REVENUE RULING SUGGESTS STRATEGIC PARTNERSHIP FAILURE TO BOOK-UP

In Revenue Ruling 99-43, 1999-42 I.R.B. 506, the Service ruled that a pair of allocations having economic effect were nevertheless invalid because the economic effect was not substantial. While much less well defined in the regulations than the economic effect requirement, the substantiality requirement will come to play an increasing role in partnership allocations because recently promulgated regulations now incorporate the detailed §704(b) substantial economic effect rules promulgated in Reg. §1.704-1(b). In particular, ordinary income recognized by an exiting partner under §751(a) can be reduced or eliminated if the partnership can ensure that the exiting partner's share of the unrealized appreciation in the partnership's ordinary income assets is small or even zero. This can be accomplished by carefully crafted special allocations, allocations that will have "economic effect" as that phrase is defined in Reg. §1.704-1(b)(2)(ii) but may lack "substantiality" as that term is defined in Reg. §1.704-1(b)(2)(iii).

Rev. Rul 99-43 is important because it offers guidance beyond that contained in the substantial economic effect regulations. Further, while it held invalid the allocations presented in the Ruling itself, it offered a roadmap for drafting equivalent tax allocations that should survive challenge. Finally, the Ruling suggest that eschewing capital account restatements may provide strategic tax advantages.

In Rev. Rul. 99-43, individuals A and B each contributed cash of $1,000 to the general partnership PRS. Each partner was allocated 50% of profits and losses, and the partnership agreement provided that if either partner contributed additional capital in the future, PRS would revalue its assets and restate capital accounts. Such revaluation and restatement is permitted but not required by Reg. §1.704-1(b)(2)(iv)(f)-(g).

The partnership purchased nondepreciable property for $10,000, using its capital of $2,000 as well as $8,000 borrowed from a bank. After one year, the value of the property fell to $6,000. As part of a workout with the bank, the loan was reduced to $6,000, A contributed additional capital of $500, and that additional capital was used to pay currently deductible expenses. The partnership agreement was amended to provide that future items of profits and loss would be allocated 60% to A and 40% to B.

As a result of the workout, the partnership recognized $2,000 of cancellation of debt income for both book and tax purposes. The partners agreed to allocate this entire amount to B who was insolvent at the time. The partnership also had $4,000 of book loss resulting from the revaluation of the partnership's property, and the partners agree to allocate this $1,000 to A and $3,000 to B. Finally, the partnership allocated the entire $500 of book and tax deductions arising from the payment of workout expenses entirely to A. In tabular form, the books become:

A	B	
1,000	1,000	Capital Contributions
2,000	0	Allocation of COD Income
(3,000)	(1,000)	Allocation of Revaluation Loss
0	0	Final Capital Account Balances

As a result of these allocations, each partners capital account was reduced to zero. Had the partners simply allocated both the COD income and the revaluation loss equally between the partners, capital accounts also would have been reduced to zero. But by allocating both the income and loss disproportionately, the partners attempted to allocate all the taxable income to the insolvent partner, thereby minimizing the partners' joint tax liability without affecting the number of dollars either partner would receive upon liquidation.

The Ruling concludes that the disproportionate allocation of COD income and revaluation loss together constitute a "shifting" pair of allocations because there is a strong likelihood that they will have offsetting effects. The disproportionate allocation of COD income entirely to A has an immediate effect of increasing A's capital account and thereby increasing the number of dollars A will receive upon liquidation of A's partnership interest.. The disproportionate allocation of the revaluation loss to A will then reduce the number of dollars A will receive upon liquidation, thereby restoring the partners' relative shares to equality.

Of course, the revaluation loss will only affect the number of dollars that the partners' will receive if the property in fact declines in value. But under Reg. §1.704-1(b)(2)(iii)(c)(2) (the "value equals basis" rule), partnership property is *conclusively* presumed to have fair market value equal to current partnership book value. Thus, when property is revalued for adjusting capital accounts, the value of the property is conclusively presumed to have declined to the restated value. As a result, the diminution in value reflected in the book-down is conclusively presumed to have occurred, so that the loss resulting from that book-down is conclusively assumed to offset the disproportionate allocation of COD. These two disproportionate allocations thus have offsetting effects and for that reason fail the substantiality test of Reg. §1.704-1(b)(2)(iii)(b).

While the conclusion of the Ruling that the allocations are invalid seems inescapable, suppose the partnership agreement had provided that partnership would *not* be revalued when new capital is contributed by either partner. Thus, when the workout occurs, the only tax items to be allocated are the COD income and the $500 of current expenditure (this latter item plays no role in the analysis of the Ruling or in the analysis that follows). Allocation of both of these items to A has economic effect that is substantial and so should be valid.

To maintain the economics of the transaction, the partners must also agree that when the partnership's property is sold, the first $2,000 of loss will be allocated entirely to A. This is not a current allocation because no book or tax loss has yet been realized from disposition of the property. But a current allocation and a future allocation can together be invalid if there is a strong likelihood that they will have offsetting effects. Such a pair of allocations is called "transitory" under the regulations? Are the current disproportionate allocation of current COD income and the anticipated future disproportionate allocation of loss invalid as transitory?

No. While the two allocations will have offsetting effects, the future loss allocation is not "reasonably certain" to occur because under the "value equals basis" rule of §1.704-1(b)(2)(iii)(c)(2), the future loss is conclusively presumed *not* to occur: the property is conclusively presumed to equal its current book value of $10,000. By electing not to revalue the partnership's property as part of the workout, the partners can cause the "value equals basis" rule to transmute from an unstoppable sword in the hands of the government into an impassable shield in the hands of the taxpayer.

If the partnership's property turns around in value after the workout, failure to have restated capital accounts may cause problems unless properly anticipated and addressed. For example, suppose one year later the property is sold for its then current fair market value of $10,000. This sale produces no book gain or loss (because the value of the asset was not restated as part of the workout) and no tax gain or loss (because the property was purchased by the partnership for $10,000 and no depreciation was allowed or allowable). Thus, the book of the partnership will read:

A	B	
1,000	1,000	Capital Contributions
2,000	0	Allocation of COD Income
0	0	Allocation of Revaluation Loss
3,000	1,000	Final Capital Account Balances

Because there has in fact been no offsetting disproportionate allocation of loss to A, A's capital account remains disproportionately high. This is not what the partners intended, and to prevent its occurrence, the partnership agreement should provide that if, upon disposition of the property by the partnership there is less than $2,000 of loss, additional items of partnership income or loss will be allocated to restore capital accounts of the partners to parity.

Is this "additional items" allocation transitory when coupled with the disproportionate allocation of COD income to A as part of the workout? Determination whether a pair of allocations will be transitory is determined when the allocations are placed into the partnership agreement. Reg. §1.704-1(b)(2)(iii)(c). Unless it is "strong[ly] likely" that additional items will occur, all allocations should be valid. To reduce a possible challenge to the "additional items" allocations, the partners might wish to limit the additional items to gain or loss from disposition of partnership property: under the "value equal basis" rule, partnership assets are conclusively presumed not to increase or decrease in value.