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The Character of a Partner's Distributive Share Under the "Substantial Economic Effect" Regulation

Alan Gunn
Notre Dame Law School, alan.gunn.1@nd.edu

THE CHARACTER OF A PARTNER'S DISTRIBUTIVE SHARE UNDER THE "SUBSTANTIAL ECONOMIC EFFECT" REGULATIONS

*Alan Gunn**

I. INTRODUCTION

For income tax purposes, a partnership's income and deductions must be allocated among the partners.[1] In many cases, the partnership agreement will provide some method for making these allocations; if it does not, or if an allocation to which the partners have agreed lacks "substantial economic effect,"[2] income and deductions are attributed to each partner "in accordance with the partner's interest in the partnership."[3] Because partnership income and deduction items retain their tax character in the partners' hands,[4] the allocation process must determine both the amount and the character of each partner's distributive share. Thus, if the *AB* partnership's income of $50,000 comprises ordinary income, capital gains, and tax-exempt interest, an allocation of the income between *A* and *B* must fix their shares of each kind of income; it is not enough simply to say, for example, that *A*'s income is $30,000 and that *B*'s is $20,000.

This article will examine the ways in which the section 704(b) regulations apply the "substantial economic effect" test to character allocations. It will first show that no test based solely upon "economic effect" (in the regulations' sense of effect on the partners' wealth) can tell us anything about character. It will then look at the character-allocation techniques implicit in the regulations' examples and will compare those techniques with the "substantiality" rules, which the regulations purport to use to disallow abusive allocations of character. Finally, it will evaluate the regulations' treatment of specific problems involving cost recovery deductions, retrospective allocations, and foreign-source income.

II. THE SUBSTANTIAL ECONOMIC EFFECT TEST: A BRIEF HISTORY AND DESCRIPTION

It was once assumed that all items of a partnership's income had to be allocated in the same way. In 1919, the Bureau of Internal Revenue ruled that "income from a particular source can not be allocated to one partner of a partnership for income tax purposes, but must be divided pro rata among the several partners."[5]

*J. duPratt White Professor of Law, Cornell University. The author is grateful to Stephen G. Utz for comments and suggestions.

[1]I.R.C. §§ 701, 702, 704.

[2]I.R.C. § 704(b).

[3]*Id.*

[4]I.R.C. § 702. The difficult problem of whether particular kinds of income should be characterized at the partnership or partner level will not be addressed here. Only allocations of items that have traditionally been subject to partnership-level characterization will be discussed.

[5]O.D. 140, 1 C.B. 174 (1919).

The pro rata division rule was easily circumvented,[6] and in 1957 the Service announced that special allocations had always been permitted.[7] By then Congress had enacted the 1954 Code, which expressly allowed special allocations of "any item of income, gain, loss, deduction, or credit" unless the "principal purpose" of an allocation was "avoidance or evasion of any tax."[8]

Under the 1954 version of section 704(b), the "avoidance or evasion" test for the validity of special allocations did not mean that item allocations were invalid if made for the purpose of reducing a partner's taxes. The 1956 regulations contained an example upholding a special allocation highly likely to have been agreed upon for tax reasons.[9] Here, as elsewhere, the "avoidance or evasion" standard was used to say that "good" allocations are permissible and that "bad" ones are not, without specifying a standard for evaluating either.[10] The regulations, with some support in the legislative history, attempted to fill the gap by listing six "relevant circumstances" to be considered in determining whether the principal purpose of an allocation was "avoidance or evasion."[11] The most important of these, and the only one expressly dealt with in the regulations' five examples, was "whether the allocation has 'substantial economic effect,' that is, whether the allocation may actually affect the dollar amount of the partners'

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[6] *See* Rev. Rul. 55-39, 1955-1 C.B. 403 (partnership investment of a member's capital in particular securities "in effect" a withdrawal of capital from the firm and an investment by the partner); Rev. Rul. 56-134, 1956-1 C.B. 649 (earnings of partnership's foreign and domestic branches shared differently on theory that arrangement created "two partnerships rather than one for federal income tax purposes"). The "constructive withdrawal" and "two partnership" fictions could eventually have swallowed up the pro rata division rule.

[7] Rev. Rul. 57-138, 1957-1 C.B. 543 (revoking Rev. Rul. 56-134). Rev. Rul. 57-138 purports to "distinguish" O.D. 140 on the ground that the agreement involved in that ruling "apparently contained no provision regarding the division of various items of partnership income." In view of the fact that O.D. 140 said nothing at all about the facts of the case at hand, but rather announced a rule about what "can not" be done in allocating income, this "distinction" must be seen as an attempt to maintain an appearance of consistency.

[8] Section 704(b) read as follows before its amendment in 1976:

> (b) DISTRIBUTIVE SHARE DETERMINED BY INCOME OR LOSS RATIO.—A partner's distributive share of any item of income, gain, loss, deduction, or credit shall be determined in accordance with his distributive share of taxable income or loss of the partnership, as described in section 702(a)(9), for the taxable year, if—
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> (1) the partnership agreement does not provide as to the partners' distributive share of such item, or
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> (2) the principal purpose of any provision in the partnership agreement with respect to the partner's distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle.

[9] Regs. § 1.704-1(b)(2) Ex. 3 (1956) (tax-exempt interest to *A*, taxable dividend income to *B*). Under the 1985 regulations, this kind of allocation may be impermissible if the allocation benefits the parties after-tax and if the amounts of tax-exempt and taxable income can be predicted accurately when the allocation is made; Regs. § 1.704-1(b)(5) Exs. 5, 7 (1956).

[10] Dyer, *Tax Conflicts in Partnership Contributions*, 1974 UTAH L. REV. 491, 498 (1974) ("avoidance or evasion" is a term of art; the Code uses that standard "to delegate authority to the courts to make law on a case by case basis in areas where tax policies involved are clear but where setting an objective standard would invite mere formal compliance."); Cohen, *Tax Avoidance Purpose as a Statutory Test in Tax Legislation*, 9th ANN. TULANE TAX INST. 229, 254 (1960) ("language which in essence condemns the sinful and upholds the virtuous").

[11] Regs. § 1.704-1(b)(2) (1956).

shares of the total partnership income or loss independently of tax consequences . . . ."[12] In 1976, Congress amended section 704(b), replacing the "avoidance or evasion" standard with an explicit reference to "substantial economic effect." The new statutory standard was expressly made applicable not only to allocations of particular items of income, deductions, or credits but also to allocations of a partnership's overall gains or losses.[13]

The language of section 704(b) provides virtually nothing in the way of rules for evaluating allocations made by agreement or for reallocating items in the event the agreement's allocation is invalid. The key statutory phrases—"substantial economic effect" (the test for validity) and "partner's interest in the partnership" (the standard for reallocations)—are at best suggestive. Both tell us that "good" allocations are allocations having some connection to the partners' economic relationship; neither helps resolve any but the simplest cases. For guidance about specific problems, one must look to the regulations.

The current section 704(b) regulations, like the Code, provide that an allocation of income or deductions is valid if it has "substantial economic effect."[14] This phrase, however, has a somewhat different meaning in the regulations than in the Code. Under section 704(b), "substantial economic effect" seems to be the standard for evaluating any agreed-upon allocation. Under the regulations, however, the substantial economic effect test applies only to partnerships that keep their books in prescribed ways.[15] The allocations of other partnerships are judged by the somewhat vague "partner's interest in the partnership" standard of the Code and regulations.[16] The regulations use the substantial economic effect test as a sort of safe harbor system. Partners can elect the relative certainty of the test by keeping their books in the approved manner.

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[12]Regs. § 1.704-1(b)(2) (1956). The other five factors were as follows:

> whether the partnership or a partner . . . has a business purpose for the allocation; . . . whether related items . . . are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the . . . item could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocation [whatever that means].

Id.

[13]Because the former version of section 704 did not expressly subject overall allocation formulas to the "avoidance or evasion" (or any other) limitation, it was possible to argue that partners could make overall allocations of taxable income or loss "for tax purposes only." The arguments were very weak, and are thoroughly refuted in Boynton v. Commissioner, 72 T.C. 1147 (1979), *aff'd*, 649 F.2d 1168 (5th Cir. 1981), *cert. denied*, 454 U.S. 1146 (1982); Cowan, *Treasury Proposes New Rules for Partnership Allocations*, 42 N.Y.U. INST. §§ 19.00, 19.01 (1984); Kalish & Rosow, *Partnerships, Tax Shelters, and the Tax Reform Act of 1976*, 31 TAX LAWYER 755, 776-79 (1978); Kamin, *Partnership Income and Loss Allocations Before and After the Tax Reform Act of 1976*, 30 TAX LAWYER 667, 668-71 (1977) [hereinafter cited as Kamin].

[14]Regs. § 1-704-1(b).

[15]Regs. § 1-704-1(b)(2)(ii)(*b*)(*1*). Regs. § 1.704-1(b)(2)(ii)(*i*) allows a small amount of flexibility by providing an "economic effect equivalence" rule. Under this rule, allocations not satisfying the "economic effect" requirement will be deemed to have economic effect if "the partnership agreement ensures that a liquidation of the partnership as of the end of each . . . year will produce the same economic results to the partners" as would occur under the prescribed rules. *See also* Regs. § 1.704-1(b)(4).

[16]I.R.C. § 704(b); Regs. § 1.704-1(b)(3).

In determining whether an allocation comes within the substantial economic effect safe harbor, the regulations look to the effect of the allocation on the partners' capital accounts. The allocations have "economic effect" if (1) the partners keep their capital accounts as the regulations direct, (2) allocations are reflected in appropriate adjustments to capital-account balances, (3) capital-account balances control the distribution of liquidation proceeds throughout the life of the partnership, and (4) partners with capital-account deficits following a liquidating distribution must restore those deficits to the partnership.[17] If that economic effect is "substantial" (which, in the case of *amounts*, seems to mean primarily "not intended to be transitory"),[18] the allocations are valid.

The capital-account version of the substantial economic effect test has received considerable criticism. It has been noted, for example, that the test's assumption that a negative capital-account balance is meaningless unless partners must restore deficit balances upon liquidation is incorrect.[19] Furthermore, the capital-account approach slights time-value-of-money considerations, although the current regulations do take time value into account in some cases.[20] These criticisms show that, even when the issue is the dollar amount of a partner's distributive share, the substantial economic effect test does not always work well.[21] When the issue

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[17]Regs. § 1.704-1(b)(2)(ii). Even if capital account deficits do not have to be repaid, an allocation that does not create a negative figure may be valid under the "alternate test" for economic effect. Regs. § 1.704-1(b)(2)(ii)(*d*). If deficits must be repaid, the "balances control liquidating distributions" requirement becomes superfluous. McKee, Nelson, & Whitmire, *An Analysis of the Proposed 704(b) Regulations*, in W. McKee, W. Nelson & R. Whitmire, Allocating Partnership Tax Benefits Under the New Treasury Regulations 3, 17-18 (1983).

[18]Regs. § 1.704-1(b)(2)(iii)(*c*).

[19]Cowan, *Substantial Economic Effect—The Outer Limits for Partnership Allocations*, 39 N.Y.U. Inst. §§ 23.00, 23.03[4] (1981) [hereinafter cited as Cowan].

[20]McKee, *Partnership Allocations: The Need for an Entity Approach*, 66 Va. L. Rev. 1039, 1059 n.85 (1980) [hereinafter cited as McKee]. The substantial economic effect test treats partners' capital accounts much as if they were bank accounts. Unlike bank accounts, however, capital accounts need not, and typically do not, bear interest. The fact that capital accounts are seldom interest bearing is evidence—if any is needed—that a partner's capital account balance is not a realistic measure of the value of the partner's interest.

In determining whether an allocation has a substantial after-tax economic effect on the partners, the regulations ask for a comparison "in present value terms." Regs. § 1.704-1(b)(2)(iii)(*a*). This falls far short, however, of taking time-value considerations fully into account in allocating income.

[21]There are cases in which the substantial economic effect test cannot determine even the amounts of partners' distributive shares. For example, if a partnership must include a payment in income, and if the money in question would go to someone other than partners if the partnership were liquidated, capital account adjustments are inappropriate. In United States v. Basye, 410 U.S. 441 (1973), payments for medical services performed by a partnership were made to a retirement trust. The identity of those who would eventually receive the money was not ascertainable because the partners' and employees' rights were not vested. In the event of a partnership liquidation, some of the money in question would have gone to nonpartner employees. Nevertheless, the Court held that the payments to the trust were includible in the partnership's income. The allocation problem, which was not before the Court, was solved by allocating payments that would have gone to employees upon an immediate liquidation equally among the partners "pursuant to the partnership agreement's stipulation that all income above each partner's drawing account 'shall be distributed equally'." 410 U.S. at 455 n.16. Curiously, the same allocation formula was used for payments "earmarked" for partners. *Id.* at 455-56. Because payments allocated to the "tentative accounts" of partners would not have been distributed pro rata upon a liquidation, this treatment is inconsistent with the immediate-

is the character, rather than the amount, of a partner's share of gain or loss, no test based solely on the amount of money each partner will receive can provide an answer.

III. ECONOMIC EFFECT AND CHARACTER

The regulations say that, as a general rule, an allocation has substantial economic effect if "there is a reasonable possibility that [it] will affect substantially the dollar amounts to be received by the partners from the partnership."[22] Such a test can have nothing to do with character. A determination that a partner will get $10,000 does not begin to suggest whether that partner's income is capital gain, dividends, or tax-exempt interest. Yet examples in the regulations indicate that allocations can have substantial economic effect when (1) a partner has a distributive share of a cost recovery deduction,[23] (2) a partner's share of income is derived from operations conducted within a particular country,[24] and (3) a partner's distributive share includes all of the partnership's wage expenses for the year.[25] Even if the results reached by these examples are correct, the explanations' references to "economic effect" are misleading. The entire burden of dealing with character falls on portions of the regulations dealing with matters other than economics.

The following example, derived from those in the regulations,[26] will confirm the inability of any economic effect test to allocate character and will help to uncover the process by which the regulations' examples proceed from a determination that an allocation has economic effect to a conclusion that the allocation treats character properly. Consider a partnership agreement providing that all gain or loss from the sale of Blackacre (a section 1231 asset, which the partnership has just purchased) is to be allocated to *A*, with all other partnership income and deductions to be shared equally by *A* and *B*. The partnership treats capital accounts in a way that conforms to the regulations, and there is no reason to

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liquidation assumption that underlies the substantial economic effect test. The Court stated, "It should be clear that the contingent and unascertainable nature of each partner's share under the retirement trust is irrevelant to the computation of his distributive share." 410 U.S. at 456. Perhaps it should be clear, but it is not, at least to me.

For a discussion of *Basye* and other cases in which the amount of money a partner will get depends on events that will take place after the partnership taxable year, *see* A. ARONSOHN, PARTNERSHIP INCOME TAXES 13-15 (1978).

[22]Regs. § 1.704-1(b)(2)(iii)(*a*). Qualifications to this definition in the form of very special meanings assigned to the word "substantial" will be discussed below.

[23]*E.g.*, Regs. § 1.704-1(b)(5) Ex. 1(iii). This example concludes only that the allocation "has economic effect"; whether that effect is "substantial" is not discussed. In view of the absence of any examples disallowing an "economic effect" allocation of depreciation on the ground that the effect is not "substantial," it seems safe to assume that allocations like those in the example will generally be valid. If they are not, what was the point of giving us the example?

[24]Regs. § 1.704-1(b)(5) Ex. 10(i).

[25]Regs. § 1.704-1(b)(5) Ex. 11(ii).

[26]The example in the text is identical in principle to Regs. § 1.704-1(b)(5) Ex. 11(ii), which involves foreign-source income rather than section 1231 gain. *See also* Regs. § 1.705-1(b)(5) Ex. 6, disallowing a special allocation of a section 1231 loss to partner *K* because at the time the allocation was made (in an amendment to the original partnership agreement) an "equivalent amount" of other partnership loss was allocated to partner *L*.

think that the special allocation of gain or loss to *A* will be offset by some other allocation. Later, the partnership sells Blackacre at a $20,000 gain and recognizes $100,000 of ordinary income from other sources. The allocation satisfies the substantial economic effect test, and *A*'s distributive share consists of $20,000 of section 1231 gain and $50,000 of ordinary income. *B*'s distributive share is $50,000 of ordinary income.

To the extent that the allocation formula described in the previous paragraph determines the amount of income to be reported by *A* and *B* ($70,000 and $50,000 respectively), the result can be fully explained by reference to substantial economic effect in the "dollar amount" sense. The allocation of character, however, (all section 1231 gain to *A*) cannot be similarly explained. Consider a different allocation formula: "ordinary income to *A* in the amount of gain from the sale of Blackacre; all other partnership income fifty-fifty." This allocation, if taken seriously, gives *A* $10,000 of section 1231 gain and $60,000 of ordinary income, while *B* has $10,000 of section 1231 gain and $40,000 of ordinary income. To be sure, in the absence of very unusual circumstances, this allocation formula would probably not be given its intended effect. The allocation is not invalid for lack of economic effect, because this allocation has the same economic effect as the one that seems so unobjectionable: each produces the same change in the balances of the partners' capital accounts and each has the same effect on the amount of money the partners will take out of the partnership.[27]

A response to an attempt to use the "alternative" allocation formula described above might be that the formula is valid to the extent that it allocates amounts but invalid to the extent that it allocates character. This is so because the "character portion" of the allocation has no economic effect at all.[28] This explanation is unacceptable, however, because the valid formula of "gain from the sale of Blackacre to *A*" also allocates character. The valid allocation says both that *A* is to be allocated an amount of income equal to the gain from selling Blackacre and that this portion of *A*'s share is to have the same character as the character of the gain recognized by the partnership upon the sale. The strangeness of the alternative allocation formula alerts us to the fact that that formula purports to allocate character. In fact, both allocations deal with character, and the character portion of the allocation has no economic effect in either case. Any number of other allocations would also produce the same result in dollar amount terms,[29] as the regulations themselves recognize.[30]

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[27]The alternative allocation could be given full tax effect only if the amount of the partnership's ordinary income for the year of the sale were equal to or more than the section 1231 gain because the "ceiling rule," *see infra* note 94, prevents allocating more than 100% of any partnership income item. For simplicity, ceiling rule problems will be ignored in this section of the article.

[28]This seems to have been the approach taken in an example in the 1983 proposed regulations. *See* Prop. Regs. § 1.704-1(b)(5) Ex. 10(ii), 48 Fed. Reg. 9871 (1983).

[29]For example: ordinary income to *A* in the amount of four-fifths of the gain from the sale of Blackacre; section 1231 gain to *A* to the extent of one-fifth of the gain from the sale of Blackacre; everything else fifty-fifty.

[30]*See* Regs. § 1.704-1(b)(2)(iii)(*b*), dealing with different allocation formulas that have a "strong likelihood" of leading to "substantially" the same increases and decreases in capital account balances.

IV. CHARACTER DETERMINATIONS UNDER THE REGULATIONS

The section 704(b) regulations consist of sixty-six examples and an extensive collection of rules. The rules display considerably more sophistication than those of the earlier versions of the regulations; in particular, they recognize that different allocation formulas can produce identical economic effects.[31] By using "substantial" in a way that gives the term a content independent of any reference to the size of an economic effect, the regulations seem to appreciate the need for character allocation rules distinct from dollar amount rules. The "substantiality" rules are unclear and overbroad, however, and in some cases they conflict with the examples.[32] For this reason, and also because it is plausible to think that the drafters began with the examples and tried to tailor the rules to fit,[33] I will discuss the principles that appear to underlie the examples before turning to the rules.

A. *The Examples*

All of the examples dealing with character can be explained as applying one of two methods of evaluating or changing agreed-upon allocations likely to produce favorable tax results for the partners.[34] The first, which I will call "source-measurement correspondence," treats a distributive share measured by the results of some partnership activity as having the character appropriate to that activity. Under this method, a valid allocation to *A* of "gain from the sale of Blackacre" would be treated as giving *A* a section 1231 gain if Blackacre is a section 1231 asset; an allocation of "ordinary income to *A* in the amount of gain from the sale of Blackacre" would not necessarily give *A* ordinary income. The second method is that of pro rata allocation, under which a partner who is allocated some fraction of the partnership's gain or loss as determined by a capital-account analysis is deemed to have that fraction of all the income and deduction items that make up the gain or loss. If pro rata allocation applies, a partner whose capital-account balance increases by 10% of the total increases for all partners will be allocated 10% of each item of partnership income.[35]

1. *Source-Measurement Correspondence*

All of the regulations' examples dealing with allocations of amounts that were uncertain when the partners agreed to the allocations apply a source-measurement test. Example 10, involving an allocation to *T* of 90% of the income from

[31]Regs. § 1.704-1(b)(2)(iii)(*b*)(*1*).

[32]*See infra* note 53 (effect of actual allocation agreement).

[33]All five of the examples of the 1956 regulations survive more or less intact in the 1985 regulations, although the rules that the new regulations purport to apply differ considerably from those of 1956.

[34]For obvious reasons of administrative economy, the regulations do not require a reallocation if the formula in the agreement was not likely to reduce the partners' taxes.

[35]An agreement may create valid character allocations for some items, but not for others. In that case, the regulations apply the pro rata method only to the invalidly allocated items, on the basis of the relative changes in capital account balances attributable to those items alone. *See* Regs. § 1.704-1(b)(5) Ex. 5(ii), reallocating tax-exempt interest and taxable investment income according to the relative changes attributable to those two items.

operations conducted by *T* within his country, is typical.[36] If the amounts of the various kinds of partnership income "cannot be predicted with any reasonable accuracy," the example holds that this allocation has substantial economic effect. If, however, the partnership agreement provides that *T* and *S* share all income equally, with income from operations within *T*'s country allocated to *T* as part of his share, all income items must be allocated equally if an equal division leads to less favorable tax results than the economically identical division to which the partners agreed.[37]

Example 10 describes the allocation it holds invalid as lacking "substantial" economic effect. The "invalid" allocation, however, has exactly the same economic effect as a simple fifty-fifty division of partnership income would have had. Indeed, the example recognizes this when it "reallocate[s]" all income items equally to *S* and *T*. The fifty-fifty allocation ratio is the ratio created by the "invalid" allocation agreement. The real difference between the valid and invalid allocations is that the valid allocation uses the same formula—90% of the income from operations within *T*'s country—to determine both the amount and the character of *T*'s share, while the invalid allocation uses a percentage of overall partnership income to measure *T*'s share, but not to determine its character. Other examples are cited in the margin.[38]

Source-measurement correspondence may be useful as a rule of thumb, because in many cases it does seem right to treat gains or losses measured by a particular activity as having the character appropriate to that activity. If, for example, a partnership agreement has always provided that gain or loss from the sale of Blackacre (a section 1231 asset) will be allocated to *A*, with other gains and losses divided equally, the situation is much the same as if *A* were the owner of Blackacre. This is so because *A* bore all of the risks associated with fluctuations in the value of Blackacre.[39] In the absence of special circumstances, it is reasonable to treat the person who is subject to the uncertainties associated with owning Blackacre as the taxpayer who has a section 1231 gain or loss when Blackacre is sold. The tax system's willingness to allow item allocations rests upon a judgment that particular partners can be treated as if they were conducting particular portions of the partnership's activities. In deciding which activities should be attributed to which partners, consideration of any substantial risks the partners bear with respect to those activities can be very helpful. Part V of this article will explore the advantages and limitations of analyses that focus upon risks in connection with several specific character allocation problems.

2. *Pro Rata Allocations*

If the partners know the amounts of the items being allocated when they agree upon an allocation formula, the formula may not reflect risk bearing in any

[36] Regs. § 1.704-1(b)(5) Ex. 10(i). The agreement also allocates all income and deduction items not derived from operations within *T*'s country equally between *S* and *T*.

[37] Regs. § 1.704-1(b)(5) Ex. 10(ii).

[38] Regs. § 1.704-1(b)(5) Exs. 3, 7(i) (as to gains and losses on sales), 7(iii), 11(ii).

[39] "Risk," as used in this article, includes the uncertainty of potential rewards.

serious sense. If, for example, partners *I* and *J* know at the beginning of the year that the partnership will receive $400 in tax-exempt interest and $600 in taxable interest, an allocation of the tax-exempt interest to *I* and the taxable interest to *J* may reveal more about *I*'s and *J*'s marginal tax rates than about the way in which the partners share risks.[40] In most cases like this, the regulations hold source-measurement correspondence allocations invalid and insist that the character of the items be allocated pro rata if a pro rata allocation is less favorable than the agreement's allocation.[41] But the regulations are not entirely consistent. Two of the examples allow the use of the source-measurement correspondence formula even though the items seem to be predictable.[42] These exceptions may result from an oversight on the part of the drafters, because all of the examples that note that the amounts in question are fairly certain insist upon pro rata allocations.[43]

Although the examples describe the source-measurement correspondence allocations they reject as lacking substantial economic effect,[44] they in fact give full effect to changes in capital-account balances created by the allocations. Thus, if an allocation of tax-exempt interest to *I* and taxable interest to *J* was adopted as an amendment to a fifty-fifty agreement to reduce taxes in a year in which *J* expected to be in a low bracket, the interest would be reallocated to treat 40% of each kind of interest as *I*'s, and the other 60% as *J*'s.[45] This reallocation gives full force to the only economic effect that the regulations recognize: the amount of each partner's distributive share of tax-exempt and taxable interest combined equals the change in the partner's capital-account balance. The reallocation involves character only, and it assigns character pro rata.[46]

B. *The Rules*

The "rule" portion of the substantial economic effect regulations does not describe the source-measurement correspondence method, and it ignores proration except as an ordering rule for partly valid allocations.[47] Instead, the rules define economic effect by reference to capital accounts and then provide special definitions of "substantial." These "substantiality" rules determine whether reallocation is required even though an allocation determines dollar amounts; the reallocations themselves are said to be made under the "partner's interest in the partnership" standard.

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[40]The example in the text is a simplified version of Regs. § 1.704-1(b)(5) Ex. 5.
[41]*See supra* note 34.
[42]Regs. § 1.704-1(b)(5) Exs. 3, 11.
[43]*See generally* Regs. § 1.704-1(b)(5).
[44]*E.g.*, Regs. § 1.704-1(b)(5) Ex. 5(ii).
[45]Regs. § 1.704-1(b)(5) Ex. 5(ii).
[46]*See also* Regs. § 1.704-1(b)(5) Exs. 6, 7(i) (as to interest and dividends), Ex. 7(ii).
[47]Regs. §§ 1.704-1(b)(2)(ii)(*e*), -1(b)(5) Exs. 15(ii), (iii). The examples deal with cases in which an allocation would satisfy the alternate economic effect test but for the fact that a partner's capital account balance is less than the total loss allocated to that partner.

The "after-tax economic benefit" rule of section 1.704-1(b)(2)(iii) says that the economic effect of an allocation is not substantial

> if, at the time the allocation becomes part of the partnership agreement, *(1)* the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation . . . were not contained in the partnership agreement, and *(2)* there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation . . . were not contained in the partnership agreement.[48]

This rule raises a serious problem. The rule requires a comparison of the tax consequences of an allocation with the tax consequences that would obtain if the agreement lacked that allocation. Such a comparison is impossible unless we know what the agreement would have said about the items in question if the partners had not agreed to the allocation in question. If the allocation in question was adopted as an amendment to a preexisting agreement, the preexisting agreement may be the basis of comparison, at least if the economic effect of the change is not large.[49] If the allocation involves only a small part of the partnership's income, with the balance divided according to some overall formula (typically fifty-fifty in the examples), the overall formula can provide the standard.[50] In other cases neither the rule nor the examples tell us how to determine the "consequences if the allocation . . . were not contained in the partnership agreement."

The "shifting tax consequences" rule of section 1.704-1(b)(iii)(*b*) resembles the "after-tax economic benefit" rule discussed above. It provides that an allocation's economic effect is not "substantial"

> if, at the time the allocation . . . becomes part of the partnership agreement, there is a strong likelihood that—
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> *(1)* The net increases and decreases that will be recorded in the partners' . . . capital accounts will not differ substantially from the net increases and decreases that would be recorded . . . if the allocations were not contained in the partnership agreement, and
>
> *(2)* The total tax liability of the partners . . . will be less than if the allocations were not contained in the partnership agreement . . . .[51]

Again, the "compared-with-what" question arises. As in the case of the "after-tax economic benefit rule," one can look to a preamendment agreement to evaluate the consequences of an amendment or to an overall allocation to evaluate item allocations. In addition, Example 10(ii) applies the "shifting tax conse-

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[48]Regs. § 1.704-1(b)(2)(iii)(*a*).
[49]*See* Regs. § 1.704-1(b)(5) Exs. 5, 6.
[50]*See* Regs. § 1.704-1(b)(5) Ex. 7.
[51]Regs. § 1.704-1(b)(iii)(*b*).

quences'' rule to invalidate an allocation of character that does not follow the source-measurement correspondence pattern.[52]

The ''after-tax economic benefit'' rule and the ''shifting tax consequences'' rules should not be taken too seriously. Read literally, they are far too sweeping to be useful. Consider a partnership agreement that allocated all income and deduction items equally between *A* and *B*. The partnership has some tax-exempt interest and some taxable interest, and the partners know that *A*'s marginal tax rate will almost always be higher than *B*'s. Both rules can be interpreted to mean that the allocation agreement is invalid. The partners could have agreed to an allocation giving *A*, the high-bracket partner, a disproportionately high share of the taxable interest, with this economic inequality being offset by allocating most or all of the tax-exempt interest to *B*. Because the amounts of interest can be estimated accurately before the beginning of each year, these allocations could have been made so as to produce the same effect on capital-account balances as the fifty-fifty allocation. They could also have been designed so that *B* comes out the same after tax as under the equal division, with *A* being worse off. Therefore, the even division seems to fail both tests, which appear to create a ''worst possible allocation'' standard. This is surely not the law.

Consider, again, Example (10)(ii) of the regulations. There, an equal division of the partnership income between *T* and *S*, with *T*'s share to include all income from operation within *T*'s country, is judged invalid under the ''shifting tax consequences'' rule because an even division of all income items would have produced identical economic consequences and less favorable tax results for *T* and *S*. Suppose that the partners had originally agreed to and consistently applied a fifty-fifty allocation of all items. The shifting tax consequences rule seems to require that the allocation should be invalidated upon a showing that an allocation of all income equally, but with *S*'s share to include all income from operations within *T*'s country, would have caused the partners to pay higher taxes.[53] The examples, however, approve only source-measurement correspondence allocations and pro rata allocations, with the latter being used when source-measurement correspondence fails as an indicator of risk bearing because the risks involved are small.[54]

The regulations say that items allocated by a provision lacking substantial economic effect will be reallocated under the ''partner's interest in the partnership'' standard of section 1.704-1(b)(3).[55] The examples applying the after-tax economic benefit and shifting tax consequences rules, however, make no attempt to apply the factors that constitute the ''partner's interest in the partnership''

[52]The other ''substantiality'' rule is the ''transitory allocations'' rule of Regs. § 1.704-1(b)(2)(iii)(*c*). This rule is, in substance, the ''shifting tax consequences'' rule applied over a period longer than a single partnership taxable year.

[53]The actual allocation agreement produces the same effect on capital accounts and a more favorable tax result than the hypothetical allocation.

[54]*See generally* Regs. § 1.704-1(b)(5).

[55]Regs. § 1.704-1(b)(1)(i).

standard.[56] Instead, every reallocation under an agreement held to have an economic effect that is not "substantial" is accomplished by allocating the items pro rata.

If the examples rather than the rules are the law, there are four techniques for assigning character:

1. An allocation agreement meeting the capital account requirements will determine the amounts, but not necessarily the character, of the partners' distributive shares.

2. An allocation using the source-measurement correspondence principle to determine character will be respected if the amounts of the items to be allocated were substantially uncertain when the allocation agreement was adopted.

3. An allocation of substantially uncertain items that does not follow the source-measurement correspondence principle is invalid as to character, but not amounts, if it is likely to produce tax results more favorable than a source-measurement correspondence allocation.

4. If amounts were not uncertain when the agreement was made, and if the allocation was expected to make the partners better off than a pro rata allocation would have, character will be reallocated on a pro rata basis.

For the following three reasons, this summary explains the results of the examples better than the "substantiality" rules do. First, the techniques described above address character questions explictly; the substantiality rules cause confusion by dealing with character without saying so. Second, the summary fills the "compared-with-what" gap in the substantiality rules by using the source-measurement correspondence principle and proration as baselines for evaluating allocations of uncertain and known-amount items respectively. Finally, the summary makes it clear that some allocations of uncertain items are permitted even if they were likely to produce favorable tax results, and even though a less favorable but economically identical allocation could have been devised. For example, "foreign-source income to *A*" is acceptable if the amount of foreign-

[56]The "factors" listed in Regs. § 1.704-1(b)(3)(ii) are as follows:

(*a*) The partners' relative contributions to the partnership;
(*b*) The interests of the partners in economic profits and losses (if different [from] that in taxable income or loss);
(*c*) The interests of the partners in cash flow and other nonliquidating distributions; and
(*d*) The rights of the partners to distributions of capital upon liquidation.

These factors are "among those that will be considered"; ultimately, "[t]he 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." Regs. § 1.704-1(b)(3)(i). If an allocation lacks "economic effect" because the requirement that a partner pay in a capital account deficit upon liquidation is not met, the "partner's interest in the partnership" may be determined by comparing hypothetical liquidations before and after the year in question. Regs. § 1.704-1(b)(3)(iii).

source income is uncertain, even if foreign-source characterization of *A*'s share is certain to be better for all partners than another characterization.[57]

In listing these "techniques," I do not mean to insist that the regulations follow them without qualification. In some cases, the drafters seem to have overlooked the likelihood that the amount of the item in question was determinable when the allocation was made, and in the examples involving cost recovery deductions the drafters made a fundamental mistake about risk bearing. The list attempts to capture what the drafters were trying to do; it does not insist that they always succeeded.

V. APPLICATIONS

The discussion so far has shown, in a general way, how the regulations deal with character. This section will examine three problems: (1) allocations of cost recovery deductions; (2) retrospective allocations generally, or allocations of known amounts; and (3) allocations of foreign-source income.

A. *Cost Recovery Deductions*

In *Orrisch v. Commissioner*,[58] the Tax Court held that the economic effect of special allocations of depreciation must be found by looking "to see who is to bear the economic burden of the depreciation if the buildings should be sold for a sum less than their original cost."[59] Except for cases involving depreciation deductions attributable to nonrecourse debt, a matter with which the 1985 regulations do not deal, the regulations attempt to follow the *Orrisch* principle. For instance, Example (1)(i) invalidates an allocation of all of a partnership's cost recovery deductions to *A* because "A will not bear the full risk of the economic loss corresponding to" the cost recovery deduction.[60] Several of the examples, however, are inconsistent with the risk-bearing principle of *Orrisch*. The examples make it clear that, if the capital account requirements of the substantial economic effect test are satisfied, cost recovery deductions are normally to be taken by the partners whose capital account balances are reduced by the amount of those deductions.[61] But the risk that partnership property will decline in value is borne by the partners whose capital accounts will reflect gains and losses on

[57]If an economically identical formula of "U.S.-source income to *A* in the amount of the partnership's foreign-source income" would produce less favorable tax results to all partners, a literal reading of the "shifting tax consequences" rule of Regs. § 1.704-1(b)(iii)(*b*) might suggest that this alternative is required. *See supra* text accompanying note 53 (effect of actual allocation agreement). I do not mean to suggest that anyone would actually attempt to apply the regulations in so absurdly literal a way; my point is only that nothing in the rules themselves prevents this kind of reading.

[58]55 T.C. 395 (1970), *aff'd mem.*, 31 AFTR 2d 1069 (9th Cir. 1973).

[59]55 T.C. at 403.

[60]Regs. § 1.704-1(b)(5) Ex. 1(i). The example deals with an agreement that ignores capital account balances in calculating liquidating distributions.

[61]Regs. § 1.704-1(b)(5) Exs. 1(iii), (iv), (v), (vi), (vii), (viii), (ix), (x), and (xi)). Only in the last of these examples does the agreement contain a gain chargeback provision.

the sale of the property, not by the partners whose capital accounts are affected by cost recovery deductions.

Suppose that the *AB* partnership, which maintains capital accounts as the regulations direct, buys an asset for $100. The partnership agreement allocates all cost recovery deductions to *A* and provides that *A*'s capital account balance will be reduced by the amount of those deductions. Gain or loss on the sale of the property will be reflected in *B*'s capital account. Under the regulations, all of the partnership's cost recovery deductions are taken by *A*. *B*, not *A*, bears the risk that the asset will decline in value. *A*'s capital account balance will decline by the amount of the partnership's cost recovery deductions no matter what happens to the value of the property. Changes in value will be reflected in *B*'s capital account because those changes will affect the amount of gain or loss upon the sale of the property. If the partnership takes the full $100 in cost recovery deductions, *A*'s capital account balance will decline by $100, irrespective of whether the property's value rises or falls. If the property declines in value by $100 and is sold, *B*'s capital account will not change; if it declines by only $50, *B*'s capital account will reflect a $50 increase, and so on. To be sure, if the property's value does decline by $100, the amount of the decline will equal the amount of the reduction in *A*'s capital account. This does not mean that *A* bore the risk of that decline: *A*'s capital account would have been reduced by $100 even if the property's value had fallen by $50, or if it had increased. The risk of decline in value will be borne by the partners to whom the deductions are allocated only when a partnership agreement provides for a "chargeback" of gain attributable to cost recovery deductions.[62] The agreement examined in the *Orrisch* opinion did involve a gain chargeback,[63] but many of the regulations' examples do not.[64]

In allowing cost recovery deductions to a partner whose capital account is charged with the amount of those deductions, the regulations appear to apply the source-measurement correspondence principle, though in fact they give undue weight to labels. As the *Orrisch* court observed, the amount of a partnership's cost recovery deductions is known as soon as the property is placed in service: "the deduction for depreciation does not vary from year to year with the fortunes

[62]*See* Culpepper, *Handling the Tax Considerations in Drafting Partnership Allocation Provisions,* 2 J. PARTNERSHIP TAX'N 291, 297-99 (1986) (chargeback necessary to make allocation of cost recovery deductions "consistent with the partners' real economic deal"); Krane & Sheffield, *Beyond Orrisch: An Alternative View of Substantial Economic Effect Under Section 704(b)(2) Where Nonrecourse Debt is Involved,* 60 TAXES 937, 944 n.28 (1982) [hereinafter cited as Krane & Sheffield] ("appropriate result" when building sold for more than adjusted basis but less than original basis "is that the . . . gain . . . should be allocated back to" the capital account of the partner who took the depreciation); McKee, Nelson & Whitmire, *The Tax Reform Act of 1976: Changes Affecting the Taxation of Partnerships and Partners,* 33 TAX L. REV. 485, 502-03 (1978) ("The effect of . . . a gain chargeback arrangement is to insure that the partners receiving the special depreciation allocation suffer economically only to the extent that the specially allocated depreciation reflects a real decline in economic value").

[63]55 T.C. at 397.

[64]Regs. § 1.704-1(b)(5) Exs. 1(iii)-(x).

of the business."[65] In other cases, the regulations recognize that source-measurement correspondence breaks down when known items are being allocated. The regulations' treatment of cost recovery deductions seems to be an oversight, attributable perhaps to the regulation's assumption that the property will decline in value by the amount of the cost recovery deductions.[66] That assumption, which also derives from the *Orrisch* opinion,[67] is made to overcome an argument that allocations of cost recovery deductions *with* gain chargebacks have no "substantial" economic effect because they are transitory. No judgment about risk bearing, however, can rest upon an assumption that an asset's value will fall by a known amount. Risk, by definition, involves uncertainty.

Partnerships have no legitimate reason for attempting to allocate cost recovery deductions without appropriate chargebacks. Since the amount of a partnership's cost recovery deductions is fixed, anything of economic significance that can be done by allocating a cost recovery deduction without a chargeback can be accomplished just as well by using a fixed dollar figure. Consider, for example, an allocation of a partnership's full \$100 of cost recovery deductions to *A*, of gain or loss on the sale of the property to *B*, and of all other partnership income fifty-fifty. This allocation does not differ economically from one giving all cost recovery deductions, all gain or loss on the sale of the property, and \$100 more than half of the other income to *B*, with *A* receiving \$100 less than half of the other income.[68] Attempts to characterize *A*'s distributive share as including the partnership's cost recovery deductions by using the first form of allocation should be rejected as inconsistent with the partners' risk-sharing arrangement.

Although the regulations' examples accept cost recovery allocations without gain chargebacks, flagrant attempts to secure unwarranted tax benefits[69] by using such allocations may fail. The cost recovery examples refrain from concluding that the allocations are valid. They conclude only that the allocations "have economic effect."[70] The substantiality rules of the regulations can therefore be

[65] 55 T.C. at 401.

[66] Regs. §§ 1.704-1(b)(2)(iii)(*c*), -1(b)(5) Exs. 1(vi), (xi).

[67] 55 T.C. at 403-04.

[68] For example, if the "other" income is \$1000, the "cost recovery" version of the allocation gives *A* \$500 of the other income and a \$100 cost recovery deduction; *B* gets \$500 of the other income. The "fixed amount" version gives *A* \$400 of the other income, while *B* gets \$600 of other income and the \$100 cost recovery deduction. In either case, the capital account balances of *A* and *B* increase by \$400 and \$500 respectively.

If the amount of other income is less than \$200, the ceiling rule, *see infra* note 94, would prevent giving full effect to the "fixed amount" version of the allocation. The purported allocation of the cost recovery deductions to *A* rather than to *B*, who bears the related risk, is simply a way of saying that *A*'s capital account will be reduced by \$100, and that *B*'s will be increased by the same amount, irrespective of the outcome of partnership operations. An attempt to do this directly might disqualify the partners from using the substantial economic effect test because their capital account adjustments were not consistent with tax principles.

[69] Using the example from the previous footnote, if *B*, but not *A*, is subject to the alternative minimum tax, the "cost recovery" version of the agreement could save taxes if the partnership used an accelerated cost recovery method. The two allocation formulas will also produce different tax results if some of the partnership's income is not ordinary.

[70] Regs. § 1.704-1(b)(5) Exs. 1(iii)-(x).

invoked in any case in which cost recovery allocations produce undesirable results, and the substantiality rules are so sweeping that they can be used as authority for striking down practically any allocation a court dislikes.[71]

B. *Retrospective Allocations*

All partnership allocations are in a sense retrospective. Any partnership agreement can be changed, and so even an allocation to which the partners agreed long before the transactions in question took place is retrospective in the sense that the partners could have changed their minds after the transactions occurred, but did not. As a practical matter though, consideration of retrospective allocations can be limited to cases in which allocations are made after significant facts about the makeup of the partnership's income became known. Ordinarily, it will be reasonable to assume that the partners made their decision about how income should be allocated when they agreed to the allocation.[72]

Even if a particular allocation is made prospectively, the existence of a power to allocate other items retrospectively may make the prospective allocation meaningless. Imagine an agreement between *A* and *B* that allocates capital gains to *A*, with the allocation of other items left to be agreed upon after the amounts of those items are known. If the partners know at all times that the amount of the other items will equal or exceed the amount of capital gains, they can use the agreement process to produce allocations that give each partner half the partnership's total income for the year. The prospective portion of the allocation agreement seems to make the amount of *A*'s income vary dollar for dollar with the amount of the partnership's capital gain. This is an illusion if the partners take the results of the "prospective" allocation into account in exercising their power to make retrospective allocations.

Allocations made after the amount and character of a partnership's income are known may have economic effect in the capital account sense. Therefore, retrospective allocations can be taken just as seriously as prospective allocations in determining the amounts of the partners' shares. The source-measurement correspondence principle, however, cannot be relied upon to determine character when retrospective allocations are involved because the form of a retrospective allocation reveals nothing about risk bearing. If a partnership agreement provides that *A* will be assigned all of a partnership's section 1231 gains and losses, and if the partnership then buys, holds, and sells Blackacre, the terms of the agree-

[71]If read literally, the "substantiality" rules would seem to automatically disallow any cost recovery allocation more beneficial to the partners than some other possible allocation, especially if the allocation is not accompanied by a gain chargeback. The drafters could not have intended this result, because this reading would render most of the cost recovery examples pointless and misleading.

[72]Suppose that the members of a small partnership have consistently amended their allocation agreement whenever the allocation previously agreed upon would have produced unfavorable tax results. Failure to change an allocation that did not turn out badly would not necessarily mean that the unamended agreement reflected the partners' economic arrangement. Instead, the overall pattern would suggest that the partners understood their agreement to be conditioned upon its keeping their taxes low. *Cf.* Regs. § 1.704-1(b)(4)(vi), requiring "close scrutiny" of amended agreements to determine whether a "purported modification was part of the original agreement."

ment show that *A* bore the risks associated with the Blackacre transaction. But if the partnership sells Blackacre at a gain and then, after the fact, adopts an agreement purporting to allocate the gain to *A* and all other income fifty-fifty, there is no good reason to think that *A* was the only partner with an economic interest in Blackacre. The partners may have decided to allocate all of the partnership's income on some percentage basis and then included gain from the sale of Blackacre in *A*'s share, reducing *A*'s share of other income by an equal amount. The allocation to *A* of gain from the sale of Blackacre is more likely to show that *A* had good use for a section 1231 gain than to show anything about how the partners' shared risks.

When the regulations focus on the question of whether the character of known-amount items can be specially allocated, they say that it cannot (with the usual qualification about after-tax benefits). Instead, character must be allocated pro rata.[73] The three examples, however, involve allocations that will be effective only for a short period, and two of them concern allocations made by amending a pre-existing agreement.[74] In practice, the pro rata allocation method may be required only for allocations that are highlighted in these ways, or that are formally retrospective. Examples allowing special allocations of research and experimental expenditures[75] and wages[76] hold the allocations valid without suggesting that the amounts in question were uncertain when the allocations were made.[77]

Some retrospective allocations are less objectionable than others. Suppose *A* and *B* invest half the partnership's surplus cash in tax-exempt municipal bonds and the other half in taxable bonds. Interest, gains, and losses attributable to the municipal bonds are allocated to *A*; interest, gains, and losses attributable to the taxable bonds go to *B*. The 1956 regulations and the 1983 proposed regulations held allocations like these valid.[78] Under the 1985 regulations their validity is not clear. Example 5 can be read to say that tax-exempt and taxable interest must be allocated pro rata between *A* and *B* if the agreed-upon allocation was expected to produce tax benefits. If the parties adhere to their allocation consistently, there is no reason for it to be rejected. Economically, the case is identical to one in which the partners withdrew their shares of the surplus funds

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[73]Regs. § 1.704-1(b)(5).

[74]Regs. § 1.704-1(b)(5) Ex. 5 (apparent amendment), Ex. 6 (amendment), and Ex. 7 (special allocation effective for partnership's first three taxable years)).

[75]Regs. § 1.704-1(b)(5) Ex. 3.

[76]Regs. § 1.704-1(b)(5) Ex. 11(ii).

[77]The regulations' substantiality rules, if read literally, would invalidate almost all retrospective allocations (including those that are pro rata), because they examine the likelihood of after-tax economic consequences as of the time the allocation becomes part of the agreement. *See* Regs. § 1.704-1(b)(2)(iii)(*a*). The likelihood of a past event is always 100%, and thus any retrospective character allocation more favorable to the partners than some possible alternative seems to fail the substantiality rules. This shows again that the substantiality rules cannot be applied mechanically, but must be limited to cases in which an agreement's allocation is understood to be unsatisfactory on some ground not spelled out by the terms of the rules.

[78]Regs. § 1.704-1(b) Ex. 3 (1956); Prop. Regs. § 1.704-1(b)(5) Ex. 7(i), 48 Fed. Reg. 9871 (1983).

and made different investments. Because the partners are not using the allocation process to obtain a benefit not available to those who are not partners, the allocation should be respected, and, under the "partner's interest in the partnership" standard, perhaps it will be. Example 5 differs on its facts from this case, because the example involves a temporary special allocation of exempt and taxable income. Nonpartners cannot exchange taxable and tax-exempt interest with each other on a year-by-year basis, depending on their tax brackets, and partners should not be able to do so either. A "permanent" allocation that accurately reflects the partners' economic arrangement should be respected, even if it does not involve uncertain items.

A "retrospective" allocation should also be upheld if it is consistent with the partners' risk-sharing arrangement, even though the particular allocation does not itself assign risks. One example is the allocation of cost recovery deductions. As discussed previously, an allocation of a cost recovery deduction cannot assign risks because the amount of the deduction is known in advance. But a special allocation of a cost recovery deduction accompanied by a gain chargeback provision should be given effect. The gain chargeback assigns risk, and the allocation of depreciation to the partner who will report the gain and bear the risk produces the appropriate tax result.[79]

The much-discussed case of *Harris v. Commissioner*[80] provides another illustration of a special allocation that may have been retrospective but which was fully consistent with the partners' economic arrangements. Harris was a 40% member of a partnership that owned a shopping center. As part of a plan to reduce Harris' interest, the partnership sold a 10% interest in its real estate. The loss on the sale was charged to Harris' capital account. The partnership then distributed the sale proceeds to Harris, reducing his partnership interest from 40 to 33.3% This series of transactions was economically equivalent to the sale by a 40% co-owner of property of one-fourth of his interest.[81]

A risk analysis shows that the Tax Court was correct in approving the allocation to Harris of all the partnership's loss, even though the allocation may have been retrospective in the sense that it was made after the amount of the loss to be allocated was known. The transactions as a whole did not change the other

[79]Similarly, if a partnership has only one predictable income or deduction item, a special allocation of that item should ordinarily be respected if other items are allocated prospectively. The allocation of the known-amount item may not assign risk, but the allocation of the other items assign risk, and giving effect to those allocations leaves the allocation of the known-amount item correct by default. Consider, for example, an allocation of all of a partnership's interest income (known) to *A*, with other income (unknown) 90% to *B* and 10% to *A*. The amount of money *B* gets depends only on the amount of the unknown income.

[80]61 T.C. 770 (1974). *Harris* is discussed in American Law Institute, Federal Income Tax Project: Subchapter K 24 (1984) [hereinafter cited as ALI Study]; Krane & Sheffield, *supra* note 62, at 939; Cowan, *supra* note 19, at § 23.04[3]; and Kamin, *supra* note 13, at 673-75.

[81]Before the transactions, Harris "owned" a 40% share of the property because he was a 40% member of a partnership that owned all the property. After the transactions, Harris "owned" a 30% share, by virtue of his status as a 33.3% member of a partnership that owned 90% of the property, and he had received an amount equal to the sale price of the 10% share of the property that was sold.

partners' shares of the risk with respect to the property at all. Both before and after the transactions, a $1000 increase or decrease in the property's value would have benefited or hurt the other partners by $600. As to Harris, a $1000 increase in the property's value before the transactions would have made him $400 better off; after the transactions, a $1000 increase would have enriched him by only $300. Therefore, an allocation of any of the loss to any partner other than Harris would have been inconsistent with the economics of the transaction.[82]

All that can be said with confidence about the treatment of retrospective allocations under the regulations is that the regulations provide ample authority for disallowing the character components of retrospective allocations, but they do not necessarily require disallowance in all cases. In particular cases, the courts and the Service should pay close attention to risk-bearing relationships and to the question of whether following an agreement's treatment of character will give the partners a tax benefit that they could not have obtained if they were not partners.

C. *Source-Measurement Correspondence, Risk, and Other Policies: The Case of the Foreign-Based Service Partner*

The source-measurement correspondence method works well only when two conditions are satisfied: (1) the test links character to risk, and (2) linking character to risk makes sense under the circumstances. In the case of items that can be measured before the partners agree upon an allocation, the method breaks down because the partner who is assigned items of a particular character may not be subject to any of the risks of the activity associated with those items. When the items being allocated are uncertain, the source-measurement correspondence method can tie character to risk, and the method will often produce acceptable results. Risk bearing, however, is not an infallible indicator of character. The policies justifying special treatment of the item in question may require allocation of the item to someone other than the risk-bearing partner.[83] An

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[82]*See* Krane & Sheffield, *supra* note 62, at 939. The *Harris* agreement would not be subject to disallowance under the regulations' "substantiality" rules. In comparison with the original agreement, the amended agreement was likely neither to produce substantially the same increases or decreases in all the partners' capital accounts, Regs. § 1.704-1(b)(2)(iii)(*b*)(*1*), nor to guarantee that every partner's after-tax economic position would be at least as good as if the amendment had not been adopted. Regs. § 1.704-1(b)(2)(iii)(*a*).

[83]It may be useful at this point to consider the extent to which source measurement correspondence applies in nonpartnership contexts. In many everyday transactions, it is obviously appropriate to look to the activity that measures a taxpayer's income to determine both the amount and the character of that income. One who buys stock and receives dividends has income in the amount of those dividends, and the income has the character of dividend income; one who buys and later sells a capital asset has income measured by the gain on the sale, with the character of capital gain; and so forth. Nevertheless, there are cases in which income measured by the economic results of an activity does not have the character associated with that activity. The existence of these cases shows that source measurement correspondence is not a necessary part of our ordinary concept of income.

One area in which source measurement correspondence does not always hold is compensation for services. Suppose an investor hires a manager to trade the investor's securities and compensates the manager by paying him a percentage of the dividends, interest, and net gains from the portfolio each year. The manager's income is ordinary income from services, even though the amount of that income depends entirely on the amount of capital gains and losses, dividends, and interest generated each year. The same applies to a lawyer handling a personal-injury case, on receiving a fraction of examination of the way in which the regulations determine whether a partner's income is from a foreign source[84] will show how the policies underlying Code provisions can be overridden when risk bearing becomes the exclusive test for character.

The tax treatment of a partner who works in a foreign country depends upon the extent to which the partner's distributive share is treated as foreign-source income. For example, a partner whose presence abroad meets the requirements of section 911(d)(1) can exclude from gross income up to $80,000 a year of foreign-source (but not domestic-source) earned income, and the overall limitation on a partner's foreign tax credit depends upon the ratio of his foreign-source taxable income to his total income.[85] The purposes of the section 911 exclusion are (1) encouraging United States citizens to work abroad, and perhaps (2) taking account of the fact that compensation paid someone who works abroad may represent less ability to pay than an equal amount of compensation paid for work in the United States because the foreign-based worker may incur extra nondeductible living expenses.[86] The overall limitation on the foreign tax credit

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a payment in settlement of the claim. Likewise, under section 83, gain attributable to the increase in value of restricted stock given an employee for services can be ordinary compensation income, even though the amount of that income is measured by the increase in value of a capital asset.

In cases not involving services, failure to recognize that there is no necessary link between the measure and the character of a taxpayer's gain has sometimes led to litigation. The taxpayer in Mesa Petroleum Co. v. Commissioner, 58 T.C. 374 (1972), operated natural gas wells that produced gas worth 14 cents per thousand cubic feet (MCF). It paid royalties of 2.40875 cents per MCF to the lessors of the natural gas rights. Under the version of section 613 then in effect, Mesa Petroleum was allowed a percentage depletion deduction of 27 1/2% of its "gross income from the property." The Commissioner argued, and the Tax Court held, that Mesa's percentage depletion deduction per MCF was 27 1/2% of the difference between 14 cents (gross income from the property) and 2.40875 cents (the royalty). This result would have been obvious but for one complication: the lessors' royalty of 2.40875 cents was determined under a formula that took into account Mesa's profits from converting the natural gas into gasoline and other finished products. Mesa's argument, in effect, was that part of the lessors' royalties were payments measured not by gas production, but by gas processing, so that a portion of the royalties was not really a share of production. The Tax Court, pointing out that the lessors had not invested in Mesa's processing plant, held that the entire 2.40875 cents per MCF constituted royalties from production. Thus, although the payments were measured (in part) by the profits of gas processing, the payments were treated as having their source in gas production. Since the lessors received the payments only because they had leased their production rights to Mesa, the court's characterization is plainly right.

Another issue that is sometimes dealt with by using a source measurement correspondence assumption is whether someone who has transferred property, retaining a right to payments measured by the productivity of the property, should be taxed on the property's income. *See* Ward, *Taxation of Gratuitous Transfers of Encumbered Property: Partial Sales and Section 677(a)*, 63 IOWA L. REV. 823, 866-87 (1987), for a thorough evaluation of the alternatives. Professor Ward's "risk-benefit" analysis, which he compares with a "personal-liability" approach, is a form of what I have called "source measurement correspondence."

[84]"U.S.-source" and "foreign-source" are sometimes used as shorthand for the statutory phrases "from sources within the United States," I.R.C. § 861(a), and "from sources without the United States," I.R.C. § 862(a). "Foreign-source" will also be used to mean "from sources within a foreign country." I.R.C. § 911(b)(1)(A).

[85]I.R.C. § 904. Under the Tax Reform Act of 1986, the exclusion is reduced to $70,000 for taxable years starting after 1986.

[86]The history of the foreign earned income exclusion is discussed in detail in Sobel, *United States Taxation of Its Citizens Abroad: Incentive or Equity*, 38 VAND. L. REV. 101, 119-46 (1985).

serves to "limit the credit in any year to the amount of U.S. tax on foreign-source income,"[87] so that "the effective rate of tax on foreign-source income . . . is the higher of the U.S. or the foreign rate."[88]

Consider a partnership formed by *S* and *T* to operate a travel agency. *T*, whose only contribution to the partnership consists of performing services, lives and works in a foreign country. Capital is not a material factor in producing the partnership's income. Example 10 of the section 704(b) regulations shows that if the partnership agreement allocates all income from foreign operations to *T*, *T*'s distributive share is foreign-source income, at least if the amounts of foreign- and domestic-source income "cannot be predicted with any reasonable certainty."[89] If the agreement allocates all partnership income equally between *S* and *T*, only half of the partnership's foreign-source income is included in *T*'s share, even if the agreement provides "that *T* will be allocated all income . . . from operations conducted by him within [the foreign] country as part of his . . . share."[90] In the latter case, the attempt to allocate foreign-source income to *T* lacks "substantial" economic effect, and must be disregarded. The reference to "substantial" economic effect must be understood as a reference to the source-measurement correspondence principle.

Suppose *T* has a "tax home" abroad and is a bona fide resident of the country in which he works. Treating part of *T*'s distributive share as domestic-source income for purposes of section 911, even though all of *T*'s work was done abroad, cannot be reconciled with any conceivable policy reason for the section 911 exclusion. If *T* were *S*'s employee, rather than his partner, $80,000 ($70,000 after 1986) of *T*'s income could be excluded from taxation no matter how the amount paid to *T* was calculated.

If *T*'s distributive share is fully taxable by both the United States and a foreign country, the overall limitation of section 904 may prevent full crediting of *T*'s foreign tax against his United States tax if part of the share is characterized as domestic-source income. Suppose, for example, that *T*'s distributive share is $60,000, half of which is classified as U.S.-source by the section 704 regulations. If *T* has no other income, and if the country in which *T* works taxes his entire distributive share,[91] *T* will be subject to both United States and foreign tax on part of his income.

[87]Isenbergh, *The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes*, 39 TAX L. REV. 227, 232 (1984).

[88]*Id. See also* STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., 1ST SESS., TAX REFORM PROPOSALS: TAXATION OF FOREIGN INCOME AND FOREIGN TAXPAYERS (Comm. Print 1985).

[89]Regs. § 1.704-1(b)(5) Ex. 10(i).

[90]Regs. § 1.704-1(b)(5) Ex. 10(ii).

[91]What matters most here is that both the foreign country and the United States characterize the taxpayer's income in the same way. If the foreign country treated half of *T*'s income as taxable, while the United States regarded all of it as foreign-source, the overall limitation would allow *T* to credit too much, rather than too little, of the foreign taxes. But this will be a problem only if the foreign tax rate is higher than the United States tax rate.

Devising consistent United States and foreign country source rules for partners' incomes could be achieved by treaty. The treaty between the United States and France does address the problem. *See* Tax Treaty Between France and the United States, July 11, 1968, CCH TAX TREATIES ¶¶ 2804-26, P-H TAX TREATIES ¶¶ 38,032-53. France, unlike the United States, treats all of a partner's

The *ST* partnership may be able to preserve the benefits of the section 911 exclusion of the foreign tax credit by giving *T* a large guaranteed payment, rather than a distributive share.[92] If the partnership's income is easily predictable, this technique could give *T* an amount of money quite close to that which he would receive under a "50% of worldwide income" allocation. If the amount of the partnership income is subject to substantial uncertainty, however, the use of a guaranteed payment would produce results very different from a straight fifty-fifty division of the partnership's worldwide income. In practice, therefore, some partners will find the regulations easy to avoid, while others will have to choose between abandoning useful business arrangements[93] or paying too much in taxes.[94]

The examples have shown how foreign-based service partners may be taxed more heavily than similarly situated nonpartners. In the much more common case of partnerships that do not have foreign operations, the present system's treatment of service partners tends to be too generous, rather than too harsh. Although a distributive share that represents compensation for services is the practical equivalent of salary, a service partner's distributive share will sometimes

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income from the performance of services by the partner in France as income from French sources. Under the treaty, France agrees to use the same source rules as the United States. Article 6, Sec. 4, CCH TAX TREATIES ¶ 2809; P-H TAX TREATIES ¶ 38,036. But the amount of a partner's income that can be exempted from French tax under this agreement is limited. Article 14, Sec. 4, CCH TAX TREATIES ¶ 2817; P-H TAX TREATIES ¶ 38,044. At the election of the partnership, the United States will treat the nonexempt (from French tax) U.S.-source income of a partner resident in France as French-source income, and the other partners' shares of French-source income will be reduced accordingly. Article 23, Sec. 4, CCH TAX TREATIES ¶ 2826; P-H TAX TREATIES ¶ 38,053.

[92]Miller v. Commissioner, 52 T.C. 752, 762 (1969).

[93]One reason a partnership might compensate a service partner working abroad with a share of worldwide income is to create a sort of "insurance device to even out his good years and bad years," Krane & Sheffield, *supra* note 62, at 939. Another possibility is that an agreement giving the foreign-based partner a distributive share measured solely by business conducted abroad would give that partner an incentive to refrain from referring business that could be handled more efficiently by the U.S. office to that office; worldwide pooling would avoid this.

If the amounts of a partnership's U.S. and foreign-source income are readily predictable, even an allocation of "90% of foreign source income to *T*" may not be given effect as to character because of the "substantiality" rules. Ex. 10(i) is limited to cases in which the amounts of the partnership's income and deduction items "cannot be predicted with any reasonable certainty."

[94]The source measurement correspondence principle is not the only barrier to sensible classification of a partner's distributive share as foreign-source. Suppose that half of the *ST* partnership's $100,000 income is foreign-source, and that the partnership has no deductions. If *T*'s distributive share is 60% of worldwide income, and if income must be characterized as foreign- or U.S.-source at the partnership level, no allocation permissible under current law could give *T* more than $50,000 of foreign-source income, even if the source measurement assumption were abandoned. Neither section 702 nor section 704 expressly prohibits an allocation of more than 100% of a partnership item, but an assumption that a partner's "share" of an item being allocated cannot exceed the amount of that item at the partnership level pervades the regulations. *See* Regs. § 1.704-1(b)(5) Ex. 14(iii), the cases (*e.g.*, Foster v. Commissioner, 329 F.2d 717 (2d Cir. 1964)), and the rulings (*See, e.g.*, Rev. Rul. 75-458, 1975-2 C.B. 258). The Government and the courts seem to accept this "ceiling rule" as part of the "nature of things," and they apply it even when the result is inconsistent with the economics of the situation. *See* Rev. Rul. 75-458, 1975-2 C.B. 258; Regs. § 1.704(b)(5) Ex. 14(iii).

The ceiling rule limits the way in which allocations can be made, but not necessarily the *results* of allocations. An allocation of "120% of the partnership's loss to *A*" would violate the rule, while an allocation of specific deduction items to *A*, and of income items to other partners, would not—even if it resulted in a loss for *A* equal to 120% of the partnership's loss for the year.

be treated as tax-exempt interest,[95] and a service partner's distributive share need not be capitalized by those who in effect pay it even if a comparable salary payment would be a capital expenditure.[96] A systematic solution to these problems would entail treating all distributive shares that are in substance compensation as if they were guaranteed payments.[97] This would require legislation, which is a distant prospect at best. In the meantime, administrative relaxation of the source-measurement correspondence rule to allow allocations that produce tax results comparable to those available outside the partnership context could reduce the pressures that now exist to conform partnership compensation arrangements to the demands of the regulations.[98]

VI. CONCLUSION

Much that seems puzzling in the section 704(b) regulations becomes understandable once allocations of character are distinguished from allocations of amounts. The tests the regulations apply to character issues have to do with source-measurement correspondence and proration, while amounts are determined according to economic effect in the capital account sense. Although the regulations' rules for character allocations purport to define "substantiality," those rules have nothing to do with whether the economic effect of an allocation is large or small, which is why one allocation can have a "substantial economic effect" while a different but economically identical allocation does not.

Except for cases involving cost recovery deductions, the regulations' examples form a reasonably coherent pattern. Coherence is not necessarily correctness, and the regulations seem to permit some abusive allocations and to prohibit some sensible ones. But perhaps the regulations should not be taken very seriously. Only the most sophisticated partnerships will keep their capital accounts according to the requirements of the substantial economic effect test. The allocations of other partnerships will be judged by the "partner's interest in the partnership" standard, which imposes no formal limits on allocations. Even the allocations of partnerships that do keep their capital accounts "properly" are supposed to be evaluated by "partner's interest in the partnership" principles if the allocations lack "substantial economic effect." In practice, therefore, the "partner's interest in the partnership" test may assume more importance than "substantial economic effect."

[95]The Service is reported to have issued a private ruling holding that the distributive share of a mutual-fund adviser who was a partner in a municipal bond fund was a share of tax-exempt interest. ALI Study, *supra* note 80, at 164. The practical effect of the ruling is similar to allowing a deduction for investment advice connected with earning tax-exempt interest, contrary to I.R.C. § 265(1).

[96]*See* McKee, *supra* note 20, at 1053-56.

[97]For a discussion of the ALI's proposal for doing something along this line, *see id.* at 1064-66.

[98]On the desirability of allowing a partnership to characterize a foreign-based partner's distributive share as foreign-source income even if the amount of the share is not measured by partnership-level foreign-source income, *see* Krane & Sheffield, *supra* note 62, at 939; Kamin, *supra* note 13, at 677-78.

Whatever its defects,[99] the "partner's interest in the partnership" standard does not lack flexibility; the current regulations may leave nearly as much scope as before for the Service and the courts to evaluate allocations on a case-by-case basis and to approve of those that reasonably reflect the partners' economic arrangements. In form, the law of partnership allocations has progressed from the nearly meaningless "avoidance or evasion" standard to an elaborate and specific code. In substance, the new regulations may have given us very little law.

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[99]Proposals for reform of the allocation process range from a suggestion that we return to the "avoidance or evasion" standard so that each case can be decided on its own merits, Kamin, *supra* note 13, 698-99, to a recommendation that item allocations be abolished, McKee, *supra* note 20, at 1066-72. The current system represents an attempt at compromise between these extremes.

The main drawback of flexible approaches like the "partner's interest in the partnership" and "avoidance or evasion" standards is their failure to impose real constraints on reporting of partnership income. What matters is not just how litigated cases turn out, but also whether penalties can be used to deter underreporting. A system relying on specific rules could have considerable administrative advantage in this respect. The substantial economic effect system, however, is largely elective.