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PARTNERSHIP TAXATION: THE ALLOCATION OF SPECIFIC ITEMS OF INCOME AND LOSS UNDER THE 1954 CODE

by Michael M. Boone

The partnership agreement plays the most important role in the determination of each partner's tax liability for the income and loss of the business. Consequently, the draftsman of the agreement must consider the desires of the partners in relation to the federal tax laws. With respect to the determination of each partner's distributive share, the 1954 Code permits the partners to agree to special allocations of specific items of income and loss in certain instances. This privilege affords the partners a vital and flexible means of tax planning. The scope and purpose of this Comment is to analyze those particular sections of the partnership tax laws which deal with the allocation of specific items of income and loss.¹

I. General Partnership Taxation

A partnership as such is not taxable, but each partner is taxed individually on his share of the partnership income or loss.² The partnership acts merely as an accounting entity by filing a required informational return.³ Each partner must, in turn, account for his distributive share of the partnership income and loss items in his own personal return whether actually distributed to him or not.⁴ The code requires each partner to state...

¹ This Comment will basically limit itself to a discussion of §§ 704(b), 704(c), and 707(c) of the Internal Revenue Code of 1954. For further references in this area, see generally: Driscoll, Tax Problems of Partnerships—Special Allocation of Specific Items, 1958 U. So. Cal. Tax Inst. 421; Gelband, Allocations of Income and Deductions Among Partners, N.Y.U. 21st Inst. on Fed. Tax 997 (1961); Jackson, The Internal Revenue Code of 1954: Partnerships, 54 Colum. L. Rev. 1183 (1954); McDonald, Distributive Share of Partnership Income and Losses, N.Y.U. 15th Inst. on Fed. Tax 41 (1957); Willis, Handbook of Partnership Taxation §§ 7.01-.09, 11.05-.07, and 12.01-.14 (1957); Willis & Bauman, Recent and Prospective Developments in Taxation of Partnerships, 16 Vand. L. Rev. 291 (1963).

² For a general discussion of partnership taxation, see 6 MERTENs, FEDERAL INCOME TAXATION § 37.01 (1957).

³ INT. REV. CODE OF 1954, § 701. The definitions of a partnership and a partner are set forth in §§ 761 and 7701(a)(2) and the related regulations.


⁵ INT. REV. CODE OF 1954, § 702. Section 182 of the 1939 Code explicitly stated that the partner must account for his distributive share "whether or not distribution is made." Although § 702(a) of the 1954 Code makes no mention of this requirement, no change in the law was intended. S. REP. NO. 1622, 83d Cong., 2d Sess. 377 (1954). The courts have upheld this point of view. Stoumen v. Commissioner, 208 F.2d 903 (3d Cir. 1953); Nash
separately his respective share of certain specific items of income, gain, loss, deduction, and credit. These specific items fall into seven enumerated classes: short-term capital gain, long-term capital gain, gain or loss from the sale or exchange of property used in trade or business, charitable contributions, dividends, taxes paid or accrued to foreign countries or possessions of the United States, and partially tax-exempt interest on obligations of the United States. In addition to these seven items, the code authorizes the Treasury, at its own discretion, to require the segregation of any item of income, gain, loss, deduction, or credit which is not otherwise treated separately. This catch-all provision means that any item, the character of which would alter any partner's personal tax liability, must be treated separately. The purpose of segregating these specific items in the return is to treat them as if each partner's share of such item had come directly to the partner in the same transaction and in the same manner as it came to the partnership. In other words, the character of each segregated item is carried over into the hands of the individual partner in order to reflect correctly income for tax purposes. For example, if the partnership recognizes a long-term capital gain from the sale of an asset, the partner's share of this item will likewise be treated as a long-term capital gain. This conduit rule, however, is limited to those enumerated items mentioned in the code and the regulations. The remaining taxable income and loss items of a partnership fall into a general class and have no particular character.

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Footnotes:

7. INT. REV. CODE OF 1954, § 702(a) (8). In implementing this discretionary power, the Service has enumerated in Treas. Reg. § 1.702-1(a) (8) (i) (1956) specific items of income, gain, loss, deduction, and credit that must be accounted for separately in reporting a partner's distributive share. Among the items are the following: recoveries of bad debts, prior taxes, and delinquency amounts (§ 111); gains and losses from wagering transactions (§ 165(d)); medical expenses (§ 213); intangible drilling and development expenses (§ 263(c)); exploration expenditures (§ 613); and any item which is subject to a special allocation under the partnership agreement. See, as an illustration of purpose, S. REP. No. 1622, 83d Cong., 2d Sess. 376-78 (1954).
8. Treas. Reg. § 1.702-1(a) (8) (ii) (1956). In addition to those specific items that the Service has listed in Treas. Reg. § 1.702-1(a) (8) (i) (1956), the partners must likewise account separately for any partnership item which if separately taken into account by any partner would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately. For example, where a partner would qualify for the retirement income credit under § 37 of the code if the partnership pension and annuities, interest, rents, dividends, and earned income were separately stated, such item must be accounted for separately by each partner.
ization upon distribution to the partners. These nonsegregated items are generally treated as ordinary profit and loss of the partnership.

II. The Partner’s Distributive Share—General Allocation Rule

The code provides that a partner’s distributive share of income, gain, loss, deductions or credit shall be determined in accordance with the partnership agreement. The importance of a thoughtfully drawn agreement is readily apparent. The partners are free, within certain limits, to control and determine their individual tax liability for the partnership profit and loss. It should be noted that the code provides that any change and modification in the partnership agreement will be effective for tax purposes if made prior to the required time for filing the partnership return in the taxable year. This rule allows the partnership a flexible means of changing the division of income and loss in order to meet substantive and economic changes in the organization and its members. As might be expected, however, limitations have been placed upon this privilege so that the income of the partnership may not be shifted arbitrarily between the partners from year to year for the purpose of obtaining the best tax result.

The average partnership agreement contains a general profit and loss ratio by which the partners may agree to share ordinary income and loss in any manner that they desire. Furthermore, the partnership agreement may provide a different ratio for sharing income than

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11 INT. REV. CODE OF 1954, § 702(a)(9). Section 703(a) of the 1954 Code provides for the computation of the partnership taxable income. The section states that the taxable income of the partnership, although not taxable as such, shall be computed in the same manner as the taxable income of an individual with certain exceptions. Among the exceptions is the requirement that the segregated items as described in § 702(a)(1)-(8) must be stated separately, i.e., such items are not considered in the computation of the partnership taxable income. Likewise, the section prohibits the use of personal deductions in determining the partnership taxable income.

12 INT. REV. CODE OF 1954, § 704(a).

13 INT. REV. CODE OF 1954, § 761(c). Treas. Reg. § 1.761-1(c) (1956) indicates that the Service will recognize all partnership agreements and modifications whether oral or written. Nevertheless, sound partnership planning requires that all internal agreements be in writing in order to safeguard against any dispute between the partners or legal question that might arise later.


15 If the partnership agreement is silent as to the manner for sharing ordinary profit and loss, the manner in which the net profit or loss is actually credited on the partnership books will control in determining the general profit and loss ratio. Treas. Reg. § 1.704-1(b)(1) (1956). It should also be noted that Treas. Reg. § 1.704-1(c)(1) (1956) provides that “As to any matter on which the partnership agreement, or any modification thereof, is silent, the provision of local law shall be considered to constitute a part of the agreement.”

16 Helman v. United States, 44 F.2d 83, 90 (Ct. Cl. 1930). This proposition is based on the assumption that any agreement as to the sharing of ordinary profit and loss is made at arm’s length.
that applicable for sharing losses. On the other hand, the majority of partnership agreements do not expressly provide for a division of specific items of income and loss such as dividends, capital gains and losses, and tax-exempt interest. The code states that if the partnership agreement is silent as to the allocation of any item of income or loss, the partners will share such item in the same ratio as ordinary income and loss is divided. This general allocation rule follows the entity theory of partnerships, i.e., the partners, like stockholders in a corporation, are treated as if they do not have separate rights in separate items of income and loss. The 1954 Code, however, permits the partners to avail themselves of the aggregate theory of partnerships, i.e., the partners are treated as co-owners who have individual rights in each item of income and loss. If the partnership agreement so provides, the partners may share a specific item of income or loss in a ratio different from the general profit and loss ratio. The present tax laws permit such allocations in three general areas: (1) section 704(b) allows the partnership agreement to make a special allocation, differing from the general ratio of dividing profit and loss, of a particular item of income, gain, loss, deduction, or credit; (2) section 704(c) allows the special allocation of depreciation, depletion, and gain or loss from property contributed to the partnership; (3) section 707(c) allows guaranteed payments to be made to a partner for services rendered without regard to partnership earnings.

III.

Section 704(b)—Specific Allocation Rule  The 1954 Code grants the partners ample freedom to determine and arrange their tax liability with respect to separate items of partnership income and loss. Section 704(b) states in a negative fashion that a specific item of partnership income, gain, loss, deduction, or credit may be allocated in a manner differing from the general profit and loss ratio if the partnership

18 INT. REV. CODE OF 1954, § 704(b)(1). Section 704(b) of the 1954 Code provides:
(b) Distributive Share Determined by Income or Loss Ratio — A partner’s distributive share of any item of income, gain, loss, deduction, or credit shall be determined in accordance with his distributive share of taxable income or loss of the partnership, as described in section 702(a)(9), for the taxable year, if —
(1) the partnership agreement does not provide as to the partner’s distributive share of such item, or
(2) the principal purpose of any provision in the partnership agreement with respect to the partner’s distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle.
agreement so provides.\textsuperscript{19} The section also stipulates, however, that a specific allocation of any item will be disregarded if such allocation is made principally for the purpose of tax avoidance.\textsuperscript{20} If an allocation is found to violate the tax-avoidance rule, the particular item of income or loss involved will be distributed in accordance with the ratio for sharing ordinary profit and loss. It should be recognized that the disallowance of one special allocation will not affect the validity of others since each one is made independently.

The problem encountered by the draftsman of the partnership agreement involves the determination of what is a valid allocation within the meaning of the tax laws. Realistically, in most situations the partners will agree to a special allocation only if it results in some tax benefit. Whether the mere existence of such a purpose is itself a violation of section 704 (b) (2) cannot be determined from the code alone since it does not elaborate on the tax-avoidance proviso. However, it seems clear from legislative history that Congress did not intend for every allocation which produced a tax savings to fall automatically within the tax-avoidance classification.\textsuperscript{21} The Senate Finance Committee report indicates that a special allocation will be allowed if it produces a “substantial economic effect” and is not “merely a device for reducing the taxes of certain partners without actually affecting their shares of partnership income.”\textsuperscript{22} The substantial economic effect concept is intended to prevent an allocation which is made in form only, \textit{i.e.}, an allocation which does not in fact change the partners’ dollar shares of partnership income independently of the tax consequences. The Service, however, does not treat the economic effect of an allocation as the only consideration in determining whether such allocation has been made principally for the purpose of tax avoidance. The regulations state that each allocation “must be considered in relation to all the surrounding facts and circumstances.”\textsuperscript{23} In addition to the primary consideration of substantial economic effect, five other factors, discussed below, are set forth which must be taken into account in determining whether an allocation is made for the purpose of tax avoidance.\textsuperscript{24} It should be

\textsuperscript{19} Ibid. The 1939 Code did not expressly provide for specific allocations of partnership items of income and loss. However, the Treasury ruled that under the 1939 Code partners could allocate items of income and loss in a ratio other than the general profit and loss ratio of the partnership, provided such allocations were not for the purpose of tax avoidance. Rev. Rul. 138, 1957-1 CUM. BULL. 543, revoking Rev. Rul. 134, 1956-1 CUM. BULL. 649.

\textsuperscript{20} INT. REV. CODE OF 1954, § 704 (b) (2).


\textsuperscript{22} Ibid.

\textsuperscript{23} Treas. Reg. § 1.704-1 (b) (2) (1956).

\textsuperscript{24} Ibid.
understood that one factor in itself will not disqualify an allocation so long as there are other indications of a purpose other than tax avoidance.

Business Purpose. Lack of a business purpose will not itself disqualify an allocation but its absence will cast considerable doubt as to the true purpose of the allocation. Numerous non-tax business reasons for agreeing to a special allocation may exist. For example, the allocation of a disproportionate percentage of foreign income to the partner in charge of foreign operations as an incentive to manage such operations more efficiently would appear to be a sound business reason. The fact that the partners bargained for a special allocation and would not have formed the partnership without such an allocation, however, is not considered a sufficient business purpose.

Substantial Economic Effect. As indicated above, an allocation must "affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences." Stated negatively, a special allocation will not have a substantial economic effect if the partners receive the same dollar amount of the total partnership income and loss that they would have received if no special allocation had been made. For example, assume that in the AB partnership the partners agree to share general profit and loss equally. The partners also agree to a special allocation by providing in the agreement that A, who is foreign partner, is to receive a greater percentage of foreign income. As a result of this allocation, partner A will actually receive more of the total partnership income than if no special allocation had been made. Since A's and B's shares of the total partnership income are affected independently of tax consequences, the allocation has a substantial economic effect.

In applying the economic effect test, a special allocation will be examined in relation to other allocations and adjustments made by the partnership. The purpose is to prevent an offset in the economic effect of an allocation through the juggling of other income and loss items. For instance, assume that in addition to the special allocation of foreign income made to A the partners agree that B is to receive an additional amount of ordinary income equivalent to A's greater percentage

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27 See Treas. Reg. § 1.704-1(b) (2), example (2) (1956).
28 See Driscoll, supra note 1, at 429.
29 See Treas. Reg. § 1.704-1(b) (2) (1956). See note 21 supra and accompanying text. For a thorough analysis of the substantial economic effect test as related to the tax avoidance limitation of § 704(b) (2), see Jackson, note 1 supra, at 1187-89.
30 See Treas. Reg. § 1.704-1(b) (2), example (2) (1966).
31 In addition, the Service will look closely at salaries, expenses, and similar items of the partnership to see if they have been adjusted in order to offset a special allocation.
of foreign income. It is obvious that the increase in B's share of ordinary income will offset the special allocation of foreign income to A. The net effect of these two allocations is to give the partners the same dollar amount of total partnership income as they would have received in the absence of any special allocation. Such an allocation has no economic effect and thus would be disregarded for tax purposes unless other circumstances showed that the allocation was not made principally for the purpose of tax avoidance.

The economic effect factor is also applicable to deductions. However, the substantial economic effect concept has a somewhat different connotation when mentioned in regard to the allocation of a deduction. The validity of a special allocation of a deduction depends primarily on the actual relationship between the item of deduction and the partner to whom the allocation is made. The allocation of an item of deduction will have a substantial economic effect if the partner to whom it is allocated has in fact an economic interest in the deduction, i.e., he has actually borne the expense of the deduction. In general, an allocation to a partner against whom the deduction has been charged on the partnership books will in most cases be considered to have an economic effect. For example, if a charitable contribution made by the partnership is charged to the capital account of a particular partner, an allocation of the charitable deduction to the partner charged will be allowed. Likewise, in an oil and gas partnership, the allocation of intangible drilling and development expenses to the partner who has in fact financed the drilling of the well would be valid.

Related Items. The third factor considers "whether related items of income, gain, loss, deduction, or credit from the same source are subject to the same allocation." For instance, where a partnership agreement provides for a special allocation of all income from taxable securities to one partner, the Service will consider how the capital gain or loss from the sale of such securities is to be allocated.

Normal Business Risks. The regulations indicate that an allocation which is not subject to normal business risks raises an inference of tax avoidance. This applies, for example, when the partners do not agree to special allocations of tax-exempt interest and dividends until the end of the taxable year when the amount of such items are reasonably certain. The time factor, like the other five, is not conclusive in de-

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30 See Treas. Reg. § 1.704-1 (b) (2), example (1) (1956).
31 See note 54 infra and accompanying text.
32 Treas. Reg. § 1.704-1 (b) (2), example (1) (1956).
33 Treas. Reg. § 1.704-1 (b) (2) (1956).
terminating tax avoidance but must be considered in relation to all the facts. A change in business conditions or in the business operations might necessitate allocations of specific items at a time when the amount of such items are readily known. Nevertheless, sound tax planning suggests that the partners should agree to special allocations well in advance of the end of the taxable year in order to safeguard against any questions arising with respect to this fourth factor.

Duration. The consistency with which an allocation is made year after year will ordinarily suggest a purpose other than tax avoidance. Apparently, an allocation made for only one year will be viewed with some suspicion. The duration factor prevents the juggling of different items of income between the partners from year to year so as to obtain the best tax advantage in each particular year. *54*

Overall Tax Consequences. In addition to the other five factors, the regulations state that each allocation must be viewed in light of its "overall tax consequences" to determine if such allocation was made primarily for tax avoidance purposes. Although this last factor is regarded as a catch-all clause, it is not intended to close the door to every allocation which results in a tax benefit. Presumably, the prime purpose of this factor is to prevent some unusual abuse of the special allocation privilege that is not reached by the other factors.

In partnership tax planning the facts peculiar to the partnership and its members will determine whether a special allocation of some specific income or loss items is needed and warranted. The regulations set out several examples *55* which not only illustrate the application of the six factors discussed above but also demonstrate possible valid uses of the special allocation privilege. For instance, one example suggests that partners can agree to the special allocation of gain arising from the sale of property which had appreciated in value prior to the admission of a partner. *56* Partner M contributes $25,000 cash and enters as an equal partner in the KL partnership, a brokerage, at a time when certain securities held by the business have a basis of $20,000 and a fair market value of $50,000. The subsequent sale of the securities at an appreciated value of $74,000 results in a taxable gain of $54,000. The partnership agreement provides that $24,000 (appreciation in value occurring after M entered the partnership) will be allocated equally between K, L, and M. However, with respect to the remaining $30,000 gain which is attributable to the appreciation in value prior to the entry of M in the partnership, the agree-

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54 See notes 13 and 14 supra and accompanying text.
55 See Treas. Reg. § 1.704-1 (b) (2), examples (1)-(5) (1956).
56 Treas. Reg. § 1.704-1 (b) (2), example (4) (1956).
ment provides that such gain is to be allocated to K and L in accordance with the profit and loss ratio existing at the time of the admission of M. The regulations state that such an allocation has substantial economic effect and will be recognized in the absence of other circumstances showing tax avoidance as its primary purpose. The reason for such an allocation in this fact situation is to remove the tax advantages accruing to the old partners if each new partner were required to share a tax burden arising before their admission. Of course, the tax planner must consider whether the complexities of such an allocation override the benefits sought.

The partnership which owns municipal bonds may desire to make a special allocation of the tax-exempt interest that is earned on these bonds. In one example in the regulations the CD partnership agreement provides that C's distributive share of income is to be the first $10,000 of tax-exempt interest and D's distributive share of income is to be the first $10,000 of dividend income, the balances of the income to be divided equally. The regulations declare that this allocation provision will be disregarded since its principal purpose is to allocate tax-exempt interest to C who is in a higher income tax bracket than D. Although the regulations do not specifically mention the fact, it is obvious that this allocation of tax-exempt interest has no substantial economic effect since the partners receive the same dollar amount of total partnership income as if no allocation had been made. Nevertheless, the fact that the regulations do not speak in terms of the lack of an economic effect in disallowing this allocation implies that the Service might draw the same conclusion even if the tax-exempt interest had been allocated to C in a manner affecting the partners' shares of the total partnership income. Would the Service still consider such an allocation to be made for the purpose of tax avoidance if the allocation had not been made to the partner in the higher tax bracket and it did have a substantial economic effect? In the absence of some other factor showing tax avoidance, the answer would appear to be no.

87 Treas. Reg. § 1.704-1(b)(2), example (3) (1956).
88 For illustration, assume the CD partnership received $12,000 of tax-exempt interest and $14,000 of dividend income. Partner C would receive $13,000 of partnership income ($11,000 of tax-exempt interest plus $2,000 of dividend income). Partner D would likewise receive $13,000 of partnership income ($12,000 of dividend income plus $1,000 of tax-exempt interest). Thus, the partners receive the same amount of the total partnership income that each would have received if the dividend income and tax-exempt interest had been shared equally under the general profit and loss ratio.
89 The third example in the regulations states that since the principal purpose of this provision is to allocate tax-exempt interest to C, who is in a higher income tax bracket than D, it will be disregarded. No other reason is given for disallowing the allocation. In other words, no mention is made with respect to the substantial economic effect of the allocation.
The regulations also present an illustration of a valid allocation of tax-exempt interest. Partner A and partner B agree to invest surplus partnership funds in an equal dollar amount of municipal bonds and corporate stock in order to avoid a distribution which might affect the credit standing of the partnership. The partners further agree that A is to receive all the interest income and capital gain or loss from the tax-exempt bonds, and B is to receive all dividend income and gain or loss from the corporate stock. The regulations state that this provision in the partnership agreement is valid since it has a substantial economic effect. It is true that this method of allocating tax-exempt interest and dividend income will change the partners' shares of total partnership income independent of the tax consequences.

However, the validity of this allocation seems to rest more on the fact that the division of the principal amount invested represents the actual economic interests of the partners. In other words, this allocation has accomplished the same results as if the AB partnership had distributed the surplus partnership funds to A and B, and each had invested his share of the funds in tax-exempt securities and corporate stock respectively. Thus, independent of any change in the partners' shares of the total partnership income, the implication is that a special allocation will have a substantial economic effect if it represents the true economic interests of the partners.

The tax advantages of special allocations are especially significant to the "service" partnership where one of the partners contributes the bulk of the capital required, and another partner provides services. The financing partner is particularly interested in the allocation.
tion of the initial partnership losses since he in fact bears the economic risks of the business venture. The regulations indicate that the entire deduction for early partnership losses may be specifically allocated to the financing partner even though the partnership agreement provides a different ratio for sharing profits and losses after the business has been established. It should be noted here that section 704(d) provides that a partner's distributive share of the partnership loss "shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred." This limitation should be considered when drafting the agreement of a service partnership. In the normal situation, a service partner's distributive share of the losses would go undeducted in the year in which they were incurred since his adjusted basis in the partnership is extremely low. To remedy this situation, the draftsman might limit the service partner's share of the partnership losses to the extent of the balance in his capital account. This provision would guarantee that all the losses could be deducted in the year in which they were sustained by the partnership. The fact that the service partner will completely lose the right to share in these initial partnership losses seems justifiable since it is the contributing partner's capital investment which actually sustains the loss.

Section 704(b) has been of particular importance to the oil and gas industry with respect to the allocation of intangible drilling and recoup his initial investment before the service partner can begin sharing in the partnership income and loss. See generally Tenen, Tax Problems of Service Partnerships, N.Y.U. 16TH INST. ON FED. TAX 137 (1958).


46 INT. REV. CODE of 1914, § 704(d).

47 See 1 RABIN & JOHNSON, CURRENT LEGAL FORMS, form 1.49 (1966). See note 87 infra showing the tax court's denial of a partner's deduction for his distributive share of the partnership losses.

48 It should be noted that a disallowed loss deduction can be carried over indefinitely. Therefore, it can be deducted at the end of the first succeeding partnership taxable year, and subsequent partnership taxable years, to the extent that the partner's adjusted basis for his partnership interest at the end of any such year exceeds zero (before reduction by such loss for such year). Treas. Reg. § 1.704-1(d)(1) (1956). In the initial years of a service type partnership, the partner who provides his services normally would have a zero basis in the partnership. Thus, his share of the initial partnership losses would go undeducted until his adjusted basis in the partnership exceeded zero in a subsequent year.

49 See Wills, The Model Partnership Agreement, N.Y.U. 15TH INST. ON FED. TAX 173, 182-83 (1957). If losses are allocated to the partner who has contributed the capital, then the partnership agreement must make an adjustment in the partner's distributive shares of the profits for subsequent years, i.e., the partner to whom the additional losses are charged must be allocated an additional amount of partnership income in order to offset the losses charged to his account. Concurrently, the service partner's distributive share of income would be reduced.
The formation of a partnership and the special allocation of such deduction items to the financing partner presents a sound solution to the carried interest problem. For example, partner A, the owner of an oil and gas lease joins with partner B, an investor, who contributes the money necessary for the drilling of the well. Partner B is particularly concerned with the deductibility of the expenditures for intangible drilling and development costs since he bears the economic risks of the operations. The regulations indicate that the partnership agreement may provide that all intangibles, all expense deductions, all depletion, and depreciation are to be specially allocated to B. Likewise, B can be allocated a greater percentage of the income until he has recovered all of his investment; thereafter, the partners will share equally in income and expenses. This special allocation reflects the economic realities of the situation since B has actually borne the expense of such deductions. This method of allocating intangible drilling and development expenses resolves the uncertainties encountered in the carried interest method of allocating such items.

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51 The carried interest problem can briefly be stated as follows: A, the owner of an oil and gas lease, assigns the lease to B, the investor, who agrees to assume all financial risks of drilling the well. The agreement between the parties provides that B is entitled to all production until he has recouped his investment, at which time half interest in the lease reverts to A, and they thereafter share equally in expenses and production. This type of transaction was upset by the case of Commissioner v. Abercrombie, 162 F.2d 338 (5th Cir. 1947), where the Fifth Circuit held that the assignor (A) had retained title to a half interest in the lease, and the assignee (B) was merely lending the assignor his share of the development expense. Since the court considered the parties to be equal owners of the lease at all times, each was held to be entitled to deduct one-half of the intangibles and each chargeable with one-half of the income. Thus, the investor who bore the risk of the venture was denied the right of deducting all the intangible drilling expenses. The results of the Abercrombie case seriously affected the oil and gas industry since no investor desired to risk his money when he could not be assured of deducting all of the intangibles. It should be noted that there now appears to be a conflict in the courts on the carried interest transaction. The Ninth Circuit refused to follow the Abercrombie decision in United States v. Thomas, 329 F.2d 119 (9th Cir. 1964). See Horrow, Current Partnership Problems in Oil and Gas Operations, SOUTHWESTERN LEGAL FOUNDATION, 17TH ANNUAL INST. ON OIL AND GAS LAW AND TAXATION 303 (1966).

52 Jackson, note 50 supra, at 444 points out that the partnership (joint venture) coupled with § 704(b) attracts risk capital.

53 Treas. Reg. § 1.704-1 (b) (2), example (1) (1956).

54 See note 51 supra. There has been some controversy as to whether a carried interest arrangement is actually a joint venture so that it will be treated as a partnership under the 1914 Code. See Comment, Is the Carried Interest a Partnership?, 13 OIL & GAS TAX Q. 51 (1964). Regardless of the controversy, the parties involved in a carried interest situation can definitely obtain the advantages of § 704(b) by merely formalizing their arrangement into a joint venture agreement.
IV.

Section 704(c)—Contributed Property

Partners are often confronted with problems arising from the contribution of property to the business by one of the members as his capital investment. Perhaps the most common one can be illustrated by the following situation. At the beginning of the AB partnership, partner A contributes $1000 worth of cash and partner B contributes nondepreciable property with a fair market value of $1000 but with an adjusted basis of $200. According to the code, the basis of the property in the hands of B is carried over into the hands of the partnership. Thus, if the AB partnership later sells the contributed property for $1000, there will be a taxable gain of $800. Such a gain is not a true economic gain to the partnership since it arose because the property had appreciated in value between the time B acquired it and the time he contributed it to the partnership. The gain is unreal to A and he will certainly question the fairness of having to pay taxes on a proportionate share of a gain which resulted from appreciation in value of partnership property prior to its contribution to the business.

In regard to this problem, the 1954 Code allows the partnership, if it so elects, to shift precontribution gains among the partners. Section 704(c) establishes the general rule that depreciation, depletion, or gain or loss with respect to contributed property is to be allocated among the partners in the same manner as if such property had been purchased by the partnership. As an exception to this general rule, the same section provides that the partners may by agreement provide for the special allocation of such items in order "to take account of the variation between the basis of the property and its fair market value at the time of the contribution." Thus, the 1954 Code adopts an entity approach under the general rule, but allows the partners to allocate such precontribution gain or loss within the concept of the aggregate approach. For instance, the AB partnership agreement

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Contributed property is defined as property which has actually been contributed by a partner to the partnership so as to become partnership property as among the partners and not merely subject to the claims of the partnership creditors. Where a property's use is subject to the consent of a partner, the property is not contributed property for the purposes of § 704(c). See Treas. Reg. § 1.704-1(c)(1) (1956).


53 INT. REV. CODE OF 1954, § 704(c)(2). The section reads as follows:

(2) Effect of Partnership Agreement. — If the partnership agreement so provides, depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, under regulations prescribed by the Secretary or his delegate, be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.
might provide that upon any subsequent sale or exchange of the property, the gains attributable to precontribution appreciation will be allocated to contributing partner B. Such an allocation would more correctly reflect the economic realities of the gain as between the partners. Of course, any gain that had arisen since contribution would be divided in accordance with general profit and loss ratio. Therefore, if the property contributed by B had been sold for $1200, B would recognize a gain of $900 (the $800 precontribution gain and his $100 share of post-contribution gain) and A would recognize a gain of $100 (his share of the $200 post-contribution gain).

The partners may also provide for the special allocation of depreciation or depletion with respect to contributed property in order to account for the difference in the basis of the property and its value at the time of contribution. Such deductions can be allocated to the noncontributing partners to approximate the deduction which they would have obtained if the basis of the contributed property equalled its value at the time of the contribution. For example, assume that in the CD partnership, C contributes depreciable property with an adjusted basis of $6000 and a fair market value of $10,000. D contributes $10,000 worth of cash. The $4000 difference in C's basis in the contributed property and its fair market value represents a potential gain to the partnership. If the basis of the contributed property had equalled its value of $10,000, the partnership would have an annual depreciation deduction of $1000 (assuming annual depreciation rate is ten per cent); and therefore, D would have a deduction of $500. But with a $6000 basis, the partnership would have an annual depreciation deduction of only $600. The partners could, however, amortize the precontribution gain of $4000 over the life of the asset by making a special allocation of the depreciation to the noncontributing partner. This is accomplished by allocating $500 to D and $100 to C of the annual depreciation. The $400 difference would represent the amortization of the precontribution gain. At the end of ten years, the contributed property would be fully depreciated. If the partnership had no other income or loss during this period, D's basis for his interest would be $5000 ($10,000, original basis of his interest, reduced by the annual depreciation deductions totaling $5000). C's interest would likewise have a basis of $5000 (his original basis of $6000 minus his share of the depreciation for ten years.

60 Treas. Reg. § 1.704-1(c) (2) (i), example (1) (1956).
totaling $1000). Thus, the special allocation of depreciation to D offsets the deferred gain attributable to appreciation in value prior to the contribution of the property by C.

The regulations have adopted the so-called “ceiling” approach in limiting the amount of precontribution depreciation, depletion, or gain or loss allocations. According to this concept, an allocation “cannot exceed the amount of gain or loss realized by the partnership or the depreciation or depletion allowable to it.” The “ceiling” will apply in those cases where the contributed property is sold at a price below its fair market value at the time of its contribution but above its adjusted basis in the hands of the contributor. In such a case, the partnership would have an economic loss (value of property to partnership minus sales price) and a taxable gain (sales price minus adjusted basis of the property to the partnership). However, under the “ceiling” limitation, only the allocation of the taxable gain realized by the partnership would be allowed for tax purposes. Likewise, the partners cannot take deductions for depletion or depreciation which the partnership did not in fact realize. This limitation prevents the partners from creating items which are not real to the partnership for tax purposes.

Section 704 (c) appears to be an adaptation of the special allocation rule under section 704 (b). The draftsmen of the code apparently recognized the importance of permitting the partners to arrange equitably the tax liability for precontribution gain or loss with respect to contributed property. Unlike section 704 (b), however, the privilege of allocating depreciation, depletion, or gain or loss with respect to contributed property is not subject to any tests of tax avoidance, business, or economic purposes. All that section 704 (c) requires is that an election be expressly set out in the partnership agreement.\footnote{\textit{Treas. Reg. § 1.704-1 (c) (2) (i) (1956)}.}

\footnote{\textit{Ibid.}}

\footnote{For example, assume that A contributes property with a fair market value of $1000 and an adjusted basis of $750. The property is sold for $900 resulting in a taxable gain of $150. If the partnership agreement is silent, A and B will be allocated $75 of the gain individually. However, if the economic realities of the sale are to be fully realized by the partnership, a $250 gain (the difference between the fair market value and the basis at the time of the contribution) should be allocated to B and a $100 loss should be allocated to the partnership. The net result being that A would realize a $50 loss and B would realize a net $200 gain ($250 precontribution gain reduced by the $50 share of partnership loss). However, under the “ceiling” approach, only the actual partnership gain or loss can be allocated to any partner. Thus, only the $150 gain allocated to B could be realized in this fact situation.}

\footnote{See note 17 supra.}
Section 707(c)—Guaranteed Payments

Prior to the 1954 Code any payment of compensation to a partner was considered to be a part of his distributive share of the partnership income. Maintaining an absolute aggregate concept of partnerships, the Treasury refused to allow such payments to be treated as deductible business expenses by the partnership. The present tax laws, however, recognize that partners may deal with the partnership as independent third persons. Section 707(c) states that "payments to a partner for services or for the use of capital shall be considered as made to one who is not a member of the partnership." Thus, salary payments to partners and interest payments on a partner's capital account are deductible expenses in determining the partnership taxable income. To qualify for a deduction, however, the salary must be in the form of a "guaranteed payment." Section 707(c) stipulates that such payments must be determined without regard to the income of the partnership in order to be classified as guaranteed payments. The term guaranteed payment as it is used in the code embraces the idea that such payments must be definite rather than contingent on the income of the partnership. Obviously, a partner's salary which is based on a certain percentage of income would not qualify as a guaranteed payment. Such a payment would be included in the determination of a partner's distributive share. Likewise, a partnership agreement whereby one partner is to receive the first $10,000 of partnership income would not meet the requirements since the partner is not assured of receiving the $10,000 salary. Another interesting example which illustrates the guaranteed payment requirement is found in the regulations. Partner C in the CD partnership is to receive 30 per cent of the partnership income, but he is guaranteed at least $10,000 regardless of partnership income. The regulations state that if the partnership income is

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65 Commissioner v. Doak, 234 F.2d 704 (4th Cir. 1956); Melville W. Thompson, 18 B.T.A. 1192 (1952). For an historical discussion of guaranteed payments, see 6 MERTENS, FEDERAL INCOME TAXATION § 35.23 (1937). The 1939 Code provided that salaries paid to partners were not deductible in computing net income of the partnership. Treas. Reg. 118, § 39.183-1(b) (1939).

66 Treas. Reg. § 1.707-1(a) (1956). The regulations state that a partner who engages in a transaction with a partnership other than in his capacity as a partner shall be treated as if he were not a member of the partnership with respect to such transaction.

67 Int. Rev. Code of 1954 § 707(c). This section reads as follows: "(c) Guaranteed Payments.—To the extent determined without regard to the income of the partnership, payments to a partner for services or use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expense)."

68 Ibid. See Treas. Reg. § 1.707-1(c) (1956).

$60,000, C is entitled to $18,000 as his distributive share and no part of this amount is to be treated as a guaranteed payment. In other words, if C's distributive share of the partnership income is the same or greater than the guaranteed minimum payment, no part of his distributive share will qualify as a guaranteed payment of salary. On the other hand, if C's percentage share of the partnership income is less than the guaranteed minimum, the difference in his minimum guaranteed and his distributive share of income will be treated as a guaranteed payment. For example, if the CD partnership has income of $20,000, $6000 would be C's distributive share, and the remaining $4000 payable to C would be a guaranteed payment.

Section 707(c) provides that guaranteed payments of salary and interest to partners are treated as made to strangers only for the purposes of the recipient partner's gross income and the partnership's deductible business expenses.70 "For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income."71 Thus, a partner who received a salary while absent from work due to illness can not claim a sick pay exclusion under section 105(d).72 Likewise, a partner who receives a guaranteed payment is not considered an employee for the purposes of withholding tax or for the purposes of contributions to employee pension or profit-sharing plans.73

Where a partnership operates on the accrual basis and a partner receiving a salary payment is on the cash basis, the question may arise as to when the partner must report the guaranteed payment. By manipulation of payments the partners might obtain a tax advantage if the partnership were allowed to deduct the payment in one year and the partner were allowed to report the receipt of such payment in a different taxable year.74 Consequently, the Service has seen

70 See note 67 supra.
71 Treas. Reg. § 1.707-1(c) (1956). The tax court in Thomas Browne Foster, 42 T.C. 974 (1964) upheld the validity of this regulation. The court held that this interpretation of the regulation applied where a nonresident citizen of the United States claimed that certain amounts he received from his United States partnership were guaranteed payments for work he performed abroad, and therefore qualified for exclusion as foreign earned income. The tax court rejected the dictum in Foster v. United States, 221 F. Supp. 291 (S.D.N.Y. 1963) that if the taxpayer had taken his income from the partnership as a salary under § 707(c), none of it would have been taxable, since it would have been earned entirely outside the United States. See Wren, Planning Problems of Partners and Partnerships, 1963 U. Ill. L.F. 400 (1963).
74 E.g., if the net income of the AB partnership is $1000 before deducting A's $4000 salary, there will be a partnership loss of $3000. If the partners share profits and losses equally, A and B will each receive a $1500 loss. In accordance with the regulations, A will have to report a salary payment of $4000 in the same taxable year that he reports the loss.
fit to close the loophole. The regulations require that guaranteed payments be reported by the partner in the same taxable year that the partnership "deducts such payments as paid or accrued under its method of accounting." Thus, in some instances, a partner will have to report his salary in his tax return even though it has not actually been received.

When earnings of a partnership are insufficient to cover the guaranteed payment, an operating loss is created. Suppose partner M is to receive a $10,000 salary and fifty per cent of the taxable partnership income and loss. The MN partnership, however, has only $2000 income for the year. As a result, the payment of the $10,000 salary to M produces an $8,000 loss to the partnership. Under present law partner M will report $10,000 of ordinary income (his guaranteed payment) and a $4000 loss (his distributive share of the partnership loss). The net of the two items is $6000 of income from partnership sources to partner M.

In situations where the partnership has received capital gains or some other special type of income but does not have enough ordinary income to cover the guaranteed payment, the regulations require that the special type of income be distributed separately and that the guaranteed payment be treated as if paid out of ordinary income. For example, assume partner X in the XY partnership is to receive a guaranteed salary of $10,000 per year plus fifty per cent of the partnership taxable income and loss. The partnership receives $30,000 in capital gains and no other income or deduction except the $10,000 paid X as a guaranteed payment. In accordance with the regulations, X would report $10,000 of ordinary income (his guaranteed payment), a $5000 loss (his distributive share of the partnership's ordinary loss created by his guaranteed payment), and $15,000. Thus, he would report a net income from the partnership of $2500 ($4000 salary minus $1500 distributive share of partnership loss). However, in the absence of the regulations, A would report only a $1500 loss from partnership sources if the partnership was on an accrual basis and A had not received the guaranteed payment. The difference in tax results is obvious. See Rev. Rul. 67-5, 1956-2 CUM. BULL. 459.

The partnership tax planner must not overlook the possible creation of losses by guaranteed payments and the resulting consequences under § 704(d) of the code. See notes 46-49 supra and accompanying text. See also Holdsworth, Tax Losses and Cash Flow: How To Treat Partners' Drawings and Salaries When There Are Losses, N.Y.U. 20TH INST. ON FED. TAX 721, 749-65 (1962).

The partnership tax planner must not overlook the possible creation of losses by guaranteed payments and the resulting consequences under § 704(d) of the code. See notes 46-49 supra and accompanying text. See also Holdsworth, Tax Losses and Cash Flow: How To Treat Partners' Drawings and Salaries When There Are Losses, N.Y.U. 20TH INST. ON FED. TAX 721, 749-65 (1962).

73 See Treas. Reg. § 1.707-1 (c), example (3) (1956).
in capital gains (his distributive share). The guaranteed payment must be paid out of the ordinary income of the partnership for tax purposes. It has been suggested that where it is known in advance that a partnership will receive substantial amounts of special income (e.g., capital gains), the partners may prefer to designate less as guaranteed payments and more as distributive share in order to share the resultant tax incidence more equally.

The reporting of a guaranteed payment as an item of gross income by the recipient partner may present an interesting problem when the computation of the partner’s gross income is important for the purposes of some other provision of the code. For instance, section 6501(e) extends the statute of limitation for assessment and collection from three years to six years if the taxpayer fails to report in his gross an amount which is in excess of twenty-five per cent of the amount of gross income stated in his return. Section 702(c) provides that where it is necessary to determine the gross income of a partner for tax purposes such amount shall include his distributive share of the partnership’s gross income. Since the partnership’s gross income must be computed without deducting guaranteed payments as an expense, there will be an obvious overlap in reporting the guaranteed payment in the partner’s gross income. First, the guaranteed payment will be included in the partner’s gross income as salary under 707(c), and secondly, part of the guaranteed payment will be included in the partner’s gross income as his distributive share of the partnership gross income under 702(c). This double exposure of a guaranteed payment might in some instances exaggerate a partner’s gross income to the extent that the understatement or exclusion of non-partnership items of gross income will not exceed twenty-five per cent as required for section 6501(e) to take effect. An amend-

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78 See Treas. Reg. § 1.707-1(c), example (4) (1956).
80 For a general discussion of this problem, see Willis, Partnership Taxation, § 11.05 (1957).
81 Int. Rev. Code of 1954, § 6101(e). Treas. Reg. § 1.702-1(c) lists several instances where it is necessary for a partner to include his distributive share of partnership gross income in the computation of his personal gross income.
82 Int. Rev. Code of 1954, § 702(c). It should be recognized that a partner’s distributive share of the partnership gross income must be substituted for the amount reported in his return as his distributive share of partnership income and loss in order to obtain the true amount of gross income stated in his return.
83 For illustration, assume that partner A fails to report on his tax return $2000 of dividend income from sources unrelated to the partnership business. The Service requires him to calculate his gross income for the purposes of § 6101(e). The partnership has a gross income of $10,000 before deducting a salary payment of $6000 to A. In determining the stated gross income in his return, A will include $6000 as a salary payment under § 707(c) and $5000 as his distributive share of the partnership gross income under § 702(c). The
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ment to section 702(c) has been proposed in order to remedy this situation. Nevertheless, at the present time, the code does not contain an answer to the problem. Therefore, it appears that until there is legislative action, the courts will have the burden of finding an equitable and yet justifiable solution when the problem arises.

Section 707(c) of the 1954 Code is the statutory implementation of the view that a partner may deal with the partnership as an unrelated third person. This view removes the unrealistic treatment that was provided under prior law. As a result, salary and interest payments made to a partner are now deductible expenses in determining the partnership taxable income. The guaranteed payments are subject only to the requirement that they must be made without regard to the income of the partnership. In this respect, the partnership agreement should clearly spell out the guaranteed salaries of the partners independent of the amount of partnership income received.

The partners should be forewarned of the consequences of a guaranteed payment in the case where there is not sufficient ordinary income to cover the salaries or where there is a considerable amount of special income received by the partnership. The incidents related to the tax treatment of guaranteed payments may affect the tax positions of partners other than the recipient. Nevertheless, careful tax planning can avoid the unintended consequences connected with guaranteed payments.

total of $11,000 that A reports from partnership sources exceeds the actual gross income of the partnership. Since A's gross income, as stated in his return, will be $11,000 ($6000 salary plus $5000 distributive share of partnership gross income), the $2000 understatement of gross income will not exceed twenty-five percent as required by § 6101(e). Thus, the exaggeration of A's gross income, brought about by the interplay of § 707(c) and §702(c), is actually beneficial to the taxpayer and prejudicial to the Commissioner's case.

See Hearings Before the House Committee on Ways and Means on Advisory Group Recommendations on Subchapters C, J, K, 86th Cong., 1st Sess. 31 (1959). The proposed amendment made it clear that the amount included in the partner's gross income computation under § 702(c) would be his distributive share of the partnership gross income in excess of his guaranteed payment included under § 707(c). The House adopted an amendment to § 702(c) in H.R. 9662, 86th Cong., 2d Sess. (1960) which varied in wording from the proposal of the advisory group, but nevertheless, obtained the same consequences. Although the bill passed the House in 1960, it died when the Senate failed to act on it. See also Anderson & Coffee, Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K, 11 TAX L. REV. 285, 297-300 (1960) for a discussion of the proposed change in § 702(c). The article questions the results that would be obtained through the application of the proposal by the advisory group.

It should be noted that the Tax Court has held that the substance of a transaction rather than its form must govern in determining whether there is a guaranteed payment under § 707(c). F. A. Falconer, 40 T.C. 1011 (1963).

See notes 76 and 79 supra and accompanying text.

CONCLUSION

The Internal Revenue Code of 1954 represents a compromise between the aggregate and entity approaches of partnership taxation. Under the general rules of those provisions pertaining to the determination of a partner's distributive share, the draftsmen of the code adopted the entity approach. However, as an alternative to the general provisions, the partners are allowed to divide specific items of income and loss under the aggregate approach of partnerships. These alternative provisions seem to acknowledge that partners may often need to divide specific items of income or loss in a special manner in order to reflect accurately the equities and economic realities surrounding such items. However, it should be emphasized again that to take advantage of the alternative provisions, the partners must expressly elect to make such allocations in the partnership agreement.

The special allocation privilege of sections 704(b), 704(c), and 707(c) can perhaps be utilized in every conceivable type of partnership arrangement, both to reap benefits and to avoid hardships. Although the careful draftsman should certainly stay within the tax-avoidance limitation in a section 704(b) allocation, he should not fear that a special allocation will be accorded unfavorable tax consequences merely because it would result in tax savings. As long as the allocation correctly reflects the surrounding economic and business realities, the tax consequences can and should mirror the express terms of the allocation agreement. Provided that the tax planner stays within the statutory boundaries, he is limited only by his own ingenuity and imagination.