership with target allocations illustrates other problems a universal concept raises. Such partnerships use distribution-dependent residual risk, much as corporations do, to determine the partners' economic interests in the partnership.<sup>216</sup> Consequently, the partners cannot accurately determine the character of specific tax items allocated to them. Furthermore, the tax-item allocations do not determine the partners' economic interests in the partnership. Instead the allocations serve as a plug figure to make the capital accounts equal the amounts partners are entitled to receive upon liquidation.<sup>217</sup> Such plug may not reflect the partners' economic arrangement. Thus, a universal concept of partners' interests in a partnership does not appear to be an appropriate fix for the tax-item allocation rules.

### C. Item-Specific Allocations

The inadequacies of other alternatives lead to item-specific allocations. Item-specific allocations accomplish several feats. First, they make tax-item allocations economic centric—tax items would follow the allocation of economic items. Second, item-specific allocations can recognize the partners' particular allocations of economic items. Third,

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214. See Borden, *supra* note 17 at Part III.B.

215. See *supra* Part III.C.3.

216. See Borden, *supra* note 17 at III.C.

217. See *id.* at Part IV.B.

item-specific allocations work with any type of partnership that has allocation-dependent residual risk.<sup>218</sup>

Economic-centric allocations of tax items reflect general principles of taxation better than the current tax-centric allocations. Generally, tax law requires the person who bears the economic burden or receives an economic benefit of a transaction to recognize the tax item that corresponds to that economic benefit or burden.<sup>219</sup> Tax law thus generally considers the flow of economic items from the transaction and requires tax items to follow the economic items.<sup>220</sup> The use of a partnership structure should not alter the application of that principle. Thus, the partner to whom an economic item is allocated should recognize the corresponding tax item.<sup>221</sup> Economic-centric allocations help ensure that happens.

Item-specific allocations of tax items would give tax law flexibility needed to anticipate the various economic arrangements partners may adopt. For example, if Sam and Claire use one formula to allocate profit and another formula to allocate changes in property value, item-specific allocations would require the corresponding tax items and hybrid tax items to follow those specific economic-item allocations. Thus, tax law would allocate tax income in the same proportion the partners allocate profit. It would allocate tax gain or loss in the same manner the partners allocate the economic gain or loss from the sale of partnership property. Because tax gain and loss may be a hybrid tax item, tax law must adjust the allocation of such item as appropriate to account for the allocation of the depreciation deduction. Finally, the flexibility of item-specific allocations makes them workable with any type of partnership that has allocation-dependent residual risk. Thus, the same tax rules would apply to default partnerships, simple partnerships, and partnerships with complex economic-item allocations. Item-specific allocations could not apply to partnerships with

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218. As demonstrated earlier, partnership tax law will never adequately account for partnerships with distribution-dependent residual risk, such as those with target allocations. *See supra* Part III.C.5.; Borden, *supra* note 17 at Part IV.B.

219. *See* *Lucas v. Earl*, 281 U.S. 111, 114–15 (1930) (requiring the allocation of tax income to the person who earned the corresponding economic income); *Lusthaus v. Comm’r*, 327 U.S. 293, 295 (1946) (rejecting a sham partnership formed to shift income between a husband and wife); *Comm’r v. Tower*, 327 U.S. 280, 291–92 (1946) (holding that no meaningful partnership existed between a husband and wife and disregarding the allocation of income from the husband to the wife).

220. *See id.*

221. In the case of tax-exempt income or non-deductible expenditures, tax law adjusts the partners’ bases in the partnership to preserve the tax effect. *See* I.R.C. § 705(a)(1)(B), (2)(B) (2006). The tax treatment does not affect the allocation of the corresponding economic item, unless the partners have adopted the section 704(b) capital account rules, which require the partners to adjust capital accounts for allocations of tax-exempt income and non-deductible expenditures. *Treas. Reg.* § 1.704-1(b)(2)(iv)(b)(3), (6) (as amended in 2008).

target allocations, but such partnerships should not come within the definition of tax partnership.<sup>222</sup>

The one challenge that item-specific allocations face is the allocation of independent tax items. Independent tax items, such as depreciation deductions, have no economic items to follow. Thus, tax law must deal with them specially. Simply granting the partners discretion to allocate the independent items does not seem appropriate because some partners would abuse such freedom and enter into tax-item transactions or other tax-revenue reducing arrangements. Consequently, tax law must govern the allocation of independent tax items.

To formulate a rule that allocates independent tax items, consider how tax law treats an individual who owns depreciable property. Tax law allows the owner of certain property used in a trade or business or held for production of income to take a depreciation deduction for the property.<sup>223</sup> Tax law also governs the computation of the amount of the depreciation deduction a property owner may claim.<sup>224</sup> The purpose of the depreciation deduction appears to be to allow the property owner to deduct the cost of the property capitalized on acquisition.<sup>225</sup> Upon disposition of the property, the owner must recapture the depreciation deduction.<sup>226</sup> A property owner who is entitled to a depreciation deduction may not assign that deduction to another party.<sup>227</sup> For example, if Sam owned a building individually, Claire could not claim the depreciation deduction for the building. Only Sam, the owner of the building, could claim the deduction. Later, if Sam sold the building, Sam would recognize the depreciation recapture.<sup>228</sup> Partnership tax law should strive to achieve a similar result to the extent possible.

With respect to the allocation of depreciation deductions, partnership rules should require the allocation of depreciation based upon the partners' deemed ownership of the depreciable property. The rules should also require the partnership to allocate depreciation recapture to the partner who took the depreciation deduction. Those principles should govern the allocation of partnership depreciation deductions. In some respects,

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222. See Borden, *supra* note 17.

223. See I.R.C. §167(a) (2006).

224. See I.R.C. §168 (2006).

225. See BRIAN E. COMERFORD & MASON J. SACKS, FEDERAL TAX DEDUCTIONS 404 (1983) ("It is reasonably clear, however, that even in the beginning, Congress intended merely that the deduction for depreciation permit a taxpayer to recover its investment in a capital asset. The deduction is not designed either to permit a taxpayer to match income and expense, since the income generated by the asset is ignored, or to enable a taxpayer to replace an obsolete asset, as replacement cost is ignored.").

226. See I.R.C. §§ 1(h)1(D), 1245(a) (2006).

227. See Borden, *supra* note 47 at 329-32.

228. See I.R.C. § 1(h)(D) (2006).

partners co-own partnership property.<sup>229</sup> Thus, they each should report a portion of the partnership's depreciation deduction. Tax law should require the partners to allocate the depreciation deduction in accordance with their interests in the partnership property. The partners' interests in the partnership property may not be obvious. Factors such as the partners' relative contributions, income-sharing arrangements related to the property, and sharing of fluctuations in the property's value will all indicate the partners' interests in the partnership property. Those factors may vary over time and the ratio of each may differ. Relying on such factors alone will therefore not solve the problem.<sup>230</sup>

The law could allow partners to determine their interests in the partnership property based upon a relevant factor related to the property. If the partners' determination is reasonable based upon the factors listed above, the law should respect the allocation. The law should also require that the partner to whom depreciation is allocated to must recognize depreciation recapture when the partnership disposes of the property in a taxable transaction. The allocation of depreciation recapture to the partner who took the depreciation deduction will help minimize abusive allocations of the depreciation deduction. Tax law would also have to develop similar rules or standards for allocating other independent tax items. Such rules may not be perfect. Nonetheless, they would more closely reflect the general rules of income tax. They would also help reduce abuse by requiring the partners to determine their interests in partnership property (or other relevant factor) and use those determined interests to allocate items. Item-specific allocations also eliminate abusive allocations of corresponding tax items.

Item-specific allocations would not require section 704(b) capital accounts. Tax law could therefore eliminate the section 704(b) capital account rules. Eliminating those rules would stop the unintended consequences that currently derive from their tax-centric nature. Consequently, tax-item allocation would not have legal or economic effect and would not affect the partners' economic interests in the partnership. In short, item-specific allocations would appear to solve many of the problems of the current system. They would also transform the tax-item allocation rules from their current tax-centric nature under the section 704(b) capital account rules, to economic-centric rules. Item-specific allocations look to the economic-item allocations and allocate tax items to reflect the economic nature of the economic-item allocations.

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229. See UNIF. P'SHIP ACT § 101(6) (amended 1997), 6 U.L.A. 61 (2001) (defining partnership as a co-ownership arrangement). *But see* UNIF. P'SHIP ACT, § 203 (amended 1997), 6 U.L.A. 96 (2001) (providing that the partnership, not the partners, owns the partnership property).

230. See *supra* Part III.

## V. CONCLUSION

Partnerships are complex economic legal structures. They raise complex tax issues. The tax-item allocation rules must take into account those complexities. Tax law must recognize how state law establishes partners' economic interests in a partnership. Tax law should adopt rules that contemplate the effects of state law but that do not affect the partners' economic interests in the partnership. Thus, it must dispose of the section 704(b) capital account rules, which have legal and economic consequences.

Tax law should require tax-item allocations to follow corresponding economic-item allocations and require the allocation of independent tax items to tie-in with an economic aspect of the partnership that relates to the tax item. Such a rule would more closely reflect general principles of taxation and not affect the partners' economic interests in the partnership. Finally, such a rule would help eliminate ambiguity and reduce abusive tax practices and traps for unsophisticated taxpayers. Such changes are in the best interests of the tax system and taxpayers.