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Thomas N. Lawson

University of Nebraska College of Law, tlawson@loeb.com

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Comment

New Restrictions On Tax Shelter Limited Partnerships

I. INTRODUCTION

The Tax Reform Act of 1976,1 signed into law by President Ford on October 4, 1976, is the culmination of more than two years of work by both houses of Congress. The Act is the most extensive tax reform effort since the enactment of the 1954 Code.2

The changes made by the Act to the partnership provisions in subchapter K are the first substantive changes in this area since the subchapter's enactment as a part of the 1954 Code. It is clear from the Act and the accompanying committee reports3 that the changes to Subchapter K were motivated by the wide use of tax shelter limited partnerships which led Congress to believe that taxpayers abused some of the partnership provisions. Most of the changes made to Subchapter K are of a restrictive nature applicable to tax shelter limited partnerships.

This comment discusses the substantive changes contained in the five subsections of section 213 of the Act. The first three subsections were intended to clarify issues which were uncertain under prior law, relating to special allocations, retroactive allocations, and guaranteed payments. The remaining two subsections narrow provisions of the prior law which were not unclear, but which had been abused by taxpayers. These provisions deal with additional first year depreciation and nonrecourse debt.

II. SPECIAL ALLOCATIONS

A. Prior Law

The Tax Reform Act clarifies the Code's restrictions on a partnership's allocation of various net income or loss items to

partners. Section 704(a) of the Code gives the partnership general authority to allocate income, gain, loss, deductions and credits generated by the partnership among the partners in any manner which the partners desire, by setting forth such allocation in the partnership agreement. Section 704(b) restricts this allocation if the principle purpose of the special allocation is the avoidance or evasion of tax. The restriction provides that any item of income, gain, loss, deduction or credit will be allocated to a partner 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. Section 702(a) requires a partner to account separately for various items received from a partnership in computing his own income tax for a year. These items are listed in sections 702(a)(1) through (8). Section 702(a)(9) is the taxable income or loss of the partnership, exclusive of the section 702(a)(1) through (8) items requiring separate computation. Thus, section 702(a)(9) is the "bottom line" income or loss.

The operation of the restriction of section 704(b) can be clarified with an example. Suppose the partnership agreement of the AB Partnership provides that income or loss will be allocated equally to partners A and B. However, all of the partnership's depreciation deductions are to be allocated to A. Because depreciation is a deduction of the partnership, section 704(a) apparently allows this allocation, subject to the restriction of section 704(b). Suppose, however, it is determined that the principal purpose of the allocation of depreciation to A was the avoidance or evasion of tax. Section 704(b) provides that in such a case, depreciation would also be allocated in accordance with "bottom line" income or loss as

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4. "EFFECT OF PARTNERSHIP AGREEMENT.—A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement." I.R.C. § 704(a) (prior to enactment of the Act, supra note 1).

5. 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—

(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.

I.R.C. § 704(b) (prior to enactment of the Act, supra note 1).

6. The substantive standard for making this determination is discussed in the text accompanying notes 26-33 infra.
described in section 702(a)(9). In this case depreciation would have to be allocated equally between A and B.

The uncertainty under the old law resulted from the fact that section 704(b) refers to items of income and gain and provides that if an item is allocated for the principal purpose of tax avoidance, then that item will be allocated in accordance with "bottom line" income described in section 702(a)(9). Because section 704(b) refers to items and because the remedial allocation is in accordance with "bottom line" income or loss, some tax practitioners argued that section 704(b) did not apply to an allocation of "bottom line" income or loss, and therefore such income or loss could be allocated in any manner whatsoever, even if the principal purpose of the allocation were the avoidance or evasion of tax.

This view was not universally accepted by tax experts. In his treatise on partnership taxation, Arthur B. Willis expressed the opinion that section 704(b) was not authority for the proposition that any allocation of bottom line income or loss was allowable. He maintained that section 704(b) simply did not deal with the problem. Willis suggested that the substance over form doctrine could be used to attack an allocation of "bottom line" income or loss which had as its principal purpose the avoidance of tax.\footnote{7. I. Willis, Partnership Taxation (2d ed. 1976).}

This argument has never been settled by court decision, although it was raised by the taxpayer in Jean v. Kresser.\footnote{8. Id. at 316-17.} There, one partner had a net operating loss carryover which would expire if not used in 1965. He asked the board of governors of the partnership to allocate all of the partnership's 1965 taxable income to him to enable him to take advantage of the loss carryover. In subsequent years, all of the income would be allocated to the other partners until the 1965 income was in effect repaid. The Commissioner asserted that the petitioner, another partner, must nevertheless report his share of 1965 income in accordance with the original partnership agreement. The petitioner argued that he did not have to report any income from the partnership in 1965 because all of it had been allocated to the other partners. He asserted that even if the allocation were for tax avoidance, section 704(b) did not apply to allocations of income or loss as defined in section 702(a)(9). The court did not handle this issue but instead held for the government on the grounds that the partnership agreement had not been amended in accordance with section 761(c),\footnote{9. 54 T.C. 1621 (1970).} and that the alloca-

\footnote{10. Id. at 1628-30.}
tion was not a bona fide allocation of income but was made in the nature of a loan. However, in a footnote, the court referred to the taxpayer's argument as "troublesome" and apparently supported by the structure of the statute and the legislative history.

B. The Tax Reform Act Changes

The ability to allocate income and loss has not been litigated since Kresser. However, when the drafters of the Tax Reform Act wrote the partnership changes, they chose to foreclose the argument. Section 213(d) of the Act amends section 704(b) of the Code to make it clear that the section 704(b) restriction does apply to the allocation of "bottom line" income or loss. Section 704(b), as amended, reads:

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

. . . .

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

By placing "or item thereof" in parenthesis at the end of the list including income and loss, it seems clear that section 704(b) now applies to "bottom line" income and loss. Also, rather than basing the remedial allocation on section 702(a)(9) income or loss, the remedial allocation is now based on the partner's interest in the partnership as determined by all of the facts and circumstances. The Senate report stated that the facts and circumstances include partners' interests in profits and losses, if different from their interest in taxable income or loss, cash flow and rights to distribution of capital upon liquidation.

11. Id. at 1630-32.
12. Id. at 1631 n.5.
   Subsection (b) . . . provides that if the principal purpose of any provision in the partnership agreement dealing with a partner's distributive share of a particular item is to avoid or evade the Federal income tax, the partner's distributive share of that item shall be redetermined in accordance with his distributive share of partnership income or loss described in section 702(a)(9) [i.e., the ratio used by the partners for dividing general profits or losses] . . . (emphasis added).
14. I.R.C. § 704(b), as amended by Act, supra note 1, § 213(d).
15. SENATE REPORT, supra note 3, at 100.
Both the House report and the Senate report clearly indicate that section 704(b) should apply to overall allocations of "bottom line" income or loss. The House version of the bill, however, would have reallocated income or loss or items thereof in a slightly different manner, in the event such reallocation was called for. The House Bill would have reallocated the distribution in accordance with the partnership's permanent method of allocating the taxable income referred to in section 702(a)(9) or if there were no permanent method, then in accordance with the partner's interest as determined by all the facts and circumstances. The Senate's version of the bill, which was enacted into law, dropped the permanent method of allocation as a standard. The Senate report explained that the permanent method of allocation standard was deleted because of the difficulty of defining the permanent method.

The House Bill also was different from the Senate Bill with regard to the substantive standard which would trigger a reallocation under section 704(b). The House Bill provided that a reallocation would occur unless the partner receiving the special allocation could establish that there was a business purpose for the allocation and that no significant avoidance or evasion of a tax would result from the allocation. The Senate Bill, which contained the language that was enacted, provided that a reallocation would be made if the allocation did not have substantial economic effect. The Senate report noted that although the language in the House and Senate bills was somewhat different, the intent of both was essentially the same—each version sought to prevent the use of

16. "The committee believes that an overall allocation of the taxable income or loss for a taxable year (described under section 702(a)(9)) should be subject to disallowance on the grounds of tax avoidance or evasion in the same manner as allocations of an item of income or loss." House Report, supra note 3 at 126. "The committee believes that an overall allocation of the taxable income or loss for a taxable year (described under section 702(a)(9)) should be subject to disallowance in the same manner as allocations of an item of income or loss." Senate Report, supra note 3, at 99.


18. Id. § 210(d).


20. Id. § 210(d).


22. House Bill, supra note 17, § 210(d).

23. Senate Bill, supra note 19, § 210(d).
special allocations for tax avoidance.24 A footnote in the Senate report indicated a concern on the part of the finance committee that the language of the House Bill conceivably could be subject to an interpretation which could cause disallowance of a special allocation to a high-bracket taxpayer, even though the allocation had a business purpose and economic substance.25 Such concern arose from language in the House Bill that a reallocation must be made if there were significant avoidance or evasion. An allocation could result in a reduction of the total tax paid by all partners if deductions or losses were allocated to partners in higher tax brackets. Such an allocation could have economic substance and a business purpose, in which case the Senate clearly intended that it be permissible.

The use of the substantial economic effect standard probably represents a codification of existing law, even though that language did not appear in the original section 704(b). The standard in the Code before amendment was avoidance or evasion of tax. The first mention of substantial economic effect as a standard appeared in the Senate report to section 704(b) of the 1954 Code.

Where, however, a provision in a partnership agreement for a special allocation of certain items has substantial economic effect and is not merely a device for reducing the taxes of certain partners without actually affecting their shares of partnership income, then such a provision will be recognized for tax purposes.26 Apparently, the Senate wanted to make clear that an allocation would not be disallowed automatically merely because it had the effect of reducing the income tax liability of one or more of the partners.

The substantial economic effect standard appeared in the treasury regulations promulgated under section 704(b). The regulations provided that the determination of whether the principal purpose of a special allocation was the avoidance or evasion of tax must be made from all of the facts and circumstances.27 The regulation then listed the following as being among the relevant circumstances:

(1) whether there is a business purpose for the special allocation;
(2) whether the allocation has substantial economic effect;
(3) whether related items of income, gain, loss, deduction, or credit from the same source are subject to the same allocation;

24. Senate Report, supra note 3, at 100.
25. Id. at 100 n.11.
whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated;

(5) the duration of the allocation; and

(6) the overall tax consequences of the allocation.\(^2\)

The regulation stated that an allocation had substantial economic effect if it might affect the dollar amount of the partners’ shares of the total partnership income or loss independent of tax consequences. The Senate report on the Act contained the same definition and cited this regulation.\(^2\)

Substantial economic effect was only one of six factors which were listed by the regulation, and those factors were not to be exclusive. In a 1970 Tax Court case, however, it became apparent that substantial economic effect was the primary consideration. In *Stanley C. Orrisch*,\(^3\) the Orrisch family and the Crisafi family formed a partnership to purchase and operate two apartment houses. The families agreed that beginning in 1966, all of the partnership’s deductions for depreciation would be allocated to the Orrischs but income or loss before depreciation would be shared equally. They further agreed that if any property was sold at a gain, the depreciation which the Orrischs had received would be “charged back” to their capital account. In other words, if the Orrischs received $35,000 of depreciation deductions through the allocation, they also would be allocated the first $35,000 of gain on the sale of the buildings. The Commissioner determined that this special allocation had as its principal purpose the avoidance or evasion of tax. The Tax Court briefly considered the other factors listed in regulation section 1.704-1(b)(2), and then turned to the Orrischs’ argument that the allocation had economic substance. The court examined the allocation to determine whether it could affect the dollar amount of the partners’ shares of the partnership income or loss independent of tax consequences. The court noted that under the agreement, if the buildings were sold at a gain, the amount of the depreciation taken by the Orrischs would be allocated to them. This would increase their capital account to the amount of the Crisafis’ capital account and any additional gain, as well as the proceeds of the sale, would be equally divided. The court concluded that in that situation economic substance could not be shown.

The court said that it was necessary to examine the effect if the buildings were sold for a loss. In order for there to be economic

\(^{28}\) *Id.*

\(^{29}\) *Senate Report, supra* note 3, at 100.

substance, the Orrischs would either have to contribute money to the partnership to equalize the disparity in capital accounts, or receive less money on liquidation. The court found no evidence covering this situation but felt that the parties contemplated an even division of proceeds in either case. Thus, there was no economic substance to the allocation and it was not upheld.

The Orrischs might have succeeded had the partnership agreement been drafted more carefully. The special allocation was made by oral agreement, thus the taxpayers could not prove the economic effect. The fact that the sale proceeds were to be divided evenly if the buildings were sold for more than the original cost should not have been fatal had the agreement shown that the proceeds would not be divided evenly if the buildings were sold for less than their original cost. If the buildings were sold for more than their adjusted tax basis but less than their original cost, there would be a tax gain, but an economic loss. After adding back the tax gain to the Orrischs' capital account, their capital would be less than the Crisafis'. Had the agreement provided that the sales proceeds would be distributed pro rata to capital account balances, the Orrischs would have received less than the Crisafis and economic substance would have been established. Further analysis of the intricacies of special allocations of depreciation deductions is beyond the scope of this article.  

After Orrisch, substantial economic effect generally was considered to be the main standard by which a special allocation was to be judged. In the recent Tax Court case of Leon A. Harris, a special allocation of loss was found to have substantial economic effect. In Harris, a partnership sold an interest in a shopping center at a loss and allocated the entire loss to one of its partners. The Commissioner asserted that the principal purpose of the allocation was the avoidance or evasion of tax and disallowed the allocation. The Tax Court upheld the allocation, emphasizing that it obviously had economic effect.

Furthermore, of critical significance is the obvious "economic effect" of the allocation agreement. Petitioner received the cash proceeds of the sale; the loss allocated to him was applied to reduce his capital account, and his share of the related items of future profits, losses, and proceeds in the case of liquidation was reduced proportionately.  

31. In depth analysis of this subject can be found in 283 Tax MNGM'T (BNA) A-10 (1973) and Lee, The Partnership "Special Allocation": When Will It Be Upheld: Orrisch Analyzed, 43 J. Tax. 138 (1975).
32. 61 T.C. 770 (1974).
33. Id. at 786.
Now that the substantial economic effect test has been codified in section 704(b), Orrisch and Harris should have even more precedential value. The Senate report noted that "allocations of special items and overall allocations should be restricted to those situations where the allocations have substantial economic effect, as presently interpreted by the regulations and case law." Regulation section 1.704-1(b)(2) gives some examples of allocations which have substantial economic effect. Example two provides that an allocation to one partner, who is a resident of a foreign country, of a percentage of the partnership's income from that country which is higher than his overall income allocation percentage has economic effect. This example is clear if the partner receives the money or has it credited to his capital account. In example three, it is permissible to allocate to one partner all of a partnership's tax exempt municipal bond interest and to the other partner all of the stock dividends received. Clearly these allocations affect the amount of income the partners will actually receive from the partnership. However, if one partner got the first $10,000 of bond interest and the other partner got the first $10,000 of dividends and after that all income was divided equally, the example says the allocation would be only of tax effects, as both partners would receive the same amount of income. That, of course, is only true if interest and dividends each exceed $10,000. Example four states that it is permissible to allocate asset appreciation which occurred prior to the entry of a new partner, entirely to the old partners. This would reflect the economic situation which would exist if the partnership sold its assets immediately prior to the admission of the new partner. Example five states that where one partner provides most of the capital, it is permissible to allocate all of certain expenditures to that partner, because the expenses so allocated are in fact borne by that partner. This example requires the assumption that the expenses were charged to the partner's capital account, in order for them to be "borne" by that partner. It is clear that these obvious examples in the regulations provide little in the way of explanation of economic effect.

How will the substantial economic effect test be applied to allocations of "bottom line" income or loss? It may be useful to work through an example similar to the facts of the Kresser case. Assume A and B are equal partners with capital accounts of $100 at the end of 1976. In 1977, they agree to allocate all of the partnership's taxable income to A, so he can offset a separate loss he incurs that year. They further agree that in future years, all income will be

34. Senate Report, supra note 3, at 99-100.
allocated to B, until he receives as much as A received in 1977, but A does not guarantee that B will ever receive this income. The agreement further provides that if the partnership is liquidated at any time, the liquidation proceeds will be distributed in the ratio of the capital accounts. In 1977, the partnership has taxable income of $20, all of which is allocated to A, but each partner withdraws $10 from the partnership. The capital accounts would appear as follows:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/77</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>1977 income</td>
<td>20</td>
<td>-</td>
</tr>
<tr>
<td>Cash withdrawal</td>
<td>[10]</td>
<td>[10]</td>
</tr>
<tr>
<td>12/31/77</td>
<td>$110</td>
<td>$90</td>
</tr>
</tbody>
</table>

Now assume that in 1978 the partnership again has $20 of taxable income which, pursuant to the agreement, is allocated to B. Again each partner withdraws $10.

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/78</td>
<td>$110</td>
<td>$90</td>
</tr>
<tr>
<td>1978 income</td>
<td>-</td>
<td>20</td>
</tr>
<tr>
<td>Cash withdrawal</td>
<td>[10]</td>
<td>[10]</td>
</tr>
<tr>
<td>12/31/78</td>
<td>$100</td>
<td>$100</td>
</tr>
</tbody>
</table>

The allocation then has had no economic substance because as of December 31, 1978, each partner has withdrawn the same amount of cash, and each has the same capital account balance. However, assume the partnership is liquidated at December 31, 1977. A and B each have contributed the same amount of cash and have withdrawn the same amount of cash, yet, as a result of the special allocation, upon liquidation A would receive 55 percent (110/200) of the proceeds and B would receive 45 percent (90/200). Clearly B has economically borne the cost of the allocation and A has economically benefited. The same result would occur if the partnership continued in existence but never made enough profit to compensate B for the special allocation in 1977.

It seems that this allocation would be disallowed by the Commissioner under the rationale of Kresser.\textsuperscript{35} It is far from clear, however, that the definition of economic effect in the regulation and in the Senate report supports such a disallowance: "[W]hether the allocation may actually affect the dollar amount

\textsuperscript{35} 54 T.C. at 1631-32. It is possible to speculate from the opinion that the allocation might have fared better if the taxpayer would have proved that there was no guarantee the amount would be repaid to the other partners.
of the partners' shares of the total partnership income or loss independently of tax consequences ... " The key word in the definition is "may." The word implies that the allocation would not necessarily have to affect the actual dollar amounts in all cases. Under some set of facts, however, it must be possible for the allocation to affect the actual dollar amounts. That seems to be the exact situation contemplated by the example. The allocation may in some cases affect dollar amounts. Such a case would be where the partnership is liquidated before sufficient income has been allocated to B to compensate him for the income allocated to A in 1977.

A court will almost surely find a way to disallow this allocation. It can find some help by considering the other factors listed in Treasury Regulation section 1.704-1(b)(2). Factors such as business purpose and the duration of the allocation add support to the disallowance of the allocation. Even though the economic effect test now has been codified, the Senate report appears to lend authority for continuing to consider the other factors. "Other factors that could possibly relate to the validity of an allocation are set forth under the present regulations [Regulations section 1.704-1(b)(2)]. . . ." In conclusion, the Act may not have changed the existing law on special allocations. The Senate report specifically states that no inference should be drawn as to the validity of a special allocation under present law. However, the Internal Revenue Service seems to have stronger weapons in its arsenal under section 704(b) to attack certain special allocations in the future.

III. RETROACTIVE LOSS ALLOCATION TO NEWLY ADMITTED PARTNERS

A. Prior Law

Section 213(c) of the Tax Reform Act clarifies another area which had been uncertain under prior law. The retroactive loss allocation was used by tax shelter limited partnerships to lure new investors near year end. This opportunity arises frequently in the case of a high bracket taxpayer who may not know until near the end of his taxable year what his tax liability for the year will be. Thus, wealthy investors frequently look for tax shelter investments in December, when they realize that they face a substantial income tax liability. A limited partnership involved in oil or gas exploration may have generated a large tax loss over the course

37. Senate Report, supra note 3, at 100.
38. Id. at 100-01.
of the year by deducting intangible drilling expenses. Similarly, a real estate partnership may have generated a tax loss by deducting construction period interest and taxes. To lure investors, the partnership might agree to allocate to a new partner a full share of the partnership's loss for the entire year even though he entered the partnership in December. If the partnership was highly leveraged, as many are, the loss allocated to the investor often would exceed the amount of his investment.

The tax status of the retroactive loss allocation has not been clear. The argument against it has come from section 706(c)(2)(B) which provided:

(B) Disposition of less than entire interest.—The taxable year of a partnership shall not close (other than at the end of partnership's taxable year as determined under subsection (b)(1)) with respect to a partner who sells or exchanges less than his entire interest in the partnership or with respect to partner whose interest is reduced, but such partner's distributive share of items described in section 702(a) shall be determined by taking into account his varying interests in the partnership during the taxable year.

The argument against the allowance of a retroactive allocation is that when a new partner is admitted, the existing partners' interests are reduced, and under section 706(c)(2)(B) they must account for their distributive shares of items of income and loss by taking into account their varying interests throughout the year. It would thus be logical that the new partner also would have to account for his share of items of income or loss by taking into account the amounts of such items which were incurred during that part of the year he held his interest. Thus, a retroactive allocation of loss would not be possible.

Several arguments were used to support the retroactive loss allocation. It was argued that because section 702(a) applied only to items of income or loss, section 706(c)(2)(B) did not apply to an overall allocation of taxable income or loss. It was further argued that the admission of a new partner did not necessarily result in a reduction of the interests of the other partners. For example, assume that A and B are equal partners of the AB partnership which has a net worth of $50,000. A and B each have a $25,000 capital account. If C is admitted as a one-third partner

39. Under prior law, if a limited partnership borrowed money on a non-recourse basis, a limited partner could include part of the debt in the basis of his interest thus enabling him to deduct losses in excess of his actual investment. See text accompanying notes 112-123 infra.
40. I.R.C. § 706(c)(2)(B) (prior to enactment of the Act, supra note 1).
for a $25,000 capital contribution, A's and B's interests are reduced from 50 per cent to one-third each. However, the partnership's net worth is now $75,000, so A's and B's reduced percentage interests are still worth $25,000 each. If interest is interpreted in dollar terms, they have not suffered a reduction, so section 706(c) (2) (B) should not apply. Even if section 706(c) (2) (B) did apply, it was argued that it could be circumvented by the partnership agreement. Section 704(a) stated that except as otherwise provided by section 704, a partner's distributive share of income or loss would be as provided in the partnership agreement. The section 704(b) limitation against allocations having as their principal purpose the avoidance or evasion of taxes would not apply, the argument went, because section 704(b) did not apply to overall allocations of taxable income or loss.\textsuperscript{41} The partnership agreement's distribution of taxable income or loss was not overridden by section 706 because the only limitation placed on section 704(a) was that of section 704(b). Furthermore, section 761(c) provided that the partnership agreement included any amendments made prior to, or at, the time prescribed by law for filing the partnership tax return. Thus, a calendar year partnership could amend its agreement on, or prior to April 15, 1977, to allocate 1976 losses to a partner admitted in December of 1976.\textsuperscript{42}

A different situation prevails if a new partner buys the entire interest of another partner. In this situation, section 706(c) (2) (A) applies and requires that the retiring partner's share of income and loss items be determined for the period ending with the sale. The regulations under section 706\textsuperscript{43} provide that the partnership may close its books on the date of the sale, or may prorate the amount of the items which the retiring partner would have taken into account had he remained a partner throughout the remainder of the taxable year. Such proration may be based upon the time which the retiring partner has held his interest, or by any other reasonable method. That regulation further provides\textsuperscript{44} that the transferee of

\textsuperscript{41} See text accompanying notes 7-13 supra. Of course, the argument that § 704(b) does not apply to overall allocations of taxable income or loss is now refuted by the change Act, supra note 1, § 213(d) made in I.R.C. § 704(b).

\textsuperscript{42} For discussions of and conclusions about the arguments for and against the retroactive allocation of losses prior to the Act, see 1 A. Willis, supra note 7, at 281-94; McGuire, Retroactive Allocations Among Partners: The Rodman Decision, 52 Taxes 325 (1974); Lee & Parker, Retroactive allocations to new Partners: An analysis of the area after Rodman, 40 J. Tax. 166 (1974); 282 Tax MNGMT (BNA) A-28 (1973).

\textsuperscript{43} Treas. Reg. § 1.706-1(c) (2) (ii) (1956) (amended 1973).

\textsuperscript{44} Id.
the interest will include in his income the pro rata amount of the items allocated to him as determined by the method of allocation used. Thus, where a new partner is admitted by the purchase of a retiring partner's entire interest, there is more authority that a retroactive allocation to the new partner is not permissible. However, the argument could still be made that items of income or loss do not apply to overall taxable income or loss, because section 706(c)(2)(A) refers to items described in section 702(a). Arguably, section 704(a) would still permit the partnership agreement to override section 706(c)(2)(A) and regulations section 1.706-1(c)(2)(ii).

Only one case squarely confronted the question of retroactive allocations to newly admitted partners. In *Norman Rodman*, a partnership was comprised of four partners, each having a 25 per cent interest. The partnership reported on the calendar year. On November 2, 1956, Walter Ornstein, one of the partners, sold his 25 per cent interest to the remaining three partners. On November 5, 1956, the three remaining partners sold Martin Rodman a 22 per cent interest in the partnership. From November 5 to the end of the year, the other three partners' interests were 33 1/3, 22 2/3, and 22 per cent. Clearly, those three partners' interests had changed throughout the year, and at least two of the three had their interests reduced by the entry of Rodman. The partnership tax return for 1956 showed a loss and a full 22 per cent of the loss was allocated to Martin even though he had only been a partner for less than two months. Martin reported 22 per cent of the partnership's loss on his individual return. The Commissioner disallowed $900,000 of basis claimed by the partnership in some stock it had sold during the year. This caused the previously reported loss to become income, of which 22 per cent was attributed to Martin by the Commissioner. Before the Tax Court, Martin argued that the intent of the partners was that Martin receive only 22 per cent of the income from November 5 to the end of the year. This argument was inconsistent with the position taken on his income tax return when he thought the partnership had a loss. The Commissioner pointed this out and the Tax Court agreed with

45. Smith v. Comm'r, 331 F.2d 298 (7th Cir. 1964) and Town & Country Plymouth, Inc. v. United States, 20 Am. Fed. Tax R.2d 5823 (C.D. Cal. 1967) are sometimes discussed in conjunction with retroactive loss allocations. However, Smith involved a retroactive allocation to a partner who had been a member of the partnership for its entire taxable year, and because of the fact that Town and Country was only unofficially reported, it is difficult to tell from the report exactly what the case stands for.


47. Id. at 1270.
the Commissioner. The court held that section 706(c)(2)(A) required that income be allocated to Ornstein for January 1 to November 2, 1956, when he was a partner. However, a full 22 per cent of the remaining income was allocated to Martin. Thus, the court apparently ignored the requirement of section 706(c)(2)(B) with respect to the three remaining partners, because they did not determine their shares of the income by taking into account their "varying interests in the partnership during the taxable year." The court apparently held that section 704(a) allowed the partners to fix their shares of income in the partnership and section 761(c) provided that the partnership agreement included any modifications made prior to, or at, the time prescribed for filing the partnership return. Thus, the November 5, 1956, agreement admitting Martin to the partnership could allocate to him a full 22 per cent of the income remaining after Ornstein's share was allocated to him.

Even though it is not surprising that the government would argue to recognize a retroactive allocation when the taxpayer's taxable income would be increased, it is somewhat surprising that the government did not seem to realize the potential for taxpayers to use retroactive allocations of losses. In the government's brief, it apparently did not argue for a retroactive allocation. It argued that even though Martin was allocated 22 per cent of the income for the entire year, all income allocated to him was earned after his admission to the partnership. If 22 per cent of the income for 1956 had not been earned after November 5, such an allocation would violate assignment of income principles.

After Rodman, some commentators took the position that a new partner retroactively could be allocated shares of losses incurred before his admission. Some even suggested that the partners could agree not to allocate any income or loss to a retiring partner, as required by section 706(c)(2)(A). Reliance on this memorandum decision, where the government argued for non-retroactive allocation of income, as authority for a taxpayer to make a retroactive allocation of loss, should cause even the most experienced tax practitioner to lose sleep!

The decision in Rodman was appealed to the Second Circuit, which decided the case on September 17, 1976. The Second Cir-

49. 42 T.C.M. (P-H) at 1269-70.
50. See McGuire, supra note 40, at 325-26; 282 Tax MNGM'T (BNA) (Changes and Additions §§ 5-6) (1976).
51. See Lee & Parker, supra note 42, at 168.
52. Rodman v. Comm't, 542 F.2d 845 (2d Cir. 1976).
The circuit held that Martin could be allocated only 22 per cent of the partnership's income which was earned after his admission to the partnership. The government apparently had realized the danger of its argument before the Tax Court because it conceded that the court had erred in allocating 22 per cent of the full year's income to Martin. The Second Circuit said that a retroactive allocation violated the assignment of income doctrine of Helvering v. Horst. The allocation also ran afoul of the section 704(b)(2) rule that an allocation will not be recognized if it has as its primary purpose the avoidance or evasion of tax. The court also found the allocation violated section 706(c)(2)(B) which required the partners whose interests were reduced by the entry of Martin to account for their share of income in accordance with their varying interests throughout the year. Thus, the partnership agreement could not override the provisions of section 706(c)(2)(B).

A footnote in the Second Circuit's opinion is particularly disturbing. Both Martin and the Commissioner claimed that Martin's share of the 1956 income should be determined under regulations section 1.706-1(c)(2) by multiplying the partnership's income by Martin's 22 per cent interest and then making a proration of that amount based on the number of days Martin held his interest (57/366). Rather than accept that computation, the Second Circuit noted that a straight daily proration would result in a prohibited income assignment to Martin if a substantial portion of the partnership's income accrued prior to Martin's entry. The court remanded to the Tax Court to determine if such an assignment had occurred or if a simple pro rata allocation was appropriate. This appears to be a failure by the court to recognize the very purpose of the regulation, which is to allow time allocations so that the partnership does not have to compute precisely how much income had been earned prior to the retirement of a partner. The regulation specifically permits a time allocation.

Technically, regulations section 1.706-1(c)(2) would not apply to this situation. It only applies to an allocation between a partner who disposes of his entire interest and the transferee of that interest. In Rodman, Ornstein disposed of his entire interest to the remaining three partners, not to Martin. Martin purchased his interest from the other three partners. Regulations section 1.706-1(c)(4) would apply to this transaction. It provides only that the

53. Id. at 857.
54. 311 U.S. 112 (1940).
55. 542 F.2d at 858.
56. Id. at 859 n.19.
three remaining partners must report their share of income in accordance with their varying interests. It has no specific provision as to an allocation to Martin, however, it would be logical to use the same time allocation permitted when a partner disposes of his entire interest. The particular situation in Rodman could also be constructively viewed as a sale of an interest by Ornstein to Martin, because on November 2, Ornstein sold a 25 per cent interest to the other three partners and three days later, they sold a 22 per cent interest to Martin. The court nowhere mentioned that section 1.706-1(c)(2) of the regulations was inapplicable. Because both parties argued for the same allocation the court should have accepted the rationale outlined above.

B. The Tax Reform Act Changes

Although section 213(c) of the Act was drafted before the Second Circuit decided Rodman, the Act reaches much the same result as did the Second Circuit's Rodman decision. The Act amends section 706(c)(2)(B) to read as follows:

The taxable year of a partnership shall not close . . . with respect to a partner who sells or exchanges less than his entire interest in the partnership or with respect to a partner whose interest is reduced (whether by entry of a new partner, partial liquidation of a partner's interest, gift, or otherwise), but such partner's distributive share of items described in Section 702(a) shall be determined by taking into account his varying interest in the partnership during the taxable year.57

The new law adds the material in italics to make it clear that the section applies to the situation where a partner's interest is reduced by the admission of a new partner. Although the section still does not refer specifically to the treatment of the new partner, logic dictates that his share of income or loss must also be computed by considering the portion of the year which he held his interest.

To make it clear that this section cannot be circumvented by the partnership agreement, section 704(a) also was amended to read: "A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter be determined by the partnership agreement."58 Previously, the word "section" appeared where "chapter" now appears. The House Bill contained the word "subchapter"59 and the Senate report refers to "subchapter."60 Apparently the inclusion of "chapter"

57. I.R.C. § 706(c)(2)(B), as amended by Act, supra note 1, § 213(c) (emphasis added).
58. I.R.C. § 704(a), as amended by Act, supra note 1, § 213(c).
59. HOUSE BILL, supra note 17, § 210(c).
60. SENATE REPORT, supra note 3, at 98.
instead of "subchapter" was an oversight, but the clear intent was that the partnership agreement not override any of the partnership provisions contained in Subchapter K as to the determination of the partner's distributive shares.\(^{61}\)

Congress apparently saw no need to amend section 706(c) (2) (A) to cover the situation where one partner sells his entire interest to a new partner, because regulations section 1.706-1(c) (2) clearly would apply to the new partner. Section 704(a) now makes it clear that the partnership agreement cannot circumvent section 706. Nonetheless, section 706(c) literally still refers to "items" as described in section 702(a). One could still argue that the section does not apply to overall taxable income or loss (the same argument that was applied to section 704(b) before amendment), however, in light of Rodman and the clear legislative intent, that argument surely would not prevail. Nonetheless, the amendment to section 706 is very poorly drafted.

The Senate report says that regulations are to apply the same methods of proration under section 706(c) (2) (B) as now are applied under section 706(c) (2) (A)\(^{62}\) by regulations section 1.706-1(c) (2). Section 706(c) (2) (A) specially authorizes regulations for making an allocation. However, section 706(c) (2) (B), even as amended is still silent on this point. Only the Senate report provides authority for the application of regulations section 1.706-1(c) (2) to cases where section 706(c) (2) (B) is applicable.

Because the regulation allows either an interim closing of the partnership's books or a proration, various planning possibilities are still available. Assume the ABC partnership is comprised of partners A, B, and C who each have a one-third interest in capital and taxable income or loss. For calendar year 1977 the partnership incurs a taxable loss of $1,000. Assume further, that on July 1, A, B, and C each sell to D and 8\(\frac{1}{2}\) percent interest, so that from July 1 to December 31, A, B, C, and D each owns a 25 per cent interest. Section 706(c) (2) (B) clearly applies, and according to the Senate report, so does regulations section 1.706-1(c) (2). If $200 of the loss was incurred prior to July 1, it would be to D's tax advantage to close the books on June 30. In this manner D is allocated 25 per cent of the $800 loss which was incurred after June 30, or $200. A straight time allocation would allocate half of the $1,000 loss to the time D was a partner, giving him 25 per cent of $500, or $125. Therefore, D is allocated $75 more of loss if the partnership closes its books on June 30. If $800 of loss had been

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61. Id.
62. Id.
incurred prior to July 1, closing the books on June 30 would give to D 25 per cent of the $200 loss incurred after June 30, or $50. A time allocation would again give D $125, so in this situation the time allocation allocates to D $75 more loss.

A cash basis tax shelter partnership apparently could postpone the payment of deductible expenses until late in the year. It could admit new partners on December 1 and close its books that day. By paying the expenses in December, the new partners would receive the benefit of the deductions. This could be attacked only by constructively putting the partnership on the accrual method of accounting for purposes of making the interim closing of the books. The Senate report appears to sanction this type of tax planning:

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

The footnote in the Second Circuit's Rodman opinion may cast some doubt on the ability of taxpayers to use time allocations where they would be more advantageous. The language of regulations section 1.706-1(c)(2) and of the Senate report, however, clearly appears to allow such allocations, so they should be respected.

In summary, to the extent a partnership can incur deductible expenses late in the year, it appears as though results similar to a retroactive allocation to new partners can still be obtained.

IV. GUARANTEED PAYMENTS

A. Prior Law

Section 213(b) of the Tax Reform Act, which is also intended to clarify prior law relates to the treatment by the partnership of guaranteed payments to partners, and organizational and syndication fees. These items frequently arise together in tax shelter

63. Other sections of the Act may limit the effectiveness of this technique by disallowing some of the deductions which were previously used to create tax losses. For example, Act § 201 requires that construction period interest and taxes on real property be capitalized and amortized.

64. Senate Report, supra note 3, at 98.
65. See note 56 and accompanying text supra.
PARTNERSHIP TAX

limited partnerships where the partnership agreement provides for guaranteed payments to the general partner for items which are classified as organizational expenses.

It has not been clear under the 1954 Code whether organizational expenses could be deducted by the partnership. There has not been a provision comparable to section 248, which applies to corporations. A provision in the House version of the Trust and Partnership Income Revision Act of 1960 would have allowed partnerships somewhat similar treatment. This provision was deleted by the Senate, however, and the entire bill was killed in committee.

Even without a specific section governing the treatment of partnership organizational costs, section 263 appears to apply. This section, as interpreted by the regulations, generally would disallow the deduction of any amount expended to acquire property having a useful life substantially beyond the tax year. The unresolved question has been whether the capitalization requirements of section 263 were overridden by the guaranteed payment provisions of section 707(c). The argument was that if an expen-

66. I.R.C. § 248 provides that a corporation may elect to amortize its organizational expenses ratably over a period of not less than 60 months. In order to qualify for amortization under § 248, the expenditure must: (1) be incident to the creation of the corporation; (2) be chargeable to capital account; and (3) be of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life. Treas. Reg. § 1.248-1(b) (1956), gives examples of amortizable expenditures, such as legal services incident to incorporation, accounting services, state fees, and costs of holding and attending organizational meetings. The regulation specifically prohibits the amortization of expenses connected with the issuance of stock or securities, expenses connected with the transfer of assets to a corporation, or expenses of a reorganization.

There was no counterpart to § 248 prior to the enactment of the 1954 Code and case law prohibited deduction of organizational expenses. Clarence Whitman & Sons, Inc., 11 B.T.A. 1182 (1928); Blumberg Brothers, Co., 12 B.T.A. 1021 (1928).


68. "No deduction shall be allowed for—(1) Any amount paid out for new buildings or for permanent improvements on betterments made to increase the value of any property or estate." I.R.C. § 263(a).


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

I.R.C. § 707(c) (prior to enactment of the Act, supra note 1).
diture for organizational expenses was made to a partner as a guaranteed payment (determined without regard to partnership income), then section 707(c) automatically allowed the partnership a deduction for the payment, even if it were of a nature which section 263 normally would require to be capitalized. The proponents of this argument pointed to the Senate report on section 707(c) for support:

Subsection (c) provides a rule with respect to guaranteed payments to members of a partnership. A partner who renders services to the partnership for a fixed salary, payable without regard to partnership income, shall be treated, to the extent of such amount, as one who is not a partner, and the partnership shall be allowed a deduction for a business expense . . . .

In *F.A. Falconer*,72 the court noted this legislative history in its opinion when it stated: "The legislative history of section 707(c) reveals that it was specifically intended to require ordinary income treatment to the partner receiving guaranteed salary payments and to give a deduction at the partnership level."73 *Falconer* dealt with salary payments to a partner for services related to the ordinary business of the partnership, which diminishes its authority for deducting organizational expenses under section 707(c). The payment clearly was not subject to section 263, so the court had no reason to consider the interplay of sections 707(c) and 263.

Proponents of the argument further pointed to Revenue Ruling 69-180,74 which discussed the character of income to the recipient. The service noted: "Thus, a guaranteed payment is includable in gross income of the recipient as ordinary income, and is deductible by the partnership from its ordinary income as a business expense."75 Once again, the fact situation considered did not raise the issue of section 263.

Only one case decided under the 1954 Code has squarely confronted the question of whether section 707(c) overrides section 263 and provides a deduction for the guaranteed payment. In *Jackson E. Cagle, Jr.*,76 Cagle, Webster, and Erlich formed a partnership in 1968 to deal in various types of commercial property. The partnership agreement provided that Erlich would be paid $110,000 for his services rendered pursuant to a management agreement. Of

73. Id. at 1015.
74. 1969-1 C.B. 183.
75. Id.
76. 63 T.C. 85 (1974).
the $110,000, $90,000 was to be paid in 1968. The court noted that the services rendered by Erlich included a feasibility study, work with architects and contractors with regard to coordinating the construction of an office-showroom development, and arranging financing for the project. The court found that the payments were of the type that section 263 required to be capitalized. It then considered whether section 707(c) allowed those payments to be deducted, regardless of section 263. The court concluded that the intent behind section 707(c) precluded a partnership from circumventing section 263, and it held that a section 707(c) guaranteed payment is subject to the capitalization requirements of section 263. The only inference from the committee reports found by the court indicated that the deduction was to be tested at the partnership rather than at the partner level. The Fifth Circuit affirmed the Tax Court's decision, noting that there was no intent to give partnerships a deduction not given to other taxpayers.

[B]ut we view it as most improbable (and we find no indication to this effect) that Congress intended to provide deductions to a partnership not permitted any other taxpayer. It is more reasonable to conclude that a guaranteed payment to a partner should be treated the same as if it had been made to a non-partner. . . . [I]f a payment made to a partner would be a capital expenditure under Section 263(a) if made to a non-partner, then such payment should not receive different treatment because made to a partner. . . .

After the Cagle decision in the Tax Court, but prior to its affirmance by the Fifth Circuit, the Internal Revenue Service issued Revenue Ruling 75-214. In the facts of this ruling, a limited partnership agreement provided that the general partner was responsible for all matters pertaining to the organization of the partnership and the sale of limited partnership interests. For this service he was paid an amount stipulated by the agreement. The ruling, referring to Cagle, held that section 707(c) did not automatically allow the partnership to deduct the payment. Instead, section 263 required that it be capitalized in this instance. Thus, prior to the Act, the Service's position on this issue was clear, and the Fifth Circuit agreed.

B. Tax Reform Act Changes—Guaranteed Payments

Section 213(b) of the Act codifies this interpretation by amend-
ing section 707(c). This subsection provides that deduction of such an item is subject to section 263.\textsuperscript{82}

The changes made by the Act to section 707(c) will limit the ability of a partnership in the Cagle situation to create a taxable loss through the use of deductible guaranteed payments to partners. However, in situations where the partnership has begun its second or third year of operation, and has substantial gross income, it might be possible to alleviate the impact of the Act. In Edward T. Pratt,\textsuperscript{83} the petitioners were the general partners of a limited partnership which was organized to purchase, develop and operate a shopping center. The partnership agreement provided that they were to receive a fee for managerial services equal to five per cent of gross base rentals received by the partnership and ten per cent of rents which the partnership received. The amounts were not paid to the general partners, but were credited to their accounts. Because the partnership used accrual accounting, it treated the amounts due the general partners as guaranteed payments under section 707(c) and took a deduction for the amounts credited. The general partners were cash basis taxpayers, and did not report any income from the amounts credited to their accounts, taking the position that the amounts had not been constructively received. The Commissioner determined that the amounts credited to the general partners' accounts were not guaranteed payments but were distributions of profit. Thus, the income was reportable whether or not the partners received any payments. Before the Tax Court, the petitioners argued that the payments were covered by either section 707(a)\textsuperscript{84} or were guaranteed payments as defined by section 707(c). The court determined that section 707(c) was not applicable because the payments were not determined without regard to the income of the partnership. The court noted that because the payments were based on a percentage of gross rental income, they should be

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\textsuperscript{82} I.R.C. § 707(c), as amended by Act, supra note 1, § 213(b) reads as follows:

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

\textsuperscript{83} 64 T.C. 203 (1975).

\textsuperscript{84} "If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner." I.R.C. § 707(a).
considered as payments based on income within the meaning of section 707(c). With regard to the applicability of section 707(a), the court found that the services to be performed by the general partners were basic duties imposed upon them by the partnership agreement. Because the partners performed the services in their capacities as members of the partnership, section 707(a) was not applicable. Because neither section 707(a) nor 707(c) applied, the court looked to partnership tax law prior to the enactment of the 1954 Code to determine the proper treatment of the payments. The court found that under prior law, the Commissioner's proposed treatment of the payments was correct. That is, the payments would be treated as distributive shares of income to the general partners, and thus includable by them in their individual income tax returns and not deductible by the partnership.

The important point to be derived from Pratt for tax planning purposes is that a payment based on a percentage of gross income will be treated as a distributive share of net income. This can be illustrated by an example. Assume the ABCD partnership is comprised of partners A, B, C and D each owning a 25 per cent interest in capital and profits and losses. Gross income has been reasonably constant at $200,000 per year, with deductible expenses of $150,000, leaving $50,000 of taxable net income, which is distributed at $12,500 each to A, B, C and D. Now assume that the partnership retains A to perform services which all of the partners agree are worth $20,000 per year. The nature of the services is such that section 263 would require the payment to be capitalized. Before Cagle and the Act, the partnership might have structured the $20,000 annual payment to A as a guaranteed payment under section 707(c), with the following result:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>$200,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regular deductions</td>
<td>[150,000]</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income before guaranteed</td>
<td>$ 50,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Guaranteed payment to A</td>
<td>[ 20,000]</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxable income</td>
<td>$ 30,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Each partner would report income on his individual income tax return as follows:

As for the notes:
85. 64 T.C. at 210.
86. Id. at 211-12.
After Cagle and the Act, the guaranteed payment to A would still be reportable by A as ordinary income; however it is not deductible by the partnership. This results in the following:

| Gross income | $200,000 |
| Regular deductions | $150,000 |
| Taxable income | $50,000 |

The distribution would be:

<table>
<thead>
<tr>
<th>Guaranteed Payment</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>$20,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$20,000</td>
</tr>
<tr>
<td>25% of $50,000</td>
<td>$12,500</td>
<td>$12,500</td>
<td>$12,500</td>
<td>$12,500</td>
<td>$50,000</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$32,500</td>
<td>$12,500</td>
<td>$12,500</td>
<td>$12,500</td>
<td>$70,000</td>
</tr>
</tbody>
</table>

The resulting disadvantage caused by Cagle and the Act is that because the guaranteed payment to A is not deductible, each partner’s taxable income is increased by $5,000 (25 per cent of the nondeductible $20,000 payment). Yet, the partnership would have exactly the same amount of cash available for distribution.

In this situation, the Pratt case may prove useful. If the partnership’s gross income is relatively stable, the partnership agreement could provide that partner A will receive as his distributive share of taxable income ten per cent of gross income and 25 per cent of the remaining taxable income. B, C and D would each receive 25 per cent of the taxable income remaining after A is allocated taxable income equal to ten per cent of gross income. Under Pratt, A’s ten per cent of gross income would not be a section 707(c) guaranteed payment. The partnership agreement should specify the duties A will perform for his additional payment. This should result in the inapplicability of section 707(a) under Pratt, because A would be performing services in his capacity as a partner. If neither section 707(a) nor 707(c) applies, Pratt provides that the additional payment of A of ten per cent of gross income would be treated as a distributive share of net income. The result should be as follows:

87. This approach is developed in Serton & Charyk, Does the recent Pratt case provide a method of insuring guaranteed payment deductions?, 43 J. Tax. 66 (1975).
Gross income $200,000
Deductions [150,000]
Taxable income $ 50,000

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>10% of gross income (10% x $200,000)</td>
<td>$20,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>$20,000</td>
</tr>
<tr>
<td>25% of taxable income remaining (50,000 - 20,000)</td>
<td>$ 7,500</td>
<td>$7,500</td>
<td>$7,500</td>
<td>$7500</td>
<td>$30,000</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$27,500</td>
<td>$7,500</td>
<td>$7,500</td>
<td>$7500</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

The result is identical to the result achieved by treating a guaranteed payment as a deduction. This approach may be of limited utility because the typical partnership will make these organizational payments in its first year. Normally, the partnership would not have taxable income at that time. In order to create the same effect as the guaranteed payment, the partnership has to have reasonably stable gross income and probably must have taxable income greater than the guaranteed payment. This situation might exist where a partnership is profitable and decides to undertake a new project. Under Cagle, the partnership must capitalize payments to a partner to do the feasibility study and generally get the project underway. However, the partnership may be able to compensate the partner doing the work by the procedure described above and effectively circumvent Cagle and the Tax Reform Act.

The Service may argue that payments based on gross income are guaranteed payments under section 707(c). If the partnership agreement is amended annually to change the percentage of gross income allocated to one partner as the partnership estimates its gross income for each year, the Service may argue that in substance, a guaranteed payment is being made. Even if the Service prevails in this argument, the taxpayers would be no worse off by having tried the Pratt approach than by having treated the payment as a nondeductible guaranteed payment in the first place.

If the taxable income of the partnership is less than the percentage of gross income to be allocated to the partner, the situation is more complex. Using the same facts as in the examples, assume that the partnership’s deductions are $190,000, leaving taxable income of $10,000. The allocation to A of ten per cent of gross income calls for A to receive the first $20,000 of taxable income, but taxable income is only $10,000.
In *Augustine M. Lloyd*, salary payments to partners in excess of partnership taxable income were treated as coming pro rata from the capital accounts of all partners. To the extent that the payment came from the other partners' capital accounts, it was taxable to the partner who received it, and the partners whose capital accounts were charged received a deduction. To the extent that the payment was deemed to come from the recipient's own capital account, it was treated as a tax free return of capital. The salary payments in *Lloyd* were not based on a percentage of income, and section 707(c) would apparently have been applicable had it been in the Code at that time.

A section 707(c) guaranteed payment is clearly taxable to the recipient even if it exceeds partnership taxable income. If the payment is not covered by section 707(a) or 707(c), as in *Lloyd*, it is uncertain whether the *Lloyd* rationale would apply to tax partner A on the full $20,000 or on that portion only of the $20,000 traceable to both partnership taxable income and the capital accounts of B, C and D.

Of course, the partnership agreement could provide that the entire $10,000 excess would be treated as a draw on A's capital account. Suppose the agreement provided that in the event A had less than $10,000 in his capital account, a debt would be created from him to the partnership. In such a case, A should only be taxed on the partnership's $10,000 of taxable income because he is really only receiving $10,000 for his services. In order for A to be in the same economic position as if the $20,000 were a guaranteed payment, the agreement must provide that the $10,000 payment to A in excess of partnership taxable income is charged to each partner's capital account in the loss sharing ratio. If a guaranteed payment created a $10,000 loss, A's capital account would be charged with 25 per cent of the loss, so he would economically receive $17,500. In the example, A receives $20,000 (.10 x $200,000) but, $2,500 of the ten per cent is charged to his capital account. Thus the accounting reflects the economic benefit of $17,500 and it would be completely logical to tax A on the $17,500.

If B, C and D are also allowed a deduction for the depletion of their capital accounts in the case where the payment to A exceeds the partnership's taxable income, as in *Lloyd*, it would be possible to circumvent *Cagle* and the Act even if the gross income allocation to A exceeds the partnership's taxable income. This can be seen

88. 15 B.T.A. 82 (1929).
89. Id. at 88.
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by following the example through. Before Cagle and the Act, a guaranteed payment in excess of taxable income before the payment would have the following effect:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>$200,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regular deductions</td>
<td></td>
<td>[150,000]</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income before guaranteed payment</td>
<td>10,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Guaranteed payment</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>[20,000]</td>
</tr>
<tr>
<td>Taxable loss</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>[$10,000]</td>
</tr>
</tbody>
</table>

Guaranteed payment: $20,000
25% of taxable loss: [2,500] [$2,500] [$2,500] [$2,500] [10,000]
TOTAL: $17,500 [$2,500] [$2,500] [$2,500] [$2,500] $10,000

Cagle and the Act disallow the deduction of the guaranteed payment with the result that each partner's income would increase by $5,000. Using the theory of Pratt and Lloyd, with the partnership agreement providing that to the extent that the ten per cent of gross income allocated to A exceeds taxable income, such excess will be charged to the partners' capital accounts in their loss sharing ratio, and the following result would occur:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>$200,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deductions</td>
<td></td>
<td>[190,000]</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxable income</td>
<td>$10,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Partnership taxable income: $10,000
Income or deduction from charge to capital accounts of B, C and D: 7,500 [$2,500] [$2,500] [$2,500] [0]
TOTAL: $17,500 [$2,500] [$2,500] [$2,500] [$2,500] $10,000

In either instance, with a deductible guaranteed payment, or with the Pratt allocation and the application of Lloyd, the results are identical as to money received, taxable income or loss reported, and charges to capital accounts.

In this situation, it is unlikely that B, C and D will be given deductions for the charges to their capital accounts. To follow Lloyd would clearly violate the purpose of Congress in amending section 707(c). Even if Lloyd cannot be used to create losses for
B, C and D, it still should be possible to allocate any taxable income to A so B, C and D report no income or loss.

C. Tax Reform Act Changes—Organization and Syndication Fees

Section 213(b) of the Act added a new Code section, section 709 to clarify the treatment of organizational expenses of partnerships in general. Section 709(a) provides the general rule that amounts paid or incurred to organize a partnership or to promote the sale of an interest in a partnership are not deductible. Section 709(b) provides that the partnership may elect to amortize organizational costs ratably over a period of not less than sixty months. Thus, this section is similar in result to section 248. The standards which must be met in order for the expenditure to be subject to amortization are similar to those specified in section 248. One difference between these sections is that under section 709, if the partnership is liquidated within sixty months of formation, any unamortized organizational costs may be deducted to the extent allowed by section 165. Neither section 248 nor the regulations

90. TREATMENT OF ORGANIZATION AND SYNDICATION FEES.

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

(b) AMORTIZATION OF ORGANIZATION FEES.—

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

(2) ORGANIZATIONAL EXPENSES DEFINED.—The organizational expenses to which paragraph (1) applies, are expenditures which—

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

(B) are chargeable to capital account; and

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

I.R.C. § 709, as enacted by Act, supra note 1, § 213(b).

91. See note 66 supra.

92. See I.R.C. §§ 709(b) (2), 248(b).

93. I.R.C. § 709(b)(1), as enacted by Act, supra note 1, § 213(b).
under it contain a comparable provision; however, case law has allowed a corporation to deduct unamortized organizational expenses upon liquidation.94

The House version of this section contained only the provision of section 709(a) which disallows the deduction.95 No amortization of the organizational expenses would have been allowed. The House took the position that the provision merely declared and clarified existing law.96 Therefore, its version applied to all years under the 1954 Code. The Senate added section 709(b) which allowed the amortization of organizational costs.97 The Senate report stated that the provision disallowing deductions would apply to taxable years beginning after December 31, 1975, but the provision allowing amortization of organizational costs would apply only to taxable years beginning after December 31, 1976.98 The Senate Bill, however, provided that all of the partnership changes would be applicable to taxable years beginning after December 31, 1975.99 The Conference Committee changed the Act to make it conform with the Senate report. Thus, organizational expenses can be amortized under section 709(b) only if they were incurred in taxable years beginning after December 31, 1976.100

It appears as though 1976 was a very bad year for a partnership to incur organizational expenses. Section 709(a) disallows deductions for such expenditures incurred in 1976, and section 709(b) allows amortization only of those expenditures incurred after 1976. Therefore, 1976 expenditures can be neither deducted nor amortized.

The Senate report stated that expenses connected with the issuing and marketing of interests in a partnership, such as commissions, professional fees, and printing costs, are not subject to the sixty month amortization rule. By analogy to the cases dealing

165 governs the deductibility of losses in general. Section 165(c) provides that an individual can deduct losses incurred in a trade or business or in any transaction entered into for profit. Thus, it appears as though deductions passed through to partners under § 709(b)(1) upon the liquidation of a partnership will usually be deductible by the partner.

95. House Bill, supra note 17, § 210(b).
97. Senate Bill, supra note 19, § 210(b).
98. Senate Report, supra note 3, at 94-95.
99. Senate Bill, supra note 19, § 210(e).
with corporations, these expenses should be offset upon liquidation of the partnership.

V. ADDITIONAL FIRST YEAR DEPRECIATION

A. Prior Law

Section 213(a) of the Tax Reform Act changes present law with respect to the amount of property subject to additional first year depreciation which a partnership may pass through to its partners. Section 179 provides that a taxpayer may elect to take 20 percent of the cost basis as depreciation in the year qualifying property is acquired, in addition to normal depreciation on the remaining basis. The amount of property subject to additional first year depreciation in any year is $10,000 per taxpayer or $20,000 on a joint return. Qualifying property is described as tangible, personal property of a character such that it is subject to a depreciation allowance under section 167 and having a useful life of six years or more at the time the taxpayer acquires the property.

To illustrate the operation of section 179, assume individual A is engaged in a trade or business. Assume further that A buys an asset for $20,000 on January 1, 1977, which qualifies for additional first year depreciation under section 179(d) to use in his trade or business. The asset has a useful life of ten years with no salvage value. A is a calendar year taxpayer and elects to take additional first year depreciation. If A is unmarried or married but filing a separate return, he can take additional depreciation on $10,000 of qualifying property. Thus, he could take $2,000 additional first year depreciation. Under section 179(d)(8), A reduces his basis by the additional depreciation before taking regular depreciation. Thus, his remaining depreciable basis is $18,000. If he uses straight line depreciation he takes $1,800 regular depreciation for 1977. His total 1977 depreciation deduction for the new asset is $3,800, or $2,000 of additional first year depreciation and $1,800 regular depreciation. If A files a joint return, he can take additional first year depreciation on the full $20,000 and his additional first year depreciation would be $4,000. The remaining depreciable basis would be $16,000 and regular straight line depreciation for 1977 would be $1,600. Therefore, his total deduction for depreciation in 1977 would be $5,600.

101. See note 92 supra.
102. I.R.C. § 179(a).
103. I.R.C. § 179(b).
104. I.R.C. § 179(d)(1).
Prior to the Act, the election under section 179 for qualifying property purchased by a partnership was made at the partnership level. However, the application of section 179 was at the partner level. Thus, the cost of section 179 property which a partnership could pass through to its partners was limited only by the number of its partners. Assume a partnership has ten partners, each of whom has a ten per cent interest in capital and profits. Ten per cent of each partnership distributive item is allocated to each partner. Each partner is married and files a joint return to his/her spouse. The partnership is in the business of purchasing machinery and equipment and leasing it to other businesses. On January 1, 1977, the partnership purchases a piece of equipment for $200,000 which qualifies under section 179(d) for additional first year depreciation. The equipment has a ten year useful life and no salvage value. The partnership elects to take additional first year depreciation and to take regular depreciation on the 200 per cent declining balance method. The regulations provide that the cost of property subject to additional first year depreciation is distributed to partners in the same manner as are depreciation deductions, which in this case would be ten percent to each partner. Under prior law, the partnership could pass up to $20,000 of the cost of the property to each partner. In this partnership, each partner would receive ten per cent of $200,000 or the full $20,000 allowable on a joint return. Those partners and spouses who had not purchased other qualifying property in 1977 could deduct $4,000 of additional first year depreciation on their return. Those partners and spouses who had purchased other qualifying property would still be limited to a $4,000 deduction. If a partner cannot use the full amount of qualifying property cost distributed by the partnership because he has purchased other qualifying property, the partnership must, nevertheless, reduce the basis of the property by the full amount which all partners could have used had they not purchased any other qualifying property. In the example an aggregate of $40,000 additional first year depreciation could be taken by the partners with respect to the equipment purchased if none of them had made other purchases of qualifying property. In any event, the equipment basis is

106. Two hundred per cent declining balance depreciation is authorized by § 167(b)(2). Section 167(c) permits its use on tangible personal property having a useful life of three years or more.
108. Id.
109. Id.
reduced to $160,000 and regular depreciation is computed on that amount. In this case, 200 per cent declining balance depreciation would be $32,000, or $3,200 per partner. Each partner's joint return could show a maximum depreciation deduction of $7,200, with respect to the equipment purchased.

The tax shelter possibility is apparent. If each partner contributed $4,000 to the partnership, and the partnership borrowed $160,000 to buy the equipment, each partner would receive a $7,200 deduction for a $4,000 investment. If a partner's incremental tax bracket is near 55 per cent, the $7,200 deduction would reduce his tax liability by $4,000 and he would recoup his entire investment in the first year. If the partner's tax bracket is 70 per cent, the $7,200 deduction reduces his tax liability by $5,040, which returns to him $1,040 in excess of his investment in the first year.

B. Tax Reform Act Changes

Congress originally enacted section 179 as an aid to small business, not to increase the deductions of a tax shelter. Thus, section 213(a) of the Act amends section 179 to impose a $10,000 cost limit on qualifying property at the partnership level. Therefore, all partners of a partnership could in the aggregate take a $2,000 additional first year depreciation deduction. In the example, each partner would receive a deduction of $200 rather than $4,000. The equipment's remaining depreciable basis would be $198,000 and regular depreciation under the 200 per cent declining balance method would be $39,600, or $3,960 per partner. Each partner's depreciation deduction has been reduced from $7,200 to $4,160 ($3,960 + $200).

This provision was enacted exactly as it appeared in the House Bill, and is effective for taxable years beginning after December 31, 1975.

VI. NON-RECOUSE DEBT

A. Prior Law

The Act also changes the use of nonrecourse liabilities to provide additional basis for a partner's interest which has previously operated to increase the amount of partnership loss which could be

110. Senate Report, supra note 3, at 92.
111. Act, supra note 1, § 213(a) redesignates § 179(d)(8) as § 179(d)(9) and adds the following new provision as § 179(d)(8). "DOLLAR LIMITATION IN CASE OF PARTNERSHIPS.—In the case of a partnership, the dollar limitation contained in the first sentence of subsection (b) shall
passed through to the partners for deduction on their individual income tax returns. Section 722 provides that a partner's basis in his partnership interest equals the amount of money and the adjusted basis of the property which he contributed to the partnership. Section 752(a) provides that an increase in a partner's share of partnership liabilities shall be treated as a contribution of money by that partner to the partnership. Sections 722 and 752(a) thus combine to give a partner a basis for his share of the partnership's liabilities. With respect to a limited partner, the regulations provide that his share of partnership liabilities shall not exceed the difference between his actual contribution to the partnership and the amount which the limited partnership agreement obligates him to contribute. An exception is made where no partner has any personal liability with respect to the partnership liability. In that case, all partners, including limited partners, will share the liability for basis purposes in the same proportion they share profits. It is this rule which has made a tax shelter limited partnership possible.

Assume a partnership has a general partner and nine limited partners each with a ten percent interest in capital and profits and losses. Each partner contributes $10,000 to the partnership for total contributed capital of $100,000. If the partnership is able to borrow $900,000 on a nonrecourse basis (such as a loan secured only by a mortgage on real property), each partner shares in the $900,000 for determining his basis in the same ratio as he shares profits, or ten percent giving him a basis of $100,000. Thus, every limited partner has contributed $10,000 and has no future liability whatsoever to the partnership or its creditors, but he would be allowed to deduct up to $100,000 in losses from the partnership because the basis of his interest is $100,000.

B. Tax Reform Act Changes

Congress responded to this perceived abuse by enacting Act section 213(e). This new section amends section 704(d) and provides that for purposes of section 704(d), the adjusted basis of any partner's interest in the partnership shall not include any portion of any liability with respect to which the partner has no personal liability. Because section 704(d) allows deductions for losses only

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112. I.R.C. § 704(d) provides that a partner's distributive share of partnership losses is allowable only to the extent of the partner's adjusted basis in his partnership interest at the end of the partnership year in which the loss occurred.

to the extent of basis, the amendment prevents the partners in the previous example from deducting losses in excess of their $10,000 contribution. Because no partner is personally liable on the loan, section 704(d), as amended, precludes any partner from including any portion of the $900,000 in the basis of his interest, thereby limiting aggregate basis for purposes of section 704(d) to $100,000 or $10,000 per partner.

Section 704(d) contains two provisions which include the application of the new rule. The first exclusion relates to partnership activity covered by new Code section 465, the "at risk" provision. A comprehensive analysis of section 465 is beyond the scope of this article. In general, the rule limits losses incurred in certain activities to the amount the taxpayer has "at risk" and applies to all taxpayers except corporations which are neither personal holding companies nor subchapter S corporations.

A taxpayer is at risk with respect to money and the adjusted basis of property he has contributed to the activity. He is also at risk on money borrowed with respect to an activity if he is personally liable for repayment or if he has pledged property as security for the loan. The property pledged can neither be used in the activity nor financed through a loan secured by other property which the taxpayer has contributed to the activity. The section 465 at risk rule applies to four types of activities: (1) holding, producing, or distributing motion picture films or video tapes; (2) farming; (3) leasing of section 1245 property; and (4) exploring for or exploiting oil and gas resources. Under the terms of section 704(d), a partnership engaged in any one of these four activities is subject to section 465 rather than section 704(d) with respect to that activity. The conference report, however, stated that rules similar to those of section 465 should be applied to section 704(d) to determine if a partner has personal liability with respect to a partnership liability. Thus, it appears as though the same standards would apply both to section 465 and section 704(d) fact patterns. The conference report further indicated that if a partnership is involved in one of the four activities covered by section 465 and one or more other activities, both sections 465 and 704(d) apply.

This means that partnerships will have to account for both their liabilities and their partners' contributions by activity. Any part-

114. Act, supra note 1, § 204(a).
115. I.R.C. § 465(a), as enacted by Act, supra note 1, § 204(a).
116. I.R.C. § 465(b), as enacted by Act, supra note 1, § 204(a).
117. Id.
118. Conference Report, supra note 3, at 423.
119. Id.
nership whose principal activity is investing in real property other than mineral property is also specifically exempted from the new basis rule of section 704(d). The conference report contained no further explanation of this provision. Presumably, regulations will be issued to define what constitutes a principal activity. Prior to the issuance of regulations, a taxpayer could argue that a partnership's principal activity could be determined by reference to a variety of factors including gross income, net income, or assets, depending on which criteria were most favorable.

It is very important to be aware of the scope of section 704(d) and its new limitation on basis. Section 704(d) limits the loss a partner may deduct to the basis of his partnership interest. For purposes of section 704(d) only, a partner's basis does not include liabilities with respect to which he has no personal liability. When basis is computed for any other purpose, such as computing gain or loss upon a sale or liquidation of the interest, the rule of section 752(a) continues to apply, and the regulations allow a limited partner to include nonrecourse debt in his basis. The limitation of basis applies only for purposes of computing the partners' allowable loss pass-through.

The provisions of section 213(e) of the Act were introduced in an amendment of the Senate floor by Senator Haskell. In its original form, the amendment would have entirely eliminated the provision in regulations section 1.752-1(e) which allows a limited partner to include nonrecourse debt in computing the basis of his partnership interest. The conference report gives no explanation why the amendment was changed to apply only to section 704(d). The amendment to section 704(d) clearly has the effect which Congress wanted to achieve. It will prevent tax shelter limited partnerships from using nonrecourse debt to increase the basis of the interests of the limited partners so as to allow loss deductions greater than the partners' investments.

It is submitted that the amendment to section 704 could create additional tax traps which may not have been intended by Congress. Assume A is a limited partner who contributed $10,000 for a ten per cent interest in capital and profits and losses. The partnership had borrowed $900,000 on a nonrecourse basis and is engaged in an activity to which section 704(d), as amended, applies. A's basis in his interest for any purpose other than the deduction of losses from the partnership is $100,000 under sections 722 and 101.
752(a) as defined by regulation section 1.752-1(e). Assume the partnership incurs a taxable loss for 1977 of $500,000, of which $50,000 would be allocated to A. Prior to the Act, A could use his distributive share of the $500,000 loss, or $50,000, as a loss on his individual income tax return. Section 704(d), as amended, would limit A's deduction to $10,000. Section 705 provides that the basis of A's partnership interest is reduced by losses of the partnership. Thus, A's basis is reduced to $50,000. Had A been allowed to deduct the full $50,000 of loss allocated to him, a reduction of his basis by the amount of the loss does not seem to be unfair. However, where A is allowed to use only $10,000 of the loss, a $50,000 reduction in basis seems punitive for the following reasons.

A's pro rata share of the liabilities of the partnership after the loss would still be $90,000. If A abandons his interest in the partnership on January 1, 1978, his share of partnership liabilities would be eliminated and, under section 752(b), that would be treated as a distribution of cash from the partnership to A. Section 731(a) provides that A recognizes gain to the extent that cash distribution from the partnership exceed his basis in his partnership interest. Thus, A is treated as having received a $90,000 cash distribution with a $50,000 basis in his interest, resulting in the recognition of a $40,000 gain. A invested $10,000, deducted a $10,000 loss, received no money back, yet he must report a $40,000 gain upon the abandonment of his partnership interest.

As a floor amendment, the only report on section 213(e) of the Act is the conference report. It seems likely that nobody carefully thought through the collateral effects of amending only section 704(d). If this result was intended, it is highly unfair, because it results in the taxpayer paying back tax benefits which he never received. The problem could be rectified by providing in regulations under section 705 that a partner's basis in his interest is reduced only by those partnership losses which are allowable on his individual return under section 704(d). The result in the above example, assuming such a regulation were in effect, would be that the partnership loss would reduce A's basis in his interest to $90,000. If he abandoned the interest, the $90,000 constructive cash distribution under section 752(b) would equal his basis and no gain would result. This result would be fair because A invested $10,000 and received no money back. Thus, his economic loss would be $10,000, and he would have received a $10,000 taxable loss from the partnership.

122. I.R.C. § 705.
123. See 1 A. WILLIS, supra note 7, at 281-94.
PARTNERSHIP TAX

VII. CONCLUSION

The Tax Reform Act has closed many channels for tax abuse through which tax shelter partnerships created and passed taxable losses to their partners for deduction on individual returns. Although practitioners now may find tax planning for wealthy clients more difficult, there may be at least one collateral benefit. In the past, many otherwise prudent investors have pumped capital into partnerships that were economically unsound, merely because such an investment would produce a tax loss. Intelligent people often seem to become irrational when contemplating the payment of taxes. Consequently, investments were made with little or no analysis of the economic aspects of the venture. Countless individuals never received a dime back from the partnerships they had invested in, and many discovered that in later years, earlier tax benefits had to be paid back with no available cash flow from the partnership. The blockage of some previous channels for tax abuse may slow the tendency of investors to throw money into worthless ventures. A premium now will be placed on finding ventures which are economically sound, and not only those which can provide tax benefits.

Thomas N. Lawson '77