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Problem Areas Under Internal Revenue Code Section 704(e): The Family Partnership Revisited

Gerald T. Snow*

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I. INTRODUCTION

Basic assignment of income principles dictate that income should be taxed to the taxpayer whose labor or capital generated the income. If the taxpayer responsible for generating the income is an entity, no further assigning or tracing is required. However, if the nominal taxpayer is merely an association or aggregate of other taxpayers, the effort must be made to trace such income beyond the association to the ultimately responsible person or persons.

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In tax law the partnership is a hybrid creation. On the one hand, it is a pass-through entity, i.e., the profit and loss of the partnership is not taxable to the partnership but passes through to the partners and is reportable by them as if they were conducting the partnership business in their individual capacities. In this respect the partnership is treated as if it were an aggregate of individuals, inasmuch as there is income tracing beyond the entity level back to the various individuals that generated it. On the other hand, the partnership is simultaneously treated as an entity for purposes of the tracing rule, i.e., in general it is not necessary to determine which partner's capital or services is responsible for partnership income. Thus, under section 704(b)¹ it is permissible, subject to certain limitations, to allocate partnership income or loss, or any item thereof, in any proportion to any partner. There is an uneasy and constant tension between the aggregate and entity models of a partnership which runs through all of partnership tax law, of which this is but one example.²

The ability to allocate income within the context of a partnership, in seeming defiance of the general assignment of income principles, has been one of the most intriguing and attractive aspects of the use of the partnership form. The complex regulations recently promulgated under section 704(b)³ are intended to curb abuses and impose consistency in this area by requiring partnership allocations to pass "substantial economic effect" tests. However, these regulations serve simultaneously to validate the basic allocation scheme under which income may be allocated one way, loss another way, and cash distributions a third way, provided that all such allocations and distributions are reconciled in the end through the mechanism of the partners' capital accounts.

Another example of a hybrid creation in the tax law is the so-called S corporation, or an electing small business corporation under Subchapter S of the Internal Revenue Code. Like a partnership, an S corporation is a pass-through entity, with the income of the corporation generally taxable on the shareholder level rather than the corporate level. However, in contrast to a partnership, an S corporation is subject to a more rigid allocation scheme, according to which each shareholder is entitled only to his pro rata share of income, loss and distributions, based strictly on stock ownership. This of course is more consistent with general assignment of income principles.

1. I.R.C. § 704(b). All section references or references to the Code are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

2. For more detail, see generally Subchapter K of the Code. I.R.C. §§ 701-761. It is beyond the scope of this article to explore the many instances in which this dualism is exhibited.

3. Treas. Reg. § 1.704-1(b) (as amended in 1986). All regulatory references are to the Treasury Regulations promulgated under the Code.

The so-called family partnership, or the partnership involving family members or donee partners, lies somewhere in between a regular partnership and an S corporation. Section 704(e), which governs allocations in this area, comes down on the side of the aggregate model of partnerships and requires tracing, consistent with assignment of income principles, much like an S corporation. Nevertheless, income allocation is still possible in a family partnership, but in a much less aggressive manner than in non-family partnerships. Thus, section 704(e) and the regulations promulgated thereunder impose more severe restrictions than section 704(b) on the ability of a parent to allocate income to a child while still retaining control over such income. Section 704(e) thereby constitutes an overlay on the general partnership allocation scheme which, when there is a conflict between the two, prevails over the more lenient rules of Section 704(b).⁴ The result, in an already complex area of the tax law, is further complexity arising from the interplay of these two sets of allocation rules, producing many areas of uncertainty.⁵

II. AN OVERVIEW OF SECTION 704(e)

A. *The Safe Harbor Rule of Section 704(e)(1)*

Under usual circumstances today, the transferee of a capital interest in a partnership is readily accepted as a partner for tax purposes. This was not always so, however, for transferees who received their partnership interest as a gift. For a time in the 1940's, the Internal Revenue Service refused to recognize the donee of a partnership interest as a true partner unless he also contributed vital services or his own capital to the partnership.

The United States Supreme Court rejected this interpretation of the law in 1949 in the case of *Commissioner v. Culbertson*,⁶ focusing instead on whether the parties in good faith and with a business pur-

4. *Id.* § 1.704-1(b)(1)(iii).

5. The complexity and uncertainty of the interplay of the allocation rules of section 704(b) and section 704(e), in addition to the restraining effect of section 704(e) generally, are a dampening factor with respect to the bracket shifting allocations that have traditionally driven much of family partnership tax planning. Moreover, the recent flattening of the income tax rates pursuant to the Tax Reform Act of 1986 has also diminished the relative desirability or need for bracket shifting. A third dampening factor is new section 1(i), the so-called "kiddie tax", which operates to tax the net unearned income of a child under the age of 14 years at his parents' top marginal rate. I.R.C. § 1(i). As a result of these developments, bracket shifting is no longer the name of the game in family partnership tax planning.

6. 337 U.S. 733, 49-1 USTC ¶9323 (1949). The Court clarified its own decision in *Commissioner v. Tower*, 327 U.S. 280, 46-1 USTC ¶9189 (1946), relied on by the Internal Revenue Service, thus opening the door to the possibility of a donee partner being accepted as a true partner in a partnership for tax purposes.

pose intended to conduct a joint enterprise. Congress followed up *Culbertson* by enacting section 704(e) in 1951,⁷ dispelling all remaining doubt regarding the true partner status of the donee of a capital interest. Section 704(e)(1) provides that any person "shall be recognized as a partner," provided that he "[i] owns [ii] a capital interest [iii] in a partnership in which capital is a material income-producing factor," however the interest may have been acquired. Thus, present law requires that the partnership must satisfy a test, the interest transferred must satisfy a test, and the transfer itself must satisfy a test. Alternatively stated, both the type and the reality of the transfer is subject to special scrutiny.⁸ If all three tests are satisfied, the transferee partner has found safety within the harbor of section 704(e): his status as a true partner for tax purposes will not be questioned.

Section 704(e)(1) is worded broadly enough to provide protection to all capital partners in a partnership, including non-related third parties who acquire their interest by purchase. In practice, however, the area of greatest application of section 704(e) concerns (1) donee partners, i.e., anyone who receives a capital interest in a partnership by way of gift; and (2) family transferees, i.e., anyone who acquires a capital interest in a partnership from a family member, whether or not by gift. As described in more detail in Part II. B. below, for donee partners and family transferees, there is a cost involved for such protection: such partners must abide by the strict income allocation rules of section 704(e)(2). Under these circumstances, it is better to avoid section 704(e) altogether by having each partner acquire his interest in the partnership directly from the partnership with capital that cannot be traced back to the transferor. However, if a donative transfer must be used, it is better to fall into section 704(e) than for the transferee not to be deemed a partner at all.

1. *The first test*

The first test for qualification under section 704(e)(1) is that the partnership must be one in which capital is a "material income-producing factor." This means that a "substantial portion" of partnership "gross income" must be attributable to partnership capital, such as investment in inventory, plant or equipment or other income producing assets. If the partnership is "principally" a service oriented business, it

7. I.R.C. § 704(e).

8. *Kuney v. Frank*, 308 F.2d 719, 62-2 USTC ¶9769 (9th Cir. 1962). If a transferee fails the section 704(e) tests, it is still possible, although more difficult, to qualify for recognition as a partner under more general partnership rules. *Carriage Square, Inc. v. Commissioner*, 69 T.C. 119 (1977).

will be difficult to satisfy this test.⁹

Under usual circumstances debt as well as equity will be considered in determining whether capital is a material income producing factor.¹⁰ Nevertheless, on at least one occasion the Tax Court attempted to disregard borrowed capital.¹¹ A majority of the justices in that case, in separate opinions, dissociated themselves from this finding but arrived at more or less the same tax result for other reasons.

2. *The second test*

The second test is that the interest transferred must be a "capital" interest. The transfer of a profits interest alone, while it may be a genuine and valuable gift, will not be recognized for income tax purposes. If one wishes to transfer future income for income tax purposes (the fruit), one must also be willing to transfer the source of such income (the tree).¹² A capital interest thus represents not only an interest in partnership profits but also an interest in the underlying assets of the partnership, an interest which is distributable upon liquidation of the partnership or withdrawal of the partner.¹³

3. *The third test*

The third and final test which must be satisfied is that the transferee must be the "real owner" of the interest, i.e., the transferee must acquire "dominion and control" over the transferred partnership interest. This is a facts and circumstances determination. Simply satisfying the legal requirements for a completed gift is not sufficient.¹⁴ Thus, the execution of legally sufficient transfer documents and corresponding reflection of the ownership of the transferee partner on the records of the

9. Treas. Reg. § 1.704-1(e)(1)(iv) (1956); *Ketter v. Commissioner*, 70 T.C. 637 (1978).

10. Section 704(e)(1), since it is a safe harbor, takes the "safe" position that capital must be a material income producing factor. What about a partnership which depends entirely on fees for personal services as a source of income but which also has a substantial investment in terms of absolute dollars in plant, equipment and premises? Clearly it is possible to have a capital interest in such a partnership, yet the capital may not be a material enough income producing factor in relation to the services rendered. Provided that capital is *essential* to the services rendered, regardless of its *relative* contribution, it may be possible for the donee holder of such an interest to nevertheless be recognized as a partner outside the safe harbor rules. *Commissioner v. Culbertson*, 337 U.S. 733, 49-1 USTC ¶9323 (1949); *Carriage Square*, 69 T.C. 119 (1977); *cf.* Treas. Reg. § 1.1348-3(a)(3)(ii) (1976, repealed 1981), under the maximum tax rules of repealed I.R.C. section 1348, for a contrary view on this point.

11. *Carriage Square*, 69 T.C. 119 (1977). The Court relied on the literal language of Treas. Reg. § 1.704-1(e)(1)(i) (1956).

12. *Wall v. United States*, 82-1 USTC ¶9121 (D.N.D. 1981). The fruit and tree analogy was first enunciated in *Lucas v. Earl*, 281 U.S. 111 (1930).

13. Treas. Reg. § 1.704-1(e)(1)(v) (1956).

14. *Pflugrad v. United States*, 310 F.2d 412, 63-1 USTC ¶9112 (7th Cir. 1962).

partnership are helpful factors, but not conclusive. The actual conduct of the parties is more indicative of the economic reality of the transfer.¹⁵

Sometimes the reality of the transfer is not recognized at all under the sham transaction doctrine. At other times, it is not alleged that the transfer was a sham but that the transferor simply retained too many controls and other incidents of ownership for ownership to pass for income tax purposes.¹⁶ The more the retained controls and other incidents of ownership, the more inclined the court is to ignore the transfer altogether, and even to treat the partnership as a nullity.¹⁷

It is in the area of this third test that the most confusion and, as a result, the most litigation has arisen. The regulations go into considerable detail on this point, setting forth a number of factors of varying weight which tend to show that ownership of the transferred interest has truly passed.¹⁸ The regulations include the following factors:

(1) Participation by the transferee partner in the control and management of the partnership.

(2) The holding out of the transferee partner to third parties (creditors, customers, etc.) as a member of the partnership.

(3) Distribution directly to the transferee partner of his share of net income at least annually (less amounts withheld for the reasonable needs of the business).¹⁹

(4) Allowing the transferee partner the unfettered right to sell or liquidate his interest without financial detriment.²⁰

(5) The nonretention in the transferor of controls or powers, direct or indirect, which can be used to vitiate the previously enu-

15. Treas. Reg. §§ 1.704-1(e)(1)(iii), 1.704-1(e)(2)(i) (1956).

16. *Compare* Carriage Square, 69 T.C. 119 (1977) (no partnership existed because no business purpose or good faith intent to join together as partners) *with* Krause v. Commissioner, 57 T.C. 890 (1972) (partnership existed but transferor retained too many controls and incidents of ownership for the court to accept the transferees as true owners of anything).

17. *Cirelli v. Commissioner*, 82 T.C. 335 (1984).

18. *See* Treas. Reg. § 1.704-1(e)(2)(ii)-(vi) (1956).

19. The distribution obviously will vary depending on the type of business involved. In *Garcia v. Commissioner*, 48 TCM 425 (1984), the court did not require actual distributions where the limited partners' capital accounts were properly credited with their share of partnership income. However, this would be the case with respect to any partnership following the section 704(b) and Reg. § 1.704-1(b) capital accounting rules and falls far short of giving the limited partners a current right of distribution. *Garcia* does not appear to be safe precedent for allowing proper capital account crediting procedures to take the place of actual distributions.

20. Presumably, this means without any kind of forfeiture or penalty, or discount upon a redemption, or restriction on the status of an assignee. A right of first refusal in connection with a proposed sale should be acceptable. In other words, a buy-sell agreement is permissible, provided it is not too restrictive. This condition also presupposes an independence of the transferee from the transferor and a capacity in the transferee both to decide to exercise and to carry out the exercise of a right of withdrawal or sale.

merated rights of the transferee partner.²¹

(6) The motive for the transfer.²²

If the transferee is a trustee, no new question is raised unless the grantor of the trust is also the trustee or otherwise controls the trustee. In that case, emphasis is put on whether the trustee is both subject to and in reality acts in accordance with the responsibilities of a fiduciary.²³ If the transferee is a minor child (except where an adult level of competence is demonstrable), control of the transferred interest must generally be exercised by a fiduciary (a trustee, custodian or guardian) for the sole benefit of such child. Where required by law, there must also be judicial supervision.²⁴ Absent such protections, a naked transfer to a minor child is likely to be regarded as a nullity.

If the transferred interest is a limited partnership interest, the factors of participation in management or the rendering of services are no longer pertinent, since by definition, in their capacity as such, limited partners do not participate in partnership management or render services to the partnership. More emphasis is thus placed on the remaining factors of the right to annual distributions and the right to sell or

21. Normal management powers may be retained, such as the right of a managing general partner to determine the reasonable cash needs of the business. However, retaining control over partnership assets by leasing them to the partnership or by controlling the flow of work to the partnership may go too far. *Ramos v. Commissioner*, 68-1 USTC ¶9337 (9th Cir. 1968); *Ketter*, 70 T.C. 637 (1978).

22. Motive is an incidental factor, relevant only insofar as it has a bearing on the reality of the transfer. *Treas. Reg.* § 1.704-1(e)(2)(x) (1956). To this extent, section 704(e)(1) is a safe harbor from the requirements of good faith and business purpose under *Culbertson*. *But cf.* *Carriage Square, Inc.*, 69 T.C. 119 (1977) (an instance in which *Culbertson* was applied in holding that no partnership even existed).

23. *Treas. Reg.* § 1.704-1(e)(2)(vii) (1956). It should be recalled, however, that the grantor trust rules of sections 671 through 678 may redirect the taxability of trust income back to the grantor, thus defeating any possible income tax benefit from having installed the grantee trust as a partner, even though the trust is respected as a true partner under the section 704(e) rules. Note also, that if the trust is taxable and retains income, it will be subject to the least favorable income tax rate structure under sections 1(e), 1(g) and 1(h), whereas if the trust distributes income to a minor beneficiary, some other fiduciary will have to be found to hold such income for the minor under state law. *See* I.R.C. §§ 1(c), (g), (h). Nevertheless, a trust is the most flexible form of ownership as compared with a custodianship or guardianship.

24. *Treas. Reg.* § 1.704-1(e)(2)(viii) (1956); *Pflugradt*, 310 F.2d 412, 63-1 USTC ¶9112 (7th Cir. 1962). In most cases involving a minor child, a parent will be a trustee or custodian for the child. The parent will be under the burden of demonstrating that he or she actively represents the interests of the child in the partnership from a fiduciary standpoint. *Ginsberg v. Commissioner*, 502 F.2d 965, 74-2 USTC ¶9660 (6th Cir. 1974). Apparently, a custodial relationship under the Uniform Gifts to Minors Act ("UGMA") satisfies this fiduciary standard. *Garcia*, 48 TCM 425 (1984). Care must be taken, however, to make sure that the property transferred is an acceptable type of gift under the applicable state UGMA (or the applicable state Uniform Transfers to Minors Act). In many states, a limited partnership interest is now an acceptable type of gift under these statutes. *See, e.g.*, UTAH CODE ANN. § 75-5-601(13) (1988).

liquidate the interest without being subject to substantial restrictions or controls. Additionally, the partnership must be organized under the applicable state limited partnership law. Here, as throughout these "true ownership" tests, the regulations are concerned with how the transferee's rights compare with those of an unrelated, arm's length partner.²⁵

B. *The Special Allocation Rule of Section 704(e)(2)*

1. *Definitional matters*

There is a cost involved for the protection of section 704(e)(1) which is applicable to a large subset of partnership interest transfers, namely, those involving a gift (to anyone, whether or not a member of the transferor's family) or a transfer to a family member, whether by gift or by purchase (i.e. to the transferor's spouse, ancestors, lineal descendants or a trust for the primary benefit of such persons). Under this arbitrary rule, it makes no difference that the transferee paid fair value for his interest.²⁶

A gift may be found from the surrounding facts and circumstances and may be direct or indirect.²⁷ A purported purchase of a partnership interest by a non-family member, which would not fall within the ambit of section 704(e)(1), is measured against the usual tests of genuineness, such as price, interest rate, maturity date and collateral security, or, absent such arm's length indicators, a valid business purpose.²⁸ If a parent gave his child the money or property to contribute to a partnership, the partnership interest itself will be deemed to be a gift.²⁹ Also, a

25. Treas. Reg. § 1.704-1(e)(2)(ix) (1956). It should be obvious that a parent who desires to set up his minor child as a limited partner in the family partnership has a difficult burden to carry under any circumstances. He is required to give his child certain income and liquidation rights that he may find undesirable, to provide a trustee or other fiduciary to protect his child's interest, and then to actively exercise (or suffer the exercise) of such rights when appropriate. The price of achieving income shifting from a parent to a child may be too high under these circumstances. Moreover, as already pointed out, section 1(i) effectively prevents income shifting for children under age 14 in any event. Notwithstanding these problems, installing one's children as limited partners in the family partnership may of course serve other worthwhile goals, such as moving present asset values and/or future appreciation in asset values out of one's estate, or protecting assets from creditors, while retaining control of the business. The gift tax cost of any such transfer must also be considered, as well as the relative complexities and effectiveness of such transfer. The recent "anti-freeze" legislation contained in section 2036(c) further complicates this whole area. I.R.C. § 2036(c).

26. I.R.C. § 704(e)(2), (3). The bias against intra-family transfers is obvious. However, the payment of fair value for a partnership interest will matter for estate tax purposes. I.R.C. §§ 2036, 2038.

27. Treas. Reg. § 1.704-1(e)(3)(ii)(b) (1956).

28. *Id.* § 1.704-1(e)(4).

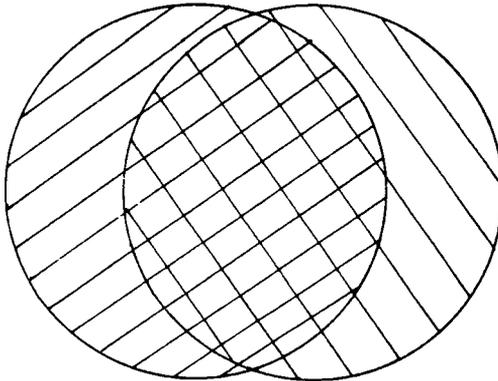
29. *Id.* § 1.704-1(e)(3)(ii)(a). *See infra* pages 45-46 examples (1) through (3). It is not clear

transfer may be part sale, or part gift, depending on the circumstances, such as whether the transferee assumes or takes subject to any liabilities (e.g., an obligation to contribute additional capital) or whether any other consideration is given in exchange for the interest (hence, part purchase) or whether the purported purchase price is artificially low (hence, part gift).³⁰

The reach of section 704(e)(2) may be diagrammed as follows:

DONATIVE
TRANSFEREES

FAMILY
TRANSFEREES



As the diagram shows, the applicability of section 704(e)(2) is not necessarily predicated either on a gift (since the transferred interest may be acquired by purchase) or on the transferee being a family member (since he may be anyone, if he is a donee) but on the presence of either such factor. In most cases, in fact, both factors are present.³¹

how far back such a tracing concept can be carried. With a minor child, the presumption that a partnership interest belonging to such child arose from a gift may be extremely difficult to rebut. A possible out may lie in being able to trace the money or property contributed to the partnership by the child to an ultimate donor who is not a partner, thereby avoiding any reallocation under section 704(e)(2).

30. Bifurcation of the transferred interest into a sale portion and a gift portion is necessary in order to determine both the size of the gift for gift tax purposes and the size of the sale portion for calculation of gain purposes. It is also necessary, at least in the case of a purchase by a non-family member, for section 704(e) purposes.

31. If neither factor is present, a family partnership is not subject to section 704(e). *Priv. Ltr. Rul. 8024013* (1980). However, the factors enumerated under Reg. § 1.704-1(e)(2) may still be relevant. *Cirelli v. Commissioner*, 82 T.C. 335 (1984).

2. *The constraints on allocations to transferees*

If the transfer of a capital interest in a partnership is accepted as genuine for tax purposes, two constraints are imposed on allocations of partnership income to the transferred interest under section 704(e)(2).

First, the transferee's allocable share of partnership income is to be determined after making an allowance for the payment of reasonable compensation to the transferor for any services rendered by him to the partnership.³² An allowance must also be made for reasonable compensation for the services, if any, of the transferee to the partnership.³³ The relative managerial contributions of the partners are to be considered in determining what is fair compensation for services. In the case of a limited partnership, the credit risk assumed by the general partner(s) may also be considered.³⁴

Second, after allowing for a proper allocation for services, the allocation of remaining income to the capital interest of the transferee may not be proportionately greater than the income allocation to the capital interest of the transferor.³⁵ In other words, transferred dollars cannot be worth more than retained dollars. If the transferee acquired his interest by purchase from the transferor, the fair market value of the purchased interest is deemed to be the amount of transferred capital.³⁶

This sounds simple enough on the surface, but numerous problems arise in the application of these principles, especially in the context of other applicable subsections of section 704. Part III, below, discusses the most significant of these problem areas.

III. PROBLEM AREAS UNDER SECTION 704(e)

A. *Capital Interests vs. Capital Account Balances*

The safe harbor rule of section 704(e)(1) extends only to a "capital interest" in the partnership.³⁷ Treasury Regulation § 1.704-1(e)(1)(v) states that such an interest means an interest in partnership assets which is distributable upon liquidation of the partnership or termination of the partner's interest in the partnership. Under Reg. § 1.704-1(b)(2)(ii)(b)(2), a capital interest which represents a distributable interest in the assets of the partnership must correspond to a posi-

32. Treas. Reg. § 1.704-1(e)(3)(i)(a) (1956).

33. *Id.* at § 1.704-1(e)(3)(i)(b). Section 1366(e) provides a somewhat analogous rule in the Subchapter S area. See I.R.C. § 1366(e).

34. Treas. Reg. §§ 1.704-1(e)(3)(i)(c), 1.704-1(e)(3)(ii)(c) (1956).

35. *Id.* § 1.704-1(e)(3)(i)(a).

36. *Id.*

37. See *supra* notes 6-25 and accompanying text.

tive capital account balance, at least at the time of distribution. Stated differently, a capital interest represents equity in the partnership and should therefore be reflected in the partner's equity or capital account.

To properly apply section 704(e), it must first be ascertained whether a capital interest has actually been transferred, and, if so, the amount of transferred capital. Consistent with the capital accounting rules of Reg. § 1.704-1(b), this can not be done without reference to the capital account balance, if any, associated with the transferred interest. However, determining which capital account balance is the appropriate indicator for this purpose poses a problem. "Book basis capital accounts" (i.e., partners' equity in partnership assets as they are carried on the books of the partnership) at any given time may or may not equal "tax basis capital accounts" (i.e., partners' equity in partnership assets at their adjusted tax basis).³⁸ More importantly for the present purpose, it is possible that neither book basis nor tax basis capital accounts will accurately reflect partners' equity in partnership assets at their market value at the time of a section 704(e) transfer.

It would be possible, for example, for the transferred interest to have a positive market value but a corresponding zero or negative balance tax basis and/or book basis capital account in the situation where there have been both tax losses and an inside build-up of unrealized gain in the partnership. Such an interest ought clearly to be viewed as a "capital interest" for section 704(e) purposes, even though it does not have a positive capital account balance under the capital account maintenance rules of Reg. § 1.704-1(b)(2)(iv) at the time of transfer. Also, the amount of transferred capital should be determined to be no less than the transferee's share of the market value of partnership assets, not the current book basis or tax basis capital account balance which does not reflect that market value. What should matter under these circumstances is whether, under the terms of the partnership agreement, the transferred interest is entitled to share in any unrealized gains and losses inherent in the partnership assets and therefore would have a positive book basis capital account balance if the assets of the partnership were then revalued to their fair market value. This hypothetical capital account balance, which assumes a revaluation of assets at the time of a section 704(e) transfer, is what is hereinafter referred to as a "section 704(e) basis capital account."

Under certain circumstances, the regulations under section 704(b) expressly recognize the right of a partner to share in the inside build-up of unrealized gain (or loss) by permitting, or requiring, book capital

38. Treas. Reg. §§ 1.704-1(b)(2)(iv)(b), 1.704-1(b)(2)(iv)(d), 1.704-1(b)(2)(iv)(f), 1.704-1(b)(2)(iv)(g) (as amended in 1986).

accounts to be restated accordingly.³⁹ Unfortunately, the transfer of a partnership interest, whether by gift or purchase, is not a revaluation event under the regulations, even when a section 754 election is in effect.⁴⁰ However, under the allocation rules of section 704(e)(2), it is necessary to determine the amount of both the transferor's and the transferee's capital at the time of transfer. Therefore, if the true economics of the transfer are to be reflected, it becomes necessary to create yet a third set of capital accounts, namely, section 704(e) basis capital accounts.⁴¹

In the case of a partnership interest acquired by the transferee by purchase from the transferor, section 704(e)(3) states that the amount of the transferee's capital is equal to the fair market value of such interest (presumably, its purchase price), which comports with the analysis given above. In the case of a partnership interest acquired by gift, section 704(e) is silent on how the amount of the transferee's or the transferor's capital is to be determined. Logic, fairness and consistency require that both the *existence* of a transferred capital interest under section 704(e)(1) and the *amount* of such interest (as well as of the transferor's capital interest) for section 704(e)(2) allocation purposes, whether the transfer be by purchase or gift, be determined with reference to what has here been called section 704(e) basis capital accounts. This would properly reflect the economic reality of the transaction.

B. Allocation for Transferor's Services: Real or Computational Only?

Before section 704(e)(2) can be applied to determine what is a fair and proportionate allocation of partnership income to transferor and transferee attributable to their respective capital, a determination must first be made of the reasonable compensation value of any services to the partnership rendered by the transferor and transferee. The amount of such compensation must then be deducted from partnership income, leaving only the net amount for allocation with respect to capital.⁴² The relative managerial contributions of the general partners and the credit risk assumed by the general partner in a limited partnership are among the factors to be considered in determining compensation value.⁴³

39. *Id.* § 1.704-1(b)(2)(iv)(f).

40. *Id.* §§ 1.704-1(b)(2)(iv)(f), 1.704-1(b)(2)(iv)(m)(2).

41. A section 704(e) basis capital account is simply an expanded version of a book basis capital account, in that it includes one more revaluation event than is presently permitted or required under Reg. § 1.704-1(b)(2)(iv)(f).

42. Treas. Reg. § 1.704-1(e)(3)(i)(b) (1956).

43. See *supra* Part II. B. 2.

This can be a burdensome and awkward requirement. Typically a partner is compensated for his services to the partnership directly through his allocable share of partnership income, whether on a current and/or residual basis, rather than through a separate salary or fee arrangement. This avoids the necessity of imputing how much of a partner's distributable share of income under Subchapter K constitutes compensation for services. However, section 704(e) forces the partners to put a value on such services. Reg. § 1.704-1(e)(3)(i)(a) is worded broadly enough to take into consideration that the transferor partner may in fact be receiving compensation for his services through a salary or guaranteed payment. One is still not spared the necessity, however, of determining whether such salary or guaranteed payment is adequate.

It is not entirely clear whether an amount of partnership income corresponding to the transferor partner's deemed compensation (to the extent not already provided for by a salary or guaranteed payment arrangement) must actually be allocated to the transferor for tax purposes. Section 704(e)(2) purports to limit only what "the distributive share of the donee" may be and does not address itself to the distributive share of the donor or transferor partner. Nevertheless, if the distributive share of the transferee does not comply with the statute, Reg. § 1.704-1(e)(3)(i)(b) provides that the income allocations of *both* transferor and transferee are to be pooled and reallocated, first to the services of both and then in proportion to their capital.

If the statute's goal is purely computational and transferee-centered, it should not matter whether compensation income is, in fact, reallocated to the transferor, so long as the transferee's allocable share of partnership income attributable to services and capital is correctly determined. This would allow the transferor to enter into a simultaneous special allocation of income to any other partners which otherwise might not be acceptable. If, however, the statute is to be interpreted not merely to prevent bracket shifting but also to ensure that income earned is taxed to the partner who earned it, then the transferor may not be able to avoid an immediate income allocation attributable to his rendering of services. This interpretation of the statute, however, creates a conflict with section 704(b) and arguably finds no justification in the underlying rationale for section 704(e). Some examples will illustrate the point.

Example (1): Father (F) is sole proprietor of a small business in which capital is a material income producing factor. The book value and tax basis of the assets of the business is \$100,000. F makes a gift of a half interest in the business to his adult son (S) on the first of the year. Their capital accounts and profit sharing percentages are thus in the ratio of 50:50. Both F and S work in the business. The busi-

ness has a gross profit of \$80,000 and expenses of \$40,000 during the year. The value of F's services is \$20,000 a year and of S's services is \$10,000 a year, but they take out no salary.

Under the more restrictive view of section 704(e) and the regulations thereunder, \$20,000 of compensation income must be allocated to F and \$10,000 to S for their services, leaving a \$10,000 bottom line profit to the partnership (\$80,000 gross income less \$40,000 expenses less \$30,000 total compensation), of which \$5,000 is allocated to F and \$5,000 to S. The net result to F is \$25,000 of income (\$20,000 income allocation for compensation plus \$5,000 bottom line profit allocation) and to S is \$15,000 of income (\$10,000 income allocation for compensation plus \$5,000 bottom line profit allocation). Without section 704(e), F and S would have shared the \$40,000 of business profit \$20,000 each (50:50). F is thus forced to pick up \$5,000 more income than he would otherwise have to, which is a proper result under the principles of section 704(e).

Example (2): Assume the same facts as in Example (1). If the less restrictive view of section 704(e) is applied (i.e., compensation income is not actually allocated to F but is taken into consideration only for purposes of determining what S's distributive share should be), S's income allocation would still be \$15,000 (\$10,000 compensation income and \$5,000 bottom line allocation). That would leave \$25,000 income allocation to F, all bottom line profit. The result is the same to F in absolute dollars, but there may be some differences resulting from the difference in character of the income received.⁴⁴ Where the partnership consists only of the transferor and transferee partners, the economic results of allocation under section 704(e) should be the same, whichever view of section 704(e) is applied.

Example (3): Assume the same facts as in Example (1), except that at the same time S joins the partnership an unrelated third partner is brought into the partnership as an investor (I), who puts in \$100,000 of new capital. The partners agree that I is to receive a preferential allocation of 80% of income in the first year.

If the more restrictive view of the statute is to be applied, thereby forcing the actual allocation of compensation income to F, the bottom line to be shared among three partners would be only \$10,000, as in example (1), of which \$8,000 is allocated to I and \$1,000 to each of F and S. On the other hand, if the less restrictive view of the statute is applied, which is concerned only that S's distributive share be determined correctly, i.e., that he receive his \$10,000 income allocation for services and his \$1,000 share of the bottom line profit, that would

44. For example, compensation income might be subject to FICA obligations or eligible as compensation for IRA purposes.

leave \$29,000 to be allocated between I and F in the ratio of 80%:10%, or \$25,778 to I and \$3,222 to F. In other words, under this view, S would give up \$4,000 to I (dropping from \$15,000 to \$11,000 total allocation) while F would give up \$21,778 to I (dropping from \$25,000 to \$3,222).

It does not appear that the tax law is better served by limiting I in example (3) to only \$8,000 of income instead of \$25,778 and forcing F to recognize \$21,000 of income (\$20,000 compensation income and \$1,000 bottom line allocation) instead of \$3,222. It would seem that this should be a matter between F on the one hand and I on the other. F is allocating away some of his income to an unrelated party, something he would clearly be allowed to do outside of section 704(e). As long as he is not allocating such income to a transferee partner, which would bring him within the reach of section 704(e), he should be allowed to do so. It would seem that to this extent an allocation under section 704(b) should not be considered as contravening section 704(e).

Another approach is possible under example (3). Suppose the partnership agreement is interpreted in such a way that I receives 80% of partnership profit before any allocations are made to F and S. In that event I would receive \$32,000 (80% of \$40,000). The remaining \$8,000 would then be allocated between F and S under Reg. § 1.704-1(e)(3)(i)(b), in accordance with which income is allocated to services first. If S is to be ensured his \$11,000 allocation to the maximum extent possible, then all \$8,000 would have to be allocated to him and there would be a zero allocation to F. It is hard to see why F and S, collectively, should not be allowed to allocate income to I in this manner since they are not allocating income to each other in contravention of the policy of section 704(e). After all, the regulation only reallocates "the distributive shares of the partnership income of the donor and donee", for the determination of which one must have reference to the partnership agreement. To interpret section 704(e) otherwise is to penalize I, a party outside the reach of section 704(e).

Another problem with the allocation of compensation income arises when the unallocated distributive shares of partnership income of the transferor and the transferee are insufficient to sustain a reallocation to both the transferor and the transferee of the reasonable compensation value of their services. Apparently, the applicable treasury regulation contemplates that when it is necessary to reallocate the distributive shares of the transferor and the transferee under section 704(e)(2), such reallocation will be done: first, by making a reasonable allowance for the services of the transferor; second, by making a reasonable allowance for the services of the transferee; and third, by allo-

cating the balance of such income, if any, between the transferor and the transferee in proportion to their respective interests in partnership capital.⁴⁵ In other words, the reallocation for compensation follows a priority rule in which the transferor's services are allowed for first, but the reallocation for capital follows a pro rata rule in which neither the transferor's nor the transferee's capital is favored.

It is hard to see how such inconsistency of treatment is justified and, indeed, because of the inartful way in which the regulation is drafted, it is not altogether certain that this is what the regulation intends. As long as the unallocated distributive shares of partnership income of the transferor and the transferee are sufficient to sustain the necessary reallocation for services, this apparent priority rule produces no different result than would a pro rata rule. The problem arises when the unallocated distributive share amounts are insufficient for the purpose, as the following example shows.

Example (4): Assume the same facts as in Example (1), except that expenses amounted to \$60,000 instead of \$40,000, leaving only \$20,000 of bottom line profit to be allocated between F and S. The total value of F's and S's services was \$30,000. Under the priority rule, all \$20,000 of profit would be allocated to F for services and zero to S, and nothing would remain for reallocation with respect to capital. Under a pro rata rule, the \$20,000 would be reallocated \$13,333 to F and \$6,667 to S for services.

It could be argued that the priority rule makes sense because the primary concern of section 704(e)(2) is to avoid the deflection of income from the transferor to the transferee. On the other hand, as the example illustrates, the priority rule actually forces a deflection of income from the transferee to the transferor, which does not make good economic or tax sense. When there is not enough income to go around, it should be apportioned both for services as well as capital on a pro rata basis.

One possibility for dealing with the insufficiency of distributive share amounts to sustain the necessary reallocation for services lies in the reallocation of gross rather than net income. The following example shows how this might be done.

Example (5): Assume the same facts as in Example (4). Even though there is insufficient net profit (\$20,000) to provide for a reallocation of \$30,000 of service income, there is sufficient gross income (\$80,000) for that purpose. If the statute can be applied to gross income, then \$20,000 and \$10,000 of gross income can be reallocated to

45. Treas. Reg. § 1.704-1(e)(3)(i)(b) (1956).

F and S, respectively, for services. This, of course, adds a cost figure of \$30,000 to the \$60,000 of costs already incurred, which then produces a \$10,000 net loss to the partnership. This hypothetical net loss must then be allocated between F and S, presumably on a 50:50 basis in proportion to capital. The final result is that F has \$15,000 of income allocation (\$20,000 income allocation for services and \$5,000 loss allocation) and S has \$5,000 of income allocation (\$10,000 income allocation for services and \$5,000 loss allocation). Thus, the reallocation of gross income produces yet a different result from either the priority rule or the pro rata rule as applied to net income only.

The primary argument against any such reallocation of gross income is that it goes beyond the apparent scope of the regulation.⁴⁶ The regulation by its terms operates only on the unallocated distributive shares of the transferor and the transferee, such as they are under the partnership agreement. Section 705(e)(2) should not be used to compel the imputation of income for services to the full extent because that is not its real purpose. Its purpose is to ensure tax equity as between the transferor and the transferee. A hypothetical allocation of gross income not only goes beyond what the partners themselves have done, but it creates a fictional loss to the partnership and arguably produces a wrong numerical result.

In conclusion, the reallocation of income under section 704(e) should be restricted to whatever the transferor's and the transferee's distributive share amounts happen to be. Such reallocation should be done using a pro rata rule rather than a priority rule for both services and capital. The reallocation to the transferor should be viewed as computational only, allowing the transferor to reallocate income to a third party if desired.

C. Tax Reallocation vs. Economic Ownership

An allocation of partnership income to a transferee partner does two things: it makes the transferee partner responsible to pay the tax on that income and it makes him the economic owner of that income. This is the result, at least, if the capital accounting rules of section 704(b) are followed. These rules require that an allocation of income to a partner be matched with a credit to such partner's capital account, and that such credit represent a distributable interest in the assets of the partnership.⁴⁷

If some of the income allocated by agreement to the transferee partner is reallocated to the transferor partner under section 704(e),

46. *Id.*

47. *Id.* §§ 1.704-1(b)(2)(ii)(b)(2), 1.704-1(b)(2)(iv)(b).

this should presumably have an effect on the economic ownership of that income. However, some commentators believe that, even though the transferor partner may have to pay income tax on any partnership income allocated under the partnership agreement to the transferee but reallocated to the transferor under section 704(e)(2), such reallocation need not alter the economics of the partnership agreement.⁴⁸ These commentators believe that the transferee partner may retain the ownership of the income allocated to him by agreement. Furthermore, they argue that the transferor partner may not only make a gift of a partnership interest, but may also pay the tax on any income allocable to such interest which has been reallocated to the transferor under section 704(e)(2) without further gift tax consequences.⁴⁹ This is so because the transferor is simply discharging his own tax liability at that point, not that of the transferee, and therefore the amount of the income tax paid by the transferor on income economically owned by the transferee does not increase the size of the gift.⁵⁰

This argument is in danger of violating section 704(b). For the transferee partner to economically own the income as originally allocated, the original allocation must be credited to the transferee partner's capital account. For the transferee partner to retain the economic ownership of such income, the income must remain credited to his capital account, notwithstanding its reallocation under section 704(e)(2) for tax purposes to the transferor. A partnership agreement that is drafted carefully enough in the first place to accomplish this result also results in precisely the kind of mismatching of the economic benefit of partnership income with the associated tax cost of such income that the regulations under section 704(b) are designed to counter.⁵¹

If it is clear, notwithstanding any reallocation occurring under section 704(e)(2), that the transferor desires the economic ownership of reallocated income to remain with the transferee, this can be accomplished. However, in order to keep the partnership agreement in compliance with section 704(b), it should be clearly stated in the partnership agreement that the transferor intends to make a gift of any such reallocated income to the transferee. Initially, section 704(b) requires that any reallocated income be debited to the transferee partner's capital account and credited to the transferor partner's capital account, but then it would seem that the provisions of the partnership agreement

48. Kinyon, Doubleday & McCabe, *Family Partnerships as an Estate Planning Tool*, 43 INST. FED. TAX'N § 50.04[1][b], at 50-42 (1985).

49. *Id.*

50. *Id.*

51. Treas. Reg. § 1.704-1(b)(2)(ii)(a) (as amended in 1986).

transferring that credit to the transferee's capital account should be allowed to operate. The result is the same as if the transferor had in fact made two gifts, the one being the original capital interest (recognized for income tax purposes) and the other being a profits interest in the reallocated income (not recognized for income tax purposes). The transferor can be viewed as the continuing owner, for income tax purposes, of the income attributable to such reallocated profits interest and also as having made an anticipatory assignment thereof for economic purposes. The income tax which the transferor pays on any reallocated income under section 704(e) is his own obligation and does not increase the size of the overall gift.

D. Section 704(c) Principles in the Context of Section 704(e)

It is necessary to know whether section 704(e)(2) requires an allocation based on book basis capital account balances, tax basis capital account balances or section 704(e) basis capital account balances.⁵² In the situation where there has been inside build-up of unrealized gain or loss in partnership properties at the time of admission to the partnership of a transferee partner covered by section 704(e), the result most consistent with economics and with the allocation requirements of section 704(b) is achieved by using section 704(e) basis capital accounts, i.e., basing the allocation on the relative economic interests in the partnership of the transferor and the transferee. There are two steps involved in stating these economic interests correctly: one, the restatement of the existing partners' capital accounts at the time of admission of a section 704(e) transferee partner; and two, the transfer of a capital account credit to the transferee partner.

However, in the case of a gift transfer, as opposed to a purchase of an interest,⁵³ consistency with section 704(b) and the principles of section 704(c)⁵⁴ requires that the transferor's share of any built-in unrealized gain in partnership assets which is reflected in his section 704(e) basis capital account pursuant to the restatement of capital accounts, when subsequently realized, be allocated to him, notwithstanding the transfer of a capital account credit corresponding to such built-in gain to the transferee under step two. Similarly, the transferee should share, in proportion to his section 704(e) basis capital account, in any *future* operating income or loss and in income or losses over and above the

52. See *supra* Part III. A.

53. See *infra* page 52, Example (1).

54. Treas. Reg. § 1.704-1(b)(2)(iv)(d)-(g) (as amended in 1986). The basic concept is that built-in gain or loss should be taxed, when realized, to the person who owned the property when the built-in gain or loss economically accrued.

built-in gains and losses, but he should not share in the built-in gain.

This is an example of when the taxability of income is retained by the transferor but the economic ownership of such income is shifted to the transferee. Stated another way, in order for section 704(c) principles to operate properly, the allocation rule of section 704(e) should be applied only to partnership taxable income corresponding to book income that has *not* already been credited to the transferor and transferee partners' section 704(e) basis capital accounts under steps one and two above, and the allocation principles of section 704(c) should be applied to partnership taxable income corresponding to already credited book income. It is not clear, however, that section 704(e) works in this way. Consider the differences in results depending on how section 704(e) works, as illustrated by the following example.

Example (1): Husband (H) and wife (W) own and operate an apartment building as a partnership. The building was acquired for \$100,000, using \$20,000 of cash and an \$80,000 mortgage. It has been depreciated to \$70,000 but has increased in value to \$200,000. There is \$50,000 of indebtedness remaining on the building. H and W each put in \$10,000 of capital. The book basis and tax basis balance sheet of the partnership looks as follows at this point:

<u>Assets</u>		<u>Liabilities</u>	
Building	\$70,000	Mortgage	\$50,000
		Capital A/C's	
		H	10,000
		W	<u>10,000</u>
Total	\$70,000	Total	\$70,000

Since the building is worth \$200,000, there is actually \$150,000 of equity in it. If H and W then admit their son (S) to the partnership and make him a one-third partner, it is clear that the value of the gift to him and of his interest in the partnership is \$50,000. The section 704(e) basis balance sheet, reflecting a revaluation of partnership assets to their market value at the time of S's admission and a transfer of the appropriate capital account credit to S, would look like this:

<u>Assets</u>		<u>Liabilities</u>	
Building	\$200,000	Mortgage	\$ 50,000
		Capital A/C's	
		H	50,000
		W	50,000
		S	<u>50,000</u>
Total	<u>\$200,000</u>	Total	\$200,000

Suppose the partnership earns \$60,000 of operating income in the following year and then sells the building for \$230,000, realizing a gain in the amount of \$160,000. Under the principles of section 704(c), \$130,000 of this gain should be allocated to and reported by H and W, since it was economically earned by them. To allow the shifting of this gain to S because S's capital account reflects a gift of the corresponding capital account credit would be to allow an assignment of income in contravention of section 704(c) principles. On the other hand, the additional \$30,000 of gain and the \$60,000 of operating income should be shared in equal thirds by the partners, reflecting their true economic interest in post-admission income.

If S had bought his one-third interest from H and W by the payment of \$50,000, then H and W would have already realized that portion of the economically accrued gain inherent in the \$50,000 payment, and it would have been appropriate to allocate the \$130,000 as well as the additional \$30,000 of gain three ways. (If a section 754 election were in effect, S would be able to avoid further gain recognition on his share of the \$130,000 gain by virtue of having a higher basis in his partnership interest than H and W.)

On the other hand, if capital accounts are not restated at the time of S's admission, then the tax and book basis balance sheet of the partnership would look like this:

<u>Assets</u>		<u>Liabilities</u>	
Building	\$70,000	Mortgage	\$50,000
		Capital A/C's	
		H	6,667
		W	6,666
		S	<u>6,667</u>
Total	<u>\$70,000</u>	Total	\$70,000

When the building is sold for \$230,000 and the \$50,000 debt is paid off, leaving \$240,000 of cash (\$180,000 net sale proceeds and \$60,000 operating income), the \$130,000 of built-in gain should go \$65,000 to

H and \$65,000 to W under section 704(c) principles, but the unretained capital accounts might force an equal thirds allocation under section 704(e). In any event, the remaining \$30,000 of gain and \$60,000 of operating income will be split three ways in accordance with the capital account ratio of H, W and S. Assuming section 704(c) principles have been applied, H and W each receive an allocation of \$65,000 plus \$30,000, and S receives an allocation of \$30,000. The closing balance sheet of the partnership therefore looks like this:

<u>Assets</u>		<u>Liabilities</u>	
Cash	\$240,000	Capital A/C's	
		H	\$101,667
		W	101,666
		S	<u>36,667</u>
Total	\$240,000	Total	\$240,000

H and W intended to make a gift of \$25,000 each to S. Instead, they were only allowed to shift to S a capital account credit of one-third of their tax and book basis capital account balance of \$10,000, or \$3,333 each. Unless at this point a further transfer of capital account balances is allowed of \$21,667 and \$21,666 by H and W, respectively, to S, resulting in a capital account balance of \$80,000 for all three of the partners, S will come up short by \$43,333 upon liquidation, if capital account balances are followed in making liquidating distributions as required by section 704(b). Of course, H and W can always liquidate the partnership and then make further gifts to S of \$21,667 and \$21,666, but the difference in capital account treatment brought about by the use of tax and book basis capital accounts in this situation would result in different consequences than those intended by the partners. Also, it may not be possible or desirable for H and W to make a further gift to S at the time of liquidation. It would be better for the partners' capital accounts to reflect the economics of the original gift in the first place.

E. Disproportionality in Allocations and Distributions

Section 704(e) by its terms only prevents disproportionately *high* allocations of income to the transferee. Yet, other problems of disproportionality may arise. These include allocations of income to the transferee that are disproportionately low, disproportionate allocations of losses, special item allocations, and disproportionate distributions of cash flow.

1. *Disproportionately low income allocations*

Section 704(e) was enacted both to provide a safe harbor with respect to the issue of true partner status for a donee partner and to prescribe rules to prevent abuse of that status by the shifting of income from the donor to the donee.⁵⁵ However, section 704(e) is only one section in Subchapter K. Partnership tax law also allows a certain freedom of income allocation in defiance of general assignment of income principles.⁵⁶ It follows that section 704(e) should not be understood as a tool to correct all inconsistencies in the partnership assignment of income arena but only to redress the impermissible assignment of income to a transferee partner. There appears to be no valid policy reason, therefore, under section 704(e) for not allowing the donor or transferor partner to make a disproportionately *low* allocation of income to the donee or transferee partner, subject of course to the section 704(b) allocation rules.

2. *Disproportionate loss allocations*

In the absence of any guidance in the regulations on the section 704(e) allocation rule regarding losses, one might assume that the transferee should not be allocated an excessive share of bottom line losses any more than of profits.⁵⁷ The theory would be that the transferee's capital is responsible for the generation of no more than its proportionate share of either profit or loss.

Losses are by their nature, however, different from profits. The assignment of income doctrine, which underlies the purpose of section 704(e), developed around the notion that income should be taxed to that person whose services or capital generated or earned it. If there is a loss, however, it cannot so easily be said that either services or capital generated that loss. The loss may well be allocable, i.e., traceable, to a particular partner's capital, but the question is not, whose money was lost, or who will eventually bear the loss, but whose services or capital is responsible for the generation of the loss. The point is to attribute economic responsibility for the loss, but it is not clear that this can be done. In the case of losses, it is urged that the assignment of income doctrine has no applicability. Therefore, partnership tax law outside of section 704(e) should govern in this area, allowing any allocation of losses which satisfies the allocation rules of section 704(b).

55. See *supra* Part II.

56. See *supra* Part I.

57. See Kinyon, Doubleday & McCabe, *supra* note 48, § 50.03[4][c], at 50-36.

3. *Special item allocations*

Special item allocations, otherwise allowable under section 704(b), present special problems for the analysis under section 704(e). If the transferor, for example, receives a special allocation of a loss item, such as depreciation, along with a bottom line allocation of partnership profits, presumably the loss item should be combined with the income allocations to the transferor and transferee in arriving at the total amount subject to reallocation. Otherwise, section 704(e) could be easily circumvented through the device of special allocations. The following examples illustrate the point.

Example (1): Father (F) and son (S) are 50:50 partners in a business. S is a section 704(e) transferee. The business generates \$140,000 of income before depreciation and \$40,000 of depreciation. F takes a special allocation of all of the depreciation, which in itself is not an impermissible allocation under either section 704(e) or section 704(b). However, the allowance of such special allocation means that F and S are then allocated \$70,000 each of net income. The final combined allocations are \$30,000 of income to F and \$70,000 to S.

This seems like an easy way to circumvent section 704(e). The term "distributive share" in section 704(e)(2) should properly be viewed as taking into account all items of income and loss allocated to the transferor and the transferee. If pooling these allocations results in a positive number, then there is something for the statute to operate upon. In the present example, pooling all of the allocations yields \$100,000 of net income and results in the reallocation of \$50,000 to F and \$50,000 to S.

Example (2): Suppose there were \$20,000 of operating income before depreciation and \$40,000 of depreciation, resulting in a net loss to the partnership. Notwithstanding the statement made in Example (1) that section 704(e) does not apply to a net loss, a special allocation of depreciation to F, leaving \$20,000 of income to be allocated to F and S, should not be allowed. The parties should be free to allocate a net loss among themselves, including the use of special item allocations, but only to the extent such allocations are not structured to create an *income* allocation to the transferee.

4. *Disproportionate distributions of cash flow*

Section 704(e) affects only income allocations for tax purposes and has no direct control over the terms of the economic arrangement between the partners, such as under what circumstances and in what amounts cash distributions will be made to the partners. Therefore, there is no reason why either the transferor or the transferee may not

receive preferential cash distributions at any time. However, since distributions reduce capital accounts, they will of necessity interact with section 704(e), inasmuch as the relative proportion of the transferor's capital to the transferee's capital will be altered by a disproportionate distribution of cash. The problem of changing proportionality will be discussed in Subpart F below.

F. Proportionality Over Time

Disproportionate distributions of cash will change the proportionality of the transferor's and transferee's section 704(e) basis capital accounts. So too, will disproportionate allocations of taxable income and loss, assuming such are allowed (such as disproportionately low allocations of income and allocations of losses).⁵⁸ Whether the allocation ratio between the transferor and the transferee under section 704(e) should be adjusted from time to time to reflect the changing proportionality of the section 704(e) basis capital accounts is a question not addressed by the statute or the regulations. Further, whether such ratio should be adjusted as of the beginning of each year to reflect any disproportionality events occurring during the prior year, or whether such adjustments should be made at the time such disproportionality events occur, is also an open question.

Consistency regarding the theory behind using section 704(e) basis capital accounts, i.e., allocating income in proportion to the relative economic earning power of the partners' capital, requires taking proportionality changes into account. Moreover, consistency with the theory would seem to require taking all such changes into account when they occur. If the transferor partner puts more capital into the partnership or the transferee partner takes some capital out of the partnership, their relative economic interests have clearly changed as of that moment. A periodic adjustment to section 704(e) basis capital accounts, however, possibly involving a revaluation of partnership assets each time and definitely involving a complex allocation calculation at year end, would be admittedly very burdensome.

One means to avoid adjustment of the allocation ratio would be to treat any preferential distribution of cash as a loan, so that capital is not affected. Such a characterization should be determined by agreement of the partners, however, not by the tax law. Another approach would be to agree that the capital account ratio is fixed and no disproportionate distributions will be allowed. This approach, however, also interferes with the economic arrangement among the partners. A third

58. See *supra* Part III. E.

remedy would be to recognize only such disproportionate changes as are in place at the beginning of a year. Not only does this interfere with the economic arrangement among the partners, but it also creates an opportunity for abuse.⁵⁹ The only adjustment that is true to the purpose of the statute is to reflect changes when they occur, however burdensome. Of course, adjustments due to profit and loss allocations will naturally occur at year end; it is only mid-year capital contributions and distributions that create a timing problem.

There is a natural planning opportunity here. If section 704(e) basis capital accounts, and therefore the allocation ratio between the transferor and the transferee, are to be adjusted as described above, then it would appear that by reducing his capital account balance in proportion to that of the transferee, the transferor can shift more income to the transferee. This is a proper result because the transferor's economic stake in the enterprise, relative to that of the transferee, has been genuinely reduced at that point. This is illustrated by the following examples.

Example (1): Suppose a father (F) and son (S) partnership has \$100,000 of net income (after allowing for services), allocated 50:50, and suppose S leaves his \$50,000 in the partnership while F takes his out. Obviously this changes their relative capital account balances. If F and S have section 704(e) basis capital account balances of \$50,000 each to begin with, then F's capital account will remain at \$50,000 and S's capital account will increase to \$100,000 as a result of the income allocation and cash distribution. Income allocations in the ensuing year should now be based on the proportionality of 1:2, since S has twice the economic stake in the enterprise as F, from the standpoint of capital.

Example (2): Suppose the partnership in Example (1) experienced a \$40,000 loss for the year, allocated equally between F and S, and F withdrew \$30,000 of capital. This would reduce S's capital account to \$30,000 and F's to zero. F does this in anticipation of a banner year in year two. His expectation is fulfilled, the partnership earns \$200,000 in year two (after services), and 100% of it is allocable to S. This should be allowed, since F has no capital interest in the partnership in year two.

Example (3): Suppose the business in which F and S are engaged generates sizeable tax losses, such that the section 704(e) basis capital accounts of both F and S go negative. How should future income be allocated under these circumstances? What is the economic stake in

59. The disproportionate change might occur in January and be in effect for virtually all of the year, yet not be reflected until the following year.

the enterprise of F and S at that point? For there to be any capital in the enterprise at all when the partners' capital accounts are negative means that there is borrowed capital. Perhaps the ratio in which F and S bear responsibility for the potential repayment of such borrowed capital would correctly reflect their economic stake in what is happening. This could be determined by reference to the partnership rules for taking partnership debt into account in the basis of the partners' interests.⁶⁰ In the present partnership, F and S have agreed to share profits and losses, and therefore responsibility for debt, on a 50:50 basis. Using this analysis, they should share taxable income on a 50:50 basis as long as their capital accounts are negative, regardless of the actual proportionality of their negative capital accounts.

It should be pointed out that if the partners have drafted their agreement so that income allocations for economic purposes are to be unaffected by any income reallocations for tax purposes, then a constructive gift may arise when the section 704(e) allocation would produce capital account balances no longer in the same ratio as specified in the agreement. The constructive gift would be the amount of capital account credit that has to be shifted from one capital account to the other to bring the capital accounts back into the desired ratio.⁶¹

G. Allocation as an Annual Concept

Finally, whether the allocation rule of section 704(e) is strictly an annual concept must be considered. It appears to be so, since otherwise it would be too difficult to apply and there would be no finality to tax reporting.

If section 704(e) were to take the long view of the partnership and evaluate the allocations between the transferor and the transferee over the life of the partnership as does section 704(b), it would permit the transferor to justify a disproportionate allocation of current income to the transferee simply by having a correspondingly disproportionate allocation of back-end income to the transferor. Conversely, a disproportionately high allocation of residual or back-end income to the transferee, balanced by a fixed, preferential allocation of current income to the transferor, such as typically underlies a partnership freeze, would also be possible.

Preferential allocations of this kind may balance out in the end in absolute dollars because it may be possible to show that the transferee is not receiving a disproportionate allocation of income in the aggregate. The potential tax deferral effect of such an allocation scheme, however,

60. Treas. Reg. § 1.752-1(e).

61. See *supra* Part III. C.

would doubtless make it unacceptable to the Internal Revenue Service. Thus, a proper balance in the allocations between the transferor and the transferee over the life of the partnership is not good enough under the statute.

The converse position is that, if section 704(e) cannot be carried out in full in a given year, such as a year in which there is no income which can be allocated to the transferor's services, there will be no carryover effect requiring a remedial allocation to be made in a future year. Each year stands on its own, for better or for worse.

IV. RECOMMENDATIONS FOR CHANGE

It is probably unrealistic to expect any changes in the near future in either section 704(e) or the regulations thereunder, given the higher priority of other statutory reform and regulatory projects. It is nevertheless appropriate to make the suggestions set out below.

First, Reg. § 1.704-1(b)(2)(iv)(f), dealing with the revaluation of partnership property and the restatement of capital accounts upon the occurrence of certain events, should be amended to include as one of the revaluation events the creation of a partnership interest by gift, within the meaning of section 704(e). The creation of a partnership interest would then include both the issuance of a partnership interest by the partnership and the transfer of a partnership interest by one of the partners. It would also include the enlargement of an existing interest. Such an amendment, which ought perhaps to make revaluation under these circumstances mandatory, would obviate the need for what has herein been called section 704(e) basis capital accounts and would harmonize the capital account maintenance rules of Reg. § 1.704-1(b) with the economic analysis mandated by section 704(e). In addition, if the revaluation concept of section 704(e) basis capital accounts is adopted, then it should also be made clear that capital accounts, and the resulting capital account proportionality for section 704(e) purposes, will be adjusted for events that affect capital, such as capital contributions and distributions, as and when they occur.

Second, Reg. § 1.704-1(e)(3) should be amended to make clear that section 704(e)(2) may not be used to create a special allocation of any particular item of income but may only be applied to reallocate the aggregate of the distributive shares (including special allocations) of partnership income of the transferor and transferee.

Third, if the aggregate of the distributive shares of the transferor and the transferee is less than the full amount of reasonable compensation for their services, Reg. § 1.704-1(e)(3) should provide for an allocation to the transferor and transferee for their services on a pro rata

basis.

Fourth, Reg. § 1.704-1(e)(3) should be amended to provide or make clear that:

(1) Section 704(e) is not intended to prevent special allocations under section 704(b) as between the transferor and non-transferee partners;

(2) The principles of section 704(c) override section 704(e) in the same way they do section 704(b), as set forth in Reg. §§ 1.704-1(b)(2)(iv)(f)(4) and 1.704-1(b)(4)(i);

(3) Section 704(e)(2) does not prevent disproportionately low allocations of income; and

(4) Section 704(e)(2) does not apply to allocations of partnership losses, except when any loss allocation may constitute an indirect allocation of partnership income.

In conclusion, partnership allocation is complex enough without introducing the problem of two statutes with differing objectives and differing rules. Section 704(e) needs to be harmonized with sections 704(b) and 704(c) and, to the extent possible, also clarified and simplified.