Concepts and Context in Partnership Capital Shifts

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I. Introduction

Partnerships are strange animals. This is due, in part, to their hybrid nature—sometimes entity and other times aggregate (*i.e.*, as if the partners owned the underlying assets directly). A partnership is not, itself, subject to income tax. Instead, for tax purposes, the partners must include income and loss earned by the partnership.

Partnerships can be quite flexible. With certain notable exceptions, assets can move in and out of partnership solution without recognition of gain or loss. Furthermore, the economic arrangements facilitated by partnerships can be inordinately complex, and there is significant flexibility in allocating income and loss to account for the economic arrangement under the U.S. tax system. Nonetheless, there are limits to this flexibility, and rules are in place to protect the fisc in certain contexts.

The hybrid nature of partnerships together with the significant flexibility afforded by subchapter K can make the analysis of value shifts among partners quite difficult to assess in many contexts. Value shifts among partners often are referred to as "capital shifts." The "capital" in "capital shifts" generally is thought of as referencing capital accounts maintained by the partnership on behalf of the partners.[1] Partnership agreements that are drafted by sophisticated tax counsel often rely on "capital accounts" for purposes of allocating income and loss.[2] Capital accounts generally reflect a snapshot of the economic entitlements of the partners at any point in time as if the partnership was to liquidate at such time. To the extent that a shift in capital occurs from one partner's capital account to the capital account of another partner, there often is concern that the recipient of the capital shift must report income. But the analysis is complicated, as will be highlighted below.

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This article begins by setting the stage—that is, highlighting many of the factors that should be considered in evaluating capital shifts and discussing certain contexts where capital shifts may occur. The article follows with a discussion of the general rules relating to realization events and income inclusion outside the

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context of partnerships. The article next discusses the concept of capital accounts, and then discusses different ways to analyze the value of a partnership interest and the role that capital accounts play in that analysis. Next, the article discusses how capital accounts are woven more broadly into the fabric of subchapter K. The article follows with a discussion of the limited authority that exists analyzing partnership capital shifts and then describes certain scenarios where the U.S. Treasury Department ("Treasury") and Internal Revenue Service ("IRS") have issued guidance accounting for capital shifts in a manner that generally avoids immediate taxation but preserves ultimate taxation to the proper parties within the framework of subchapter K. Finally, the article analyzes a number of different situations where capital shifts might occur and highlights how the context can alter the analysis for shifting capital.

II. Setting the Stage

A. Thinking About Capital Shifts in the Context of Subchapter K

Arguably, there is no better topic to help one understand the theory of subchapter K than capital shifts. To explore the implications of a capital shift, one should understand (1) the nature of partnerships as a combination of aggregate and entity, (2) rules relating to contributions, distributions, and allocations and the impact on economic entitlements, and (3) various anti-abuse rules that are intended to prevent the improper shifting of tax attributes among partners.

As a passthrough entity, partnerships in some ways replicate the direct ownership of the underlying partnership assets. A partner is allocated income and loss as if he or she owned the assets directly—that is, there is no entity level tax. For many purposes, however, a partnership is viewed as an entity.[3] An interest in a partnership generally represents a share in a conglomeration of assets that cannot be broken apart and sold separately by a partner. A partner can engage in a transaction with a partnership—*e.g.*, selling assets to a partnership or providing services to a partnership.[4] Income and loss of the partnership is calculated by the partnership and allocated to the partners. Partners do not calculate and report their shares of partnership income and loss directly.

The blended nature of a partnership as an aggregate and entity should be considered in analyzing capital shifts. Arguably, a taxpayer should not accomplish a different result when shifting value in assets through the use of a partnership than would be the case if the partners held the assets directly. Nonetheless, partnerships are intended to be flexible vehicles, and in some circumstances, a transaction occurring inside the partnership that impacts holders of interests in the partnership may be viewed differently.[5]

The rules for taxing partners consistent with their economic entitlements in a partnership also play heavily into the analysis of capital shifts. As a passthrough entity, a partnership must report its income and loss to the partners on an annual basis even though the economic entitlements associated with those allocations generally will not be realized annually.[6] For example, a partnership may specially allocate all items of depreciation to a single partner and may charge back those allocations with the first dollars of partnership gain upon disposition or revaluation of the property. Assuming that the gain chargeback is expected to fully offset the specially allocated depreciation, allocations made prior to the disposition or revaluation of the partnership property may not truly reflect the perceived value of one partner's interest as compared to another's. But the flexibility provided with respect to partnership allocations permits these disconnects. In analyzing shifts that occur in partnership capital, one seemingly must be analyze the shift with an eye towards preserving the integrity of the allocation system that facilitates the flexibility. At the same time, the true value that relates to a shift in interests among partners may differ from the "capital" that is transferred, and this difference may be relevant in analyzing these transactions.

Partnership capital is impacted by the fair market value of contributed and distributed property. The partnership rules allow for nonrecognition treatment upon the contribution of property to,[7] and distribution of property by,[8] a partnership. In order to facilitate this flexibility in adjusting the asset make-up of a partnership, while preventing partners from artificially altering their tax attributes with respect to the assets, the rules of subchapter K, like Code Secs. 704(c), 737, and 751(b), track to specific partners the built-in gain and loss with such property as well as the ordinary or capital gain characteristics of a partner's share of partnership property.[9] To the extent that partnership capital shifts among partners, and that capital is partially attributable to these tracked items, the impact of the capital shift on the operation of these tracking rules should be considered.

The nature of partnership capital also should be considered in analyzing a capital shift. Partnership capital comes in at least three, and probably four, flavors. Post-tax capital relates to a partner's share of capital attributable to previously included taxable income. This could be capital related to contributed property purchased with after-tax proceeds or alternatively could be prior inclusions of taxable income that have yet to be distributed. One form

of pre-tax capital relates to the portion of contributed property attributable to built-in gain. As described above, the partnership rules are strict as related to this capital (*i.e.*, Code Secs. 704(c) and 737) and go to great pains to track the related built-in gain and built-in loss to the contributing partner. Another form of pre-tax capital relates to capital resulting from the revaluation of partnership property[10] and the related "reverse Code Sec. 704(c) gain and loss" layers produced by the revaluation.[11] A partner's capital account is credited with the partner's share of additional value in partnership assets that is reflected in the revaluation, but this capital arises from the allocation of gain and loss that accrued while the partners were participants in the partnership. There may be reasons for viewing capital related to this property appreciation differently from capital that a partner brings to the partnership from outside the partnership relationship. The last form of what is arguably pre-tax capital that may be shifted among partners relates to asset appreciation that has not yet been booked into the partner's capital accounts. While a transfer of un-booked appreciation has the same economic impact upon the parties as a capital shift of other types of pre-tax capital, there may be reasons for viewing un-booked asset appreciation differently than appreciation that is reflected in the partners' capital accounts.

In addition to accounting for the various partnership rules when analyzing capital shifts, it is important to recognize that three different taxpayers must be considered in analyzing a capital shift. Most people think of the capital shift in terms of the recipient's tax results (*i.e.*, is there an inclusion of income), but the results also must be considered for the party whose capital is shifting and for the partnership that must account for the shifting capital. Also of importance, a capital shift may result from an arrangement between a partner and the partnership or between two partners.

B. How Does Value Shift Among Partners?

In thinking about "capital shifts", it is important to appreciate how value might be transferred among partners. In some contexts, the transfer is intentional or designed to accomplish a purpose. In other contexts, the shift may occur more as a product of circumstances, sometimes almost by accident. Also relevant, a shift may be accomplished by actually transferring interests in a partnership or alternatively through bookkeeping entries made by the partnership to adjust economic entitlements among partners.

In the simplest form, one partner might transfer part of his or her partnership interest to another partner. This transfer may be undertaken because the transferring partner owes a debt to the recipient partner, wants to compensate another partner for services provided to the transferring partner, intends to make a gift to another partner, and numerous other reasons.

Alternatively, the partnership could amend the partnership agreement and dilute the interests in profits and capital of other partners in order to entice a person to join the partnership—that is, compensate the new partner for joining. Similarly, the partnership may dilute the interests of other partners in order issue a valuable partnership interest to a creditor and hence satisfy a liability of the partnership. A partnership also may dilute the interest of a partner who defaults on its obligation to contribute capital to the partnership in an effort to discourage such behavior. There are many instances in which a partnership may choose to use its valuable capital in order to accomplish a goal or impact behavior.

These are all "purposive" transactions—that is, transactions that are intended to transfer value in order to accomplish a purpose. As illustrated, the purpose may be that either of an individual partner or the partnership.

There are many other situations where value related to the partnership's assets may migrate from one partner to another in scenarios that are less "purposive". For example, in an effort to attract much-needed capital to a struggling partnership, the partnership may admit a partner for a capital contribution that is disproportionately small as compared to the percentage interest that the partner will receive in capital—in effect, allowing the new partner to make a bargain purchase.[12] As another example, all partners' interests in partnership capital may increase because a partner forfeits his or her unvested interest (*e.g.*, for bad behavior, ceasing to provide services to the partnership, *etc.*).[13] Additionally, the economic arrangement of the partners may provide that certain partners will receive a rate or return on their contributed capital regardless of whether the partnership earns income, effectively putting the capital of other partners at risk for dilution in a scenario where sufficient income fails to materialize. Here, the shift in capital, if it occurs, is arguably purposive, but the intention of the partners upon inception of the partnership is that the return will be paid with partnership income. The potential capital shift is merely a backstop and thus seems less purposive than those discussed in the prior paragraph.

Finally, the partnership may shift value among partners in order to facilitate a tax result desired for one or more partners. For example, the partnership may disproportionately allocate income to a partner who has expiring pre-2018 net operating losses and, in the future, amend the

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partnership agreement to shift the capital created by the disproportionate income allocation to the partners who were diluted by that allocation.[14] Unlike the arrangements described above, such a shift in capital does not have a commercial purpose but instead is undertaken solely to accomplish an abusive tax purpose. A similar result (*i.e.*, shifting capital related to previously included taxable income) may occur in less abusive circumstances, raising questions as to whether the mere fact that the capital shift may effectively accomplish a reallocation of taxable income among partners should be considered in analyzing such arrangements.

The examples discussed above merely scratch the surface of scenarios where value related to partnership capital may shift among partners.

C. Questions for Consideration

As the discussion in this section highlights, there are many different factors that might be considered in determining how to tax a shift in value among partners. Among the questions to consider are: (1) at what level should the taxation of the shift be analyzed—the partner (as a shift in equity interests in the partnership) or partnership (as a shift among partners in their shares of capital/assets held by the partnership); (2) how should the value of the shift be determined for tax purposes—the value of the partnership interest received by the partner or the amount of partnership capital shifted to the partner; (3) how should the taxation of a direct property transfer in analogous situations inform the taxation of value shifts occurring in the partnership context; (4) should the commercial reason for the capital shift be considered in determining the tax consequences of the arrangement; (5) should the tax profile of the shifting capital (*i.e.*, previously taxed income, built-in gain allocated to the diluted partners' capital accounts, or unallocated built-in gain) be relevant to the analysis; (6) how are capital shifts among partners accounted for on the books of the partnership and can such accounting help to bring about tax results consistent with the rules of subchapter K, (7) how should one distinguish a capital shift from a delayed allocation of income or gain, and (8) should an abusive tax purpose accomplished by the shift in capital impact the tax treatment of the transaction?

III. Law Regarding Gross Income

Before diving into the rules of subchapter K for purposes of analyzing capital shifts among partners, it is useful first to consider the general rules relating to inclusion of gross income applicable to all taxpayers. To the extent that a shift of valuable property interests among taxpayers would be taxable, an analogous shift in the partnership context presumably would be subject to current tax unless the policies under subchapter K should produce a different result.[15] Alternatively, to the extent that the shift in value among taxpayers occurs in the context of a transaction that would not result in the realization of gross income under general tax principles, presumably the transaction should not be taxable unless the failure to tax the capital shift would compromise the rules of subchapter K in a way that would justify such taxation.[16]

Code Sec. 61 describes "gross income" as "all income from whatever source derived" and goes on to provide a non-exclusive list of income items, including compensation for services, gross income derived from business, property gains, rents, interest, and dividends, as well as other items.[17] The definition is circular, given the reference to "income" in the definition of "gross income", and the Supreme Court has a long line of cases which have provided more definitive parameters regarding when a taxpayer must report gross income.

The initial case addressing the scope of the term "gross income" was *Eisner v. Macomber*,[18] which considered whether a pro rata stock dividend should be included as gross income to the shareholders. The Court stated that "[i]ncome may be defined as the gain derived from capital, from labor, or from both combined" and provided further that a gain must be "something of exchangeable value *proceeding* from the property, *severed* from the capital however invested or employed."[19]

The standard laid down in *Eisner v. Macomber* was significantly expanded in subsequent decisions. In *Helvering v. Brun*,[20] in determining that the receipt by the landlord of property constructed on leased land following termination of the lease gave rise to income, the Court noted that the statement in *Eisner v. Macomber* that gain should be separate from the capital and separately disposable was intended to "clarify the distinction between an ordinary dividend and a stock dividend."[21] The Court went on to state:

> While it is true that economic gain is not always taxable as income, it is settled that the realization of gain need not be in cash derived from the sale of an asset. Gain may occur as a result of exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction.[22]

The Court subsequently addressed the receipt of punitive damages in *Commissioner v. Glenshaw Glass Co.*,[23] which involved items derived neither from capital or services, as

had been required in *Eisner v. Macomber*. In holding that punitive damages were taxable, the Court laid down the broad standard that is most frequently cited today—that is, gross income involves "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[24]

"Accessions to wealth" obviously could capture many items that are not thought to be income, including simple increases in the value of an asset. The "realization" requirement provides the limiting constraint in this regard. The realization requirement was referenced in *Palmer v. Commissioner*,[25] where the Court held that a bargain purchase of assets by a shareholder from a corporation did not give rise to income for the purchaser when the price of the assets represented a reasonable estimation of value at the time that the corporation committed to the sale. There, the Court stated that "one does not subject himself to income tax by the mere purchase of property, even if at less than its true value, and that taxable gain does not accrue to him before he sells or otherwise disposes of it."[26]

With regard to bargain purchases, it is important that the purchase occur in an arm's length arrangement in order to avoid income. "[P]roperty acquired in connection with a 'bargain purchase' may represent compensation where the seller and the purchaser bear the relationship of an employer and employee, or a dividend distribution, or a gift."[27] This point was a focus in the Court's decision in *Commissioner v. LoBue*,[28] which involved the issuance of stock options that allowed employees to purchase stock at a significant discount to fair market value. In that case, the taxpayer argued that he was merely purchasing "a proprietary interest on which no gain was 'realized' in the year of purchase." In discarding the taxpayer's argument under *Palmer v. Commissioner*, the Court focused on the broad definition of income in *Commissioner v. Glenshaw Glass Co.* and emphasized that the transaction at issue "was not an arm's length transaction between strangers."[29] The Court further stated that "this was an arrangement by which an employer transferred valuable property to his employees in recognition of their services" and on that basis found that the options would give rise to taxable income when exercised.[30]

The realization requirement was the focus of the Court in *Cottage Savings Association v. Commissioner*.[31] The case involved an exchange of 90-percent participation interests in a group of residential mortgage loans for 90-percent participation interests in a group of residential mortgage loans held by other lenders where all of the loans involved in the transaction were secured by single-family homes, most of which were located in the same geographic area. In addition, the fair market value of the interests received was approximately equal to the fair market value of the interests relinquished, and for Federal Home Loan Bank Board accounting purpose, the transaction was treated as an exchange of substantially identical mortgages. In evaluating whether the exchange of these mortgage participation interests was a realization event for Federal income tax purposes, the Court began by acknowledging that realization is "founded on administrative convenience."[32] According to the Court, the realization requirement avoids problems of regularly valuing assets in an appreciation-based tax system.[33] The Court referenced Code Sec. 1001(a) as providing a "straightforward test for realization"—that is, "the taxpayer must engage in a 'sale or other disposition of [the] property.'"[34] In elaborating on the standard required for a realization event in the context of an exchange of loan participation interests, the Court stated that "an exchange of property gives rise to a realization event so long as the exchanged properties are 'materially different'—that is, so long as they embody legally distinct entitlements."[35] In defending this standard, the Court stated that "[n]o more demanding standard is necessary … to satisfy the administrative purposes underlying the realization requirement" since so "long as the property entitlements are not identical, their exchange will allow" the IRS and taxpayers to easily "fix the appreciated or depreciated values of the property relative to their tax bases."[36]

Obviously, the standard laid down by the Court in *Cottage Savings* sets a low burden for finding a realization event. It is unclear, however, in what contexts Treasury and the IRS believe this standard should apply. Reg. §1.1001-3 was drafted to provide clarity as to the application of *Cottage Savings* in the case of modifications of debt instruments. The drafters of those regulations recognized the possibility that different standards may apply in determining realization status depending on the context of the determination. Specifically, the preamble to the final regulations states:

> With the exception of those temporary and proposed regulations [addressing dealer assignments of notional principal contracts], the final regulations have not been expanded to cover the modification of financial instruments other than debt instruments. The modification of other instruments is less common than the modification of debt instruments, and the rules for modifications of debt instruments would not necessarily work well or be appropriate in determining whether modifications of other instruments result in exchanges under section 1001. For equity instruments in particular, the IRS and Treasury believe that the application of certain rules in these regulations would

> be inappropriate. Similarly, for contracts that are not debt instruments, the final regulations do not limit or otherwise affect the application of the 'fundamental change' concept articulated in Rev. Rul. 90-109 (1990-2 CB 191) in which the IRS concluded that the exercise by a life insurance policyholder of an option to change the insured under the policy changed the fundamental substance of the contract, and thus was a disposition under section 1001.[37]

It is arguable that *Cottage Savings* has no application if the taxpayer does not undertake any voluntary action that causes an "exchange." In LTR 200045028 (dealing with realignment of trust interests and assets), the IRS has indicated that a two-step analysis is necessary in order to determine if a realization transaction occurs. Specifically, the IRS stated:

> [I]n order for a transaction to result in a section 1001 taxable event, the transaction must be (1) a sale, exchange, or other disposition, and (2) if an exchange, the exchange must result in the receipt of property that is 'materially different' (as defined in *Cottage Savings*) from the property that was given up. In this case, the first element will not be present because the beneficiaries of Trust do not acquire their interests in the subtrusts as a result of an exchange of their interests in the Trusts, but rather by reason of the authority granted under the Cal. Prob. Code section 15412. There is no exchange here, instead the trustee is merely exercising a right to divide Trust as allowed by California state law.[38]

There appears to be no authority directly addressing the application of *Cottage Savings* to adjustments with respect to partnership interests.[39] The analysis relating to partnership conversion transactions in Rev. Rul. 84-52[40] (general partnership converts to limited partnership and Rev. Rul. 95-37[41] (domestic partnership converts to domestic limited liability company) arguably sheds some light on the difficult nature of the analysis as it relates to adjustments to partnership interests. In those rulings, the IRS determined that each conversion transaction would give rise to an "exchange" with respect to the partners. Specifically, the partners are considered to contribute their interests in the historic partnership to the new partnership in a transaction that qualifies for nonrecognition treatment under Code Sec. 721. Even though these transactions involved no change in the proportionate interests of the partners, the view of the transactions as realization events is supportable under *Cottage Savings* (recognizing that Rev. Rul. 84-52 was issued before the *Cottage Savings* decision) due to the change in legal rights of the partners resulting from the status of the different entities.[42] This is consistent with corporate authority that distinguishes reincorporation transactions based on whether the incorporation jurisdiction changes.[43]

It is significant that the IRS's decision to treat the transaction considered in Rev. Rul. 84-52 as an "exchange" of interests appears to have been a "close" call. In GCM 38687,[44] which apparently involved consideration of Rev. Rul. 84-52, the IRS stated:

> Our initial reaction to the issue was that the Service should take a strict entity approach and find a sale or exchange whenever there is a conversion of a general partnership interest into a limited interest. This appeared to be the most supportable position under the statute and regulations. After careful consideration, however, we have come to the conclusion that there is no clearly correct answer to this question and that an aggregate approach may be the more reasonable one under the facts of this case. Therefore, we agree with the conclusion of the proposed revenue ruling that the conversion of the general interests to limited interests should not be treated as a taxable exchange.[45]

The analysis in Rev. Rul. 84-52 did not conform to the conclusion in GCM 38687, but interestingly, in more recent private letter rulings addressing conversion transactions, the IRS appears to have stepped back from its conclusion reached in Rev. Rul. 84-52 that the conversion transactions represent exchanges, instead concluding that the converted partnership is simply a continuation of the original partnership.[46]

Commentators have discussed the application of *Cottage Savings* in the context of adjustments to partnership interests. One commentator has conveyed the following thoughts with respect to a recapitalization of partnership interests:

> How do we reconcile such nonrealization with the hair trigger approach taken by the Supreme Court in *Cottage Savings*? Subchapter K principles indicate realization and potential recognition are appropriate when there is a capital shift—*not* the case in our variant here [where the parties simply rearrange a proportionate sharing to reflect a preferred return for one partner and residual sharing for the other], because C will receive a priority allocation based on the restated (fair market) value of the partnership's

assets, rather than on C's historic capital account prior to the partnership reallocation of profits and losses. The real tension is between subchapter K and *Cottage Savings* hair trigger. It is submitted that it is more in line with the overall structure of partnership taxation to analyze the tax treatment of partnership realignments in terms of concepts such as capital shifts (or the lack thereof) and shifts of unrealized appreciation and depreciation, rather than under traditional concepts of realization as to whether anything is 'materially different' after the reallocation of profits and losses (*i.e.*, the test employed in *Cottage Savings*).[47]

Recognizing that uncertainty that exists with respect to the concept of realization and its application to adjustments to partnership interests, in light of *Cottage Savings* and the earlier decision in *Glenshaw Glass Co.*, it is important to appreciate that the scope of gross income and realization can be very broad. For example, it is not necessary that a taxpayer undertake any voluntary or purposive action to be in receipt of income. As proof of this point, treasure trove or found property is included in gross income when such property is reduced to possession.[48]

While the definition is quite broad, in some instances the IRS chosen to ignore amounts that could be included as gross income under *Glenshaw Glass Co.* One example includes government transfer payments excluded under the general welfare exclusion.[49] Catching a record-breaking home-run baseball is another example.[50] Court decisions also can be difficult, at times, to reconcile with the *Glenshaw Glass Co.* standard. For example, in *United States v. Gotcher*,[51] VW paid all expenses related to a VW dealer's trip to Germany which was intended to showcase VW's facilities and generate goodwill for the VW brand. The court held that the trip was not taxable to the recipient by analogy to the "convenience of the employer doctrine" since the trip served the purpose of VW and was not intended to compensate or reward the VW dealer/taxpayer. The analogy was not perfect, however, given that the dealer was not an employee of VW.

In light of IRS administrative practice and court decisions, one group of commentators has developed a term called "administered income" and defined this term as follows:

> Gross income is all accessions to wealth, clearly realized, over which the taxpayer has dominion unless excluded by statute, or by the IRS's not ever having attempted to tax it, or by the IRS's having announced an administratively created exclusion pursuant to no specific authority whatsoever or by the IRS's having taken the position that it is income but having a court, albeit not the Supreme Court, disagree in part, on grounds that cannot withstand rigorous analysis, which therefore allows the IRS to take a contrary position in a case in which amounts are larger, or adopting without explanation a position driven by administrative convenience, or uncertain application beyond the specific facts provided, or otherwise having indicated that it doesn't know whether it can or should tax it but for the moment it won't.[52]

Obviously, this definition is somewhat "tongue in cheek." The definition, however, may be apt in evaluating the taxation of partnership capital shifts. As will be discussed, not all capital shifts are created equal. In many contexts, there will be competing factors at play in determining the most equitable way to evaluate the tax treatment of a capital shift. While the Supreme Court seems to have created a standard that could lead to the taxation of many, if not most, partnership capital shifts, it is less clear that taxation should be the result in a number of instances.

IV. Capital Accounts

Keeping the general principles of gross income inclusion in mind as background, it next is useful to explore the concept of partnership capital accounts and to consider the role that capital accounts should play in analyzing shifts in value among partners. Capital accounts have existed as a financial accounting concept for many years, and these capital account calculations often determined the economic entitlements of partners. The regulations issued after the Tax Reform Act of 1954 (the "1954 Act") referenced the "accounts" of the partners as being relevant to the allocation of income and loss in certain instances.[53] Some state laws also established "capital accounts" as the default rule for determining entitlements upon liquidation, although partners were free to vary from these rules by agreement.[54] As described below, the legislative history accompanying the Tax Reform Act of 1976, which introduced the statutory concept of substantial economic effect in evaluating allocations,[55] specifically referenced capital accounts, as determined for financial accounting purposes, in evaluating what would be the economic entitlements of partners independent of tax consequences.[56]

Capital accounts took on a much more significant role in the determination of partnership allocations with the publication in 1986 of final regulations under Code Sec. 704(b).[57] These regulations implemented the statutory change made in 1976, which established a statutory

"substantial economic effect" standard for analyzing partnership allocations. In understanding the significance and scope of the regulations, it is helpful to consider the purpose of the changes made in 1976.[58]

Under regulations promulgated following enactment of the 1954 Act, a partner's distributive share of partnership items generally would be determined under the partnership agreement unless a principal purpose of a provision determining a partner's share of a particular item was to avoid or evade Federal income tax.[59] Prior to the 1976 Act, there was uncertainty as to whether the tax avoidance test in these regulations applied only to special allocations of items of income, gain, loss, deduction, or credit. A case decided fairly soon before enactment of the 1976 Act, *Kresser v. Commissioner*,[60] had implied that this rule did not apply to special allocations of bottom-line income, such as special allocations of all income to a partner for a number of years followed by an allocation of all income to another partner in later years. The legislative history accompanying the 1976 Act cited *Kresser* and, in describing the reasons for changing the law, stated that Congress believed "an overall allocation of taxable income or loss … should be subject to disallowance in the same manner as allocations of items of income or loss."[61]

In describing the new rules, the legislative history accompanying the 1976 Act states:

> The Act provides that an allocation of overall income or loss (described in section 702(a)(9)), or of any item of income, gain, loss, deduction, or credit (described under section 702(a)(1)-(8)), shall be controlled by the partnership agreement if the partner receiving the allocation can demonstrate that it has 'substantial economic effect', *i.e.*, whether the allocation may actually affect the dollar amount of the partners' share of the total partnership income or loss, independent of tax consequences.[62]

A footnote following this explanation further states:

> The determination of whether an allocation may actually affect the dollar amount of the partners' share of total income or loss, independent of tax consequences, will to a substantial extent involve an examination of how these allocations are treated in the partners' capital accounts for financial (as opposed to tax) accounting purposes; this assumes that these accounts actually reflect the dollar amounts that the partners would have the rights to receive upon liquidation of the partnership.[63]

Note that the explanation is describing a rule that will affirmatively allow taxpayers to conclude that special allocations described in the partnership agreement will be respected. It is not describing the exclusive method for analyzing partnership allocations. Under the legislation, allocations not respected under the substantial economic effect standard would be allocated in accordance with the "partners' interests in the partnership."[64] Accordingly, "substantial economic effect"[65] would appear to have been contemplated as a safe harbor providing comfort as to situations where special allocations of items or bottom-line income or loss would be respected. Otherwise, such special allocations will be analyzed based on the economic arrangement of the partners.

Consistent with this view of the intended purpose of the legislative changes, the regulations published in 1986 effectively established a safe harbor for determining whether allocations satisfy the substantial economic effect standard and contain an elaborate set of rules for maintaining capital accounts that are integral to determining whether an allocation meets the "economic effect" portion of those rules.

According to the preamble to these regulations, the economic effect prong of the regulation "means that in the event there is an economic benefit or burden that corresponds to an allocation, the partner receiving such allocation must receive the benefit or bear such burden."[66] In describing the role of capital accounts, the preamble states, "an allocation will not have economic effect unless the partners' capital accounts are maintained properly, liquidation proceeds are required to be distributed in accordance with the partners' capital account balances, and, following the distribution of such proceeds, partners are required to restore any deficits in their capital accounts to the partnership."[67]

Under the regulations, capital accounts are calculated as follows: a partner's capital account is increased by (1) the amount of money contributed by the partner to the partnership, (2) the fair market value of property contributed by the partner to the partnership (net of liabilities that the partnership assumes or takes the property subject to), and (3) allocations to the partner of partnership income and gain (or items thereof), including tax-exempt income and gain determined by reference to the "book value" of partnership property (but excluding income and gain that is a product of book/tax differences in the basis of partnership property), and is decreased by (4) the amount of money distributed to the partner by the partnership, (5) the fair market value of property distributed to the partner by the partnership (net of liabilities that the partner is considered to assume or take the property subject to),

(6) allocations to the partner of nondeductible expenditures of the partnership, and (7) allocations of partnership loss and deduction (or item thereof), including losses and deductions determined by reference to the "book value" of partnership property (but excluding deductions and loss that is a product of book/tax differences in the basis of partnership property).[68]

In certain circumstances, a partnership is allowed to revalue its assets and adjust the capital accounts of the partners to account for their shares of the increase or decrease in the value of partnership assets.[69] A partner's share of built-in gain and loss in partnership assets resulting from a revaluation will be memorialized as "reverse Code Sec. 704(c) gain or loss" such that future tax items correlating to the "book" items that adjusted the partner's capital account will be taken into account by such partners.[70]

Consistent with the preamble, the regulations require that a partnership must liquidate in accordance with the partners' properly-maintained capital accounts in order for allocations to have economic effect.[71]

A partner's capital account traces the partner's economic entitlement with respect to the partnership on an annual basis. By increasing a partner's capital account for allocated income and gain and reducing a partner's capital account for allocated deductions and loss and also requiring that a partnership must make liquidating distributions consistent with capital accounts, the regulations ensure that a partner will receive the benefit of income and gain and bear the burden of deductions and loss.

It is significant that these rules analyze partnership economics, and thus allocations, by reference to an annual liquidation of the partnership. Obviously, this is not the only possible approach for analyzing allocations. But viewed as a safe harbor that gives partners comfort that special allocations will be respected, the approach is rational. In providing a safe harbor, Treasury and the IRS would understandably avoid highly subjective rules that depend on uncertain results accruing over multiple years. Rules that define how economics are determined and that analyze the change in the defined economics on an annual basis seem appropriate for a safe harbor analysis. If taxpayers choose this route, they generally can have comfort that the allocations will be respected, and Treasury and the IRS can feel comfortable that the allocations are consistent with a defensible measure of economic entitlements.[72]

A partnership may make allocations that satisfy the test for economic effect, but offsetting special allocations may limit the substance of the allocations. For example, a two-person partnership may, in the same year, allocate $100 of tax-exempt interest income to a taxable partner and $100 of taxable interest income to a tax-exempt partner.[73] Similarly, another two-person partnership may specially allocate $100 net income to a partner with expiring pre-2018 net operating losses and allocate a like amount of income to the other partner in the following year.[74] Both allocations accomplish an aggregate reduction of taxes for the partners without impacting the ultimate economic results for the partners, ignoring taxes. The rules relating to substantiality police these sorts of arrangements and will cause such allocations to not be respected.[75]

Importantly, the rules regarding substantial economic effect are not the exclusive means for analyzing allocations. As mentioned above,[76] these rules effectively represent a safe harbor. If an allocation does not satisfy the rules for substantial economic effect, the allocation will be analyzed under a set of rules describing the "partners' interests in the partnership." The regulations state that "partners' interests in the partnership" signifies "the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated."[77] The regulations acknowledge that a special allocation of items is possible, stating that "a partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in a particular item of income or deduction."[78] The regulations state that the determination of a partner's interest in a partnership will be made by taking into account all facts and circumstances relating to the partners' economic arrangement and set forth the following non-exclusive list of factor for consideration:

(a) The partners' relative contributions to the partnership,
(b) The interests of the partners in economic profits and losses (if different than that in taxable income or loss),
(c) The interests of the partners in cash flow and other non-liquidating distributions, and
(d) The rights of the partners to distributions of capital upon liquidation.[79]

If a partnership that follows the capital account rules and liquidates based on positive capital accounts makes an allocation that does not have economic effect, the regulations state that

> the partners' interests in the partnership with respect to the portion of the allocation that lacks economic effect will be determined by comparing the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the taxable year to which the allocation relates with the manner in which distributions

> (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the prior taxable year.[80]

As with the substantial economic effect rules, this rule analyzes a partner's interest in the partnership based upon to the impact of an allocation on entitlements or obligations of a partner in isolation to the taxable year as if the partnership was to liquidate at the end of such year. This rule, however, is rarely applicable. More frequently, a partnership whose allocations are analyzed under the partners' interests in the partnership standard will not liquidate based on capital accounts, and those allocations will be analyzed based upon the facts and circumstances and economic arrangement of the partners.

V. Approaches to Allocations and the Role of Capital Accounts

Partnership allocations factor heavily into the determination of partner capital accounts. Sophisticated partnerships typically use one of three approaches in making allocations. In a "safe harbor" partnership agreement, the partnership will liquidate based on capital accounts, which are determined as described in the prior section. Allocations are specifically described to produce the intended economic results. In those arrangements, capital accounts determine the ultimate economic entitlements of the partners.

As a second approach, many (and probably most) sophisticated partnerships make allocations following a "target" approach.[81] Under this approach, the allocation section cross references the distribution waterfall, and allocations are made in a manner such that capital accounts (increased by minimum gain) will equal an amount that is as close as possible to the economic entitlements of the partners, determined as if the partnership sold all of its assets for book value and then distributed the proceeds in accordance with the waterfall. For these partnerships, capital accounts do not determine the partnership economics (*i.e.*, if capital accounts ultimately do not match the distribution waterfall, the distribution waterfall will govern liquidating distribution), but capital accounts are intended to conform to such economics.

A third approach allocates items "in a manner that as closely as possible gives economic effect to" the distribution (and liquidation) provisions of the partnership. Return preparers reporting allocations under this approach generally follow the same methodology as is applied under the target approach, although this language arguably permits a more flexible approach.

Under the first approach, in all instances, capital accounts will track a partner's economic entitlements with respect to a partnership at a given point in time, determined by reference to the book value of partnership assets. The same generally is intended under the second and third approaches, although these allocations will be analyzed under "partners' interests in the partnership",[82] and it is at least possible that capital accounts will not conform to economic entitlements (based on Code Sec. 704(b) book value) at certain points in time.

VI. Capital Accounts and Value

Importantly, capital accounts represent the partnership's *internal* mechanism for recording on behalf of each partner the economic benefits and burdens associated with items of income, gain, loss, and deduction generated, along with property received and distributed, by the entity that is the partnership. But the snapshot created by this internal recordkeeping exercise does not necessarily reflect the *external* value that the market would determine with respect to an interest in the entity—that is, the partnership interest.[83] In addition, capital accounts are determined by reference to the book value of partnership assets. Unless assets have been revalued or sold immediately prior to the determination, capital accounts will ignore appreciation or depreciation in partnership assets that has occurred since the determination of the book value of partnership assets (except that depreciation generally is taken with respect to the book value of depreciable assets in the same manner as is taken with respect to the tax basis of the property).[84] Capital accounts are not the same thing as the liquidation value of a partnership, which is determined based on the fair market value (as compared to the book value) of partnership assets.

One commentator described the challenge that partnerships present and the arguable shortcomings of the economic effect/capital account model as follows:

> [T]he problem is that the regulations are trying to achieve something which cannot be done. As detailed above, the conduit model requires the existence of an economic baseline against which a tax allocation can be tested. Yet so long as there is state law separation between the entity and the owners—that is, the owners do *not*, in fact, own the assets directly but instead only own interests in the firm which owns the assets—the economic baseline against which the tax allocation needs to be compared is necessarily missing.

For example, we simply don't know how the partners would have shared undistributed income earned by a firm had there, in fact, been a distribution of that income in the year it was earned. Indeed, in many cases, the partners themselves don't even know how they would have shared the income, because their 'deal' extends far beyond the economic outcome of the first year. But without that piece of information, it is not possible to fashion a workable rule that can ferret out purely tax-advantaged allocation arrangements under a conduit model of taxation.[85]

In highlighting the problem referenced with respect to the economic baseline, this commentator states:

> [C]apital account balances only supply some indication of the economic rights and obligations of the partners upon a hypothetical liquidation in the current year of either the partner's interest in the partnership or the partnership itself. Yet in the vast majority of cases, neither of those two events is specifically contemplated by the partners, so that a capital account adjustment resulting in a currently negative or positive account balance may not be particularly meaningful. Rather, in most cases, the economic outlook of the partners goes far beyond such a hypothetical current liquidation to encompass events that may occur well in the future. In short, capital accounts provide at best a mere static snapshot of the economic situation of the partners whereas their real situation may well be based on dynamic, multi-year expectations.[86]

The point made is important in understanding the development of divergent valuation methodologies for partnership interests. The capital account concept underlies the use of "liquidation value" to value partnership interests in some contexts.[87] That is, liquidation value is a snapshot of partnership entitlements determined as if the partnership liquidated immediately, as impacted by income and loss allocations to date and what would be the allocation of existing built-in gain or loss if all assets were sold currently. Liquidation value ignores time value of money concepts as well as varying allocation ratios that may apply prior to and after the date that liquidation value is determined.[88] By contrast, the more traditional "willing-buyer-willing-seller"[89] valuation of a partnership interest would take account of the overall economic arrangement—not just what has happened to date. This measure of value also would account for commercial factors related to the partnership interest like the ability (or inability) to control decisions related to the partnership, limitations on the ability to transfer interests in the partnership or liquidate the partnership, and any other terms of the arrangement that could impact what a third party would pay for an interest in the partnership.

The distinction between these two valuation concepts is considered in the context of family limited partnership authority. A significant part of estate and gift planning involves the use of discounts related to lack of control, marketability, and liquidity in measuring the value of a partnership interest. In this context, the valuation analysis appears to vary depending on whether the transfer is made in connection with the formation of the partnership or following formation. As highlighted by one group of commentators:

> To obtain the largest available discount, however, a taxpayer must take care to ensure that the transaction is structured as a gift of a partnership interest rather than an indirect gift of the contributed assets. In the case of a disproportionate capital contribution to a corporation, the contributing shareholder is generally treated as making an indirect gift to the other shareholders 'to the extent of their proportionate interests in the corporation.' Courts have traditionally valued the gift simply by subtracting the donor's retained proportionate interest from the value of the contributed assets. In the case of a partnership, however, the capital account rules of section 704(b) require that the value of the contributed assets be credited to the contributing partner's capital account. If the contribution results in the enhancement of another partner's capital account—in violation of the capital account rules—the contributing partner is likely to be treated as making an indirect gift of the contributed assets, generating a smaller discount than a gift of a partnership interest.[90]

The authors describe the product of the divergent valuation methodologies used in the context of contributions to partnerships and gifting of partnership interests as "the problem of disappearing value."[91] That is, in the view of the courts, a contributor experiences an immediate loss of value by virtue of contributing assets to a partnership.

The discussion in this section highlights that there is no single method that is "correct" in measuring the taxable capital shift as between partners, and the context of the analysis may matter.[92] As will be discussed, in some contexts, liquidation value may appropriately measure the shift, while in others the shift may more properly be measured by reference to the willing-buyer-willing-seller value. Finally, in some contexts, the capital account migration

from one partner to another may be the best measure of the taxable shift among those partners.

VII. Capital Accounts and the Fabric of Subchapter K

While the allocation rules relying on capital accounts are merely a safe harbor, since the promulgation of the substantial economic effect rules in 1986, capital accounts have taken on what seems to be a constantly expanding role in the rules under subchapter K. In thinking about the analysis of capital shifts, it is important to appreciate (or at least acknowledge) how a shift in capital accounts can affect the application of subchapter K in various contexts.

A. Nonrecourse Deductions

Nonrecourse deductions generally are items of deduction or loss where the lender, rather than a partner, would bear the economic loss attributable to the item if the property securing the debt did not recover in value. These items of deduction and loss cannot have economic effect because the allocations do not have an economic impact on the partners.[93] The regulations permit the allocation 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 property securing the nonrecourse liabilities."[94] In order to rely on these rules, the partnership agreement must satisfy either the primary[95] or alternative[96] test for economic effect. By referencing allocations that have substantial economic effect as the benchmark for the proportionate allocation of nonrecourse deductions, the rules require compliance with capital account maintenance, liquidation based on positive capital accounts, and the other rules applicable to satisfying substantial economic effect.

As with the substantial economic effect rules, the regime for allocating nonrecourse deductions is a safe harbor. Allocations that do not meet the requirements of these rules will be "determined under Reg. §1.704-1(b)(3) ([*i.e.*, the rules for "partners' interests in the partnership)], according to the partners' overall economic interests in the partnership."[97]

B. Code Sec. 704(c) and Contributed Property with Built-in Gain or Loss

Code Sec. 704(c) addresses the contribution to a partnership of property with built-in gain or built-in loss. The statute and regulations are intended to cause the contributing partner to bear the impact of the built-in gain or built-in loss through allocations from the partnership, and non-contributing partners generally should receive allocations as if the property was purchased by the partnership for the property's fair market value.[98] Due to the "ceiling rule", the goal of Code Sec. 704(c) is not always perfectly achieved.[99] The same principles apply to "reverse Code Sec. 704(c) gain or loss" that is created in connection with a revaluation of partnership property.[100]

Under the Code Sec. 704(c) rules, the Code Sec. 704(b) "book" and "tax" capital accounts of the partners should converge when the property is fully depreciated or sold.[101] Code Sec. 704(c) operates by recording contributed property on the books of the partnership at fair market value and depreciating the property for "book" purposes on the same schedule as the tax basis.[102] Non-contributing partners are allocated "tax" items of depreciation to equal the allocated "book" items (to the extent of available tax items), and the contributing partner is allocated the remaining tax items.[103] When property is sold, the contributing partner is allocated gain or loss equal to the difference between the "book" and "tax" basis of the property, and the remaining economic gain or loss is allocated under the partnership agreement.[104]

The capital account rules under Code Sec. 704(b) are integral to the operation of Code Sec. 704(c).[105] According to the regulations:

> Property contributed to a partnership is section 704(c) property if at the time of contribution its book value differs from the contributing partner's adjusted tax basis. For purposes of this section, book value is determined as contemplated by §1.704-1(b). Therefore, book value is equal to fair market value at the time of contribution and is subsequently adjusted for cost recovery and other events that affect the basis of the property. For a partnership that maintains capital accounts in accordance with §1.704-1(b)(2)(iv), the book value of property is initially the value used in determining the contributing partner's capital account under §1.704-1(b)(2)(iv)(d), and is appropriately adjusted thereafter (*e.g.*, for book cost recovery under §§1.704-1(b)(2)(iv)(*g*)(*3*) and 1.704-3(d)(2) and other events that affect the basis of the property). A partnership that does not maintain capital accounts under §1.704-1(b)(2)(iv) must comply with this section using a book capital account based on the same principles (*i.e.*, a book capital account that reflects the fair market value of property at the time of contribution and that is subsequently adjusted for cost recovery and other events that affect the basis of the property).[106]

As highlighted in the last sentence of the quoted language above, even for partnerships that do not strictly maintain capital accounts under the Code Sec. 704(b) regulations, the rules require application of the same principles.

The Code Sec. 704(c) allocation rules do not just guide the allocation of built-in gain or loss with respect to partnership assets. The anti-mixing bowl rules triggering gain or loss under Code Secs. 704(c)(1)(B) and 737 operate by reference to these allocation rules, as do the loss limitation rules in Code Sec. 704(c)(1)(C).

C. Taxation of Compensatory Profits Interests

Current IRS guidance provides that, assuming certain requirements are met, a partner who receives a compensatory profits interest will have no current income inclusion, and the partnership will receive no deduction.[107] A profits interest is defined as a partnership interest which has no "liquidation value" upon receipt. In effect, because there would be no capital account associated with the interest if all partnership assets were sold for their fair market value at the time the profits interest is issued, the interest is presumed to have $0 fair market value. Obviously, this presumption will not always comport with reality.

The treatment of profits interests is justified, at least in part, by virtue of the roll of capital accounts under subchapter K. That is, because the profits interest has no "liquidation value" upon receipt, there is no capital account associated with the interest. As income and gain is allocated with respect to the profits interest, the partner will include that amount in taxable income and the partner's capital account will increase. If the profits interest is currently taxable, the recipient would be subject to taxation twice (*i.e.*, upon receipt by reference to the present value of anticipated future income and again when income is allocated), with a loss ultimately upon liquidation of the partnership interest.[108]

D. Debt-for-Equity Contribution Under Code Sec. 108(e)(8)

Code Sec. 108(e)(8) addresses the contribution of debt to a partnership in exchange for an equity interest in the partnership and provides that the partnership will be treated as satisfying the debt with an amount of money equal to the fair market value of the partnership interest. Final regulations issued under Code Sec. 108(e)(8) in 2011 provide that the partnership may follow two different approaches in determining the fair market value of the partnership interest issued to the creditor for purposes of Code Sec. 108(e)(8). The general rule applies a facts and circumstances analysis in determining fair market value,[109] while a separate safe harbor allows the partnership to look to the liquidation value of the partnership interest as the fair market value.[110]

One requirement for using the liquidation value safe harbor is that "[t]he creditor, debtor partnership, and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of the debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange."[111] While the final regulations eliminated the requirement that the partnership must maintain "the capital accounts of its partners in accordance with the capital accounting rules of Reg. §1.704-1(b)(2)(iv)",[112] the use of liquidation value in determining the value of the contributed indebtedness is consistent with the capital account that the creditor would receive upon contribution of the indebtedness.

Treasury and the IRS apparently believed that they could not mandate liquidation value for purposes of valuing the partnership interest. Nonetheless, the use of liquidation value allows for rationalization of the debt-for-equity transaction in a manner that coordinates well with the rules in subchapter K, so it is not surprising that Treasury and the IRS provided this option.[113]

E. Code Sec. 751(b) Proposed Regulations

The "hot asset" rules under Code Sec. 751(b) generally address partnership distributions that have the effect of changing a partner's share of ordinary income and capital gain, as determined before and after the distribution. Proposed regulations issued in 2014 followed the suggestions of numerous commentators and attempted to utilize Code Sec. 704(c) and reverse Code Sec. 704(c) principles to determine a partner's share of ordinary income assets following a distribution. The proposed regulations would analyze a partner's share of "net Code Sec. 751 unrealized gain or loss" before and after the distribution by reference to the net income or loss from the sale of Code Sec. 751 property that would be allocated to a partner before and after a distribution, also taking into account, for the distributee partner, Code Sec. 751 assets distributed to such partner.[114]

As previously discussed, the rules under Code Sec. 704(c) rely heavily on capital accounts for purposes of their operation. By incorporating Code Sec. 704(c) principles, the proposed regulations under Code Sec. 751(b) also exhibit a reliance on capital accounts or at least capital account principles. In this regard, the proposed regulations provide as follows:

> For a partnership that distributes money or property (other than a *de minimis* amount) to a partner as

> consideration for an interest in the partnership, and that owns section 751 property immediately after the distribution, if the partnership maintains capital accounts in accordance with §1.704-1(b)(2)(iv), the partnership must revalue its assets immediately prior to the distribution in accordance with §1.704-1(b)(2)(iv)(*f*). If a partnership does not maintain capital accounts in accordance with §1.704-1(b)(2)(iv), the partnership must comply with this section by computing its partners' shares of partnership gain or loss immediately before the distribution as if the partnership assets were sold for cash in a fully taxable transaction (taking into account section 7701(g)), and by taking those computed shares of gain or loss into account under the principles of section 704(c) (making subsequent adjustments for cost recovery and other events that affect the basis of the property).[115]

While the proposed regulations under Code Sec. 751(b) are not currently effective, they are consistent with the trend in providing guidance under subchapter K that relies on principles that are consistent with a capital account regime for analyzing partnership transactions. In addition, even in the absence of final regulations, many practitioners view Code Sec. 704(c) principles as relevant in determining a partner's share of "hot" assets for purposes of applying Code Sec. 751(b).[116]

F. Regulations Regarding Noncompensatory Options

In 2013, Treasury and the IRS issued final regulations addressing tax issues related to noncompensatory options and convertible debt and equity. The regulations specifically address the potential capital shift that could occur when a taxpayer exercises an option (or converts debt or equity) and succeeds to part of the value that, absent the option (or conversion feature), would be attributable to other partners in the partnership. Not surprisingly, the regulations rely heavily on capital account concepts and rules for their operation.

The regulations address both allocations made to partners while noncompensatory options are outstanding with respect to the partnership and the treatment of the holder of a noncompensatory option upon exercise. The regulations acknowledge that, because a partner who exercises a noncompensatory option has a right to share in partnership capital that may exceed the amounts paid to acquire and exercise the option, allocations to partners while such an option is outstanding cannot have economic effect.[117] More to the point, if the option is exercised, the exercising partner, rather than the existing partners, may receive the economic benefit, or bear the detriment, associated with the items.[118]

Among the requirements that must be satisfied in order for allocations to existing partners to be deemed to satisfy the partners' interests in the partnership, the partnership agreement must require that, while noncompensatory options are outstanding, the partnership will comply with the rules for adjusting capital accounts under Reg. §1.704-1(b)(2)(iv)(*f*), as modified to account for outstanding noncompensatory options. In addition, upon the exercise of a noncompensatory option, the partnership will comply with rules under Reg. §1.704-1(b)(2)(iv)(*s*) governing adjustments to capital accounts to account for the noncompensatory options.[119] As an additional requirement, it is necessary that all material allocations and capital account adjustments under the partnership agreement would be respected under Code Sec. 704(b) if the partnership had no noncompensatory options outstanding.[120]

At a high level, these rules require that, when partnership assets are revalued while noncompensatory options are outstanding, the partnership will adjust the fair market value in connection with the revaluation to account for the noncompensatory options (*i.e.*, depress the value when options are in the money to account for the value that the optionholder could claim or increase the value to the extent that the amount paid for the option exceeds the value of the option).[121] Then, when a noncompensatory option is exercised, the partnership must revalue assets immediately before the exercise and allocate items of unrealized income, gain, or loss to the optionholder to reflect that partner's right to share in partnership capital under the partnership agreement.[122] These rules are intended to account for the capital shift to the optionholder on a deferred basis using book value created in the revaluation of partnership assets and making related reverse Code Sec. 704(c) allocations to the exercising optionholder equal to the shifted capital. To the extent that insufficient book value is created in the revaluation to account for the shifted capital, taxable "corrective allocations" must be made to account for the shortfall and cause the exercising optionholder's capital account to equal that partner's right to share in partnership capital following the exercise.[123]

These rules are quite important in the broader discussion of capital shifts and will be considered in greater detail later in this article. For purposes of this section, the significant point is that capital accounts and related concepts are integral to the analysis of such arrangements.

G. Impact on Capital Shift Analysis

The rules described above and their reliance upon, or influence by, capital accounts seemingly can be broken down into three categories.

The rules relating to nonrecourse deductions are like the general allocation rules. Nonrecourse deductions are allocated by reference to other significant items that have substantial economic effect.[124] A capital shift that compromises the general allocations similarly may raise questions with respect to the validity of nonrecourse deductions allocated under the safe harbor rules.

The rules relating to Code Sec. 704(c), Code Sec. 751(b), and noncompensatory options all relate to the allocation of built-in gain and built-in loss to the appropriate partners. The rules under Code Sec. 704(c) directly address such allocations and attempt to ensure that built-in gain or loss associated with contributed or revalued assets are allocated to the appropriate partners. The proposed regulations under Code Sec. 751(b) rely on those rules to determine if a partner's proportionate share of built-in gain in ordinary and capital assets shift as a result of the distribution of partnership property. The rules relating to noncompensatory options rely on Code Sec. 704(c) to account for what otherwise would be capital shifts in order to delay the taxation of such shifts in value. A shift in capital from a partner who has a share of Code Sec. 704(c) or reverse Code Sec. 704(c) gain or loss has the potential to compromise the tracking of that built-in gain or loss to the proper person. As will be discussed in more detail later in this article, the noncompensatory option rules also illustrate how Code Sec. 704(c) principles may be used to facilitate nonrecognition treatment for certain capital shifts in a way that is consistent with the rules of subchapter K.

The rules relating to the taxation of compensatory profits interests and contributions of debt to equity, by relying on liquidation value for purposes of determining the tax consequences of the transactions, essentially operate based upon an assumption that the valuation approach for capital accounts (*i.e.*, based upon an immediate liquidation of the partnership) are proper for determining tax consequences relating to these transactions generally. Where a partnership is relying on these rules for purposes of analyzing such transactions, there may be some pressure to use a similar metric in valuing capital shifts.[125]

VIII. A Regulation Addressing Capital Shifts

As part of the regulations implementing the rules of subchapter K following enactment of the 1954 Act, Treasury and the IRS promulgated a regulation specifically addressing capital shifts. This regulation provides, in part, as follows:

> Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply.[126]

The regulation is a bit confusing, as it speaks initially to a shift in the capital (*i.e.*, money or property) contributed by a partner, whether upon formation of the partnership or thereafter. The regulation does not reference a shift in capital accounts or otherwise coordinate with the capital account rules, although this is not surprising, given that this regulation originally was promulgated decades prior to the formal incorporation of capital accounts into the fabric of subchapter K. The regulation is limited in its application to transfers that represent compensation or that satisfy an obligation. This scope is clearly more limited than the shifts in value that could represent gross income, as described in section III.[127]

The regulation goes on to describe the amount that is included in income, although only by reference to amounts that represent compensation. This portion of the regulation states:

> The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61 … The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest.[128]

Presumably the regulation does not address the income inclusion for amounts paid in satisfaction of an obligation

because such amounts would not always represent income. For example, the shifting of partnership capital to repay a loan previously advanced by the recipient would not represent income to the recipient.[129] By contrast, a shift in partnership capital to satisfy a rental obligation owed to a cash method taxpayer should represent gross income.[130]

The regulation recognizes that a shift in partnership capital may represent a payment by the partnership or a direct transfer by a partner. Again, the regulation addresses only compensatory capital shifts. In this regard, the regulation provides:

> To the extent that the value of such interest is: (i) Compensation for services rendered to the partnership, it is a guaranteed payment for services under section 707(c); (ii) compensation for services rendered to a partner, it is not deductible by the partnership, but is deductible only by such partner to the extent allowable under this chapter.[131]

In considering the application and scope of the regulation under Code Sec. 721, it is interesting to compare the parallel regulation addressing contributions to a corporation under Code Sec. 351. That regulation states:

> When property is transferred to a corporation by two or more persons in exchange for stock, as described in paragraph (a) of this section, and the stock received is disproportionate to the transferor's prior interest in such property, the entire transaction will be given tax effect in accordance with its true nature, and the transaction may be treated as if the stock had first been received in proportion and then some of such stock had been used to make gifts (section 2501 and following), to pay compensation (sections 61(a)(1) and 83(a)), or to satisfy obligations of the transferor of any kind.[132]

Unlike the regulation under Code Sec. 721, this regulation is not limited to transfers that are compensatory or that satisfy an obligation. Instead, this regulation states that "the entire transaction will be given tax effect in accordance with its true nature." In effect, the regulation makes clear that a substance over form analysis must be undertaken in connection with contributions to a corporation. Code Sec. 351 nonrecognition treatment applies only with respect to contributions that, in substance, are in exchange for stock. The regulations contain examples of transfers to a corporation that represent compensation[133] or a gift[134] to another shareholder.

IX. Judicial and Administrative Authority Addressing Capital Shifts

As will be discussed in this section, there is only limited authority addressing capital shifts, and what authority does exist is focused primarily on compensatory capital shifts. The analysis contained in this authority is fairly simplistic, focusing primarily on whether a capital shift has occurred and the measure of the recipient-taxpayer's inclusion in taxable income.

A. Compensatory Capital Shifts

Lehman v. Commissioner,[135] decided prior to the enactment of the 1954 Code,[136] is often referenced in analyzing compensatory capital shifts.[137] In this case, the taxpayers (husband and wife) each contributed $10,000, and the remaining three limited partners contributed a total of $40,000. The taxpayer-husband, as general partner, was responsible for managing the business of the partnership, while the taxpayer-wife was a limited partner. The partnership agreement provided that once the three limited partners (other than the taxpayer-wife) received $50,000, each of the taxpayers would be credited on the partnership's books with $5,000, and this amount would be deducted from the capital accounts of the limited partners (other than the taxpayer-wife). Upon satisfaction of the $50,000 distribution threshold, the designated capital was recorded in the taxpayers' capital accounts. The court analyzed the shift in capital under the general standard for inclusion in gross income.

In arguing for no current inclusion in income, the taxpayers argued that the adjustment to capital accounts was not available for distribution until after dissolution of the partnership and hence was not actually or constructively received. The Tax Court dismissed this argument and stated:

> We think this situation should be no different in its tax consequences than if the partners had paid over to petitioners the $10,000 under an arrangement whereby petitioners agreed to use that sum to increase their investment in the partnership with a corresponding reduction in the capital shares of the other partners. Under those facts, there could be no question but that the amount would be income to the petitioners.[138]

In 1964, the Fifth Circuit Court of Appeals decided *U.S. v. Frazell*[139] and found a compensatory transaction in a scenario where the taxpayer, a geologist who provided services in procuring oil and gas properties, was to receive

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an interest a joint venture once the other partners had received their full costs and expenses for the properties. Importantly, the taxpayer did not receive a current profits interest that would participate only after the other partners had received all costs and expenses, but instead was given a right to receive a partnership interest at the time that the other partners had received all costs and expenses. Given the timing of when the full costs and expenses were received, and the fact that the entity was converted to a corporation around that time, it was unclear whether the compensatory event was the receipt of stock or a partnership interest. The court saw no difference in the analysis or compensatory amount under the different theories. The court cited Reg. §1.721-1(b)(1) in concluding that a transfer of a capital interest as compensation would represent gross income.

Although not directly addressing the taxation of compensatory capital interests, the decision in *Diamond v. Commissioner*[140] warrants some discussion due to its analysis of Reg. §1.721-1(b)(1) as well as subsequent IRS action taken in light of the decision that bears some relevance to the analysis of capital interests. Thus, we will take a short detour before turning back to the sequential discussion of cases addressing taxation of compensatory capital interests.

In *Diamond*, the taxpayer secured financing for the acquisition of property which was purchased through the exercise of an option. In exchange for these services, the taxpayer received an interest in 60 percent of the profits of the partnership formed to hold the property following the return of capital to the other investor. The taxpayer sold the interest less than three weeks after acquisition for $40,000 and reported the proceeds as short-term capital gain.[141]

The Tax Court held that the receipt of the partnership interest was taxable as ordinary income under Code Sec. 61, and the Seventh Circuit Court of Appeals affirmed that decision.[142] As part of its decision, the Tax Court engaged in a lengthy discussion of the following sentence, and specifically the highlighted parenthetical, from Reg. §1.721-1(b)(1): "To the extent that any of the partners gives up any part of his right to be repaid his contributions (*as distinguished from a share of partnership profits*) in favor of another partner as compensation for services (or in satisfaction of an obligation), Code Sec. 721 does not apply."[143] The Tax Court initially stated that the effect of this parenthetical clause was "obscure."[144] The court followed with the discussion below:

> [W]hat is plain is that the regulations do not call for the applicability of section 721 where a taxpayer has performed services for someone who has compensated him therefor by giving him an interest in a partnership that came into being at a later date. Regardless of whether there may be some kind of equitable justification for giving the parenthetical clause some limited form of affirmative operative scope, as perhaps where there is a readjustment of partners' shares to reflect services being performed by one of the partners, we cannot believe that the regulations were ever intended to bring section 721 into play in a situation like the one before us. The Commissioner disavows such intention, and we agree with him. To apply section 721 here would call for a distortion of statutory language, and we cannot believe that the regulations were ever intended to require that result.[145]

The Seventh Circuit essentially followed the Tax Court's interpretation of Reg. §1.721-1(b)(1)[146] and also addressed the risk of double taxation upon inclusion of the value of a profits interest as compensatory income, stating that further regulations were needed to address this issue. The Seventh Circuit eventually decided to "defer to the expertise of the Commissioner and the Judges of the Tax Court" in affirming the decision.

The decision in *Diamond* prompted a debate within the IRS as to whether a pure profits interest should be taxable, and that debate necessarily involved a discussion of how one should distinguish a tax-free profits interest from a taxable capital interest. In GCM 36346[147] the IRS attached a proposed revenue ruling that would have provided tax-free status for a pure profits interest. In distinguishing a profits interest from a capital interest, the IRS stated:

> [T]he proposed revenue ruling is limited to interests that give the holder no rights to existing partnership assets upon the liquidation of his interest. Correspondingly, a 'capital' interest, which is taxable, includes an interest in earned but unrealized gains. This broad definition of a capital interest is simply an extension of the rule in Treas. Reg. §1.61-2(d)(1) that property received as compensation is taxed at its fair market value. This rule is reflected in both Treas. Reg. §1.704-1(e) and Treas. Reg. §1.721-1(b)(1).[148]

In further highlighting that existing appreciation in partnership assets that shifts to another partner pursuant to a compensatory arrangement should be taxable, the IRS also stated:

> For purposes of section 1.721-1(b)(1) a partner's right to be repaid his contributions consists of the value of any property that would be distributable to him on

> liquidation of his interest. Thus, under the regulations the value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.
>
> Correspondingly, a partner who receives a partnership interest as compensation for services is treated as receiving a capital interest to the extent of the fair market value of partnership assets that would be distributable to such partner if the partner withdrew from the partnership or if the partner's interest were liquidated immediately after it was acquired. For example, an interest in any unrealized appreciation of partnership assets is a capital interest. A service partner who receives only an interest in the appreciation occurring subsequent to such partner's admission receives an interest the value of which is attributable to the right to participate in the partnership's future profits. Whether an interest in a partnership is a capital interest as distinguished from an interest in future partnership profits, must be determined on the facts and circumstances of each case.[149]

The revenue ruling attached in GCM 36346 was never issued. In 1991, the Eighth Circuit Court of Appeals decided *Campbell v. Commissioner*[150] and determined that a profits interest received for services should not be taxable upon receipt.[151] While the court discussed numerous theories, it ultimately rested its decision on the speculative value associated with the interest.

In response to *Campbell*, Treasury and the IRS eventually issued Rev. Proc. 93-27[152] providing a safe harbor whereby, assuming certain conditions were satisfied, a profits interest issued in connection with the performance of services to, or for the benefit of, the partnership would be treated as having a fair market value of $0, as determined by reference to the liquidation value of the interest. Rev. Proc. 93-27 defines a profits interest as any interest in a partnership that is not a capital interest.[153] Consistent with GCM 36346, the revenue procedure defines a capital interest as:

> an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest.[154]

Having completed that detour relating to the interrelationship between profits interests and capital interests, we will now turn back to the cases specifically addressing compensatory capital interests. In 1974, the Tax Court considered a transaction where capital was shifted to a service partner in connection with the formation of a partnership. Specifically, in *McDougal v. Commissioner*,[155] a husband and wife acquired a horse and entered into an agreement with the trainer whereby the trainer would receive a 50-percent interest in the horse once the owners had recovered their costs and expenses of acquisition. The partnership was formed approximately ten months after the horse was purchased, and at that point, the horse had appreciated in value significantly. Citing Reg. §1.721-1(b)(1), the Tax Court concluded that the owners granted the trainer an interest in capital and profits as compensation for having trained the horse. In describing the construct for the transaction, the Tax Court stated:

> When on the formation of a joint venture a party contributing appreciated assets satisfies an obligation by granting his obligee a capital interest in the venture, he is deemed first to have transferred to the obligee an undivided interest in the assets contributed, equal in value to the amount of the obligation so satisfied. He and the obligee are deemed thereafter and in concert to have contributed those assets to the joint venture.[156]

Following an analysis similar to Rev. Rul. 99-5,[157] the Tax Court treated the owner as transferring an interest in the property as compensation to the service provider. The court held that the owners should recognize gain in connection with the transfer of appreciated property to satisfy a compensatory obligation.[158] The trainer recognized income equal to the fair market value of the transferred property interest and was deemed to contribute the property to the partnership with an adjusted basis equal to the fair market value of such property.[159]

The Tax Court again found a compensatory capital shift in *Hensel Phelps Construction Co. v. Commissioner*.[160] In this case, the taxpayer, a construction company, entered into a partnership with a landowner who contributed land to a newly-formed partnership. The taxpayer agreed to construct a building on the land at cost with no profit. In exchange for this agreement, the taxpayer received a 50-percent interest with respect to both capital and profits of the partnership.

The court held that the value of the capital interest[161] was taxable to the taxpayer, again citing Reg. §1.721-1(b)(1).[162] Importantly, however the court also treated the partnership interest as property subject to Code Sec. 83 and determined the timing of the income inclusion by reference to the rules under Code Sec. 83.[163] This represented

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the first time that a capital interest in a partnership was treated as property subject to Code Sec. 83.

The next case finding a taxable capital shift in the context of a compensatory arrangement was *Mark IV Pictures v. Commissioner*.[164] In that case, the taxpayers were in the business of film production. Each partnership raised funds by selling limited partnership interests to investors, and once the partnerships were fully subscribed and operating, the taxpayers (general partners) assigned their film rights to the respective limited partnership. The taxpayers received a 50-percent interest in the profits, any distributions of capital, and liquidation proceeds of each limited partnership. The taxpayers did not assign a value to the film rights in connection with the contributions.

Because the taxpayers could not prove the value of the film rights contributed and also could not prove that they were fully compensated for services through fees received, the Tax Court found that they failed to prove they received their interests in exchange for property rather than services.[165] The Eight Circuit Court of Appeals affirmed the Tax Court decision.

Citing Reg. §1.721-1(b)(1), the Eight Circuit acknowledged that the fair market value of a capital interest received as compensation for services must be included in gross income. The court specifically stated:

> To determine whether an interest is a capital one, we examine the effects of a hypothetical liquidation occurring immediately after the partners received their interests, which, in this case, was the date the partnerships were formed.[166]

The court held that the interests received by the taxpayers were capital interests and valued those interests by reference to their share of the capital contributions made by the other limited partners as of the end of each taxable year.[167]

As relevant to the timing of the income inclusion under Code Sec. 83, the Tax Court had found that the partnership interest was freely transferable and not subject to a substantial risk of forfeiture so that income could not be deferred beyond the receipt of the interests.[168] The Eighth Circuit found the taxpayer's argument to the contrary on appeal to have "no merit."[169]

The next significant case addressing a compensatory capital shift was *Johnston v. Commissioner*.[170] In this case, the limited partnership was formed initially with minimal capital of $100–$90 contributed by the taxpayer as the general partner and $10 contributed by another individual. Additional limited partners subsequently contributed $8 million to the limited partnership. Under the terms of the partnership agreement, the taxpayer, as general partner, was entitled to one percent of all capital, profits, and losses of the partnership.

Again citing Reg. §1.721-1(b)(1), the court stated that a compensatory shift of partnership capital will give rise to gross income, and the court made clear that this rule applies regardless of whether the capital shift occurs upon formation of the partnership or at a later time.[171] Consistent with the decision in *Mark IV Pictures*, the court indicated that a capital interest will exist if the taxpayer would be entitled to a distribution upon liquidation of the partnership.[172] Consistent with the other cases, the court determined that the measure of the taxpayer's gross income was the amount that would have been received had the partnership liquidated on the date of the capital shift (which was the date of the contribution by the other limited partners).[173] The court indicated that this was the value put forth by the IRS, and the taxpayer failed to offer any evidence that this number was incorrect.[174] Significantly, however, in a footnote, the court acknowledged that liquidation value is not the only way to measure the compensatory amount. In this regard, the court stated:

> The fair market value of that interest is not necessarily the same as the amount of capital to which Mr. Johnson could have been entitled if Maple Village partnership had been liquidated immediately after the limited partners shifted that interest to him. This is because of factors that might exist which could affect fair market value, such as anticipated gains and/or losses of the Partnership and material restrictions on transferability of the partnership interests.[175]

This statement appears to be the only instance where a court has explicitly acknowledged that the compensatory amount related to a compensatory capital shift may be different from the liquidation value of the interest. In addition, it is worth noting that in this case the Tax Court approved a negligence penalty for the taxpayer's failure to include as compensation the amount of the capital shift.

The final notable case addressing compensatory capital shifts is *Crescent Holdings LLC v. Commissioner*.[176] The issue in this case was not whether the receipt of a capital interest was taxable. Instead, this case addressed whether a service-provider had received a capital interest that it was treated as owning for federal income tax purposes even though the interest was subject to a substantial risk of forfeiture under Code Sec. 83. More specifically, the Tax Court analyzed whether the taxpayer was a partner that should receive allocations of profit and loss prior to the time that the partnership interest was forfeited.

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In this case, the taxpayer had not made an election under Code Sec. 83(b) to be treated as the owner. As a result, in order to treat the taxpayer as a current partner for federal income tax purposes, it was necessary to find either that (1) the taxpayer held a profits interest and hence could be treated as a current partner under Rev. Procs. 93-27[177] and 2001-43,[178] or (2) a capital interest is not property subject to the timing rules under Code Sec. 83 for purposes of determining ownership.

In determining whether the taxpayer had received a profits or capital interest in the partnership, the court looked to the definitions in Rev. Proc. 93-27. The court determined that the taxpayer would have been entitled to a share of proceeds in a hypothetical liquidation of the partnership and thus had received a capital interest rather than a profits interest.[179] Rev. Proc. 93-27 is a "safe harbor" revenue procedure and thus arguably does not represent authority for determining what is a compensatory capital interest. Significantly, however, the Tax Court acknowledged that "[t]he test used in Rev. Proc. 93-27 to determine whether an interest is a capital interest is similar to the test that had been used by [the Tax Court]," citing *Mark IV Pictures*.[180]

The Tax Court's decision contains an extended discussion regarding the application of Code Sec. 83 to partnership capital interests and specifically states that the failure of Code Sec. 83 and the legislative history to mention partnerships is not a barrier to treating a partnership capital interest as "property" for purposes of Code Sec. 83.[181] The opinion explicitly reconciles Reg. §1.721-1(b)(1) and Reg. §1.83-1(a)(1) as follows:

> Section 721(a) provides that 'no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of *property* to the partnership in exchange for an interest in the partnership.' (Emphasis added.) Section 721 applies to contributions of property; it does not apply to contributions of services. Section 1.721-1(b)(1), Income Tax Regs., provides that the nonrecognition treatment for contributions of property to a partnership provided by section 721 does not apply to contributions of services. In other words, the regulation requires the service provider to recognize as income the fair market value of his partnership capital interest. Section 1.721-1(b)(1), Income Tax Regs., also states that 'the time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or dispose of such interest.' This regulation provides no statements regarding who is treated as the owner of the partnership capital interest prior to the capital interest becoming substantially vested. As a result, the provision in section 1.83-1(a)(1), Income Tax Regs., providing that the transferor of the property is treated as the owner of the property until it becomes substantially vested, does not conflict with section 1.721-1(b)(1), Income Tax Regs., or with section 721.[182]

To summarize the case law, the receipt of a capital interest for services clearly gives rise to income equal to the fair market value of the interest received. While the determination of whether a partnership interest is a capital interest appears to be based upon whether the recipient would be entitled to proceeds on liquidation immediately after receipt of the interest, the fair market value of the interest received may be, but is not necessarily, dependent on the liquidation value of the interest. The argument for using a fair market value amount that is different from liquidation value appears to be better when the capital shift occurs with respect to an existing partnership than when a capital interest is received in connection with the formation of a partnership. Certain authority can be read to stand for the proposition that the partnership may recognize gain or loss in connection with a capital shift to a service partner, although as will be discussed, Treasury and the IRS appear to have concluded that this often is not a proper result from a policy perspective.[183] Finally, Code Sec. 83 applies in determining the timing for inclusion of the value of a compensatory capital interest in gross income.

B. Indirect Gifts

This author has been unable to locate any cases or administrative authority finding a taxable capital shift outside of the compensatory context. Authority does exist, however, treating a gratuitous shift in capital among partners as a gift.[184]

The leading case in this regard is *Shepherd v. Commissioner*.[185] In this case, a husband and wife executed two deeds transferring 100 percent of their interests in certain land to a partnership. The husband would own a 50 percent interest in the partnership, and his two sons each would own 25 percent interests. The partnership came into existence on the date when the two sons signed the partnership agreement, which was the day after execution of the deed.

The court determined that the partnership could not receive the property prior to formation. Accordingly, the court did not view the transaction as a contribution of land to the partnership followed by a gift of partnership interests to the sons. The court stated that "gifts to

a partnership, like gifts to a corporation, are deemed to be indirect gifts to the stakeholders 'to the extent of their proportionate interests' in the entity."[186] The court further stated that the father "created a partnership in which his sons held established shares and then gave the partnership a taxable gift of land (making it an indirect gift of land to his sons)."[187]

Subsequent cases have evaluated the formation of the partnership and gift of the interest under an "integrated transaction" analysis. That is, where the contribution of assets to a partnership and conveyance of the partnership interest were part of a single integrated transaction, the court has analyzed the gift tax implications by reference to an indirect gift of assets followed by a contribution to the partnership.[188] Where, however, the assets were contributed to the partnership sufficiently in advance of the gift so that the partnership held the assets for a period of time that allowed the partnership to bear real economic risk as to a change in value of the contributed assets, the formation of the partnership has been viewed as an independent transaction and that should be respected.[189]

The impact of these decisions related to the fair market value of the gift. The gift of a partnership interest generally is evaluated differently than a gift of a direct property interest, as the partnership interest typically is subject to discounts for lack of liquidity, control, and other factors.[190] Interestingly, however, where assets have been contributed to a disregarded LLC and gifts have been made of the LLC interests, courts have evaluated the transfer by reference to the entity interests and not direct interests in the assets.[191] In making this determination, the courts have looked to state law, rather than Federal tax law,[192] in determining the nature of the assets transferred.[193]

Cases evaluating indirect gifts through partnerships have analyzed whether a contributing partner receives a capital account that is consistent with the value of the property contributed in determining whether an indirect gift results from a disproportionate contribution of property.[194] If the contribution to the partnership is respected, and the contributing partner is credited with a capital account that is consistent with the value of the property contributed, there will be no indirect gift of the contributed asset. A subsequent gift of the partnership interest will be respected and will convey with it a proportionate share of the capital account associated with the partnership interest.[195]

C. Other Mentions of Capital Shifts

The IRS has considered certain other situations where the potential for a capital shift apparently was considered to be relevant, although no taxable capital shift was found to exist.

Two of the situations involved recapitalizations of partnership interests. In LTR 200345007,[196] the partnership proposed to take a single class of units in the partnership and permit partners to convert existing units into three different classes of units with different rights, preferences, privileges, and restrictions from one another. As a condition to obtaining a ruling that the conversion of units would not result in the recognition of gain, the partnership was required to represent that "[e]ach member's proportionate share in [the partnership's] capital will remain the same after the planned conversion of the membership interests."[197]

In Chief Counsel Advice 201517006,[198] the IRS considered a situation where a publicly-traded partnership converted "incentive distribution rights" (*i.e.*, a profits interest in the partnership) into common units. While the holder of the incentive distributions rights did not originally have any capital account with respect to those units, the partnership assets had since appreciated significantly. As a result of a contribution by the general partner, the partnership revalued its assets and allocated significant appreciation to the incentive distribution rights consistent with the entitlements of those units. The "booked-up" capital account related to the incentive distribution rights was equal to the capital account of the common units received upon conversion. In providing that the conversion of units was not a taxable event, the IRS highlighted that "no taxable capital shift occurred."[199]

Finally, in a 1998 field service advice,[200] the IRS considered a scenario involving a bargain sale of assets of a subsidiary corporation to a partnership formed by shareholders of the parent corporation. The IRS recognized the possibility for a capital shift in this transaction, although this theory seemed to be considered merely as one of a number of potential theories that the IRS might assert in attacking the transaction. Although the IRS did not actually describe a capital shift as having occurred, the IRS made the following statement:

> Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at or after the formation of the partnership. Treas. Reg. §1.721-1(b)(1). Therefore, the value of the interest that each partner has in the partnership should reflect the value of the capital contributed to the partnership. To the extent that any partner gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits), I.R.C. §721 does not apply.

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Instead, the value of an interest in such partnership capital is treated as transferred to the other partners and constitutes income to the partners under I.R.C. §61 to the extent of the fair market value of the interest in capital so transferred at the time of the transfer.

Although there is no explicit statutory provision mandating such a result in this case, this principle is found in Treasury Regulation §1.721-1(b)(1) and, generally, applies in the situation in which the income is compensation for services or in satisfaction of an obligation.[201]

X. Addressing Capital Shifts in Regulations

The prior section contains a discussion of authorities that address capital shifts on a somewhat haphazard basis. That is, the authorities analyze whether a shift in value has occurred among partners, and where such a shift has occurred, tax implications related to that shift (either compensation or a gift) have been recognized. These authorities contain no real analysis regarding whether recognition of the capital shift was producing an equitable result or how the shifting of capital should interact with the rules of subchapter K.[202]

In two regulation projects initiated in the early 2000's,[203] Treasury and the IRS did undertake such an analysis. These regulation projects addressed tax issues related to compensatory partnership interests (including options) and non-compensatory partnership options. One of these regulation projects was discussed at a high level in section VII addressing the importance of capital accounts in the operation of subchapter K. This section undertakes a deeper dive into those regulations, focusing specifically on how Treasury and the IRS analyzed the "equities" involved in determining whether to tax shifts in capital, and once that decision was made, how the results were carried out within the confines of the rules under subchapter K.

A. Non-Compensatory Partnership Options

We will first consider regulations addressing the taxation of non-compensatory partnership options.[204] Although the holder of a non-compensatory partnership option is not currently a partner, such person has an economic claim to the value of partnership assets by reference to the option terms. That is, if a person holds an option acquire a 25-percent interest in a partnership in exchange for a $500 contribution to the partnership, that person can capture one-quarter of the value of the partnership's assets in exchange for paying the $500 exercise price of the option. When the optionholder exercises the option, the historic partners' shares of the assets are partially transferred to the optionholder, thus resulting in a shift in capital among the parties.

The preamble to the proposed regulations begins by recognizing that, under general tax principles, the issuance of an option typically is an open transaction for the issuer.[205] The holder, by purchasing an option, is merely making a capital expenditure that is neither taxable nor deductible. Such treatment is adopted for partnership options, creating parallel treatment with options to acquire other types of property. Although not discussed in the preamble, it is important to recognize that the exercise of an option also does not represent a taxable transaction outside the partnership context.[206]

In describing its rationale for determining that the exercise of a non-compensatory option generally should not give rise to a taxable capital shift, the preamble to the proposed regulations contains the following statements:

> Section 1.721-1(b) provides that, to the extent that a partner gives up his right to be repaid all or a portion of his capital contribution in favor of another partner 'as compensation for service (or in satisfaction of an obligation),' section 721 does not apply. Some commentators have expressed a concern that this regulation could be read to exclude from the application of section 721 a shift in partnership capital from the historic partners to the holder of the noncompensatory option in satisfaction of the partnership's option obligation upon exercise of the option. If this were the case, the partnership could be deemed to have sold a portion of each of its assets to the holder in a taxable exchange. Alternatively, the partnership could be deemed to have sold a partnership interest with a $0 basis to the option holder in a taxable exchange.
>
> Despite these concerns, most commentators believe that 1.721-1(b)(1) should not cause the issuance of a partnership interest upon exercise of a noncompensatory option to be taxable. They assert that the exercise of such an option should be nontaxable to the holder and the partnership, both under general tax principles and under the policy of section 721 to facilitate business combinations through the pooling of capital.
>
> Treasury and the IRS agree that, in general, the issuance of a partnership interest to the holder of a

noncompensatory option should not be taxable to the holder or the partnership. Upon exercise, the option holder may be viewed as contributing property in the form of the premium, the exercise price, and the option privilege to the partnership in exchange for the partnership interest. Generally, this is a transaction to which section 721 should apply—a transaction through which persons join together in order to conduct a business or make investments. Accordingly, the proposed regulations generally provide that section 721 applies to the holder and the partnership upon the exercise of a noncompensatory option issued by the partnership.[207]

This discussion is interesting for several reasons. First, it references Reg. §1.721-1(b)(1) as the rule that governs analysis of capital shifts. The preamble makes no reference to broader concepts of gross income. Second, the discussion references both general tax principles and the policies underlying subchapter K in support of the decision not to tax capital shifts that occur in connection with the exercise of a noncompensatory partnership option. Finally, the treatment of the option premium as property for purposes of Code Sec. 721 seemingly indicates a need from the Treasury and IRS perspective to find a way to justify the results within the technical rules of subchapter K.

The technical path followed through subchapter K in taxing noncompensatory partnership options is intricate. As indicated above, nonrecognition treatment is justified under Code Sec. 721 by treating the option premium as property that is contributed upon exercise, but that option premium disappears (*i.e.*, merges out of existence) in connection with the contribution. The partner had no basis in the option premium, so the premium would have been Code Sec. 704(c) property in the hands of the partnership, had it survived. In an attempt to replicate the results that would have occurred if the premium had survived as Code Sec. 704(c) property, the preamble to the proposed regulations states that partnerships will be allowed "to substitute built-in gain or loss in the partnership's assets for the built-in gain or loss in the option."[208]

The process for substituting the built-in gain or loss involves the use of the partnership revaluation rules and allocation of Code Sec. 704(b) book gain or loss with respect to partnership assets first to the option holder so as to produce the capital account that economically relates to the interest received upon exercise.[209] That built-in gain or loss will result in reverse Code Sec. 704(c) gain or loss allocable to the partner who exercised the option, and this will impact future gain or loss (or depreciation) allocated to that partner.

In order to make it most likely that adequate gain or loss will exist when the noncompensatory option is exercised, the regulations permit the revaluation of partnership assets immediately before the issuance of a noncompensatory option[210] and modify the rules for determining the value of partnership assets when a noncompensatory option is outstanding.[211] In determining the fair market value of partnership assets, the value of assets reflected on the books of the partnership "must be adjusted to account for any outstanding noncompensatory options" at the time of the revaluation.[212] In effect, the value of assets reflected in the revaluation are artificially adjusted in an effort to preserve sufficient built-in gain or built-in loss to account for the capital account of the option holder immediately after conversion. More specifically, if option premium exists with respect to the option at the time of the revaluation, the value of partnership assets must be reduced to account for the amount of the option premium to the extent of unrealized appreciation in partnership assets, and that reduction is allocated among assets with unrealized appreciation in proportion to such appreciation.[213] If the amount contributed to the partnership in exchange for the option exceeds the value of the option on the date of the revaluation, then the value of partnership assets must be increased by such excess to the extent of unrealized loss in partnership assets.[214]

Upon exercise of the option, the partnership assets are revalued immediately after the exercise, and the partnership must first allocate unrealized income, gain, and loss in partnership assets (that has not previously been accounted for in capital accounts) to the exercising partner to the extent necessary to reflect that partner's share in partnership capital under the partnership agreement.[215] If these allocations do not cause the exercising partner's capital account to reflect such partner's share in partnership capital, then the partnership must reallocate (*i.e.*, shift) partnership capital between existing partners and the exercising partner so that the exercising partner's capital account reflects that partner's right to share in partnership capital under the partnership agreement.[216]

In a situation where a reallocation of capital is necessary, the exercising partner is being allocated capital that was actually reflected in the capital account of another partner. This may be after-tax capital, such as previously allocated, but undistributed, income. Alternatively, this may be built-in gain reflected in a forward Code Sec. 704(c) layer related to contributed property or a reverse Code Sec. 704(c) layer created in a revaluation before the exercising partner acquired its option.

If the partnership is required to reallocate capital among its partners, the partnership must make "corrective

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allocations" in order to account for the reallocation of capital among the partners. More specifically, "the partnership must, beginning with the taxable year of the exercise and in all succeeding taxable years until the required allocations are fully taken into account, make corrective allocations so as to take into account the capital account reallocation."[217] For these purposes, "[a] corrective allocation is an allocation (consisting of a *pro rata* portion of each item) for tax purposes of gross income and gain, or gross loss and deduction, that differs from the partnership's allocation of the corresponding book item."[218]

The regulations relating to noncompensatory options seem to illustrate three important points with respect to the Government's view of capital shifts. First, there are instances where a capital shift should not be taxable. Second, where a capital shift is not taxable, it still is important to account for the capital shift in a manner that is consistent with the rules of subchapter K.[219] Third, where the rules of subchapter K are not sufficiently flexible to accommodate a non-taxable capital shift, the rules of subchapter K will be given priority and the capital shift will be taxable.

With respect to the second and third point, Treasury and the IRS clearly felt it necessary to account for the option holder's economic entitlements upon exercise within the constraints of the rules related to capital accounts. That is, the capital shift is accounted for, to the extent possible, under the rules relating to reverse Code Sec. 704(c) allocations using previously unbooked built-in gain and built-in loss in partnership assets. To the extent that the capital shift cannot be fully accounted for using such "book", and not taxable, items, the partnership must separate current book and taxable items, allocating the book item to the partner who shifted true "book" capital (and possibly post-tax) capital to replicate for that partner the book capital shifted to the exercising option holder, and allocating the tax item to the exercising option holder to cause the shifted capital to become post-tax capital. In effect, the corrective allocation rule prevents a partnership from allocating taxable income and gain to certain partners and then shifting the related value to the option holder on a tax-deferred basis.[220] Arguably, the corrective allocation rule is overbroad, as it also requires corrective allocations to account for shifts in capital attributable to Code Sec. 704(c) and reverse Code Sec. 704(c) gain—that is, gain not yet subject to tax. Apparently, Treasury and the IRS considered alternative approaches but settled on the corrective allocation approach for reasons related to administrability.[221]

The regulations do not apply to the exercise of a noncompensatory option with respect to a disregarded entity. In explaining the reason for excluding this scenario from the regulations that attempt to facilitate non-taxable capital shifts, Treasury and the IRS explained that the inability to coordinate proper capital accounting for such transactions justified the decision. According to the preamble:

> [U]pon exercise of the option, the owner of the eligible entity would be treated as contributing all property owned by the eligible entity prior to exercise of the option to the new partnership, while the option holder would be treated as contributing only the exercise price and premium to the partnership. The new partnership would have no unbooked unrealized gain in its property that it could allocate to the exercising option holder.[222]

One additional issue considered but dismissed by Treasury and the IRS in connection with the noncompensatory option regulations bears mention. Commentators had suggested that the Code Sec. 704(b) regulations should be amended to permit partnership property to be revalued by reference to the fair market value of the partnership interest rather than the fair market value of partnership property.[223] According to the preamble, commentators had indicated that the value of the partnership interest "may vary because of restrictions on the transferability or liquidity of the partnership interest or other factors."[224] These commentators appear to have been arguing that the true value to the partner in a capital shift is reflected in the willing-buyer-willing-seller value of the partnership interest and not the liquidation value. Interestingly, the suggested approach would have essentially conformed the willing-buyer-willing-seller value of the partnership interest and the liquidation value of the partnership interest immediately following a revaluation event. Treasury and the IRS stated that such a change was beyond the scope of the regulations relating to noncompensatory options and hence chose not to make the suggested change.[225]

B. Compensatory Partnership Options

In 2005, Treasury and the IRS promulgated proposed regulations addressing the issuance of compensatory partnership interests, including compensatory partnership options. Initiation of legislative efforts to address the taxation of carried interest followed soon thereafter, and these regulations appear to be on permanent hold in light of those continuing efforts. Nonetheless, the proposed regulations provide further insight into Treasury and IRS thoughts relating to capital shifts and hence justify some discussion.

The preamble to the proposed regulations states as a goal the coordination of the principles of subchapter K and Code Sec. 83. In this regard, the preamble highlights the following proposed changes:

> (1) conforming the subchapter K rules to the section 83 timing rules; (2) revising the section 704(b) regulations to take into account the facts that allocations with respect to an unvested interest may be forfeited; and (3) providing that a partnership generally recognizes no gain or loss on the transfer of an interest in the partnership in connection with the performance of services for that partnership.[226]

The preamble highlights that the current version of Reg. §1.721-1(b)(2) treats the recipient of a compensatory capital shift for services provided to the partnership as receiving a guaranteed payment under Code Sec. 707(c) equal to the fair market value of the interest received.[227] The proposed regulations provide that the rules under Code Sec. 83 should govern the timing of the income inclusion and deduction related to the compensatory interest.[228] Nonetheless, the payment otherwise would continue to be treated as a guaranteed payment under Code Sec. 707(c) due to concerns relating to the application of other rules in the Code and regulations that currently reference Code Sec. 707(c).[229]

The proposed regulation providing for forfeiture allocations illustrates Treasury's and the IRS's efforts to coordinate the rules of Code Sec. 83 and the capital account rules in Code Sec. 704(b). This rule addresses the situation where a partner makes a Code Sec. 83(b) election to be treated as the current owner of a partnership interest and is allocated income or loss prior to forfeiture of the interest. According to the preamble to the proposed regulations:

> Generally, forfeiture allocations are allocations to the service provider of partnership gross income and gain or gross deduction and loss (to the extent such items are available) that offset prior distributions and allocations of partnership items with respect to the forfeited partnership interest. These rules are designed to ensure that any partnership income (or loss) that was allocated to the service provider prior to the forfeiture is offset by allocations on the forfeiture of the interest.[230]

In other words, if a partner who was allocated $100 of undistributed income subsequently forfeits the partnership interest, that $100 of income remains in the partnership and will benefit other partners. In an effort to reconcile partner capital accounts, the forfeiting partner will be allocated items of gross deduction or loss which will offset the prior $100 income inclusion for the forfeiting partner, effectively inflating the capital accounts of the other partners by a like amount.[231]

The proposed regulations also address the nature of a compensatory capital shift from the perspective of the partnership. That is, should the partnership be treated as transferring an undivided interest in assets related to the shifted capital in satisfaction of a compensatory obligation, thus triggering gain to the partnership, or should the nonrecognition principles of Code Sec. 721 prevail? According to the preamble:

> [T]he Treasury Department and the IRS believe that partnerships should not be required to recognize gain on the transfer of a compensatory partnership interest. Such a rule is more consistent with the policies underlying section 721—to defer recognition of gain and loss when persons join together to conduct a business—than would be a rule requiring the partnership to recognize gain on the transfer of these types of interests.[232]

Note that, in providing for this result, the proposed regulations would permit the allocation of a current deduction funded by the transfer of appreciated property.[233] In order to facilitate the nonrecognition result while still ensuring that the partners for whom appreciated capital funded a current deduction, the preamble states that "[u]nder Reg. §1.704-1(b)(4)(i) (reverse Code Sec. 704(c) principles), the historic partners generally will be required to recognize any income or loss attributable to the partnership's asset as those assets are sold, depreciated, or amortized."[234] Following such a rule locks in for the historic partners the gain related to the share of appreciated assets transferred to fund the compensation deduction, so those partners ultimately would bear the tax cost of any appreciation that funded the deduction.[235]

Note that this rule is contrary to the general rule that requires recognition of gain upon the transfer of appreciated property to satisfy an obligation.[236] In the typical situation, the transferor of the property divests all interests in the property such that the transfer is the last clear chance to tax gain inherent in the property.[237] By contrast, where the transfer reflects an interest in property recorded on the books of the partnership, the deemed "transferors" (*i.e.*, the partners) remain tied to the property through the partnership, and the last clear chance to tax the gain and allocate it to the proper partners has not been lost.

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Consistent with the regulations relating to noncompensatory partnership options, the proposed regulations do not extend the nonrecognition result to the transfer or substantial vesting of a compensatory partnership interest issued by a disregarded entity. Treasury and the IRS did not provide any explanation for this result other than to cite to the *McDougal*[238] case discussed previously.[239]

A final and significant aspect of these proposed regulations relates to the valuation of a compensatory partnership interest, and particularly capital interests. Guidance previously issued by Treasury and the IRS had permitted valuation of a profits interest by reference to the liquidation value of such an interest.[240] No guidance had been issued with respect to the valuation of compensatory capital interests, although most cases considering the issue also had valued such interests by reference to liquidation value.[241] While the proposed regulations along with a proposed revenue procedure would permit partnerships to elect to use liquidation value for purposes of valuing all compensatory partnership interests (*i.e.*, capital interests and profits interests) if certain requirements are satisfied,[242] this is not the general rule stated in the proposed regulations. Unless the election is made, a compensatory capital interest would be valued based under a "willing-buyer-willing-seller" standard that generally applies for purposes of Code Sec. 83.[243] According to the preamble:

> [T]he Treasury Department and the IRS do not believe that there is a substantial basis for distinguishing among partnership interests [(*i.e.*, capital interests and profits interests)] for purposes of section 83. All partnership interests constitute personal property under state law and give the holder the right to share in future earnings from partnership capital and labor.[244]

Where taxpayers follow the general rule for valuing the compensatory capital interest, the proposed regulations would provide the taxpayer with a capital account equal to the income inclusion. The preamble states that:

> Under section 83, the economic benefit of receiving a partnership interest in connection with the performance of services is the amount that is included in the compensation income of the service provider, plus the amount of interest paid for the interest. This is the amount by which the service partner's capital account should be increased.[245]

The coordination of the income inclusion amount and capital account in this context is clearly incorrect and has been universally criticized.[246] Capital accounts are intended to reflect a partner's economic entitlements on a current liquidation basis, and the use of a willing-buyer-willing-seller measure of the partnership interest value (which may take into account discounts for lack of control, marketability, liquidity, *etc.*) to determine capital accounts will not reflect the partner's economic entitlement upon liquidation.[247]

The point that a partnership interest is property like any other asset is significant and does raise questions regarding whether Treasury and the IRS can properly require that taxpayers value a partnership interest by reference to the liquidation value of such an interest.[248] Unfortunately, the proposed regulations do not provide useful insights as to how Treasury and the IRS might rationally coordinate such a valuation methodology with the capital account rules in Code Sec. 704(b).

XI. Conceptualizing and Contextualizing Capital Shifts

A. What Have We Learned?

While the journey through existing authority has been interesting (at least arguably), it has provided little clarity as to the treatment of capital shifts beyond certain narrow sets of circumstances. Let's take stock in what we have learned.

For starters, the authority relating to gross income and realization events is quite broad. If treasure trove represents gross income, the IRS certainly has colorable arguments that many partnership capital shifts represent gross income.[249] But the IRS seems inclined to exercise some restraint in taxing capital shifts.[250] The regulations under Code Sec. 721 address capital shifts only in instances where the shift is compensatory or in satisfaction of an obligation. Courts and the IRS seem to reference that regulation, rather than general gross income authority, when analyzing partnership capital shifts.[251]

Most of the authority has addressed capital shifts in a fairly superficial manner, simply concluding that compensatory capital shifts are taxable to the recipient. But when Treasury and the IRS have undertaken meaningful analysis of the issue in the context of noncompenstaory partnership options and issuance of compensatory partnership interests, they have not taken a particularly hard line. In the noncompensatory option context, Treasury and the IRS tried to avoid immediate taxation for the optionholder and the partnership upon exercise of an option. However, when faced with the choice of deferring income/gain at the expense of infringing on the integrity of the capital account system that forms the fabric of much

of subchapter K, Treasury and the IRS chose to preserve the capital account system at the expense of creating income for the optionholder.[252] Efforts in addressing the taxation of compensatory partnership interests through proposed regulations showed a similar effort to protect the capital account system, although the approach taken seemed misguided.

Regarding valuation, Treasury and the IRS seem to recognize that they cannot force taxpayers to analyze transactions relating to partnership interests by reference to liquidation value in all instances. Final regulations under Code Sec. 108(e)(8) and the proposed regulations relating to compensatory partnership interests both allow an election to value partnership interests by reference to liquidation value, but the default rule in both instances looks to a willing-buyer-willing-seller valuation model.[253]

In some contexts where the capital shift analysis is more about protecting the allocation system than measuring a compensatory event, *etc.*, the shift in the Code Sec. 704(b) capital account may be the relevant benchmark.[254] Further to this point, and as will be highlighted in certain scenarios discussed below, in some contexts there is a legitimate question regarding whether rules addressing allocations are sufficiently flexible to account for a shift in value or instead, whether a migration in value among partners should be accounted for as a taxable capital shift.

Beyond these bits of "directional" guidance, taxpayers are left to struggle with the tax implications of capital shifts in many instances. In situations where guidance is lacking, context should matter. In some scenarios, a "capital shift" may be merely a product of annual accounting, and more flexible allocation principles under "partners' interests in the partnership" may provide some relief. By contrast, where a capital shift is "purposive" and intended to shift the economic benefit of amounts already allocated as taxable income to other tax indifferent parties, strict adherence to capital account principles may be justified. And there are many instances where the most equitable treatment may fall somewhere in between. The discussion below describes a number of scenarios involving what are at least arguably capital shifts and analyzes the scenarios by reference to the authority and other factors that seem relevant, given the context.

B. Compensatory Capital Shifts

As previously described, most of the authority discussing partner capital shifts addresses such shifts in the compensatory context. This authority makes clear that compensatory capital shifts are taxable as compensation and Code Sec. 83 applies to such transfers. But with those basic conclusions settled, there still are significant unanswered questions.

1. Partner-to-Partner Shift

Consider first a compensatory capital shift that occurs directly between partners. By way of example, assume that John, a partner in PRS, has been the recipient of services performed by Mike and owes Mike $100 for such services. John and Mike agree that John will convey his PRS interest to Mike in satisfaction of that obligation. A third-party bargaining at arm's length would pay John $100 for his PRS interest, but the liquidation value of the interest is $125. John has an adjusted basis of $50 in the PRS interest.

As an initial matter, it is important to recognize that this transfer is both a compensatory transfer and a transfer in satisfaction of an obligation. Thus, Reg. §1.721-1(b)(1) clearly applies to the transfer and indicates that Mike should be treated as receiving income under Code Sec. 61 equal to the fair market value of the interest. Code Sec. 83 would provide for the same result.

Reg. §1.721-1(b)(2) addresses the nature of the payment as one between partners and concludes that the payment is not deductible by the partnership and is deductible by the partner only to the extent allowable under Chapter 1 of the Code.

The fact that this transfer essentially occurs outside the partnership potentially has broader consequences. While most cases addressing compensatory capital shifts measured the income resulting from the shift based upon the liquidation value of the capital interest, that result seems harder to defend when the transaction occurs between partners. First, issues relating to reconciliation of the Mike's capital account and income inclusion are not problematic since the capital account related to the transferred interest simply carries over to the transferee partner.[255] Likewise, any Code Sec. 704(c) or reverse Code Sec. 704(c) layer also would carry over with the transferred interest.[256] In addition, there is no question as to the construct of the asset transferred in this context—that is, this is the transfer of a partnership interest between partners. Based upon these factors, the better answer would seem to be that Mike's has $100 of income—the willing-buyer-willing-seller value of the interest.

As a partner-to-partner transaction, it seems more difficult for John to avoid recognition of gain upon transfer of the interest. Under general tax principles, a taxpayer will recognize gain upon the transfer of appreciated property to satisfy an obligation.[257] As previously discussed, proposed regulations addressing the issuance of compensatory capital interests would not force the partnership to recognize gain upon issuance of capital interest in a partnership.[258] Instead, the partners who are the beneficiaries of the compensation deduction would be allocated reverse Code

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Sec. 704(c) gain with respect to the partnership assets that underlie the capital interest and effectively fund the deduction. As a result, those partners ultimately would bear the tax cost associated with the payment that funds the deduction. In the context of a partner-to-partner transfer, however, there is no opportunity under the rules of subchapter K to defer and preserve the tax cost of John's deduction, particularly if John completely exits the partnership.[259] Hence, John likely would recognize $50 of gain upon transfer of the capital interest to Mike.

2. Issuance of Capital Interest to New Partner

As an alternative, consider a situation where PRS has agreed to issue a PRS interest with the same characteristics as previously described to Mike in order to entice Mike to come work for PRS. Mike was not a partner prior to the transaction.

Again, Reg. §1.721-1(b)(1) and Code Sec. 83 make clear that the receipt of the capital interest will be taxable based upon the fair market value of the interest. Under Reg. §1.721-1(b)(2), the transfer of the capital interest will be treated as a guaranteed payment for services under Code Sec. 707(c).[260]

Analysis of the transaction is altered significantly by virtue of PRS being the payor rather than another partner. Measurement of the income inclusion by reference to the fair market value of the PRS interest is less clear under these circumstances. In this instance, the partner should take a capital account equal to the liquidation value of the interest. While this is not the approach taken in the proposed regulations,[261] those regulations were heavily criticized and clearly wrong.[262] Consistent with the view that a partner's capital account should equal the economic entitlements on an "as liquidated" basis, there is no justification for providing a different result in the context of a compensatory capital interest. But this leaves open the question as to how to reconcile an income inclusion by reference to an amount other than liquidation value if the partner's capital account will be determined by reference to liquidation value.

There does seem to be support for valuing the capital interest issued by PRS by reference to the willing-buyer-willing-seller value rather than the liquidation value. While cases considering this issue typically have measured the value by reference to liquidation value, the Tax Court in *Johnston v. Commissioner*[263] acknowledged that the partnership interest did "not necessarily" have to be valued on this basis in all instances.[264] Likewise, the proposed regulations addressing the issuance of compensatory partnership interests acknowledged that there is no basis for distinguishing a partnership interest from any other kind of property under Code Sec. 83 in determining the value of the interest.[265] The proposed regulations required an election to use liquidation value.[266] Otherwise, the value would be determined on a willing-buyer-willing-seller basis.[267]

If the partner measures the income inclusion by reference to the willing-buyer-willing-seller value, the partnership's deduction necessarily will equal the same amount. Assuming that the partnership will not recognize gain on the issuance of the capital interest, following the theory of the proposed regulations, the reverse Code Sec. 704(c) gain allocated to the existing partners to account for the tax cost of the deduction presumably need only take that value into account.[268] This accounts for bringing Mike's capital account to $100—the willing-buyer-willing-seller value. Given that Mike's capital account should be $150, the additional $50 must be accounted for in some way.

Commentators have suggested different approaches. One group suggested that the additional $50 should be accounted for as a guaranteed payment under Code Sec. 707(c).[269] This group seemed to be influenced by the fact that partnerships benefit from use of liquidation value in determining $0 current taxation for compensatory profits interests so that consistency in providing for a tax result that essentially replicates taxation based on liquidation value for capital interests is fair. Another group suggested, as a secondary alternative, creating a mechanic similar to that used for noncompensatory options whereby built-in gain in partnership assets would be allocated to the recipient of the capital interest to account for the difference between the amount included in income and the liquidation value of the partnership interest.[270] A full embrace of the approach taken by the noncompensatory option rules presumably would involve an allocation of taxable corrective allocations to the service partner to the extent that insufficient appreciation (by reference to Code Sec. 704(b) book value) existed in the partnership's assets to account for the excess portion of the partner's capital account.[271]

Alternatively, some commentators have stated that there is no necessity that the income inclusion under Code Sec. 83 with respect to the partnership interest need be coordinated with the service partner's capital account.[272] According to these commentators, the *external* partnership interest and *internal* partnership assets are completely separate assets and the value proposition for each does not require coordination.

Note, however, that even if this approach is taken, the partnership is left with the question as to how it should allocate income and loss among the partners following issuance of the capital interest. It seems that the

partnership assets should be revalued in connection with the issuance of the capital interest in order to lock in any reverse Code Sec. 704(c) gain related to the built-in gain in assets that indirectly funds the compensation deduction allocated to historic partners, as this reverse Code Sec. 704(c) gain justifies allowing the partnership to avoid recognition of gain. As previously discussed, Treasury and the IRS did not embrace comments whereby the revaluation of partnership assets could be made by reference to the value of the partnership interests,[273] so it seems that a disconnect between the Code Sec. 83 value and the liquidation value will likely exist. Accordingly, there may be additional reverse Code Sec. 704(c) gain attributable to the excess of liquidation value over willing-buyer-willing seller value. If available, it would seem appropriate to allocate reverse Code Sec. 704(c) gain to the service partner to match the difference between the amount included in income upon receipt of the interest and the capital account attributable to the interest. There is a general goal in subchapter K, as reflected in Code Sec. 704(c), to eliminate disparities between a partner's book and tax basis capital accounts,[274] and such an allocation of reverse Code Sec. 704(c) gain would facilitate achievement of that goal. Note, however, that there is no guarantee that such built-in gain will exist. It is possible that the assets of the partnership have a basis equal to their liquidation value at the time that the capital shift occurs. In that instance, after-tax capital shifts to the service partner. Under these circumstances, it will not be possible to reconcile book and tax capital accounts.[275] Accordingly, the service partner ultimately would recognize gain on liquidation of his or her interest under Code Sec. 731, and the other partners would recognize a loss.

Under current law, an approach that values the compensatory interest based upon a willing-buyer-willing-seller standard seems defensible. Given the apparent inclination of courts to follow the liquidation value in measuring the compensation amount, if this approach is to be taken, it would be advisable to obtain objective evidence of the willing-buyer-willing-seller value of the interest contemporaneous with the issuance of the interest. To the extent possible, it also seems advisable to coordinate built-in gain allocations under reverse Code Sec. 704(c) principles so as to eliminate book-tax disparities for the service partner (after first accounting for the deduction allocated to existing partners). Any effort made to reconcile the results of a capital shift with the principles of subchapter K should help in defending the results before the IRS or a court. Finally, if the partnership is relying on the liquidation value of compensatory profits interest to justify no current tax for the recipients of such interests, query whether that puts pressure on the ability to rely on the willing-buyer-willing-seller value for measuring compensation with respect to capital interests.[276]

3. Issuance of Capital Interest to Existing Partner

Next, consider a situation where Mike is already a partner in PRS. To illustrate the relevant issues, assume that Mike is a 50–50 partner with Scott. Each partner's existing capital account and basis in its partnership interest is $50. The willing-buyer-willing-seller value of each interest is $100, and the liquidation value of each interest is $125. In order to reward Mike for his contribution to the success of the partnership, Mike and Scott agree that $50 of Scott's share of appreciation in the partnership assets should be allocated to Mike along with future profit and loss related to that portion (*i.e.*, $50/$125) of Scott's partnership interest. Following such a reallocation, the liquidation value of Mike's interest in PRS would be $175, and Scott's would be $75. Is this shift in appreciation, which has yet to be booked into capital accounts, taxable as a capital shift to Mike consistent with the description in the prior section?

The answer to this question may depend on when the appreciation in PRS's assets occurred. Code Sec. 761(c) provides that a partnership agreement will include any modifications made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners or which are adopted in such other manner as may be provided by the partnership agreement.[277] In addition, Reg. §1.706-4(b)(1) permits changes allocations of distributive share items described in Code Sec. 702 among contemporaneous partners for the entire partnership taxable year so long as (1) any variation in the partner's interest is not attributable to contributions or distributions of property or cash between the partnership and a partner and (2) allocations resulting from the modification otherwise satisfy the provisions of Code Sec. 704(b) and the regulations thereunder.[278] On the basis of these rules, it appears that the partnership should be able to amend its allocation provisions on or prior to March 15 on a retroactive basis to the beginning of the prior taxable year. Accordingly, it would seem possible to reallocate among partners appreciation that has been created during this time period. In fact, the preamble to the proposed regulations addressing compensatory partnership interests seems to confirm this result. The preamble states:

> Section 761(c) generally allows a partnership to modify its agreement at any time on or prior to the due date for the partnership's return for the taxable year (without regard to extensions). Thus, for example,

> a partnership could, at the end of its taxable year, amend its partnership agreement to provide that a service provider was entitled to a substantially vested or non-vested interest in partnership profits and losses from the beginning of the partnership's taxable year.[279]

With regard to appreciation in partnership assets that arose prior to the effective date of an amendment to the partnership agreement pursuant to Code Sec. 761(c), there is greater uncertainty. The leading treatise on partnership tax contains a discussion that seems encouraging. The treatise states:

> Although the §704 Regulations contain a vague hint that, in certain circumstances, a failure to restate capital to prevent a shift in unrealized appreciation may be taxable, it seems quite clear that no taxable shift results when existing partners agree to adjust their interests in unrealized appreciation in partnership assets. Otherwise, any reallocation of profits by an existing partnership, for example, an accounting firm, would result in a taxable capital shift with respect to partnership assets if their fair market values differ from their book values. This conclusion is confirmed by a Private Letter Ruling in which the Service ruled that no tax consequences resulted from an amendment to a partnership agreement that fixed the partners' interests in certain appreciated partnership assets.[280]

The private letter ruling cited in the discussion is LTR 9821051.[281] In this private letter ruling, the partnership originally allocated profits and losses upon asset dispositions as determined by the executive committee, and the agreement was amended to provide that, upon a liquidation event, the partnership would transfer to each partner its share of the units. The ruling holds that the amendment "will not result in the realization of income by the Partnership [(*i.e.*, the parent partnership)], Limited [(*i.e.*, the subsidiary partnership)], or any of their respective partners." There are two important aspects to this private letter ruling that require consideration in determining the scope of situations to which it may apply. First, the ruling addressed a situation where the partnership agreement had no definitive method for allocating profits and losses upon the disposition of assets. The partnership agreement went from a situation where allocations were discretionary to a situation where the allocations were fixed.[282] Such a situation differs from a scenario where allocations that are fixed in one ratio are altered to a different ratio. Second, it is not clear that the situation considered in the ruling involved a compensatory arrangement. Accordingly, Code Sec. 83 and Reg. §1.721-1(b)(1) may not to have been relevant under the facts of the ruling.[283]

In the example described above, if the appreciation that is reallocated from Scott to Mike existed as of the effective date of the amendment to the partnership agreement, it is clear that the interest issued to Mike is a capital interest for purposes of applying Code Sec. 83. The relevant authority defines a capital interest as an interest that, at the time of issuance, would receive proceeds upon a hypothetical sale of all partnership assets at fair market value[284] and liquidation of the partnership.[285] The built-in appreciation in partnership assets allocable to Mike's interest would provide Mike with $50 upon immediate liquidation of the partnership.

In determining whether this transaction is a taxable capital shift or a permissible reallocation of appreciation among existing partners, the question seems to be which principles should prevail—rules under Code Sec. 83 relating to the taxation of compensation upon receipt of property or flexibility of subchapter K. As previously discussed, the courts have uniformly held that Code Sec. 83 applies in connection with the issuance of a compensatory capital interest in a partnership.[286] As of the effective date, the amendment to the partnership agreement to alter the profit-sharing ratio stated in the partnership agreement effected the issuance of a capital interest unless one can conclude that the flexibility provided under Code Sec. 706 prevented any partner from having a claim to appreciation that had yet to be recorded in partner capital accounts. While the capital interest conclusion may seem to be at odds with the holding in LTR 9821051, which many practitioners point to in support of non-taxable treatment for a reallocation of existing appreciation,[287] it seems significant that the ruling may not have involved a compensatory arrangement. The facts of the ruling certainly were not analyzed with reference to the rules applicable to compensatory arrangements.

The commentators above highlight the potential treatment of service partnerships, like accounting firms, in justifying the nontaxable nature of these transfers.[288] That is, service partnerships like law firms, accounting firms, *etc.* often reallocate profits on an annual basis to reward the contributions made by partners to the success of the business. In addition, upon entry into such a service partnership, a new partner generally does not pay for a share of goodwill or other intangibles and hence arguably experiences a capital shift at such time. Such partners typically do not report taxable income related to a shift in value attributable to partnership goodwill resulting from the change in percentage interests. Significantly, however, for these types of service firms, existing partners

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rarely are ensured participation in the firm goodwill upon liquidation.[289] Instead, these partners typically participate in annual profits so long as they are providing services and are entitled to a return of their capital contribution (sometimes with an interest-like return) upon redemption from the partnership. In these partnerships, it is unlikely that any of the partners who are the subject of a shift in profits ultimately will share in the appreciation related to the goodwill in the business. In substance, nobody owns the goodwill of such businesses.[290] Or more specifically, any partner's claim to goodwill is contingent on remaining a partner until liquidation of the partnership, and the resolution of this contingency is highly speculative in virtually all instances. The difficulty in addressing these situations under subchapter K was the subject of numerous comments with respect to the proposed regulations relating to compensatory partnership interests.[291]

Needless to say, these service partnership arrangements are quite distinguishable from a scenario where an investment partnership, in the year that an investment is sold, reallocates appreciation accruing in prior taxable years to specific partners to reward their services. In this situation, value relating to property appreciation clearly is shifting among partners and is being realized by the recipient partners. Given the flexibility provided under Code Sec. 706,[292] it is arguable that no partner had a right to the appreciation that accrued prior to liquidation, since allocation of the profit was always subject to change in recognition of the performance of the partners.[293] This author has located no authority addressing this specific situation,[294] but there certainly is risk that such a purposive shift intended to compensate a partner represents a taxable event under Code Sec. 83 and Reg. §1.721-1(b).[295]

There is a further question as to whether the result should be different if the partnership had revalued its assets so that the appreciation shifted from Scott to Mike was previously reflected in Scott's capital account. Some commentators have made good arguments for ignoring the impact of revaluations in analyzing some capital shifts.[296] It seems odd that an event justifying a revaluation of partnership assets and resulting in mere accounting adjustments to the books of the partnership could change the ultimate substantive tax treatment of the partners. But the "book up" is not without impact. The allocation of tax deductions for depreciation and amortization under among partners Code Sec. 704(c) may be impacted. In the regulations addressing noncompensatory partnership options, Treasury and the IRS clearly gave significance to the book value of assets, as impacted by revaluations, and they did not allow a nontaxable shift attributable to such capital but instead required taxable corrective allocations to account for such shifts.[297] The issue as to whether a shift in appreciation among existing partners in recognition of the performance of services should be treated as a taxable capital shift is a close enough call in the first place. If the shift occurs with respect to amounts already booked into another partner's capital account, this could tip the scales more strongly towards finding a taxable compensatory event.

4. Issuance of a Capital Interest upon Formation of Partnership

Consider next a situation where no partnership yet exists, and a service provider will receive a capital interest in a newly-formed partnership in connection with the formation of the entity. As an illustrative example, Scott owns property with a fair market value of $200 and an adjusted basis of $100. Scott wants to form a 50–50 partnership with Mike, and Mike will contribute only services for his 50-percent interest. The issues that arise upon the issuance of a compensatory capital interest as part of the formation of a new partnership arguably are different than when the partnership already exists.

The transaction between Scott and Mike resembles the transaction described in Rev. Rul. 99-5 and arguably would be treated as the transfer by Scott of a 50-percent interest in his property in exchange for past or future services, followed by a contribution of the property to the newly-formed partnership. The transaction mirrors the facts of *McDougal v. Commissioner*, where not only did the Tax Court find the service partner to be in receipt of compensation, but it also found that the service recipients recognized gain upon the transfer of property in satisfaction of the service obligation.

The decision in *McDougal* was cited in the preamble to the proposed regulations addressing compensatory partnership interests as justification for the decision not to treat these transactions as subject to the proposed regulations (which permit nonrecognition treatment for the partnership upon issuance of a capital interest).[298] The regulations addressing noncompensatory partnership options also exclude transactions where exercise of the option converts a disregarded entity to a partnership.[299] In that instance, Treasury and the IRS cited the inability to coordinate reverse Code Sec. 704(c) allocations where an actual property contribution occurs, such that forward Code Sec. 704(c) gain may not be manipulated in order to preserve the built-in gain that would properly be allocated among the parties to justify deferral of gain.[300] In connection with the service transaction, Scott will receive a deduction for the issuance of the compensatory property interest unless the cost is subject to capitalization.

One may question whether an alternative structure might permit the deferral of gain for Scott in this transfer. The proposed regulations addressing compensatory partnership interests permit deferral of gain by an issuing partnership by allocating to existing partners the built-in gain related to the service partner's new share of partnership property under reverse Code Sec. 704(c) principles.[301] In order to accomplish this result in a formation transaction, Scott would have to be treated as contributing a 100 percent interest in the property to the newly-formed partnership, Mike would have to be treated as contributing services to the new partnership, the partnership would have to be treated as issuing a capital interest to Mike, and the partnership would deduct the cost of the services, allocating 100 percent of the deduction to Scott. Rev. Rul. 99-5 does distinguish transactions whereby a new partner purchases an interest in a disregarded entity from situations where the new partner contributes property to a disregarded entity and respects the contribution transaction consistent with the form. Taxpayers might point to this revenue ruling in arguing for the construct described. Whether this result would prevail under current law, however, is unclear.[302]

In addition to issues relating to the recognition of gain by the service recipient, there also are issues relating to the valuation of the capital interest received. As previously discussed, in many situations, good arguments exist to measure the compensation upon receipt of a capital interest by reference to the willing-buyer-willing-seller value of the interest. This value often represents a discount as compared to liquidation value due to lack of liquidity, marketability, control, *etc.* It is far less clear that such discounts are available when the property received as compensation is not a partnership interest but instead is a direct property interest.[303] In *McDougal*, the compensation amount was measured by reference to the liquidation value of the property interest, with no consideration for discounts. While some discount amount might be argued for,[304] the discount may be significantly less than would be available if the transferred property was treated as the capital interest in the partnership.[305]

If, rather than transferring a direct property interest in the formation transaction, Scott first contributed his property to an LLC and then conveyed to Mike an interest in the LLC,[306] the valuation issue becomes much more confusing. In undertaking a willing-buyer-willing-seller analysis, existing case law has valued the transfer of a partial interest in a disregarded LLC by reference to the state law property rights (*i.e.*, a personal property interest in an LLC) rather than the property rights as determined for federal tax purposes (*i.e.*, a direct interest in the underlying property). The Tax Court addressed this issue in the gift tax context in *Pierre v. Commissioner*[307] and in the income tax context (determining the value of a charitable contribution) in *RERI Holdings I, LLC v. Commissioner*.[308] But how is this valuation of the LLC interest reconciled with the capital accounts that should result from the deemed asset contributions that occur in the transaction? The deemed contribution under Rev. Rul. 99-5 is of assets that are not saddled with the LLC entity wrapper.

It may be that this transaction sets up the same dynamic as considered in section XI.B.2. relating to the issuance of a capital interest to a new partner. That is, the measure of compensation for the recipient of the LLC interest and the establishment of capital accounts may be determined independently.[309] As previously discussed, in the gift tax context, it is crucial that the donor receive capital account credit consistent with the value of the assets contributed in order to avoid an indirect gift.[310] Thus, in the gift tax context, the LLC interest value/capital account dichotomy seemingly cries out for reconciliation, but the capital account determination was not discussed by the Tax Court in *Pierre*. *Pierre* was a reviewed decision by the full Tax Court, and there were vigorous dissents asserted, citing Rev. Rul. 99-5 and addressing the transactional construct set forth in the revenue ruling. But the dissenting opinions did not reference the LLC interest value/capital account disconnect that seemingly would result from the majority decision.

This transaction highlights in very stark terms the difficulty presented by the conflicting aggregate and entity views of a partnership in evaluating the tax implications that flow from a capital shift. Absent guidance to the contrary, there would seem to be a position for determining the compensatory inclusion separately from the determination of capital accounts for the partners. Given, however, the limited authority that exists, the force of the dissenting opinions in *Pierre*, and the failure of the existing authority to directly take on the LLC interest value/capital account dichotomy, this may be an evolving area where the positions that ultimately prevail are difficult to predict.

5. Service Partner Succeeds to Part of Forfeited Interest

In the investment fund context, often times members of the investment team will have interests in an entity that serves as the general partner in an investment fund. Interests held by members of the investment team generally are subject to forfeiture if a person leaves employment within a period or commits other bad acts. While the general partner may hold only a carried interest related to an investment fund, once the underlying

fund assets have appreciated so that the carried interest would be "in the money" on an as-liquidated basis, interests in the general partner will represent capital interests. If a member of the investment team forfeits his or her interest, the value attributable to the interest will inure to the benefit of the other partners, presumably in proportion to their existing interests.[311] Under these circumstances, the capital shift has occurred as a matter of course without any purposive act that is intended to create compensation. Should such a capital shift be taxable in these instances?

Many advisors conclude that there is no taxation in these circumstances based upon a view that there is no realization event for the partners who are benefitted by the shift in value. The basis for this conclusion is not altogether clear. There clearly is an accession to wealth as required by *Glenshaw Glass*,[312] and if treasure trove can be gross income, it is arguable that a purposive action to earn income is not required. As described above, little was required by the Supreme Court in *Cottage Savings* to find a realization event,[313] and a change in percentage interests owned by a partner seemingly could cause the property interests held before and after the forfeiture to be "materially different", as required by the Court. By analogy to the authority relating to the realignment of trust interest and assets discussed previously, however, it is arguable that *Cottage Savings* should not apply where the alteration of property interests was outside of the partners' control.[314] In addition, it is not clear that the *Cottage Savings* standard should apply in such a straightforward manner in relation to adjustments to partnership interests—the analysis for partnership readjustments arguably should be more nuanced.[315]

An alternative, and possibly better, argument for avoiding taxation on this capital shift may be that the transfer does not fall within the scope of Reg. §1.721-1(b)(1). That is, the transfer is not made as compensation for services or in satisfaction of an obligation. Since the issuance of this regulation, every case addressing compensatory capital shifts has cited the regulation as the basis for the decision.[316] The author has located no cases involving compensatory capital shifts that have delved into a broader discussion of *Glenshaw Glass*, *Cottage Savings*, and more generally what constitutes gross income under the common law of tax. Accordingly, a strong argument would seem to exist that adjustments to partnership capital are analyzed through a more narrow lens than are general gross income determinations.

There is some risk that such a capital shift could be viewed as occurring "in connection with the performance of services" for purposes of Code Sec. 83 since the individuals who benefit from the capital shift presumably would not receive a portion of the forfeited interests if they were not performing services.[317] Courts have developed the following factors in determining whether property is transferred in connection with the performance of services under Code Sec. 83:

(1) whether the property right is granted at the time the employee or independent contractor signs his employment contract;
(2) whether the property restrictions are linked explicitly to the employee's or independent contractor's tenure with the employing company;
(3) whether the consideration furnished by the employee or independent contractor in exchange for the transferred property is services; and
(4) the employer's intent in transferring the property.[318]

Given the lapse in time from the initial compensatory grant to the partners and the circumstances surrounding the receipt of the forfeited interests, it seems that factors 1, 3, and 4 would not be satisfied. In addition, Reg. §1.721-1(b)(1) seems to require more than simple receipt of the property in connection with the performance of services. The regulation requires that a partner must "give up his right to be repaid his contributions … in favor of another partner as compensation for services."[319] The regulation implies an intention to compensate in finding a taxable capital shift. The Tax Court previously has attempted to read the rules under Code Sec. 83 and Code Sec. 721 so as to reconcile the two.[320] On this basis, it seems reasonable to conclude that a partner should not be in receipt of compensation income when benefitting from a capital shift in this context.

The lack of compensatory income for the beneficiaries of the capital shift is not, however, the end of the story. How should the partnership account for this capital shift? In these circumstances, presumably the recipient partners will succeed to the forfeiting partner's share of built-in gain and loss in the partnership assets.[321] With respect to the forfeiting partner, there is a question as to whether forfeiture allocations, as described in the proposed regulations applicable to compensatory partnership interests,[322] will be permitted to effectively reverse the income, gain, loss, and deductions previously allocated to the forfeiting partner to the extent not distributed. While the proposed regulations do not state that they may currently be relied upon, a number of partnership agreements currently provide for such allocations. These forfeiture allocations properly coordinate the impact of the capital shift and the underlying rules of subchapter K by shifting the taxable effect of the items to the partners who will economically benefit from, or bear the burden of, such items, so it would

seem permissible to apply such allocations currently, even in the absence of regulations.

C. Capital Shift to Satisfy an Obligation

In addition to compensatory capital shifts, Reg. §1.721-1(b)(1) also addresses shifts in partnership capital in satisfaction of an obligation. As previously discussed, a transfer of property will not always result in income for the recipient. For example, if a lender advances proceeds as a loan, a transfer of property to the original lender in an amount equal to the adjusted issue price of the debt will not result in income for the creditor. Income may accrue, however, when property is transferred to satisfy certain other types of obligations.

Consider a scenario where Kim leases property to PRS. Kim, a cash-method taxpayer, is owed $100 in rent. PRS assets have a net value of $1,000. The adjusted basis and Code Sec. 704(b) book value of the assets are $500. PRS issues a 10-percent interest to Kim in satisfaction of the amount owed under the lease.

Regulations addressing contributions of debt to a partnership describe the treatment of partnership interests issued in satisfaction of certain obligations. Specifically, Reg. §1.721-1(d)(2) provides that nonrecognition treatment under Code Sec. 721 will not apply to the creditor upon receipt of a partnership interest in satisfaction of partnership indebtedness for unpaid rent, royalties, or interest (including original issue discount) that accrued on or after the beginning of the creditor's holding period for the indebtedness.[323] The preamble to the final regulations states that such treatment is necessary in order to prevent creditors from converting ordinary income to capital gain through the receipt of a partnership interest rather than cash in satisfaction of such obligations.[324] Providing an exception to nonrecognition treatment, however, does not mean that the creditor is going to be in receipt of income in all events upon receipt of a partnership interest. For example, an accrual method taxpayer would have included rent as income upon satisfaction of the "all events" test, so the issuance of a partnership interest would represent payment of income that was already accrued. For cash method taxpayers, however, income would be included upon receipt of the partnership interest.

The debtor-partnership will not recognize gain or loss upon the transfer of the partnership interest.[325] In explaining this result, the preamble to the final regulations states:

> The preamble to the proposed regulations states the general rule that when property is transferred as payment on indebtedness (or in satisfaction thereof), gain or loss on the property is recognized. Under that approach, in a debt-for-equity exchange, if the partnership is treated as satisfying its indebtedness for unpaid rent, royalties, or interest on indebtedness (including accrued original issue discount) with a fractional interest in each asset of the partnership, the partnership could recognize gain or loss equal to the difference between the fair market value of each partial asset deemed transferred to the creditor and the adjusted basis in that partial asset. The IRS and the Treasury Department believe that in a debt-for-equity exchange where the partnership has not disposed of any of its assets, the partnership should not be required to recognize gain or loss on the transfer of a partnership interest in satisfaction of its indebtedness for unpaid rent, royalties, or interest. Therefore, under the final regulations, a debtor partnership will not recognize gain or loss upon the transfer of a partnership interest to a creditor in a debt-for-equity exchange for unpaid rent, royalties, or interest that accrued on or after the beginning of the creditor's holding period for the indebtedness.[326]

As with the proposed regulations for compensatory partnership interests, presumably it is intended that the partnership will revalue its assets and lock in any gain or loss in partnership assets as reverse Code Sec. 704(c) gain or loss to the historic partners who benefit from the deduction for rent, royalties, or interest.[327] Following this approach, those partners ultimately would bear the tax cost of the deductible amounts. While this result is outlined in the preamble to the proposed regulations for compensatory partnership interests, oddly, no such rule or preamble discussion is included in the regulations under Code Secs. 108(e)(8) and 721.

As discussed above, for compensatory capital shifts, it appears that the value of a shift in partnership interests may be measured either by reference to the liquidation value of the additional interest received or the willing-buyer-willing-seller value.[328] Where certain requirements are met, these different choices for valuing the partnership interest received also are available when a debt obligation is contributed to a partnership.[329] In evaluating the two options, commentators made the following observations:

> Valuing the partnership equity issued in a debt-for-equity exchange at its liquidation value avoids Subchapter K accounting concerns that otherwise could arise if the former creditor's capital account reflects a value for the contributed debt that differs from the amount the former creditor would receive on an immediate liquidation of the partnership. This

> assumes, as the Proposed Regulations contemplate, that if the equity issued in the exchange is valued at its liquidation value, the same value will be used for determining the initial capital account of the creditor. In contrast, the use of a pure fair market value methodology frequently will produce a disparity between the amount initially reflected in the former creditor's capital account and what the former creditor would be entitled to on liquidation of the partnership (based on the economic terms of the partnership agreement) …
>
> Under such circumstances, it will be necessary to adopt a mechanism to eliminate such disparity. Maintaining the disparity would frustrate a central purpose of the Section 704(b) capital account rules, which is to ensure that allocations of partnership items have an economic effect on the partners by requiring that allocations be reflected in the partners' capital accounts and that capital account balances reflect what each partner would receive if the partnership were liquidated for tax purposes.[330]

As this statement highlights, where the parties determine the tax consequences of the debt-for-equity exchange using the liquidation value of the partnership interest to satisfy the obligation owed, the capital accounts of the partners should line up properly. In the example stated above, the rental obligation owed to Kim would be treated as satisfied for $100, and Kim would include $100 in income. The assets of PRS would be revalued in connection with the contribution of the rental obligation, and the historic partners would have a reverse Code Sec. 704(c) layer of $500, which would ensure that they ultimately would bear the tax cost of the $100 deduction related to the rental expense (even though no gain is recognized upon effectively satisfying the rental obligation with appreciated property). The capital account of the historic partners would be $900 ($1,000 upon revaluation of the PRS assets, and then reduced by $100 for the allocated rental expense deduction). Kim's capital account would be $100, and she would have no share of the existing built-in gain in PRS's assets.

Assume, instead, that the parties use the willing-buyer-willing-seller value of the PRS interest issued to Kim for purposes of determining the tax results of the transaction, and assume that this value would be $80. The assets of the partnership would be revalued to $1,000, and $500 of reverse Code Sec. 704(c) gain would be locked in for the historic partners. Kim would include $80 in income, and the historic partners would be allocated an $80 deduction, taking their capital accounts to $920. Assuming that PRS is a cash-method taxpayer, PRS would exclude $20 of cancellation of indebtedness income under Code Sec. 108(e)(2), given that payment of the amount would give rise to a deduction. Thus, there would be no further increase to the capital accounts of the historic partners. Assuming that Kim receives a capital account equal to the value of her debt contributed, she would have a capital account of $80.

Note the problems that exist under this scenario. Although Kim is entitled to 10 percent of proceeds from PRS upon liquidation, her $80 capital account represents only eight percent of total PRS capital ($80/$1,000). The disconnect arises because the methodology for evaluating the transaction at the partner and partnership level is essentially mixes apples and oranges. The revaluation of partnership assets to $1,000 measures the value of the assets that will be deemed to satisfy the rental obligation at $100, and yet the partnership deduction and capital account of Kim both are determined as if the property had a fair market value of $80.

There are a number of different approaches that may be used to reconcile partner capital accounts under these facts. One group of commentators posited a system similar to that used for noncompensatory partnership options. That is, use a combination of revaluation gain and taxable corrective allocations to bring the parties' capital accounts into alignment. The commentators recognized that this could produce some very imperfect results.[331] More specifically, in a debt-for-equity exchange, often the partnership will be in distress such that there will be no built-in gain in partnership assets. Hence, taxable corrective allocations would be used to increase the creditor's capital account, which essentially has the effect of offsetting the cancellation of indebtedness income allocated to the historic partners and causing the creditor to bear the impact of such income. Without regulations, however, it probably is defensible to utilize this general approach without applying corrective allocations, accepting that some disparity may exist so that book and tax capital accounts would not be fully reconciled upon liquidation.[332]

Another alternative would be to revalue partnership assets by reference to the value of the partnership interests rather than the liquidation value of the partnership assets. Importantly, the current regulations provide no support for this approach, and Treasury and the IRS previously have refused to amend the relevant regulation to permit this result.[333] For a partnership that makes its allocations under partners' interests in the partnership, however, flexibility may be available to vary from the strict capital account rules applicable to safe harbor partnership agreements. So this approach may be viable in such instances.

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As this discussion highlights, exploitation of the disconnect between partnership interest and asset values can lead to significant complexity in reconciling partnership allocations with the economic arrangement of the partners. In debt-for-equity exchanges, oftentimes use of liquidation value will represent the path of least resistance.[334] Where this path is not chosen, care must be taken to ensure that other intended results of the partnership arrangement will not be compromised.

D. Bargain Purchase of a Partnership Interest

Partnership contributions are not all created equal. In raising capital for a partnership, different deals legitimately may be cut with different partners depending on factors like the amount of capital committed by a partner, the economic need of the partnership at the time of the contribution, or the relationship with a partner who has contributed significant capital to various projects over time. While the regulations provide that a partner's capital account should be credited with the amount of money or fair market value of property contributed,[335] such credit will not always be consistent with the partner's economic interest in the partnership immediately following the contribution.

Consider the following example: PRS has raised $1 million of capital. No investment has been made, so all capital currently sits in the bank as cash. PRS desperately needs an additional $900,000 in order to acquire the desired investment. Lori agrees to contribute the entire $900,000 needed by PRS. Because of the circumstances, Lori is able to negotiate to receive a 50-percent interest in PRS in exchange for her contribution. Accordingly, by contributing $900,000, Lori obtains an immediate entitlement to $950,000 if PRS was to liquidate on the same day. Strict adherence to the capital account rules would indicate that the historic partners shifted $50,000 of capital to Lori upon her contribution to the partnership.

As previously discussed, outside the partnership context the authority is quite clear that a bargain purchase undertaken as part of an arm's length transaction should not result in income to the purchaser. According to the Supreme Court in *Palmer v. Commissioner*,[336] absent extenuating circumstances, one does not subject himself or herself to income tax by the mere purchase of property.[337] Based upon the rule laid down by the Court in *Palmer*, in this instance, the purchaser has not engaged in a transaction that will result in gross income for the purchaser.

But should the rules of Subchapter K provide for a different result than applies with respect to all other property due to the hybrid (*i.e.*, aggregate/entity) nature of the property interest and the role of capital accounts in accounting for the economics of the entity? The answer to this question, it seems, should be no.

Admittedly, the analysis, from a policy perspective, should balance (1) factors such as treating similar transactions similarly so that the tax system produces sensible and predictable results, with (2) the policies of Subchapter K.[338] In thinking about the policies of Subchapter K as applicable to this situation, the factors seem to point in both directions. While the capital account system underlies the accounting for allocations and other aspects of Subchapter K, the Subchapter K regime also is intended to be flexible and to facilitate business combinations through the pooling of capital.[339] Clearly to impose tax on Lori in this instance would not facilitate legitimate business combinations. On balance, the policies would seem to weigh in favor of following general tax principles in evaluating the transaction and not to create taxable income by virtue of strict adherence to the capital account system.

From a technical perspective, Lori also would appear to have strong arguments for avoiding taxation in connection with the contribution. By its terms, Reg. §1.721-1(b)(1) applies only to capital shifts that are compensatory or that satisfy an obligation. Neither of such circumstances exists in the context of Lori's contribution to PRS. Even if this regulation does not define the universe of taxable capital shifts due to the broader nature of gross income authority, if one looks outside of Subchapter K and finds definitive authority, like *Palmer*, concluding that the value conveyed does not give rise to a taxable event, one should take comfort that taxable income will not arise in connection with the transaction.

While strong arguments can be asserted that any excess value viewed as conveyed to Lori in connection with her contribution should not produce taxable income, a partnership that relies on capital accounts in undertaking its allocations presumably should make some effort to coordinate partner capital accounts to facilitate allocations that may be defended on a going-forward basis. Under a target allocation agreement, it is likely that profit or loss (or items of income, gain, loss, and deduction) would be allocated in the first year so as to produce capital accounts that as nearly as possible reflect the economic entitlements of the partners. These allocations could result in an immediate allocation of $100,000 of income to Lori to bring the capital account associated with her 50-percent interest equal to the $1 million capital account of the other partners. In a loss year, the allocations could result in an allocation of $100,000 loss to the historic partners to bring their capital accounts down to $900,000—an amount equal

to Lori's capital account. In a breakeven year, it may be possible to disproportionately allocate $50,000 of gross income to Lori and $50,000 of loss and deduction to the historic partners to bring the capital accounts of both groups to $950,000.

Other options may be available if the partners do not desire to reflect the value shift through immediate allocations of taxable items. PRS might adopt a special allocation whereby the first $100,000 of gain will be allocated to Lori, but otherwise all items would be allocated consistent with percentage interests (or such other sharing as provided in the partnership agreement).[340] So long as the gain ultimately materializes, the allocations of PRS would conform to the economic entitlements of the partners upon liquidation.[341] Alternatively, PRS may choose to revalue its assets to reflect a value that is consistent with Lori's contribution—that is, a 50 percent in PRS assets is worth $900,000. Obviously, such a revaluation would be difficult to justify if the assets of PRS are $1,900,000 cash. Assuming that PRS allocates based on partners' interests in the partnership, it may be defensible to hold the negative adjustment in abeyance until assets are acquired that could absorb such an adjustment.[342]

PRS also may simply shift $50,000 of capital from the capital accounts of the historic partners to Lori so as to equalize the capital accounts of the partners, relying on the non-taxable nature of the transaction and simply treating the shift as an adjustment that is necessary to properly account for the transaction on the books of the partnership. Determining the nature of the shifted capital can become complicated, however. Where the historic partners have contributed Code Sec. 704(c) property, it may be inappropriate to shift capital that carries with it the Code Sec. 704(c) built-in gain. On the other hand, shifting full-basis post-tax capital also may be viewed as questionable since Lori would never be allocated taxable gain to account for her disproportionate interest and would only recognize gain under Code Sec. 731 upon liquidation of her interest, assuming a complete liquidation of her interest for cash.[343]

In supporting the nontaxable nature of the capital shift, it seems wise to make every attempt to coordinate capital accounts in a manner that produces a defensible allocation scheme consistent with the economic entitlements of the partners. While the bargain purchase scenario seems to be one where general tax principles should win out over the technical capital account rules of Subchapter K, the partnership still will operate going forward under the rules of Subchapter K regime. Operating in that world may not be easy if thought is not given to reconciling the results within Subchapter K.[344]

E. Shifts in Connection with Capital Defaults and Forfeitures

In a typical investment partnership, partners commit to contribute a fixed amount of capital over time to fund target investments. Many partnership agreements contain provisions that address the failure by a partner to contribute capital when called. Oftentimes, one of the remedies upon a failure to contribute capital will involve a forfeiture by the defaulting partner of a portion of his or her partnership interest for no consideration.

Consider, for example, the following situation: John commits to contribute $1 million as called by the general partner during a three-year investment period. John's commitment accounts for 10 percent of the partnership's capital, and John receives a 10 percent interest in the partnership in exchange for his commitment. Two years after formation of the partnership, 50 percent of committed capital, or $5 million, has been called and contributed. The assets acquired with that capital have a Code Sec. 704(b) book value and adjusted basis of $5 million, and the fair market value of the assets has increased to $7.5 million. At this time, the general partner calls the remaining capital, and John defaults on his $500,000 contribution obligation. The other partners fulfill John's contribution obligation on a proportionate basis, and their percentage interests are increased accordingly. In addition, John (who now has a five percent interest—that is, $500,000/$10 million), is required pursuant to the terms of the partnership agreement to forfeit one-half of his partnership interest to the partners who fulfilled his capital commitment, taking his interest to two and one-half percent.

This example presents the potential for two capital shifts. First, when the partners other than John fund John's contribution obligation and succeed to John's percentage interest related to that contribution, they also succeed to five percent of the $2.5 million existing appreciation in the partnership's assets (*i.e.*, $125,000). Second, when John forfeits one-half of his interest (*i.e.*, a two and one-half percentage interest in the partnership), the other partners succeed to one-half of John's capital account (*i.e.*, $250,000) and two and one-half percent of the $2.5 million appreciation in the partnership's assets (*i.e.*, $62,500). By satisfying the $500,000 default obligation on behalf of John, the liquidation value of the other partners' interests increased by $937,500. Thus, the shifted capital, determined on a liquidation value basis, would be $437,500.

The shift in value that occurs as a result of a capital contribution default raises a number of difficult issues. First, does the shift in value attributable to John's interest give rise to taxable income for the other partners

who benefit from the shift? Looking to Reg. §1.721-1(b)(1), one must ask whether the shift in capital was intended as compensation for services or in satisfaction of an obligation? The shift clearly was not compensation for services, and it is debatable as to whether it was in satisfaction of an obligation. The shift in John's capital did not satisfy a typical obligation like a debt owed to a lender, landlord, or vendor. The partnership agreement did, however, establish an obligation on behalf of John to give up part of the value related to his partnership interest upon his failure to contribute capital. Arguably, the movement of John's capital is in satisfaction of an obligation to pay a penalty. While not entirely clear, there certainly is risk that the other partners are in receipt of income by virtue of benefiting from this penalty.[345]

Some practitioners argue that the contribution by the non-defaulting partners should be viewed as a bargain purchase and thus nontaxable on that basis. This argument seems suspect, as the case law addressing bargain purchases makes clear that the nontaxable nature of such transactions is dependent on the arm's length nature of the arrangement.[346] Where the bargain element of the transaction has a purpose to convey value to the parties who benefit from the bargain (*e.g.*, pay compensation or make a gift), the bargain element typically will not be tax free.[347]

Others argue that the terms of the partnership agreement, in effect, create an option whereby the non-defaulting partners have a pre-established contractual right to purchase a partnership interest at a discount (*i.e.*, the discount is the value attributable to the defaulting partner's shifting capital) upon the occurrence of a capital contribution default. As with the bargain purchase argument, there would seem to be risk that a court would find this argument specious given that the form is not clearly an option, and the arguable "option" is exercisable only upon a partner's default in its obligation to contribute capital (*i.e.*, the contingency permitting exercise is intended to facilitate imposition of a penalty). Under these circumstances, a court may find that the substance of the arrangement is the payment of a penalty rather than a non-taxable option premium.[348]

If the shift in value does give rise to taxable income for the recipient, there is a question as to construct of the capital shift. Reg. §1.721-1(b)(2) recognizes the possibility that the payor in a compensatory capital shift could be either the partnership or the partners. The regulation is not directly applicable in the context of a capital shift upon default, as the shift does not represent compensation for services. Nonetheless, by analogy, the regulation acknowledges that a capital shift can occur directly between partners or between the partnership and one or more partners.

In the example, the form of the forfeiture transaction is somewhat ambiguous. There is no direct privity among the partners. Instead, the shift in value occurs by reference to the terms of the partnership agreement, and the partnership orchestrates the alteration in percentage interests and movement of capital accounts. These factors point towards a capital shift that occurs in a transaction between the partners and the partnership. That is, John forfeits a portion of his interest to the partnership, and the partnership allocates the value attributable to that forfeited interest among the other partners. On the other hand, a partner who contributes the defaulted capital is contributing capital on behalf of the defaulting partner, and the partnership agreement describes the shift as coming from the defaulting partner's interest and capital in the partnership. No privity is required in a disguised sale of a partnership interest,[349] and this transaction bears resemblance to such a disguised sale.

No authority describes the results of a capital default transaction, and it is not clear which construct should prevail in the example. One commentator analyzing a similar factual situation recognized that the proper characterization is not clear, but stated that "[t]here is no readily apparent reason to favor recharacterizing the transaction as [a transfer between partners rather than a transaction with the partnership], so we may conclude that form should be respected."[350] Other commentators have been less committal with respect to the proper result.[351]

It is important to recognize that default provisions vary greatly in their remedies, and some terms may push the conclusion one way or another. For example, some default provisions allow select non-defaulting partners to purchase the interest of the defaulting partner at a significant discount. Other default provisions allow the partnership to redeem a portion of the defaulting partner's interest at a significant discount with payments of the redemption price being made over time. The benefit of that discount inures to the existing partners on a pro rata basis. The first obviously should be characterized as a transaction between the partners, while the second seems more like a transaction with the partnership. The nature of the remedy also could impact the overall treatment of the capital shift, as arguments for avoiding income inclusion by the non-defaulting partners or gain/loss by the defaulting partners will vary depending on the remedy.

If the transaction is treated as a transfer directly from the John to the non-defaulting partners, the analogy to the treatment of a compensatory capital shift between partners, discussed above,[352] is strong. If the transaction is

taxable to the non-defaulting partners, it is arguable that the amount of income should be measured by reference to the willing-buyer-willing-seller construct. The property interest received is an equity interest in the partnership, and the attributes of that interest carry over to the transferee regardless of the income inclusion amount. That is, the capital account attributable to the interest[353] and any Code Sec. 704(c) gain or loss[354] in partnership assets would carry over to the non-defaulting partners under the rules applicable to transfers of partnership interests.

With regard to John, if the transaction is treated as a payment of damages or a penalty, it seems that John should be entitled to a deduction for the value of the interest transferred.[355] The measure of John's deduction should mirror the income inclusion of the non-defaulting partners. A transfer of property under this construct would be treated as a transfer in satisfaction of an obligation, so that John would recognize gain or loss upon the transfer.[356]

The analysis is more complicated in a construct that views the transaction as occurring between the partners and the partnership. Under this construct, John, in effect, is transferring part of his partnership interest to the partnership for no consideration. But the partnership already holds the underlying property that relates to that interest. The partnership merely shifts on its books the "credit" for that property from John to the non-defaulting partners.

The magnitude of the taxable capital shift is unclear in these circumstances. If the partnership's property is appreciated and the partnership does not revalue its property in connection with the transaction, the capital account shifted on the books of the partnership will represent an amount that is less than the value that is shifted among the partners.

Assuming that the amount of the taxable shift is by reference to the value shifted among partners, the measure of income to the partnership and the deduction for John seems to come down to one's view of John's penalty paid to the partnership and from whose perspective the penalty is analyzed.[357] John is disgorging part of his partnership interest, and that partnership interest arguably should be valued under a willing-buyer-willing-seller standard. But the partnership may be viewed receiving unfettered ownership of a direct interest in assets that the partnership may allocate to the non-defaulting partners. From this perspective, the income of the partnership upon receipt of the penalty may be determined by reference to the liquidation value of the interest.

If the value of the shift is measured on a willing-buyer-willing-seller basis, the partnership is left with the same challenge in coordinating the book value of partnership assets and capital accounts of the partners as is discussed above with respect to compensatory capital shifts and shifts in satisfaction of an obligation.[358] If the shift is measured by reference to liquidation value, the book value of partnership assets and capital accounts of the partners will be more easily coordinated.

From John's perspective, he seemingly should be allocated a deduction in an amount equal to the income included by the other partners. Similar to the approach taken for use of partnership interests to satisfy obligations to pay rent, royalties, and interest (as well as for compensatory interests under the proposed regulations),[359] it may be possible to allocate built-in gain in partnership assets under reverse Code Sec. 704(c) principles to John so that he ultimately bears the tax cost of the deduction without forcing immediate recognition of gain with respect to the partnership assets that arguably satisfy the relevant obligation.[360]

There is a completely different way to view the default transaction that may be supportable. It is arguable that the unallocated value of partnership assets not yet reflected in capital accounts was not properly claimable by any partner before all capital was contributed. Under a partnership agreement that makes allocations under the "partners' interests in the partnership" standard, in effect, the default provision in the partnership agreement could be viewed as an overlay to the allocation provisions so that gain and loss should be allocated by reference to capital actually contributed rather than capital committed, and if a partner defaults, non-defaulting partners who fund the defaulting partner's capital will be given credit for part of the defaulting partner's contributed capital. In effect, allocations made during the period while capital is being called are contingent, and adjustments may be necessary to account for facts that unfold during the investment period that impact the ultimate entitlements of the partners.[361] Under this view, the "penalty" would represent only the capital contributed. The entitlement to value created by appreciation to partnership assets would be reflected in allocations made by reference to the ultimate entitlements derived from contributions made by partners to the partnership.[362]

Questions arise under this view in situations where there have been prior allocations of income, gain, loss, or deduction, or capital accounts previously were revalued, so that capital accounts vary from contributed capital. Where the defaulting partner's capital account varies from capital contributed due to allocation of taxable items, it may be appropriate to measure the shift by reference to the shifted portion of the partner's capital account rather than capital contributed. Using such a measure would facilitate proper coordination of capital accounts

and would ensure the integrity of allocations made on a going forward basis. Note, however, that the basis for the overall approach to addressing the capital shift in this context is that, in hindsight, the defaulting partner was not entitled to the allocations received. Consistent with this view, it may be more appropriate to measure the shift by reference to contributed capital and undertake allocations that are analogous to the forfeiture allocations described in the proposed regulations addressing compensatory partnership interests[363] in order to effectively reverse the allocations that, in hindsight, were improperly made to the defaulting partner.

If the partnership has previously revalued its assets so that the defaulting partner's capital account represents, in part, appreciation or depreciation accounted for as reverse Code Sec. 704(c) gain or loss, the issues are difficult. At first blush, it would seem fair to simply reallocate this reverse Code Sec. 704(c) gain or loss consistent with the way allocations should have been made, in hindsight, if the ultimate percentage interests had been known from inception. Of course, this approach for reverse Code Sec. 704(c) gain or loss becomes more complicated (and possibly less defensible) if allocations of depreciation or amortization have been made by reference to these reverse Code Sec. 704(c) layers. In this situation, simply adjusting reverse Code Sec. 704(c) gain and loss layers so as to conform to the correct capital account balances does not fully reverse the effect of what, in hindsight, were incorrect allocations.[364] In thinking about this methodology, one must recognize what seems to be a reluctance on the part of Treasury and the IRS to embrace this approach. Specifically, in the regulations relating to noncompensatory partnership interests, the Government requires taxable corrective allocations to reverse the result of revaluation gain and loss that, in hindsight, was allocated inconsistent with the adjusted economic arrangement.[365]

As one can see from this discussion, the issues related to capital defaults are complicated, and the answers are unclear. Capital shifts in this context highlight the difficulty in distinguishing (1) what is a purposive conveyance of value that arguably should be taxable from (2) an economic relationship among partners (*i.e.*, entitlement to allocations) that is uncertain until certain contingencies are resolved. These alternative paradigms for analyzing the transaction highlight the potential interplay between partnership allocations and capital shifts. Capital accounts are, in part, a product of allocations among partners, and in a number of instances, it may be defensible to account for a change in economic entitlements *via* a capital shift or modification to allocations. Capital defaults are merely one example of a scenario where it may not be clear whether a value shift among partners is properly accounted for through a taxable capital shift, adjustment to allocations to reflect the value shift, or some other theory.

F. Preferred Interests

One of the most hotly debated issues in partnership tax relates to the treatment of preferred interests where the preferred return may be paid from the capital of other partners in a situation where the partnership does not earn sufficient income.[366] The issue typically arises for partnerships that undertake allocations on a targeted or similar basis and that are not required to liquidate consistent with partner capital accounts.

The following example illustrates the issue. Linda contributes $1 million to PRS in exchange for a preferred interest. Katherine contributes $1 million in exchange for a common interest in PRS. Under the distribution waterfall, Linda is entitled to receive an eight-percent return on her capital and then her $1 million contributed capital. Katherine, as the common interest holder, is entitled to all distributions thereafter. Distributions upon liquidation are to be made consistent with this distribution waterfall, and without regard to the capital accounts of the partners. The allocation provisions contained in the partnership agreement follow a targeted allocation approach and provide that profit and loss will be allocated among the partners so that, at the end of each year, capital accounts of each partner will equal an amount that is as close as possible to sum of (1) the amounts that would be produced if the partnership sold all of its assets for their Code Sec. 704(b) book values and distributed the proceeds in liquidation, and (2) the partner's share of minimum gain (both partnership minimum gain and partner nonrecourse debt minimum gain).

Assume that PRS will construct an office building. PRS will not earn income during the construction period, but projections indicate that profit (*i.e.*, net income and gain) over the life of PRS will be sufficient to satisfy Linda's preferred return.

During PRS's first year, PRS has no profit or loss. Based solely on allocations under Code Sec. 704(b), Linda and Katherine each would have a capital account at the end of the year equal to $1 million. If PRS was to liquidate at the end of the year, however, Linda would receive $1,080,000 to account for her preferred return entitlement, and Katherine would receive $920,000. While allocations were made so as to get the partners' capital accounts "as close as possible" to the liquidation entitlements, PRS had no profit or loss to allocate, so "close" did not equate to "exact."

Analyzing partner entitlements on a strict annual basis, $80,000 of Katherine's capital was shifted to Linda. Linda's preferred return arguably created an "obligation" as referenced in Reg. §1.721-1(b)(1), so the capital shifted arguably could be taxable under that provision. But note that the capital shift in this instance is purely a product of the annual accounting system, and it is not at all clear that the annual accounting system should control allocations in this context.[367] In this situation, the partnership fully expects to earn enough profits over its life to satisfy Linda's preferred return. Under the standard of "partners' interests in the partnership", a strong argument could be made that allocations of the first available profit to match the preferred return entitlement should be respected even though such allocations may not produce capital accounts that match the "as-if-liquidated" entitlements at the end of each year.[368] Of course, "partners' interests in the partnership" relies on facts and circumstances, and if circumstances change such that sufficient profits cease to be expected, the analysis could be revised. A taxable capital shift may be appropriate in such circumstances.

Putting aside the balancing of considerations between the theories underlying capital shifts and partnership allocations, there is another angle to the analysis of the preferred return that must be considered in this situation. It will be necessary to account for the rules regarding guaranteed payments under Code Sec. 707(c). Interestingly, for compensatory capital shifts in exchange for services rendered to the partnership, Reg. §1.721-1(b)(1) characterizes the capital shifted as a guaranteed payment. For the preferred return, it is arguable that the technical rules providing for guaranteed payments are the starting point for the analysis that, in effect, accounts for a capital shift. Code Sec. 707(c) provides:

> To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).[369]

The applicable regulations provide:

> Payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership. However, a partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting.[370]

Under these rules, the question arises as to whether a payment of a preferred return that may be funded with another partner's capital is a payment that is made "without regard to the income of the partnership." In effect, these rules provide that the partner's entitlement with respect to such payments will necessarily be taken from the entitlements of other partners. By providing that the payments are made without regard to partnership income, the rule seemingly eliminates any conflict with the profit and loss allocation rules in characterizing the payments, definitively providing that the payment will not be accounted for as an allocation of profit. Where a guaranteed payment is involved, other partners share in partnership profits and losses, and the partner who is entitled to a guaranteed payment (to the extent of its entitlement) dilutes the capital entitlements of the other partners with its guaranteed entitlement. The guaranteed payment partner infringes on the capital of other partners, thus creating a capital shift, but the shift is determined by concluding that the payment is not made from profit. The guaranteed payment rules apply only with respect to payments for services or for the use of capital, so these payments account for only a subset of the value shifts among partners that could represent capital shifts.

Although Code Sec. 707(c) references a "payment", it is not necessary that the recipient actually receive cash or property in satisfaction of the guaranteed payment obligation in order to accrue income.[371] Instead, the partner must include the payment as ordinary income for his or her taxable year within or with which ends the partnership taxable year in which the partnership deducts such payments as paid or accrued under its method of accounting.[372] For an accrual method partnership, the deduction may accrue before making the actual payment.[373] As a result, a guaranteed payment can replicate a scenario that involves a more traditional capital shift—that is, a conveyance of value as between partners with respect to their participation in a partnership and without a direct transfer of cash or property between the partners.[374]

The concept of the guaranteed payment is simple enough, but in practice, the determination of whether a payment entitlement is determined without regard to partnership income is not always clear. The preferred return scenario where allocations are made following a target

capital account approach presents a perfect example where the characterization of a payment as a share of profits or a guaranteed payment is not clear. In the example described above, Linda will be entitled to receive the $80,000 preferred return amount so long as Katherine's capital remains sufficient to satisfy the partnership's payment obligation. It will not be necessary that the partnership earn income in order for Linda to be paid. The partners intend and expect, however, that the payments of preferred return will be made from profits. By liquidating based on the waterfall rather than capital accounts, the preferred return entitlement is not necessarily profit-dependent. Should this difference cause the preferred return entitlements to become guaranteed payments rather than attracting a distributive share of profits?

No definitive guidance exists with respect to this topic, although Treasury and the IRS did provide some hint as to their belief on the topic with the following statements in the preamble to the proposed regulations addressing disguised payments for services under Code Sec. 707(a), which were issued in 2015.

> The Treasury Department and the IRS have become aware that some partnerships that assert reliance on §1.704-1(b)(2)(ii)(i) (the economic effect equivalence rule) have expressed uncertainty on the proper treatment of partners who receive an increased right to share in partnership property upon a partnership liquidation without respect to the partnership's net income. These partnerships typically set forth each partner's distribution rights upon a liquidation of the partnership and require the partnership to allocate net income annually in a manner that causes partners' capital accounts to match partnership distribution rights to the extent possible. Such agreements are commonly referred to as 'targeted capital account agreements.' Some taxpayers have expressed uncertainty whether a partnership with a targeted capital account agreement must allocate income or a guaranteed payment to a partner who has an increased right to partnership assets determined as if the partnership liquidated at the end of the year even in the event that the partnership recognizes no, or insufficient, net income. *The Treasury Department and the IRS generally believe that existing rules under §§1.704-1(b)(2)(ii) and 1.707-1(c) address this circumstance by requiring partner capital accounts to reflect the partner's distribution rights as if the partnership liquidated at the end of the taxable year*, but request comments on specific issues and examples with respect to which further guidance would be helpful. No inference is intended as to whether and when targeted capital account agreements could satisfy the economic effect equivalence rule.[375]

It is important not to take the preamble language too seriously, as it is merely a statement made as part of a request for comments. The preamble language is interesting, however, as it seems to represent a middle ground between the most conservative and most aggressive of the positions regarding possible treatment some or all of the preferred as a guaranteed payment.

At the most conservative end of the spectrum, one could view the entire preferred return that accrues annually as a guaranteed payment.[376] So long as there remains subordinated capital attributable to other partners available to satisfy the preferred return,[377] the preferred return can be satisfied even if there is no partnership profit. On that basis, one could view the payments as being made without regard to partnership income. Few practitioners adhere to this view.

Some practitioners rely on Example 2 of Reg. §1.707-1(c) for a middle-ground position where profit is allocated to the extent available to match the preferred return, with a guaranteed payment being accrued to the extent of any shortfall so that capital accounts will represent liquidation entitlements as of the end of the year.[378] The example involves a situation where the partner is to receive 30 percent of the partnership's income annually, but not less than $10,000. In a scenario where the partnership has $20,000 of income for a taxable year, the example concludes that the partner will include $6,000 as its allocable share of income with the excess $4,000 necessary to reach the $10,000 entitlement representing a guaranteed payment.[379] The analogy to a preferred return in a target agreement is not perfect, as the 30 percent share of profit in the example provides the partner with a potential entitlement above the $10,000 minimum payment (*i.e.*, if 30 percent of partnership income exceeds $10,000). With the preferred return that is intended to be matched by income, the amount of income earned by the partnership has no potential to vary the amount of the preferred partner's entitlement. That partner, in all circumstances, will earn the preferred return amount. Nonetheless, the example can be viewed as conveying a principle that is broader than the facts represent, and the preamble language set forth above[380] arguably follows this interpretation. That is, the preamble language, by citing both the rules regarding economic effect under Code Sec. 704(b) and the guaranteed payment rules, and stating that year-end capital accounts should correspond to the liquidation entitlements, seems to recognize that allocations under Code Sec. 704(b) should be made, with the

guaranteed payment amount determined by reference to the amount necessary to make up the shortfall.

Some practitioners go a step further and conclude that, so long as adequate profit has accrued before the preferred distribution is actually paid, there will be no guaranteed payment. If there is a shortfall in profits at the time of payment, a guaranteed payment equal to the shortfall will accrue.[381] Some argue in support of this approach based upon the view that the preferred return accrual creates no separate property right and thus should not be viewed as giving rise to a realization event.[382] An alternative argument in support of this treatment is largely based on the purpose of the guaranteed payment rules. According to one commentator describing this theory:

> [S]ection 707(c) is primarily a characterization provision for dealing with amounts that cannot otherwise be accounted for under section 704(b); only secondarily is it a timing provision.[383]

Following this line of thinking, so long as the payment is intended to represent a distribution of profits and it can be so treated based on the timing of the actual distribution, the intended substantive treatment of the payment should prevail.

Finally, at least one commentator has argued that a guaranteed payment should accrue only to the extent that the preferred partner has been allocated insufficient profits to match its preferred return entitlement upon liquidation of the partnership. This commentator, however, prefaces his suggested analysis of payments on liquidation with the statement that "the partners' robust expectations [with respect to partnership profits] did not materialize."[384] Thus, this commentator might not assert such treatment in a situation where profits are expected to be insufficient to satisfy the cumulative preferred return entitlement.

As this discussion highlights, there is great uncertainty with regard to the proper treatment of preferred return entitlements under a partnership agreement that relies on target allocation or similar provisions. For purposes of this article, however, the discussion is most important in that it highlights the interaction of the rules regarding partnership allocations and concepts relating to capital shifts. If one determines that a preferred return should be accounted for as a capital shift (either under Reg. §1.721-1(b)(1) or Code Sec. 707(c)), then contrary to earlier discussions where there seems to be an argument for evaluating a capital shift by reference to the amount that a willing buyer would pay for the equity interest represented by the shifted capital, such an argument would not seem to be available where the shift relates to an accrued preferred return. In this context, the capital shift is essentially a "plug" to conform capital accounts to partner entitlements upon liquidation. It is part of the approach to making valid allocations by reference to capital accounts, and thus the capital shift must follow a capital account approach—not an approach that views the recipient partner as receiving a new equity interest that is the proper unit for valuation.

G. Tax Avoidance and Other Allocations That Just Don't Work

There may be situations where parties intend to use a capital shift to effectively convey the benefits of income or detriments of deductions that accrue with respect to a specific partner instead to another partner. As one example, consider a scenario where a partnership agreement provides that all depreciation with respect to partnership property will be allocated to Partner A. Partner A will undertake a deficit restoration obligation in order to support the disproportionate allocations. Assume that the partners other than Partner A are tax-exempt, so that the deductions would provide no tax benefit to such partners. If the deficit restoration obligation is subsequently eliminated, Partner A in fact will not have borne the economic detriment associated with disproportionate depreciation allocations. Instead, the partners other than Partner A will have borne the effect of the allocations, and the elimination of Partner A's deficit restoration obligation would shift the capital that actually bore the losses from the other partners to Partner A.

If this transaction is analyzed as a capital shift, it would seem hard to defend measurement of the income arising from the shifting capital other than by reference to the capital account that is transferred to Partner A. In this context, the capital shift is a direct product of what, in hindsight, was a misallocation of deductions which impacted capital accounts on a dollar-for-dollar basis. The income inclusion measured by reference to the capital account migration would rectify the result of that misallocation.

It is important to recognize that the IRS may attack this arrangement in a more straightforward manner by disallowing the special allocation of depreciation rather than asserting a taxable capital shift. The IRS has weapons designed to address such allocations if the plan to undercut the economics associated with the allocations is in place from the beginning. The Code Sec. 704(b) regulations disregard a deficit restoration obligation where the facts and circumstances indicate a plan to avoid the obligation.[385] In addition, if a partnership agreement is amended to eliminate a deficit restoration obligation, the amendment will be closely scrutinized to determine if it

was part of the original partnership agreement, and if it is so determined, prior allocations may be reallocated to take account of the modified terms of the agreement, and subsequent allocations may be reallocated to take account of such modified terms.[386]

But what if the original allocations cannot be reallocated—say, because the statute of limitations has run with respect to the years when such allocations were made? What are the IRS's options in such an event? If the partnership will not liquidate based on capital accounts, the allocations cannot be defended as satisfying substantial economic effect and thus will be analyzed under the partners' interests in the partnership standard. In at least one instance, the Tax Court has provided for a disproportionate allocation of gain on the sale of the partnership's property in order to prevent the capital account of a partner who previously took special allocations of depreciation from remaining negative.[387] Thus, it appears that the IRS may be entitled to a second bite at the apple by using allocations in the final years of the partnership to correct what previously were incorrect allocations. But what if there are insufficient items of income, gain, loss, and deduction available to fully offset the partner's negative capital account? Is the sanctity of capital accounts and economic effect so strong that the IRS will get a third bite at the apple by forcing a taxable capital shift to reconcile the ultimate economic entitlements and allocations made with respect to a partner? In a case where the taxpayer essentially hoodwinks the Government by, pursuant to a plan, eliminating a deficit restoration obligation at a time when it is too late for the IRS to challenge the prior allocations,[388] one can see a court embracing such an approach. In situations involving more innocent mistakes, the proper result seems less clear.

Apart from the more abusive scenarios like the one described above, in some situations, the drafter of a partnership agreement may intentionally provide for a capital shift "plug" (reflected as a guaranteed payment) in the event that capital accounts do not match economic entitlements upon liquidation. One often sees this approach taken in partnerships that incorporate a clawback. In a partnership that follows an American waterfall (*i.e.*, deal-by-deal carry) and attempts to liquidate based on capital accounts, in early years, there may be allocations of profit to the partner who is entitled to carried interest, but as the investor preferred return continues to accrue in future years, the carried interest entitlement may be overtaken (and hence eliminated) by the additional preferred return. If losses are not available to offset the prior allocations to the carried interest partner, that partner's capital account cannot be made negative so as to match the contribution obligation to return previously received carried interest distributions, as required by the clawback. In this situation, the partnership agreement may treat the distribution to the investors of clawback proceeds in excess of their capital accounts as guaranteed payments under Code Sec. 707(c),[389] with the deduction related to the guaranteed payments being allocated to the carried interest partner to take that partner's capital account negative by an amount equal to the required contribution.

The capital shift accomplished through a guaranteed payment in the clawback scenario represents an effort on the part of the partnership to do the best that it can in matching allocations to economic entitlements.[390] In these and other instances, the ultimate entitlements of partners cannot be predicted in the taxable year when allocations are made. Allocations in such a year may be made based on the best information available, and when future events do not correspond to assumptions made in that year, items of income, gain, loss, and deduction may not be available to reconcile capital accounts to the ultimate entitlements. While the guaranteed payment is a product of what, in hindsight, were incorrect allocations, the result seems appropriate[391] and generally should be defensible.[392]

Again, in a situation like this, where the capital shift is purely a mechanism for correcting a defect in prior allocations, the measure of the taxable shift should be the amount of partner capital accounts that reflect the previous inaccurate allocations and that are migrating to reflect the proper entitlements of the partners. Any argument for a willing-buyer-willing-seller measure to the income inclusion would be unsupportable and inconsistent with the purpose of the adjustment.

XII. Conclusion

To repeat, partnerships are strange animals. As this article has shown, a partnership's blend of aggregate and entity treatment often makes the analysis of value shifts among partners very difficult to analyze. The first step generally will be to determine if the value shift is taxable. If the shift is not taxable, and the partnership relies on capital accounts in making allocations, it will be necessary to reconcile the partner capital accounts with the nontaxable nature of the shift. If the value shift is taxable, the next step is to determine the measurement of taxable income associated with the shift. A willing-buyer-willing-seller valuation will be more easily defended in some situations than others. If this measurement of value can apply, the partnership accounting for the transfer will be easier to rationalize in a shift that occurs directly between partners than in one where the partnership is responsible for the shift. In the latter situation, the partnership again is left with a difficult

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exercise in reconciling capital accounts of the partners to facilitate allocations on a going forward basis.

So what conclusions may be drawn from this analysis? There is only one overarching conclusion—that is, context matters. While the phrase "capital shifts" often is used by tax professionals in a somewhat generic fashion, in fact, capital shifts come in all shapes and sizes, and there is no "one-size-fits-all" theory that can apply to all such transactions. When one identifies the occurrence of a shift in partnership capital, it will be imperative to consider the context and think about how the intersection of general tax principles and subchapter K should be reconciled in that specific context. In many instances, guidance will be lacking, which may present some flexibility in determining the path to be taken. This article has attempted to provide some analytical background, illustrate scenarios, and set forth one or more analyses of the scenarios which may be helpful as models in thinking about these and analogous situations. The subject matter is quite complex, but it is the author's hope that this exercise will prove useful.

ENDNOTES

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[1] As will be discussed, the taxable income associated with a "capital shift" may be determined in a number of ways, including (1) liquidation value, which is consistent with the capital account calculation, although based on the fair market value of partnership assets, (2) the value that would be paid in a willing-buyer-willing-seller negotiation, or (3) the shifted capital account, as determined under Code Sec. 704(b). *See infra* notes 83–92 and accompanying text.

[2] *See* section V *supra*.

[3] *Basye*, SCt, 73-1 USTC ¶9250, 410 US 441, 93 SCt 1080 (1973).

[4] Code Sec. 707.

[5] One commentator has made the following statement in this regard:

> It is proposed that in analyzing any issue under K involving a partner transaction for which there is no clear statutory authority there should first be determined the tax consequences as if there were no special rules of K (a pure aggregate theory), and then a determination should be made as to whether or not, for reasons of internal consistency, tax policy, or otherwise for reasons associated with special rules of K, there should be a departure from the rule that would generally be applied.

S. Kamin, *Partnership Options—A Modified Aggregate Theory*, 91 TAX NOTES 975, 976 (May 7, 2001) (hereafter referred to as "*A Modified Aggregate Theory*").

[6] *See infra* notes 85–86 and accompanying text.

[7] Code Sec. 721.

[8] Code Sec. 731.

[9] *See infra* notes 98–106 and 114–116 and accompanying text.

[10] Reg. §1.704-1(b)(2)(iv)(*f*).

[11] Reg. §§1.704-1(b)(2)(iv)(*g*); 1.704-3(a)(6)(i).

[12] In some instances, a bargain purchase may be more "purposive", such as a situation where, in order to compensate a partner for services, that partner is allowed to acquire a partnership interest for a contribution that is less than the fair market value of the interest being received. *See infra* notes 27–30 and accompanying text.

[13] Where the interests of all partners increase on a proportionate basis, the shift in value arguably is not purposive. If management of the partnership specifically directs the forfeited interests to certain partners to reward the performance of those partners, the value shift seems more purposive.

[14] Where the ultimate capital shift is part of a plan from the time of the adoption of the relevant partnership allocations, the allocations certainly could be challenged as not complying with Code Sec. 704(b). *See, e.g.*, Reg. §1.704-1(b)(2)(ii)(*c*)(4) (obligation to restore a deficit capital account ignored if the facts and circumstances indicate a plan to avoid or circumvent the obligation); Reg. §1.704-1(b)(2)(ii)(*h*) (partnership agreement includes all agreements among the partners or between one or more partners and the partnership, whether or not embodied in the document referred to by the parties as the partnership agreement); Reg. §1.704-1(b)(4)(vi) (if an allocation satisfies substantial economic effect or partners' interests in the partnership, but the partnership agreement is subsequently modified, both the tax consequences of the modification and the facts and circumstances surrounding the modification will be closely scrutinized to determine whether the modification was part of the original agreement).

[15] *See A Modified Aggregate Theory*, *supra* note 5.

[16] *Id.*

[17] Reg. §1.61-1(a) states: "Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services."

[18] SCt, 1 USTC ¶32, 252 US 189, 40 SCt 189 (1920).

[19] *Id.* at 207 (emphasis in the original).

[20] SCt, 40-1 USTC ¶9337, 309 US 461, 60 SCt 631 (1940).

[21] *Id.* at 468 and 469.

[22] *Id.*

[23] SCt, 55-1 USTC ¶9308, 348 US 426, 75 SCt 473 (1955).

[24] *Id* at 431.

[25] SCt, 37-2 USTC ¶9532, 302 US 63, 58 SCt 67 (1937).

[26] *Id.* at 69.

[27] *F. Pellar*, 25 TC 299, Dec. 21,347 (1955), *acq.* 1956-2 CB 7; *see also J.L. Honigman*, CA-6, 72-2 USTC ¶9613, 466 F2d 69 (1972) (bargain purchase to a shareholder gave rise to a dividend).

[28] SCt, 56-2 USTC ¶9607, 351 US 243, 76 SCt 800 (1956).

[29] *Id.* at 248.

[30] *Id.* Inclusion of income was delayed until exercise of the options due to concern with valuation of the options upon receipt.

[31] SCt, 91-1 USTC ¶50,187, 499 US 554, 111 SCt 1503 (1991).

[32] *Id.* at 559 (citing *Helvering v. Horst*, SCt, 40-2 USTC ¶9787, 311 US 112, 116, 61 SCt 144 (1940)).

[33] *Id.* at 559.

[34] *Id.*

[35] *Id.* at 566.

[36] *Id.* at 565.

[37] T.D. 8675 (1996), 1996-2 CB 60; *see also* CCA 201547004 (Aug. 11, 2015).

[38] LTR 200045028 (Aug. 16, 2000); *see also* LTR 200743022 (Jul. 19, 2007); LTR 201134017 (May 26, 2011). For further discussion, *see* L. Plaine, *Generation Skipping Transfer Tax Planning—Skipping in Place or Out of View*, 36-15 U. of Miami Law Center on Est. Planning ¶1503 (2013); *NYSBA Tax Section Comments on Tax Consequences of Trust Decanting*, 2012 T.N.T. 82-13 (Apr. 27, 2012).

[39] *See* J. Peaslee, *Modifications of Nondebt Financial Instruments as Deemed Exchanges*, 2002 T.N.T. 83-25 (Apr. 30, 2002) ("[t]here do not appear to be any authorities discussing whether other types of modifications, such as changes in profit and loss shares, are 1001 exchanges") (hereafter referred to as "*Modifications of Nondebt Financial Instruments*"); *but cf.* LTR 9821051 (Feb. 23, 1998), which analyzes an arrangement whereby a partnership agreement was amended to establish a sharing ratio for partners upon the occurrence of a liquidation

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event. More specifically, the partnership originally allocated profits and losses upon asset dispositions as determined by the executive committee, and the agreement was amended to provide that, upon a liquidation event, the partnership would transfer to each partner its share of the units. The ruling holds that the amendment "will not result in the realization of income by the Partnership, Limited, or any of their respective partners." *See infra* notes 281 and 282 and accompanying text.

[40] 1984-1 CB 157.

[41] 1995-1 CB 130.

[42] *See Modifications of Nondebt Financial Instruments*, *supra* note 39.

[43] If the state of incorporation does not change and other rights remain constant, there is no change in legal rights and hence no realization event. If the state of incorporation does change, legal rights are altered and hence a realization event occurs. *See* J. Cummings, *A General Theory of F Reorganizations*, 2012 T.N.T. 238-7 (Dec. 11, 2012).

[44] (Apr. 10, 1981).

[45] GCM 38687 (Apr. 10, 1981); *see also* LTR 7948063 (Sep. 3, 1979) (initial position reflecting no sale or exchange upon conversion from GP to LP).

[46] *See* LTR 201745005 (Aug. 4, 2017) (conversion will not cause a termination of partnership; Code Sec. 721 not discussed); LTR 201605004 (Oct. 19, 2015) (conversion did not result in the assets of the partnership being contributed or distributed to the partners of the partnership).

[47] S. Banoff, *Partnership Ownership Realignments via Partnership Reallocations, Legal Status Changes, Recapitalizations, and Conversions: What are the Consequences?*, 83 TAXES 105 (2005) (hereafter referred to as "*Partnership Realignments*"); *see also* P. Gall, *Nothing for Something: Partnership Continuations Under Code Sec. 708(a)*, 95 TAXES 187, 214 (2017) ("[e]ven if Code Sec. 708(a) does not trump realization in the context of a recapitalization of partnership interests, the basic framework of subchapter K and its intended flexibility should be viewed as trumping realization"); Willis, Postlewaite & Alexander, *Partnership and Limited Liability Entity Taxation*, ¶12.01[1] (seemingly distinguishing annual re-allocations, such as performance-based alterations that often occur in service partnerships, and more permanent re-allocations that essentially effect a recapitalization of interests).

[48] Reg. §1.61-14(a) provides: "Treasure trove, to the extent of its value in United States currency, constitutes gross income for the taxable year in which it is reduced to undisputed possession." *See also E. Cesarini*, DC-OH, 69-1 USTC ¶9270, 296 FSupp 3 (1969) (cash found in a purchased piano was gross income). *See generally* J. Dodge, *Accessions to Wealth, Realization of Gross Income, and Dominion and Control: Applying the "Claim of Right Doctrine" to Found Objects, Including Record-Setting Baseballs*, 5 FLA. TAX REV. 685 (2000).

[49] *See*, *e.g.*, Rev. Rul. 2009-19, 2009-2 CB 111; *see generally* R. Wood & R. Morris, *The General Welfare Exception to Gross Income*, 109 TAX NOTES 203 (2005).

[50] IR 98-56, *reprinted at* 98 T.N.T. 174-14 (Sep. 8, 1998).

[51] CA-5, 68-2 USTC ¶9546, 401 F2d 118 (1968).

[52] A. Abreu & R. Greenstein, *Defining Income*, 11 FLA. TAX REV. 295, 315 (2011).

[53] Reg. §1.704-1(b)(1) (1956) provided as follows:

> If the partnership agreement makes no specific provision for the manner of sharing one or more classes of items, a partner's distributive share of such items shall be determined in accordance with the provisions of the partnership agreement for the division of the general profits and losses (that is, the taxable income or loss of the partnership as described in section 702(a)(9)). In applying this rule, the manner in which net profit or net loss (computed after excluding any item subject to a recognized special allocation) is actually credited on the partnership books to the accounts of the partners will generally determine each partner's share of taxable income or loss as described in section 702(a)(9).

[54] *See*, *e.g.*, RUPA §401. For good discussions of the relevance of capital accounts under state law, *see* D. Weidner, *Capital Accounts in LLCs and Partnerships: Powerful Default Rules and Potential Significance,* 14 FLA. ST. U. BUS. REV. 1, 14–21 (2015); B. Borden, *The Allure and Illusion of Partners' Interests in a Partnership*, 79 U. CIN. L. REV. 1077, 1092–1094 (2011).

[55] "Substantial economic effect" was referenced as a factor to consider in the regulations that were effective in 1976 (*see infra* note 59), but the concept was not fully developed until regulations issued implementing the 1976 Act amendment.

[56] *See infra* note 63 and accompanying text.

[57] T.D. 8065, 1986-1 CB 254. For an interesting discussion of the adoption of capital accounts as the driving force in partnership allocations, *see* M. Gergen, *Partnership Tax: The End of the Revolution in Partnership Tax?*, 56 SMU L. REV. 343, 346 and 347 (2003).

[58] For an analysis of the changes brought about by the statutory change in 1976, *see* S. Kamin, *Partnership Income and Loss Allocations Before and After the Tax Reform Act of 1976*, 30 TAX LAW. 667 (1977).

[59] Reg. §1.704-1(a) & (b)(2) (1956). Among the relevant facts and circumstances considered in determining a tax avoidance purpose were:

> Whether the partnership or a partner individually has a business purpose for the allocation; whether the allocation has 'substantial economic effect,' that is, whether the allocation may actually affect the dollar amount of the partners' shares of total partnership income or loss independently of tax consequences; whether related items of income, gain, loss, deduction, or credit from the sale source are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated items could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocation.

Reg. §1.704-1(b)(2).

[60] 54 TC 1621, Dec. 30,294 (1970).

[61] Jt. Comm. on Tax'n, *General Explanation of the Tax Reform Act of 1976*, at 95 (Dec. 29, 1976) (hereafter referred to as the "*1976 Blue Book*").

[62] *Id*.

[63] *Id*. at 95 n. 6.

[64] Code Sec. 704(b) (flush language at the beginning of statute).

[65] Code Sec. 704(b)(2).

[66] T.D. 8065, 1986-1 CB 254 (preamble). Prior to promulgation of the regulations, Professor William McKee stated: "[m]ost commentators believe, however, and the staff of the Joint Committee on Taxation has stated, that the *presence or absence of substantial economic effect can be determined by an analysis of the effect of the special allocation on the partner's capital accounts*." W. McKee, *Partnership Allocations: The Need for an Entity Approach*, 66 VA. L. REV. 1039 (1980) (emphasis added).

[67] T.D. 8065, 1986-1 CB 254.

[68] Reg. §1.704-1(b)(2)(iv)(*b*).

[69] Reg. §1.704-1(b)(2)(iv)(*f*).

[70] Reg. §§1.704-1(b)(2)(iv)(*g*) and 1.704-3(a)(6)(i).

[71] Reg. §1.704-1(b)(2)(ii)(*b*) & (*d*). Reg. §1.704-1(b)(2)(ii)(*i*) provides the allocations can satisfy economic effect equivalence if the allocations will, in all instances, produce economic results that are consistent with the results if the partnership liquidated in accordance with capital accounts. The regulations do contain certain limited exceptions where economics are not determined strictly in accordance with the capital account rules. A partnership will not fail to be treated as liquidating in accordance with capital accounts if a partner's interest is purchased (other than in connection with the liquidation of the partnership) by the partnership or another partner (or related person) pursuant to an agreement negotiated at arm's length by parties with material adverse interests and if a principal purpose of the purchase is not to avoid the economic effect requirement. Reg. §1.704-1(b)(2)(ii)(b)(5). This rule does not actually permit a partnership to liquidate other than in accordance with capital accounts, but it does permit one-off transactions whereby a partner may exit the partnership for an amount other than its capital account balance. Separately, minor discrepancies between partners' capital accounts as actually maintained as compared to capital accounts calculated strictly in compliance with the regulations will not impact the validity of an allocation if the discrepancies are minor and are attributable to a good faith error by the partnership. Reg. §1.704-1(b)(2)(iv)(*p*). This rule essentially allows partnerships to continue to allocate items within the safe harbor even though a minor mistake has been made in prior allocations. While this provision will permit a partnership to liquidate other than in accordance with properly maintained capital

accounts, the variance is small and probably not meaningful. *See generally* T. Cuff, *Some Nuances on Nonrecourse Deductions*, 100 J. TAX'N 297 (2004).

[72] Admittedly, the "substantiality" prong of the safe harbor, discussed immediately below (*see infra* notes 73–75 and accompanying text), does contain more subjective standards, analyzing whether the economic effect of special allocations could be offset by other allocations and the aggregate tax savings that result from the special allocations.

[73] Reg. §1.704-1(b)(2)(iii)(*b*) (shifting allocations).

[74] Reg. §1.704-1(b)(2)(iii)(*c*) (transitory allocations).

[75] Reg. §1.704-1(b)(2)(iii).

[76] *See supra* note 65 and accompanying text.

[77] Reg. §1.704-1(b)(3)(i).

[78] *Id*.

[79] Reg. §1.704-1(b)(3)(iii). The factors listed in the regulations are consistent with those described in the legislative history accompanying the 1976 Act except that the first factor (*i.e.*, contributions to the partnership) was not contained in the legislative history. *Blue Book*, *supra* note 61, at 96. A respected group of commentators makes the following statement with regard to these four factors:

> Not surprisingly, these four factors are the essential elements of the capital account rules: (1) capital accounts are increased by contributions, (2) increased or decreased by economic profits and losses, (3) decreased by current distributions, and (4) ultimately satisfied on liquidation. The partners' interests are thus tightly tied to partnership economics.

W. McKee, W. Nelson, & R. Whitmire, *Federal Taxation of Partnerships and Partners*, ¶11.02[3] (Warren, Gorham & Lamont 2022) (hereafter referred to as "*Federal Taxation of Partnerships*").

[80] Reg. §1.704-1(b)(3)(ii). The rule also provides for certain adjustments consistent with those made under the rules for the alternate test for economic effect applicable when a partner does not have an unlimited obligation to restore a deficit balance in the partner's capital account. Reg. §1.704-1(b)(2)(ii)(d)(4)-(6).

[81] *See generally* N.Y. St. Bar Assoc. (Tax Section), *Report on Partnership Target Allocations*, 2016 T.N.T. 221-13 (Nov. 14, 2016).

[82] *See supra* notes 77–80 and accompanying text.

[83] In this regard, the L.A. County Bar Assoc., *Comments on Proposed Partnership Equity Compensation Regulations*, 2006 T.N.T. 133-56 (Jun. 19, 2006) states:

> [T]he fair market value of a partnership interest for Section 83 purposes takes into account *external* factors such as minority and liquidity discounts, which can never be internally reconciled with the liquidation value of the interest until the reasons for those discounts are eliminated (*e.g.*, after an actual liquidation of the partnership or an initial public offering of the partnership interests).

[84] The "book value" of partnership assets for purposes of Code Sec. 704(b) initially is determined by reference to the fair market value of such assets upon contribution to, or the purchase price paid by, a partnership. Reg. §1.704-1(b)(2)(iv)(*b*)(*2*). Upon certain events, the book value of partnership property may be adjusted to reflect the current fair market value of the property. Reg. §1.704-1(b)(2)(iv)(*f*). For purposes of determining the Code Sec. 704(b) book income or loss of a partnership, depreciation and amortization or partnership property is determined by reference to the book value of partnership property, and the book value is adjusted to reflect such depreciation and amortization. Reg. §1.704-1(b)(2)(iv)(*g*)(*1*).

[85] G. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 163 and 164 (1999) (hereafter referred to as "*Private Business Firms*").

[86] *Id*. at 157 and 158. Another commentator conveyed the same message but described the problem as follows:

> [The capital account system] focuses on the consequences of a hypothetical immediate liquidation. While business people in planning transactions focus on likely exit strategies, they usually do not plan to liquidate immediately or at every year end when taxable income is allocated. Thus, under the capital account system, immediate tax consequences are governed by economic consequences that may be delayed indefinitely and whose timing is in the control of the partners. In other words, the capital account system ignores the time value of money.

S. Friedman, *Practitioner Note: Partnership Capital Accounts and Their Discontents*, 2 N.Y.U. J LAW & BUS. 791, 796 (2006) (hereafter referred to as "*Capital Accounts and Their Discontents*"); *see also* S. Friedman, *Noncompensatory Capital Shifts: Rethinking Capital Accounts*, 107 TAX NOTES 597 (May 2, 2005) (hereafter referred to as "*Rethinking Capital Accounts*").

[87] As discussed above, liquidation value is based on the fair market value of assets rather than book value.

[88] *See supra* note 86 and accompanying text.

[89] *See*, *e.g.*, *Cartwright*, SCt, 73-1 USTC ¶12,926, 411 US 546, 551, 93 SCt 1713 (1973) ("[t]he willing buyer-willing seller test of fair market value is nearly as old as the federal income, estate, and gift taxes themselves ...").

[90] K. Burke & G. McCouch, *Commentary: Family Limited Partnerships: Discounts, Options, and Disappearing Value*, 6 FLA. TAX REV. 649, 653 and 654 (2004) (footnotes omitted) (hereafter referred to as "*Family Limited Partnerships*"). As support for the stated analysis, the commentators state, in a footnote:

> *See Shepherd v. Commissioner*, 115 TC 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002). In *Shepherd*, the Tax Court treated a contribution of land to a newly formed partnership as an indirect gift of undivided fractional interests in the land. The court allowed a combined 15% discount to reflect lack of operational control, risk of disagreement about disposition, and possibility of future partition. *See* 115 TC at 388-90, 400-02. This was less than half the 33.5% stipulated discount for lack of control and lack of marketability that would have applied to gifts of limited partnership interests.

Id. at 654 n. 12.

[91] *Id*. at 665 and 666. In discussing the concept of discounts in relation to the allocation system based on capital accounts, one commentator has stated:

> That the valuation of the whole (partnership) does not equal the sum of the values of its parts (the partnership interests) suggests that the whole differs in kind from its parts. Moreover, the idea that a partnership is merely an aggregate of the separate interests of the partners can readily be translated into operational tax rules only by assuming that partnership assets and interests in a partnership are merely two expressions of the same thing and that the aggregate value of one equals the aggregate value of the other.

L. Lokken, *Partnership Tax: As the World of Partnership Taxation Turns*, 56 SMU L. Rev. 365, 373 (2003).

[92] The legislative history to the Deficit Reform Act of 1984 under Code Sec. 707(a)(2)(A) relating to disguised allocations and distributions in exchange for property highlights how capital accounts can diverge from true economic interests and present the opportunity for abuse. In determining whether purported allocations and distributions might be treated as made in exchange for property, one factor is stated as follows:

> The sixth factor, which relates to purported allocations/distributions for property, is whether the requirement that capital accounts be respected under section 704(b) (and the proposed regulations thereunder) makes income allocations which are disguised payments for capital economically unfeasible and therefore unlikely to occur. This generally will be the case unless (i) the valuation of the property contributed by the partner to the partnership is below the fair market value of such property (thus improperly understating the amount in such partner's capital account), or (ii) the property is sold by the partner to the partnership at a stated price below the fair market value of such property, or (iii) *the capital account will be respected at such a distant point in the future that its present value is small and there is to be no meaningful return on the capital account in the intervening period*.

Jt. Comm. on Tax'n, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 229 (1984) (emphasis added). The highlighted statement recognizes the prospect that property might be treated as contributed for its fair market value, but the partner's interest will not be liquidated until such a distant point in the future that the fair market value capital account credit given for the property does not translate into a partnership interest that reflects the fair market value of the contribution.

[93] Reg. §1.704-2(b)(1).

[94] Reg. §1.704-2(e)(2).

[95] Reg. §1.704-1(b)(2)(ii)(b).

[96] Reg. §1.704-1(b)(2)(ii)(d).

[97] Reg. §1.704-2(b)(1).

[98] Reg. §§1.704-3(a)(1); 1.704-3(b)(1).

[99] Reg. §1.704-3(b)(1) (final sentence). It may be possible to cure shortfalls in taxable allocations caused by the ceiling rule through the use of the curative or remedial method under Code Sec. 704(c). Reg. §1.704-3(c) (curative method); Reg. §1.704-3(d) (remedial method).

[100] Reg. §1.704-3(a)(6)(i).

[101] Reg. §1.704-3(a)(1) (second sentence).

[102] Reg. §§1.704-1(b)(2)(iv)(*h*); 1.704-3(a)(3)(i).

[103] Reg. §1.704-3(b)(1) (traditional method). Under the curative or remedial methods, other items may be allocated to make up for any shortfall in tax items that should match book items allocated to a non-contributing partner. Reg. §§1.704-3(c); 1.704-3(d).

[104] Reg. §1.704-3(b)(1) (traditional method). Again, under the curative or remedial methods, other items may be allocated to make up for any shortfall in tax items that should match book items allocated to a non-contributing partner. Reg. §§1.704-3(c); 1.704-3(d).

[105] *See generally* D. Simmon, *Built-In Gain and Built-In Loss Property on Formation of a Partnership: An Exploration of the Grand Elegance of Partnership Capital Accounts*, 9 Fl. Tax Rev. 599 (2009); H. Abrams, *Partnership Inequalities: The Consequences of Book/Tax Disparities*, 92 Taxes 3 (2014).

[106] Reg. §1.704-3(a)(3)(i).

[107] Rev. Proc. 93-27, 1993-2 CB 343; Rev. Proc. 2001-43, 2001-1 CB 191.

[108] *McKee and Nelson Submit Amicus Brief Arguing That Receipt of a Profits Interest by a Service Partner is Not Taxable*, 91 T.N.T. 44-73 (Jan. 8, 1991).

> [A] partner cannot become entitled to 'share' as a partner in future partnership income under an aggregate theory until the partnership has 'paid' him under an entity theory with 'property' representing the right to 'share,' under an aggregate theory, in future income. The harsh practical result of this circularity is that the recipient partner will be taxed twice on the same partnership income—once under an entity theory when the present value of the income is taken into account in valuing the 'property' received from the partnership, and again under the aggregate theory when the income is realized by the partnership and included in the partner's distributive 'share.'

[109] Reg. §1.108-8(b)(1).

[110] Reg. §1.108-8(b)(2). The preamble to the proposed regulations stated:

> The IRS and the Treasury Department believe that provided certain requirements are satisfied, it is appropriate to allow the partnership and the creditor to value the partnership interest transferred to the creditor in a debt-for-equity exchange (debt-for-equity interest) based on liquidation value. For this purpose, liquidation value equals the amount of cash that the creditor would receive with respect to the debt-for-equity interest if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets, and then liquidated. If a partnership maintains capital accounts in accordance with the capital accounting rules of §1.704-1(b)(2)(iv), the amount by which the creditor's capital account is increased as a result of the debt-for-equity exchange will equal the fair market value of the indebtedness exchanged. *See* §1.704-1(b)(2)(iv)(*b*) and (*d*).

REG-164370-05, 73 FR 64903 (Oct. 31, 2008) (preamble).

[111] Reg. §1.108-8(b)(2)(i)(A).

[112] Proposed Reg. §1.108-8(b)(1)(i).

[113] If cancellation of indebtedness income is measured by reference to the difference in the adjusted issue price of the debt and the liquidation value of the partnership assets, the allocated cancellation of indebtedness income would increase partner capital accounts by an amount equal to the asset liquidation value that is uncovered by the contribution of the debt.

[114] Proposed Reg. §1.751-1(b)(2).

[115] Proposed Reg. §1.751-1(b)(2)(iv).

[116] *See*, *e.g.*, M. Jackel & A. Stok, *Blissful Ignorance: Section 751(b) Uncharted Territory*, 98 Tax Notes 1557, 1576 (Mar. 10, 2003) (describing Code Sec. 704(c) approach).

[117] Reg. §1.704-1(b)(4)(ix).

[118] *Id*.

[119] Reg. §1.704-1(b)(4)(ix)(*a*)(*2*).

[120] Reg. §1.704-1(b)(4)(ix)(*a*)(*3*). As a third requirement, the holder of the noncompensatory option must not be treated as a partner under Reg. §1.761-3. Reg. §1.704-1(b)(4)(ix)(*a*)(*1*).

[121] Reg. §1.704-1(b)(2)(iv)(*h*)(*2*).

[122] Reg. §1.704-1(b)(2)(iv)(*s*).

[123] Reg. §1.704-1(b)(4)(x).

[124] Reg. §1.704-2(e)(2).

[125] In commenting on potential regulations relating to compensatory partnership interests, a group of respected commentators suggested that the "Subchapter K approach" (*i.e.*, liquidation value) would be more appropriate than the "Code Sec. 83 approach" (*i.e.*, willing-buyer-willing-seller) for purposes of analyzing the results upon the exercise of a compensatory partnership option. N.Y. St. Bar Assoc. (Tax Section), *Report on the Taxation of Partnership Options and Convertible Securities*, p. 69, *available at* 2002 T.N.T. 21–24 (Feb. 4, 2002) (hereafter referred to as "*NYSBA First Partnership Option Report*"). In support of this suggestion, the commentators stated:

> First, that approach would harmonize the tax treatment of the exercise of compensatory partnership options with the tax treatment of direct issuances of compensatory profits interests. We see no compelling reason for differentiating between the valuation methodologies used in those two situations, and harmonizing the two sets of rules would eliminate the incentive to restructure compensatory options as partnership profits interests in order to achieve a more favorable tax result. Second, the Subchapter K approach generally would be easier to apply, because it requires valuing only the partnership assets and does not require analyzing a myriad of other factors (many of which are quite subjective) relevant to determining the true fair market value of a partnership interest. The Subchapter K approach would create a difference between the law regarding compensatory partnership options and the law regarding corporate stock options, but that difference would simply mirror the existing tension, implicit in Rev. Proc. 93-27, between the treatments of partnership equity and corporate stock. On balance, we believe it more important to have internal consistency within Subchapter K.

Id. at 69 and 70.

[126] Reg. §1.721-1(b)(1). The regulation also states: "To the extent that an interest in capital representing compensation for services rendered by the decedent prior to his death is transferred after his death to the decedent's successor in interest, the fair market value of such interest is income in respect of a decedent under Code Sec. 691." *Id*. Proposed regulations issued in 1971 and 2005 would have modified the regulation to account for the enactment of Code Sec. 83, but neither such regulation has ever been finalized.

[127] *See supra* notes 15–52 and accompanying text. One commentator has cautioned against relying too heavily on the narrow scope of Reg. §1.721-1(b)(1). In addressing whether a preferred interest that is not limited by reference to income can give rise to a current guaranteed payment, the commentator stated:

> Treasury Regulations explicitly provide that to the extent a partner gives up the right to the return of its capital as compensation for services rendered, that transfer is to be treated as a guaranteed payment. The investors have not performed services and there is no

counterpart provision involving partners receiving capital as compensation for providing capital. Too much, however, cannot be read into regulatory silence and, indeed, one can argue that the regulation as to services should apply by analogy.

Capital Accounts and Their Discontents, *supra* note 86, at 808 and 809 (footnote omitted).

In a separate article, that same commentator stated:

> [I]f one takes the issue of capital shifts seriously, it is difficult to devise a rationale that would provide significant comfort that a capital shift does not result in income. One alternative is not to take capital shifts seriously. Capital contributions to a partnership on its formation are generally tax-free under section 721; also, it is rare for a person acquiring any kind of property for cash to be allocated income in connection with the acquisition. Given that the capital account system is only a safe harbor, one can challenge the IRS to point to the realization and recognition events. Given that most capital shifts are business- and not tax-motivated and that the IRS is sympathetic on the policy issues, that is not a challenge that the IRS may be interested in meeting.

Rethinking Capital Accounts, *supra* note 86, at 504.

In the distribution context, Reg. §1.704-1(b)(2)(ii)(*b*)(5), discussed *supra* at note 71, arguably implies some relief with respect to capital shifts in the context of a redemption or sale of a partner's interest where the transaction is negotiated at arm's length by parties with material adverse interests so long as the purpose of the transaction is not to avoid the economic effect requirement. Admittedly, the regulation does not specifically address the treatment of the potential capital shift but instead provides that future allocations following such a transaction will not necessarily fail the test for economic effect.

[128] Reg. §1.721-1(b)(1).

[129] In *F.C. McDougal*, 62 TC 720, Dec. 32,746 (1974), the Tax Court stated:

> [I]f the obligation arose out of a loan, the obligee will recognize no income by reason of the transaction; if the obligation represents the selling price of a capital asset, he will recognize a capital gain to the extent that the amount he is deemed to have realized exceeds his adjusted basis in the asset; if the obligation represents compensation for services, the transaction will result in ordinary income to the obligee in an amount equal to the value of the interest which he received in the joint venture.

Id. at 726 n. 12.

[130] Reg. §1.721-1(d)(2) ("Code Sec. 721 does not apply to a debt-for-equity exchange to the extent the transfer of the partnership interest to the creditor is in exchange for the partnership's indebtedness for unpaid rent, royalties, or interest (including accrued original issue discount) that accrued on or after the beginning of the creditor's holding period for the indebtedness").

[131] Reg. §1.721-1(b)(2).

[132] Reg. §1.351-1(b)(1). In Rev. Rul. 79-10, 1979-1 CB 140, the IRS applied a similar theory in analyzing a liquidating distribution that was not in proportion to stock held by the shareholders.

[133] Reg. §1.351-1(b)(2), Ex. 2.

[134] Reg. §1.351-1(b)(2), Ex. 1; Reg. §25.2511-1(h)(1); *Est. of Trenchard*, 69 TCM 2164, Dec. 50,536(M), TC Memo. 1995-121 (1995) (contribution of property with value in excess of stock received gave rise to a gift), *reconsideration denied*, 69 TCM 2732, Dec. 50,663(M), TC Memo 1995-232 (1995). *See also* Rev. Rul. 76-454, 1976-2 CB 102 (contribution of property with value in excess of stock received resulted in a dividend to the other shareholders).

[135] 19 TC 659, Dec. 19,410 (1953).

[136] Significantly, prior to enactment of the 1954 Code, partnerships generally were viewed as an aggregate, with most tax issues being analyzed as if the partners owned their shares of the partnership's assets directly. *See* J. Rabkin & M. Johnson, *The Partnership Under the Federal Tax Laws*, 55 HARV. L. REV. 909, 911 (1942). Reg. §1.721-1(b)(1), which recognizes the partnership as an entity clearly separate from its partners, had not yet been promulgated. Other pre-1954 cases analyzing what were arguably compensatory capital shifts include *Rosenbaum*, 16 TC 664, Dec. 18,185 (1951), *supplemental opinion*, 18 TC 35, Dec. 18,889 (1952), and *Farris*, CA-10, 55-1 USTC ¶9411, 222 F2d 320 (1955). In both cases, the court found no taxable capital shift. In *Rosenbaum*, the court found that the taxation of the adjustment to capital should be delayed until liquidation, and in *Farris*, the court indicated that the sharing with respect to the capital structure was impacted by the value of services contributed.

[137] *See*, *e.g.*, G. Mincey, E. Sloan, & S. Banoff, *Rev. Proc. 2001-43, Section 83, and Unvested Profits Interests*, 95 J. TAX'N 205, 207 n. 9 (Oct. 2001).

[138] 19 TC at 662, Dec. 19,410.

[139] CA-5, 64-2 USTC ¶9684, 335 F2d 487 (1964), *rehearing denied*, CA-5, 65-1 USTC ¶9125, 339 F2d 885 (1964), *cert. denied*, SCt, 380 US 961, 85 SCt 1104 (1965).

[140] 56 TC 530, Dec. 30,838 (1971), *aff'd*, CA-7, 74-1 USTC ¶9306, 492 F2d 286 (1974).

[141] The taxpayer had an unrelated short-term capital loss available to offset the gain, so the capital gain character, even though short term, provided a benefit to the taxpayer.

[142] Code Sec. 83 had not yet been enacted as of the date when the profits interest was issued.

[143] Reg. §1.721-1(b)(1) (emphasis added).

[144] 56 TC at 546, Dec. 30,838.

[145] *Id*.

[146] CA-7, 74-1 USTC ¶9306, 492 F2d 286 (1974). The Seventh Circuit stated:

> The quoted portion of the regulation may well be read, like §721, as being directly addressed only to the consequences of a contribution of money or other property. It asserts that when a partner making such contributions transfers to another some part of the contributing partner's right to be repaid, in order to compensate the other for services or to satisfy an obligation to the other, §721 does not apply, there is recognition of gain or loss to the contributing partner, and there is income to the partner who receives, as compensation for services, part of the right to be repaid.
>
> The regulation does not specify that if a partner contributing property agrees that, in return for services, another shall be a partner with a profit-share only, the value of the profit-share is not income to the recipient. An implication to that effect, such as is relied on by taxpayer, would have to rest on the proposition that the regulation was meant to be all inclusive as to when gain or loss would be recognized or income would exist as a consequence of the contribution of property to a partnership and disposition of the partnership interests. It would have to appear, in order to sustain such implication, that the existence of income by reason of a creation of a profit-share, immediately having a determinable market value, in favor of a partner would be inconsistent with the result specified in the regulation.
>
> We do not find this implication in our own reading of the regulation.

Id. at 288 and 289.

[147] (Jul. 23, 1975).

[148] *Id*. The GCM also cites legislative history issued in connection with proposed legislation specifically addressing capital shifts, although such legislation was never enacted. The Seventh Circuit in *Diamond* stated that the legislation had been proposed at the suggestion of an advisory group who reviewed the partnership regulations issued following enactment of the 1954 Act due to concern expressed by that group that Reg. §1.721-1(b)(1) lacked an adequate "statutory basis in the light of §721 providing that there shall be no recognition of gain or loss in the case of a contribution of property." CA-7, 74-1 USTC ¶9306, 492 F2d at 289. In discussing the proposed legislation, the IRS stated:

> In addition, support for including unrealized appreciation in partnership capital may be found in the proposed Trust and Partnership Income Tax Revision Act of 1960, H.R. 9662, 86th Cong. 2d Sess. (1960). That Act would have added a section 770 to the Code to govern the treatment of an exchange of an interest in partnership capital for services rendered to the partnership. The Senate Report states as follows:

> It is important to note that the section does not deal with the transfer of a partnership interest which gives the service partner merely the right to share in appreciation in partnership assets which occurs, or in partnership profits which are earned, subsequent to the date of transfer. Thus, for example, assume that a person who has been associated with a cash basis partnership as an employee is admitted as a partner in the partnership, and acquires an interest in the appreciation then existing in partnership assets, as well as an interest in profits of the partnership which have been earned as of that time, but not yet taken into partnership income. Such pre-existing appreciation and previously earned profits are considered to be an interest in partnership capital, and section 770 is applicable. However, if such service partner had acquired only an interest in the appreciation occurring subsequent to his admission and in profits of the partnership earned after such time, the rules of section 770 would have no application. S. Rep. No. 1616, 86th Cong. 2d Sess. 117 (1960).

GCM 36346 (Jul. 23, 1975).

[149] *Id*.

[150] CA-8, 91-2 USTC ¶50,420, 943 F2d 815 (1991).

[151] Having won at the Tax Court level, the IRS actually reversed course and conceded on appeal that a profits interest should not be currently taxable at the time issued by the partnership. *Id*. at 818. Nonetheless, the Eighth Circuit addressed the issue on the merits in its opinion.

[152] 1993-2 CB 343. Treasury and the IRS subsequently issued Rev. Proc. 2001-43, 2001-2 CB 191, addressing the treatment of unvested profits interests.

[153] *Id*.

[154] *Id*. *Cf.* Reg. §1.1061-3(c)(3)(i) (defining capital interest for purposes of exception under Code Sec. 1061 as "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value at the time the interest was received and the proceeds were then distributed in a complete liquidation of the partnership.").

[155] 62 TC 720, Dec. 32,746 (1974).

[156] *Id*. at 725.

[157] 1999-1 CB 434. In *ES NPA Holding, LLC*, 121 TCM 1522, Dec. 61,878(M), TC Memo. 2021-68, the Tax Court also considered the transfer of an interest in a disregarded LLC under Rev. Rul. 99-5, 1999-1 CB 434, in the compensatory context, although the court found there to be a genuine issue of material fact as to whether the interest transferred was a capital or profits interest and hence held that summary judgment was not appropriate.

[158] 62 TC at 726, Dec. 32,746; *see also W.G. Campbell*, CA-8, 91-2 USTC ¶50,420, 943 F2d 815 (1991), where the court stated:

> [R]egulation 1.721-1(b)(1) simply clarified that the nonrecognition principles no longer apply when the right to return of that capital asset is given up by transferring it to another partner. At that time, the property has been disposed of and gain or loss, if realized, must be recognized. As a corollary, section 1.721-1(b)(1) outline the tax treatment of the partner who receives that capital interest.

Id. at 822; GCM 36346 (Jul. 23, 1975) (citing *McDougal* for the proposition that if the value of the capital interest exceeds the basis, "the transferor will be required to recognize gain").

[159] *Id*.

[160] 74 TC 939, Dec. 37,114 (1980), *aff'd*, CA-10, 83-1 USTC ¶9270, 703 F2d 485 (1983).

[161] Because the value of the partnership interest was difficult to determine, the court measured the value of the capital interest received as compensation by reference to the value of the services performed, reasoning that in an arm's length transaction, the value of the services and compensatory partnership interest should be the same. 74 TC at 953, Dec. 37,114.

[162] *Id*.

[163] *Id*.; *see also T.E. Larson*, 55 TCM 1637, Dec. 44,993(M), TC Memo. 1988-387 (1988) (partner received a capital interest in satisfaction of unpaid management fees; court cited *Hensel-Phelps* in treating the capital interest received as subject to Code Sec. 83); 1993 FSA Lexis 48 (Nov. 10, 1983) (applying Code Sec. 83 to determine the timing for including the value of a capital interest in gross income); *cf. S. Schulman*, 93 TC 623, Dec. 46,181 (1989) (Code Sec. 83 applies to a partnership option).

[164] 60 TCM 1171, Dec. 46,963(M), TC Memo. 1990-571 (1990), *aff'd*, CA-8, 92-2 USTC ¶50,365, 969 F2d 669 (1991).

[165] *Id*.

[166] CA-8, 92-2 USTC ¶50,365, 969 F2d at 674.

[167] *Id*. at 675; *see also* GCM 36346 (Jul. 23, 1975), which states:

> [A]ssume that a person who has been associated with a cash basis partnership as an employee is admitted as a partner in the partnership, and acquires an interest in the appreciation then existing in partnership assets, as well as an interest in profits of the partnership which have been earned as of that time, but not yet taken into partnership income. Such pre-existing appreciation and previously earned profits are considered to be an interest in partnership capital, and section 770 [sic] is applicable.

Id. This GCM discusses a proposed revenue ruling, never issued, that was proposed to address the decision in *Sol Diamond*, 56 TC 530, Dec. 30,838 (1971), *aff'd*, CA-7, 74-1 USTC ¶9306, 492 F2d 286 (1974).

[168] 60 TCM 71 (1991) *aff'd*, CA-8, 92-2 USTC ¶50,365, 969 F2d 669 (1991).

[169] CA-8, 92-2 USTC ¶50,365, 969 F2d at 675.

[170] 69 TCM 2283, Dec. 50,558(M), TC Memo. 1995-140 (1995).

[171] *Id*.; *see also* 1996 FSA Lexis 246 (Jun. 25, 1996) (discussing *Johnston* in the context of a capital shift occurring after formation of a partnership).

[172] 69 TCM 2283, Dec. 50,558(M), TC Memo. 1995-140 (1995).

[173] *Id*.

[174] *Id*.

[175] *Id*. at n. 16; *see also* S. Banoff, *What's the Value of a Capital Interest Received for Services?* 96 J. TAX'N 57 (2002).

[176] 141 TC 477, Dec. 59,705 (2013).

[177] 1993-2 CB 343.

[178] 2001-1 CB 191.

[179] *Id*. at 488.

[180] *Id*. at 488 n. 13.

[181] *Id*. at 498. The court cited *W.G. Campbell*, CA-8, 91-2 USTC ¶50,420, 943 F2d 815 (1991) as acknowledging some question as to whether a partnership profits interest is property under Code Sec. 83, but quoted that case as stating "the receipt of a capital interest appears to be taxable under the authority of Code Sec. 83 of the Internal Revenue Code." *Id*. at 820.

[182] *Crescent Holdings*, 141 TC at 504-505, Dec. 59,705.

[183] *See infra* notes 232–235 and 325–327 and accompanying text.

[184] Note that the potential for a gift is recognized under the Code Sec. 351 regulation addressing contributions to a partnership when stock is not received in proportion to contributed value. Reg. §1.351-1(b)(1).

[185] 115 TC 376, Dec. 54,098 (2000), *aff'd*, CA-11, 2002-1 USTC ¶60,431, 283 F2d 1258 (2002).

[186] CA-11, 2002-1 USTC ¶60,431, 283 F2d at 1261. Reg. §25.2511-1(h)(1), applicable to corporations, was cited as support for this statement.

[187] CA-11, 2002-1 USTC ¶60,431, 283 F2d at 1261.

[188] *See W.A. Linton*, CA-9, 2011-1 USTC ¶60,611, 630 F3d 1211 (2011); *M.W. Senda*, CA-8, 2006-1 USTC ¶60,515, 433 F3d 1044 (2006), *rehearing denied*, CA-8, 2006 U.S. App. Lexis 8153 (2006); *D. Heckerman*, DC-WA, 2009-2 USTC ¶60,578 (2009).

[189] *See T. Holman*, 130 TC 170, Dec. 57,455 (2008) (partnership formed six days in advance of the gift), *aff'd*, CA-8, 2010-1 USTC ¶60,592, 601 F3d 763 (2009), *rehearing denied*, CA-8, 2010 U.S. App. Lexis 27469 (2010); *B. Gross*, 96 TCM 187, Dec. 57,544(M), TC Memo. 2008-221 (2008) (partnership formed 11 days in advance of the gift).

[190] *See generally Family Limited Partnerships*, *supra* note 90.

[191] *S.J. Pierre,* 133 TC 24, Dec. 57,910 (2009), *supplemental decision*, 99 TCM 1436, Dec. 58,217(M), TC Memo. 2010-106 (2010); *cf. RERI Holdings I, LLC*, 143 TC 41, Dec. 59,987 (2014) (following *Pierre* in evaluating the fair market value of a charitable contribution of a remainder interest in a disregarded LLC).

[192] Rev. Rul. 99-5, 1999-1 CB 434, treats such a transaction, for Federal tax purposes, as a transfer of assets followed by a contribution of such assets to the partnership.

[193] *S.J. Pierre,* 133 TC 24, 34-36, Dec. 57,910 (2009).

[194] *See, e.g.*, *W.A. Linton*, CA-9, 2011-1 USTC ¶60,611, 630 F3d 1211 (2011); *D. Heckerman*, DC-WA, 2009-2

USTC ¶60,578 (2009); *T. Holman*, 130 TC 170, Dec. 57,455 (2008), *aff'd*, CA-8, 2010-1 USTC ¶60,592, 601 F3d 763 (2009); B. *Gross*, 96 TCM 187, Dec. 57,544(M), TC Memo. 2008-221 (2008).

[195] Reg. §1.704-1(b)(2)(iv)(*l*).

[196] (Aug. 7, 2003); *see also* J. Erickson, *Recapitalizations of Partnerships; General Issues under Subchapter K*, 45 TAX MGMT. (BNA) (Mar. 22, 2004).

[197] LTR 200345007 (Aug. 7, 2003).

[198] (Oct. 9, 2014).

[199] *Id*.

[200] 1998 F.S.A. Lexis 571 (Nov. 10, 1998).

[201] *Id*. In GCM 37053 (Mar. 22, 1977), the IRS noted that the receipt by a convertible noteholder of a lesser interest in partnership capital than the value of the note surrendered could give rise to a taxable capital shift, for example if the shift was intended to compensate the general partner for services, but stated that the facts under consideration did not indicate any desire to create such a compensatory capital shift.

[202] The court in *F.C. McDougal*, 62 TC 720, Dec. 32,746 (1974), did undertake some discussion of the basis and holding period results that followed from the deemed transactions in the capital shift, although technically these transactions occurred in connection with the formation of the partnership. Capital was not shifting in connection with a pre-existing partnership.

[203] In Notice 2000-29, 2000-1 CB 1241, Treasury and the IRS requested comments on the tax treatment of the exercise of an option to acquire a partnership interest, the exchange of convertible debt for a partnership interest, and the exchange of a preferred interest in a partnership for a common interest in that partnership.

[204] Reg. §1.721-2(g)(1) provides that an option includes a contractual right to acquire an interest in the issuing partnership, including a call option, warrant, or other similar arrangement, the conversion feature of convertible debt or the conversion feature of convertible equity.

[205] REG-103580-02, 68 FR 2930 (Jan. 22, 2003) (preamble).

[206] Rev. Rul. 78-182, 1978-1 CB 265 cites Rev. Rul. 58-234, 1958-1 CB 279, stands for the proposition that when an option to buy property is exercised, the option cost (premium) will be included by the optionee, with the option price thereupon paid or accrued, in determining the total cost basis of the property that the optionee purchased pursuant to the option, for purposes of determining gain or loss in the future. The preamble to the proposed regulations cites Rev. Rul. 78-182.

[207] REG-103580-02, 68 FR 2930 (Jan. 22, 2003) (preamble).

[208] *Id*.

[209] Reg. §1.704-1(b)(2)(iv)(*s*).

[210] Reg. §1.704-1(b)(2)(iv)(*f*)(*5*)(*iv*).

[211] Reg. §1.704-1(b)(2)(iv)(*h*)(*2*). Note that because the value accounted for in a revaluation can be reduced only to the extent of unrealized appreciation in partnership assets, it is not possible to reduce the value of a partnership asset below the then-current Code Sec. 704(b) book value of the asset.

[212] *Id*.

[213] *Id*.

[214] Reg. §1.704-1(b)(2)(iv)(*h*)(*2*).

[215] Reg. §§1.704-1(b)(2)(iv)(*s*)(*1*) & (*2*).

[216] Reg. §1.704-1(b)(2)(iv)(*s*)(*3*).

[217] Reg. §1.704-1(b)(4)(x).

[218] *Id*. The preamble to the final regulations states:

> The Treasury Department and the IRS considered other alternatives but believe that corrective allocations are the most administrable alternative means to address the potential problem of income shifting when, prior to the exercise of a noncompensatory option, a partnership recognizes gain or loss that is, in part, economically attributable to the option holder, but is allocated entirely to the existing partners.

T.D. 9612, 2013-2 CB 678 (preamble).

[219] *Capital Accounts and Their Discontents*, *supra* note 86, at 813 ("[w]hat the proposed regulations [relating to noncompensatory options] illustrate is that while the IRS is sympathetic to avoiding income recognition related to capital shifts, it will, when faced with the alternatives of income recognition or 'wrong' capital account balances, protect the capital account system.").

[220] The preamble to the final regulations recognized that corrective allocations "address the potential problem of income shifting when, prior to the exercise of a noncompensatory option, a partnership recognizes gain or loss that is, in part, economically attributable to the option holder, but is allocated entirely to the existing partners." T.D. 9612, 2013-2 CB 678. Treasury and the IRS recognize that corrective allocations may not conform capital accounts in all situations. Partnership items are correctively allocated to the exercising option holder only from items properly allocable to a partner whose capital account was reduced and only to the extent of such reduction. In some instances, that partner may leave the partnership before the corrective allocations are made, in which case the corrective allocations will not be made. *Id*.

[221] *Id*.

[222] *Id*.

[223] *Id*.

[224] *Id*.

[225] *Id*.

[226] REG-105346-03, 2005-1 CB 1244 (preamble).

[227] *Id*.

[228] Proposed Reg. §1.707-1(c). As a result, the timing of the partnership's deduction would be determined by reference to the partner's income inclusion rather than determining the partner's income inclusion by reference to the timing of the partnership's deduction. *Compare* Code Sec. 83(h) *with* Code Sec. 706(a) & Reg. §1.707-1(c).

[229] REG-105346-03, 2005-1 CB 1244 (preamble).

[230] *Id*.

[231] Proposed Reg. §1.704-1(f)(5)(*c*). Technically, the proposed regulations require that a partnership agreement must include a provision requiring forfeiture allocations in order for allocations to satisfy the rules related to "partners' interests in the partnership" when made while a partner who has made a Code Sec. 83(b) election holds a forfeitable interest. The proposed regulations contain an anti-abuse rule providing that allocations will not be deemed to satisfy the "partners' interests in the partnership" rules if, at the time the Code Sec. 83(b) election is made, there is a plan that the interest will be forfeited. Proposed Reg. §1.704-1(f)(5)(*e*).

[232] REG-105346-03, 2005-1 CB 1244 (preamble).

[233] Proposed Reg. §1.704-1(b)(5), Ex. 29(ii).

[234] REG-105346-03, 2005-1 CB 1244 (preamble).

[235] Interestingly, the "rule" stated in the preamble is not actually contained in the proposed regulations. The stated result would follow so long as the partnership revalues its assets as permitted under Reg. §1.704-1(b)(2)(iv)(*f*)(*5*)(*iii*), but such a revaluation technically is not required. Regulations issued relating to the contribution of debt in exchange for equity in a partnership similarly provide that the partnership will not recognize gain or loss upon the transfer of a partnership interest to a creditor in a debt-for-equity exchange for unpaid rent, royalties, or interest. Reg. §1.721-1(d)(2). While not stated in that preamble or regulations, presumably the same revaluation and reverse Code Sec. 704(c) rules should apply in that context to ensure that appreciated capital funding the related deduction ultimately will be recognized by the partners who benefitted from the deduction for such items.

[236] *See H.L. Blalock*, 35 TC 649, Dec. 24,628 (1961), *acq.* 1961-2 CB 4; *F.T. Norman*, 27 TCM 181 (1968), *aff'd*, CA-3, 69-1 USTC ¶9245, 407 F2d 1337 (1969), *cert. denied*, SCt, 395 US 947, 89 SCt 2021 (1969).

[237] *Cf.* Rev. Rul. 93-7, 1993-1 CB 125 (partnership acquires debt owed by a partner and distributes the debt to the partner; partner recognizes gain with respect to the debt because there would be no mechanism for preserving the gain or loss in the debt).

[238] 62 TC 720 (1974).

[239] *See supra* notes 155–159 and accompanying text.

[240] Rev. Proc. 93-27, 1993-2 CB 343; Rev. Proc. 2001-43, 2001-2 CB 191.

[241] *See supra* cases discussed in section IX.A.

[242] Proposed Reg. §1.83-3(e)(1); Notice 2005-43, 2005-24 IRB 121. *See also NYSBA First Partnership Option Report*, *supra* note 125 (discussing that the "Subchapter K approach" (*i.e.*, liquidation value) would be more appropriate than the "Code Sec. 83 approach" (*i.e.*, willing-buyer-willing-seller) for purposes of analyzing the results upon the exercise of a compensatory partnership option). Note that proposed legislation related to the taxation of carried interest would require that all compensatory partnership interests must be valued by reference to liquidation value. *See* H.R. 1068 (Carried Interest Fairness Act of 2021) §2 (2021) (amending Code Sec. 83(c)).

[243] Reg. §1.83-1(a)(1)(i); *Steinberg*, 46 TCM 1238 , Dec. 40,415(M), TC Memo. 1983-534 (1983).

[244] REG-105346-03, 2005-1 CB 1244 (preamble).

[245] *Id*.

[246] *See, e.g.*, N.Y. St. Bar Assoc., *Comments Regarding Partnership Interests Received in Exchange for*

Services, reprinted at 2005 T.N.T. 214-19 (Oct. 26, 2005) (hereafter referred to as "*NYSBA Comments on Compensatory Interests*") (suggesting that the difference between the amount included in income under Code Sec. 83 and the liquidation value of the capital interest should be taxed as a guaranteed payment under Code Sec. 707(c)); Am. Bar Assoc., *Comments on Exchanges of Partnership Equity for Services, reprinted at* 2006 T.N.T. 1-34 (Dec. 29, 2005) (hereafter referred to as "*ABA Comments on Compensatory Interests*") (suggesting that the regulations either should (a) allow the capital account of the service partner to be determined based on the agreed-upon liquidation value of the partnership interest rather than the fair market value of the partnership interest granted or (b) provide a mechanism similar to that provided in the proposed regulations relating to noncompensatory options to eliminate the disparity between the service partner's capital account based on the fair market value of the partnership interest and a capital account balance based on the parties' economic deal with respect to liquidating distributions); L.A. County Bar Assoc., *Comments on Proposed Partnership Equity Compensation Regulations*, 2006 T.N.T. 133-56 (Jun. 19, 2006) (hereafter referred to as "*LA County Bar Comments on Compensatory Interests*") (suggesting that the proposed regulations should be modified to eliminate the rule requiring that capital accounts must equal the income inclusion with respect to the receipt of a compensatory partnership interest and to indicate that both the Code Sec. 83 income and the corresponding deduction are irrelevant for capital account maintenance purposes and should be recognized for tax purposes only).

[247] Comments received prior to issuance of the proposed regulations had suggested that the Code Sec. 704(b) safe harbor rules "should be amended to allow partnerships to reallocate capital between the historic partners and service provider to accord with the economic agreement of the parties." REG-105346-03, 2005-1 CB 1244 (preamble).

[248] *See also* Reg. §1.108-8(b) (permitting the determination of the fair market value of a partnership interest received in exchange for the contribution of debt based upon the liquidation value of such interest, assuming certain requirements are met, but otherwise requiring that the partnership interest would be valued under general tax principles (*i.e.*, willing-buyer-willing-seller)) discussed *supra* at text accompanying notes 109–113.

[249] Arm's length bargain purchases are one exception that immediately comes to mind where the gross income authority would not tax a capital shift. *See supra* note 25 and 26 and accompanying text.

[250] *See supra* notes 207 (referencing decision not to tax recipient of capital shift for noncompensatory options), 232 (referencing decision not to tax partnership on gain related to share of assets shifted for compensatory capital interest), and *infra* note 326 (referencing decision not to tax partnership on gain related to share of assets indirectly paid in satisfaction of an obligation).

[251] *See supra* notes 139–182 and accompanying text discussing case law and administrative authority as well as note 207 and accompanying text discussing rationale for regulations addressing noncompensatory options.

[252] *See supra* notes 217 and 218 and accompanying text.

[253] *See supra* notes 109–113 and 242–244 and accompanying text.

[254] As discussed *supra* at notes 84, 87 and 88 and accompanying text, a partner's capital account differs from the liquidation value associated with a partner's interest in that the partner's capital account represents the proceeds that the partner would receive in liquidation if all assets were sold for the partnership's Code Sec. 704(b) book value while liquidation value assumes that all assets are sold for their willing-buyer-willing-seller fair market value.

[255] Reg. §1.704-1(b)(2)(iv)(*l*).

[256] Reg. §§1.704-3(a)(7), 1.704-4(d)(2), 1.737-1(c)(2)(iii).

[257] *See supra* note 236.

[258] *See supra* notes 232–237 and accompanying text.

[259] Even if John remains a partner after transferring a portion of his partnership interest, there is no mechanism in the rules of subchapter K for John to maintain his share of built-in gain in partnership assets. The rules relevant to Code Sec. 704(c) provide that a proportionate part of the Code Sec. 704(c) gain associated with the pre-transfer partnership interest will migrate with the transferred portion of the interest. *See supra* note 256. In addition, in this transaction, John's gain is determined by reference to his adjusted basis in the transferred interest and not the underlying partnership assets. For a number of reasons, the inside and outside basis amounts may not be the same.

[260] Regulations proposed in 2005 would have explicitly changed the timing rules for the capital shift to conform to the rules of Code Sec. 83 (*i.e.*, timing of deduction conforms to partner's inclusion in income). *See supra* note 228 and accompanying text.

[261] *See supra* note 245 and accompanying text.

[262] *See supra* note 246 and accompanying text.

[263] 69 TCM 2283, Dec. 50,558(M), TC Memo. 1995-140 (1995); *see supra* notes 170–175 and accompanying text.

[264] *Id*. at n. 16.

[265] *See supra* note 244 and accompanying text.

[266] *See supra* note 242 and accompanying text.

[267] *See supra* note 243 and accompanying text.

[268] Note that the purpose of the reverse Code Sec. 704(c) gain in this context is to account for the deduction allocated to the existing partners that is funded by using appreciated property to fund that deduction. Unlike the situation discussed *infra* at notes 271 and 275 and accompanying text, there will necessarily be gain associated with partnership assets in this situation.

[269] *NYSBA Comments on Compensatory Interests*, *supra* note 246.

[270] *ABA Comments on Compensatory Interests*, *supra* note 246.

[271] Unlike the situation discussed *supra* at note 268 relating to the deduction allocated to other partners, it is not clear that there will be sufficient built-in gain in partnership assets to account for the service partner's deferred income, as determined by reference to liquidation value.

[272] *LA County Bar Comments on Compensatory Interests*, *supra* note 246.

[273] *See supra* notes 223–225 and accompanying text.

[274] Code Sec. 704(c) generally allocates tax items related to property among partners to account for the difference between a partner's share of book value and tax basis related to the property. To the extent that Code Sec. 704(c) effectively eliminates these disparities with respect to partnership property (*i.e.*, the ceiling rule does not prevent full reconciliation *see* Reg. §1.704-3(b)(1)), the book value and tax basis of each partner's interest in the partnership should be equal upon liquidation of the partnership.

[275] It might be possible to develop a regime whereby the movement of Code Sec. 704(b) capital among partners is accounted for by, with respect to the same assets, creating a Code Sec. 704(c) loss for partners who give up capital and Code Sec. 704(c) gain for those who are the recipients of capital. Obviously, such a regime would be quite complicated, and without mandating remedial allocations to ensure ultimate conformity of Code Sec. 704(b) book and tax capital accounts, the potential for mischief could be significant.

[276] Note that a number of partnership agreements now provide that if Proposed Reg. §1.83-3(l) and the proposed revenue procedure contained in Notice 2005-43, 2005-24 IRB 1 or substantially similar successor rules become effective, the partnership is authorized to elect the safe harbor described therein providing that the fair market value of any interest transferred in connection with the performance of services will be treated as the liquidation value of the interest when transferred. Query whether such language puts any pressure on consistent use of liquidation value for compensatory interests more generally.

[277] *See also* Reg. §1.761-1(c).

[278] In explaining this rule, the preamble to the final regulations under Code Sec. 706 states:

> The 2009 proposed regulations contained a 'contemporaneous partner exception' based on the Tax Court's opinion in *Lipke v. Commissioner*, 81 TC 689 (1983), and the legislative history of section 706. Section 761(c) provides that a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions).
>
> In *Lipke*, the Tax Court held that section 706(c)(2)(B) (as in effect prior to 1984) prohibited retroactive allocations of partnership losses when the allocations resulted from additional capital contributions made by both new and

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existing partners. However, the Tax Court held that the prohibition on retroactive allocations under section 706(c)(2)(B) did not apply to changes in the allocations among partners that were members of the partnership for the entire year (contemporaneous partners) if the changes in the allocations did not result from capital contributions.

Congress amended section 706 in 1984, in part to clarify that the varying interests rule applies to any change in a partner's interest, whether in connection with a complete disposition of the partner's interest or otherwise. To that end, Congress replaced the varying interests rule in section 706(c)(2)(B) with the rule that now appears in section 706(d)(1). The legislative history pertaining to this amendment reflects Congress's intention that the new rule of section 706(d)(1) be comparable to the pre-1984 law without overruling the longstanding rule of section 761(c):

> The committee wishes to make clear that the varying interests rule is not intended to override the longstanding rule of section 761 (c) with respect to interest shifts among partners who are members of the partnership for the entire taxable year, provided such shifts are not, in substance, attributable to the influx of new capital from such partners. *See Lipke v. Commissioner*, 81 TC 689 (1983).

S. Prt. 98-169, Vol. I, 98th Cong., 2d Sess. 218-19 (1984); see also H. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. 1212-13 (1984) (containing similar language).

Consistent with this authority, proposed §1.706-4(b)(1) provided an exception to the rule in proposed §1.706-4(a)(1) for dispositions of less than a partner's entire interest in the partnership described in §1.706-1(c)(3), provided that the variation in the partner's interest is not attributable to a capital contribution or a partnership distribution to a partner that is a return of capital, and the allocations resulting from the modification otherwise comply with section 704(b) and the regulations promulgated thereunder.

T.D. 9728, 2015-2 CB 169 (preamble).

[279] REG 105346-03, 2005-1 CB 1244 (preamble). The preamble notes that, given the retroactive timing of the issuance of the profits interest, it may not be possible to make a valid Code Sec. 83(b) election, which must be filed within 30 days of the receipt of the partnership interest. *See also* GCM 37193 (Jul. 13, 1977) (retroactive allocation of gain that accrued and was recognized during the taxable year); *H. Smith*, CA-7, 64-1 USTC ¶9390, 331 F2d 298 (1964) (retroactive allocation allowed under Code Sec. 761(c) among existing partners so long as tax evasion was not a purpose of the change in allocations). *See generally* B. Schippel, *Should My CEO Be My Partner? A Practical Approach to Dealing with LLC and Partnership Equity Compensation*, 53 TAX MGMT. MEM. (BNA) (Feb. 27, 2012); S. Banoff, P. Carman & J. Maxfield, *Prop. Regs. on Partnership Equity for Services: The Collision of Section 83 and Subchapter K*, 103 J. TAX'N 69, 84 (Aug. 2005).

[280] *Federal Taxation of Partnerships*, *supra* note 79 at ¶12.04[1]. The "vague hint" referenced in the first sentence references Reg. §1.704-1(b)(2)(iv)(*f*), which states that if capital accounts are not adjusted in circumstances permitted under the regulations, Reg. §1.704-1(b)(1)(iii) (effect of other sections) and (iv) (other possible tax consequences) should be consulted regarding the potential tax consequences that may arise if the principles of Code Sec. 704(c) are not applied with respect to partnership property.

[281] (Feb. 23, 1998).

[282] It is difficult to measure a capital shift when the sharing among partners is undefined. One might distinguish (1) a situation where a certain number of units are left undesignated in order to provide the owners of the business discretion to issue such units to compensate individual service providers from (2) a situation where the sharing for all partners is undesignated and a committee acting on behalf of all such partners determines the sharing based on some defined criteria. In the first situation, the existing partners who decide to hold back and then issue units would likely be treated as owning the units until issued. In the latter situation, a defined sharing of partnership income simply does not exist and the ownership of units is impossible to discern. It is true that a partnership's income must be allocated in some manner in each year. The scenario where income allocations are not defined as of the end of a taxable year is probably most viable in a situation where the sharing for operating income is defined, and it is only sale gain that will arise in the future that is undefined—as was the case in LTR 9821051 (Feb. 23, 1998).

[283] Neither provision was cited in the analysis of LTR 9821051 (Feb. 23, 1998).

[284] It is important to recognize that the deemed sale of assets is at fair market value and not Code Sec. 704(b) book value (which would not capture existing appreciation in partnership assets).

[285] Rev. Proc. 93-27, 1993-2 CB 343; *Mark IV Pictures*, CA-8, 92-2 USTC ¶50,365, 969 F2d 669, 674 (1991); *Crescent Holdings LLC*, 141 TC 477, 488 n. 13, Dec. 59,705 (2013); GCM 36346 (Jun. 23, 1975). *See supra* notes 166, 179, and 180 along with accompanying text.

[286] *See supra* notes 163, 168, 181, and 182 and accompanying text. In *R. Johnston*, 69 TCM 2283, Dec. 50,558(M), TC Memo. 1995-140 (1995), the Tax Court addressed a compensatory capital shift from (1) new partners making contributions to the partnership to (2) pre-existing partners. Because the parties did not raise the application of Code Sec. 83, the opinion only addresses the result under Reg. §1.721-1(b)(1). The court does, however, state that the result would have been the same under Code Sec. 83 had the parties raised the application of Code Sec. 83 as an issue for decision. *Id*. at n. 15. Admittedly, there was no asset appreciation at the time of the capital shift in *Johnston*, so the potential for accomplishing a shift in value through a change in the share of existing appreciation for pre-existing partners was not relevant to the decision.

[287] A private letter ruling may not be used or cited as precedent. Code Sec. 6110(k)(3). Some courts, however, have found private letter rulings to be "a useful tool" or "evidence of administrative practice." *See, e.g., J.L. Thom*, CA-8, 2002-1 USTC ¶50,293, 283 F3d 939, 943 n. 6 (2002), *rehearing denied*, CA-8, 2012 U.S. App. Lexis 14378 (2002); *A.B.C. Rentals of San Antonio, Inc.*, CA-10, 98-1 USTC ¶50,340, 142 F3d 1200, 1207 n. 5 (1998), *supplemented by*, 77 TCM 1229, Dec. 53,217(M), TC Memo. 1999-14 (1999); *Taproot Admin. Servs., Inc.*, 133 TC 202, 237 n. 10, Dec. 57,950 (2009), *aff'd*, CA-9, 2012-1 USTC ¶50,256, 679 F3d 1109 (2012).

[288] *See supra* note 280 and accompanying text.

[289] *But see Clark Raymond & Co. PLLC*, 124 TCM 246, Dec. 62,117(M), TC Memo. 2022-105 (partners were distributed customer relationships/goodwill in redemption of their partnership interests).

[290] Although there likely will be no ability for a new partner to participate in the goodwill value of the service partnership, there typically are unrealized accounts receivable that likely create some measure of liquidation value for the interest received, even ignoring goodwill. R. Upton, *Proposed Regs, Rev. Proc. On Transfers of Partnership Equity Interests for Services: Did the IRS Get It Right?*, 109 TAX NOTES 791 (Nov. 7, 2005) (hereafter referred to as "*Did the IRS Get It Right?*"); GCM 36346 (Jul. 23, 1975) ("[i]t should be noted that unrealized accounts receivable are also considered partnership capital. This can be important for professional partnerships."). The new partner who benefits from the unrealized receivables upon entry into the partnership likely will give up his or her share of unrealized receivables in place when he or she leaves the partnership. This "rough justice" balancing might justify ignoring the shift in these instances.

[291] *See generally ABA Proposed Reg Comments*, *supra* at note 246; *L.A. County Bar Proposed Reg Comments*, *supra* note 246; *NYSBA Proposed Reg Comments*, *supra* note 146; *Did the IRS Get It Right?*, *supra* note 290, at 813 and 814.

[292] *See supra* note 278 and accompanying text.

[293] The arguments favoring this view of the arrangement seem most sympathetic in a scenario where partners who are co-equals negotiate among themselves at the time of sale to reflect who has a claim to underlying appreciation based upon efforts contributing to the success of the venture. This scenario portrays a negotiation by each partner for his or her rightful share of the partnership. This scenario can be distinguished from a scenario where a controlling partner determines an increased share that will be allocated to a minority employee-like partner who has no role in negotiating his or her share. The latter situation has more of a compensatory flavor.

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[294] *Cf*. GCM 37193 (Jul. 13, 1977). This General Counsel Memorandum analyzed a shift in appreciation in the year a property was sold to reward efforts of a service partner. The General Counsel Memorandum contains language that may imply the permissibility of such an allocation so long as the individual was a partner when the appreciation accrued. Significantly, however, the property was sold in the same year that the partnership was formed so it seems that the shift in appreciation could be justified through application of Code Sec. 761(c); *see supra* notes 277–279 and accompanying text.

[295] *Cf. Partnership Realignments, supra note* 47, *stating*:

> It is submitted that it is more in line with the overall structure of partnership taxation to analyze the tax treatment of partnership realignments in terms of concepts such as capital shifts (or the lack thereof) and shifts of unrealized appreciation and depreciation, rather than under traditional concepts of realization as to whether anything is 'materially different' after the reallocation of profits and losses (*i.e.*, the test employed in *Cottage Savings*).

[296] K. Thomason, *Partnership Options and Related Instruments*, 61-13 N.Y.U. Annual Inst. Fed. Tax'n §13.02 (2003). In this article, the author states:

> When discussing 'capital shifts,' it is first important to clarify what is meant by that term. Some refer to the need, in order to more accurately reflect the underlying economic substance of the partners' relative positions in the partnership, to move amounts from one capital account to another as a 'capital shift.' Such a need may actually be a simple remediation of a mistaken prior adjustment of such accounts. It is important to remember that capital accounts are kept to *reflect* economic effects, not to *cause* them. Instead, the 'capital shifts' which merit our attention would be situations where there has occurred an *actual transfer of economic wealth*, albeit still in solution, from one partner to another, or more precisely from the historic partners to the exercising option holder.

See also K. Burke, *Taxing Compensatory Partnership Options*, 100 Tax Notes 1569, 1572 (Sep. 22, 2003) (indicating that a capital shift following a revaluation of partnership assets "might be viewed as an artificial result of the pre-exercise bookup").

[297] *See supra* notes 217 and 218 and accompanying text.

[298] *See supra* note 238 and accompanying text; *see also* GCM 36346 (Jun. 23, 1975).

[299] *See supra* note 222 and accompanying text.

[300] *See supra* note 222 and accompanying text.

[301] *See supra* notes 234 and 235 and accompanying text.

[302] *See supra* note 238 and accompanying text, referencing the preamble to proposed regulations stating that the nonrecognition result in the proposed regulations will not apply with respect to an interest issued by a disregarded entity. *Compare F.C. McDougal*, 62 TC 720, Dec. 32,746 (1974) (gain recognized where owner transferred interest in asset to service provider as part of formation of partnership); *J. C. Shepherd*, 115 TC 376, Dec. 54,098 (2000), *aff'd*, CA-11, 2002-1 ustc ¶60,431, 283 F3d 1258 (2002) (there could be no transfer to a partnership that had yet to be formed).

[303] *Id.*; *see supra* note 90 and accompanying text.

[304] *J. C. Shepherd*, 115 TC 376, Dec. 54,098 (2000), *aff'd*, CA-11, 2002-1 ustc ¶60,431, 283 F3d 1258 (2002) (in gift case, court allowed a 15-percent discount for lack of operational control, risk of disagreement about disposition, and possibility of future partition, but this was less than half the 33.5-percent stipulated discount if the conveyed property had been a partnership interest).

[305] *See supra* notes 90 and accompanying text.

[306] Note that existing case law in the gift tax context requires that the contribution to the LLC must occur some period of time in advance of the transfer of the LLC interest in order to avoid analyzing the transaction as a direct transfer of an interest in the LLC's assets. *See supra* notes 188 and 189 and accompanying text.

[307] 133 TC 24, Dec. 57,910 (2009), *supplemental decision*, 99 TCM 1436, Dec. 58,217(M), TC Memo. 2010-106 (2010).

[308] 143 TC 41, Dec. 59,987 (2014).

[309] By way of example, assume that the owner of a disregarded LLC transfers a two-percent non-voting membership interest to a service provider. Due to the minority nature and lack of meaningful voting rights attributable to the interest transferred, presumably the transferred interest would be valued less on a proportionate basis than the 98-percent interest that is retained. If, however, the 98-percent and two-percent interests share economically in the LLC on a proportionate basis, the capital accounts should be proportionate and not consistent with the relative values of the LLC interests.

[310] *See supra* note 194 and accompanying text.

[311] In some instances, the leaders of the sponsor organization will designate specific individuals who should benefit from the forfeited interests. A shift in capital interests under those circumstances is likely to be analyzed similar to the discussions above (*see supra* notes 260–297 and accompanying text), as that designation of interests is more clearly made in a compensatory context.

[312] *See supra* notes 23 and 24 and accompanying text.

[313] *See supra* notes 31–36 and accompanying text.

[314] *See supra* note 38 and accompanying text.

[315] *See supra* notes 39–47 and accompanying text.

[316] *See supra* notes 139–182 and accompanying text.

[317] *See L.J. Alves*, CA-9, 84-2 ustc ¶9546, 734 F2d 478 (1984).

[318] *QinetiQ U.S. Holdings, Inc.*, 110 TCM 17, Dec. 60,340(M), TC Memo. 2015-123 (2015), *aff'd*, CA-4, 845 F3d 555 (2017), *cert. denied*, 138 SCt 299 (2017).

[319] Reg. §1.721-1(b)(1)

[320] *See supra* note 182 and accompanying text.

[321] *Cf.* Reg. §1.704-3(a)(7).

[322] Proposed Reg. §1.704-1(b)(2)(xii)(*c*); *see supra* notes 230 and 231 and accompanying text.

[323] The limitation of the nonrecognition exception to the portion of the obligation that accrued on or after the beginning of the creditor's holding period in the debt aligns the treatment of partnership debt-for-equity exchanges with the statutory treatment of a corporate debt-for-equity exchange (*i.e.*, Code Secs. 351(d)(3) and 354(a)(2)(B)). *See NYSBA Members Comment on Proposed Regs on Discharge of Partnership Indebtedness Income*, 2009 T.N.T. 122-75 (Jun. 26, 2009) (hereafter referred to as "*NYSBA 108(e)(8) Comments*").

[324] T.D. 9557, 2011-2 CB 855.

[325] Reg. §1.721-1(d)(2). Comments addressing the proposed regulations suggested that nonrecognition treatment should not apply where an interest in a disregarded entity is transferred in satisfaction of the obligation. *NYSBA 108(e)(8) Comments*, *supra* note 323. In support of this result, these commentators referenced the proposed regulations addressing compensatory partnership interests and *F.C. McDougal*, 62 TC 720, Dec. 32,746 (1974). *Id*. The final regulations did not explicitly address this situation. After issuance of the final regulations, commentators have reached different conclusions with respect to whether nonrecognition treatment should apply where an interest in a disregarded entity is issued in satisfaction of debt owed by the disregarded entity. *Compare* J. Sowell, *Debt Workouts: The Partnership and the Partners*, 73 Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances (PLI) 1, 58 (2022) (nonrecognition should not apply); D. Friedline, *Debt-For-Equity Exchange of a Disregarded Entity*, 39 J. Real Est. Tax'n. 52 (2012) (same); *with* P. Gall & F. Wang, *The Mysterious Case of Disappearing Debt in Partnership Transactions*, 90 Taxes 157 (2012) (nonrecognition should apply).

[326] T.D. 9557, 2011-2 CB 855 (preamble). Although not stated in the regulations, the IRS apparently views the transaction as following a deemed circular flow of cash construct. In a panel discussing the final regulations, Beverly Katz, former Special Counsel, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), was quoted as follows: "It's as if the debtor partnership paid the interest and the creditor took the cash that they received from the payment of the interest, along with the remaining outstanding debt, and contributed it back to the partnership." M. Dalton, *Nonrecognition Treatment in Final Debt-For- Equity Regs Praised*, 2011 T.N.T. 222-5 (Nov. 17, 2011); *see also* A. Elliott, *Treasury Finalizes Debt-For-Equity Regs With Implied Circular Flow of Cash*, 2011 T.N.T. 221-1 (Nov. 16, 2011) (quoting Bob Crnkovich, former Senior Counsel (Partnerships) in Treasury's Office of Tax Legislative Counsel, as stating that "[t]his could be viewed as creating an implicit circular flow of cash from the debtor's standpoint.").

[327] *See supra* notes 234 and 235 and accompanying text.

[328] This result clearly would be allowed under the proposed regulations addressing compensatory partnership interests. *See supra* notes 242 and 243 and accompanying text. The result is somewhat less certain under existing case law. *See supra* notes 139–182 and accompanying text.

[329] Reg. §1.108-8(b).

[330] *NYSBA 108(e)(8) Comments*, *supra* note 323.

[331] *Id*.

[332] These results are similar to those describe *supra* at text accompanying notes 273–275.

[333] *See supra* note 225 and accompanying text.

[334] The use of liquidation value typically maximizes the value of the partnership interest received because of the lack of discounts (*e.g.*, lack of marketability, control, liquidity, *etc.*) applicable to the interest and thus minimizes COD income recognized.

[335] Reg. §1.704-1(b)(2)(iv)(*b*)(*1*) & (*2*).

[336] SCt, 37-2 USTC ¶9532, 302 US 63, 58 SCt 67 (1937); *see supra* notes 25 and 26 and accompanying text.

[337] As previously discussed, where the bargain purchase does not occur under circumstances representative of an arm's length arrangement, the bargain element may represent compensation, a deemed distribution, a gift, or some other recognized conveyance of value. *See supra* notes 27–30 and accompanying text.

[338] *A Modified Aggregate Theory*, *supra* note 5.

[339] *See supra* note 207 and the last two sentences of the accompanying text.

[340] One could be most comfortable that such an allocation would be respected if the partnership uses a "safe harbor" agreement that follows the capital accounts rules in Reg. §1.704-1(b)(2)(iv) and liquidates based on capital accounts.

[341] *See infra* notes 367-368 and accompanying text discussing whether allocations that do not conform to partner entitlements on an annual as-liquidated basis will be respected under partners' interests in the partnership.

[342] *Cf*. Reg. §1.755-1(b)(5)(iii)(C) (carryover of negative Code Sec. 743(b) basis adjustment when no basis is currently available in the proper asset class to absorb basis adjustment); Reg. §1.755-1(c)(4) (carryover of negative Code Sec. 734(b) basis adjustment when no basis is currently available in the proper asset class to absorb basis adjustment).

[343] Note, however, that the same result would follow if PRS books down its assets to $1,800,000 and elects the traditional method under Code Sec. 704(c). Reg. §1.704-3(b)(1). If the assets were sold for $1,900,000, there would be no allocation of gain due to the ceiling rule, so that Lori would receive $950,000 of cash from the partnership and would be allocated $50,000 of Code Sec. 704(b) book, but no tax, gain. *Id*. (last sentence).

[344] For example, if there is built-in gain in partnership assets that has not been booked into partner capital accounts, it seems most defensible to shift capital that carries with it a share of this built-in gain. Doing so makes it most likely that the Code Sec. 704(b) book and tax capital accounts of the partners will be equal upon liquidation of the partnership.

[345] In one article, the author stated:

> The tax effect of a forfeiture clause on the partnership and continuing partners are uncertain. A good argument can be made that the continuing partners should be taxable on the forfeiture of ABC's capital interest in the partnership. It is uncertain whether the income of the continuing partners will equal the forfeited capital account, the fair market value of the defaulting partner's capital interest, or the full fair market value of the forfeiting partner's partnership interest. It is also possible that a court would embrace a theory under which the continuing partners do not recognize income.

T. Cuff, *Tax Aspects of Partnership Dilution Provisions*, 1 BUS. ENTITIES 17, 18 (Mar./Apr. 1999) (hereafter referred to as "*Dilution Provisions*"); *see also* S. Schneider & B. O'Connor, *LLC Capital Shifts: Avoiding Problems When Applying Corporate Principles*, 92 J. TAX'N 13, 25 (Jan. 2000) (hereafter referred to as "*LLC Capital Shifts*"). Note that a number of partnership agreements refer to the forfeited amount as liquidated damages for breach of the obligation to contribute additional committed capital. Reference to damages obviously is not helpful in arguing against penalty status for the payment.

[346] *See supra* notes 25 and 26 and accompanying text.

[347] *See supra* notes 27–30 and accompanying text.

[348] One may legitimately question why a shift in value upon forfeiture of an interest under these facts should give rise to taxable income for the other partners if a shift in value upon forfeiture by a service partner who ceases to perform services for a partnership seemingly does not. *See supra* notes 312–320 and accompanying text. There are material differences between the two situations, although some may still question whether the distinctions justify different treatment.

As one difference, in the example, John was a 10-percent partner under state law by virtue of his contributions to date. By diluting his interest, John is being penalized for his failure to contribute. By contrast, a service partner who holds his or her interest subject to vesting requirements does not actually own the interest until vesting. While the service partner is, in a way, being penalized for ceasing to perform services, the continued performance of services was actually a condition to this partner obtaining the state law rights as a partner. The tax rules (*i.e.*, either Code Sec. 83(b) or Rev. Proc. 2001-43, 2001-1 CB 191) cause the service partner to be treated as a current partner for tax purposes, but that is a fiction of the tax law. The forfeiture in the service context actually comes from the failure to satisfy conditions to secure ownership rather than giving up existing ownership as a penalty for bad behavior.

As a second difference, in the example, the non-defaulting partners are required to fund their shares of John's defaulted contribution in order to obtain the additional value attributable to John's shifting interest. Thus, there is some purposive activity on the part of the non-defaulting partners that is undertaken in order to obtain the excess value. In the case of the forfeiting service partner, the other partners are deriving a benefit by simply remaining partners (assuming that the benefit is not targeted to specific partners). They undertake no additional actions to obtain the additional value attributable to the forfeiting partner's interest.

Finally, in the example, John previously funded capital, and that capital is shifting. In the case of the service partner who shares in carried interest earned by the GP, no after-tax contributed capital shifts. Instead, only the service partner's share of appreciation shifts.

All three differences seem to point to the capital shift in the default context described in the example as being less sympathetic in avoiding current taxation.

[349] Code Sec. 707(a)(2)(B); Proposed Reg. §1.707-7(a) (withdrawn in Ann. 2009-4, 2008-8 IRB 597); TAM 200301004 (Aug. 27, 2002); TAM 200037005 (May 18, 2000).

[350] *Dilution Provisions*, *supra* note 345, at 19.

[351] *LLC Capital Shifts*, *supra* note 345, at 25.

[352] *See supra* notes 255–259 and accompanying text.

[353] Reg. §1.704-1(b)(2)(iv)(*l*).

[354] Reg. §§1.704-3(a)(7); 1.704-4(d)(2); 1.737-1(c)(2)(iii).

[355] The nature of the deduction as a trade or business deduction under Code Sec. 162 or deduction related to investment under Code Sec. 212 would seem to depend on how the defaulting partner holds the partnership interest. By way of analogy, certain authorities have allowed a partner to treat debt as business debt by reference to the activities of the partnership borrower, particularly when the partner/lender is engaged in the business of the partnership. *See G.A. Butler*, 36 TC 1097, Dec. 25,038 (1961), *acq*. 1962-2 CB 4; *see also M. Davis*, 11 TC 538, Dec. 16,615 (1948); *A.L. Stanchfield*, 24 TCM 1681, Dec. 27,635(M), TC Memo. 1965-305 (1965). *Cf. I.J. Smith*, 68 TCM 1538, Dec. 50,318(M), TC Memo. 1994-640 (1994) (payment on guarantee of corporate debt was related to support of taxpayer's construction business that was conducted through a partnership and was held to qualify as a business bad debt deduction); *T.A. Dagres*, 136 TC 263, Dec. 58,581 (2011) (business bad debt deduction allowed for principal of venture capital sponsor where borrower on debt provided referrals for venture capital business conducted through LLCs and an S corporation).

[356] *See supra* note 236.

[357] *Cf. Pope &Talbot, Inc.*, CA-9, 99-1 USTC ¶50,158, 162 F3d 1236 (1999) (value of limited partnership interests distributed by corporation that effectively owned the entire partnership could be different for purposes of determining the corporation's gain under Code Sec. 311(b) than would be the case for purposes of determining the taxation under Code Sec. 301 or Code Sec. 302 of approximately 6,000 shareholders receiving minority interests in the limited partnership; court stated that "if the corporation distributes one form of property and the shareholders receive another, there is no 'symmetry.'").

[358] *See supra* notes 268–275 and 328–333and accompanying text.

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[359] *See supra* notes 325–327 and accompanying text.

[360] In a default situation, often partnership assets are not appreciated. In such a situation, a built-in loss in partnership assets would be isolated under reverse Code Sec. 704(c) principles for the other partners.

[361] As previously discussed, Code Sec. 706 provides significant flexibility to adjust allocations among contemporaneous partners. *See supra* note 278 and accompanying text.

[362] These entitlements would exceed percentage interests for the non-defaulting partners, given that they will succeed to appreciation on the shifted capital contribution as well as the default contribution funded by such partner.

[363] *See supra* notes 230 and 231 and accompanying text.

[364] In this situation, a combination of adjusting reverse Code Sec. 704(c) layers and creating forfeiture allocations of taxable items may be appropriate.

[365] *See supra* notes 217 and 218 and accompanying text.

[366] *See, e.g.*, D. Paul, *What's Unrealized About the Tax Treatment of Partnership Capital Shifts*, 176 TAX NOTES FED. 1835 (Sep. 19, 2022) (hereafter referred to as "*What's Unrealized*"); N.Y. St. Bar Assoc. (Tax Section), *Report No. 1357 on Guaranteed Payments and Preferred Returns*, *reprinted at* 2016 T.N.T. 221-12 (Nov. 14, 2016) (hereafter referred to as "*NYSBA Preferred Return Report*"); R. Gaughan, S. Good & G. Hanks, *When Do Targeted Allocations Need Economic Effect?*, 43 REAL EST. TAX'N 140 (2016) (hereafter referred to as "*Targeted Allocations Need Economic Effect?*"); L. Fowler & H. Preston, *Using Target Allocations in Investment Funds: Pros, Cons, But Ultimately Uncertainties*, 28 J. TAX'N F. INST. 17 (2015); W. Cavanaugh, *Targeted Allocations Hit the Spot*, 129 TAX NOTES 89 (Oct. 4, 2010) (hereafter referred to as "*Target Allocations*"); T. Golub, *Target Allocations: The Swiss Army Knife of Drafting (Good for Most Situations—but Don't Bet Your Life on It)*, 87 TAXES 157 (2009) (hereafter referred to as "*Swiss Army Knife*"); J. Flora, *M&A Tax Report—Archive, Venture Capital, Meet Capital Shift*, The M&A Tax Report (CCH) (Feb. 1, 2008); B. O'Connor & S. Schneider, *Capital-Account-Based Liquidations: Gone with the Wind, or Here to Stay?* 102 J. TAX'N 21 (Jan. 2005); L. Steinberg, *Fun and Games with Guaranteed Payments*, 57 TAX LAW. 533 (2004) (hereafter referred to as "*Fun and Games*").

[367] In *PNRC Limited Partnership*, 66 TCM 265, Dec. 49,186(M), TC Memo. 1993-335 (1993), the Tax Court acknowledged that there is some flexibility in determining allocations under the "partners' interests in the partnership" standard. The court stated that determining allocations based on a comparative annual liquidation at book value could conform with the "partners' interests in the partnership" standard, but it did not require such an allocation and instead found that the partners' contributions to the partnership was the most important factor under the facts of that case. Regarding the annual liquidation approach, the Tax Court stated:

> We recognize that there are other possible ways to determine the partners' interests in the partnership. One such approach would be to compare (1) the manner in which distributions and contributions would be made if all partnership property were sold at book value and the partnership were liquidated at the end of the taxable year at issue with (2) the manner in which such distributions or contributions would be made if all partnership property were sold at book value and the partnership were liquidated at the end of the prior taxable year, adjusting for certain items. *See* Sec. 1.704-1(b)(3)(iii), Income Tax Regs. (mandatory in the limited case where the sole reason a partnership fails the basic test for economic effect is because it lacks a deficit makeup obligation). Neither party raised this approach and we do not consider it.

Id. at n. 18. Looking specifically to the fourth factor of the partners' interests in the partnership factors, some authority does focus on annual liquidations. One court has stated that this factor is analyzed as follows:

> The fourth factor to consider in determining a partner's interest in the partnership is the partner's right to distributions of capital upon liquidation of the partnership. This factor requires that we determine how the partnership would have been liquidated in each of the years in issue.

Est. of Tobias, 81 TCM 1163, Dec. 54,245(M), TC Memo. 2001-37 (2001).

[368] Addressing whether "partners' interests in the partnership" might require a gross income allocation or guaranteed payment where insufficient net profit is available, one commentator has stated:

> The difficulty in imputing phantom income each year is that it often may not correlate well with economic reality and the parties' business expectations. The parties generally expect the preferred return to come out of earnings—anticipated to be low in early years and more significant down the road. The better view would appear to be to allocate net profit and net loss items only, particularly if the partners anticipate early-year low profits and expect that the preferred return would be funded from expected future profits.

Target Allocations, *supra* note 366, at 105. In reference to the possibility of allocating gross income where insufficient profit exists, another commentator has stated that:

> the rationale for doing this is unclear. Allocating gross income to [a partner] equal to [that partner's preferred return] accretion would result in capital accounts equal to liquidating distributions if the partnership were to liquidate at the end of year 1. But whether that result is appropriate is the same debate this report has been discussing [with respect to capital shifts and guaranteed payments]. The existence of gross income and gross deduction is incidental to the fundamental question whether, in a case where [a partner's] return is expected to arise from growth in the business, [that partner] should nonetheless be taxed currently.

What's Unrealized, *supra* note 366, at 1845. The regulations do reference the allocation of items, specifically stating that a partner's interest in the partnership is determined by reference to "the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated" (*see* Reg. §1.704-1(b)(3)(i)). Seemingly recognizing, however, that rights upon liquidation should not always drive annual allocations, the Tax Court has recently stated, in analyzing a partnership agreement that contained an allocation waterfall and attempted to operate by reference to capital accounts:

> [G]iven that the allocation at issue is an allocation of annual income (not in liquidation of the partnership), we believe that the partners' agreement as to how to allocate that income, in particular the provisions regarding the QIO, are the most indicative of how the partners agreed to share the economic benefits and burdens of the partnership. We therefore afford this liquidation factor the least weight in our consideration of the partner's interest in the partnership.

Clark Raymond & Co. PLLC, 124 TCM 246, Dec. 62,117(M), TC Memo. 2022-105.

[369] Code Sec. 707(c).

[370] Reg. §1.707-1(c).

[371] *Taxation of Partnerships*, *supra* note 79 at ¶14.03[2] (inclusion in income of guaranteed payment is dependent on accrual of deduction by partnership, not payment to partner); *NYSBA Preferred Return Report*, *supra* note 366, at 12.

[372] Reg. §1.707-1(c).

[373] Timing of the accrual of the guaranteed payment is beyond the scope of this article. For a discussion of this issue, *see NYSBA Preferred Return Report*, *supra* note 366 at 12–15; *What's Unrealized*, *supra* note 366, at 1841–1843.

[374] There is some question as to whether an accrued guaranteed payment is more properly accounted for as a liability of the partnership or as a deemed payment and recontribution by the recipient. *Compare* S. Banoff, *Guaranteed Payments for the Use of Capital: Schizophrenia in Subchapter K*, 70 TAXES 820, at 832, ns. 90-91 (1992) (guaranteed payment treated as payment and recontribution), *with Targeted Allocations Need Economic Effect?*, *supra* note 366, at 143 (guaranteed payment is a liability of the partnership); *see also* D. Cameron & P. Postlewaite, *The Lazarus Effect: A Commentary on In-Kind Guaranteed Payments*, 7 FLA. TAX REV. 339, 348 n. 144

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(describing both alternatives). One group of commentators, while acknowledging the argument for treatment as a liability, has referred to the payment and recontribution analysis as the "more widely accepted" approach. *NYSBA Preferred Return Report*, *supra* note 366, at 30.

[375] REG-115452-14, 2015-2 CB 158 (preamble) (emphasis added).

[376] In the *NYSBA Preferred Return Report*, *supra* note 366, this approach is referred to as "Approach 1." *Id*. at 22. In a footnote, the report states that "the statutory and policy considerations animating Code Sec. 707(c) do not seem to support Approach 1 generally, other than in circumstances where the preferred return is required to be paid annually (or perhaps within some other fixed period of sufficiently short duration after issuance)." *Id*.

[377] The theory for finding a guaranteed payment would not seem to hold up where no partner capital is available to support payment of the preferred return (since profit will be necessary to fund the preferred return) or when the available capital is common capital held by the same partner.

[378] *See Swiss Army Knife*, *supra* note 366. In the *NYSBA Preferred Return Report*, *supra* note 366, this approach is referred to as "Approach 2A." *Id*. at 22.

[379] Proposed regulations issued in 2015 would change the result in this example so that the $10,000 assured payment would be a guaranteed payment in all events, but that proposed regulation has not been finalized and the guidance project has not been on the Priority Guidance Plan since the 2016-2017 Priority Guidance Plan. *See* Proposed Reg. §1.707-1(c), Ex. 2.

[380] *See supra* text accompanying note 375.

[381] *See NYSBA Preferred Return Report*, *supra* note 366 at 23 (described as "approach 2B").

[382] Two sets of commentators simply make the statement that the accrual is not a realization event without discussing the relevant authority (*see What's Unrealized*, *supra* note 366 at 1837 and 1838; *Targeted Allocations Need Economic Effect*, *supra* note 366 at 150), while the third set cites only to *Eisner v. Macomber*, SCt, 1 USTC ¶32, 252 US 189, 40 SCt 189 (1920) with a "*cf.*" cite to *Helvering v. Bruun*, SCt, 40-1 USTC ¶9337, 369 US 461, 60 SCt 631 (1940) (*see NYSBA Preferred Return Report*, *supra* note 366, at 19–21). As discussed *supra* at notes 23–37, the law regarding what constitutes a realization transaction has evolved since those cases, and the analysis regarding what constitutes a realization transaction may sweep in a number of transactions. Importantly, it now is clear that the statement in *Eisner v. Macomber* indicating that a realization event requires "something of exchangeable value *proceeding* from the property, *severed* from the capital however invested or employed" no longer applies. *See supra* note 22 and accompanying text. Note, however, that the "hair-trigger" standard for finding a realization event under *Cottage Savings* arguably only applies in a transaction where an exchange is present (*see supra* note 38), and with respect to the preferred return, there is no modification to the arrangement that could produce an exchange. Instead, the preferred return is simply a product of the partnership's distribution waterfall. Separately, in the corporate context, Code Sec. 305 was necessary to create a current accrual in similar circumstances. A separate rule in Code Sec. 368(a)(1)(E) accounts for recapitalizations where there is an actual exchange to alter the interests of corporate shareholders. Some commentators argue that, without a specific regime requiring annual accrual like exists with the original issue discount rules for debt instruments and Code Sec. 305 with respect to stock, it would be inappropriate to require annual accrual in all events for partnerships. *NYSBA Preferred Return Report*, *supra* note 366, at 19 and 20, n. 56; *What's Unrealized*, *supra* note 366, at 1845 and 1846.

[383] *Fun and Games*, *supra* note 366; *see also What's Unrealized*, *supra* note 366, at 1839 and 1840.

[384] *Target Allocations*, *supra* note 366, at 106.

[385] Reg. §1.704-1(b)(2)(ii)(*c*)(*4*).

[386] Reg. §1.704-1(b)(4)(vi). *See also* L. Lokken, *Partnership Allocations*, 41 TAX L. REV. 547, 618-620 (1986) (discussing the distinction between a legitimate amendment that shifts value, which the author concludes generally will be analyzed as a capital shift characterized by reference to the reason for the shift (*e.g.*, compensation, gift, *etc.*), and an amendment that represents the formal adoption of an unwritten understanding, which should result in a reallocation of items consistent with the unwritten understanding).

[387] *Cf. S.J. Vecchio*, 103 TC 170, 194, Dec. 50,027 (1994) (partner had a negative capital account due to special allocation of depreciation; upon disposition of property, court required special allocation of gain to partner because otherwise "the other partnership interests would have to bear part of the economic cost of the special allocation that resulted in the deficit capital account").

[388] If the "hoodwink" rises to the level of a willful attempt to defeat or evade tax, there would be no statute of limitations on assessment for prior years. Code Sec. 6501(c).

[389] *See* M. Dalton, *Uncertainty Prevalent in Treatment of Investment Fund Clawbacks*, 2012 T.N.T. 207-6 (Oct. 25, 2012) (discussing potential Code Sec. 707(c) treatment of clawback payments).

[390] Some practitioners argue that the gain or loss recognized under Code Sec. 731 in connection with the liquidation of a partnership interest properly reconciles total income and loss amounts reported by the partners and that allocations should be respected on this basis. In counter to this argument, one respected commentator has stated:

> Since, as a matter of accounting, all allocations will eventually have tax and economic consequences which coincide, an interpretation of the regulation that such a coincidence satisfies the substantial economic effect test would render it meaningless.

W. McKee, *Partnership Allocations in Real Estate Ventures: Crane, Kresser and Orrisch*, 30 TAX L. REV. 1, 20 (1974). To highlight that the "accounting" referenced in the statement includes gain or loss recognized under Code Sec. 731, a footnote accompanying the statement provides:

> As the example in the preceding paragraph in text demonstrates, the deemed distributions of section 752(b) in conjunction with the basis rules for partnership interests ensure this result.

Id. at 20, n. 38. Admittedly, the "substantial economic effect" test referenced in the article is the test contained in the regulations issued before the statutory change made in the 1976 Act, but the statement still would hold true with respect to the rules applicable under current law.

[391] Admittedly, in some situations there may be a character mismatch created when using a guaranteed payment to essentially correct prior misallocations. For example, if a general partner in an investment fund is allocated capital gain with respect to its carried interest, and the ultimate clawback of the carried interest distribution is accounted for through a guaranteed payment, the general partner will have received capital gain income and a later ordinary deduction (which might be of little use in some circumstances due to Code Sec. 212). The limited partner, who in hindsight should have been allocated capital gain in an earlier year, now is receiving the economic benefit associated with that capital gain through the guaranteed payment taxable as ordinary income.

[392] In effect, the guaranteed payment, combined with allocations made among the partners, reconciles ultimate entitlements with the aggregate income or loss items included by the partners. Arguably, allocations should meet the standard for partners' interests in the partnership in this instance. It is harder to argue that such allocations can satisfy substantial economic effect. The guaranteed payment "plug" makes it hard to argue that the partnership is liquidating based on capital accounts, as the liquidating distribution to one or more partners is being made in the form of a guaranteed payment and not as a distribution with respect to such partners' capital accounts.

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