The Target Method for Partnership Special Allocations and Why It Should Be Safe-Harbored

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Abstract

The Treasury Regulations' concept of "substantial economic effect" is the holy grail of partnership special allocations. Special allocations that have substantial economic effect will come within a safe harbor in the regulations and have assurance that the allocations that are provided in the partnership agreement will be respected. In order for the allocations to come within the substantial economic effect safe harbor, the partnership must (1) maintain capital accounts in accordance with the Treasury Regulations' standard; (2) provide for liquidation in accordance with capital accounts in all events; and (3) either (a) provide for a deficit restoration obligation (DRO) on the partners, so that they have an obligation to restore any deficits in their capital accounts, or, (b) in the alternative, include in the agreement a qualified income offset provision (QIO), so that if a partner's capital account drops below zero because of an "unexpected distribution," the partner who experiences this circumstance will be allocated a sufficient amount of the partnership's gross income to raise his capital account to zero. These requirements are sometimes referred to as the "Big Three."

The Treasury Regulations, by virtue of these safe harbor requirements, effectively push drafters to write allocation sections of partnership agreements to comply with these requirements, which the Article refers to as the Treasury Capital Account Method of Allocation.

An alternative approach to drafting allocation provisions is sometimes referred to as the "Target Capital Account Method of Allocation" or more simply the "Target Method." Under the Target Method, all distributions are made in accordance with the partnership distribution provisions. Even though capital account balances are maintained for the partnership in the same manner as under the Treasury Capital Account Method, partners' capital accounts do not govern the distributions upon liquidation of the partnership, which they do under the Treasury Method. Rather, distribution provisions determine liquidation distributions without regard to the partners' capital accounts. However, allocations of income, gain, losses and deductions

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are made and affect capital account balances in a manner so that the capital accounts reflect liquidation distribution priorities.

This Article discusses both methods and argues in favor of the superiority of the Target Method in both achieving the economic goals of the partners and in achieving the overriding purposes of the section 704(b) special allocation regulations. It sets forth and analyzes several situations in which the two allocation methods diverge in liquidation distribution results and explains how the Treasury Capital Account Method may fail to carry out the economic deal of the partners whereas the Target Method always does.

In the course of the discussion of the Target Method, the Article addresses several important interpretive issues in the current Treasury Regulations that inject unfortunate doubt regarding the acceptability of Target Method allocations for partnerships that desire certainty that their allocations will be respected, which drafters of allocation provisions should be aware of and appreciate. The Article ultimately recommends revision of the partnership special allocation regulations to safe-harbor Target Method allocations.

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Introduction

All JD partnership tax students study the "substantial economic effect" rules in the section 704(b) regulations and are taught the importance of complying with the regulatory safe harbor relating to "economic effect."[1] The safe harbor ensures that special allocations will have "economic effect" if the partnership agreement includes three provisions, known to practitioners as the "Big Three."[2] If allocations also satisfy the "substantiality" requirement in the regulations, the allocations will be respected for income tax purposes, that is, they will govern the tax consequences of the allocations provided in the partnership agreement.[3]

The SEE "Big Three" are the following: (1) maintain capital accounts in accordance with the Treasury Regulations' standard;[4] (2) provide for liquidation in accordance with capital accounts in all events;[5] and (3) either (a) provide for a deficit restoration obligation (DRO) on the partners, so that they have an obligation to restore any deficits in their capital accounts,[6] or, (b) in the alternative (sometimes referred to as requirement 3 of the "Alternate Big Three"),[7] include in the agreement a qualified income offset provision (QIO), so that if a partner's capital account drops below zero because of an "unexpected distribution," that partner will be allocated a sufficient amount of the partnership's gross income to raise his capital account to zero (or to the negative amount which he has an obligation to restore if he has a limited deficit restoration obligation).[8] Thus, the Treasury Regulations appear to push drafters to write allocation sections of partnership agreements to record all contribution, distribution, income, gain, and loss events (and some others) in the partners' capital accounts (Big Three requirement 1), and then provide that liquidation distributions from the partnership will be made in accordance with the capital account balances (Big Three requirement 2). I will refer to this approach as the "Treasury Capital Account Method" of allocation or "Treasury Method." Examples 1(a) and 2(a) in Part I show allocation

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[1] *See, e.g.*, Stephen Schwarz & Daniel J. Lathrope, Fundamentals of Partnership Taxation 138-45 (9th ed. 2012).
[2] *See id.* at 138-39.
[3] Reg. § 1.704-1(b)(1)(i).
[4] Reg. § 1.704-1(b)(2)(ii)(b)(1).
[5] Reg. § 1.704-1(b)(2)(ii)(b)(2).
[6] Reg. § 1.704-1(b)(2)(ii)(b)(3).
[7] Reg. § 1.704-1(b)(2)(ii)(d).
[8] *Id.*

provisions taken from leading treatises using the Treasury Capital Account Method approach.

An alternative approach to drafting allocation provisions is sometimes referred to as the "Target Capital Account Method of Allocation," or more simply, the "Target Method." Under the Target Method, all distributions are made in accordance with the partnership distribution provisions. Even though capital account balances do not govern the distributions upon liquidation of the partnership, income, gain, losses, and deductions are allocated so that capital accounts reflect distribution priorities.

This Article discusses both methods and argues in favor of the superiority of the Target Method in both achieving the economic goals of the partners and in achieving the overriding purposes of the section 704(b) regulations. Yet, there are several nagging interpretative issues in the current Treasury Regulations that inject doubt regarding the acceptability of Target Method allocations for partnerships that desire certainty that their allocations will be respected.

Part I of this Article demonstrates that in many, probably most, situations, the Treasury Capital Account Method of Allocation and the Target Method will lead to the same allocations and capital account balances of the partners and therefore the same distributions upon eventual liquidation of the partnership.

Part II of the Article sets forth the Target Method's connection to the Treasury Regulations that the Treasury Method is intended to satisfy. The Target Method in most situations will not only carry out the expectations of the partners but should satisfy the economic effect equivalence test of the regulations[9] and therefore be respected. This Part makes the point that if the Target Method and Treasury Method always lead to the same allocations and distributions, then the Target Method nevertheless would be superior because it is more easily understood by the principals in the deal, less prone to accounting errors affecting ultimate distributions to the partners, and more consistent with the underlying theory of the Treasury's special allocation regulations. However, when the two methods diverge in consequences, the Target Method, not the Treasury Method, carries out the intent and expectation of the partners and yields results that are more consistent with the underlying principles of the allocation regulations than the Treasury Method. Part II does this by exploring situations in which the two methods diverge, and makes the affirmative case that when this occurs, the Target Method is superior because it always leads to the correct economic results to the partners; that is, the results that they expected and bargained for. Yet in those very circumstances, the Treasury could contend that the allocations do not meet either the Treasury's SEE safe harbor or lead to an economically equivalent result and therefore do not have "economic effect."

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[9] *See* text at note 52, *infra*.

Part III of the Article responds to the principal arguments that are generally made by leading commentators defending the Treasury Method and criticizing the Target Method.

Part IV of the Article recognizes that the principal reason the Treasury Method, which is based on the principle that capital accounts should control distributions rather than vice-versa, is still used by practitioners is traced to the current Treasury Regulations' safe harbor. This Part contends that the Treasury Regulations in this aspect are misguided and should be revised to grant safe harbor status to the Target Method. Other appropriate revisions to these regulations are also suggested.

I. Allocations Employing the Treasury Capital Account Method and, in the Alternative, the Target Method

The Treasury Method uses the accounting convention of capital accounts for the partners, increasing them with contributions by the partner and income and gain allocated to the partner, and decreasing them by distributions to the partner and losses or deductions allocated to the partner.[10] Upon liquidation of the partnership, the partners receive the amounts in their respective capital accounts. Examples 1(a) and 2(a) set forth and employ allocation provisions that use the Treasury Method.

The Target Method, in contrast, directs its allocations to cause the partner's capital accounts to conform to the distribution priorities set forth in the partnership agreement. Drafting allocation provisions under the Target Method can be as simple as merely providing that allocations will be made so that capital accounts will equal the distributions that will be made in the event of a liquidation of the partnership following sale of its assets. Whitmire et al. provide an example of such a provision.[11]

It is more usual, however, and more helpful to the partnership's accountants, who will be charged with making the annual allocations, for drafters employing the Target Method to provide the partnership accountants with more guidance. Examples 1(b) and 2(b) set forth and employ allocation provisions that use the Target Method. Target Method allocation provisions, however, vary among practitioners in the level of specificity contained in them.

Under the Target Method, drafters often augment the priority of distributions in the agreement with a provision in the distribution section that requires that after all distributions that are provided have been made, when the partnership is being liquidated, a further distribution will be made to partners in accordance with their positive capital account balances. This extra provision is included so that the partnership agreement formally complies with the second safe harbor requirement of the Big Three (liquidation in

[10] Reg. § 1.704-1(b)(2)(iv).

[11] Stephen L. Whitmire et al., Structuring and Drafting Partnership Agreements: Including LLC Agreements ¶ 5.05[2] (3d ed. 2003), *available at* www.checkpoint.thomsonreuters.com (last visited June 29, 2015).

accordance with capital accounts), because that requirement formally requires that liquidation distributions will be made in accordance with capital account balances. Under the Target Method, however, in most if not all situations, the partners' capital accounts will all be zero by the time the capital account liquidation provision operates in the agreement.

A. *Example 1: Basic Arrangement*[12]

G and L form a limited partnership. G, the general partner, contributes $10,000 and L, the limited partner, contributes $90,000 to the partnership. Upon obtaining a nonrecourse loan from a commercial bank (Bank) in the amount of $900,000, the Partnership purchases a building on leased land for $1.0 million (leaving no working capital in this simple example). Assume Partnership operations result in operating income (rents in the amount of $150,000) being exactly equal to operating expenses (maintenance, repairs, land lease payments, loan interest in the aggregate amount of $150,000), so that net losses equal depreciation deductions for the year. Assume for computational simplicity that depreciation is allowed over a ten-year recovery period, ignoring the mid-month convention, so that each year's depreciation is $100,000.

After the purchase of the building, the Partnership's balance sheet looked as follows:

GL Limited Partnership

Cash	0	Liabilities (NR)	$900,000
Building	$1,000,000	Capital	
		G	$ 10,000
		L	$ 90,000
	$1,000,000		$1,000,000

The financial arrangement of the partners, the so-called "deal," is that the partners will receive the amount of their original capital contributions *pro rata*, first, ($10,000 to G and $90,000 to L) and thereafter will share distributions equally. This latter sharing arrangement represents the arrangement for sharing the economic profit from the deal. This financial arrangement is incorporated in the distribution provisions of the partnership agreement.

A typical straightforward arrangement is to provide that distributions, whether operating or from sales or refinancing, will be made by first returning to the partners the amount of their original capital contributions and thereafter in accordance with their agreement for the sharing of profits from

[12] Example 1 is based on the problem on page 172 in SCHWARZ & LATHROPE, *supra* note 1, which I have used for several years in teaching Taxation of Partnerships and LLCs.

the endeavor, often referred to as their "Percentage Interests."[13] Percentage Interests are generally provided elsewhere in the partnership agreement and under the arrangement in the above hypothetical example would be as follows: 50% to G and 50% to L, even though their respective capital contributions were made in the ratio of 10% by G and 90% by L.

The partnership agreement tracks the progress that is made in returning to the partners the amount of their original capital contributions by means of a bookkeeping device, often referred to as a "Contributions Account," for each partner. The concept of a Contributions Account (although sometimes by use of different terminology) is a frequently used drafting technique to keep running track of the first tier of distributions. The Contributions Account, if that term is used, may be defined in the partnership agreement as set forth in the margin below.[14]

The intended financial arrangements of the partners in the partnership, set forth in the distributions provision described above, will be the same regardless of the method of allocation used in the partnership agreement.

1. *Example 1(a): Treasury Capital Account Method*

Under the Treasury Capital Account Method, the partnership agreement provides that L and G share losses in the following manner: 90% to L and 10% to G, and share nonrecourse losses in that ratio as well. G and L are allocated profits in the same ratio that they shared earlier losses (net of earlier profits) until the profits allocated to them equal the losses previously allocated to them, and thereafter share profits 50/50.

The partnership maintains capital accounts in accordance with the section 704(b) regulations and the partnership agreement provides that liquidation proceeds will be distributed in accordance with capital accounts. Although the partnership agreement does not contain a Deficit Restoration Obligation (DRO), that is, impose an obligation on partners to restore any deficits in capital accounts, it does contain Qualified Income Offset (QIO)[15]

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[13] ARTICLE VIII

Distributions of Net Cash Flow and Net Proceeds

1. The Net Cash Flow and Net Proceeds of the Partnership shall be paid or distributed (at such time or times as may be determined by the General Partner, in his reasonable discretion) to the Partners as follows and in the following order of priority:

a. First, to the Partners, pro rata, in proportion to their respective Contributions Accounts (as defined herein) until such Contributions Accounts have been reduced to zero;

b. Second, to the Partners, pro rata, in proportion to their respective Percentage Interests.

[14] Definitions: "Contributions Account" shall, with respect to each Partner, mean and refer to the separate "book" account for such Partner, to be established and maintained as follows: A Partner's Contributions Account shall be credited with such Partner's cash Capital Contributions (as defined herein) and shall be debited with distributions made to such Partner as of the time made.

[15] Reg. § 1.704-1(b)(2)(ii)(d)(3).

and Minimum Gain Chargeback (MGC)[16] provisions in accordance with the section 704(b) regulations.

The partnership agreement contains Treasury Capital Account Method allocation provisions as follows:

"3. Subject to the provisions of paragraphs 4 and 5 [provisions that comply with the regulatory provisions in the Treasury regulations], the distributive shares of each item of Profit, Loss, deduction, credit or basis for any Partnership Accounting Year or other period shall be allocated to the Partners, as follows:

(a) Profits for any Allocation Year shall be allocated in the following order and priority:

(i) First, 10% to G and 90% to L in amounts equal to the excess, if any, of (A) the cumulative Losses allocated pursuant to Paragraph 3(b)(i) for all prior Allocation Years over (B) the cumulative Profits allocated pursuant to this Paragraph 3 (a)(i) for all prior Allocation Years; and

(ii) The balance, if any, 50% to G and 50% to L.

(b) Losses for any Allocation Year shall be allocated in the following order and priority:

(i) First, 50% to G and 50% to L in amounts equal to the excess, if any, of (A) the cumulative Profits allocated pursuant to Paragraph 3(a) for all prior Allocation Years over (B) the cumulative Losses allocated pursuant to this Paragraph 3(b) for all prior Allocation Years; and

(ii) The balance, if any, 10% to G and 90% to L."

Frequently, the partnership agreement will be drafted to include a special allocation provision for nonrecourse deductions.[17] The provision might read as follows:

(c) (i) All Nonrecourse Deductions shall be allocated 10% to G and 90% to L. Further, the General Partners may elect that, for purposes of determining their interests in nonrecourse liabilities of the Partnership (excluding Partner Nonrecourse Debt), "excess nonrecourse liabilities" (within the meaning of Reg. § 1.752-3(a)(3)) shall be allocated among the Partners in accordance with the allocation of Nonrecourse Deductions.

[16] Reg. § 1.704-2(f)(1).

[17] Reg. § 1.704-2(c) provides as follows:

The amount of nonrecourse deductions for a partnership taxable year equals the net increase in partnership minimum gain during the year (determined under paragraph (d) of this section), reduced (but not below zero) by the aggregate distributions made during the year of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain (determined under paragraph (h) of this section).

> *(ii) Notwithstanding the provisions of paragraph (c)(i), all losses and deductions which are attributable to any Partner Nonrecourse Debt shall be allocated solely to the Partners who bear the economic risk of loss for such Partner Nonrecourse Debt, in accordance with Treasury Regulation §1.704-2(i)(1).*[18]

In this example, the depreciation in each year and therefore the loss in each year, beginning with year 1, of $100,000 would be allocated as follows: $10,000 to G and $90,000 to L. The resulting capital accounts after year one would be as follows: $0 to G and $0 to L. There would not yet be any

[18] Note that in the situation for which the provision above was drafted, the nonrecourse loss sharing percentages are the same as the residual loss sharing percentages, but they need not be, subject to paragraph 2 of the requirements set forth in Regulation section 1.704-2(e). That regulation section provides that allocations of nonrecourse deductions are deemed to be in accordance with the partners' interests in the partnership only if—

> *(1)* Throughout the full term of the partnership requirements (1) and (2) of § 1.704-1(b)(2)(ii)(b) are satisfied (i.e., capital accounts are maintained in accordance with § 1.704-1(b)(2)(iv) and liquidating distributions are required to be made in accordance with positive capital account balances), and requirement (3) of either § 1.704-1(b)(2)(ii)(b) or § 1.704-1(b)(2)(ii)(d) is satisfied (i.e., partners with deficit capital accounts have an unconditional deficit restoration obligation or agree to a qualified income offset);
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> *(2)* Beginning in the first taxable year of the partnership in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, the partnership agreement provides for allocations of nonrecourse deductions in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities;
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> *(3)* Beginning in the first taxable year of the partnership that it has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain, and thereafter throughout the full term of the partnership, the partnership agreement contains a provision that complies with the minimum gain chargeback requirement of paragraph (f) of this section; and
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> *(4)* All other material allocations and capital account adjustments under the partnership agreement are recognized under § 1.704-1(b) (without regard to whether allocations of adjusted tax basis and amount realized under section 613A(c)(7)(D) are recognized under § 1.704-1(b)(4)(v)).

Minimum Gain,[19] because the adjusted basis of the property (which in this example equals the property's book value) after year one would be $900,000, an amount not less than the amount of the partnership's nonrecourse liability, also $900,000.

The depreciation in year two and therefore the loss in year two would again be $100,000, causing the basis of the property to be reduced to $800,000. Minimum Gain would be $100,000 (the excess of the nonrecourse liability over the property's book basis).[20] As a result, the entire loss in year two would be a nonrecourse deduction, because Partnership Minimum Gain would have increased from $0 to $100,000. Under the agreement, the nonrecourse deduction would be allocated in the same ratio as the loss in year one, namely 10,000 to G and 90,000 to L. The partners would each have a share of the partnership's Partnership Minimum Gain of those amounts (G: $10,000; L: $90,000) and would be permitted to have their capital accounts reduced below zero to that extent, even without a DRO. In this example, G's capital account becomes (-$10,000) after year two; L's capital account becomes (-$90,000). The allocations for year three operate similarly, bringing G's capital account down to (-$20,000) and L's down to (-$180,000). At that point, each partner has a share of Partnership Minimum Gain, G's being $20,000, and L's being $180,000. The results for years one through three are summarized in Table 1(a).

Note that the absence of partner contributions to maintain working capital in this example results in the negative capital accounts of the partners being equal to their respective shares of Minimum Gain. However, negative capital accounts and Minimum Gain, while related, need not be equal. For example, the independence of the negative capital accounts and shares of Minimum Gain of the partners could be illustrated if G had contributed $20,000 and L had contributed $90,000. In that case, G's and L's respective shares of Minimum Gain after year two still would have been $10,000

[19] Reg. § 1.704-2(d)(1).

Amount of partnership minimum gain.

The amount of partnership minimum gain is determined by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains. The amount of partnership minimum gain includes minimum gain arising from a conversion, refinancing, or other change to a debt instrument, as described in paragraph (g)(3) of this section, only to the extent a partner is allocated a share of that minimum gain. For any partnership taxable year, the net increase or decrease in partnership minimum gain is determined by comparing the partnership minimum gain on the last day of the immediately preceding taxable year with the partnership minimum gain on the last day of the current taxable year. *See* paragraph (m), Examples (1)(i) and (iv), (2), and (3) of this section.

[20] In this example and the example that follows in this part of the paper, book basis and tax basis will be equal. However, Regulation section 1.704-1(b)(2)(iv)(g) provides that if they are not, book basis rather than tax basis governs in the special allocation rules.

and $90,000, respectively, even though G did not have a negative capital account.[21] Nevertheless, I have used the simplified example because I intend to focus on the capital accounts, and the effects of the nonrecourse deductions and Minimum Gain chargebacks should offset one another.

If the building were sold at the beginning of year four (ignoring operating income or losses and depreciation for year four) for the amount of the nonrecourse loan, $900,000, the partnership would have gain of $200,000 ($900,000 - $700,000), although there would be no cash proceeds from the sale to distribute. G would be allocated gain equal to his share of partnership Minimum Gain, that is, $20,000, the amount of his previous nonrecourse deductions. Similarly, L would be allocated his share of partnership Minimum Gain, that is, $180,000, the amount of his previous nonrecourse deductions. Their respective capital accounts after the sale would then be as follows: $0 to G and $0 to L. Upon liquidation in accordance with positive capital account balances, neither G nor L would be entitled to be distributed any cash amounts under requirement two of the Big Three, as provided in the partnership agreement, because neither had a positive capital account balance. This situation comports with the fact that the partnership has no cash or other assets to distribute.

However, if the building were sold at the beginning of year four (ignoring operating income or losses and depreciation for year four) for $1.3 million instead of $900,000, the partnership would realize gain in the amount of $600,000 ($1.3 million - $700,000). $900,000 of the sale proceeds would be paid to the lender, leaving $400,000 of the sale proceeds for distribution to the partners.

Gain would be allocated in stages of priority under the partnership agreement. First, G would be allocated gain equal to his share of partnership Minimum Gain of $20,000, and L would be allocated gain equal to his share of partnership Minimum Gain of $180,000. Their respective capital accounts would then be: G with $0 and L with $0. Second, the next $100,000 of gain would be allocated in the same manner as that amount of losses (other than nonrecourse deductions) had been allocated in previous years: $10,000 to G and $90,000 to L. (Partnership Agreement 3(a)(i)). This allocation would increase their respective capital accounts to $10,000 for G and $90,000 for L, the amounts of their original contributions to the partnership's capital.

Third, the remaining $300,000 under the partnership agreement would be allocated 50% to each partner, that is, $150,000 to G and $150,000 to L. (Partnership Agreement 3(a)(ii)). This third tier of allocation would raise their capital accounts to $160,000 for G and $240,000 for L. Upon liquidation in accordance with positive capital account balances, G would be distributed $160,000 and L $240,000 of the $400,000 cash proceeds of the sale, the only asset of the partnership. Viewed another way, they would have shared the ultimate economic profit of $300,000 ($1.3 million - $1.0

[21] In this situation, G's capital account would be $0: $20,000-$10,000-$10,000.

million) from the venture 50% each: $150,000 and $150,000, which was their economic arrangement. In addition, G and L would have received the return of their original capital contributions of $10,000 and $90,000, respectively. They would have been allocated gain from the sale as follows: G: $180,000 ($20,000 of Minimum Gain plus $160,000 of other gain); L: $420,000 ($180,000 of Minimum Gain plus $240,000 of other gain). These results are summarized in Table 1(a).

Table 1(a)–Treasury Capital Account Method

	G's Capital Account	L's Capital Account	Total Capital Accounts
Y4 – Before allocation of gain	($20,000)	($180,000)	($200,000)
Allocated according to Ps share of P/S Min Gain	+$20,000 = 0	+$180,000 = 0	+$200,000 = 0
3(a)(i) Allocated in the same manner that the losses had been allocated in previous years	+$10,000	+$90,000	+$100,000
3(a)(ii) Balance, if any allocated 50:50	+$150,000	+$150,000	+$300,000
Total capital accounts after allocations	$160,000	$240,000	$400,000
Distribution of cash in accordance with capital accounts	-$160,000 = 0	-$240,000 = 0	-$400,000 = 0

2. *Example 1(b): Target Capital Account Method*

Example 1(b) uses the same factual background, except that the partnership agreement uses the Target Method of allocation. Under this method, allocations are made with reference to the distributions that the partnership agreement provides, so that after each annual allocation of profits or losses, the capital accounts of the partners have balances equal to the amounts that would be distributed to the partners under the distribution provisions of the agreement if the partnership properties were all sold at book value. This method assures that the capital account balances, to the extent possible,[22] will be consistent with the order and priority of distributions to be made under the agreement in the event of liquidation. Thus, if the partnership's assets

[22] This issue and the possibility that capital accounts will not be so aligned will be discussed further in Part II.

were sold for book value and the partnership were liquidated immediately thereafter, the distributions would cause the capital accounts to be reduced to zero.

To illustrate, assume that the partnership agreement contains provisions that satisfy the Alternate Big Three, using a QIO provision instead of a DRO, and the regulation-complying provisions as in Example 1(a), including a Minimum Gain chargeback provision.

The partnership agreement defines "Target Capital Account" as follows:

> *Target Capital Account shall, with respect to each Partner as of any particular date, mean and refer to the sum of (i) such Partner's Capital Account, increased by (ii) the amount such Partner is deemed to be obligated to restore with respect to any deficit balance in its Capital Account pursuant to the next to last sentences of each of Treasury Regulation §1.704-2(g)(1) (that is, the Partner's share of the Partnership Minimum Gain) and Treasury Regulation §1.704-2(i)(5) (that is, the Partner's share of the minimum gain attributable to Partner Nonrecourse Debt).*

Under the Target Method, the profit and loss allocation provisions read as follows:

> *3. Subject to the provisions of paragraphs 4 and 5 [provisions that comply with the regulatory provisions in the Treasury regulations] the distributive shares of each item of Profit, Loss, deduction, credit or basis for any Partnership Accounting Year or other period shall be allocated to the Partners, as follows:*
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> *(a) Profit shall be allocated as follows and in the following order of priority:*
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> *(i) First, without reducing capital accounts to reflect any distributions pursuant to Article VIII-1, [These are the Distribution Provisions set forth in footnote 13,* supra.*] to any Partners having negative balances in their respective Target Capital Accounts,*[23] *in proportion to such balances, in amounts sufficient to bring such respective negative balances to zero;*
>
> *(ii) Second, to the Partners who are entitled to the distributions pursuant to Article VIII-1(a), to the extent necessary so that the Target Capital Account balances of those Partners are at least equal to the amounts remaining to be distributed to them under Article VIII-1(a), [this is the balance in the Partners' respective Contributions Accounts] whether or not cash is actually distributed or available for distribution thereunder, or in the event there is not sufficient Profit to*

[23] Recall that Target Capital Account balances already include the partners' shares of any Minimum Gain Chargeback that will ultimately be made.

achieve that allocation, so that the amounts allocated hereunder to those Partners are in proportion to such amounts remaining to be distributed to them under Article VIII-1(a);

(iii) Third, to the Partners who are entitled to the distributions pursuant to Article VIII-1(b), to the extent necessary so that the Target Capital Account balances of those Partners, are at least equal to the amounts to be distributed to them under Article VIII-1(a) and -1(b), or in the event there is not sufficient Profit to achieve that allocation, so that the amounts allocated hereunder to those Partners, after giving effect to Subparagraphs 3(a)(i) and (ii) of this Article VIII-1(a), shall cause the Target Capital Accounts of the Partners in excess of the Partners' remaining balances in their Contributions Accounts to be in proportion to the amounts to be distributed to them under Article VIII-1(b).

(iv) Fourth, 50% to G and 50% to L.

(b) Loss shall be allocated as follows and in the following order of priority:

(i) First, among those Partners whose Target Capital Account balances exceed the balances of those Partners of their respective Contributions Accounts, in proportion to and to the extent of their respective excesses; and

(ii) Second, 10% to G and 90% to L.

(c) (i) All Nonrecourse Deductions shall be allocated 10% to G and 90% to L. Further, the General Partners may elect that, for purposes of determining their interests in nonrecourse liabilities of the Partnership (excluding Partner Nonrecourse Debt), "excess nonrecourse liabilities" (within the meaning of Reg. § 1.752-3(a)(3)) shall be allocated among the Partners in accordance with the allocation of Nonrecourse Deductions.

(ii) Notwithstanding the provisions of paragraph (c)(i), all losses and deductions which are attributable to any Partner Nonrecourse Debt shall be allocated solely to the Partners who bear the economic risk of loss for such Partner Nonrecourse Debt, in accordance with Treasury Regulation §1.704-2(i)(1).

As in Example 1(a), in each year the operating income and losses are equal and the depreciation in each year is $100,000, so that the loss in year one is $100,000. That loss of $100,000 would be allocated between the partners in the ratio of the partners' capital contributions, that is, in the ratio of 10% to G and 90% to L. The allocations of loss would therefore be as follows: To G: $10,000; to L: $90,000. The resulting capital accounts after year one would be: G: $0; L: $0. Target Capital Account balances would be in those amounts as well. There would not yet be any Minimum Gain, because the adjusted basis of the property after year one would be $900,000, an amount not less than the amount of the partnership's nonrecourse liability, which is also $900,000.

The depreciation and therefore the loss in year two would again be $100,000, causing the basis of the property to be reduced to $800,000. Minimum Gain would be $100,000 (the excess of the nonrecourse liability over the property's basis). As a result, the entire loss in year two would be a nonrecourse deduction, because partnership Minimum Gain would have increased from $0 to $100,000. Under the partnership agreement, the nonrecourse deduction would be allocated in the ratio of 10%-90%, which is the same ratio as the loss in year one, namely $10,000 to G and $90,000 to L. The partners would each have a share of the partnership Minimum Gain of those amounts (G: $10,000; L: $90,000) and would be permitted to have their capital accounts reduced below zero to that extent if necessary. Thus, G's capital account would become (-$10,000) after year two; L's capital account would become (-$90,000) after year two. Target Capital Account balances, however, would both remain at $0, because each would be computed by adding back to their actual Capital Accounts the partners' respective shares of Minimum Gain.

The allocations for year three operate similarly, bringing G's capital account down to (-20,000) and L's down to (-$180,000), but leaving their respective Target Capital Accounts at $0. At that point, each partner has a share of Partnership Minimum Gain, G's being $20,000, and L's being $180,000. The results for years one through three are summarized in Table 1(b).

If the building were sold at the beginning of year four (ignoring operating income, expenses and depreciation for year four) for the amount of the nonrecourse loan, $900,000, the partnership would have gain of $200,000 ($900,000 - $700,000), although there would be no cash from sale proceeds to distribute. G would be allocated gain equal to his share of partnership Minimum Gain, that is, $20,000, the amount of his previous nonrecourse deductions. Similarly, L would be allocated gain equal to his share of partnership Minimum Gain, that is, $180,000, the amount of his previous nonrecourse deductions. Their respective Capital Accounts after the sale would then be as follows: $0 to G and $0 to L. (These amounts would equal the partners' respective Target Capital Accounts, because all Minimum Gain would have been accounted for by being included in actual Capital Accounts. Upon liquidation in accordance with positive capital account balances, neither G nor L would be distributed any cash amounts as provided in the distribution provisions, because the partnership had no assets after the sale. These results, not surprisingly, are the same as in Example 1(a), in which the Treasury Capital Account Method was used.

If the building were sold at the beginning of year four (ignoring operating income, expenses and depreciation for year four) for $1.3 million instead of $900,000, the partnership would realize gain in the amount of $600,000 ($1.3 million - $700,000), and cash would be available for distribution of

$400,000 (sale proceeds of $1.3 million minus repayment of the loan of $900,000). Under the Target Method, gain would be allocated in stages of priority under the partnership agreement. First, G would be allocated gain equal to his share of Partnership Minimum Gain, that is, $20,000, and L would be allocated his share of partnership Minimum Gain, that is, $180,000. Their respective capital accounts would then be as follows: G; $0; L: $0.

Second, the next $100,000 of gain would be allocated so that the Target Capital Accounts (which would be equal to the actual Capital Accounts) had balances equal to the amounts that would be distributed to the partners under Article VIII 1(a) of the distribution provision, that is, the amounts of their respective "unreturned" capital contributions to the partnership, as tracked by the Contributions Accounts of the partners. This allocation of gain would increase their respective Target Capital Accounts (and actual Capital Accounts) by $10,000 for G and $90,000 for L, to the amounts of their original contributions to the partnership's capital, that is, G: $10,000, L: $90,000, assuming no prior distributions had been made.

Third, the remaining $300,000 under the partnership agreement would be allocated so that the Target Capital Accounts (and actual Capital Accounts) had balances equal to the amounts that would be distributed to the partners under Article VIII 1(b) of the distribution provisions, that is, $150,000 to each partner. That is because the referenced distribution provision divides the distribution equally between the partners after each has received the return of his original capital contribution to the partnership (or that amount has been included in his capital account). This third tier of allocation would increase the respective Target Capital Accounts (and actual Capital Accounts) of the partners to $160,000 for G and $240,000 for L. To accomplish that, the allocation provision provides an allocation of gain of $150,000 to each partner. A distribution of $160,000 to G and $240,000 to L, as provided in the Article VIII 1(a) and (b) of the partnership agreement, would cause the partners' respective capital accounts to be reduced to zero. Liquidation in accordance with positive capital account balances at this point, as provided in the partnership agreement, would not result in any additional distributions to be made to either G or L, because their capital accounts were already reduced to zero by virtue of the distributions provided in the distribution section of the partnership agreement. These results are summarized in Table 1(b).

Table 1(b) Target Capital Account Method

	G's Capital Account	L's Capital Account	Total Capital Accounts
Y4 – Before allocation of gain	($20,000)	($180,000)	($200,000)
Allocated according to Ps share of P/S Min Gain	+$20,000 = 0	+$180,000=0	+$200,000 = 0
Allocated according to Article VIII1(a) of distribution provision – to members pro rata in proportion to respective contributions accounts = amounts of "unreturned" capital contributions	+$10,000	+$90,000	+$100,000
Allocated according to Article VIII1(b) of distribution provision – to the members pro rata in proportion to their respective percentage interests (equal division)	+$150,000	+$150,000	+$300,000
Total capital accounts after allocations	$160,000	$240,000	$400,000
Distribution of cash as provided in distribution provisions	-$160,000 = 0	-$240,000 = 0	-$400,000 = 0

3. *Summary of Examples 1(a) and 1(b)*

In summary, G and L would have shared the ultimate economic profit of $300,000 ($1.3 million - $1.0 million) from the venture 50% each: $150,000 and $150,000, which was their economic arrangement, and have received the return of their original capital contributions. While this formulation in the partnership agreement using the Target Method is different than the formulation using the Treasury Capital Accounts Method, it nevertheless achieves the same result in this example. For this reason, the Target Method should have—and I believe generally is regarded as having in these circumstances—"economic effect equivalence"[24] under Regulation section 1.704(b)-1(b)(ii)(i)

[24] *See infra* notes 46-48.

and therefore is "deemed to have economic effect," thereby complying with the economic effect safe harbor.[25] Curiously, as indicated earlier, the examples in the regulations under section 704(b) contain no examples of this kind of allocation provision and the Service has never ruled that having economic effect equivalence is sufficient to satisfy requirement 1 of the nonrecourse deduction safe harbor, thereby leaving some uncertainty (in my view, unfortunate) in this conclusion.[26]

B. *Example 2: Arrangement Including Priority Return on Capital*

Examples 2(a) and 2(b) introduce a common variation in the economic deal. Assume the facts of Example 1, except that the partners will receive a priority return equal to 5% per year of their capital contribution, similar to interest on their capital contributions, either by distribution from cash flow or upon sale of the property, before the final gain sharing ratio of 50/50 applies. This priority return reflects a normal rate of return on invested capital before G becomes entitled to his extra 40% (50% - 10%) "carried interest." This financial arrangement is incorporated in the distribution provisions of the partnership agreement.[27]

Note that under the financial arrangement of Example 2, the distribution provisions section of the partnership agreement would be unchanged from Example 1.[28] The priority return aspect of the deal is built into the concept of the Contributions Account, which operates like a bank account, accruing interest. The partnership agreement tracks the progress that is made in returning to the partners their original capital contributions as well as the "interest equivalent" that is earned on the unreturned contributions by means of the bookkeeping device of Contributions Account for each partner. The

[25] *See id.*; *infra* notes 58-60 (analyzing the likely treatment of the nonrecourse deductions).

[26] *Id.* It is possible that the uncertainty is designed to dissuade practitioners from using the Target Method and push practitioners to use the Treasury Method.

[27] ARTICLE VIII

Distributions of Net Cash Flow and Net Proceeds

1. Except to the extent that Net Cash Flow and Net Proceeds shall be distributed upon the termination of the Company pursuant to Article XVI-2 hereof, the Net Cash Flow and Net Proceeds of the Company shall be paid or distributed (at such time or times as may be determined by the General Partner, in his reasonable discretion) to the Partners as follows and in the following order of priority:

a. First, to the Partners, pro rata, in proportion to their respective Contributions Accounts (as defined herein until such Contributions Accounts have been reduced to zero;

b. Second, to the Partners, pro rata, in proportion to their respective Percentage Interests.

[28] *See* Whitmire et al., *supra* note 11.

Contributions Account is defined in the partnership agreement to incorporate the interest equivalent, with the added language highlighted in italics.[29]

The addition of the priority return provision in these examples affects only actual or anticipated distributions and allocations when there are, or there are expected to be, distributions from cash flow or net sale proceeds. It does not affect the provision for allocating losses (although it could affect their operation if there have been previous allocations for undistributed priority return amounts).

1. *Example 2(a). Treasury Capital Account Method with Priority Return*

A partnership agreement that uses the Treasury Capital Account Method of Allocation would build a priority return into the allocation provisions as follows, with the added language highlighted:

> *3. Subject to the provisions of paragraphs 4 and 5 [provisions that comply with the regulatory provisions in the regulations], the distributive shares of each item of Profit, Loss, deduction, credit or basis for any Partnership Accounting Year or other period shall be allocated to the Partners, as follows:*
> *(a) Profits for any Allocation Year shall be allocated in the following order and priority:*
> *(i) First, 10% to G and 90% to L in amounts equal to the excess, if any, of (A) the cumulative Losses allocated pursuant to Paragraph 3(b)(i) for all prior Allocation Years over (B) the cumulative Profits allocated pursuant to this Paragraph 3 (a) for all prior Allocation Years;*
> ***(ii) Second, 10% to G and 90% to L in amounts equal to their Priority Return on Capital;***[30] *and*
> *(iii) The balance, if any, 50% to G and 50% to L.*

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[29] ARTICLE I

Definitions

"Contributions Account" shall, with respect to each Partner, mean and refer to the separate "book" account for such Partner, to be established and maintained as follows: A Partner's Contributions Account shall be credited with (1) such Partner's cash Capital Contributions (as defined herein) *and (2) such Partner's Priority Return on Capital*, and shall be debited with distributions made to such Partner under Article VIII-1(a) as of the time made.

A priority return on capital provision, if computed on a compound basis, would read as follows:

"Priority Return on Capital" shall mean a return equal to five percent (5%) per annum on the balance, from time to time, of such Partner's respective Contributions Account, based on a 360-day year comprised of twelve (12) thirty (30) day months, and for any partial month, based on the actual number of days elapsed. The Priority Return on Capital shall be credited semi-annually to and shall become a part of the respective Contributions Account of the Partner entitled thereto and shall thereafter accrue a Priority Return on Capital.

[30] Notice the resort to a target-type allocation because it is uncertain how much income or gain will be covered by this provision, the amounts depending upon the number of years that the capital remained in the partnership.

(b) *Losses for any Allocation Year shall be allocated in the following order and priority:*

(i) *First, 50% to G and 50% to L in amounts equal to the excess, if any, of (A) the cumulative Profits allocated pursuant to Paragraph 3(a)(i) for all prior Allocation Years over (B) the cumulative Losses allocated pursuant to this Paragraph 3(b)(i) for all prior Allocation Years;*

(ii) Second, 10% to G and 90% to L in amounts equal to the excess, if any, of (A) the cumulative Profits allocated pursuant to Paragraph 3(a)(ii) for all prior Allocation Years over (B) the cumulative Losses allocated pursuant to this Paragraph 3(b)(ii) for all prior Allocation Years; *and*

(iii) *The balance, if any, 10% to G and 90% to L.*

(c) (i) *All Nonrecourse Deductions shall be allocated 10% to G and 90% to L. Further, the General Partners may elect that, for purposes of determining their interests in nonrecourse liabilities of the Partnership (excluding Partner Nonrecourse Debt), "excess nonrecourse liabilities" (within the meaning of Reg. § 1.752-3(a)(3)) shall be allocated among the Partners in accordance with the allocation of Nonrecourse Deductions.*

(ii) *Notwithstanding the provisions of paragraph (c)(i), all losses and deductions which are attributable to any Partner Nonrecourse Debt shall be allocated solely to the Partners who bear the economic risk of loss for such Partner Nonrecourse Debt, in accordance with Treasury Regulation §1.704-2(i)(1).*

Suppose that the partnership did not make cash flow distributions during the first three years, but in year four sold the property for $1.3 million. Under the Treasury Capital Account Method, after the allocation of Minimum Gain to G and L of $20,000 and $180,000 respectively, the further allocations of gain would be:

First, gain would be allocated to reverse previous net loss allocations and therefore $10,000 to G and $90,000 to L.

Second, gain would be allocated to assure a 5% annual return on capital (which, for computational simplicity, I will assume to be computed using simple instead of compound interest). Thus, the second level of gain allocation would be $1,500 to G and $13,500 to L.

Third, the remaining gain of $285,000 would be allocated equally between G and L or $142,500 each. Thus, in the aggregate, G would be allocated $174,000 of gain and L would be allocated $426,000 of gain. The results of this allocation are set forth in Table 2(a).

Table 2(a) Treasury Capital Account Method with priority return.

	G's Capital Account	L's Capital Account	Total Capital Accounts
Y4 – Before allocation of gain	($20,000)	($180,000)	($200,000)
Allocated according to Ps share of P/S Min Gain	+$20,000 = 0	+$180,000=0	+$200,000 = 0
3(a)(i) Allocated in the same manner that the losses had been allocated in previous years	+$10,000	+$90,000	+$100,000
3(a)(ii) Allocation of priority return on capital of 5% (NOTE: 3 yrs int. at 5%/yr)	+1,500	+$13,500	+$15,000
3(a)(iii) Balance, if any, allocated 50/50	+$142,500	+$142,500	+$285,000
Total capital accounts after allocations	$154,000	$246,000	$400,000
Distribution of cash in accordance with capital accounts	-$154,000 = 0	-$246,000=0	-$400,000 = 0

2. *Example 2(b). Target Capital Account Method with Priority Return*

A partnership agreement that uses the Target Capital Account Method of Allocation would have an allocation provision that is the same allocation provision used in Example 1(b).

Under the Target Method, after Minimum Gain has been allocated, the next portion of the gain will be allocated in order to cause the partners' capital accounts to equal their Contributions Accounts, which incorporate the priority returns. Thus, G will be allocated $11,500 ($10,000 plus priority return of $1,500) of gain and G will be allocated $103,500 ($90,000 plus priority return of $13,500) of gain.

The remaining gain of $285,000 ($600,000 minus $200,000 minus $115,000) will be allocated equally between G and L, that is, $142,500 to G and $142,500 to L. As under the Treasury Capital Account Method, in the aggregate, G will be allocated gain of $174,000 and have a resulting capital account of $154,000 and L will be allocated gain of $426,000 and have a resulting capital account of $246,000. The results of this allocation are set forth in Table 2(b).

Table 2(b) Target Capital Account Method with priority return.

	G's Capital Account	L's Capital Account	Total Capital Accounts
Y4 – Before allocation of gain	($20,000)	($180,000)	($200,000)
Allocated according to Ps share of P/S Min Gain	+$20,000 = 0	+$180,000=0	+$200,000 = 0
Allocated according to Article VIII1(a) of distribution provision - to members pro rata in proportion to respective contributions accounts = "unreturned" capital contributions+ priority returns (NOTE: 3 yrs int. at 5%/yr)	$10,000 + $1,500 = $11,500	+$90,000 + $13,500 = $103,500	$115,000
Allocated according to Article VIII1(b) of distribution provision → *to the members pro rata in proportion to their respective percentage interests (equal division)*	+$142,500	+$142,500	$285,000
Total capital accounts after allocations	$154,000	$246,000	$400,000
Distribution of cash as provided in distribution provisions	-$154,000 = 0	-$246,000 = 0	-$400,000 = 0

3. *Summary of Examples 2(a) and 2(b)*

As in Examples 1(a) and (b), under both formulations of allocation provisions, G and L each received the return of their original capital contributions and shared the ultimate economic profit of $300,000 ($1.3 million - $1.0 million) from the venture first in the amounts of their priority return on capital of $1,500 and $13,500, respectively, and second, as to the remaining economic gain in the amount of $285,000, 50% each: $142,500 and

$142,500, which was their economic arrangement. While the allocation provision in the partnership agreement using the Target Method is different than the formulation using the Treasury Capital Account Method, it nevertheless achieves the same result in this example, that is, distributions of $154,000 to G and $246,000 to L, and allocation of $174,000 of gain to G ($20,000 of Minimum Gain and $154,000 of other gain), and $426,000 of gain to L ($180,000 of Minimum Gain and $246,000 of other gain). The Target Method in this example provides "economic effect equivalence" to the Treasury Method, which is both sanctioned and encouraged by the regulations, but as I indicated with regard to Example 1(b), there is some uncertainty whether this is sufficient to satisfy requirement one of the nonrecourse deduction safe harbor.

C. *Example 3: Arrangement Including Priority of Return for Only One Partner and Not the Other*

Assume the facts of Example 2 (L contributes $90,000; G contributes $10,000) except that only L is entitled to a priority return on his investment and his investment plus priority return both have priority over G's return of capital. The Partnership purchases the building for $1.0 million all rent and operating expenses are both $150,000 and depreciation is $100,000, which is allocated $90,000 to L and $10,000 to G, as in Example 2. This allocation of losses reduces both G's and L's capital accounts down to zero at the end of the first year of operations.

Now, suppose, unlike Example 2, the property is sold for $1.0 million after year one, and therefore for a gain of $100,000, At the time, L's preferred return would be 5% of $90,000 or $4,500. Therefore, the parties expect to split the $100,000 net sales proceeds, after payment of the liability, $94,500 to L and $5,500 to G, notwithstanding that their respective capital contributions were $90,000 by L and $10,000 by G. So, L expects to end with a positive financial return of $4,500 and G with a negative financial return of $4,500.

Under the Treasury Method, and a standard Layer Cake Allocation provision, L would be allocated $90,000 of the gain and G $10,000, reversing the allocation of that amount of loss allocated to them in year one. This would bring the capital accounts up $90,000 and $10,000 respectively, and control the liquidation distributions in contravention of the economic deal contemplated by the partners.

However, under the Target Method, Using the allocation provisions discussed earlier, L would be allocated $94,500 gain and G would be allocated the remaining $5,500 of gain, bringing their respective capital accounts to $94,500 and $5,500, which would match the distributions and the economic deal contemplated by the partners.

Part II of this Article will expound further on this example and provide other situations where the two allocation methods diverge, and will discuss possible tax consequences in these situations.

D. *Conclusions about the Target Method to be drawn from Examples 1, 2, and 3*

The attraction of the Target Method is that the draftsman provides the economic terms of the deal only once in the partnership agreement—in the distribution section. The allocations are forced to conform to the distributions to be made, because by their terms they operate to build up the capital accounts in layers so that they (adjusted for shares of Minimum Gain) equal the amounts to be distributed under the distribution provisions. As such, they cannot be in conflict with them (as long as there is sufficient gain to allocate).

Indeed, Whitmire et al. refer to the Target Method as "The Forced Allocation Technique" because it provides for allocations that force the capital accounts to become equal to the distributions to which the partners are entitled, rather than allocations that build up the capital accounts without direct reference to the distributions.[31] Whitmire et al. recognize that this method is a relatively simple way, *at least in theory*, to achieve the desired result. That is because the method applies a "hypothetical liquidation test." The method builds up the capital accounts through allocations of profits and losses so that at any time one could be generally assured that if a liquidation of the partnership would take place, the liquidation in accordance with capital accounts would result in distributions that reflect the economic deal among the partners as set forth in the distribution provisions. Thus, each partner's capital account strives at all times to be equal to the amount such partner would be entitled to receive under the terms of the partners' economic arrangement if the partnership's assets were sold for book value and the partnership liquidated. Such a scheme of allocations forces the capital accounts to seek to reflect the economic deal of the partners, that is, the distribution order and priorities, and will generally ensure that the capital account balances at all times reflect this distribution arrangement. As a result, in most usual circumstances, this allocation method could allow capital account balances to govern liquidating distributions and achieve the desired economic result. But, there are circumstances where the allocations would not achieve the same result as if liquidating distributions were tied inexorably to the capital accounts.[32]

The technique is both theoretically correct and theoretically simple, because it operates after the fact, that is, the allocations are provided after the relevant events have occurred. The Target Method (Forced Allocation Technique) prescribes allocations to be made, so that if one understands the economic deal among the partners in the event of a hypothetical liquidation, one can simply focus directly on building up or reducing the balances of the partners' year-end capital accounts so that they exactly equal the amounts the partners would receive under the hypothetical year-end liquidation.

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[31] WHITMIRE ET AL., *supra* note 11, at ¶ 5.05[2].

[32] *See* Part II.C.

II. The Affirmative Case for the Target Method

A. *The Target Method's Connection to Substantial Economic Effect (SEE) and the Framework of the Treasury Allocation Regulations*

The Treasury Capital Account Method and Target Method proceed from different basic premises and concepts centering on a different view of the importance and effect of capital accounts. In short, under the Treasury Capital Account Method, capital account maintenance presents a bookkeeping device for keeping score. Capital accounts represent the partners' equity in the partnership, based on book values. Just as a partner's equity increases with an allocation of income, it decreases with an allocation of losses. Ultimately, upon liquidation of the partnership after the sale of its assets for which gains or losses will be allocated, a partner's equity in the partnership, accounted for as his capital account, will determine the amount of his final distribution. Under this method, the accounting for gains and losses and other partnership events will be crucial, because that accounting will determine the partners' capital accounts and therefore economic stakes and return from their investments in the partnership.

In contrast, the Target Method evidences distrust of the capital accounts as the determinant of the partners' ultimate economic return from their investments in the partnership. The Target Method alternative provides the "deal," that is, the economic arrangement of the partners, in the partnership agreement by specifying the order and priority of distributions, to govern all distributions, including those to be made upon liquidation of the partnership. Allocations are then provided to cause the capital accounts to mirror as much as possible the order and priority of distributions on liquidation of the partnership provided in the partnership agreement. Often this method causes the capital accounts at time of liquidation to mirror the distribution priorities set forth in the partnership agreement, as they do in Problems 1 and 2 of Part I.

However, the distinguishing feature of the Target Method is that liquidation distributions are not made in accordance with capital accounts, but rather are provided in the distribution section of the partnership agreement. That means that when the capital account balances diverge from the distribution priorities, the distribution priorities will govern. In contrast, the Treasury Method explicitly provides that liquidation distributions will be made in accordance with capital account balances, satisfying requirement 2 of the SEE Big Three safe harbor.

Importantly, the Target Method, properly used, would also include DRO or QIO provisions in order to ensure that no partner can be allocated losses that have no economic reality, reflected in a negative capital account, because the partner does not bear the economic responsibility of the loss, that is, obligation to contribute (DRO) an amount to the partnership equal to his capital account deficit at the time the partnership is liquidated. Alternatively, and more commonly, the partnership agreement would contain a QIO, so that if an event occurs, like an "unexpected" distribution, that creates a negative capital account for a partner, gross income will be allocated to that partner to eliminate the negative capital account as quickly as possible so as to restore the economic reality of the capital accounting system of the partnership. These measures, already built into the current SEE special allocation safe harbor regulations, deal with the negative capital account issue raised in the *Orrisch* case,[33] the genesis of those regulations. Thus, the only significant variance of Target Method allocations from Treasury Method allocations would involve SEE safe harbor requirement 2, liquidations in accordance with capital accounts.

In addition, the drafter would include all of the other standard Treasury Method provisions that allocations are of "Book Income" or "Book Losses" rather than tax income or tax loss, subject to section 704(c) tax allocations, as well as other provisions dealing with revaluations, "book-ups," and, as indicated earlier, a DRO or QIO provision.

Other terminology is sometimes used interchangeably for the Target Method, such as "Forcing the Capital Accounts Method of Allocation," "Layer Cake Method of Allocation," and more recently, the "Waterfall Method of Allocation."[34] In this Article, I will use the Target Capital Account Method or "Target Method" terminology, because it has gained widest acceptance and I believe it to be most descriptive and least ambiguous. The other terminologies, that is, Forcing the Capital Accounts, Layer Cake, and Waterfall, are not used in the same way by all people. Some practitioners[35] will use the allocation provisions to force the capital accounts to reflect the order and priority of distributions to the extent that there are gains, profits, deductions, and losses to accomplish this or come as close as these allocations permit, although ultimately, liquidating distributions will be made in accordance with capital accounts so determined, even if they do not completely reflect the order and priority of distributions agreed to in the partnership agreement, that is, the deal. This method ultimately relies on capital accounts to determine

[33] Orrisch v. Commissioner, 55 T.C. 395 (1970), *aff'd per curiam in unpublished opinion,* (9th Cir. 1973).

[34] *But see* Todd D. Golub, *Target Allocations: The Swiss Army Knife of Drafting (Good for Most Situations—But Don't Bet Your Life on It)*, Taxes, Mar. 2009, at 157 (using the latter two terms (Layer Cake and Waterfall) to denote a Treasury Capital Account Method Allocation where profit and loss-sharing percentages differ).

[35] *See, e.g.*, Terence Floyd Cuff, *Some Selected Issues in Drafting Real Estate Partnership and LLC Agreements*, *in* Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 2007 327 (Louis S. Freeman ed., 2007); Whitmire et al., *supra* note 11, ¶ 5.05[2]. *But see Targeted Allocations Hit the Spot*, 2010 Tax Notes Today 192-4, (Oct. 4, 2010) (using the term "Forced Allocations" synonymously with "Target Method").

distributions and not the distribution provisions and therefore is best viewed as a variation of the Treasury Method.[36]

Interestingly, the state statutes governing partnerships and limited liability companies generally choose to define the rights to distributions of partners and members, as the case may be, in terms of their economic rights to distributions as well. For example, the Delaware Limited Partnership Act provides that a limited partner who withdraws from a partnership is entitled to the fair market value of his interest as of the date of withdrawal "based upon such partner's right to share in distributions from the limited partnership" unless the partnership agreement provides otherwise.[37] Further, upon dissolution of the partnership, the Delaware Limited Partnership Act requires that distributions be made to the partners (after provision is made for liabilities of the partnership both to non-partners and partners) "[u]nless otherwise provided in the partnership agreement, to partners first for the return of their contributions and second respecting their partnership interests, in the proportions in which the partners share in distributions."[38] The use of capital accounts under the Treasury Capital Account Method of determining liquidating distributions appears to fall within the flexibility that the Delaware statute gives to partnerships under the "unless otherwise provided" clause.[39] Similarly, and not surprisingly, the Delaware Limited Liability Company Act contains provisions that are parallel to the foregoing.[40]

The accounting convention of capital accounts is not abandoned in the Target Method, however. Rather, the allocation provisions of the agreement allocate income, gains, deductions, and losses in a manner that seeks to cause

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[36] The NYSBA, however, suggests that those types of allocation provisions may violate the "substantial" requirement of SEE. N.Y. State Bar Ass'n Tax Section, Report on Partnership Target Allocations 12 (2010). Yet, if they mirror the Treasury Allocations, that would seem unlikely.

[37] Except as provided in this subchapter, upon withdrawal any withdrawing partner is entitled to receive any distribution to which such partner is entitled under a partnership agreement and, if not otherwise provided in a partnership agreement, such partner is entitled to receive, within a reasonable time after withdrawal, the fair value of such partner's partnership interest in the limited partnership as of the date of withdrawal based upon such partner's right to share in distributions from the limited partnership.

Del. Code Ann. tit. 6, § 17-604 (2015).

[38] *Id.* at § 17-804.

[39] *See id.*

[40] Except as provided in this subchapter, upon resignation any resigning member is entitled to receive any distribution to which such member is entitled under a limited liability company agreement and, if not otherwise provided in a limited liability company agreement, such member is entitled to receive, within a reasonable time after resignation, the fair value of such member's limited liability company interest as of the date of resignation based upon such member's right to share in distributions from the limited liability company.

Id. at § 18-604 (2015). "Unless otherwise provided in a limited liability company agreement, to members first for the return of their contributions and second respecting their limited liability company interests, in the proportions in which the members share in distributions." *Id.* at § 18-804 (2015).

the capital accounts to have balances equal to the distributions that would be made if all properties were sold at book value and liquidation distributions were made forthwith as set forth in distribution provisions of the partnership agreement. This alternative method carries out the purpose or "fundamental principles"[41] of the SEE safe harbor Big Three, which, as stated in the regulations, are designed to cause the allocations to be "consistent with the underlying economic arrangement of the partners."[42] "[I]n the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden."[43]

The Target Method assures that appropriate allocations of gains and losses are made to do just that. Further, as pointed out by the NYSBA Tax Section Report, its use is intended to cause the capital accounts to reflect future distribution priorities, not for tax avoidance.[44] In that sense, with respect to loss allocations, they better reflect the allocation of financial loss and profits than the Treasury Method. And, by correctly reflecting the burden of loss allocations and the benefit of profit and gain allocations, they accomplish the purposes of the SEE rules of Regulation section 1.704-1(b)(2)(ii)(a), which should cause those allocations to have "economic effect."

At the same time, Target Allocations generally mirror the allocations that would be made each year under the Treasury Method, and capital accounts generally end up in the same place under both methods. In that sense, Target Allocations generally yield the "Safe Harbor Result."[45]

1. *Substantial Economic Effect (SEE)*

Arguably, when Target Method Allocations mirror the Safe Harbor Result, they satisfy the SEE criteria of the regulations,[46] particularly if the partnership agreement contains a provision that provides for liquidation in accordance with capital accounts *after* all distributions provided in the agreement are made. If Target Method Allocations do not mirror the Safe Harbor Result, then liquidation distributions will not be governed by book capital accounts. As a result, the Target Method may fail SEE requirement 2 as a technical matter.

Indeed, two leading commentators have suggested that it does not satisfy the Treasury Allocation Regulations either directly under the SEE Big Three safe harbor or indirectly as a method that has "economic equivalence" to the SEE Big Three safe harbor.[47] Moreover, there also may be uncertainty that the allocations satisfy the fallback PIP standard. Each of these

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[41] Reg. § 1.704-1(b)(2)(ii)(a).
[42] *Id.*
[43] *Id.*
[44] N.Y. State Bar Ass'n Tax Section, *supra* note 36, at 9-11.
[45] *Id.* at 11.
[46] *See* Tax Notes Today, *supra* note 35, at 104.
[47] *See* Cuff, *supra* note 33, at 413; Tax Notes Today, *supra* note 35, at 104.

possibilities will now be discussed as a technical matter under the current Treasury Allocation Regulations.

The Target Method's failure to "provide" explicitly for liquidation in accordance with capital accounts may cause the allocations to fail to satisfy the SEE safe harbor Big Three. However, Cavanagh has argued that the Target Method contains the liquidation requirement inherently[48] because it is designed to accomplish the Safe Harbor Result and requirement 2 of the Big Three does not require an agreement to explicitly state that liquidating distributions will be made in accordance with capital accounts. Rather, the term "provide" used in the regulations "has a results-oriented, rather than means-oriented, connotation."[49] In most cases, the results of Target Method allocations will satisfy this results-oriented test. Moreover, as suggested earlier, the liquidation in accordance with capital accounts explicit provision can be included in the agreement, to take effect after other prescribed distributions have been made.

Thus, the Target Method in Examples 1 and 2 of Part I may very well satisfy the Big Three or Alternate Big Three, as a technical matter, as well, as long as a provision is included that on liquidation, distributions will be made in accordance with positive capital account balances, following other distributions provided in the agreement. If this requirement is not in the agreement, or is ignored by the Service for whatever reason, then the Target Method allocation provisions might not satisfy the SEE Big Three or Alternate Big Three safe harbor because of its lack of an explicit liquidation in accordance with capital accounts provision (even if the economic effect equivalence test is satisfied so that the allocations are respected, discussed next). In any event, it is problematic whether one can count on SEE compliance to avoid uncertainty.

2. *Economic Effect Equivalence (EEE)*

The Target Method's deviation from the requirement to liquidate in accordance with the partners' capital accounts, if it causes it to fail the SEE safe harbor, would thereby force it to rely on the EEE test for acceptance. Accordingly, drafters of partnership agreements who use the Target Method rely generally on its "economic effect equivalence" (EEE) to the safe harbor result, that is, the result that would be attained under the Treasury Method and the Treasury Regulation that sanctions that method under those circumstances. The "economic effect equivalence" regulation provides as follows:

Allocations made to a partner that do not otherwise have economic effect under this paragraph (b)(2)(ii) shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if

[48] *See* Tax Notes Today, *supra* note 35, at 104.
[49] *Id.* at 104.

requirements (1), (2), and (3) of paragraph (b)(2)(ii)(b) of this section had been satisfied, regardless of the economic performance of the partnership.[50]

The regulation provides an example of an allocation method in which the Big Three are not satisfied, but which nevertheless satisfies the economic effect test by virtue of its equivalence in result of such an allocation method to the SEE Safe Harbor Result.[51] The example (in paragraph (ii)) sanctions as having economic effect under the economic effect equivalence test an arrangement in which the partners have agreed to a straight percentage sharing arrangement (75%/25%) between the partners who have made capital contributions in those same percentages, and have agreed to share profits and losses in those same percentages as well, even though no capital accounts have been maintained as otherwise required under the Big Three, and therefore capital accounts do not govern the distribution of liquidation proceeds.[52]

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[50] Reg. § 1.704-1(b)(2)(ii)(i). This regulation is sometimes referred to as the "dumb-but-lucky" rule. *See* Tax Notes Today, *supra* note 35, at 95 & n.17 (quoting IRS, *MSSP Audit Technique Guide on Partnerships* 6-8, 2003 Tax Notes Today 241-26 (Dec. 16, 2003)), but is really anything but that, in that many if not most Target Method users know exactly what they are doing and use the Target Method rather than the Treasury Method for the reasons stated earlier in this article. If the allocations work out to satisfy the EEE regulation, then fine. If not, then they favor the correct economic result over the surprise Treasury Method result.

[51] Reg. § 1.704-1(b)(2)(ii)(i). It provides: "See examples (4)(ii) and (iii) of paragraph (b)(5) of this section."

[52] *Id.*

> *Example (4).* (i) G and H contribute $75,000 and $25,000, respectively, in forming a general partnership. The partnership agreement provides that all income, gain, loss, and deduction will be allocated equally between the partners, that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, but that all partnership distributions will, regardless of capital account balances, be made 75% to G and 25% to H. Following the liquidation of the partnership, neither partner is required to restore the deficit balance in his capital account to the partnership for distribution to partners with positive capital account balances. The allocations in the partnership agreement do not have economic effect. Since contributions were made in a 75/25 ratio and the partnership agreement indicates that all economic profits and losses of the partnership are to be shared in a 75/25 ratio, under paragraph (b)(3) of this section, partnership income, gain, loss, and deduction will be reallocated 75% to G and 25% to H.
>
> (ii) Assume the same facts as in (i) except that the partnership maintains no capital accounts and the partnership agreement provides that all income, gain, loss, deduction, and credit will be allocated 75% to G and 25% to H. G and H are ultimately liable (under a State law right of contribution) for 75% and 25%, respectively, of any debts of the partnership. Although the allocations do not satisfy the requirements of paragraph (b)(2)(ii)(b) of this section, the allocations have economic effect under the economic effect equivalence test of paragraph (b)(2)(ii)(i) of this section.
>
> (iii) Assume the same facts as in (i) except that the partnership agreement provides that any partner with a deficit balance in his capital account must restore that deficit to the partnership (as set forth in paragraph (b)(2)(ii)(b)(2) of this section). Although the allocations do not satisfy the requirements of paragraph (b)(2)(ii)(b) of this section, the allocations have economic effect under the economic effect equivalence test of paragraph (b)(2)(ii)(i) of this section.

As Cavanagh points out,[53] however, while the Treasury's EEE test sanctions an allocation method under which the allocations achieve the same result as would be achieved under one that satisfies the SEE safe harbor when the partners have deficit restoration obligations, it, as a technical matter, would appear not to do so when there is no DRO but rather the partnership agreement uses a QIO instead. Thus, it is possible that the SEE test may be interpreted narrowly to require a DRO and it would be insufficient merely to provide an allocation scheme that merely matches the results of one that satisfies the alternative SEE test having a QIO without a DRO. Cavanagh acknowledges that there is no good rationale for this omission,[54] and I suggest that the Service would not press it in a case, but technical language is technical language, and therefore we are left with some uncertainty.

In addition, Cavanagh points out that the EEE test technically requires uniformity of result, "regardless of the economic performance of the partnership," thereby reading out any possible application of the EEE test absent a DRO, even if the agreement contains a prohibition against loss allocations in excess of capital accounts and contains a QIO.[55] Such a result would be curious indeed and a true oddity of Treasury draftsmanship, to give with one hand and take away immediately with the other. That would be particularly the case since there is no policy justification for this odd result, which if anything, would be clearly inconsistent with the intent of the EEE test to provide a safety net for other simplified (See Regulation example)[56] allocation methods that put the partners in the same position they would be in under the SEE test. Nevertheless, as Cavanagh acknowledges, there is academic disagreement over this point.[57]

3. *Partner's Interest in the Partnership (PIP)*

Finally, even if not falling within the SEE or EEE test, Target Method allocations may still be respected if they are considered made in accordance with the partner's interests in the partnership (PIP).[58] PIP is generally determined by the manner in which the partners share the "economic benefit or burden (if any) corresponding to the income, gain, loss, deduction or credit" from the operations of the partnership[59] and that is precisely what the Target Method seeks to and indeed is best able to achieve.

The PIP test is the ultimate fallback test in determining how allocations will be made. It is called upon when the partnership agreement does not satisfy the SEE safe harbor or alternate test or the EEE test. PIP, instead, relies on a facts-and-circumstances, multiple-factor, analysis. These factors include the

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[53] Tax Notes Today, *supra* note 35, at 95.
[54] *Id.* at 96.
[55] *Id.* at 95-96.
[56] *See supra* note 51.
[57] Tax Notes Today, *supra* note 35, at 96.
[58] Reg. § 1.704–1(b)(3)(i). *See* N.Y. State Bar Ass'n Tax Section, *supra* note 36, at 19.
[59] *Id.*

partner's relative contributions to the partnership, their interests in economic profits and losses, their interest in nonliquidating distributions and their rights to distribution of capital upon liquidation.[60] As a consequence, the PIP factor analysis does not prescribe a test that always leads to an unambiguous result and may vary with the contextual circumstances of the partnership in which the partners' interest in the partnership must be determined. The PIP test is most likely to be applied in a manner that seeks to achieve the objective. In this light, it is most reasonable to interpret the objective of the PIP test as seeking to determine how economic income and loss items should be allocated among the partners to accomplish the partners' economic objective of dividing cash from the overall operations of the partnership, both during operations and upon liquidation of the partnership. Upon ascertaining the partners' objectives for the division of cash, the PIP test would then assign accounting income and losses to the partners and reflect them in those partners' capital accounts so that after the allocations are made, the partners' capital accounts reflect those economics.[61] In that event, liquidating (and other) distributions could be made in accordance with capital accounts and reflect the agreed-upon sharing arrangement.

This view of the PIP test is best exemplified in the situation in which requirements one and two (but not three) of the SEE Big Three are satisfied and an allocation of loss is provided that reduces capital accounts. In that situation, the Treasury Regulations provide that the allocation of loss will be made based upon the amount that a partner's hypothetical liquidation distribution would be reduced upon the sale of all of the partnership's properties at book value and the liquidation of the partnership following the allocation year as compared with such a sale and liquidation following the end of the prior taxable year.[62] Such an allocation is respected under PIP for exactly the above rationale: that the loss allocation reflects a partner's reduction of ultimate distributions upon liquidation of the partnership. To a similar end, the Target Method seeks to achieve this fundamental purpose in all situations. Thus, its goal is consistent with the fundamental purpose of the PIP test.

4. *Deemed PIP*

Satisfaction of the Big Three (or Alternate Big Three) of the SEE safe harbor is important in another context as well, that of nonrecourse deductions. Nonrecourse deductions can never have economic effect, as defined in the regulations, because by their nature, they allocate losses or deductions, the economic cost of which no partner will ever bear. Nevertheless, allocations of nonrecourse deductions that satisfy the four-part 'Deemed PIP' safe harbor in Regulation section 1.704-2(e) will be respected. The first requirement is that

[60] Reg. § 1.704-1(b)(3).
[61] *See* Reg. § 1.704-1(b)(3)(ii).
[62] Reg. § 1.704-1(b)(3)(iii).

> [t]hroughout the full term of the partnership requirements (1) and (2) of §1.704-1(b)(2)(ii)(b) are satisfied (*i.e.*, capital accounts are maintained in accordance with §1.704-1(b)(2)(iv) and liquidating distributions are required to be made in accordance with positive capital account balances), and requirement (3) of either §1.704-1(b)(2)(ii)(b) or §1.704-1(b)(2)(ii)(d) is satisfied (*i.e.*, partners with deficit capital accounts have an unconditional deficit restoration obligation or agree to a qualified income offset) . . . .[63]

As explained below, it is uncertain whether an allocation method that has economic effect equivalence (EEE) under Regulation section 1.704-1(b)(2)(ii)(i) is sufficient to satisfy the Regulation section 1.704-2(e), the Deemed PIP safe harbor.[64]

The rationale for the Deemed PIP rule is that every nonrecourse deduction will eventually be matched with an equivalent amount of income or gain—a "Minimum Gain Chargeback." Under the Minimum Gain Chargeback rule, "nonrecourse deductions" create "partnership minimum gain"[65] and "partner nonrecourse deductions" create "partner minimum gain."[66] In applying all of the SEE, EEE, and PIP tests to recourse deductions, the regulations reduce a partner's deficit capital account by the gain that that partner would be certain to receive under the minimum gain and partner minimum gain chargeback provisions included in properly drafted partnership agreements.[67] The net effect of this process is that nonrecourse deductions and their counterpart Minimum Gain Chargeback work independently of recourse deductions and economic reality.

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[63] Reg. § 1.704-2(e). The other three Deemed PIP requirements are as follows:

> (2) Beginning in the first taxable year of the partnership in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, the partnership agreement provides for allocations of nonrecourse deductions in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities;
>
> (3) Beginning in the first taxable year of the partnership that it has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain, and thereafter throughout the full term of the partnership, the partnership agreement contains a provision that complies with the minimum gain chargeback requirement of paragraph (f) of this section; and
>
> (4) All other material allocations and capital account adjustments under the partnership agreement are recognized under § 1.704-1(b) (without regard to whether allocations of adjusted tax basis and amount realized under section 613A(c)(7)(D) are recognized under § 1.704-1(b)(4)(v)). *Id.*

[64] *See* N.Y. State Bar Ass'n Tax Section, *supra* note 36, at 2, 27.

[65] Reg. § 1.704-2(b).

[66] Reg. § 1.704-2(b)(24).

[67] Often this drafting is accomplished by defining the term, "adjusted capital account," as capital account plus these two assured items of eventual gain, and precluding the allocation of losses to a partner whose adjusted capital account would go below zero by virtue of the allocation.

Indeed, in theory, if it were not for the substantial item consistency requirement of the Deemed PIP test (requirement 2 of the Deemed PIP regulation),[68] the drafter of such a provision could separately allocate nonrecourse deductions and require minimum gain chargebacks, as well as other regulatory allocations such as the QIO, before any other allocations are made for the year. These nonrecourse deduction allocations and minimum gain chargebacks could thereby effectively operate apart from the partners' capital accounts, because each partner's share of partnership nonrecourse deductions would be matched by his share of partnership minimum gain, so as not to affect the part of capital accounting that affects distributions in liquidation of the partnership. As a technical matter, this is accomplished in the Regulations by adjusting each partner's capital account to include his share of minimum gain, which is treated as a deemed DRO, thereby restraining a nonrecourse deduction from creating a "nonrestorable" deficit, which would violate the third requirement of the SEE Alternate Big Three.[69]

The nonrecourse deduction regulations, however, link them to reality under its Deemed PIP test, a four-part test[70] that requires, most importantly, substantial item consistency, that is, that an allocation of a nonrecourse deduction must conform to the treatment of some other item of income or deduction, the allocation of which has SEE.[71]

As a matter of logic and policy, the nonrecourse deductions should be respected under the Deemed PIP test if either the SEE or EEE tests are satisfied. Yet, under the technical language of the current PIP test, the PIP test is satisfied if the recourse deduction allocation satisfies the three part SEE Big Three or Alternate Big Three safe harbor test.[72] There appears to be no policy justification not to grant safe harbor status if the EEE test is satisfied in lieu of the SEE test.

The risk that a challenge to a nonrecourse allocation under this technical argument would prevail is likely more theoretical than real for several reasons. The Target Method is economically equivalent to the Treasury Capital Account Method in most cases and therefore accomplishes the same economic result as the SEE safe harbor test, which is the goal at which the "economic effect equivalence" test in the regulations is aimed. In addition, if drafted carefully with a capital account liquidation provision as suggested earlier, the Target Method arguably conforms technically to the SEE Big Three or Alternate Big Three safe harbor requirements.

Further, it would be unwise for the Treasury to raise the potential argument because to do so would not carry out the purpose of the special allocation regulations. Rather, the Target Method carries out that purpose better than the

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[68] *See* Reg. § 1.704-2(b).
[69] *See* Reg. § 1.704-2(g)(1).
[70] *See* Reg. § 1.704-2(b).
[71] Reg. § 1.704-2(e)(2).
[72] Reg. § 1.704-1(b)(2)(i).

Treasury Method where the results of the two methods would differ, because the Target Method's results more closely adhere to the PIP test, the ultimate test regarding nonrecourse deductions allocations.[73]

Finally, any potential argument based on the absence of explicit coverage in the words of the regulations can and should be ignored by the Treasury when such an argument is in conflict with other policy goals of the regulations. For example, it has been ignored in the Treasury's most recent proposed regulations dealing with the treatment of the receipt of a partnership interest for services. Those proposed regulations recognize the absence of substantial economic effect of any allocations to the service partner while he has a risk of forfeiture, yet condone it (as long as the partnership agrees to corrective subsequent allocations in the event of forfeiture) as in accordance with the partner's interest in the partnership.[74] Those proposed regulations condone this with nary a mention of the effect such a treatment would or could have on the safe harbor treatment of nonrecourse deductions. The implication of that position appears to be that it would have no effect on the qualification of allocations of nonrecourse deductions even though the SEE Big Three "economic effect" test is not strictly satisfied.

Nevertheless, the risk of running afoul of the technical requirements of the Deemed PIP rule, so that the nonrecourse deduction fails to satisfy the Deemed PIP safe harbor, is perceived—and lawyers are risk-averse. To the extent that there is not always complete conformance in result between the Target Method and the Treasury Method, some drafters will choose simple adherence to the Treasury Method in order to avoid the more obvious risk, but subject the agreement to the allocation savings clause risk which involves risk that is not generally perceived.[75]

Accordingly, at the very least, the Treasury should amend its Deemed PIP regulations to provide that compliance with EEE constitutes compliance with SEE for purposes of the Deemed PIP regulations. In addition, as Part IV recommends, the Treasury should provide explicitly in its amended regulations that use of the Target Method satisfies the first requirement of Deemed PIP test as well.

5. *Section 514(c)(9)(E) Exception to Unrelated Business Income Tax (UBIT)*

Moreover, there are situations under current law in which varying from the SEE safe harbor by using the Target Method could render the transaction unacceptable to a tax-exempt investor.[76] Section 514(c)(9)(E) dealing with partnerships containing tax-exempt entities currently requires absolute compliance with the liquidation in accordance with capital accounts requirement

[73] *See supra* text accompanying text notes 40-43.
[74] Prop. Reg. § 1.704-1(b)(4)(xii), 79 Fed. Reg. 65,151-01 (2014).
[75] *See* discussion *infra* Part II.D.2 for a discussion of the risk of using savings clauses.
[76] *See* Golub, *supra* note 34, at 170.

of the SEE safe harbor.[77] Accordingly, in this situation as well the Treasury should amend its regulations to provide that compliance with EEE satisfies SEE, as suggested in Part IV below.

6. *Value Equals Basis–Book Presumption*

Additional uncertainty is added by the Regulation's technical treatment of the value equal basis presumption, which many observers believe applies throughout the allocations regulations. It is noteworthy that the regulation does not explicitly incorporate the "value equals tax basis–book value" presumption of the SEE test.[78] Cavanagh observes that this omission could mean that the current fair market value rather than merely book value enters into the analysis of EEE and PIP (a shuddering thought for all concerned) or that perhaps current distribution priorities should be valued more highly than rights to liquidating distributions, thereby adding a present value component to the analysis. The regulations do not explicitly cover situations that involve economic effect equivalence or any allocation method unless capital accounts determine liquidation distributions. All of these possibilities would be at odds with the well-established realization rule. For all of these reasons, it would seem both reasonable and likely that the "value equals tax basis–book value" presumption would be applied to these tests as well. Indeed, as Cavanagh points out, the regulations apply this presumption in the context of the PIP test if capital accounts govern liquidation distributions but the partnership agreement does not include either a DRO or a QIO and does not satisfy either the SEE test or the Alternate SEE test.[79] Application of value equals basis/book to all EEE and PIP as well as SEE determinations better assures *certainty*, in applying all of the foregoing rules.

7. *Summary*

Thus, as the discussion above makes clear, the Treasury Regulations upon which the Target Method would rely to achieve protection under one of the levels of analysis, are littered with uncertainties regarding their scope and the meaning of those protections. As a result, there is a concern that the Target Method does not satisfy the current Treasury Regulations' SEE safe harbor Big Three test, the EEE test, or Deemed PIP test, even if it achieves the same

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[77] I.R.C. § 514(c)(9)(E)(i)(II).

[78] Tax Notes Today, *supra* note 35, at 96 (identifying this curious omission); *see* Reg. § 1.704-1(b)(2)(iii)(c). Regulation section 1.704-1(b)(2)(iii)(c) provides a presumption that for testing whether the *economic effect* of an allocation is "substantial" (a requirement of SEE), the fair market value of depreciable property is always equal to its adjusted basis (book value), so that there cannot exist a "strong likelihood" that a gain chargeback will cause the allocation to be transitory. Reg. § 1.704-1(b)(2)(iii)(c); Reg. § 1.704-1(b)(5), Ex. 1(vi), (xi).

[79] *See* Reg. § 1.704-1(b)(2)(iii)(c). Regulation section 1.704-1(b)(2)(iii)(c) explicitly applies the value equals basis (book value) rule to situations governed by the Regulation section 1.704-1(b)(3)(iii) special rule when SEE safe harbor requirements one and two are satisfied, but not three. See text at note 61 for a discussion of this latter Treasury Regulation.

ultimate distribution results, and that its use may result in undesirable, and in the case of section 514(c)(9)(E), unacceptable, uncertainty, because its resultant allocations will have to rely on the PIP fallback standard.

These matters provide the focus of the remainder of this part of the Article and the basis for its policy recommendations in Part IV for changing the Treasury Allocation Regulations.

B. *The Superiority of the Target Method*

The uncertainty discussed in the previous section of this Part II is both unwarranted and unfortunate from a policy perspective because it elevates the inferior Treasury Method of allocation over the superior Target Method. The essence of the argument that the Target Method is superior to the Treasury Method as a matter of concept and drafting is that the Treasury Method requires two statements of the deal in the partnership agreement—one in the distribution section and one in the allocation section. In contrast, the Target Method requires only one—in the distribution section. As illustrated in Examples 1 and 2 of Part I, in simple cases, and in the theory of the regulations, both methods will yield the same results in that after the allocations, the capital accounts of the partners will be in amounts that turn out to be equal to the amounts the partners expect to receive as distributions under the partnership agreement.

The questions then become: (1) can the allocations and expected distributions ever conflict? And, (2) which one governs if they do conflict? The answer to the first question is unfortunately yes, as illustrated by Example 3 of Part I and other examples to follow. The answer to the second is "You don't want to ever face the question!"

More seriously, regarding the second question, if the Treasury Method is used and the allocations fail to cause the resulting capital accounts to correctly conform to the partners' desired, expected and "agreed" order and priority of distributions, that is, the "deal" agreed to by the parties, one does not know which one will govern. Presumably, the partners will each expect to receive the cash proceeds that they bargained for and set forth in the distribution provisions, because that is the financial arrangement that they negotiated. Their deal was based upon how the economic profits would be shared, and they then brought it to the tax lawyers to translate the deal into allocation and capital account language. In doing this, they relied on their respective counsels' assurances that the capital accounts would properly reflect the partners' economic interests in the partnership at the time of ultimate liquidation of the partnership, so that making liquidating distributions in accordance with positive capital accounts would carry out their negotiated arrangement. Practitioners, if they know what is happening, will likely scurry to get the economic deal right in order to satisfy the client's rightful desire rather than have to explain why the economic deal has turned out to be different than the original understanding of the parties.

A Treasury Method apologist's expected response is that the capital accounts will always correctly reflect the economic deal. Nevertheless, many lawyers, I for one, believe that the Treasury Method may fail to do this under some important circumstances, and in those circumstances, the capital accounts may not reflect the Partners' agreed priority of distribution on liquidation. Some lawyers as well as the leading treatises and commentators,[80] as I indicated above, respond to the general uneasiness about the Treasury Capital Account Method failing to achieve the financial deal expected and agreed to by the parties, by including "curative allocations" and a "savings clause." Curative allocations make allocations to reverse regulatory allocations, that is, allocations required by the Treasury Regulations such as the QIO. The savings clause would allow the accountants to override the Treasury Capital Account Method results where they depart from the "deal." (I will comment later on the problems those savings clauses could create.) Accordingly, notwithstanding that several leading practitioners and commentators have shown a sharp preference for the Treasury Capital Account Method (although the tide appears to be shifting),[81] they appear to be reluctant to use it without inclusion of curative allocations and the crutch of a savings clause, which stands ready to undo some of the allocations.

This section of the Article will support in more detail the affirmative case for the Target Method by exploring the above questions and the circumstances in which the Treasury Capital Account Method can cause diversion from the economic arrangement of the partners. It will start with the arrangement that the partners negotiated as their economic deal, which I have already set forth in Examples 1 and 2.

Before embarking on describing several circumstances in which the Target Method will avoid a potentially very bad economic outcome for one of the partners and therefore potentially all of them, I want to re-emphasize that the Target Method allocation should be a carefully drawn agreement containing the standard provisions mentioned earlier that would be included in a carefully drafted Treasury Method allocation.[82] Believing that the Target Method can reduce a 35 or 50 page agreement to a four-page agreement is foolhardy.[83] Rather, the focus of this discussion is on whether it is preferable to provide all distributions explicitly in the agreement, or do it through capital accounts that will govern liquidation distributions.

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[80] *See* Whitmire et al., *supra* note 11, at ¶ 5.05[2]; *see* Cuff, *supra* note 35, at 420.

[81] *See* N.Y. State Bar Ass'n Tax Section, *supra* note 36, at 1, 3.

[82] These include DRO or QIO provisions as well as a Minimum Gain Chargeback provision. *See* Golub, *supra* note 34, at 167.

[83] *Id.* at 170.

C. *The Principal Argument for Choosing the Target Method over the Treasury Method: Sometimes the Results Diverge*

There are several circumstances in which capital accounting will fail to reflect the distribution priorities of the economic deal made by the partners. As a result, the Treasury Capital Account Method can, under some circumstances, fail to cause the capital accounts to correctly reflect the deal, that is, interests of the respective partners at the time of liquidation of the partnership and distribution in accordance with positive capital account balances. In particular, certain events during the operation of the partnership can cause the partners' capital accounts to fail to reflect the economic arrangement of the partners. Under such circumstances, the parties would want their economic arrangement, rather than the accountants' capital account determination, to govern ultimate distributions, but partnership agreements are sometimes not drafted or cannot be drafted to accomplish this objective.

Moreover, a potential purchaser of a partner's partnership interest, which comes with the capital account of the selling partner, would like certainty about the economic entitlements of the partnership interest that he is purchasing.

The diversion between capital account balances at time of liquidation and the parties agreed financial sharing arrangement can occur in several ways.

1. *Uncertain Future Distributions*

Capital accounts can fail to reflect the economic arrangement of the partners (get out of alignment) under the treasury capital account method if ultimate distributions on liquidation are determined by contingencies that have not occurred as of the time allocations of income or loss from operations in earlier years must be made.

This situation can occur if at the time that allocations must be made, it is uncertain what the future sharing of distributions will be. This was the situation in Example 3 of Part I of this Article. In that example, both partners contribute cash, but only one is entitled to a preference of 5% on invested capital. In that situation, uncertainty is inherent because the number of years the partners' capital will remain in the partnership and therefore the actual amount of the preference cannot be known.

The foregoing example is not an isolated situation. It can arise whenever distribution preference amounts are uncertain and depend on future events. Suppose in the following situation, the deal is that the partners L and G will share liquidating distributions (on the sale of a building) 70/30 instead of 80/20 if all 8% preferences have been paid for five years giving G an extra 10% as a reward for the partnership's success, but not otherwise. If during those years all preferences have been paid and the building is sold after five years for very little gain above minimum gain (which is allocated to the partners in accordance with how nonrecourse deductions were allocated and nonrecourse refinancing proceeds, if any, had been distributed) and the partnership is liquidated, there simply may not be enough gain from sale of property for a partnership using the Capital Account Method to allocate a sufficient amount of income or gain to G to effect a 70/30 sharing, when previous allocations anticipated a sharing ratio of 80/20. Likely, G's capital account and therefore distribution under the Treasury Capital Account Method requiring distributions in accordance with capital account balances will not reflect his extra 10% of the liquidation proceeds. In that event, it may be uncertain which liquidation distribution arrangement should govern, liquidation in accordance with capital accounts or the now effective new 70/30 split.[84]

The answer to this question for such a partnership is apt to be a matter of serious contention. Presumably, the parties themselves have viewed the deal on the basis of the cash-sharing provisions and not the capital accounts and G would expect to receive the 30% percentage share provided. L may not agree.

A Target Allocation format would take care of this problem. By its terms, the 70/30 split would govern and the allocations to capital accounts would follow as best they could. And, if they did not achieve capital account balances in a 70/30 ratio, then so be it and the Service would be satisfied by treatments of gain or loss for G and L upon liquidation. Upon liquidation, G could receive an amount greater than his outside basis (which did not have an opportunity to be credited with sufficient gain) and therefore would have a capital gain under section 731(a) and L could receive an amount less than his outside basis (because he was credited with too much income under the 80/20 sharing ratio when it turned out that cash resulting from that gain would be shared under the updated sharing ratio of only 70/30), and therefore would realize capital loss under section 731(b).

So what is at stake when the parties choose the Target Method in this example? Timing and character of income and losses are at stake, as they are always at stake in allocation questions. Absolute gain or loss is not if basis accounting is done correctly. Of course, timing and character could be important.

However, contrast the relatively minor disruption of expected tax consequences, generally involving timing and character, with the potential massive disruption of economic consequences if capital accounts govern the final distribution so that only a part of, or perhaps none of, the 70/30 sharing ratio was ever effectuated because the capital account balances overrode the cash sharing provisions. Can you spell litigation?

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[84] Note that the NYSBA illustrates this risk with this example. Assuming both partners contribute cash, but only one is entitled to a preference of 8% of invested capital. In that situation, uncertainty is inherent because the number of years the partners' capital remains in the partnership and therefore the actual amount of the preference cannot be known. *See* N.Y. State Bar Ass'n Tax Section, *supra* note 36, at 7-8.

2. *Entry of a New Partner or Receipt by a Partner of a Nonliquidating Distribution that Reduces Such Partner's Interest in the Partnership*

Capital accounts can also get out of alignment and fail to reflect the economic arrangement of the partners if there is (1) an entry of a new partner or (2) a nonliquidating distribution to an existing partner that reduces his interest, and in either situation, the partnership chooses not to revalue or "book-up" its assets and its partners' capital accounts.

In the situation involving entry of a new partner, book capital accounts will fail to reflect proceeds-sharing amounts upon entrance of a new partner (for cash, property, or services) in the absence of a "book-up," because the old partners' capital accounts will not reflect the pre-entry appreciation in their partnership interests and of the properties of the partnership. When the problem arises as the result of admission of a new partner without a concurrent "book-up," one solution is special allocation of the gain for the sale of the partnership's existing properties to the old partners. That solution, however, does not always accomplish the correction. If (a) the assets are never sold for a gain, and (b) reverse section 704(c) allocations (of depreciation) do not eliminate the section 704(c) amount, but rather there is operating income generated that is held in cash until liquidation of the partnership, then the special allocation provisions simply will not come into play. There could be no special allocations with sales of the properties. The result is that the new partner's capital account is too high relative to the original partners, because the capital accounts were never set to their proper levels reflecting expected distributions on liquidation of the assets at the time of the entry of the new partner. This could affect partnership liquidation proceeds unless accountants step in and override the agreement at time of liquidation.

Similarly, liquidation of a partner's interest or making certain non-liquidation distributions to a partner without booking up can have this same unfortunate consequence. For example, suppose that the partnership makes a distribution to a partner that reduces but does not eliminate the interest of an existing partner and that results in gain to the distributee partner, who receives an amount of cash that exceeds his outside basis. Such a situation triggers a section 734(b) upward adjustment in the basis of partnership assets if a section 754 election is in effect for the partnership (which in general is optional). Now assume that the partnership has not done a book-up.

The entire benefit of any increase in partnership inside basis should go to the non-distributee partners,[85] and the mechanism for accomplishing this result is a special allocation of the benefits of the extra basis to them.[86] Now suppose that extra basis, which was determined by the unrealized appreciation in the assets to which it attaches, is never reflected in value to the partnership because, for example, the property becomes worthless. Only those partners

[85] Reg. § 1.704-1(b)(2)(iv)(m)(4).

[86] This special allocation is condoned in the Regulations even though it only has a tax effect and has no economic effect. *See* Reg. § 1.704-1(b)(2)(iv)(m)(4).

to whom benefits from the extra basis were specially allocated would suffer a tax loss upon the partnership's disposition of the property with respect to the basis adjustment amount. Yet, it should have no effect on their eventual sharing of liquidation proceeds from the partnership, because the section 734(b) special basis adjustment was designed as a special "tax fix," not something that would affect the non-tax economics of the deal.

If the partnership makes section 734(b) inside basis adjustments but does not make corresponding special allocation of deductions relating to those basis adjustments, the misallocation problem will exist. This is a potential trap for the partners (and their accountant) that often can be fixed by specially allocating pre-distribution gain or loss, as the case may be, to the non-distributee partners, which the section 704(b) regulations condone.[87] This solution does not work in all cases, however, even if the partnership agreement provides that the extra basis is specially allocated, because the depreciation may never occur and the assets may be sold for their new basis, so there is no loss to allocate, or if that "built-in" gain or loss is never realized because the property increases or decreases in value in a manner that eliminates the gain.

A revaluation and book-up of capital accounts provides a solution to the conundrum, and cures the problem. The book-up increases the book value of the partnership assets and capital accounts to fair market value and thereby correctly aligns the partners' capital accounts at that time to correctly reflect their economic interests in the partnership. Built-in (tax) gains resulting from the book-up are dealt with by application of principles of section 704(c).[88] Book-ups, however, are optional, and not all partnerships choose to do them.

To summarize, the Treasury Method is a prisoner of these capital accounts. If the capital accounts do not reflect the economic deal and the agreement provides for liquidation in accordance with capital accounts, there will be trouble in River City! The Target Method eliminates this risk, because the distribution section of the partnership agreement will expressly control distributions, including those upon liquidation of the partnership.

3. *Accountant Errors*

Perhaps most common as a practical matter, capital accounts can get out of alignment if the partnership's accountants have made allocations erroneously in the early years of a partnership so that even reversal allocations provided in the partnership agreement fail to bring the partner's capital accounts into alignment with the economic deal. Under the Treasury Method, those errors can affect the economic arrangement of the partners. Under the Target Method, they do not.

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[87] Reg. § 1.704-1(b)(2)(iv)(m)(4).

[88] Reg. § 1.704-1(b)(2)(iv)(f); Reg. § 1.704-1(b)(4)(i).

4. *Sometimes the Economic Deal of the Partners is just too Complicated for the Treasury Method*

This problem can occur, for example, if the partnership agreement provides for different classes of interests with layered priorities, that is, some classes of partners have priority over other classes. Under the Treasury Method, one would build up capital accounts in successive layers.

For example, suppose G and L enter into the arrangement in Example 1, a real estate venture, under which G and L get their investment back first ($90,000 to L, $10,000 to G) proportionately, from distributions, and thereafter share further distributions 50/50. Times become bad, rents are down, so the partnership cannot satisfy its expenses, including servicing its mortgage. The partners find a savior (Savior 1), who invests $100,000 and become entitled, as a priority, to the return of his investment and an 8% interest equivalent, before G and L will get any distributions (under their earlier arrangement).

Business continues to be disappointing, so in order to save the project from foreclosure, the partners, now G, L, and Savior 1, find a new savior, Savior 2, who negotiates the following deal: Savior 2 gets his investment back first plus a 10% interest equivalent preference, before the existing distribution order among Savior 1, G, and L becomes operative, with the following modification: Savior 2 also becomes entitled to an additional 10% of all other distributions to Savior 1, G, and L, that is, any amounts that go out to those other partners would cause 10% of that amount to be distributed to Savior 2.

You, the partnership's attorney, are now asked to draft allocation provisions to accomplish the deal by which Savior 2 enters the partnership. Would you use the Treasury Capital Account Method or the Target Method? If you use the former, you will undoubtedly be asked to provide assurance that the priorities outlined above and understood by the partners will be accomplished. This is an easy choice for me: make sure the money goes out correctly, and then force the allocations to align the capital accounts correctly. It is interesting to note at this point that Terence Cuff, one of the leading proponents of the Treasury Method, suggests that if the distribution scheme is very complicated, the Target Method may be advisable.[89] My reaction to this statement is that if the Target Method is preferred for the hardest cases and is most easily understood by the clients, whose money is on the line, then why would one not use it as a standard in all cases?

5. *Failure to Draft for all Eventualities or to Carry out Drafting Schemes*

Capital accounts can also get out of alignment and fail to reflect liquidation distribution priorities that are understood by the partners, in several other ways, resulting from lawyers failing to draft for all eventualities or accountants

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[89] *See* Cuff, *supra* note 35, at 412; *see also* discussion *infra* Part III.B. regarding Cuff's reasons for favoring the Treasury method over the Target Method; *see* text accompanying notes 111-124.

failing to implement and effectuate complicated drafting schemes. The most common ways in which this situation can arise are the following: (1) the existence of (a) timing only priority distributions to partners that exceed their capital contributions, or (b) permanent priority distributions without a corresponding allocation of income; (2) there is a limitation on loss allocations to a partner without an offsetting curative allocation; (3) there is a minimum gain chargeback allocation of gross income without any cash distributions. Each of these situations will be explained and illustrated below.

a. *Timing Only Preferences or Permanent Preferences for Cash Flow.* Cash flow distributions are sometimes made by the partnership that are not intended to alter the economic deal of the partners in any way other than timing. A partnership agreement that uses the Treasury Capital Account Method of allocation must carefully provide for allocations to keep the capital accounts reflecting ultimate liquidation priorities and amounts in addition to providing the terms of the partners' agreement with regard to distributions. Otherwise, a timing only distribution can turn out to create an extra distribution to a partner without reflecting the agreed priorities on liquidation of the partnership. Similarly, a distribution that is intended to be a permanent priority, unless correctly handled in the allocation provisions, can turn out to be a timing only priority.

In contrast, under the Target Method, the agreement can provide for allocations that can assist the partnership's accountants but would not, in the case of a mistake, affect the economics of the deal as agreed by the partners and inscribed in the distribution provisions. I will first review the possibilities of difficulties that could arise under the Treasury Method.

A discrepancy of the capital account balances with the economic deal can occur if the order and priority of distributions were dependent on timing variables. In previous Examples 1 and 2 in Part I of this Article, the order and priority of distributions did not vary with the circumstances. The agreements provided that G and L would each receive their contributed money back first, then a priority return (in Example 2) or not (in Example 1) and finally would get a percentage sharing. If the priority return were never achieved because there were insufficient funds to make distributions either during operations or on sale of the property and liquidation, then no allocation of income or gain would ever be made to the priority return of either partner, or if one were made because there were undistributed profits at any time, the capital accounts reflected by those allocations would be the first to suffer reductions when there were subsequent losses.

Now suppose that the order and priority of distributions depended on timing variables. This situation can occur when cash flow distributions are made in percentage terms different than the agreed sharing of income from operations or gain on sale, so that those distributions reduce capital accounts disproportionately to the agreed sharing ratio on liquidation.

For example, consider the following business arrangement. L contributes the full $1,000,000 and G contributes no cash or other property to a partnership. The partnership uses most of the funds to purchase depreciable rental real estate but retains a portion as working capital.

The partnership agreement provides that L will receive an 8% preference and priority return on his investment, to be paid currently out of cash flow if it is available, and any remaining cash flow will be shared 80% to L and 20% to G. On liquidation, L will receive the return of his investment plus any shortfall in priority return payments (*i.e.*, any part of the annual 8% return on his invested capital that was not paid to him because there was insufficient cash flow) ahead of anything that G gets. Thereafter, the remaining amount in the partnership will be shared 80% to L and 20% to G. However, the "Excess Cash" sharing ratio of 80/20 may never be attained because all previous unpaid cash flow priority amounts must be satisfied first and there may not be sufficient cash on liquidation to distribute to G.

This sharing arrangement resembles the examples in the last part, but with some important differences. Under the arrangement in this example, cash flow will be shared differently than in the previous examples. L will have first priority in cash flow for the payment of his preferred return plus any preferred return not paid in prior years. Thereafter, cash flow distributions will be shared 80% to L and 20% to G. L's invested capital will remain in the partnership until liquidation, which presumably will occur on the sale of the property.

Suppose, as posited above, that the partnership purchases depreciable real estate for $900,000, leaving $100,000 in the Partnership as working capital. Also suppose that in each of the first two years, operating revenue equals $250,000, operating expenses, all paid in cash currently, equal $150,000, depreciation equals $100,000, and no principal payments are required on any mortgage. This situation results in no net income, but there is positive cash flow of $100,000, which is distributable and distributed to the partners.

Under the agreed arrangement for cash flow distributions, $80,000 of the annual cash flow goes to the contributing partner, L, to satisfy his 8% priority. The Excess Cash flow in the amount of $20,000 goes in the ratio 80% amounting to $16,000 to the contributing partner, L, and 20% amounting to $4,000 to G.

The partners may have contemplated that this operating distribution arrangement would work in either of two ways. First, it is possible that this arrangement is intended to work in a way that G is receiving only a timing preference on distributions to be offset later by a catch-up distribution to L at time of liquidation in order to maintain an alternate sharing arrangement of money back and priority return first, then sharing of any excess 80/20. Second, it may be intended that G is receiving an absolute preference with no catch-up to the other partner or obligation to return any distributions even if G's capital account is negative at time of liquidation. The challenge to the draftsman under the Treasury Method is to ensure that the capital accounts reflect the appropriate choice that has been made.

In either event, as a result of the distribution, the cash flow distribution to G in the amount of $4,000 exceeds his capital account of $0, resulting in a deficit capital account balance to him at the end of year one equal to $4,000.

In year two under the QIO, which operates when an unexpected distribution causes a partner's capital account to decrease below the level of the amount that will be actually or deemed restored either through a DRO or a Minimum Gain Chargeback, G is allocated gross income of $4,000, interpreting this distribution as "unexpected" (and also not for services rendered and thus not characterized as a "guaranteed" payment under section 707(c)). This allocation of gross income under the QIO results in a "residual" additional tax loss to the Partnership (allocated to L) after the allocation of $4,000 of gross income to G.

Assume also that year two's cash flow distributions replicate year one's, so that G again receives an unexpected distribution in the amount of $4,000, decreasing G's capital account again by $4,000.

The effect of application of the QIO becomes complicated, so it is useful to introduce the concept of "Adjusted Capital Account," which is used in many skillfully drafted partnership agreements. The term "Adjusted Capital Account," is generally used to mean a partner's Capital Account increased by his share of Partnership Minimum Gain and deficit restoration obligation (which does not exist in this example).

Note that if the property acquisition were financed with a nonrecourse liability, G may share in nonrecourse deductions if his ultimate sharing ratio in economic profits upon sale is 20% and the partnership agreement provides for such an allocation to G.[90] Any such allocation of nonrecourse deductions, however, will not affect the conclusions illustrated by this example because the nonrecourse deductions will eventually be offset by an allocation of that same amount of income or gain from the chargeback of partnership minimum gain.[91]

The effect of this distribution pattern and the application to G of the QIO is to reduce G's Adjusted Capital Account to below zero, but then increase his Adjusted Capital Account as a result of the gross income allocation to him under the QIO by that same amount. That is because the QIO causes G's Adjusted Capital Account, which will become negative by virtue of the distributions received by G, to be brought back to zero by an allocation of gross income. The operation of the QIO provision will, in effect, shift income from L to G. L will be allocated an additional $4,000 loss as a result of the allocation of gross income to G under the QIO.

Now suppose the parties desired the operating distributions to G only as a timing preference. The customary correction for the problem in the above

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[90] This allocation will be respected as long as either a 20% gain-sharing or cash flow percentage is a "significant partnership item attributable to the property servicing the nonrecourse liabilities." Reg. § 1.704-2(e)(2); *see supra* note 63 and accompanying text.

[91] *See* Reg. § 1.704-2(e)(3), (f)(1).

example, arising from the QIO allocation of gross income, is a provision in the agreement requiring curative or corrective allocations. That is, if a "regulatory allocation" such as the QIO causes an allocation of income to one partner, at the next opportunity, the effects of that allocation will be reversed or cured by allocating losses to that partner equal to the previous allocation of income under the QIO. The curative allocation is intended to cause under-allocation of income and gains to G so that L's and G's respective capital accounts are equal to their agreed sharing arrangement of liquidation distributions from the deal, less their respective earlier distributions.

Nevertheless, even if the agreement contains such a curative allocation provision, it could be ineffective in correcting capital accounts if there is never sufficient net income in the partnership allocable to G to permit a curative loss allocation to G to offset G's previous allocation of gross income under the QIO. Seen from L's point of view, there would not be sufficient income in the partnership to allocate to L to build back L's capital account to what it would have been absent the QIO income allocation to G and extra loss to L. In that event, the intended timing preference would turn into a permanent preference for G.

This situation could occur under the Treasury Capital Account Method because liquidation distributions are made in accordance with capital accounts instead of in accordance with the distribution provisions. In contrast, under the Target Method, the distribution provisions could take into account that G had already received the earlier distributions for purposes of determining later distributions, and the operation of the QIO would not alter the division of any future distributions between G and L.

On the other hand, there may be sufficient income to ensure that L's capital account gets built up by the curative allocation so that the early cash flow distributions to G are only a timing preference. Only the eventual outcome of the business operations of the partnership and realized appreciation of its property on sale will determine which it turns out to be, timing or permanent preference. (Note that if a true permanent preference were desired, then the partnership agreement should not contain a curative allocation for the QIO. In that situation, the triggering of a gross income allocation to G would not be reversed.)

Even the foregoing expectation of a timing preference only can be haphazard if G has a positive Adjusted Capital Account when the cash flow distributions are received. For example, if G had contributed $1,000 to the partnership originally, then $1,000 of the year one distribution to G would be a return of capital and would not trigger the QIO and resultant allocation of gross income, and the other $3,000 would trigger the QIO, with its ultimate characterization of timing or permanent preference uncertain. The $1,000 distribution would reduce G's claim to the $1,000 upon liquidation to zero, because his right to get distributions equal to his capital account on liquidation would suffer by virtue of the $1,000 reduction of his unreturned capital contribution. Thus, G's right to the $1,000 distribution operates as a timing priority rather than a permanent preference. Absent any correction to this situation, G's right to the remaining $3,000 of current distributions of cash flow could work as either a timing or permanent preference, depending upon future events. For example, if on liquidation of the partnership, there were insufficient proceeds to pay anything to G, the earlier distributions to G of $3,000 would have worked out to be permanent.

Perhaps the surest way to draft the timing preference to G is to avoid triggering the QIO in the first place by providing that G has a limited deficit restoration obligation (DRO) in the amount by which he receives distributions in excess of his capital account. That solution, however, can run into partner objections. For example, suppose the partners want to provide essentially for a timing preference, but not one that requires partners to put money back. Rather, any timing preference would be offset by a lesser distribution at time of liquidation. This means that the partners are willing to live with the prospect of a partner having a negative capital account but without a DRO, which is antithetical to the Treasury Capital Account Method.

On the other hand, if the operating cash flow distribution to G were intended to be permanent, one would want to allocate gross income in the agreement to the partners who are distributees in the amount of the cash flow distributions in order to ensure that they are permanent preferences rather than rely on the haphazard workings of a QIO. In that manner, the distributions would be matched by gross income allocations to the distributee partners and their capital accounts would remain intact. The gross income allocations increase the capital account by the amount of the allocations and the distributions of these amounts reduce the capital accounts back to where they were. As a result, the capital account balances will reflect the priorities for the liquidation distributions and will generate the same economic result as the Target Method, which controls distributions directly.

In contrast to the Treasury Method, the Target Method lets the distributions control the deal. The allocations would, mechanically, strive to align the capital accounts with the priorities of distributions on liquidation, and it may very well accomplish that. But, it may not, and even if it does not, the distribution provisions would provide the way in which the cash is distributed on liquidation. The allocation provision to be drafted, then, may be for guidance and will assign items of income among the partners to seek to have the capital accounts reflect future distributions, but the capital accounts themselves would not control any *distributions.*

b. Absence of Curative Allocations. If there is a limitation on losses imposed on a partner by section 704(b) in a situation in which (1) there is no curative allocation clause in the partnership agreement to reverse any regulatory allocation of loss to another partner *and* (2) this limitation on loss allocation is applied by the partnership's accountants; in this event, capital accounts can fail to reflect the partners' intended deal.

In these situations, gain or loss is allocated to book capital accounts under the so-called "regulatory provisions" of the partnership agreement instead of the regular allocation provisions set forth in the partnership agreement. Any time an allocation of income, gain or loss must be made outside of the normal allocation provisions in the agreement and either (1) the agreement fails to provide for a reverse allocation from future income or loss (sometimes called a "curative allocation") or (2) the agreement provides for such a reverse or curative allocation but there is not at any time sufficient income or loss to accomplish it, capital account balances will not reflect expected liquidation distribution priorities and amounts.

This situation can arise when a partner, typically the general partner, G, is provided with a percentage share of losses in excess of his share of capital contributions. In that event, G's loss allocations will deplete his capital account and, without a DRO (and assume there is none) the excess will be reallocated to L and thereby reduce L's capital account. Then, when gains are reallocated on a percentage basis or pursuant to an income and gain allocation provision that does not take into account the regulatory rule proscribing the previous loss allocation, the capital accounts could diverge from the economic sharing deal.

For example, suppose as in the example above, that L contributed $1,000,000 and G contributed zero (L to receive his capital contribution amount back before any sharing of economic profits), but in the agreement, G was allocated 20% of the losses. If there were $100,000 of losses in year one, then (absent a DRO applicable to G), the $20,000 of the losses putatively allocated to G would be reallocated to L. This would occur under the regulatory provision in the agreement, not by the allocation provisions. Thereafter, when income of $100,000 was earned by the partnership and shared under the terms of the agreement, 20% to L and 80% to G, L's capital account would increase to $80,000 and G's capital account would increase to $20,000, even though the economic deal would be that upon liquidation of the partnership at that point, L would get the return of his entire $1,000,000 contribution and G would get zero.

A curative allocation provision eliminates this potential problem by allocating the earliest gains to L to reverse the previous losses allocated to L by virtue of the regulatory allocation provision. This type of curative allocation must be included in a partnership agreement using the Treasury Allocation Method and applied correctly by the partnership's accountants, because the Method depends on capital account balances to govern distributions.

Curative allocations are also generally provided in Target Method allocation provisions. However, even in their absence or if the accountants fail to apply them, the Target Method allocation will make the curative correction happen automatically.

c. *Minimum Gain Chargeback Event Without Sale.* There is a Minimum Gain Chargeback (MGC) that creates a positive capital account balance for a partner and no cash distribution in the year of the chargeback. This situation can occur if G guarantees a portion of the nonrecourse liability at a time when the partnership has already taken nonrecourse deductions (allocated between G and L and reflected in their respective shares of partnership minimum gain). The seeming unrelated event of G guaranteeing all or a portion of the partnership's nonrecourse liability converts the liability (or a portion of it) to recourse and reduces partnership minimum gain to the amount by which the remaining nonrecourse portion of the liability exceeds the book value of the property (I will assume the excess to be zero to make the point more clearly). This guaranty causes a reduction in L's share of partnership minimum gain and triggers a minimum gain chargeback (MGC) of gross income to L[92] (and none to G, who became the guarantor and as such become liable for the guaranteed portion of the debt),[93] even though the property had not yet been sold. The MGC can potentially result in L having a capital account in excess of the amount to which he would be entitled if the partnership at that point sold all of its properties at book value and liquidated. Thus, the minimum gain chargeback could alter the economic deal of the partners.

The regulations recognize this possibility[94] and allow for a variation from the general allocation of minimum gain required by the MGC regulations, but such a variation requires application to the Service and a Service grant of a waiver of the normal MGC rule. Such a waiver is discretionary with the Commissioner.[95]

Let me illustrate this situation with a numerical example.[96] Suppose the partnership had purchased property for $900,000 with no cash payment, but rather by financing the entire purchase with nonrecourse debt in the amount of $900,000. Suppose also that only L furnished a capital contribution to the partnership of $100,000, which was used for working capital. Assume also depreciation of $100,000 per year and gross income of $150,000 and cash operating expenses of $150,000, generating a loss of $100,000 which is shared under the agreement 20% to G and 80% to L. Now, suppose at the beginning of year three, when the property's basis is $700,000 and the nonrecourse liability has remained at $900,000, G guarantees $200,000 of the liability (causing that $200,000 of the liability to no longer be a nonrecourse liability), reducing minimum gain to zero. The guarantee triggers a Minimum Gain chargeback by virtue of the guarantee (assuming no waiver has been applied for and granted), yet no net income is generated. There is only $150,000 of gross income of the partnership, which is allocated to L.

In this situation, depreciation for the first *two years* has reduced the basis of the property down to $700,000, and G's and L's respective capital accounts, after sharing losses in the ratio set forth in the partnership agreement, 20/80 (but, before the guaranty and operation of the Minimum Gain chargeback),

[92] *See* Reg. § 1.704-2(f)(1).

[93] *See* Reg. § 1.704-2(f)(2).

[94] *See* Reg. § 1.704-2(f)(4).

[95] *Id.*; *see also* Reg. § 1.704-2(f)(7), Ex. (1) (showing such a distortion of the economic arrangement of the partners and how a waiver can correct the distortion).

[96] This example is based on an example in SCHWARZ & LATHROPE, *supra* note 1, at 172.

to the following: G: (-$40,000); L:(-$60,000). At that point their respective shares of Partnership Minimum Gain are as follows: G: $40,000, L: $160,000. After operation of the Minimum Gain Chargeback (MGC) provision, the capital accounts are as follows: G:-$190,000[97]; L:$90,000.[98]

Now, suppose the property is sold at the beginning of year three for $700,000, resulting in no gain, and revenues ceased. The partnership pays $100,000 from its working capital and G makes a capital contribution of $100,000 to satisfy the portion of his guarantee to the lender not otherwise satisfied by partnership assets, increasing his capital account from -$190,000 (*i.e.*, -$40,000) from regular nonrecourse deduction loss allocations and $150,000 resulting from all gross income having been allocated to L under the MGC) (since it was reduced by all of the depreciation plus the $100,000 contribution) to -$90,000. Therefore, the Partnership has no net assets out of which liquidation proceeds could come but the partners' capital accounts are $90,000 for L and -$90,000 for G. This result is antithetical to the Treasury Capital Account Method because G has no DRO, so his negative capital account is meaningless. Moreover, L's positive capital account does not entitle him to any distribution on liquidation. Under the Target Method, in contrast, the position of the capital accounts will not affect the partners' proceeds in liquidation. Rather, liquidation proceeds are governed by the distribution provisions in the partnership agreement.

D. *Curative Allocations to Offset Regulatory Allocations and The Phenomenon of the "Savings Clause" Under the Treasury Method as the Partnership Accountant's Trump Card*

In each of the five situations described above, the Treasury Method can cause the capital account balances to fail to reflect what the business deal prescribes if liquidating distributions are made in accordance with positive capital account balances. Thus, practitioners, as a matter of practice, typically include in the partnership agreement provisions that seek to alter the allocation provisions from the allocations specified in the partnership agreement.

1. *Curative Allocations*

One class of allocation provisions that can alter the intended allocations designed to build capital accounts in the manner that would cause them to carry out the agreed economic deed, are those mandated in the regulations, referred to as regulatory allocations. Examples of regulatory allocations, which are done outside of the normal allocation provisions, include (1) the QIO, (2) preclusion or reduction of loss allocation because of the absence of a DRO or limited DRO, and (3) a minimum gain chargeback resulting from a reduction in a partner's share of minimum gain without an equal amount of minimum gain being realized by the partnership. The methods and provisions

[97] Computed as follows: $0 - $20,000 - $20,000 - $150,000 = -$190,000.

[98] Computed as follows: $100,000 - $80,000 - $80,000 + $150,000 = $90,000.

that accomplish these offsetting reversals are curative allocations. Curative allocations are designed to effectively reverse and offset mandated regulatory allocations when appropriate income or losses become available to allocate.

Curative allocations, in effect, reverse the effect of the regulatory allocation provisions with offsetting future allocations of income, gains, losses or deductions, as the case may be, seeking to reinstate the effect of the allocation scheme set forth in the partnership agreement. As discussed above, these curative allocation sometimes cure the problem of capital account misalignment, but, as also discussed above, sometimes they do not.

2. *Savings Clause*

As a result of the possibility that certain allocations or errors can cause capital accounts to become misaligned so that they do not reflect the partners' economic arrangement upon liquidation of the partnership, savings clauses have become a common drafting crutch in partnership agreements. They allow partnership accountants to make whatever allocation they deem necessary to alter the partners' capital accounts in order to make the economics come out as originally agreed, even if partners with larger capital account balances do not get the benefit of them. Savings clauses provide the following vernacular overriding rule: forget what you read in the partnership agreement; if the economic results do not comport with the understanding of the parties, do what the parties intended. Moreover, the partnership's accountant will be charged with making that determination and creating the fix. My view, as stated earlier, is that such a savings clause gives the parties carte blanche to ignore those finely drafted and complicated Treasury Capital Account Method allocation provisions in favor of Target Method allocations determined by the distribution priorities that will govern the economics of the arrangement.

The technical problem with the savings clause solution is that if, at the outset of the partnership, the savings clause could override either the provisions requiring maintaining capital accounts in accordance with the Treasury Regulations and requiring liquidating distributions to be made in accordance with the capital accounts so maintained, then the agreement could not satisfy the Big Three SEE safe harbor, because liquidating distributions would not necessarily be made in accordance with capital accounts *in all events*. The savings clause therefore violates requirement 2 of the Big Three.

Arguably, the final "correction distribution" under the savings clause constitutes a "capital shift" and should be viewed as a guaranteed payment rather than a distribution, giving rise to income to the distributee and deduction for the partnership and therefore the other partners, who are being shortchanged their capital accounts. If so, presumably it should be explicitly drafted as such rather than as a distribution, often yielding capital gain to the distributee. But, for what would the guaranteed payment have been paid—services, capital?

It also has been suggested by Golub[99] that it could be argued that the guaranteed payment result should be triggered as soon as the capital accounts no longer reflect the agreed-upon distributions in liquidation, determined based on a hypothetical sale of partnership properties at book value followed by a hypothetical liquidation—an accrual theory.

Moreover, and alternatively, the shift might call for a gross income allocation to align the capital accounts with the "agreed" and understood liquidation priorities.[100]

These approaches to aligning the capital account all indicate that correction of a capital account misalignment has to be rationalized in some way, but none of the alternative ways are wholly satisfactory. Thus, any way one views this savings clause situation, there is a disconnect with the SEE safe harbor.

Perhaps the argument goes that this provision is just another method of forcing the capital accounts to do the deal understood by the accountants but not expressly written into the partnership agreement. If that is so, however, then the Treasury Capital Account Method with supervisory power by the accountants is no better than ignoring the allocation provisions in the agreement and forcing the capital accounts to reflect the agreed distribution scheme, that is, using the Target Method of Allocation. And, if that is so, then one should conclude that the Target Method should be used in the first place because it is the ultimate standard to which the Treasury Method results are compared. Accordingly, one should draft the partnership agreement to expressly use the Target Method for allocations.

Thus, inclusion of a Savings Clause in the allocation section of a partnership agreement results in two serious compliance problems:

(1) It may violate requirement 2 (and perhaps 3) of the SEE safe harbor, because capital account balances would not always determine liquidation proceeds; and

(2) It could result in a lawsuit in which one side argues that the "deal" is embodied in the distribution provisions, not the capital accounts controlled by the rules set forth in the Treasury Regulations, and the other side argues that the capital accounts rule. The accountants making the super-agreement allocation decisions could get enmeshed in that lawsuit.

However, omitting a savings clause from a partnership agreement that relies on the Treasury Method risks the divergence of the capital accounts from the partners' expected economic sharing deal. The real solution to the misaligned capital account problem is for the partnership agreement to use distribution provisions to describe the deal, and then do allocations to align capital accounts to accomplish the deal to the extent possible, that is, use the Target Method.

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[99] *See* Golub, *supra* note 34, at 167-70.
[100] *Id.* at 165-67.

III. The Commentators who Favor the Treasury Capital Account Method: Their Arguments and My Responses

Notwithstanding all that has been said in Part II of this Article, two leading commentators in Partnership Taxation strongly favor the Treasury Capital Account Method over the Target Method. I will discuss their principal reasons and set forth my responses.

A. *Whitmire, Nelson, McKee, et al.*

Whitmire et al. note, indeed warn, that in using the Target Method in practice, the provisions governing allocations of profits and losses must be carefully tailored to mesh with the partners' exact economic arrangement to achieve the correct balances under any conceivable set of economic circumstances. That means that the drafter of these allocation provisions must be precise and must anticipate all possible combinations and sequences of profits, losses, and items thereof, as well as capital contributions, operating distributions, and distributions from refinancings and sales. They caution that in all but the simplest transactions, the drafter must anticipate and accurately deal with a wide range of unpredictable future events, thereby inviting a "very real risk that some combination of future events will be overlooked or mishandled."[101]

More ominously, they conclude that notwithstanding the appealing theoretical simplicity of the Forced Allocation Technique, that is, the Target Method, in practice, it is fraught with risk, and if used indiscriminately by the draftsman without considering a multitude of issues that must be addressed, it "is almost certain to lead to disaster." It does not relieve the draftsman of the need to think through the deal.

This warning I believe is far too ominous. If it means that in the realm of drafting complicated partnership distribution provisions and allocation provisions, the draftsman should think through the deal, then of course, it should be heeded. However, the way to think through the deal is to carefully consider all circumstances that could arise and how distributions would be made in all of those circumstances. The Target Method, contrary to the Whitmire warnings, actually assists in this process because it focuses efforts on ensuring that the distribution provisions accurately reflect the deal. Presumably, the respective partners themselves will be able to verify the accomplishment of this objective.

In any event, the Treasury Capital Account Method by no means relieves the draftsman of this responsibility. In contrast to the Target Method, however, the Treasury Capital Account Method does not provide any shortcut or easy route to ensure that the agreement reflects the economic arrangement of the partners. One still has to set forth precise distribution provisions, at the very least, to cover interim, nonliquidating distributions, and this is

[101] WHITMIRE ET AL., *supra* note 11, at ¶ 5.05[2], at 9.

typically the case. However, one must also reflect that arrangement a second time although in accounting parlance, in the allocation provisions to ensure that the capital accounts are in the appropriate amounts to accomplish the deal as set forth in the distribution provisions.

Whitmire et al. helpfully catalog the most prevalent drafting problems faced in using the Target Method, referred to by them as the Forced Allocation Technique. I have used the latter terminology in this part of the Article in stating the problems they identify, because it is the Whitmire et al. preferred terminology. Those problems are set forth below, each followed by my comments using Target Method terminology.

1. *Problem 1*

"The distribution provisions that provide the benchmark for the forced allocations must not be based in any way on the partners' capital accounts."[102]

Avoidance of this problem is precisely what the Target Method is designed to do. Liquidation distributions are provided in the distribution provisions, typically with a liquidation clause making reference to those distribution provisions such as "liquidations will be made in accordance with Article XXX dealing with distributions." Lip service can then be given to the SEE Big Three safe harbor test by allowing a final distribution to be made in accordance with capital account balances *after* all of the provided distributions have been made. At that point, of course, the capital account balances should be zero.

2. *Problem 2*

"The distribution provisions that are used as the benchmark for forced allocations must be drafted with great care."[103]

The first part of this thought is self-evident and has been dealt with earlier. Whitmire et al.'s warning as it relates to any potential deficit restoration obligations of the parties, however, is subtler. If the financial arrangement is designed to eliminate any deficit restoration obligation to the extent that other partners have positive capital accounts, then the Target Method would allocate profit or gain to the deficit partner first, in order to bring that partner's capital account up to zero.[104] On the other hand, if the deficit restoration obligation were designed to survive, then it must be explicitly stated as an obligation to be fulfilled before final allocations are made or restated as a separate obligation to make further contributions to the partnership's capital in an amount determined prior to liquidation and the allocations associated with liquidation. In most circumstances, it would appear that a partner's obligation to make future contributions based upon an obligation to restore deficits

[102] WHITMIRE ET AL., *supra* note 11, at ¶ 5.05[2], at 10.

[103] *Id.*

[104] Note this is the manner in which the Target Method allocations provisions for Examples 1(b) and 2(b) were drafted. *See supra* Part I.

rather than an obligation to make an additional capital contribution in a fixed sum, are likely the result of an attempt to achieve a tax objective rather than primarily to obligate an additional contribution. In this latter case, the Target Method allocation would allocate income or gain to eliminate deficits first in order to accomplish this business objective.[105]

3. *Problem 3*

"If some of the partners are not fully liable for capital account deficits or nonrecourse deductions are generated by the partnership, the special allocation provisions relating to the alternate economic effect test and the nonrecourse [deduction] rules must be included in the agreement even if other allocations are to be determined under the Forced Allocation Technique."[106]

Whitmire et al. correctly point out that the Target Method allocations must be used in conjunction with the so-called "regulatory provisions" involving (1) loss limitations on a partner who does not have a deficit restoration obligation, (2) qualified income offset provisions and associated gross income allocation, (3) minimum gain chargeback provisions, and (4) definitions of profits and losses with reference to book rather than tax amounts. The Treasury Method, of course, also requires these regulatory provisions, so the Target Method in this regard requires no more complexity than the Treasury Method. The Target Method, however, obviates the need for curative allocations in many cases because, as Whitmire et al. point out, they are inherently curative,[107] but they are not always inherently curative when it comes to partners having deficit accounts for which there are no DROs.

4. *Problem 4*

"Use of the Forced Allocation Technique does not relieve the drafter of the need to determine whether priority returns or other special distributions should be matched (if at all) with profits or items of gross income."[108]

Frequently, distributions of cash flow are provided in an order and priority different than distributions resulting from refinancing or a sale of assets. Such distributions, whether they involve priority returns for capital or services or for some other reason, have to be separately justified as either advances, in which case eventual allocations of profits or gains would have to match the earlier distribution, or carry with it allocations of gross income. This in turn depends upon whether the special distribution is designed to be permanent and viewed apart from any subsequent economic arrangement regarding amounts in the partnership. These questions are all important ones in any deal, but they are not different than if the Treasury Capital Account Method were used.

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[105] *Id.*

[106] Whitmire et al., *supra* note 11, at ¶ 5.05[2], at 11.

[107] *Id.*

[108] *Id.*

5. *Problem 5*

"The Forced Allocation Technique is difficult to use if the drafter desires to limit offsetting special allocations to specified items. Thus, it is difficult to use this approach if the parties desire to disproportionately allocate losses or depreciation and limit the chargeback to gains as opposed to profits."[109]

The Target Method is typically designed to achieve the overall economic arrangement of the partners. It therefore, operating alone, cannot make the fine distinctions referred to above. However, to the extent that these goals are desirable, additional provisions can be drafted providing for special allocations that would operate prior to the Target Method allocation provisions. For example, depreciation can be specially allocated to be offset with gain chargebacks, if gain is ultimately realized. In such a situation, the partner who is specially allocated depreciation deductions would suffer the economic loss if the depreciation was matched with reduction in value of the property. In such a situation, the Treasury Method provision is easier to draft than the economically equivalent Target Method provision, which would have to reflect the depreciation deduction amount in a distribution provision designed to impose the economic loss from depreciation on the partner to whom it was allocated. Indeed, the provisions in the Part I examples do this by causing the contributing partners to suffer any losses first. Doing this with separate items like depreciation is more complicated. Under such an arrangement, the Treasury Method may be superior to the Target Method. This would be the unusual case. Alternatively, a simple gain chargeback provision can be used with the Target Method in a manner similar to a Minimum Gain Chargeback provision.

More usual would be a special allocation of nonrecourse deductions. That special allocation, however, does not pose a more difficult problem under the Target Method because the Minimum Gain Chargeback provision is an automatic self-correction. Nonrecourse deductions can be specially allocated as long as they are offset with Minimum Gain Chargeback provisions (and other requirements are satisfied).[110]

B. *Cuff*

Terrence Cuff, in his PLI article entitled *Some Selected Issues in Drafting Real Estate Partnership and LLC Agreements*[111] also cautioned against using the Target Method. Referring to this approach alternatively as the "Layer Cake" approach and the "Target Allocations" approach, Cuff describes the technique as incorporating the concept of "Adjusted Capital Account." The Target Method draft provisions in Part I of the article used the term "Target

[109] *Id.*

[110] The Target Method allocation provisions for Examples 1(b) and 2(b) specially allocate nonrecourse deductions.

[111] *See supra* text accompanying note 35.

Capital Account" for this concept.[112] However, I will use Cuff's terminology of Adjusted Capital Account for the concept in this part of the Article. The term partners' Adjusted Capital Accounts includes the partners' actual capital accounts increased by their shares of Minimum Gain. Allocations build up Adjusted Capital Accounts.

Cuff notes that the approach is most commonly found in allocations of gain or loss from the sale of partnership assets rather than operating income of the partnership. He also notes that this approach generally starts by eliminating negative Adjusted Capital Accounts, and thereafter builds up Adjusted Capital Accounts until the Adjusted Capital Accounts equal the sum of unrecovered capital plus preferred returns. Thereafter, the approach generally allocates by percentage interests. This is the approach followed in the Target Method provisions discussed in Examples 1(b) and 2(b) of Part I.

Similar to Whitmire et al., Cuff observes that the attraction of this approach is the apparent ease by which one can provide highly complex tiered arrangements. That is because the Target Method has the effect of building the Adjusted Capital Accounts so that the Capital Accounts will conform to the economic scheme for distributing proceeds on liquidation. In that manner, this approach overcomes the discomfort that many drafters of allocation provisions perceive in simply distributing proceeds of liquidation in accordance with capital account balances, an accounting concept rather than an economic concept.

Nevertheless, Cuff strongly disfavors this approach for several reasons. He dismisses what he calls the "current rage" as a tool of "inexperienced and unskilled draftsman" and as a panacea for all partnerships and all situations,[113] even though he concedes that "Target Allocations [usually] produce mathematically 'correct' results over the life of the partnership (without considering timing or character)."[114] Cuff's reasons are set forth below, followed by my comments.

1. *Problem 1*

The Target Method fails to provide the partnerships' accountants with sufficient guidance to complete the partnership's tax return in more complicated cases. Thus, they appear to be deceptively simple to draft, which adds to their appeal, but are difficult to account for on tax returns.[115]

The Target Method simply requires the accountants to use a somewhat different methodology in allocating income, gains, and losses. The logic of that

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[112] Note that Target Capital Account does not include a partner's obligation to restore under a DRO whereas the Treasury Regulations, when using the term "Adjusted Capital Account," does include the DRO amount. Cuff's term does not.

[113] Cuff, *supra* note 35, at 412.

[114] *Id.*

[115] *Id.* at 412-13. *See* Noel Brock, *Targeted Partnership Allocations (Part I)*, The Tax Advisor, June 2013, at 374-79 (identifying this point as a principal reason that many partnership tax advisors prefer the Treasury Method).

alternative method is straightforward as described above, and familiarity will breed ease.

2. *Problem 2*

Complexity is confronted under the Target Method when distributions of liquidation proceeds differ from distributions of operating cash. In such circumstances, the allocation scheme can create an unintended distribution scheme, and can result in unexpected tax effects, including potential capital shifts among partners.[116]

Cuff does not explore the former possibility further. Nor does he explain whether if such unfortunate complications arise, they would not also arise under the Treasury Capital Account Method, absent corrections. I believe those unfortunate complications would arise, and even more severely.

For example, if a permanent preference were intended in a provision for the distributions of cash flow, there should be an allocation of gross income so that the distribution is offset by the allocation and does not alter the liquidation priorities. This is true under the Treasury Method as well as the Target Method. However, failure to provide this gross income allocation is more likely to alter the economics of the deal if the Treasury Method is used than if the Target Method is used, because the Target Method is self-correcting in many cases at time of liquidation. Indeed, the Target Method, by allowing distributions set forth in the partnership agreement to govern ultimate allocations, inoculates the economic arrangement of the parties from unusual allocation agreements under which operating distributions and allocations differ from liquidation distributions. Thus, the exact opposite of Cuff's proposition is true.

3. *Problem 3*

Combining the Target Method with meaningful capital account accounting is fraught with peril, because liquidating in accordance with capital accounts when one has forced the capital accounts by virtue of the Target Method makes it more likely to affect the economics than if the liquidation provision simply requires liquidation in accordance with capital accounts.[117]

Under the Target Method, capital account accounting mandated for SEE safe harbor treatment under the Treasury Regulations can be employed so that capital accounts at the time of the liquidation of the partnership are likely to match the liquidation distributions explicitly set forth in the partnership agreement.[118] Under the Target Method, liquidation proceeds are dis-

[116] Cuff, *supra* note 35, at 415.
[117] *Id.* at 415-16.
[118] *See* Examples 1 and 2 *supra* Part II.

tributed in accordance with the distribution provisions, not capital account balances.[119]

Moreover, suppose that at the time of liquidation, one partner had a positive capital account and another partner had a negative capital account because of previous distributions under the partnership agreement that were not matched by gross income allocations, and there were no more assets to distribute. This situation indicates that the previous distributions accomplished the economic deal of the partners. Thus, had the Capital Account Method been used (requiring that capital account balances control all distributions prior to making those distributions), then the distributions under the agreement (requiring distributions be made in accordance with positive capital account balances) would have been different than the ones set forth in the agreement and designed to accomplish the partners' agreed economic deal.

4. *Problem 4*

A partnership agreement under which allocations are controlled by the economic scheme as under the Target Method provisions risks inadvertent taxable capital shifts among the partners.[120]

This capital account shift could occur, particularly at time of liquidation as discussed earlier,[121] but if it does occur, it is a function of the deal made by the partners and not a choice made by the drafter.

5. *Problem 5*

The Target Method may also cause unexpected allocations of income to a partner and can thereby have major impacts on all of the partners. For example, under the Target Method, a service partner who receives a profits interest that is non-taxable at the inception of the partnership begins the partnership with a zero balance capital account. He will be allocated income to the extent that the profits interest, which he received as compensation for his services, causes that service partner to attain a priority on distributions. This result, in Cuff's language, represents a "tax tsunami for the service provider."[122]

However, financially the result to the service provider is exactly what he should expect if he wants assurance that he will receive his negotiated share of profits. Indeed, these consequences are entirely appropriate under the theory of capital accounts. Moreover, any hardship can be alleviated by also providing the service provider with distributions sufficient to pay his tax bill.

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[119] Note, as stated earlier, that after those distributions are accomplished, any remaining amounts could be distributed in accordance with capital accounts balances, which of course, would be zero at the end of the liquidation process. Thus, this final provision of liquidating in accordance with capital account balances may technically comply with the SEE safe harbor requirement 2, liquidation in accordance with final capital accounts, even though it would never control any actual distributions.

[120] Cuff, *supra* note 35, at 415.

[121] *See supra* Part II.D.; *see supra* text accompanying notes 99-100.

[122] Cuff, *supra* note 35, at 417.

On balance, what Cuff is describing as complexities from the Target Method are really complexities resulting from a financially complicated sharing of proceeds scheme among the partners, rather than the method of tax accounting used to record it. For example, when a service partner receives a profits interest, which is not taxable currently when received, then of course that service partner's share of profits is going to be taxable regardless of whether the service partner receives any distributions, either because the agreement does not provide for distributions or because there is no available cash to make distributions (perhaps because the loan agreements prohibit them). One has to know how things are likely to work in the future in order to plan appropriate consequences. This is the case whether the Treasury Capital Account Method is used or whether the Target Method is used.

6. *Problem 6*

The Target Method may not satisfy the safe harbor test in the Treasury Regulations.[123]

Cuff notes that Target Allocations depend upon satisfying the "economic effect equivalence" test in order to achieve deemed economic effect. As discussed earlier, that would occur as long as, under the test, "as of the end of each partnership taxable year liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if the Big Three have been satisfied, regardless of the economic performance of the partnership."[124] Cuff leaves this problem as an open question, with the suggestion by the problem itself that all other allocations would be called into question. Moreover, and perhaps most important, satisfying the economic effect equivalence test is necessary in order to meet the tests of the nonrecourse deduction allocation safe harbor, discussed in Part II.

Cuff's point in this regard highlights the need to at least clarify but preferably revise the Treasury allocation regulations to assure appropriate treatment of Target Method allocations.

IV. Conclusion

A. *Recommendations: The Treasury's Special Allocation Regulations Should be Revised to Safe Harbor the Target Method and Deal with Other Related Matters*

The current regulations should be revised because they encourage the use of Treasury Method allocations seeking to satisfy the SEE safe harbor test and thereby create the unfortunate uncertainty described in this Article for Target Method allocations. In a world in which partners rightly desire an allocation of economic profits and losses that reflects their deal and not one that is

[123] Cuff, *supra* note 35, at 413.
[124] Reg. § 1.704-1(b)(2)(ii)(i).

subject to alteration by Treasury tax regulations, it should be incumbent on the Treasury to accommodate this legitimate objective.

As this Article argues, the Target Method is the method of allocation that best reflects the economic arrangement of the partners and Treasury should strive to accommodate its regulations to that reality and assist in attaining certainty to the extent possible in the partners' tax consequences. To that end, this Article has argued that the Treasury should revise the current EEE, PIP, and Deemed PIP rules to accommodate Target Method allocations for safe harbor protection under EEE, and revise the EEE regulations to explicitly cause EEE qualifying allocations to be considered as satisfying SEE for all purposes.

Target Method allocations for the kinds of deals described in Examples 1 and 2 in Part I of this Article should satisfy the economic effect equivalence test of economic effect, because the economic result of their application in the situations of those examples will mirror the result of relying upon capital account balances to determine the distribution of proceeds on liquidation of the partnership. More precisely, under the economic effect equivalence test, the Target Method in these situations achieves economic effect because "as of the end of each partnership taxable year liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if [the Big Three] had been satisfied, regardless of the economic performance of the partnership."[125] Any other result would ignore purpose in favor of sophistry. This result should be confirmed in the regulations.

This proposed change would bring certainty to allocations that have a result that is equivalent to those that satisfy the current SEE safe harbor. Currently, compliance with the Treasury SEE "safe harbor" under the current regulations is only absolutely certain for allocations that use the Treasury Capital Account Method. They should be certain for other allocation forms that satisfy the EEE test as well. As a result of this proposed change, allocations that satisfy the EEE test will also be certain to satisfy the Deemed PIP test for nonrecourse deductions. This would be an important *clarifying* change. Currently, some practitioners view nonrecourse deduction allocations seeking the Deemed PIP safe harbor to be held hostage to the Treasury Method. This should end.

More broadly Target Method allocations should also be able to satisfy the SEE safe harbor test in situations in which an economic equivalent result to the Treasury Method may not be attained by the Target Method. As demonstrated in Part II of the Article, there are situations in which the Target Method generates a different result than the Treasury Method but in so doing better accomplishes the partners' agreed arrangement for sharing among the partners than does the Treasury Method. The current SEE safe harbor regulation requiring that liquidations be in accordance with capital accounts in all

[125] Reg. § 1.704-1(b)(2)(b)(ii)(i).

events calls into question allocations made under the Target Method. This consequence should not occur. Accordingly, the SEE test should be satisfied under a third (in addition to the SEE and Alternate SEE safe harbors) available safe harbor. When the Target Method does not yield the same economic result as the Treasury Method in the situations discussed in Part II.C., the Target Method—not the Treasury Method—yields the result most consistent with the theoretical underpinnings of the SEE test, the PIP test, and the economic objectives of the parties. Its use should be encouraged by permitting it safe harbor qualification.

As this Article has argued, the Target Method is superior to the Treasury Method by reason of its acceptability to business people who desire absolute clarity in a partnership agreement as to how distributions will be shared, and their aversion to the artificial constructs of capital accounts in these agreements that impede understanding of how liquidating distributions will be made. Rather, business people prefer closer adherence to the underlying principles of economic effect to which the method of allocations should strive.[126]

Thus, the Target Method better achieves the economic goals and expectations of the partners than the Treasury Method and with greater clarity. In addition, the participants in the transaction, who are partners, are more comfortable with an agreement by which economic results are governed by the express distribution provisions, that is, the Target Method, and not by allocations and capital accounts, that is, the Treasury Method. Finally, the current Treasury Regulations introduce uncertainties in tax treatment to partnerships which employ the Target Method rather than the Treasury Method, and those uncertainties are harmful to economic transactions. Accordingly, the Target Method should be safe-harbored.

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[126] *See* Tax Notes Today, *supra* note 35, at 90. As William Cavanagh has pointed out, the economic effect test of SEE is far from ideal as a foundation governing tax allocations and economic sharing rules for partnerships. It departs in very significant ways from economic reality. First, the capital accounts limitation for distributions only comes into play with liquidating distributions and not with generating cash flow or capital events distributions, which in many partnerships have much greater economic significance. Second, the line between operating distributions and liquidating distributions is not always clear. Third, the economics of partnerships are enjoyed generally during operations and partnerships rarely liquidate. Fourth, purchases and sales of partnership interests often take place without the purchasers and sellers paying attention to capital accounts. And fifth, the effects of income, loss, contributions and distributions are unrealistically treated in absolute dollar terms without taking into account the time value of money. *Id.* at 93-94.

However, these criticisms of the use of capital accounts probably go too far. One can rationalize each of these apparent deviations from economic reality by recognizing that capital accounts generally provide an anchor for all of the above partnership transactions, because at the end of the day, distributions that do not follow capital accounts will have to be accounted for, and have tax consequences in the same way. For example, it is structurally comforting to know that (1) capital accounts will be maintained in a precise way, (2) distributions in excess of capital accounts will be matched by gross income allocations under a QIO and partnership agreements generally provide curative mechanisms for reversing regulatory allocations such as those under the QIO, and (3) purchasers and sellers who do not pay attention to capital accounts do so at their own peril. As for the uncertainty of what is a liquidation distribution and most importantly, the failure to correct for the benefits resulting from deferral of income and the time value of money, these are departures from economic reality, but not unusual by any means in the tax law. Indeed, both are common to many areas of the tax law. For example, the tax law's treatment of depreciation in the absence of actual reduction in value, and of unrealized appreciation both ignore time value of money corrections. The existence of this same failing in the partnership allocation regulations is neither surprising nor inconsistent with much of tax law.

A more significant criticism of the SEE test's departure from economic reality, I believe, is that adherence to the liquidation in accordance with capital accounts requirement can actually alter the economics of a partnership transaction for the partners without their understanding that the alteration is occurring. It can lead partners into an economic arrangement to which they have not knowingly agreed. Because of that, adherence to the current SEE safe harbor can lead to confusion, uncertainty and litigation. In contrast, use of the Target Method, which abandons the requirement of liquidation in accordance with capital accounts, will assure the partners their expected economic results.

B. *Proposed Changes*

1. *Target Method Safe Harbor*

The Treasury regulations should be issued to create an additional SEE safe harbor, to read substantially as follows:

"If allocations are made so that the capital accounts are equal to the amounts that would be distributed in liquidation of the partnership if all properties of the partnership were sold for book value and immediately following the allocation, the partnership paid its liabilities (other than nonrecourse liabilities in excess of the book value of the property securing such liabilities), and distributed the net proceeds of the sale and other cash to the partners in liquidation of the partnership, then such allocations shall be deemed to have economic effect for all purposes of the Treasury Regulations under section 704(b), [note that the substantiality portion of the SEE test would still need to be satisfied] as long as (1) capital accounts are maintained in accordance with Regulation section 1.704-1(b)(2)(iv); (2) requirements of either Regulation section 1.704-1(b)(2)(ii)(b) or 1.704-1(b)(2)(ii)(d) are satisfied [relating to DRO and QIO]; and (3) allocations are made in a manner to cause the Partners Adjusted Capital Accounts (capital accounts plus the partners' shares of partnership minimum gain and partner minimum gain) to be maintained in a manner, at all times during the life of the partnership, that reflect, as much as possible, the distributions that would be made if the partnership liquidated by selling all of its properties at book value, paid its liabilities (other than nonrecourse liabilities in excess of the book value of the property securing such liabilities) and distributed the net proceeds to the partners."

This proposed new safe harbor for the Target Method reverses the order set forth in the current Treasury Method safe harbor, allowing safe harbor allocations to achieve reality rather than having the allocations create reality and hoping for the best.

2. *Clarification (or Expansion) of Economic Effect Equivalence*

Regulation section 1.704-1(b)(2)(ii)(i) subtitled "economic effect equivalence" should explicitly state: "for the avoidance of doubt, allocations that yield economically equivalent results to the 'economic effect' test shall be deemed to have economic effect for all purposes of the Treasury Regulations under I.R.C. § 704(b)."

Thus, the three-part SEE safe harbor test, summarized in the introduction to this Article, would be satisfied by such an allocation. As a result of these changes, there would be no doubt that the use of the Target Method or other methods (such as the straight percentage sharing method illustrated in the regulations example and discussed earlier[127]) that yield the same economic

[127] *See supra* note 51; *see supra* text accompanying notes 49-56.

results as one of the SEE safe harbors, as in Examples 1 and 2 of Part I, would satisfy the SEE safe harbor test for all purposes.

3. *Mandatory Revaluations and Book-ups*

As long as the above-proposed changes are being considered, the Treasury should consider one more change that would make both the Treasury Method and Target Method allocations work better. The Treasury Regulation should require revaluations and book-ups where they are now merely optional. Otherwise, book capital accounts cannot reflect the agreed order and priority of distributions. Thus, a new Treasury regulation provision should read substantially as follows:

"A revaluation and book-ups are required if either of the following occurs:

(1) Entry of new partner

(2) Distributions that reduce a partner's interest in the partnership, including retirements of partners, when Section 734(b) does not fully reflect appreciation or depreciation in assets used to make such distribution."

C. *The Importance of the Foregoing Proposals*

The changes in the special allocation regulations proposed above would involve a minimal change in the wording of the regulations but could make a very important change in the way practitioners are likely to draft allocation provisions to comply with the regulations. The importance of adopting these proposals is three-fold.

First, because lawyers strive for certainty in drafting their partnership agreements, they tend to follow the Treasury's Capital Account Method format believing they are getting tax certainty. Instead, they are trading away simplicity, understanding of the agreement by their clients, and potential certainty in the economic results that could lead to litigation among the partners. And, many lawyers likely do not understand that there is such a trade-off. These proposed changes would provide them with an alternative drafting method and avoid the unfortunate trade-off forced upon them by the current limited SEE safe harbor test.

Second, elevating the Target Method to safe harbor status would provide partners and partnerships assurance that allocation provisions using the Target Method that are intended to accomplish and assure a particular economic sharing arrangement will not result in uncertain tax consequences for the partners. Under the proposal, this would be accomplished without doing damage to the anti-tax shelter protections built into the current regulations, which include the current DRO and QIO rules.

Third, the proposed change in the regulations would resolve the section 514(c)(9)(E)(i)(11) issue as well. That section requires for its allocations to be permitted to be free of UBIT consequences that "each allocation with respect to the partnership has *substantial economic effect* within the meaning of section 704(b)(2)." This requires for qualification under this special rule that the allocation meet the SEE Big Three or Alternate Big Three safe harbor, although perhaps qualification under EEE might be enough. Query: would a charitable organization take this chance?

The inclusion of the Target Method within the SEE safe harbor would qualify these partnership allocations under section 514(c), an important objective for organizations seeking to avoid UBIT on their pass-through income from debt-financed property and usually a requirement on which they insist as a precondition to entering a partnership.

As a result, adoption of the proposals in this Article will likely cause the Target Method to replace the Treasury Method among practitioners because of its superiority in governing business relationships and carrying out the partners' economic intentions and expectations.