December 28, 2005

IRS Proposed Regulations Affect Allocations

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Partnerships are prized as investment vehicles for many reasons, not the least of which is the flexibility partnerships have in allocating income among partners, a flexibility which is, however, limited by a complex set of rules. The Internal Revenue Service has recently proposed amendments to the Treasury Regulations governing partnership allocations that will require a partnership, in order to determine whether the tax law will respect the allocation of income set out in its partnership agreement, to have knowledge not only of the tax posture of the partners in the partnership, but also that of certain indirect partners.

The Internal Revenue Code provides that a partner's distributive share of tax items is generally determined by the partnership agreement. Section 704(b) of the Code limits this flexibility by providing that allocations in the partnership agreement will not be respected if they lack "substantial economic effect." (In such a case, partnership tax items must be allocated in accordance with "the partners' interests in the partnership," the determination of which requires inquiry into all the facts and circumstances affecting the economic and legal relationship among the partners.)

Treasury Regulations under section 704(b) explain that the "substantial economic effect" test has two components:

1) Does an allocation have "economic effect?"

2) Is that effect "substantial?"

The economic effect rules are generally mechanical and require that the partnership maintain capital accounts in a particular manner and that it make distributions in liquidation of the partnership in accordance with the balances of such accounts. In a word, economic effect is about making tax allocations match the way cash derived from partnership profits is distributed -- if not on an annual basis, at least upon liquidation.

'Substantial' Effect

Even when the economic effect rules are complied with, different tax attributes of partners combined with the time value of money can induce "game playing." For example, if one partner ("loss partner") has loss carryforwards, the partnership could allocate income in the early years to loss partner with a later makeup allocation to the other partner ("income partner"). At the end of the day, each partner has the right amount of income, but income partner has received a benefit by deferring his tax liability.

Once satisfied that a given allocation or set of allocations has economic effect, the regulations ask: "is the economic effect substantial?" The regulations provide as a general rule that the economic effect of an allocation (or allocations) is substantial "if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences." The regulations go on to provide a number of specific tests including the following (the "general substantiality test"):

> the economic effect of the allocation (or allocations) is not substantial if, at the time the allocation (or allocations) becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement , and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement.

In simple terms: If a set of allocations may give an after-tax benefit to a partner, with a strong likelihood of leaving the after-tax position of the other partners undisturbed, the allocations fail the substantiality requirement of section 704(b). The regulation goes on to explain how after-tax benefits are determined under this test:

> In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allo-

cation with such partner's tax attributes that are unrelated to the partnership are taken into account.

Thus, under existing regulations, to determine whether an allocation will be respected, a partnership may need to analyze the tax posture of its partners. In the example described above, the partnership would have to take into account the fact that loss partner has loss carryforwards and, therefore, will not suffer an after-tax detriment (in present value terms) from having its income allocations frontloaded. (Therefore, prong 2 of the general substantiality test will be met.) Since the after-tax consequences to income partner may be enhanced through deferral of his tax liability, prong 1 of the test is met and these allocations would lack substantiality.

Look-Through Entities

What if, loss partner and income partner are themselves partnerships? Do we look at the tax positions of the owners of loss partner and income partner? The result under the existing regulations is unclear, but recently proposed regulations affirmatively require the partnership to examine the tax attributes of certain owners of partners that are themselves partnerships.

Under the proposed regulations, in determining the after-tax economic benefit or detriment to any partner that is a look-through entity, the tax consequences that result from the interaction of the allocation with the tax attributes of any person that owns an interest in such a partner, whether directly or indirectly through one or more look-through entities, must be taken into account.

For this purpose, look-through entities include partnerships, S corporations, trusts, certain controlled foreign corporations, and entities that are disregarded for federal tax purposes. Although regulated investment companies (RICs) and real estate investment trusts (REITs) have certain flow through characteristics, the regulations do not include them in the list of look-through entities -- because the Treasury Department and the IRS believe that the burdens of a rule requiring taxpayers to look through these entities in determining the substantiality of partnership allocations generally would outweigh the benefits of such a rule. However, if necessary, RICs and REITs or other look-through entities may be added to the list of look-through entities in future guidance.

Consolidated Returns

Where a partner is a corporation that is a member of a group that files consolidated returns, the proposed regulations provide that the interaction of a partnership allocation with the tax attributes of all members of the group must be taken into account when testing the substantiality of the allocation.

The regulations then give the following example: PRS is a partnership with three partners, A, B, and C. A is a corporation that is a member of a consolidated group. B is an S corporation that is wholly owned by D, an individual. C is a partnership with two partners, E, an individual and F, a corporation that is member of a consolidated group.

In determining the after-tax economic benefit or detriment of an allocation to A, the tax consequences that result from the interaction of the allocation to A with the tax attributes of the consolidated group in which A is a member must be taken into account. In determining the after-tax economic benefit or detriment of an allocation to B, the tax consequences that result from the interaction of the allocation with the tax attributes of D must be taken into account. In determining the after-tax economic benefit or detriment of an allocation to C, the tax consequences that result from the interaction of the allocation with the tax attributes of E and the consolidated group in which F is a member must be taken into account.

One of the common complaints about the substantiality rules contained in the existing regulations is that they require one to assess the benefit or detriment of allocations to partners without specifying the baseline against which to compare such allocations. Therefore, the proposed regulations clarify that for purposes of the substantiality test quoted above, the after-tax economic consequences of a partner resulting from an allocation or allocations must be compared to the after-tax economic consequences to that partner if allocations were made in accordance with the partners' interests in the partnership. This clarification is not much practical help, however, since "the partners' interests in the partnership" is such an elusive standard.

On the one hand, it is hard to argue with these proposed regulations since the tax attributes of an indirect partner are clearly relevant. On the other hand, partnership transactions are often done with tiers of investment entities where the lower-tier partnership remains blissfully unaware of upper-tier investors, and it may often not be feasible to apply these regulations.