PARTNERSHIP CAPITAL ACCOUNTS AND THEIR DISCONTENTS

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Over the last twenty years or so, business persons investing through entities such as limited liability companies that are taxed as partnerships have undoubtedly become used to agreements that include elaborate provisions designed to comply with Treasury Regulations governing the allocation of partnership income and loss.[1] The provisions are almost comical in their intricacy. In their full glory, they include long definitions of profits and loss, book income and tax income, capital accounts and adjusted capital accounts; paraphrases of the relevant regulations highlighting technical terms such as qualified income offsets, two varieties of minimum gain chargebacks, two varieties of allocation of deductions attributable to nonrecourse debt, loss limitations and gross income allocations; precatory statements that the paraphrases be interpreted consistently with the regulations they are paraphrasing; curative allocations that provide that all preceding allocations, having been carefully made, be unmade as quickly as possible; and a final provision stating that in the year of liquidation, to the extent possible, all errors in the preceding making and unmaking of allocations be undone so that the business deal is respected. All of these provisions tend to be "boilerplate," unchanged from document to document, and taken for granted, barely skimmed by the average business person or, truth be told, even by the average tax lawyer. Often, the boilerplate provisions are preceded by transaction-specific provisions

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1. Treas. Reg. §§ 1.704-1(b) (as amended 2005); 1.704-2 (as amended 2005). All references to Code sections are to sections of the Internal Revenue Code of 1986, as amended, and references to Treas. Reg. sections are to sections of the regulations issued under the Code.

which do tend to be considered carefully, at least by tax lawyers. There is a growing trend, however, to avoid the difficulties and potential for error of devising allocations to reflect specific transactions. Instead, agreements include "targeting" or "tracking" allocations. These allocations use technical vocabulary to instruct the accountants to allocate income and loss at the end of every taxable year so that each partner's capital account balance equals the amount that would be distributed to the partner if the partnership sold its assets for their book value and liquidated. Such allocations automatically comply with the Treasury Regulations and can be identical in each document. The result is a three to four page, single spaced tax section that is impressive, impenetrable and which generally need not be read.

The development of standardized tax allocations is not all evil. The capital account system was designed with the worthy goal of relating tax allocations to the underlying risks and benefits of business transactions. The boilerplate usually causes the system to work properly. Standard forms are efficient; it is neither cost nor time-effective to reinvent the system each time a document is drafted. The danger, however, is that the system and its impressive boilerplate may be accepted as immutable, with two opposite but equally unfortunate consequences. Business persons may give primacy to the dictates of the system, modifying their transactions to fit the system and the boilerplate. This is not necessarily the most rational way to maximize profits or to allocate capital in the economy. Alternatively, business people may decide to go ahead with their predetermined business plans and ignore the system, which may result in unexpected and unpleasant tax consequences. Accepting the capital account system blindly is dangerous, because though it often does work well, it is a based on a couple of factually erroneous assumptions. As in logic and morality, a tax system built on false premises may lead to imperfect conclusions.

This article begins with a simplified description of the capital account system as it applies to unleveraged transactions. It focuses on the purposes and assumptions of the system, rather than on its technical details. It then considers two situations, neither tax motivated, in which those assumptions have the problematic result of causing recognitions of income that do not correlate with current entitlements to cash. Separating taxable income from current cash flow is pernicious in two ways. It can be exploited to create tax shelters by routing phantom income to persons who are not tax sensitive and sheltered cash to persons subject to high tax rates. Additionally, it can impede legitimate business transactions by requiring the raising of additional capital to fund artificial tax liabilities. The article first considers the treatment of partners that receive a disproportionate share of profits. This problem appeared to have been solved as a practical matter until the Internal Revenue Service ("IRS") reopened the issue in recently issued proposed regulations.[2] Second, it considers situations in which providing contributors of capital with minimum returns results in "capital shifts." These situations are less well understood and harder to resolve; recently issued proposed regulations on noncompensatory options acknowledge the problem, but do not quite resolve it.[3] The article does not recommend means to perfect or replace the capital account system, but merely suggests the importance of being sensitive to the system's real world implications.

I.
Capital Accounts

The capital account system was initially devised to combat the tax shelters of the early eighties. Its basic idea was to allow tax losses, at least as long as they were funded by equity, only to persons that were at risk should the tax losses turn out to be real. That idea was implemented by drawing on accounting conventions under which a partner's interest in a partnership was represented by the partner's capital account balance, much as stockholders' interest in a corporation is represented by the equity line in a balance sheet. The capital accounts were given economic significance by governing the partners' rights to distributions on an immediate liquidation. The partners' initial capital account balances equaled the value of their contributions to the partnership. Allocations of taxable losses to a partner would decrease that partner's capital account bal-

2. Prop. Treas. Reg. §§ 1.83-3; 1.83-6; 1.704-1; 1.706-3; 1.707-1; 1.721-1; 1.761-1; 70 Fed. Reg. 29675 (May 24, 2005).

3. Prop. Treas. Reg. §§ REG-103580-02, issued 1/22/2003 and proposing amendments or additions to Treasury Regulations under Code sections 704, 721, 761, 1272, 1273 and 1275.

ances, thereby decreasing that partner's rights to liquidation proceeds. For example, if partners A and B each contributed $100 to a partnership, their opening capital account balances would be $100 each. If the partnership then acquired an asset with a basis of $200 and had depreciation of $100, it would be permissible to allocate the entire amount of the depreciation to A if and only if the depreciation reduced A's capital account to zero. If the asset were sold for its depreciated value of $100, the entire $100 would be distributed to B and A would not receive any distributions. Thus A took the risk of suffering the economic loss, should the tax loss prove to be real. In an unleveraged partnership, deductions that drove a partner's capital account negative would be permitted only if the partner receiving the deduction undertook to contribute to the partnership any negative balance in its account on liquidation. Thus, in the prior example, A could be allocated an additional $50 of depreciation, bringing capital accounts to negative $50 for A and $100 for B, only if on a sale of the property for its depreciated value of $50, A would contribute 50 to the partnership, so that the partnership would be able to distribute to B its entire $100 capital account balance. Symmetrically, allocations of income to a partner are valid if they increase the partner's capital account balance and thus increase the partner's entitlement to liquidation proceeds.[4] Because of the reg-

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4. More formally, the capital account system represents a safe harbor for insuring that a partnership's allocation of income, gain, loss and deduction is respected. A partnership may ignore the safe harbor, at the cost of having the validity of its allocations tested under the deliberately vague test of whether the allocation accords with the partners' interest in the partnership under all the facts and circumstances. Treas. Reg. § 1.704-1(b)(3) (as amended in 1987). Under the safe harbor, a partnership's allocation is respected if the allocation has "substantial economic effect," or, in the case of certain allocations (e.g., allocations of deductions attributable to nonrecourse debt) that cannot satisfy the substantial economic effect test, if those allocations are contained in partnerships which satisfy the substantial economic effect test to the extent possible and also satisfy other specific rules. Treas. Reg. §§ 1.704-1(b)(1)(i) (as amended in 1991); 1.704-1(b)(4)(ii) (2003); 1.704-2(b)(1) (1991). An allocation has "substantial economic effect" if the allocation has "economic effect" and the effect is substantial. Treas. Reg. § 1.704-1(b)(2)(ii)(a) (as amended in 1986).

A partnership allocation has economic effect if (i) the partnership maintains capital accounts in a prescribed fashion, so that, generally, each partner's capital account is increased by the amount of cash and the net fair market value of any property contributed by the partner to the partnership ulations' genesis in combating tax shelters, far less attention

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and by any income or gain allocated to the partner and decreased by the amount of cash and the net fair market value of any property distributed by the partnership to the partner and the amount of loss and deduction allocated to the partner, Treas. Reg. § 1.704-1(b)(2)(iv)(b) (as amended in 2005), (ii) upon liquidation of the partnership, liquidating distributions are effected in accordance with capital account balances and (iii) if any partner has a deficit balance in his capital account after receiving its liquidating distributions, the partner is unconditionally obligated to restore any deficit balance in his capital account, which amount is to be paid to creditors or distributed to other partners. Treas. Reg. § 1.704-1(b)(2)(ii)(b) (as amended in 1986). In recognition of the reality that most partners would not be willing to undertake unlimited deficit restoration obligations, the regulations provided an alternate test for "economic effect." Treas. Reg. § 1.704-1(b)(2)(ii)(d) (as amended in 1992). Under that alternate test, an allocation will have economic effect even if the requirement to restore deficit capital account balances is not met, if it properly maintains capital accounts and effects distributions in accordance with capital accounts, but only to the extent the allocation does not cause or increase a deficit capital account balance in excess of any limited obligation to restore deficit balances in a partner's capital account and only if the partnership agreement contains a "qualified income offset" provision. The extent to which an allocation causes an impermissible deficit capital account balance is determined by assuming that the fair market value of partnership property is its book value. (Book value equals adjusted tax basis except that it is computed with respect to the fair market value at contribution of contributed property and to the fair market value of property held by the partnership at the time of certain "revaluation" events. Treas. Reg. § 1.704-1(b)(2)(iv)(f) (as amended in 2004), Treas. Reg. § 1.704-1(b)(2)(iv)(g) (2002).) The qualified income offset provision requires that a partner's capital account be reduced by certain amounts, including expected distribution during the year in excess of expected income allocations for the year. Treas. Reg. § 1.704-1(b)(2)(iv)(f) (as amended in 2004); Treas. Reg. § 1.704-1(b)(2)(iv)(g) (2002). In addition, to the extent certain unexpected distributions and certain other events would cause the partner's capital account to have a deficit balance in excess of that permitted amount, the partner must be allocated items of income and gain to offset that deficit as quickly as possible. Treas. Reg. § 1.704-1(b)(2)(iv)(f) (as amended in 2004); Treas. Reg. § 1.704-1(b)(2)(iv)(g) (2002).

An allocation that has economic effect, will have "substantial" economic effect "if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership." Treas. Reg. § 1.704-1(b)(2)(iii)(a) (as amended in 2004). Thus, under three anti-abuse rules, an allocation is not substantial if it reduces the aggregate tax liability of the partners and its economic effect is likely to be undone by offsetting allocations in the same or within the five succeeding years, or if the economic effect is less than its tax effect (on a present value basis). *Id.* The last, most general, anti-abuse test is discussed in the next footnote.

has been paid to problems related to the allocation of income than to those related to allocation of losses. This article focuses on issues related to allocations of income.

The capital account system departs from reality in two ways. First, it focuses on the consequences of a hypothetical immediate liquidation. While business people in planning transactions focus on likely exit strategies, they usually do not plan to liquidate immediately or at every year end when taxable income is allocated. Thus, under the capital account system, immediate tax consequences are governed by economic consequences that may be delayed indefinitely and whose timing is in the control of the partners. In other words, the capital account system ignores the time value of money. As applied to allocation of deductions, this leaves open (and indeed facilitates) the development of tax shelters.[5] As applied to al-

5. Shortly after the capital account regulations were issued, tax shelters appeared in which a profitable corporation formed a partnership with a corporation that had tax losses. The partnership would allocate its taxable income to the loss corporation and distribute its cash to the profitable corporation. The loss entity built up a large capital account balance and the partnership would ultimately distribute that balance to the loss entity, but only after several decades, so that the present value of the profitable corporation's tax savings far outweighed the present value of the cash that would ultimately be paid to the loss corporation. The IRS countered by adding an anti-abuse provision that attempted to take into account the time value of money. It provides that, taking into account the tax attributes of the partners, the economic effect of an allocation is not substantial if "at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation . . . were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation . . . were not contained in the partnership agreement." *Id.* This rule is of doubtful efficacy because it relies on comparing the actual allocations in the partnership agreement to some "normative" allocations that should govern. The comparison can be readily made if the taxpayer cooperates, as it does in the regulatory example, by blatantly superimposing tax motivated allocations on clear economic allocations. Treas. Reg. § 1.704-1(b)(5) (as amended in 2005). The IRS attempted to apply the rule to a tax shelter transaction in TIFD III-E Inc. v. United States, 342 F. Supp. 2d 94, 117-21 (D. Conn. 2004). It argued that the partnership's actual allocations should be compared to an allocation of income and loss in accordance with percentage of capital contributions. The court rejected that position, noting that there was no reason to treat percentage of capital contribution as a standard against which the partnership's actual allocations should be

locations of income, legitimate business transactions may be impeded by the requirement that income be allocated currently to reflect some hypothetical future (and potentially long deferred) entitlement to distributions.

Second, the capital account system assumes that the fair market value of property is equal to its book basis. When the system was first devised, the assumption was needed because depreciation was computed under the accelerated cost recovery system, a system that intentionally provided for depreciation in excess of economic depreciation. If actual fair market values were considered, the rationale of allocating tax losses to the partner that potentially bore the economic loss would run into the reality that there was no economic loss. The assumption, however, is contrary to all parties' business expectations, because no person enters into an enterprise assuming that there will be no appreciation or profits. Furthermore, it makes giving partners cash entitlements, which the parties reasonably expect will be satisfied out of future profits, problematic.

The assumption that a property's fair market value equals its book basis is mitigated by permitting partnership assets to be "marked to market" on most contributions of cash or property in exchange for a partnership interest, on most distributions of cash or property in redemption of a partnership interest, and on the liquidation of the partnership.[6] On these occasions, the partnership may treat all of its assets as being sold for their fair market value with the resulting gain or loss being allocated to the partners. The reasons for permitting a mark to market are straightforward. Assume two partners, A and B contribute $100 each to a partnership and the partnership acquires an asset for $200 that appreciates to $400. New partner C would be required to contribute $200 for a 33.33% partnership interest. If capital accounts were not marked to market, A and B would each have $100 capital accounts and C a $200

judged. *Id.* at 118. On November 18, 2005, the IRS issued proposed regulations that specified that a partnership's allocation should be compared to that which would govern if the partnership allocated is allocations in accordance with the partners' interests in the partnership. Prop, Treas. Reg. §1.704-1(b)(2)(iii)(a)(1). This attempted clarification is not too helpful, because it essentially rephrases the issue of determining the "normative" allocation without making it any easier to determine it.

6. Treas. Reg. § 1.704-1(b)(2)(iv)(b) (as amended in 2005).

capital account, entitling C to more than its true share of proceeds in a liquidation. The mark to market permits A and B to increase their capital account by $100 each to reflect the unrealized gain of $200, so that all partners correctly have equal capital accounts of $200 each.[7] Allowing unlimited marking to market would solve many of the problems with the capital account system. However, it would also open the door to valuation disputes and abusive tax schemes, and for this reason the right to mark to market is strictly limited.

II.
PROFITS INTERESTS

Partnership profits interests allow a partner to receive a share of profits disproportionate to the partner's share of capital. There are two common forms of profits interests. First, in the typical private equity fund or hedge fund, investors (limited partners or non-managing limited liability company members) will contribute 99% of the fund's capital, and its sponsor (general partner or managing member) will contribute 1% of the capital. The capital partners (including the sponsor) are entitled to the return of their capital plus, at times, some preferred return. If there is a preferred return, the sponsor is often entitled to catch-up distributions, typically 50%, 80% or 100% of all distributions until the sponsor has received 20% of all distributed profits. Thereafter, 80% of the distributions are made to the investor capital partners and 20% to the sponsor. The sponsor, in effect, is entitled, in addition to whatever entitlement it has as a contributor of capital, to 20% of net profits. A second example of a profits interest is an interest that is given to the management of a limited liability company and is analogous to the grant of restricted stock or options in a corporation. For example, a CEO may be entitled to 3% of all distributions after the owners of the entity have received distributions aggregating some pre-determined amount, typically the return of their capital plus a specified return on that capital.

Both kinds of profits interests raise similar issues. The first issue is whether the grant of the profits interests should be

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7. I.R.C. § 704(c) (2004) and related tax regulations provide complex rules for dealing with the resulting difference between book and tax bases. These rules are not discussed here.

viewed as taxable compensation to the recipient. Under both general principles and under Code section 83, which governs the treatment of property transferred in connection with services, the answer is clearly yes. The recipient has received valuable property and there is no doctrine that states that payments in kind are not income. The capital account system, however, focuses solely on entitlements to liquidation, and profits interests, by definition, have no entitlement on an immediate liquidation. After much confusion and litigation,[8] the anomaly appeared to be resolved in a taxpayer favorable manner through two Revenue Procedures: Revenue Procedure 93-27, 1993-2 C.B. 343 and Revenue Procedure 2001-43, 2001-2 C.B. 191. Under those procedures, subject to exceptions for profits interests disposed of within two years, profits interests in publicly traded partnerships, and profits interests in partnerships with predictable cash flows, the recipient of a profits interest need not recognize income. The result, while economically wrong, was not unreasonable as a policy matter. Partnership interests generally cannot be amortized. Thus if the recipient of a profits interest had to recognize income on receipt equal to the present value of expected cash flows, the recipient would have to recognize the same income again as the income was earned. On liquidation of the partnership, the recipient would have a capital loss equal to the ordinary income it had originally recognized. This was an unfair result because capital losses cannot offset ordinary income and because individuals cannot carry back capital losses.

However, on May 24, 2005, Treasury and the Internal Revenue Service issued proposed regulations on the grant of partnership interests in connection with services, trying to reconcile the partnership rules with Code section 83. Code section 83 is very clear that property cannot be valued on a liquidation basis.[9] As a result, maintaining the capital account system and

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8. *See* Diamond v. Comm'r, 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974); Campbell v. Comm'r, 59 T.C.M. (CCH) 236, 253 (1990), *aff'd in part and rev'd in part*, 943 F.2d 815, 823 (8th Cir. 1991) (reversing the Tax Court decision that the taxpayer should have included the receipt of profit interests in ordinary income in the year of receipt).

9. Treas. Reg. § 1.83-7(b)(3) (1978) ("[T]he fair market value of an option is not merely the difference . . . between the option's exercise price and the value of the property subject to the option . . . ").

following Code section 83 is impossible.[10] The issued regulations, while reopening what seemed to be a settled area, do not perform the impossible. Instead, after bowing to Code section 83 by declaring that the receipt of any partnership interest is taxable, the regulations offer taxpayers an election to value profits interests at liquidation value. The terms of the election are administratively onerous - every partner must somehow be bound by the election. Electing partnerships must also include special allocation provisions that specify the tax treatment of the income allocated and cash distributed to holders of profits interests who ultimately forfeit those interests. If the election is properly made, the regime of the Revenue Procedures is re-established, with the IRS having marginally greater assurance that no partner will claim a deduction for income not recognized by the recipient of the profits interest - a small gain for the administrative nuisances involved.

More tellingly, the proposed regulations do not explain how capital accounts are to be adjusted if the election is not properly made, either because a taxpayer could not satisfy the onerous requirements, chose not to, or was not aware of the election. In that case the interest recipient will have income and will have a capital account equal to the income it recognized. For example, assume that investors to a hedge fund contribute $100 and that the value of the sponsor's 20% profits interest is $8. The investors' capital account balances equal $100 and the sponsor's is $8. The partnership only has $100 of cash to distribute on a hypothetical liquidation, so there must be some reconciling entries. If the $8 deemed paid to the sponsor is deductible, it would be tempting to allocate the deduction to the sponsor, bringing his capital account back to zero. That, of course, would have the same effect as if the partnership had made the election or if the Revenue Procedures had been left in force. It is not clear that the allocation would be valid.[11] In addition, the payment of the $8 may not be de-

10. Of course, it is not literally impossible. One can solve any capital account problem with sufficient regulatory complications. For example, one can move the problem up a subsection by dictating that the recipient of the profits interest take a zero capital account and account for the difference between basis and capital account balance under Code section 704(c). I.R.C. § 704(c) (2004).

11. The better answer is to allocate the deduction attributable to the grant of a partnership interest to a service provider to the partners other

ductible (e.g., because it represents syndication costs) or it may be deductible only over time (e.g., because it represents organizational costs or start up costs deductible only over fifteen years[12]). Amounts that are never deductible may, under a special rule, be used to reduce capital accounts balances.[13] If the amount is deductible over time, it could be allocated to the sponsor over time.

However, it is not clear that it is permissible to leave the sponsor with a positive capital account balance and have it reduced over time. The capital account system looks to the effect of an immediate liquidation. Under the capital shift theory discussed in the next section, there has been a capital shift of \$8 from the sponsor to the other partners because the sponsor is not entitled to \$8 on an immediate liquidation. Arguably, this capital shift gives the other partners some kind of income and the sponsor some kind of expense that may or may not be currently deductible. There is opportunity here for multiple taxation of a single transaction. First, the sponsor has income of \$8 and the partnership has an offsetting deduction of \$8 which may be capitalized or disallowed. Later, the other partners have capital shift income of \$8 and the sponsor has an offsetting deduction of \$8 which may also be capitalized or disallowed. It is unlikely that the IRS is seeking to benefit the fisc in this complicated a fashion. Rather, it is probably hoping that taxpayers will make the liquidation value election. But if that is the hope, the IRS could certainly make the election procedure less onerous.[14]

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than the service provider. That is clearly correct if the service provider receives a capital interest. For example, assume partners with capital account balances aggregating 100 transfer a 10% interest in the partnership to service provider A. A has income and a capital account of 10. The partnership has a deduction of 10 which it allocates to the pre-existing partners, bringing their capital accounts down to 90, resulting in aggregate capital accounts of 100. Allocating the compensation to an incoming service provider is arguably a retroactive allocation that is invalid under I.R.C. § 706 (2005). However, if the service provider is already a partner (as can be arranged), then I.R.C. § 761(c) (2005) may apply and permit the retroactive allocation.

12. I.R.C. §§ 195, 709 (2005).

13. Amounts that are never deductible are I.R.C. § 705(a)(2)(B) (1984) amounts, which may be allocated to partners and reduce their capital account balances. Treas. Reg. § 1.704-1(b)(2)(iv)(b) (as amended in 2005).

14. The treatment of the grant of profits interests is further complicated by Congress' enactment of I.R.C. § 409A (2005) which governs deferred

The second widely recognized issue raised by the issuance of profits interests is the potential divorce between income allocation and cash distribution. This issue arises most often with private equity funds or hedge funds. For example, assume that limited partners have contributed $100, there is no preferred return, and the general partner has not contributed any capital, but is entitled to 20% of all profits. Assume further that the fund acquires 10 properties for $10 each and sells one property for $20. If, as is common, all distributions are made to the limited partners until they have recovered their capital, the entire $20 will be distributed to the limited partners. The partnership has income of $10 and the capital account system requires that $8 be allocated to the limited partners and $2 to the general partner. The rationale is that in a hypothetical liquidation of the partnership in which the partnership sold all of its remaining assets for their book values and then liquidated in accordance with capital accounts, the general partner would be entitled to $2 (20% of the $10 profit). Opening capital accounts are $100 limited partner/$0 general partner. The distribution of $20 to the limited partner reduces the capital accounts to $80/$0. If the $10 of gain is allocated $8/$2, capital accounts would then be $88/$2. If the remaining assets were sold for their book value of $90, $80 would be distributed to the limited partners as a return of capital and the remaining $10 would be distributed $8/ $2, so that the limited partners would receive $88 and the general partners $2. If, instead, the $10 of gain were allocated to the limited partners as the persons receiving the immediate cash, capital account balances would be $90/$10. As a result, a distribution to the partners in accordance with the business deal ($88/$2) would violate the capital account system rule that liquidating distributions be effected in accordance with capital accounts.

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compensation generally. The IRS stated that until additional guidance is issued, taxpayers may treat the issuance of a profits interest that does not result in the inclusion of income as also not resulting in the deferral of compensation. I.R.S. Notice 2005-1, I.R.B. 279 (Jan. 10, 2005). Proposed regulations, released at the end of September 2005, reserve on the treatment of partners and partnerships. Prop. Treas. Reg. § 1.409-A1, *et seq.*, 70 Fed. Reg. 57930 (Oct. 4, 2005). This article does not consider the effect of I.R.C. § 409A (2005) further, but guidance under that section could have a significant impact on profits interests.

General partners usually resist the allocations of phantom income, i.e., income without corresponding cash, even if they understand that they will be entitled to the cash after eight to ten years when the fund liquidates. There are a number of standard solutions to this problem. Some partnerships allocate the $10 of income to the limited partners, distribute in accordance with capital accounts, and hope that there will be enough items of income and loss on liquidation to achieve the right capital account balances. Some partnerships take that position, but reduce the resulting business risk by providing that if the general partner's capital account has not reached its proper limit, the general partner will be paid a fee or a guaranteed payment to make it whole. This ensures that the general partner will get the right liquidating payment. However, such a structure may turn some of the capital gains realized by the partnership into ordinary income. Moreover, it is not at all clear that this position satisfies the capital account system.

Other partnerships return capital on an investment by investment basis, which solves this problem. Those partnerships sometimes have "clawbacks" which provide that the general partner will return amounts it receives if it turns out, because the partnership has sold its "winners" before it sold its "losers," that the general partner has received more than the 20% of profits to which it is entitled. Limited partners may resist that solution for non-tax reasons. The most common solution is to provide the general partner with distributions, referred to as "tax distributions," sufficient to enable the general partner to pay its taxes. The tax distributions ultimately reduce the distributions to which the general partner will be entitled. If all the partners are roughly equally taxable, this solution provides rough justice. Unlike the capital shifts discussed in the next section, this aspect of the capital account system does not create new income, but simply dictates the allocation of income that has already been recognized by the partnership. If the income were allocated to the limited partners, they would have to pay tax on it; instead they allocate the income to the general partner and distribute the money they would have paid in taxes to the general partner as well. The solution is not perfect. If the profit allocated to the general partner is later offset by losses, the general partner may be reluctant to give back to the limited partners any tax savings generated by the losses. Additionally, because the losses are likely to be capital losses, they may not generate a tax savings equal to the tax distributions. If the limited partners are tax-exempt and the general partner is not, which is fairly common, the tax distributions are a net cost to the partners. However, it would be somewhat unseemly for the general partner to complain that it cannot efficiently take advantage of the tax-exempt nature of its partners. Overall, the tax distribution system works fairly well.

Generally, the fact that the capital account system does not deal effectively with profits interests has caused more theoretical than practical problems. The anomalies are either taxpayer favorable or are well enough understood that, with a minimum of care, they can be planned around. There is some risk that the IRS, in seeking to solve the theoretical problems raised by profits interests, will create practical problems. Therefore, the fate of the proposed regulations on the compensatory grant of partnership interests should be watched carefully. The next section discusses capital shifts, an area that is less well understood and thus more likely to cause unexpected problems.

III.
CAPITAL SHIFTS

The basic capital shift can be illustrated by considering a common form of real estate partnership. A real estate developer and a number of passive investors join forces to purchase a building. The developer contributes $200 and the investors $800 to a partnership which acquires the building for $1000. The opening capital accounts are $800 for the investors and $200 for the developer. The investors are more risk averse than the developer and wish to assure themselves of at least the return of their capital and some minimum return on capital, say 8%. The developer, who will be managing the building for a fee, is more confident and expects to create significant value in five years. The parties agree that on the sale of the building, $1120 of the proceeds will be distributed to the investors (return of capital and 8% simple interest), then $200 to the developer, and the remaining proceeds will be split 50/50 between the investors and the developer. The investors may force a sale of the building and the liquidation of the partnership at any time after five years have elapsed. Before that time, a sale of the building requires the unanimous consent of the partners. There is not expected to be significant cash flow during the first five years that the partnership owns the building, but whatever cash flow is not reinvested in the building will be divided 50% to the investors and 50% to the developer.

If the partnership sold the building for its book value ($1000) and liquidated immediately after its formation, the investors would be entitled to the entire $1000. If capital account balances are supposed to represent distribution entitlements on liquidation, then should not the investors' capital accounts be immediately marked up to $1000 and the developer's capital account reduced to 0? If so, does this mean that $200 of capital has shifted (the source of the term "capital shift") from the developer to the investors, that the investors have had an immediate accession of wealth and that they should immediately recognize $200 of income? There is surprisingly little authority on this issue.[15] The better answer on general principles would appear to be no. There is no Code or regulatory provision mandating this result in a noncompensatory context and, as a factual matter, the investors have not had an accession to wealth. The developer and the investors have agreed at arms' length on the capital contributions that entitle each of them to their interests, and their valuations should be respected. If any interest has been misvalued, the developer's interest may be worth more than $200 because the developer may be receiving some compensation for services; there is no economic reason for the investors' interests to be worth more than $800. Conceivably, the investors could be viewed as selling 30% of their interests in future profits for $200 and as being required to include the $200 in income under an assignment of income theory. That would be the correct analysis if some third party (or the developer) paid them $200 in cash for the income interest and they either retained the cash or contributed the cash to the partnership, increasing their capital account and the value of the partnership's assets. But that is not what happened. All the investors have actually received is the right to the developer's capital at some time in the future (a time the developer has the right to defer for at least five years) in the event that the partnership cannot sell its property for at least $1320, an amount sufficient

15. TAX NOTES Article at 599 n.14.

to pay the investors their $1120 and to allow the developer to recoup his $200. A contingent right to $200 in five or more years cannot be worth $200.

The strongest technical argument for ascribing income to the investors, at least if the partnership is an accrual basis partnership, is to analogize their right to a Code section 707(c) guaranteed payment for the use of capital. If the partnership agreement between the investors and developer provided the investors an 8% annual preferred return for the use of capital, payable regardless of the partnership's income, then it is likely that the investors would have an annual income inclusion of 8% at such time as the partnership could deduct or capitalize the payment (i.e., at the time the return was paid in the case of a cash basis partnership or at the time the return accrued in the case of an accrual basis partnership). While the treatment of guaranteed payments is surprisingly unclear,[16] there seems to be no requirement that a guaranteed payment be paid currently or be expressed as an annual amount. If the investors' entire liquidation entitlement in excess of contributed capital of $320 were treated as a guaranteed payment, the cash flows to the developers and the partners would correspond to the business understanding. If the guaranteed payment were deductible by the partnership, under the usual capital account loss allocation rules, the first $200 of the deduction would be allocated to the developer because the developer had subordinated its return of capital to the investors' return of capital and thus bore the first risk of loss. Once the developer's capital account were zero, the remaining $120 deduction would be allocated to the investors, offsetting $120 of their $320 of ordinary income and reducing their capital account to $680. The guaranteed payment would be considered a partnership liability, reducing the partnership's equity to $680. Upon liquidation, $680 would be distributed to the investor and $0 to the developer in accordance with the capital accounts. In addition, the investors would be entitled to their guaranteed payment of $320, yielding a total of $1000. The net result, $200 of ordinary income and cash payments and distributions totaling $1000 to the investors, is the same as the result of a capital shift. If the guaranteed payment had to be capitalized, the re-

16. Sheldon I. Banoff, *Guaranteed Payments for the Use of Capital: Schizophrenia in Subchapter K*, 70 TAXES 820 (1992).

sults would not be precisely equivalent to the results of a capital shift, but the cash flows would be the same. The investors would have $320 of ordinary income and the partnership property's basis would increase to $1320. If the partnership's property were sold for $1320, there would be no additional gain or loss; $320 would be distributed to the investors as a guaranteed payment, and in accordance with their capital account balances, $800 would go to the investors and $200 to the developer. If the property were sold for $1,000, there would be a loss of $320, which would be allocated $200 to the developer and $120 to the investors, thus reducing the capital accounts to $0 and $680 respectively. The developer would receive zero and the investors would receive $680 with respect to their capital account and $320 as a guaranteed payment, for a total of $1,000.

There are a number of counter-arguments to this approach. First, while the developer and investor could have included guaranteed payments in their agreement, they did not do so. Whether an agreement has any preferred returns and whether the preferred returns consist of allocations of net income, gross income or guaranteed payments is generally elective. The IRS should not be entitled to impose its characterizations of a transaction on the participants. That is hardly a definitive argument, however, because for tax purposes, the parties' labels or lack thereof are never determinative and the IRS can tax a transaction in accordance with its substance. The issue then, must be the substance of the transaction.

A standard partnership treatise states that the touchstone for determining whether a payment is a guaranteed payment or a distribution is whether the payment affects the recipient's capital account,[17] with a guaranteed payment leaving the capital account unaffected. The result of this test, however, is unclear. If, upon actual liquidation, there is enough income to allocate to the investors, their capital accounts will exceed $1120, and the distribution of the $1120 will reduce their capital accounts. If the investors' capital accounts are not high enough, they may receive some payments that will not affect their capital account balances. This will generally be the case if the test is performed immediately or when income is being

17. WILLIAM F. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 13.03[b], (3d ed. 1997)

allocated at the end of the first year. An example in the Treasury Regulations states that if a partner is entitled to 30% of partnership income, but not less than $10,000 and the partnership has $60,000 of net income, no part of the $18,000 allocated to the partner is a guaranteed payment; however, if partnership income were $20,000, $6,000 would be a distributive share of income and $4,000 would be a guaranteed payment.[18] This would suggest that the determination of whether the investors had a guaranteed payment should be deferred to an actual liquidation and that the investors should be treated as receiving a guaranteed payment only to the extent they receive cash beyond their capital account balance, as increased for all allocations of income.

The argument for deferring determination of guaranteed payment status until liquidation is further supported by policy considerations. Determining the issue at the time the partnership is formed ignores the time value of money and requires the investors to accrue what is probably five years' yield in one year. If the investors had purchased corporate preferred stock with an equivalent redemption premium of $320, they would, at worst, be required to recognize the premium over the expected life of the preferred stock.[19] Indeed, because the preferred stock would have a non-illusory participation of 50% of all profits, the stock would not be considered "preferred stock" under Code section 305 and the investors would not have to recognize the premium at all until payment.[20] Similarly, if the investors purchased a debt instrument with a face value of $1120 at a discount for $800, they would only be required to recognize the discount over time. The participation feature of the debt would turn it into a contingent payment debt instrument, so that the investors would also be required to recognize to recognize their expected 50% profit over time.[21] Policy arguments, of course, are not determinative.

Finally, Treasury Regulations explicitly provide that to the extent a partner gives up the right to the return of its capital as compensation for services rendered, that transfer is to be

18. Treas. Reg. § 1.708-1(c), 489 (2001).

19. Treas. Reg. § 305.771-1 (1984).

20. Treas. Reg. § 1.305-5(a) (1973).

21. Treas. Reg. § 1.1275-4 (as amended in 2004).

treated as a guaranteed payment.[22] The investors have not performed services and there is no counterpart provision involving partners receiving capital as compensation for providing capital. Too much, however, cannot be read into regulatory silence and, indeed, one can argue that the regulation as to services should apply by analogy.

On balance, the better answer is that the investors should not be viewed as having immediate income as a result of a capital shift. One cannot, however, be entirely comfortable with this favorable conclusion, as the stakes are high. If taxed as immediate income, the $200 would be phantom income that is not related to any earnings of the partnership and, therefore, would likely exceed the partnership's annual cash flow. Consequently, there would be no way to fund tax distributions. In effect, in order to make an $800 investment in real estate, the investors would have to make an additional investment equal to the tax on $200. This requirement would discourage the investment and interfere with the economically proper allocation of capital.

The greatest source of risk in the capital shift situation is the fact that the capital account system becomes inapplicable if capital account balances do not reflect liquidation entitlements. Should the partnership be required at year end to allocate its net income and net loss so as to bring its capital account balances in line with liquidation entitlements? Again, the better answer appears to be no. The capital account system is a safe harbor, and a safe harbor is not a requirement. That answer, however, is not at all certain. Outside the safe harbor, the validity of allocations is determined under the partners' interest in the partnership in light of all the facts and circumstances, and there is no clearly valid or invalid allocation. An allocation of income (though probably not loss) of 50% to the investors and 50% to the developer could be justified as in accordance with the distributions of cash flow and the residual allocation of profits. Similarly, an allocation of 80% of income and loss to the investors and 20% to the developer could be justified as being in accordance with capital contributions, and an allocation of 100% of income to the investors could be justified as taking into account their preferred return. Whatever the ultimate outcome in litigation, there can

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22. Treas. Reg. § 1.721-1(b) (as amended in 1996).

be no assurance that an IRS agent would not resolve this uncertainty by seeking to force investors back into adherence with the capital account system.

Requiring the investors to recognize 100% of the partnership net income until their capital accounts reached $1120 would not be so detrimental if the allocation could be limited to the partnership's actual net income and not extended to an allocation of all items of income and deduction (e.g., gross rents, operating expenses, depreciation deductions) that enter into the computation of net income and net loss. An allocation limited to the partnership's actual net income would not create artificial income. Someone needs to be taxed on the partnership's net income in any event and that income is likely to be accompanied by partnership cash, so tax distributions should be available. There is a significant risk, however, that if income and loss are to be allocated to cause the partner's capital to correspond to their liquidation entitlements, partners will be required to allocate items of income and loss. For example, the investors might be allocated $320 of gross rents and the developer might be allocated $200 of depreciation to bring the capital accounts to the right balances with the remaining net income and net loss (calculated without taking into account the specially allocated gross rents and depreciation) being allocated so as to preserve the equality of capital accounts and liquidation entitlements. There is ample precedent in the regulations governing the capital account system for such use of items of income and deduction, such as in the qualified income offset provisions discussed above and in the minimum gain provisions that govern certain allocations in leveraged partnerships. The use of items of net income and net loss would expose the investors to phantom income in excess of the partnership's net income and, thus, probably in excess of the cash available to fund tax distributions. While the developer would have an offsetting loss, the developer might not be able to use the loss and it is quite unlikely that the developer would be willing to contribute its tax savings to the partnership to enable it to fund tax distributions to the investors.

The risk that the investors would be required to recognize income either immediately or at year end so as to conform to the capital account system is increased if the partnership agreement follows normal drafting practices and includes all the boilerplate provisions related to the capital account system. An agent might legitimately ask why all these provisions were included if the partnership did not intend to follow the capital account system's basic principle. Should the partnership agreement include "targeting" or "tracking" allocations, then an allocation of income to the investors would be mandatory. That allocation could be limited to net income or might extend to gross income depending on such subtleties of the drafting as whether the allocation referred simply to "net income and net loss" or, as is common in certain forms, to some variant of "net income and net loss and all items of income, gain, loss and deduction entering into the computation thereof." Capital shifts present one situation in which the casual use of tax boilerplate could prove costly.

The fear that the IRS might force adherence to the capital account system is consistent with the ambivalence the IRS manifested in the recent proposed regulations dealing with noncompensatory options. Both the purchase and the later exercise of an option can be viewed as capital shifts. For example, assume that two partners have formed a partnership by contributing $100 each (so that each has a capital account balance of $100) and that the partnership acquires an asset with a value of $200. Assume that a third person simultaneously contributes $10 in cash in exchange for the right to acquire a 20% interest for $40. If the partnership were to liquidate immediately, the two initial partners would each be entitled to distributions of $105 (representing their initial contribution of $100 and half of the potential partner's $10 option payment). Should these two partners be treated as having income of $5? Assume that the asset appreciates from $200 to $300 and the third partner exercises the option. He has contributed a total of $50 ($10 option purchase price and $40 exercise price) and the partnership now has an asset worth $300 and $50 in cash. On an immediate liquidation, the incoming partner would be entitled to 20% of $350, or $70. Should the new partner have income of $20 on exercise of its option?

The IRS almost agrees that neither the purchase of an option nor its exercise should be a taxable event. Under proposed regulations, the purchase of an option is treated as an open transaction on which neither the partnership nor the partners are required to recognize gain[23] and the contributed option purchase price ($10 in the example) is not reflected in any partner's capital account.[24] On exercise of the option, the proposed regulations require that the partners' capital account be adjusted to their appropriate balances ($140 each for the two initial partners and $70 for the partner exercising its option). If there is sufficient appreciation in the assets (as there is in the example), the partners may mark the partnership assets to market[25] and use the non-taxable mark to market gain to achieve these balances. If there is insufficient mark to market gain, then the appropriate balances must be reached using "corrective allocations" of items of taxable gross income and loss.[26]

The preamble to the proposed regulations explicitly discusses capital shifts. It states that "Some commentators have expressed a concern that [Treasury Regulation 1.721-1(b)] could be read to exclude from the application of section 721 a shift in partnership capital from the historic partners to the holder of the noncompensatory option in satisfaction of the partnership's option obligation upon exercise of the option." It then explains that the capital shift should generally not be a taxable event.[27] The proposed regulations, however, effect a compromise by attempting to reconcile that conclusion with the capital account system. The purchase of an option is not a taxable event. The taxable event is deferred until option exercise and then further deferred (applying Code 704(c) principles) if the facts permit, leaving the threat of "corrective allocations" as a last resort to achieving the desired capital account balances.[28]

The regulations on noncompensatory options are not directly relevant to the capital shift in the real estate example,

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23. Prop. Treas. Reg. § 1.721-2(f), 68 Fed. Reg. 2930-01 (Jan. 22, 2003).

24. The proposed regulations do not specifically make this point because they only specify the accounting on the exercise of the option, but it is implicit in that accounting. *See* Prop. Treas. Reg. § 1.704-1(b)(5), Fed. Reg. 9871-01 (Mar. 9, 1983).

25. Prop. Treas. Reg. § 1.704-1(b)(2)(iv)(s), 68 Fed. Reg. 2930-01 (Jan. 22, 2003).

26. Prop. Treas. Reg. § 1.704-1(b)(4)(ix), 68 Fed. Reg. 2930-01 (Jan. 22, 2003).

27. Prop. Treas. Reg. § 1.721-2, 68 Fed. Reg. 2930-01 (Jan. 22, 2003).

28. Prop. Treas. Reg. § 1.704-1, 68 Fed. Reg. 2930-01 (Jan. 22, 2003).

though it is possible, with some strain, to devise an analysis in which the developer is viewed as contributing all or a portion of its capital contribution in exchange for an option to acquire, for nominal consideration, an interest in partnership profits equal to 100% of building appreciation above $1120 and 50% of building appreciation above $1320. What the proposed regulations illustrate is that while the IRS is sympathetic to avoiding income recognition related to capital shifts, it will, when faced with the alternatives of income recognition or "wrong" capital account balances, protect the capital account system.

Given the risk posed by capital shifts, what are the practical alternatives? One alternative is to take one's chances, abandon the capital account system, and insist that there is no Code provision that mandates income recognition on noncompensatory capital shifts. It is likely that such bravery will be rewarded, either because the IRS will not want to take on a complex battle in the context of transactions that are more business than tax oriented or because the taxpayer is victorious on the merits. For those who are less brave, there are a number of ways to deal with the risk of capital shifts, but none is quite satisfactory.

One approach is to avoid capital shifts by having a partnership make its liquidating distributions in accordance with the partners' capital account balances, but to provide for "catch up" allocations, either on an actual liquidation or at some earlier point, which cause the capital account balances on liquidation to correspond to those which reflect the business understanding. Of course, the risk entailed, i.e., that there will be insufficient income to bring capital accounts to their desired level, is precisely the kind of risk the investors were negotiating with the developer to avoid. The risk increases to the extent the catch up allocations are deferred, but deferral is the point for tax purposes. If a partnership operates an active trade or business with significant gross income and deductions, or if it trades in numerous assets, the partnership can increase the probability of achieving the correct balances by allocating items of gross income and gross deductions to achieve that result. However, that raises the risk that the IRS will treat the provision that liquidations are to be effected in accordance with capital account balances as a sham.

A second approach is to make the distribution triggering the capital shift contingent on some objective event so as to defer the shift until the contingency is satisfied. The difficulty lies in devising a contingency that is sufficiently real to be respected for tax purposes but does not substantially alter the risk allocation negotiated by the partners. One common contingency is the occurrence of a "liquidity event" such as the sale of substantially all the assets held by the partnership. If the definition of liquidity event is broad enough, the issue becomes whether the contingency is certain to happen.

A third approach is to characterize the capital shift as a guaranteed payment. In the case of a cash basis partnership, the guaranteed payment could be made effective in the partnership's first year. The partnership would not be entitled to its deduction and the partner would thus not be required to recognize income until the guaranteed payment was actually made. An accrual basis partnership would not have that option, but it could attempt to spread income recognition over some period by having the guaranteed payment accrue periodically. In the example, the investors could be entitled to an 8% annual simple return for five years. The recipient of the guaranteed payment would face the risk that the partnership would liquidate prematurely, but that risk could be reduced by providing the recipient with the right to approve any sale of partnership assets or a partnership liquidation. Slightly more aggressively, the developer could be allowed to liquidate at any time, but at a cost of accelerating the guaranteed returns, in a manner analogous to a prepayment penalty on a loan. The IRS could argue that a contingency based on the partnership liquidating was triggered by the deemed liquidations used to test allocations under the capital account system, but that argument appears weak.

IV.
CONCLUSION

This article has surveyed certain non-economic quirks of the capital account system. Some, like profits interests, are well understood while others, like capital shifts, are less well understood. The primary moral of the survey is that, despite the sonorous boilerplate in which the system is enshrined, it should not be accepted blindly. In particular, tracking allocations should not be used without some thought as to their consequences. Similarly, there is a small but growing tendency to provide that the general partner or managing member will allocate income and loss in a manner consistent with applicable law and the distribution provisions. That kind of drafting should be considered only if one is representing the general partner or managing member and even then it poses risks of conflicts of interest.

A second moral is to always consider whether to provide for tax distributions. Especially when partners are in comparable tax brackets, tax distributions can be a fair way of mitigating the timing quirks of the capital account system. Tax distributions work best when the tax consequences of partnership allocations are clear, as when a capital shift is characterized as a guaranteed payment. They work less well if income is shifted on an audit, though the timing issue may be rendered moot if the audit does not conclude until after the partnership sells its assets and is liquidated.

Morals advising the reader to pay attention to the tax consequences of one's transactions and avoid being lulled by forms are, of course, relatively basic, and, from the perspective of a tax lawyer, even mildly self-serving. As a practical matter, there is not much more to be said about capital accounts in the abstract. What matters is the immediate transaction and sensitivity to the issues it raises. One might conclude with a plea to business persons. Much as it is proper to deplore the effect of tax complexity on commercial planning and to give priority to commercial allocations of risk, complexity for its own sake is not a virtue - a transaction so fine tuned as to be close to incomprehensible as a business matter is also likely to have uncertain tax consequences.

On a more theoretical level, the analysis raises the question of whether the IRS and the tax bar should be charged with devising a better method of allocating income in partnerships, one that has a better sense of the time value of money and that better coordinates tax allocations with cash distributions? The capital account system clearly can bear improvement. In the TAX NOTES article, this author semi-seriously suggested an alternate safe harbor for allocations.[29] On the other hand, partnerships have thrived for the last twenty years under

29. 29. *See* TAX NOTE Article at 597.

the capital account system. The IRS and the nation may well have issues, even tax issues, more important than perfecting capital accounts. Perhaps the proper compromise is for the IRS not to be charged with the task of perfecting the capital account system, and the quid pro quo for taxpayers would be that the IRS would stop attempting to perfect the system. In particular, the proposed regulations on the grant of compensatory partnership interests which allow taxpayers to maintain the status quo, but only if the partnership makes an administratively onerous election, the partnership boilerplate is expanded to include certain magical language and, in the case of unvested profits interests, the service recipient makes an election whose timing is often impractical, appear wrong headed.[30]

Finally, on a lofty jurisprudential level, the capital account system furnishes a case study on the effects of legislation through safe harbor. There are a number of examples in the tax law of the IRS influencing taxpayer behavior not through overt legislation or regulation, but by specifying the effects of certain transactions and leaving the consequences of remaining transactions unclear. For example, the application of the old four factor test for partnership characterization was heavily influenced by a number of revenue procedures that did not have the effect of law. Similarly, the practical law relating to profits interests is currently controlled by revenue procedures. The positive side of the use of such safe harbors is that it enables the IRS to provide certainty in business affairs without having to sort out complex theoretical legal issues and to face some of their more impractical consequences. As just noted, the proposed regulations on compensatory partnership interests may be proof of the virtues of revenue procedures and safe harbors. The negative side is that, given the weak theoretical underpinnings of the safe harbors, they tend to be highly detailed and, as the details are elaborated, progressively complex. Worse, they tend to channel commercial behavior in unexpected ways. Perhaps the moral, one which is easy to state

30. It is conceivable (though in this context, unlikely) that the administrative complexities are intentional. Both the experience of safe harbor leasing in the early 1980s and the current experience with foreign applications of the "check the box" regime suggest that too much rationality may have a fiscal cost and that apparently irrational transaction costs may serve a useful, if informal, rationing function.

but hard to follow, is to exercise moderation, create simple safe harbors and avoid having a safe harbor become so widespread as to dominate an area. There is no need to abolish the capital account system, but a greater official recognition of its optional nature and some official public recognition that other allocation systems are permissible would be helpful.