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The End of the Revolution in Partnership Tax

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A quiet intellectual revolution has taken place in partnership tax over the last quarter century. As in most intellectual revolutions in the law, old ideas were elaborated into a new system to address particular anomalies within the field. Once the system took hold on people's minds it changed the terms of analysis across the entire field. The system is best known by the name capital accounts analysis. It also has been called the deferred sale approach, which is less grand but gets at an important feature. Key elements in the system were laid in the late 1970s and early 1980s to get a handle on special allocations. The system flourished in the late 1980s and 1990s because it helped address two significant areas of trouble in those years, shifting tax attributes and disguised sales.

The system is a way to take apart a partnership to identify each partner's tax interest in each asset while connecting this to his economic interest in the partnership. Think of a partnership as a pot. When an asset is put into the pot it is valued and the contributor is given a claim on the pot—his capital account—for that amount. The contributor does not recognize gain or loss, but instead a tag is put on the asset to record that he has an interest in so much deferred tax gain or loss on the asset. He will recognize this deferred tax amount when the asset is sold, as it is used up, or perhaps when the asset leaves the pot. The opposite is done when a partner takes an asset out of the pot. The value of the asset he takes is subtracted from his claim on the pot and, if the partner has no other claim on the pot, then his deferred tax amounts on other assets in the pot are added up and attached to the asset he takes out (assuming the assets are of the same character).

Professor Lokken aptly describes this revolution as a victory of an aggregate theory over an entity theory of partnership tax. A hallmark of the revolution is a change in how we think about partnership basis. The old way of thinking focused on curing discrepancies between inside and outside basis. The new way of thinking focuses on tagging a partner with his deferred tax gain or loss. Another hallmark of the revolution is to

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look to provisions on capital accounts in the partnership agreement to determine partnership economics.

Part I makes the case for my claim that there has been an intellectual revolution in the field and fills out the description of the system. Part II explains that there is still useful work to be done in elaborating the system. The system can help solve two enduring problems in partnership tax, preventing shifts in the character of income on distributions and identifying partnership compensation. Part III explores the anomalies in the system. It is well known that the system's weakness lies in the fact that a capital account can be a poor measure of a partner's economic interest in a partnership. This usually is associated with special allocations and guaranteed payments. Two phenomena that are just now getting attention—discounts in the value of a partnership interest and options (and side agreements more generally)—will put further strain on the system because they further cloud the relationship between capital accounts and partnership economics. My sense is that these anomalies in the system do not justify junking it just yet. Recent problems in subchapter K involve Exploiting gaps in the system of capital accounts analysis and can be addressed within the system. But the system is in for rough times.

One change is necessary if we are to maintain the present system. While capital accounts analysis is workable as a conceptual system—it is fairly easy to use, becoming almost intuitive once you get your mind around it, and it does a fairly good job of connecting tax and economic income (that is until you have to deal with options, discounts, guaranteed payments, special allocations, and other things that can make payoffs independent of capital accounts)—the system has a serious practical problem. It assumes that people write and abide by formal partnership agreements and it requires that they collect and retain a fair amount of information. I know from personal experience that accountants in family partnerships often do not demand asset revaluations and do not do capital account adjustments that are required by partnership agreements, even when there are real economic consequences to partners. It is unrealistic to expect accountants to do this to satisfy the taxman.

Professor George Yin has proposed a solution to the practical prob-

2. Lawrence Lokken, Taxation of Private Business Firms: Imagining a Future Without Subchapter K, 4 FLA. TAX REV. 249 (1999), argues that we should abolish subchapter K because it is so complicated as to be unworkable. He would limit flow-through taxation to service partnerships on the basic lines of current subchapter K and deny it to capital intensive partnerships. This essay may be considered an answer to Lokken's thoughtful critique, which I take to be conceptual in nature. My argument is that beneath the surface complexity of subchapter K is a simple conceptual system for taxing capital-intensive partnerships that is just coming into focus. Jeffrey L. Kwall, Taxing Private Enterprise in the New Millennium, 51 TAX LAW. 229 (1998), proposes abolishing subchapter K and leaving firms with the choice between a simple capital structure to be taxed under subchapter S (with some tweaking) or an entity level tax.

3. This is likely to be a rich source of civil litigation in coming years. Accountants and lawyers who fail to make these adjustments should fear claims for breach of fiduciary duty by partners who are disadvantaged.
lem. He proposes the creation of a simplified pass-through regime—call it K-lite—along the lines of current subchapter S. Entities that opt for this regime would be excused from the rigmarole of valuing assets whenever sharing ratios change, as well as, tagging assets with deferred tax amounts, and keeping track of the tags. Reasonable minds may differ on the details of what people must give up to get simple pass-through rules. Yin would limit K-lite to entities owned by U.S. individuals, allow only the simplest type of special allocations, and give up non-recognition on distributions. Whatever its precise contours, once K-lite is available, we may demand more from entities that opt for the freedom of K-heavy. Compliance can be improved with simple, practical measures, such as requiring that a partnership return be signed by a certified person, presumably an accountant, who would attest that he made the necessary inquiries about asset values and sharing ratios and the necessary adjustments to tag partners with deferred tax amounts.

I. THE REVOLUTION

Much of capital accounts analysis follows straight from basic principles of business law and tax law. It is basic business law that a partner is credited for the value of what he puts into the partnership pot and debited for the value of what he takes out. It is basic tax law that unrecognized gain or loss is deferred to be recognized at a future time. It also is basic tax law that if partnership gain or loss is allocated to a partner for tax purposes, he gets the economic income or loss through a credit or debit to his capital account. The breakthrough in the system lies in associating deferred gain or loss with specific assets. Again, it is useful to think of each asset carrying tags that identify each partner's deferred tax amount on the asset.


5. Bracken v. Means, 631 So. 2d 178 (Miss. 1994) (holding that additional contributions had to be added to capital account and reimbursed on liquidation); Langness v. O St. Carpet Shop, Inc., 353 N.W.2d 709 (Neb. 1984) (holding that service partner who contributed no capital has no claim on capital).

6. In theory, a depreciable or amortizable asset can look like a pom-pom with a new streamer added for each partner on each revaluation. Each streamer is treated as a mini-asset that is depreciated for book purposes over its own hypothetical useful life beginning from the revaluation that produced the streamer. I say “in theory” because the regulations make this method elective unless not using it would be abusive. This comes from the § 704(c) regulations. This is required under the remedial allocation method. When a depreciable asset with built-in gain (value in excess of basis) is contributed to a partnership, the gain is treated as a separate asset put in service at that time. Treas. Reg. § 1.704-3(d)(2) (as amended in 1997). This is not required under the traditional method and the traditional method with curative allocations. Treas. Reg. § 1.704-3(b)(2), Example 1(ii) (as amended in 1997); Treas. Reg. § 1.704-3(c)(4), Example 1 (as amended in 1997). The traditional method is problematic in the case of an asset with a short remaining tax life because of the convention that deferred tax gain is written off at the same rate as the tax basis of an asset. The regulations give as an example of a case where use of the traditional method is
An example is tedious but useful.

**Example:** *K* and *L* each invest $10,000 in a partnership as equal partners. The partnership buys securities for $20,000. These increase in value to $50,000 when *M* contributes $25,000 for a one-third interest in the partnership. The partnership restates the capital accounts of *K* and *L* to $25,000 and it restates the book value of the securities to $50,000. *K* and *L* each are tagged with $15,000 deferred tax gain on the securities. Later the securities are sold for $74,000. Each partner takes $8,000 of the $24,000 book gain. The $54,000 tax gain is allocated $23,000 each to *K* and *L* and $8,000 to *M*.

Older readers will recognize this as example (4) from the pre-1983 § 704(b) regulations. This example used to give people trouble. In his 1971 treatise, Willis worried that nowhere in the example did it say that the partnership agreement provided for the allocation of the pre-admission gain to *K* and *L*. He concluded that “the act of the partners in increasing the amount at which the securities are carried on the partnership's accounting record and the agreement to share profits” is equivalent to an amendment of the partnership agreement. In an insightful 1977 article, Sherwin Kamin concluded that “the regulations reach the correct result” because they “give[ ] the taxable gain to the persons who are receiving the economic benefit.” He criticized the regulation for saying that the allocation of the tax gain had an economic effect. Kamin pointed out that this conflates the decision to increase the capital accounts of *K* and *L* on the admission of *M* (which does have an economic effect) and the decision to allocate the pre-admission tax gain to *K* and *L* (which does not).

Today we think of these steps as interdependent parts of a system that connects tax and economics in a partnership through the capital account. While this is some evidence of a change in thinking, there is better evidence in the analysis of more technical issues, to which I will come.

If anyone deserves to be called father of the revolution in subchapter K, it is William McKee. The revolution's seminal legal text is the § 704(b) regulations, which were issued in preliminary form in 1983 and finalized in 1985. McKee, then at the Treasury, was the principal author. The § 704(b) regulations require partnerships to maintain capital accounts and to respect these accounts on liquidation by dividing assets

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7. Id. at 212.
10. Id. at 672-73.
11. McKee went on to King & Spaulding in 1983 and in 1999 moved to McKee, Nelson, Ernst & Young.
THE END OF THE REVOLUTION?

based on capital account balances.\textsuperscript{12} The regulations do not strictly re-

quire revaluation of assets and adjustment of capital accounts when inter-

ests shift (the old \textit{KLM} example), but they strongly warn against failing
to make these adjustments.\textsuperscript{13} In any event, the mandatory rules on main-
taining and respecting capital accounts ensure that \textit{K} and \textit{L} cannot reap
the $30,000 gain without taking it into income. Professionally drafted
partnership agreements routinely require revaluations and adjustments.\textsuperscript{14}

The roots of McKee’s system lay further back. The first edition of the
McKee treatise, published in 1977, used capital account analysis as the
touchstone for the validity of special allocations. Three years earlier Mc-
Kee—then a Professor at the University of Virginia School of Law—used
capital accounts to analyze partnership allocations in debt-financed real
estate ventures.\textsuperscript{15} McKee properly credited others for recognizing “that
the presence or absence of substantial economic effect can be determined
by the analysis of the effect of the special allocation on the partner’s capi-
tal accounts.”\textsuperscript{16} McKee’s contribution turned what had been a factor to
be considered in evaluating special allocations into a system of analysis
with implications that reach far beyond the problem of special
allocations.

Many of the changes in subchapter \textit{K} over the last twenty years can be
understood as working the system out. Most of these changes prevent
shifting tax attributes among partners or limit the ability to use a partner-
ship to exchange assets tax-free, two areas of particular trouble in the late
1980s and 1990s. Shifting tax attributes among partners hardly is a new
problem, the authors of the partnership rules in the 1954 Code were well
aware of it.\textsuperscript{17} They addressed the problem through elective rules in

\begin{itemize}
  \item \textsuperscript{12} Treas. Reg. § 1.704-1 (as amended in 1999).
  \item \textsuperscript{13} Treas. Reg. § 1.704-1(b)(2)(iv)(f) (as amended in 1999) (flush paragraph at end
    warning that if capital accounts are not adjusted, the anti-abuse principles in subsections
    (b)(1)(ii) and (b)(1)(iv) should be consulted). Example 14 is the same facts as the old
    \textit{KLM} example. It concludes that if the securities are not booked up on the admission of
    the new partner, the gain must be allocated to the old partners under the general anti-
    abuse principles.
  \item \textsuperscript{14} Revaluation of assets and adjustment of capital accounts is necessary on economic
grounds when the partnership agreement provides for the allocation of gain and loss based
on relative capital accounts. This is customary in capital intensive partnerships. Failure to
revalue assets and adjust capital accounts will result in a shift of wealth among partners. In
the \textit{KLM} example, if the partnership agreement allocates gain and loss based on capital
account balances and the book value of the securities and the amount in \textit{K} and \textit{L}’s capital
accounts are not increased on the admission of \textit{M}, then \textit{M} will take twenty-five fifty-fifths
of $54,000 instead of $8,000 at the end of the day.
  \item \textsuperscript{15} William S. McKee, \textit{Partnership Allocations in Real Estate Ventures: Crane, Kresser
  \item \textsuperscript{16} \textit{WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND
PARTNERS} ¶ 10.02[2] (1st ed. 1977) (“The \textit{§ 704(b)} Regulations neither define the [substantial
economic effect] test in theoretical terms, nor explicate the manner in which it has been
applied. However, most commentators believe, and the staff of the Joint Committee on
Taxation has stated, that the presence or absence of substantial economic effect can be
determined by the analysis of the effect of the special allocation on the partner’s capital
accounts.”). \textit{See also} McKee, \textit{ supra} note 15, at 10 n.18, 18.
  \item \textsuperscript{17} The classic texts are J. Paul Jackson et al., \textit{A Proposed Revision of the Federal
Income Tax Treatment of Partnerships and Partners—American Law Institute Draft}, 9 Tax L.
§ 704(c) for handing pre-contribution gain or loss and elective rules in §§ 734 and 743 for handling basis adjustments on distributions and transfers of interests. Only the hot asset rules in § 751 were mandatory.

The authors of the 1954 Code took a laissez faire approach to the problem of shifting tax attributes because they thought the costs of complexity in the solution outweighed the gains in accuracy. Their premise was:

Most of the problems encountered in the partnership area are concerned with the distribution of the burden of taxation among the members of the group. Since the Treasury from the standpoint of tax policy is not greatly concerned with this allocation, the issues are essentially not between Treasury and taxpayer-partner but between partner and partner. 18

We have learned that shifting tax attributes among partners is very much a problem for Treasury. The authors of the 1954 Code were less sensitive to timing issues than are we who experienced the high-interest rates of the 1970s and 1980s. Often when tax attributes shift the tax benefit is temporary because there is a later offsetting tax detriment that sets things right. The authors of the 1954 Code also had in mind a world in which partners tended to be high income individuals. We are accustomed to tax shelter promoters bringing together persons with different tax profiles in a partnership to exploit the difference.

Reversing the laissez faire policy of 1954, § 704(c)(1)(A), enacted in 1984, makes mandatory the allocation of pre-contribution gain or loss to the contributing partner if an asset bearing such gain or loss is sold or depreciated. The § 704(b) regulations (1985) push partners to make what are called “reverse 704(c) allocations.” This means the allocation is made to the appropriate partner of gain or loss that accrues within a partnership when interests in the partnership change (the trigger in the regulations is a non pro rata contribution or distribution). 19 This is our old friend the KLM example. Regulations implementing § 704(c), finalized in 1993, include the remedial allocative method 20 as an option. This is a theoretically correct method for handling pre-contribution gain or loss under capital accounts analysis, and implicitly is the benchmark for determining if two other simpler methods can be used. 21

Rev. 109 (1953) [hereinafter Proposed Revision], and J. Paul Jackson et al., The Internal Revenue Code of 1954: Partnerships, 54 Colum. L. Rev. 1183 (1954). What the authors call the “credited value or deferred sale approach” for dealing with contributed property is basically modern capital accounts analysis. The authors rejected it because they thought it too complex for taxpayers or agents in the field. McKee, supra note 15, at 120-23. The authors did not carry forward the approach to distributions and sales of interests. My guess is that they foresaw the possibilities but chose not to pursue them because they had rejected the approach in the easiest case.

18. Proposed Revision, supra note 17, at 112.
21. The regulations require use of the remedial allocation method when use of the other methods would be abusive. See supra note 6.
Current legislative proposals aimed at loss duplication extend the system a bit further. The proposals respond to a spate of loss-duplication tax shelters in which a taxpayer contributes a loss asset to a partnership and then exits from the partnership leaving the built-in loss for other partners to realize. One proposal would restrict the allocation of pre-contribution loss to the contributing partner. Another would make mandatory downward basis adjustments by the transferee on a transfer of a partnership interest and by the remaining partners on a liquidation of an interest when there is a substantial built-in loss. The latter proposal is the more artful solution. It is a step in the general direction of making mandatory the basis adjustments on distributions that are now elective, something that several commentators have advocated.

A more obscure 1999 change in the regulations on elective basis adjustments is more telling evidence of the change in thinking. A change in a conceptual system in the law makes the greatest difference on technical or peripheral issues where the proper action is not clear cut. The rules on elective basis adjustments come into play when a partner disposes of his interest recognizing gain or loss. They give the successor a cost basis in the partnership's assets equal to his cost basis in the interest in order to avoid duplicating gain or loss recognized by his predecessor. Under the old way of thinking, the idea was to correct the discrepancy between the successor's basis in his interest (called outside basis) and the aggregate basis of partnership assets (called inside basis). This meant that adjustments in the basis of assets could be made in only one direction towards outside basis. The new way of thinking is that the adjustments give the successor credit for deferred tax amounts recognized by his predecessor. Adjustments are by asset and can be plus or minus. In effect, the predecessor's deferred tax amount tags are stamped "recognized" and given to the successor to present when an asset is sold or used up.

A 1997 amendment to the rules for allocating basis to distributed assets also is indicative of the change in thinking. The rules for allocating basis to distributed assets come into play when a partner takes assets for his interest without recognizing gain or loss. The idea is to embed this gain or loss in the assets he takes to be recognized at a future time. Under the

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22. Amending § 737 to cover pre-contribution loss as well as pre-contribution gain does not do the trick by itself because inside basis adjustments are not mandatory.
26. Treas. Reg. § 1.755-1 (as amended by T.D. 8847 (Dec. 14, 1999)). William Andrews made the case for this change in Andrews, supra note 25, at 23. This was endorsed by Cunningham, supra note 25, at 84-89.
27. This can be by a sale of the interest or by taking cash or trade securities in liquidation of an interest. The passing of an interest on death is the other case. The basis adjustment gives the successor in interest the benefit of the basis step up at death.
new way of thinking, this is done by adding up the retiring partner’s deferred tax amounts for ordinary and capital assets and then dispersing the net amount among the distributed assets in a way that preserves the character of gain and loss (so a net capital gain must go to capital assets) and evens out the resulting embedded gain (or loss) across assets to minimize the opportunities for “cherry-picking” by spreading the gain (or loss) across assets. The 1997 amendments do essentially this albeit by a somewhat circuitous route. The old way of thinking conceived of the problem as a matter of adjusting asset basis to equal outside basis. It allocated a basis increase among assets in proportion to their respective bases, which could enlarge embedded gains and losses when gain and loss assets were distributed together.\(^2\)

Once one understands that the point of the exercise is to carry over deferred gain or loss, this seems perverse.

The handling of distributions that alter interests in ordinary income and capital assets is some of the most striking evidence of the old way of thinking. The new way of thinking has not yet had much effect in this area. A 1999 amendment to the § 751 regulations is a small first step in the direction of the new thinking. The amendment changes how ordinary income is determined on a sale of a partnership interest. Under the old way there was a deemed distribution of ordinary partnership assets to the transferee followed by an asset sale. This step was necessary under the old way of thinking to determine how much of the gain on the sale of the interest was attributable to ordinary income assets. The new way is to ask how much ordinary income would have been allocated to the transferee had the partnership sold all of its assets.\(^2\) In other words, tote up the ordinary income on the transferee’s tags. This is a fairly modest simplification with a minor substantive impact.\(^3\)

More significant changes that would significantly simplify preventing character shifts are possible in the new system. I will come back to this.

The system of capital accounts analysis also has been useful in designing rules to prevent people from taking undue advantage of partnerships

\(^{28}\) Here is an example. \(A\) retires from \(ABCD\) partnership taking 2 parcels of land in liquidation of his interest. \(A\)'s basis in his interest is $70. \(A\) is left with a net capital gain of $50 between parcels 1 and 2 composed of $60 gain on parcel 1 and a $10 loss on parcel 2.

\(^{29}\) Treas. Reg. § 1.751-1(a)(2) (as amended in 1999).

\(^{30}\) Estate lawyers are in a tizzy because they can no longer rely on § 732(d) to make basis adjustments to avoid ordinary income on a sale of an interest. See James E. Maule & Lisa Marie Starczewski, IRS Hot Asset Reg Re-Tuning Falls Flat, Causing Sharp Pain for Partner Estates, 94 Tax Notes 751 (2002), 2002 Tax Notes Today 29-28 (2002).
to exchange assets tax free, another problem that bedeviled the partnership area in the 1980s and 1990s.\textsuperscript{31} Section 704(c)(1)(B), enacted in 1989, and § 737, enacted in 1992, require a partner who contributes a gain asset to a partnership to recognize pre-contribution gain should he or the asset go separate ways—the partner by liquidating his interest, the asset by being distributed to another partner\textsuperscript{32}—within a five-year period. This was extended to seven years in 1997. The system also underlies an exception to § 731(c), enacted in 1994, which limits the power to exchange assets tax-free through a partnership by treating marketable securities as cash. The exception defers tax on the distributee’s own share of gain on a distributed security.\textsuperscript{33}

The system of capital accounts analysis provides the information to tax the correct person on the correct amount when an asset is exchanged through a partnership. However, it does not resolve when is the correct time to recognize a deferred tax amount. It treats a contribution of an asset to a partnership as a sale for economic or book purposes while deferring recognition of the gain or loss for tax purposes to a later, unspecified event.\textsuperscript{34} Some later recognition events are settled. When an asset is sold or used up, deferred tax amounts associated with it are recognized.\textsuperscript{35} When a partner sells his interest, his gain or loss is recognized and the slate is wiped clear.\textsuperscript{36} This also happens when a partner completely liquidates his interest taking cash\textsuperscript{37} and when a partner completely liquidates

\begin{itemize}
  \item \textsuperscript{31} I.R.C. § 707(a)(2)(B) (1984), implementing regulations adopted in 1992, Treas. Reg. § 1.707-3, 4, 5, 6, 8, and 9, tackle the problem by saying that transfers to and from a partnership that look too much like a sale are taxed as a sale.
  \item \textsuperscript{32} A partner and an asset might also separate by the partner selling his interest or the partnership selling the asset. Section 704(c) ensures the contributing partner is taxed on pre-contribution gain in the latter case. It has no time limit. No special rule is necessary to cover the former case.
  \item \textsuperscript{33} I.R.C. § 731(c)(3)(B) (1986). This result is reached under the statute through a twisted route. The amount of the distribution (normally the market value of the security) is reduced by the excess of (1) the gain that would be allocated to the distributee if all shares of a like kind were sold by the partnership immediately prior to the distribution, over (2) the gain that would be allocated to the distributee if all the remaining shares of like kind were sold by the partnership immediately after the distribution. This should equal the gain that would have been allocated to the distributee had the distributed security been sold.
  \item \textsuperscript{34} The same holds true for a contribution or a distribution that alters a person’s interest in future gain or loss on an asset already in a partnership. Capital accounts analysis treats this as a sale of the asset that requires an accounting of current gain or loss for economic or book purposes, but it defers recognition of the economic gain or loss for tax purposes to a later, unspecified event.
  \item \textsuperscript{35} I.R.C. § 704(c) and the regulations.
  \item \textsuperscript{36} This statement is a bit of an over-simplification. The seller recognizes capital gain or loss under § 741. Section 751(a) picks up ordinary income. There is no effort to break out other items of deferred gain or loss—such as ordinary loss or odd bits of capital gain subject to special rates—that would make the sale of an interest precisely equivalent to an asset sale. If a § 754 election is in effect these finer adjustments will have to be made to give the buyer proper credit. If partners elect to make the effort to get it right on the buyer’s side, then it is hard to see a reason why the same should not be done on the seller’s side.
  \item \textsuperscript{37} Again this is a bit of a simplification. A partner who liquidates his interest for cash recognizes capital gain or loss under § 731. Section 751(b) tries to ensure that deferred
his interest taking marketable securities (except for deferred tax amounts associated with the securities he takes in the liquidation). Assuming § 751 does not come into play, as the law stands now, deferred tax amounts are not recognized if a partner takes cash or marketable securities in partial liquidation of his interest until the value of what he takes exceeds his basis in his interest. Further, deferred tax amounts are not recognized if a partner completely liquidates his interest taking assets in which his deferred gain or loss can be embedded.

II. EXTENDING THE SYSTEM

Extending the system of capital accounts analysis can help solve two persistent problems in partnership tax. What follows assumes two other changes in the law. One change is a requirement that assets be revalued and capital accounts adjusted whenever there is a change in sharing ratios. The § 704(b) regulations push people to make these adjustments on a non-pro rata contribution or distribution.\textsuperscript{38} This should become mandatory and the rule should be extended to cover modifications of a partnership agreement that alter sharing ratios. The other change is that basis adjustments on distributions under § 734(b) that now are elective should be made mandatory.

A. PREVENTING CHARACTER SHIFTS ON DISTRIBUTIONS

Capital accounts analysis can improve and simplify the rules that prevent character shifts on distributions. The problem arises when a partnership with a mix of capital and ordinary assets distributes an asset of one type to a partner in exchange for his interest in an asset of another type. This is dealt with by § 751(b), which comes into play when a partner receives ordinary assets in a distribution in exchange for his interest in capital assets or vice versa. This triggers a deemed distribution to the partner of assets of the relinquished character, which is followed by a sale of those assets back to the partnership in return for equal value of assets of the acquired character.

Others have shown how the system of capital accounts analysis can be used to improve and simplify this system.\textsuperscript{39} First, the statute gets it wrong right off the bat by asking whether a distribution alters a partner's relative holdings of capital and ordinary assets. The proper question is whether a corrective measure is necessary so that a distribution does result in a character shift. The following example illustrates:

\begin{footnotesize}
\textsuperscript{38} See supra note 19.

\textsuperscript{39} These changes were proposed by Andrews and endorsed by Cunningham in 1991. Andrews, supra note 25, at 37; Cunningham, supra note 25, at 89-93. See also Karen C. Burke, Partnership Distributions: Options for Reform, 3 FLA. TAX REV. 677, 704 (1998).
\end{footnotesize}
Example: AB Partnership has two capital assets—C1 (value $100, basis $60) and C2 (value $100, basis $100)—and two ordinary assets—O1 (value $100, basis $100) and O2 (value $100, basis $60). A and B each have a $160 basis in their interest and a $40 deferred gain, which is half capital (on C1) and half ordinary (on O2). A takes C1 and O1 in liquidation of his interest and B takes C2 and O2. There is no deemed exchange under §751 because each partner takes $100 in value of capital assets and $100 in value of ordinary assets. There is a shift of $20 ordinary income and capital gain between A and B.

This is more evidence of the baleful effects of the old way of thinking. Today we understand that the statutory trigger misses the point of the exercise, which is to ensure that a partner does not escape ordinary income tagged to him.

The system of capital accounts analysis can simplify the rules that prevent character shifts. I use a loaded example, taken from Revenue Ruling 84-102,40 in which the application of §751(b) is particularly complicated and utterly pointless in light of the new thinking. The ruling addresses a case where a partnership that has an unrealized receivable admits a new partner who assumes a share of partnership debt. The new partner’s assumption of debt results in a deemed distribution of cash to the old partners, which brings into play §751(b). The old partners are treated as if they sold a share of the receivable in return for cash.

Example: A, B, and C are equal partners in a partnership with net assets worth $75x, including a $40x unrealized receivable, and liabilities in the amount $100x. D contributes $25x for a one-quarter interest and assumes one quarter of the liabilities ($25x) resulting in a deemed distribution of $8.33x each to A, B, and C. Of the $25x deemed distribution, $10x is attributable to the receivable. A, B, and C each have $3.33x ordinary income. The partnership has a $10x basis in the receivable.

Under the §704(b) regulations, the remaining $30x ordinary income on the receivable must be allocated to A, B, and C when it is collected if the receivable is valued on the admission of D. This suggests a way to simplify the law. Eliminate the deemed exchange of a share of the receivable on D’s assumption of debt and rely on the §704(b) regulations to allocate the entire $40x ordinary income to A, B, and C. This is precisely what we would do had D contributed $50x cash to the partnership rather than contributing $25x and assuming $25x of debt.

Taking this a considerable step further, §751(b) might be replaced entirely by a rule requiring a partner to recognize a deferred tax amount if it could not be attached to an asset of appropriate character after a distribution. For example, if a partner takes high-basis inventory in a distribution giving up an interest in zero-basis receivables, then we would decrease his basis in the inventory and increase the remaining partner’s basis in the

receivables to preserve everyone’s tax position. If effect, deferred tax amount tags are moved from one asset to another. If there is no appropriate asset on which to stick a tag, then the amount on the tag is recognized. This rule coupled with a rule that requires asset revaluations and capital account adjustments on contributions and distributions would prevent character shifts better than § 751(b) does presently. It is more simple because it does not require constructing a deemed distribution and a deemed exchange. It also simplifies allocating basis to distributed assets.

This more considerable step raises an issue that is not unique to distributions that alter interests in ordinary assets. This change gives partners more leeway to trade ordinary assets among themselves without recognizing gain or loss. It is difficult to justify § 751(b) as a limitation on asset trading among partners. Current law permits tax-free trading of ordinary assets if capital and ordinary assets of equal value are on both sides of the trade, though this could be chalked up to a glitch in the statute. More importantly, current law permits tax-free trading of capital assets (other than publicly traded securities) among partners so long as the assets do not bear pre-contribution gain or loss that is less than seven-years old. Tax-free trading of capital assets generally is more worrisome than tax-free trading of ordinary assets because capital assets tend to have longer lives and people tend to have more control over recognition of capital gain and loss.

B. Taxing Service Partners

Current law does a poor job of identifying when returns from a partnership represent compensation for services. This is important because compensation is taxed at higher rates and is subject to employment taxes on top.41 Tax law also generally makes it difficult to defer tax on compensation once wealth is in an employee’s hands. A deal I heard about over a decade ago is an extreme example of how partnerships can be used to beat the system. A movie star is given a profits interest in a partnership that will produce the film in which he will star with an agreement that the partnership will buy a personal jet and distribute the jet to him in partial satisfaction of his right to profits. The Treasury threw in the towel on trying to tax the receipt of a profits interest in 1993.42 If the star waits until profits are earned by the partnership, then he will be taxed on the earnings. But he can avoid tax by liquidating his interest and taking the jet for his right to future profits. He ends up with a private jet as tax-free compensation.

41. Partners are subject to the self-employment tax, which is currently at a rate of 15.3%. This consists of two taxes, the OASDI tax of 12.4%, which disappears at around $87,000 of income (the ceiling is indexed for inflation), and the HI tax of 2.9%, which has no ceiling. Under § 1402, the self-employment tax is assessed on an individual’s “distributive share (whether or not distributed) of income or loss described in § 702(a)(8) from any trade or business carried on by a partnership of which he is a member.” Rents, dividends, interest, and capital gains are excluded.

A more prosaic problem arises when a person contributes an idea (or other intangible property) and a commitment to work to bring the idea to fruition to a partnership in which others contribute capital.\textsuperscript{43} This brings into play a rule that if other partners give up a right to capital they contribute to compensate a partner for services, what they give up is compensation to the service partner.\textsuperscript{44} The problem is to determine how much of the value of the interest the idea-man receives is attributable to the property and how much is attributable to the services.

The system of capital accounts analysis helps solve both problems. We should treat an addition to the capital account of a person who provides services to a partnership and has no capital invested in the partnership as compensation. This catches the film star because the distribution of the jet must be preceded by an addition to his capital account either through an allocation of earned income or through a revaluation of partnership assets.

The problem of valuing contributed property can be dealt with in many cases by a presumption that the property is worth the amount credited to the contributor’s capital account. This presumption should be conclusive if capital accounts are meaningful, as they are if gains and losses are allocated based on capital account balances, or if a partner has the right to liquidate a partnership and force a sale of its assets. I also would respect asset valuation if the contributing partner faces a risk of civil liability to other partners if a statement of value is false or a lie. While this would be an improvement over the status quo, it is far from a perfect solution because capital accounts may not be a true measure of a partner’s economic interest in a partnership. This problem is foundational.

\section*{III. ANOMALIES IN THE SYSTEM}

The usual criticism of the system of capital accounts analysis is that it weakly regulates special allocations.\textsuperscript{45} The system can be gamed by offsetting allocations. For example, a high-tax bracket partner is allocated a loss that will be offset by a later allocation of a gain. Such offsetting allocations are regulated by an anti-abuse standards that ask whether the allocations have a sufficient economic effect.\textsuperscript{46}

\begin{footnotesize}
\begin{enumerate}
\item United States v. Stafford, 727 F.2d 1043 (11th Cir. 1984), is a leading case. Stafford contributed a letter of intent that promised financing and a lease for a real estate project and a commitment to manage the project in order to raise around $2 million capital. The case is important for the holding that an intangible right that may not be legally enforceable can be property under § 721. The case was remanded so the lower court could determine how much of the value of the interest Stafford received was attributable to the property.
\item These, of course, are found in the substantiality requirement. Treas. Reg. § 1.704-1(b)(2)(iii) (as amended in 1999).
\end{enumerate}
\end{footnotesize}
Implicit in the worry about offsetting allocations is an awareness that capital accounts may not be a good indicator of a partner's economic interest in a partnership. A partner who is allocated a tax loss suffers no corresponding economic loss if he is assured an offsetting allocation of a tax gain. Meanwhile he is able to defer tax on income. Special allocations are not unique in having this property. It is well-known that guaranteed payments can be used to make payoffs that differ from capital account balances. This part explains how options (along with other side agreements) and discounts in the value of a partnership interest have the same property. We are just beginning to grapple with the implications of options and discounts. How the government will respond to the challenges they pose is not yet clear. At best, the response to discounts and options will erode the system's conceptual elegance and require more complex rules. Options and discounts may turn out to be the death of the current system. The proliferation of ways or justifications for making payoffs from a partnership that differ from capital accounts makes it difficult to trust how partners value assets, which is the linchpin of the system of capital accounts analysis.

A. Options

Capital accounts analysis is not a closed system. Tax law must recognize side agreements that make payoffs from a partnership independent of capital accounts. Side agreements are necessary if a case as basic as United States v. Basye is to fit within the system. The case is a staple in many partnership tax courses because it is a rare Supreme Court opinion in the area. It illustrates the unremarkable proposition that partnership income flows through to the partners. The issue was thought worth arguing about in Basye because income earned by a partnership of physicians was placed in to a trust and was subject to forfeiture by a partner-physician if he quit prematurely or violated a covenant not to compete.

Today Basye raises the question of how to do the same deal within the constraints of the § 704(b) regulations, which do not allow for forfeiture of a capital account. The answer is that forfeiture may be provided for in the partnership agreement by a guaranteed payment from a defaulter to the other partners. It also may be provided for outside the partnership agreement by a side agreement requiring a defaulter to surrender his partnership interest to the other partners. The guaranteed payment is the better solution because it gets the character of income, and loss correct—the defaulter has an ordinary deduction to offset earlier ordinary income and the other partners have ordinary income. But neither capital ac-

counts analysis nor any other rule in subchapter K compels this particular solution.

There has been much discussion of how to handle partnership options in the last few years.48 A variation on our old friend the $KLM$ example can be used to get some of the issues on the table.

**Example:** $K$ and $L$ each invest $9,500 in $KL$ Partnership. $M$ invests $1,000 in return for an option to acquire a one-third partnership interest by a further contribution of $16,000. The partnership invests the $20,000 in securities. When the securities are worth $50,000, $M$ exercises his option and acquires a one-third interest by contributing $16,000. $M$'s one-third interest is worth $22,000. His investment in the interest is $17,000.

Whether anyone should recognize gain on the grant or exercise of a non-compensatory option is mostly a non-issue.49 The answer is no under the general rules on options, and it is no under the general rules of subchapter K. The option could be structured as a partnership interest from the outset, giving $M$ a right to a share in asset appreciation subject to an obligation to make a further capital contribution. It would be perverse to make a special exception to these rules for partnership options.

How to account for this transaction within the system of capital accounts analysis also seems fairly clear. The Tax Section of the New York State Bar Association (“NYSBA”) gives what is the logical answer if the goal is to square capital accounts with the economics of the deal. Before $M$ exercises the option, the partnership carries a $1,000 obligation to him on the capital and liabilities side of the ledger. When $M$ exercises the option he is given a capital account of $22,000 and tagged with $5,000 of the $30,000 deferred gain on the securities. This is what would be done were the option structured as a partnership interest from the outset. By the same logic, if the partnership has multiple assets of different types, some gainers and some losers, then $M$ should be tagged with a one-sixth share of the deferred gain and loss on each asset to yield a net gain of $5,000.50 These questions can be answered within the system of capital accounts analysis.

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49. The one sticking point under current law is the treatment of the other partners on the exercise of an option. Generally, the writer of an option is taxed on its exercise because he disposes of the underlying property. The exercise of a partnership option dilutes the interests of the original partners. Typically, the value of what they seem to give up upon exercise will exceed the price paid by the option holder. In truth, the original partners give up and get nothing on exercise for the option holder always had a claim on asset appreciation. This makes it a bit awkward to tax the original partners on exercise of the option. The effect of doing so is to require them to recognize some of their share of gain on asset appreciation.

50. Regulations recently issued to handle discounts in the value of an interest when basis adjustments are made upon the exchange of an interest take a very different approach. See infra text accompanying note 58.
account analysis because $M$'s option can be recast as a partnership interest.

This scratches the surface of the issues raised by options. Particularly troublesome is the question of what to do if $KL$ Partnership sells the securities before $M$ exercises the option. By the logic of the preceding analysis some of the gain on the securities should be allocated to $M$, as it would be were the option structured as a partnership interest. The NYSBA argues that an option holder should not be treated as a partner until he exercises the option. This opens the door to investment partnerships that combine tax-exempt persons as partners and tax-paying persons as option-holders to allow security trading without anyone paying tax on the gain. The NYSBA proposes to close this door with an anti-abuse rule. I am skeptical that this will do. Their answer allows stakeholders in a partnership to opt out of pass-through taxation as a matter of general principle. That other partners will bear the tax dodged by those who opt out by taking an option in a partnership is little comfort because the world is full of potential tax-indifferent partners.

While the position of the NYSBA on this issue is difficult to accept, the other answer, which is to treat the holder of an unexercised option as a partner, grounds in a way of thinking that is inimical to the system of capital accounts analysis. The system of capital accounts analysis translates an economic interest in a partnership into an interest in partnership assets in order to determine who should be tagged with deferred gain or loss. This is accomplished by asking how gain and loss would be allocated upon a hypothetical asset sale and liquidation of a partnership. Bringing unexercised options within the system moves in the direction of a system that tags a person with deferred gain or loss based upon the value of his claim on the pot, rather than what he would receive in a hypothetical sale and liquidation at that time. This may seem a small thing, but a hypothetical sale and liquidation has been the touchstone for deriving a partner's deferred gain or loss from the partnership agreement. The NYSBA countenances this in a context where it seems a small and obvious step to take. They recommend in the case of the admission of a new partner who pays a discounted price for his interest because of an extant unexercised option that the option holder be tagged with gain or loss for book purposes (with tax consequences to follow if he exercises the option). The logic behind the answer is impeccable because to otherwise would require crediting the new partner with a capital account greater than the amount of his contribution.

This may seem a small step, but the decision to abandon the touchstone of a hypothetical sale and liquidation has momentous possibilities. Say

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51. NYSBA Report, supra note 48, Part V-C.
52. Upon a contribution or distribution the hypothetical sale and liquidation occurs immediately before the contribution or distribution. In the case of an option to make capital accounts conform with the economics the hypothetical sale and liquidation must occur immediately after exercise.
53. NYSBA Report, supra note 48, Appendix One ex. 4.
we decide to tag an option-holder with book gain when he clearly seems the economic beneficiary. Why not go one step further than the NYSBA and tax him on that gain when it is recognized by the partnership, even if he has not yet exercised the option? It is fairly easy to make a case for imposing this regime on traded options that have a readily determined market value. But why stop with traded options or, indeed, why stop with options? A case for similar measures can be made whenever contractual mechanisms are in place that make payoffs from a partnership materially differ from capital accounts.

There also will be vexing administrative problems. The allocation of book gain (and at some point tax gain) to an option holder based on the value of the option involves a great deal of discretion when the value of a partnership's assets and/or the value of an option is indeterminate. There also will be vexing technical issues in translating an interest in a partnership into an interest in assets. To give you an idea of the sort of technical problems that arise I turn to another phenomenon that we have just begun to grapple with.

B. Discounts

The value of a partnership interest will not equal the value of a partner's interest in partnership assets when a partner cannot realize the asset value by forcing a liquidation of the partnership or by selling his interest. Discounts in the value of a partnership interest due to restrictions on liquidity or minority status have become bread and butter to the estate tax bar, who rely on discounts to reduce the value of an estate, sometimes by 50 percent or more, when wealth is passed through a family partnership.

If the government ever gets serious about trying to tax compensatory grants of partnership interests, it likely will face similar arguments. It seems fairly clear how discounts should be handled in principle within the system of capital accounts analysis if asset value is known. Assume KL Partnership has marketable securities priced at $50,000 with a basis of $20,000. It admits M as an equal one-third partner for a contribution of $16,000. M buys in at a discount because he has a minority interest that he cannot sell. The question is how to handle the $30,000 built-in gain on the securities. Under § 704(b) regulations, K and L are tagged with the full amount of this gain. But the partners agree that M is entitled to one-third of the value of partnership assets upon liquidation,

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54. I focus on discounts because they are more common. Premiums present similar problems.

55. In a typical family limited partnership, the older generation transfers assets to a limited partnership. The older generation makes gifts of partial interests in the partnership while they live, and the remaining interest passes to the younger generation at death. The interests conveyed during life and at death are discounted in value as minority interests and because of contractual restrictions on liquidity and the like. There has been much litigation and much written on the viability of a family limited partnership as an estate-planning device and the legal risks of steep valuation discounts.

56. Except for the amount of C's contribution, this is example four from the old § 704(b) regulations.
which would be $22,000 in an immediate liquidation. The purpose of the
capital account rules is to describe the economics—they are not meant to
be a strait jacket. To describe the economics, M should get a $22,000
capital account. The natural inference is that M should be tagged with
$6,000 of the deferred tax gain on the securities because that slice of the
value is his.

Tagging M with the appropriate amount of deferred gain or loss on
particular partnership assets can be quite cumbersome when a partner-
ship has multiple assets. Treasury has taken two cracks at this in regula-
tions issued under § 755 that apply to elective basis adjustments upon the
acquisition of an interest. The regulations would apply if M purchased or
inherited his interest from K or L. The following brief description is
meant to give you just a taste of what is required. In order to do basis
adjustments, you must determine asset value (based on an asset's hypo-
thetical sale price) and interest value and then decide how to allocate the
difference across assets. Regulations issued in 1999 use a nine-step
method.57 The end result of the nine steps is to allocate a downward
adjustment from asset value first to capital assets in proportion to their
market value (defined as the hypothetical sale price) and then to ordinary
assets if capital assets cannot absorb the full amount of the adjustment.
On the heel of these regulations, in the year 2000, came proposed regula-
tions58 that divide assets into five classes—cash and cash equivalents,
most ordinary assets, tangible capital assets, intangible assets other than
goodwill, and goodwill. Under the proposed regulations, deemed asset
value is derived from the value of an interest. Interest value is allocated
first to cash and cash equivalents, then to tangible ordinary assets (based
on their hypothetical sale price), and so on down the ladder until interest
value is exhausted. The end result is similar to the current regulations in
that capital assets absorb a discount before tangible ordinary assets. A
difference is that intangible assets, including certain ordinary income in-
tangible assets,59 absorb a discount before capital assets.

I expect these regulations are not the final word on handling basis ad-
justments when an interest is sold or inherited with a discount in value.
The regulations make it possible for ordinary income to escape tax. The
working assumption of the regulations is that the acquirer of an interest
starts with a clean slate with a basis in assets equal to market value.
Downward adjustments because of a discount create built-in gain that
goes first to capital assets. This creates the possibility of a partner purg-

57. Treas. Reg. § 1.755-1(b). For a longer explanation and an example, see M. CARR
FERGUSON ET. AL., FEDERAL INCOME TAXATION OF ESTATES TRUSTS AND BENEFICIARIES
regulations cover only adjustments under § 743 upon the transfer of an interest. The pre-
amble explains three different methods that the Treasury is considering for handling basis
adjustments on distributions. See 65 Fed. Reg. 17829; 2000 TAX NOTES TODAY 69-81
(2000).
this class an asset must be both a § 197 intangible and an unrealized receivable.
ing an interest of potential ordinary income by selling the interest to a related person at a discount. This might be solved at the seller's end by adopting parallel rules for allocating the purchase price under § 751.60 Although this solution would permit ordinary income not in the nature of income in respect of a decedent to escape tax when an interest is inherited.

When $M$ buys into a partnership at a discount by making a contribution, similar questions arise about how to allocate his contribution to assets or how to tag him with appropriate amounts of built-in gain or loss. This is very much like the problem of tagging an option-holder with gain attributable to his option. One possibility is to tag $M$ with a share of the built-in gain and loss on all partnership assets in a way that leaves him with a net gain equal to the difference between what he paid for his interest and his share of the value of partnership assets. This approach makes intuitive sense when $M$ acquires an interest at a discount through exercise of an option because it is how we handle the parallel case in which $M$ takes a profits interest that is contingent on his making a further capital contribution. $M$ is in a similar position if he buys into a partnership at a discount that is a result of minority status or liquidity restriction, but it seems odd in this situation to tag $M$ with a share of built-in loss.

The § 755 regulations take a radically different approach. They start by giving $M$ a basis in assets equal to their market value. This is then reduced to absorb the discount, which has the effect of tagging $M$ with a share of built-in gain (but never a share of built-in loss). Under the 1999 regulations, capital assets absorb the discount before any ordinary assets are discounted. Under the 2000 proposed regulations, intangible assets, then capital assets, then ordinary assets, and finally cash and cash equivalents absorb the discount. An argument for the approach in the proposed regulations is that, in an acquisition of a pool of assets of speculative value, basis should go first to the assets with the least speculative value in order to at least get acquisition cost right with respect to those assets.

Plausible arguments can be made for either approach. The suggested approach for handling the exercise of an option is consistent with the system of capital accounts analysis in that the objective is to tag stakeholders in a partnership with deferred gain and loss that is attributable to their interest. But this approach requires accurate valuation of a stakeholder's interest and partnership assets. The approach in the § 755 proposed regulations is skeptical about asset valuation. It takes the one hard fact in a cash acquisition—the purchase price—and doles it out as basis to cash, then to tangible receivables, then to tangible assets, and finally to intangibles. The idea is to assign basis to hard assets with the most readily measured value.

\[\text{60. The issue of discounts was not addressed when § 1.751-1(a) was amended in 1999.}\]
Perhaps we will want to use these two approaches selectively. This, of course, makes the system more complex and creates line-drawing problems. If your mind is not yet reeling over the possibilities, let me throw in one more wrinkle. To justify tagging an option-holder with book gain, the NYSBA gives as an example the case where $N$ buys into $KL$ Partnership at a discount under book value because of an outstanding option held by $M$. The NYSBA reasons that $M$ must be tagged with book gain in this situation for, if he is not, then $N$ must be given a capital account greater than his contribution, which misdescribes the economics of the deal. But $N$ could also be given a capital account greater than what he paid for his interest because he paid a discounted price for his interest. This means that if we have different systems for handling basis or book adjustments on discounts and options, people may choose between the systems by attributing the discrepancy between what $N$ pays for his interest and the book value of partnership assets to one or the other source or to both.

C. Fishy Valuation

Asset valuation is the Achilles heel of the system of capital accounts analysis. People can defeat the system by misstating the value of an asset. For example, property can be exchanged through a partnership without recognizing gain under §§ 704(c)(1)(2) and 737 by valuing it at basis to hide pre-contribution gain. The system opens the door to new abuses if people are willing to lie about asset value. For example, a tax exempt entity may overstate the value of depreciable property it contributes to a partnership to create depreciation deductions for other partners at no cost to itself.  

Regrettably, we cannot depend upon people to be honest in dealing with the taxman. In the partnership area, we hope that partners will police each other. More precisely, we hope that partners will insist that fair values be placed on what is put into and taken out of a partnership because this affects their claim on the pot. This might seem a safe bet in business partnerships, particularly if they involve more than a few people or they involve firms that act through agents. Few businessmen will trust an informal, undocumented side agreement that a deal is radically different than what the paperwork says.

But special allocations, guaranteed payments, options (and other side agreements), and valuation discounts and premiums can be used to beat

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61. This could happen under the remedial allocation method. Treas. Reg. § 1.704-3(d)(1) (as amended in 1997). The method creates depreciation deductions to the non-contributing partner to eliminate a book-tax disparity and an equal amount of gain the contributing partner. The regulations temper the incentive to do this by treating value in excess of basis as a new asset put in service on the date of the contribution.

62. Leandra Lederman tells me that the celebrated high rate of self-compliance by Americans in paying taxes is misleading. The rate combines compliance in paying taxes on wages—where evasion is quite difficult—with compliance in other areas. Compliance is much lower, below 50 percent, in areas where we depend upon honesty.
the system through mis-valuation with contractual security.\textsuperscript{63} For example, a person may under-value an asset he contributes at an amount equal to basis to avoid the rules on pre-contribution gain and cover his loss from the under-valuation by taking an in-the-money option on a partnership interest or a partnership asset. Or he could cover his loss by getting a capital account greater than the value of his contribution and justify this by a discount in the value of the interest. Or he could cover his loss with a guaranteed payment. Or he could cover his loss with a special allocation.

One thought is to deter people from misvaluing assets through disclosure requirements.\textsuperscript{64} However, the number of disclosed transactions would be so large that the threat of scrutiny by a field agent would not be credible. Disclosure would have to include partnership agreements with special allocations, guaranteed payments on capital plus such commonplace arrangements as buy-back agreements, and forfeiture provisions. Disclosure might be limited to partnerships with at least one partner who is not a U.S. individual in the event of significant non-cash contribution or distribution. But I expect this still will be a daunting number.\textsuperscript{65}

\section*{IV. CONCLUSION}

The system of capital accounts analysis elegantly solves many of the problems that have beset subchapter K since its creation in its modern form in 1954. It is ironic that the immediate impetus behind the creation of the system was handling special allocations, for this is one of its weaker points. The system excels at connecting partnership level and partner level tax consequences as partners and assets come and go from a partnership, while preserving the general principle of nonrecognition. Anyone who has worked with the rules on basis adjustments and hot assets will appreciate that this is no small accomplishment. Most of the problems of the day can be solved by extending the system.\textsuperscript{66}

In coming years we are likely to see new types of problems in the partnership area that the system of capital accounts analysis is ill-suited to

\begin{itemize}
\item \textsuperscript{63} These methods can also be used to try to beat the rules on special allocations. A partnership may be used to strip interest and create a zero-coupon bond without imputed interest by allocating all interest to a class of partners. A guaranteed payment is used to wipe out the positive capital account balance of the interest class upon maturity of the bonds that the principal class will receive all the principal payments. For a fuller discussion of the stratagem, see Gergen, supra note 45, at 30-32.
\item \textsuperscript{64} Disclosure is used as a deterrent elsewhere in partnership tax. The real teeth of the disguised sale regulations are provisions that require partners to disclose transfers to and from a partnership if the transfers occur within two years of each other, unless the transfers come within exceptions written to cover some ordinary and unproblematic distributions. Treas. Reg. §§ 1.707-3(c)(2), 1.707-5(a)(7)(ii), 1.707-6(c) (1992).
\item \textsuperscript{66} “Take therefore no thought for the morrow: for the morrow shall take thought for the things of itself. Sufficient unto the day is the evil thereof.” Matthew 6:34.
\end{itemize}
solve. Tax lawyers have just begun to explore the ramifications of partnership options. As the wheel goes round on family limited partnerships tax lawyers will learn how to work with discounts in valuing a partnership interest. Options and discounts put further pressure on what has always been the weak point of the system of capital accounts analysis. Like special allocations and guaranteed payments, they break the relationship between capital accounts and partnership economics. At best, responding to options and discounts will make the system much more complex. Time will tell whether these new anomalies will bring the system down.