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The Problem of Abusive Related-Partner Allocations

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THE PROBLEM OF ABUSIVE RELATED-PARTNER ALLOCATIONS

by

Emily Cauble*
Gregg D. Polsky**

Abstract

This Article highlights a flaw in the existing rules regarding partnership tax allocations that has not yet received sufficient attention by existing literature. Namely, the partnership tax allocation rules are implicitly premised on the assumption that partners are unrelated and, thus, transact with each other at arm's length. As a result, related partners can and do devise tax allocation schemes that exploit the gap in the current partnership tax allocation rules to achieve unwarranted tax savings.

This Article proposes to end this abuse by disallowing special allocations among related partners. Under the proposal, allocations among related partners would be required to be made on a strictly pro rata basis, in accordance with the value of each related partner's interest in the partnership. While this proposal would rationalize the existing partnership tax allocation rules and prevent abusive related partnership allocations, it would not have any detrimental effect on real economic transactions.

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I. INTRODUCTION

The immensely complicated tax rules governing partnership allocations—the notorious section 704(b) regulations—have been the subject of criticism ever since their promulgation nearly 30 years ago. Yet, one particular problem with those rules has thus far escaped significant scrutiny. The problem involves partnership allocations that are shared by partners who are related to one another. Because the section 704(b) regulations are premised on the assumption that partners deal with each other at arm’s length, they are ill-suited to deal with related-partner allocations. As a result, these regulations can easily be abused by related partners.

For instance, the recent surge in publicly-traded partnerships that are exempt from corporate tax (“Exempt PTPs”) may be attributable, at least in part, to abusive related-partner allocations that are allowed under the section 704(b) regulations. Only publicly-traded partnerships that earn sufficient passive-type income (“qualifying income”) are Exempt PTPs; all other publicly-traded partnerships are taxed as corporations. Traditionally, Exempt PTPs were found only in certain narrow industries, such as real estate and natural resources, which generated almost exclusively passive-type income (as opposed to income earned in the ordinary course of a trade or business). However, as the *Wall Street Journal* recently explained,¹ Exempt PTPs are now being used in a host of nontraditional industries. Thus, for example,

1. John D. McKinnon, *More Firms Enjoy Tax Free Status*, WALL ST. J., (Jan.) 10, 2012), <http://online.wsj.com/news/articles/SB10001424052970203733504577026361246836488>.

private equity firms and even cemetery operators have been able to classify themselves as Exempt PTPs.²

This new breed of Exempt PTPs is evidence of two distinct problems. First, the existing partnership allocation rules suffer from a serious flaw—namely, they cannot effectively police allocations among related partners. As a result, related persons can easily exploit this shortcoming to achieve outcomes that are unwarranted. For instance, the new Exempt PTPs can rely on the existing section 704(b) regulations to easily “launder” their nonqualifying income through an affiliated blocker corporation. Second, the integrity of the corporate tax is under attack, as taxpayers who traditionally would be subject to it increasingly find ways to avoid it. Each problem is more pervasive than the Exempt PTP problem highlighted in the *Wall Street Journal*, and each problem warrants attention in its own right. This Article will focus mostly on the first problem—the easy ability to abuse related-partner allocations under the current section 704(b) regulations—though it will offer some preliminary thoughts on the second problem. As to the first problem, existing literature contains limited discussion of the partnership tax allocation rules’ failure to effectively constrain allocations among related partners, and, to the extent that the literature discusses this issue, it focuses on assessing ways in which the IRS might challenge taxpayers under current law.³ Given the limitations of the tools currently available to the IRS, this Article, by contrast to existing literature, proposes reforms to close the loophole in the current partnership tax allocation rules.

This Article proceeds as follows. Part II provides examples that illustrate how taxpayers can abuse related-partner allocations. Part III explains the ineffectiveness of existing law in preventing this abuse. Part IV proposes reforms to the partnership tax allocation rules to fix this problem. In general, the proposal would require partnerships to allocate tax items among related partners pro rata based on the relative value of each related partner’s equity interest in the partnership. Although the proposal will not necessarily foreclose all opportunities for Exempt PTPs to expand beyond their traditional scope, the proposed reforms would make it more difficult in some cases for nontraditional businesses to reclassify as Exempt PTPs and, perhaps more importantly, close a significant gap in the partnership tax allocation rules that could easily be exploited by taxpayers for other myriad purposes.

2. *Id.*

3. See, e.g., Emily Cauble, *Was Blackstone’s Initial Public Offering Too Good To Be True?: A Case Study in Closing Loopholes in the Partnership Tax Allocation Rules*, 14 FLA. TAX REV. 153 (2013); Richard M. Leder, *Tax-Driven Partnership Allocations with Economic Effect: The Overall After-Tax Present Value Test for Substantiality and Other Considerations*, 54 TAX LAW. 753, 769, 779–80 (2001) [hereinafter Leder, *Tax-Driven Partnership Allocations*].

II. EXAMPLES OF ABUSIVE RELATED-PARTNER ALLOCATIONS

While entities treated as partnerships for federal income tax purposes (“partnerships”) are not themselves subject to tax, a partnership’s items of income, gain, loss, deduction, and credit (“tax items”) flow through the partnership and are allocated to its partners, who must include these tax items on their own tax returns. A fundamental issue in partnership taxation is how these tax items are allocated among partners. Because partners often have different tax attributes, an allocation regime that is too permissive would result in easy tax avoidance. For example, a partner with an expiring capital loss carryover could be allocated all of the partnership’s capital gains, which would result in those gains going completely untaxed. To deal with this problem, partnership tax regulations known as the section 704(b) regulations created the substantial economic effect test. Allocations made by the partnership agreement generally must satisfy this test to ensure that they will be respected.

The substantial economic effect test is infamously lengthy, technical, and complex. It has long been criticized as inscrutable, impossible-to-apply, and ineffective. Yet, despite all of this criticism of the substantial economic effect test, commentators have not focused much attention on one particularly glaring problem.⁴ As we explain below, the test was designed only with arm’s length partners in mind, yet it appears to apply with equal force to allocations among related partners.⁵ Because of this mismatch,

4. See *supra* note 3 and accompanying text.

5. In the context of section 704(c), by contrast, the regulations do contain a special rule that may apply when partners are related. In particular, the regulations provide that, if a partnership uses the remedial allocation method and allocates remedial items to one partner and offsetting remedial items to a related partner, the contribution of property and allocation method may be inconsistent with the intent of subchapter K. Reg. § 1.704-3(a)(1). Furthermore, section 704(e) contains a special rule that can, in some cases, affect allocations among related partners. In particular, the special rules can apply if one partner (the “donor”) provides a gift of a partnership interest to another partner (the “donee”), directly or indirectly, such as by giving the donee property which the donee, subsequently, contributes to the partnership. In addition, the special rules apply if one family member sells a partnership interest to another family member. When the special rules apply, the IRS can re-allocate income among the affected partners if the allocations in the partnership agreement do not adequately compensate these partners for the services and capital they contribute. For further discussion, see William S. McKee, William F. Nelson & Robert L. Whitmire, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 15.05 (2014) [hereinafter MCKEE ET AL., PARTNERSHIPS AND PARTNERS]. The special rules, however, do not require reallocation of income among family members who were not parties to a gift or sale of a partnership interest. *Id.* Regarding allocations among family members in situations not covered by section 704(e), see *id.* (“[I]t is unclear whether the Service can reallocate partnership income

testing related-party allocations for substantial economic effect proves to be a pointless exercise. As a result, the section 704(b) regulations freely allow taxpayers to use related-party allocations to obtain unwarranted tax benefits.⁶

Before we discuss the section 704(b) regulations and their inability to effectively police related-partner allocations, we will provide two examples to illustrate how related-partner allocations can be used to derive significant tax benefits. The first (the “CFC example”) is based on an example added to the section 704(b) regulations in 2008:

A, a domestic corporation, wholly owns corporations B and C. B is a domestic corporation, while C is a foreign corporation. A is the common parent of a consolidated group (which includes B but not C, because C is a foreign corporation) that files a consolidated tax return. B and C form partnership BC by contributing equal value to the partnership. Substantially all of BC’s income is expected to be foreign source income that will not be subpart F income. The BC partnership agreement provides that, for the first fifteen years, BC’s gross income will be allocated 10 percent to B and 90 percent to C, and BC’s deductions and losses will be allocated 90 percent to B and 10 percent to C. The partnership agreement also provides that, after the initial fifteen year period, BC’s gross income will be allocated 90 percent to B and 10 percent to C, and BC’s deductions will be allocated 10 percent to B and 90 percent to C.⁷

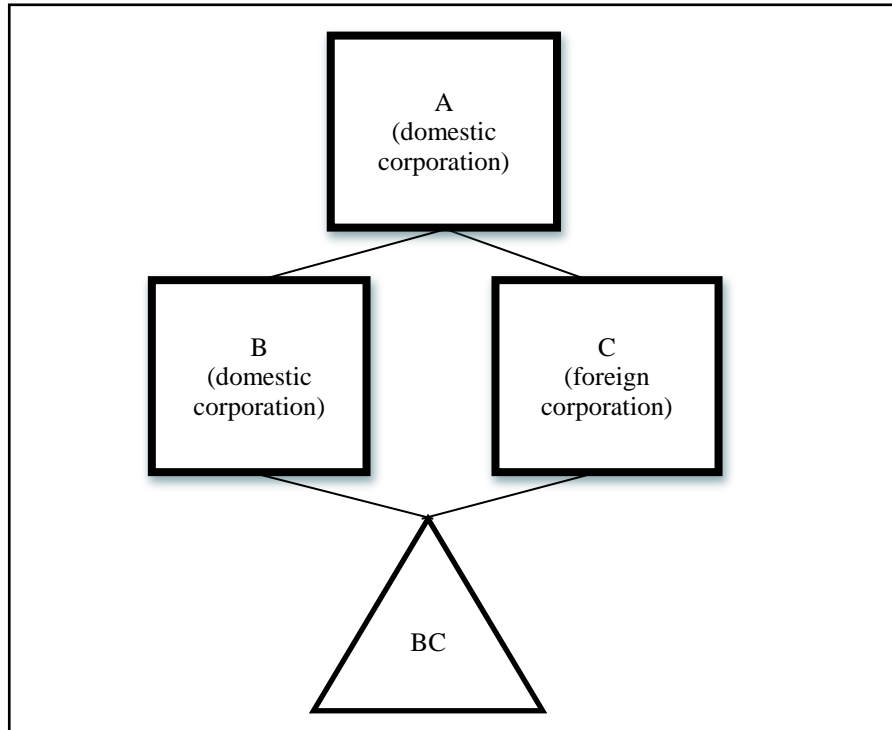
among related persons who are admittedly partners . . . but who are not subject to section 704(e)(2). Prior to the enactment of section 704(e), the Service argued on a number of occasions that partnership income could be so reallocated. The courts generally were reluctant to remake the partners’ contract except in situations of clear abuse. In general, it seems that family partners who are not subject to § 704(e)(2) should have the same freedom to allocate partnership income among themselves as unrelated partners. On the other hand, because of the lack of adversity that may exist among family partners, allocations that are palpably unreasonable may be subject to attack.”).

6. This gap in the section 704(b) regulations has not gone unnoticed by the Treasury and the IRS. In a 2008 preamble to an amendment to the section 704(b) regulations, the Treasury and the IRS announced that they “continue to consider issuing additional guidance addressing the proper treatment of special allocations of items of a partnership that is owned primarily by related parties.” T.D. 9398, 2008–24 I.R.B. 1147.

7. See Reg. § 1.704-1(b)(5), Ex. 28.

The CFC example is illustrated in Figure 1 below.

Figure 1



If effective, these special allocations will reduce the U.S. taxable income of the consolidated group of which A is the common parent during the initial fifteen year period. Gross income is shifted over to C, which does not pay U.S. tax on that income because the income is foreign sourced (and A does not pay tax currently on the income because it is not subpart F income). Meanwhile, deductions are shifted over to B, which allows the consolidated group to use those deductions to reduce its U.S. tax liability. After the initial fifteen year period, the arrangement is designed to flip, which in theory would increase the consolidated group's U.S. tax liability after the flip. But, of course, the arrangement could be modified before that occurs to mitigate this effect or, alternatively, the parties could enter into another similar arrangement that would shelter the disproportionate net income realized by the consolidated group beginning in Year 16. Regardless, at a minimum, if this arrangement were respected, the allocations would reduce the consolidated group's U.S. tax liability during the first fifteen years as compared to the tax liability that the consolidated group would incur if BC's income and deductions were simply allocated equally between B and C in those years.

It appears that, under current law, this arrangement would be respected as long as the consolidated group satisfies two technical conditions, both of which lack economic significance. First, the arrangement must satisfy the requirements of section 482, which generally requires related taxpayers to transact on arm's length terms.⁸ After describing the facts, the recently added CFC example concludes that the allocations under the agreement *may* be reallocated under section 482.⁹ The example, however, does not go on to explain how the section 482 issue would be analyzed. It would appear that the critical issue under section 482 is whether the respective partnership interests acquired by B and C were acquired on arm's length terms. Thus, to comply with the section 482 standard, B's and C's partnership interests presumably must be valued upon acquisition, and the contributions that each makes to the partnership must have a value commensurate with the value of their respective partnership interests. If B's interest is worth more than C's or vice versa, then the parties' respective contributions would have to account for that, or else section 482 would operate to recast the arrangement on arm's length terms.¹⁰

While the new section 704(b) example indicates that section 482 applies to the BC partnership, section 482 should not be much of an obstacle. A merely has to ensure that, when the partnership is formed, the expected value paid by B and C (in the form of current and future contributions of property or services or both to the partnership) is commensurate with the expected value to be received by each subsidiary (in the form of future

8. *See infra* Part III.B.

9. Reg. § 1.704-1(b)(5), Ex. 28.

10. It is worth noting that the reallocation under section 482 is not necessarily the only remedy available to the IRS in the case of disproportionate contributions. For example, in the corporate context, constructive transactions would apparently be used if contributions were not commensurate with expected distributions. *See* Reg. § 1.351-1(b)(1) (explaining that disproportionate contribution transactions may be recharacterized as gift or compensation transactions between contributors); *see also* Rev. Rul. 76-454, 1976-2 C.B. 102 (applying Reg. § 1.351-1(b)(1) to create a constructive distribution of stock in the case of disproportionate contributions). However, while a partnership's tax items are allocated to its owners under a pass-through regime, a corporation is a separate taxpaying entity—it is subject to entity-level tax on its income and therefore does not allocate tax items to its owners. Because corporations are separate taxpaying entities, the section 482 reallocation-of-tax-items remedy is not available in the corporate context, so the only remedy for disproportionate allocations is to reconstruct the purported capital contributions. On the other hand, in the partnership context, reallocations can be utilized, and the section 704(b) regulations expressly contemplate the possibility of reallocating partnership tax items using section 482. *See* Reg. §§ 1.704-1(b)(1)(iii), -1(b)(5), Ex. 28. Accordingly, it does not appear that Regulation section 1.351-1(b)(1)'s constructive transaction approach used in the corporate context is relevant in the partnership context.

nonliquidating and liquidating distributions) after appropriate discounting. Thus, the section 482 issue is simply a pricing issue, which can be resolved with appraisals. Satisfying section 482 might require that the subsidiaries contribute amounts that are not equal (contrary to the facts of the example set forth in the regulations). However, given the brother-sister relationship between B and C, contributing different amounts of capital should not be difficult to arrange. If either subsidiary lacked the requisite capital to make the appropriate contributions, the subsidiary could receive a capital contribution from the parent or borrow the capital from the parent or from some other lender.

Second, the allocations would have to satisfy the section 704(b) regulations' substantial economic effect test. This also should not be at all difficult. As discussed below, the economic effect part of that test merely requires the parties to maintain capital accounts in a specified manner and to respect those capital accounts upon liquidation, two technical requirements that, in the related party context, are easily satisfied. The substantiality prong requires that one or more partners bear the risk that the allocation scheme might harm that partner, after taking into account tax considerations. This prong is also easily satisfied because it is surely possible that the aggregate taxable income of the BC partnership might differ substantially between the initial fifteen year period (in which C is allocated a disproportionate amount of that taxable income) and the remaining life of the partnership (where B is allocated a disproportionate amount of that taxable income). Thus, B bears the risk that the initial period will be disproportionately profitable, while C bears the risk that the subsequent period will be disproportionately profitable. In the context of related partners, however, this risk-of-harm analysis is meaningless. Whatever loss might be incurred by B will inure directly to the benefit of C and vice versa. Because B and C are wholly owned by A, this is akin to moving money from a person's left-hand pocket to her right-hand pocket; it is a zero-sum game for A. For these reasons, the substantial economic effect test will not even remotely deter A's tax-minimization strategy.

Thus, it appears that BC's special allocations will be respected as long as the parties comply with these technical, but completely nonsubstantive conditions. This is true even though the allocations are entirely tax motivated and even though tax-motivated allocations are the precise target of the substantial economic effect test.

The second example (the "PTP example") of related party allocations involves the use of so-called blocker structures to qualify publicly-traded partnerships as Exempt PTPs. In general, blockers are shell corporations that are, for tax purposes, interposed between a parent company and an operating business. Blockers are used in many different situations, some of which implicate the related-partner allocation issues discussed in this Article and others that do not. One common use of blockers is to allow a

publicly traded partnership to satisfy the income requirement in section 7704(c) so as to qualify as an Exempt PTP.¹¹ To qualify as an Exempt PTP, publicly traded partnerships cannot realize more than an insubstantial amount of nonqualifying income.¹² Qualifying income is generally passive-type income, such as interest, rents, dividends, and capital gains.¹³

Traditional operating businesses usually expect to realize more than an insubstantial amount of nonqualifying income, such as compensation for services or other active business income. Historically, these businesses would not attempt to qualify for Exempt PTP status, instead simply resigning themselves to paying corporate tax on their income. However, as described in the *Wall Street Journal* article mentioned in the Introduction, many traditional businesses are now using blockers to qualify their parent company as an Exempt PTP. Instead of realizing nonqualifying income directly, which would preclude Exempt PTP status, the parent company instead can run the nonqualifying income through the blocker, which reports that income on its own corporate tax return and, after deducting expenses, pays corporate tax on the net income.¹⁴ The blocker can thereafter distribute the nonqualifying income (net of corporate taxes paid) up to the Exempt PTP parent as a dividend, which is qualifying income. While nonqualifying income is run through the blocker in this manner, qualifying income (i.e., interest, rents, dividends, and capital gains) are realized directly by the Exempt PTP, which means that these items are exempted from corporate tax.

Furthermore, to reduce the blocker's corporate tax liability, blockers are often heavily leveraged using loans from the parent Exempt PTP, which allows some of the nonqualifying income to be paid up to the parent as deductible interest. The interest income realized by the parent constitutes qualifying income. Thus, for example, a leveraged blocker that realizes \$100x of nonqualifying income might distribute \$50x in the form of interest paid on loans from the parent. If the loan qualifies as debt for tax purposes, then the interest deduction reduces the blocker's taxable income to \$50x. Assuming a 40 percent corporate tax rate, the blocker could then, for example, pay \$30x of dividends (which is qualifying income) to the parent, while \$20x (i.e., 40% * \$50x of taxable income) is paid in corporate tax. The end result is that the blocker pays tax of \$20x on the \$100x of nonqualifying income that it earns. Meanwhile all of the qualifying income received by the PTP parent—\$50x of interest paid by the blocker, \$30x of dividends

11. Exempt PTPs can be treated as partnerships for tax purposes. I.R.C. § 7704(c). As such, they will not be subject to entity level tax. I.R.C. § 701.

12. I.R.C. § 7704(c).

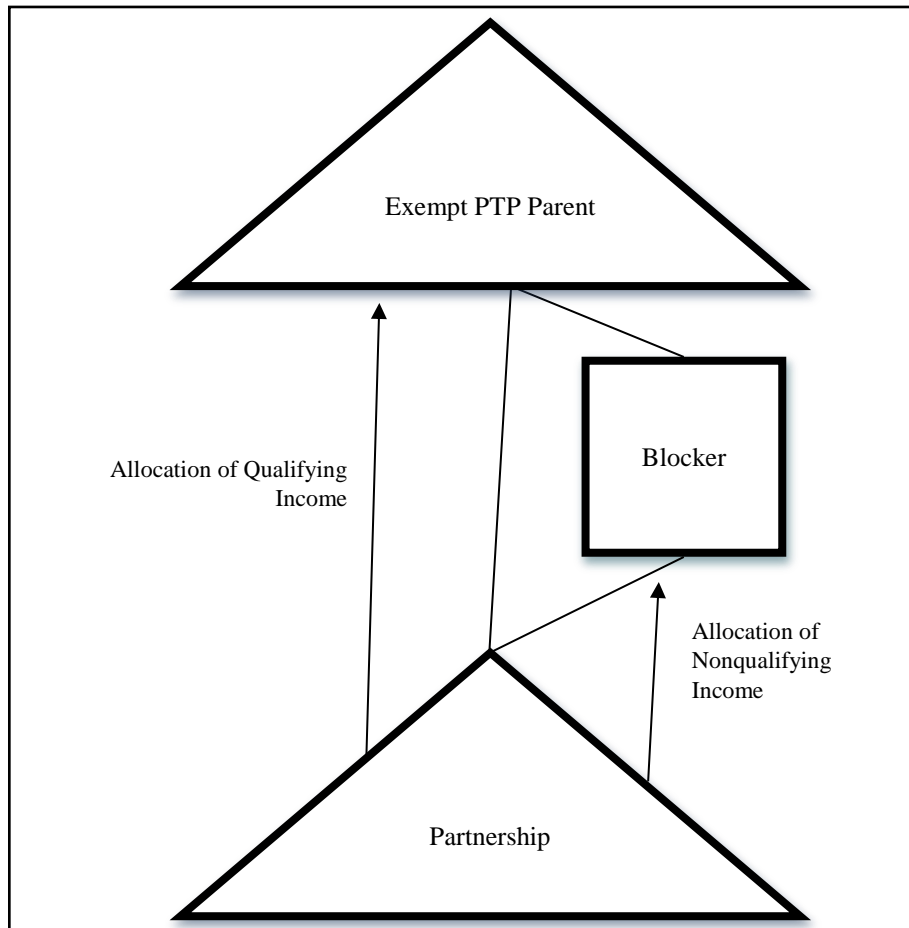
13. I.R.C. § 7704(d).

14. In some cases, the blocker may not pay U.S. tax on the income. In particular, the blocker may be formed outside the U.S. and, as a result, would generally not pay U.S. tax on foreign source nonqualifying income allocated to it, provided that such income was not effectively connected to a U.S. trade or business.

distributed by the blocker, and all of the PTP's income that is not run through the blocker—is exempt from corporate tax.¹⁵

To run its nonqualifying income through a blocker, the Exempt PTP may set up a partnership between itself and its wholly owned blocker corporation to operate the business. Qualifying income is allocated entirely to the parent, while nonqualifying income is allocated entirely to the blocker. This structure is shown in Figure 2 below.

Figure 2



15. The ability to deduct interest would be subject to certain limitations. For example, if the blocker were too thinly capitalized, some of the debt could be recast as equity for tax purposes. Likewise, if the parent charged an interest rate that was higher than a market rate, the debt could be recast as equity for tax purposes. Furthermore, section 163(j) could limit the amount of interest deductible by the blocker if the owners of the Exempt PTP are not subject to tax on the interest.

Due to the interrelatedness of the Exempt PTP Parent and the Blocker, there is a risk of reallocation under section 482. However, as in the CFC example, with appraisals (and, if necessary, intercompany transfers or loans), section 482 will not be an obstacle. The parent simply must ensure that the respective contributions by itself and the blocker are commensurate in value with the distributions that each is expected to receive from the partnership.

Likewise, the substantial economic effect test will not be difficult to satisfy. So long as there is a reasonable chance that the amount of qualifying income and nonqualifying income might fluctuate by more than an insignificant amount, there would be the requisite possibility that one partner might suffer from this arrangement, as compared to an arrangement in which all tax items were allocated pro rata based on the partners' interests in the partnership. To illustrate, assume that the nonqualifying income is expected to equal 20 percent of the business's income, but could vary between 10 percent and 30 percent. Assume the blocker contributes 20 percent of the partnership's capital, and the parent contributes 80 percent of the partnership's capital. If the nonqualifying income turns out to be 10 percent, then the blocker corporation would be worse off than it would have been had it simply received a 20 percent allocation of all of the partnership's income (in lieu of the actual allocation of 100 percent of the partnership's nonqualifying income and none of the partnership's qualifying income). This possibility that the blocker might be worse off would allow the arrangement to pass the substantiality test. Nevertheless, this risk will not deter the parent from using the blocker structure because whatever harm is done to its captive blocker inures directly to the benefit of the parent, and whatever harm is done to the parent inures to the benefit of its captive blocker.

Thus, in both examples, allocations that are wholly tax motivated will be respected, even though the substantial economic effect test was designed precisely to deter tax-driven allocations. The next section describes this gap in the substantial economic effect test and other shortcomings of existing law in more detail.

III. THE FAILURE OF EXISTING PARTNERSHIP TAX LAW

The partnership tax allocations used in the CFC example and the PTP example are entirely tax-driven. The IRS has certain tools at its disposal that could be used to combat tax-driven allocations. However, none of these tools are adequate in preventing this abuse. This Part discusses the instruments available to the IRS under current law and explains why they are insufficient.

A. *The Substantial Economic Effect Test*

Because partners in a partnership can have widely disparate tax attributes, allocations among partners can be abused. For instance, a partnership could allocate all of its high-rate income to its tax-exempt or low-tax-rate partners and all of its tax-exempt or low-rate income to its high-tax-rate partners, which would result in a reduction of the partners' collective tax liabilities. To inhibit this type of gaming, the section 704(b) regulations generally require that a partnership agreement's allocations satisfy the economic effect test and the substantiality test, which together comprise the substantial economic effect test.

The economic effect test requires that the allocations be consistent with the economic arrangement among the partners. This reduces the partners' flexibility in making tax allocations because it requires the allocations to be tethered to their economic deal.¹⁶ Pursuant to the economic effect requirement, if the partnership allocates a \$5 item of income to a partner, the allocation must increase the partner's capital account by \$5, and this must increase that partner's right to liquidating distributions by \$5.¹⁷ Proper capital accounting ensures that the partner is better off (in pre-tax terms) by \$5 than had she not been allocated the \$5 item of income.¹⁸ By requiring that allocations be consistent with the economic deal, the economic effect test provides some friction against tax-motivated allocations. If a partnership wishes to allocate \$5 of income to a low-bracket partner or \$5 of loss to a high-bracket partner, the economic effect prong requires that those allocations must affect capital accounts and that capital account balances must determine the amount of liquidating distributions to each partner.

Nevertheless, because of the possibility of offsetting allocations, the economic effect requirement is not, by itself, much of an obstacle to engaging in tax-motivated allocations. If a partnership expects to receive different characters of tax items or even different timing of same-character tax items, the partnership could (consistent with the economic effect test) still allocate the items in a tax-advantaged way while not changing the real, overall economic deal.¹⁹ The partnership would do this by using offsetting allocations.

16. Reg. § 1.704-1(b)(2)(ii)(a).

17. See Reg. § 1.704-1(b)(2)(ii)(b). Liquidating distributions can be negative, meaning that a partner with a negative capital account would be required to contribute money to the partnership upon liquidation. See Reg. § 1.704-1(b)(2)(ii)(b)(3).

18. However, the partner will not receive the additional \$5 until a liquidation occurs, which could be many years in the future. Thus, in present value terms, the partner may not receive a benefit as large as \$5.

19. See Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1, 4 (1990) [hereinafter Gergen, *Reforming Subchapter K*] (explaining

To illustrate, assume that there is a 50/50 partnership between X and Y and that X is tax-exempt²⁰ while Y is taxable. The partnership could specially allocate the first \$5 of its taxable income to X and the first \$5 of its tax-exempt income to Y, with all other items split evenly. Assuming that the partnership earns at least \$5 of taxable income and \$5 of tax-exempt income, X and Y are, from a pre-tax perspective, in the same economic position that they would have occupied absent the special allocations. Nevertheless, they have effected a partial sale of X's tax-exemption, which makes Y better off (by exchanging \$2.50 of taxable income for \$2.50 of tax-free income), X no worse off (because X is tax-exempt), and the government worse off (because it is collecting less tax revenue from the partners collectively).²¹

The substantiality test is intended to inhibit this type of tax planning.²² In operation, the substantiality prong does not prohibit outright the effective selling of tax attributes through the use of partnership allocations. Instead, to be respected, such a "sale" must be accompanied by some degree of risk that the partners' original economic deal will be altered. In particular, to satisfy the substantiality test, allocations in a partnership agreement must overcome a number of obstacles, the most stringent of which

that partners could use special allocations to "shift gain and loss [to] take advantage of tax rate differences between partners" and to "shift income, gain, or loss on assets so that partners may take advantage of differences in their character.").

20. For example, X might have large amounts of net operating losses that it expects would otherwise expire before being utilized.

21. X and Y are in the same pre-tax position because their capital accounts will be the same after the special allocations as they were before. The critical fact in this regard is that the partnership will realize at least \$5 of each type of income.

22. See Terence Floyd Cuff, *Proposed Regulations Try – Unsuccessfully – to Fix a Broken Set of Substantiality Rules*, 104 J. TAX'N 280, 282 (2006) ("The after-tax filter of 'substantiality' in the Regulations represents an effort to objectify what is an inherently subjective inquiry—whether the transaction is motivated by business profit as opposed to tax profit."); Gergen, *Reforming Subchapter K supra* note 19, at 14 (noting that substantiality "is essentially a rule against tax-driven allocations"); GEORGE K. YIN & KAREN C. BURKE, *PARTNERSHIP TAXATION* 97 (2009) (noting that the "general intent [of the substantiality prong] is to ferret out and invalidate allocations that allow taxpayers, operating through a partnership, to achieve greater tax savings than had they simply operated on their own."); Andrea Monroe, *Too Big To Fail: The Problem of Partnership Allocations*, 30 VA. TAX REV. 465, 487 (2011); Gregg D. Polsky, *Deterring Tax-Driven Partnership Allocations*, 64 TAX LAW. 97, 99 (2010) [hereinafter Polsky, *Tax-Driven Allocations*] ("If a partnership expects to receive different types of income or gain, or different types of deduction or loss, the partnership could—consistent with the economic effect prong—still allocate the items in a tax-advantaged way while not changing the real, overall economic deal. . . . The second prong of the substantial economic effect test (substantiality) is intended to inhibit this type of tax planning.").

is the overall tax effects test contained in Regulation section 1.704-1(b)(2)(iii)(a) which provides:

[T]he economic effect of an allocation . . . is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation . . . were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation . . . were not contained in the partnership agreement.²³

More simply, a set of potentially offsetting allocations lacks substantiality if it may make one partner better off (after tax) and is not likely to make any partner substantially worse off (after tax), as compared to what would occur if the allocations were not in the partnership agreement.²⁴

Applying this test to the XY partnership example reveals that the allocations lack substantiality. In applying the test, we compare what each partner is likely to receive, as a result of the allocations, to what each partner would have received if the partnership had allocated each type of income

23. Reg. § 1.704-1(b)(2)(iii)(a). There are other hurdles that an allocation must overcome in order for the allocation to have substantiality. For example, the allocation cannot be a “shifting allocation” and the allocation cannot be a “transitory allocation.” See Reg. §§ 1.704-1(b)(2)(iii)(b), -1(b)(2)(iii)(c).

24. Regarding what occurs if the allocation were not in the partnership agreement, the regulations instruct us to determine what would occur if everything were allocated based on the Partners’ Interests in the Partnership (PIP). Reg. § 1.704-1(b)(2)(iii)(a). PIP utilizes a facts and circumstances test. To determine PIP, one must examine all the facts and circumstances that relate to the economic arrangement of the partners (including but not limited to: the partners’ relative contributions to the partnership, the interests of the partners in economic profits and losses, the interests of the partners in cash flow and other nonliquidating distributions, and the rights of the partners to distributions of capital upon liquidation). Reg. §§ 1.704-1(b)(3)(i) to -(ii). For further discussion of PIP, see Bradley T. Borden, *The Allure and Illusion of Partners’ Interests in a Partnership*, 79 U. CIN. L. REV. 1077 (2011). Furthermore, for purposes of determining PIP that is used as a baseline for testing allocations for substantiality, we must ignore the potentially suspect allocation that is being evaluated. Reg. § 1.704-1(b)(2)(iii)(a) (“References in this paragraph (b)(2)(iii) to a comparison to consequences arising if an allocation . . . were not contained in the partnership agreement mean that the allocation . . . is determined in accordance with the partners’ interests in the partnership . . . *disregarding the allocation . . . being tested under this paragraph (b)(2)(iii).*”) (emphasis added).

equally to each partner.²⁵ At the time the partners agree to specially allocate the taxable and tax-exempt items, it appears that Y is definitely better off and X definitely no worse off than if all items were allocated 50/50. The only way that one partner might be worse off by virtue of the special allocations is if there is a realistic possibility that both of the following conditions are satisfied: (1) the partnership could realize less than \$5 of taxable or tax-exempt income and (2) the amounts of taxable and tax-exempt income could differ. Otherwise, it is clear that no partner will be worse off and, accordingly, the special allocations would lack substantiality.

By contrast, consider the facts of the following example. Assume that, in the VW partnership, partner V is tax-exempt while partner W is taxable. Each partner contributes an equal amount of capital to the partnership. The partnership allocates its taxable income 90 percent to V and 10 percent to W and allocates its tax-exempt income 10 percent to V and 90 percent to W.

The allocations in this example will likely pass the substantiality test because, at the time the partners agree to the allocations, there is a real risk that one or the other partners would be worse off compared to a 50/50 allocation scheme. If the taxable income is sufficiently greater than the tax-exempt income, then W is substantially worse off, and, if the tax-exempt income is sufficiently greater than the taxable income, V suffers substantially. The only way the allocations might not pass muster is if there is a high degree of likelihood that the respective amounts of taxable income and tax-exempt income recognized by the VW partnership will be approximately equal.²⁶ In that case, V (the tax-exempt partner) would not be substantially worse off, because it would be allocated approximately the same amount as it would have been allocated absent the special allocation. Meanwhile, W (the taxable partner) would be better off after taxes because it will be allocated roughly the same amount as it would have otherwise been allocated, but its allocations will be disproportionately comprised of tax-exempt income.

When partners are transacting at arm's length, the economic effect and substantiality rules are, at least in theory if not in practice, sensible. If two arm's length partners want to use allocations to play tax games, then they must take the risk that one partner might suffer a loss and the other might receive a windfall. While it would be a zero-sum game between the

25. See *supra* note 24.

26. In fact, if, in retrospect, the amount of taxable income is very close to the amount of tax-exempt income, the IRS could benefit from a presumption that the allocation was a shifting allocation and therefore lacked substantiality. See Reg. § 1.704-1(b)(2)(iii)(b). The taxpayers could, nevertheless, rebut this presumption by showing that, at the time they agreed to the allocations, there was adequate risk that the amounts of income could have been sufficiently different. *Id.*

partners, the partners' original economic deal would be altered, and a partner might refuse to play the game because of the risk that it might end up the loser. Thus, in the VW partnership example, for instance, given that the special allocations create significant risk for the parties, they may be unwilling to go along with them if the only goal of the allocations is to reduce taxes. And, by implication, if V and W do agree to the special allocations notwithstanding this significant risk, the allocations might serve some goal other than mere tax avoidance. Perhaps, for instance, V is primarily responsible for selecting investments that generate taxable income, W is primarily responsible for selecting investments that generate tax-exempt income, and the special allocations are designed to incentivize each party to select investments wisely. While this line of reasoning can be and has been critiqued on a number of different grounds,²⁷ it is not patently absurd.

On the other hand, when partners are closely related, these rules are completely nonsensical. The rationale behind the rules is premised on economic tension between partners, though this is never stated explicitly. For tax-motivated allocations to be respected, there must be the risk that one partner might be worse off (and, by implication, the other partners better off). But, in the context of related partners, the partners are effectively different pockets of the same taxpayer. Therefore, the risk of making one partner worse off will not result in any deterrent effect because the other related partner(s) would always receive an equal and offsetting windfall. In the VW partnership example, for instance, if V and W were wholly-owned subsidiaries of a common parent, the fact that the allocations might make W worse off after tax (to the benefit of V) would provide no assurance that the allocations were not entirely tax-motivated.

This analysis proves two points. First, the substantial economic effect test will not deter tax-motivated allocations among related partners. Second, because the substantial economic effect test is premised on economic tension among partners, it is clear that the drafters of the section 704(b) regulations did not have related-partner allocations in mind when they wrote those rules.

B. Section 482

Section 482 deals broadly with the ubiquitous problems arising from the fact that related parties do not negotiate at arm's length. Accordingly,

27. For a discussion of the theoretical deficiencies of the substantiality test, see Polsky, *Tax-Driven Allocations*, *supra* note 22. For discussion of substantiality's practical shortcomings and other flaws, see, for example, Gergen, *Reforming Subchapter K*, *supra* note 19; Calvin H. Johnson, *Partnership Allocations from Nickel-on-the-Dollar Substance*, 134 TAX NOTES 873 (Feb. 13, 2012); Leder, *Tax-Driven Partnership Allocations*, *supra* note 3.

related parties might transact with each other in artificial ways purely to minimize aggregate tax liability. Section 482 provides:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.²⁸

In the context of partnership tax allocations, the regulations explicitly note that the IRS may use section 482 to challenge partnership tax allocations when partners are related.²⁹ In particular, Regulation section 1.704-1(b)(1)(iii) states: “[A]n allocation that is respected under [the substantial economic effect rules] nevertheless may be reallocated under other provisions, such as section 482”³⁰ This language is supplemented by Example 28 (similar to the CFC example described above), which concludes that the special allocations “may be” reallocated under section 482.³¹

Section 482 will not, however, be effective in dealing with the problem of abusive related-partner allocations. As long as the amounts and types of income earned by a partnership are sufficiently variable, the partnership can easily comply with both section 482 and the substantial economic effect rules.

28. I.R.C. § 482

29. For further discussion, see Leder, *Tax-Driven Partnership Allocations*, *supra* note 3, at 785–87; MCKEE ET AL., *PARTNERSHIPS AND PARTNERS*, *supra* note 5, at ¶ 3.07[4] (“While there is limited case law dealing with the application of § 482 to partnerships, the courts have not been reluctant to apply it to situations where partners are related or are under common control. . . . The scope of § 482 is broad enough to encompass . . . partnerships between corporations and their controlling shareholders, . . . assuming the controlling shareholders are viewed as ‘organizations, trades or businesses’ for purposes of § 482”); *id.* at ¶ 11.03[3] (“[A]n allocation provision, which is in substance a contract among the partners as to how they will share the partnership’s income and loss, can distort the income of the partners vis-à-vis each other. Accordingly, § 482 should apply to permit the Service to correct such distortions where certain partners are under common control.”).

30. Reg. § 1.704-1(b)(1)(iii).

31. *See* Reg. § 1.704-1(b)(5), Ex. 28; *supra* text accompanying note 9.

To illustrate, consider again the facts of the PTP example and assume that nonqualifying income is expected to equal 20 percent of the business's total income, but could vary between 10 percent and 30 percent. To avoid challenge under section 482, it appears that the partnership interests acquired by the blocker and the Exempt PTP Parent simply must be acquired on arm's length terms.³² Thus, in this example, to comply with section 482, the blocker might contribute 20 percent of the partnership's capital and the parent might contribute 80 percent of the partnership's capital to match the distributions each partner expects to receive. If the blocker does not own enough capital to make the 20 percent capital contribution, then the parent could contribute or lend additional capital to the blocker to allow it to make the requisite contribution.

This structure would also pass muster under the substantial economic effect test because there is sufficient risk that the blocker will be substantially worse off than if all income items were simply allocated on a 20/80 basis, as opposed to allocating all of the nonqualifying income to the blocker and all of the qualifying income to the parent. The blocker bears the risk that the amount of nonqualifying income might be as low as 10 percent of the total income.³³

32. See Reg. § 1.482-1(b)(1) (“[T]he standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer.”).

33. If the types of income earned by a partnership are not sufficiently variable, simultaneous compliance with section 482 and the substantial economic effect rules presents a greater challenge. For instance, consider again the facts of the PTP example but assume the nonqualifying income could vary between 18 percent and 22 percent of the business's income. In order to guard against challenge under section 482, the Blocker and the Exempt PTP Parent would still contribute 20 percent and 80 percent of the partnership's capital, respectively. However, contributing capital in these amounts could leave the partners vulnerable to challenge under the substantial economic effect rules. To bolster their chances of passing the substantiality test, the partners may be inclined to require the Blocker to contribute more than 20 percent of total capital so that the allocations would have greater potential to make the Blocker worse off, after tax, relative to the after tax consequences that would result from allocating all income pro rata based on the partners' interests in the partnership. However, if the Blocker contributes greater than 20 percent of total capital while expecting to receive (on an average) only 20 percent of the future distributions, then the partners are more susceptible to challenge under section 482. Moreover, even if the amounts of income earned by a partnership are quite variable, partners may be concerned that, if the partnership indeed earns the amounts and types of income they predict and if they have contributed capital based on the expected future income to guard against challenge under section 482, the IRS could benefit from a presumption that the allocations are shifting allocations and therefore lack substantiality. However, the partners should be able to rebut the presumption by showing that the amounts of income could have been quite different. See *supra* note 26. Furthermore, although there is no formal presumption in the case

C. *Reading More Into Substantiality*

When applying the substantiality test, the section 704(b) regulations direct us to take into account “the interaction of an allocation with [a] partner’s tax attributes that are unrelated to the partnership.”³⁴ In a 1993 field service advisory, the IRS suggested obliquely that a partner’s “tax attributes” could include the fact that the partner is related to another partner.³⁵ This approach has apparently not gained any traction over the past 20 years, but it could conceivably address the problem identified in this Article. Presumably, under such an approach, if the amount by which an allocation scheme might make one partner worse off inured entirely to the benefit of a related partner, the partnership could not rely on the fact that the allocation scheme might harm the first partner in order to establish that the allocations pass the substantiality test. In other words, the approach would allow the IRS to combine the economic consequences of related partners to determine whether the combination of partners could suffer a substantial economic detriment.

Reading “tax attributes” expansively in this manner is a tempting approach to closing an unintended gap in the section 704(b) regulations. However, the IRS or courts might determine that the approach is foreclosed by the literal language of the regulations. After all, the regulations refer to a partner’s “tax attributes”—not a partner’s “attributes.” Furthermore, the regulations provide some examples of tax attributes that are taken into account, such as a taxpayer’s marginal tax rate,³⁶ net operating loss carryforward,³⁷ and foreign taxpayer status. Thus, “tax attributes” appears to refer to tax-specific attributes of a partner, not to a partner’s economic relationship with other partners.

Furthermore, this expansive interpretation of “tax attributes” would effectively mean that allocations in an entirely captive partnership (i.e., a partnership where all of the partners are related) would apparently never pass

of the overall tax effects test, as a practical matter, the test might be applied as if there were such a presumption. *See* Polsky, *Tax-Driven Allocations*, *supra* note 22, at 113. Nevertheless, in many cases, the amounts and types of potential income earned by a partnership will vary sufficiently so that the partnership can easily pass the substantiality test and withstand challenge under section 482.

34. Reg. § 1.704-1(b)(2)(iii)(a).

35. *See* F.S.A. (Sept. 10, 1993), 1993 WL 1469410 (“Given the present facts, it is important to examine the economic relationship of the partners of the Partnership. While the substantiality regulations do not specifically address the issue of related partners, section 1.704-1(b)(2)(iii)(a) does require the Service to consider each partner’s tax attributes.”) For further discussion of this possibility, see Leder, *Tax-Driven Partnership Allocations*, *supra* note 3, at 779.

36. *See, e.g.*, Reg. § 1.704-1(b)(5), Ex. 5.

37. Reg. § 1.704-1(b)(5), Ex. 9.

muster under the substantial economic effect test. These allocations would not have substantial economic effect because, once you combine the related partners in a captive partnership, there is only one partner, so there is no partner who could be made worse off. In other words, once you consider relatedness in a captive partnership, it will be a foregone conclusion that allocations are simply shifting amounts from one pocket to another of a single taxpayer to obtain better tax results.

This effect of reading “tax attributes” expansively—that is, that captive partnership allocations will almost never have substantial economic effect due to the overlapping interests of the related partners—is problematic for two reasons. First, if the regulation’s drafters had intended for this result, presumably they would have simply said that captive partnership allocations lack substantial economic effect rather than relying on a strained interpretation of “tax attributes” to get there. Second, it is not at all clear how related party allocations would be reallocated according to the partners’ interest in the partnership (“PIP”), which is the consequence of failing the substantial economic effect test.³⁸ The PIP test requires that tax items must be allocated in accordance with the economic arrangement of the partners, and, to determine the partners’ economic arrangement, one must examine all relevant facts and circumstances. The PIP test specifically identifies some relevant economic facts and circumstances—the partners’ relative contributions to the partnership, the interests of the partners in economic profits and losses, the interests of the partners in cash flow and other nonliquidating distributions, and the rights of the partners to distributions of capital upon liquidation—but acknowledges that there may be other relevant facts and circumstances.³⁹ If relatedness of the parties is a relevant “tax attribute” in applying the substantial economic effect test, then presumably that factor is relevant to the PIP analysis. And once relatedness is taken into account under PIP, the related partners would presumably be collapsed together in applying that test. The end result then is that there really is no partnership,⁴⁰ just multiple pockets of a single taxpayer, which makes the PIP test impossible to apply. While it is possible that the related parties could be “looked through” for purposes of substantiality while still respected as separate for purposes of the PIP analysis, such an approach would be bizarre because allocations under PIP are supposed to be based on the real-world economics of the partners’ sharing arrangement. If related partners are treated effectively as one partner for purposes of the substantiality safe

38. Reg. § 1.704-1(b)(1)(i).

39. Reg. §§ 1.704-1(b)(3)(i) to -(ii).

40. If there is at least one nonrelated partner, then there would still be a partnership, but the related partners would be collapsed together into a single partner with multiple pockets.

harbor because they are really a single economic unit, it is difficult to understand how they could be respected as separate under PIP.

In summary, while interpreting “tax attributes” expansively might have superficial appeal as an instrument to attack abusive related party allocations, it seems to stretch the language too far. It would also throw all related party allocations into the highly uncertain PIP test. And it is extremely unclear how that test, which is based on the real economic deal between partners, would apply to reallocate items among partners that are merely components of a single economic unit.

D. *The Partnership Anti-Abuse Rule*

In May 1994, the Treasury proposed regulations known as the “Partnership Anti-Abuse Rule” in response to the increasing prevalence of abusive partnership transactions.⁴¹ The proposed regulations provoked intense criticism from practitioners.⁴² They complained that the regulations were overly vague and beyond the scope of the Treasury’s rulemaking authority.⁴³ Partially in response to criticisms, Treasury revised the regulations to include additional examples and a list of factors that may be relevant in determining whether or not a transaction is abusive.⁴⁴ Yet, despite the revisions made by Treasury, practitioners continue to criticize the regulations.⁴⁵

41. For the Proposed Regulation, see Prop. Reg. § 1.701-2, 59 Fed. Reg. 25,581 (1994). For discussion of the events prompting the proposed regulation, see, for example, Andrea Monroe, *What’s in a Name: Can the Partnership Anti-Abuse Rule Really Stop Partnership Tax Abuse?*, 60 CASE W. RES. L. REV. 401, 408–13 (2010) [hereinafter Monroe, *What’s in a Name*].

42. See, e.g., Monroe, *What’s in a Name*, *supra* note 41, at 407.

43. See, e.g., Monroe, *What’s in a Name*, *supra* note 41, at 416–24. Although most practitioners criticized the proposed regulations, some scholars and practitioners supported the Partnership Anti-Abuse Rule. *Id.*

44. See, e.g., Monroe, *What’s in a Name*, *supra* note 41, at 426 (“[T]he Treasury did revise the [Partnership Anti-Abuse Regulation], presumably to mollify the regulation’s critics.”).

45. See, e.g., Sheldon I. Banoff, *Anatomy of an Anti-Abuse Rule: What’s Really Wrong with Reg. Section 1.701-2*, 95 TAX NOTES TODAY 56-84 (Mar. 22, 1995); Richard M. Lipton, *The Partnership Anti-Abuse Regs Revisited: Is There Calm After the Storm?*, 83 J. TAX’N. 68, 68 (1995); MCKEE ET AL., PARTNERSHIPS AND PARTNERS, *supra* note 5, at ¶ 1.05[5][a] (concluding that the Partnership Anti-Abuse Rule is invalid under a *Chevron* analysis); Monroe, *What’s in a Name*, *supra* note 41, at 436; Lee Sheppard, *Government Officials Discuss Partnership, Shelter Issues*, 2007 TAX NOTES TODAY 107-1 (June 4, 2007) (mentioning that practitioners think the Partnership Anti-Abuse Rule is invalid); Sheryl Stratton, *They’re Back . . . Washington Lawyers Attack Anti-Abuse Rules*, 95 TAX NOTES TODAY 178-4 (Sept. 12, 1995). However, for an argument that the anti-abuse rules are necessary and also

As finally adopted, the Partnership Anti-Abuse Rule provides:

[I]f a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of [the partnership tax rules], the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of [the partnership tax rules].⁴⁶

The regulations further provide that, in order to determine whether a partnership was formed or availed of for such a prohibited purpose, the IRS must consider all relevant facts and circumstances.⁴⁷ Furthermore, the regulations contain a list of factors that may indicate, but do not necessarily establish, that a partnership was used for a prohibited purpose.⁴⁸ These factors include, among others: (1) whether the present value of the partners' aggregate tax liability is substantially less than the tax liability the partners would incur if they engaged in the partnership's activities and owned the partnership's assets directly;⁴⁹ (2) whether substantially all of the partners are related to one another,⁵⁰ and (3) whether partnership items are allocated in compliance with the literal language of the substantial economic effect rules but with results that are inconsistent with the purpose of those rules.⁵¹

These three factors appear to cover the CFC example and the PTP example. Regarding the first factor, in the case of the CFC example, if B and C directly owned the underlying assets of the BC partnership, B would earn more income (and benefit from fewer deductions) in the first 15 years, and the present value of the consolidated group's and C's aggregate U.S. tax liability could increase. In the PTP example, if the Exempt PTP Parent and the Blocker directly owned what they own through the partnership, the Exempt PTP Parent would earn more nonqualifying income. As a result, the Exempt PTP Parent could fail to qualify as an Exempt PTP. This failure would subject the Exempt PTP Parent to corporate level tax on its qualifying income. Thus, the partnership structure used in the PTP example substantially reduces the partners' aggregate tax liability.

valid under a *Chevron* analysis, see, for example, Noël B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1, 39–62 (2004).

46. Reg. § 1.701-2(b).

47. Reg. § 1.701-2(c).

48. *Id.*

49. Reg. § 1.701-2(c)(1).

50. Reg. § 1.701-2(c)(4).

51. Reg. § 1.701-2(c)(5).

With respect to the second factor, all of the partners are related given that, in the CFC example, the two partners are wholly-owned subsidiaries of a common parent and, in the PTP example, one partner is a wholly-owned subsidiary of the other partner. Regarding the third factor, in both cases, the partnership's allocations comply with the literal language of the substantial economic effect rules,⁵² yet, the allocations are inconsistent with the purpose of those rules because the allocations are entirely tax-motivated.⁵³

If the Partnership Anti-Abuse Rule applies, the IRS could seek a number of remedies including re-allocating items allocated by the partnership or disregarding the partnership entirely.⁵⁴ Thus, application of the Partnership Anti-Abuse Rule could remedy the problem of abusive related-partner allocations.

Nevertheless, we are not confident that the Partnership Anti-Abuse Rule will suffice. First, because it is a general standard, as opposed to a technical rule, there will be significant litigation risk if the IRS were to challenge related-partner allocations by relying on the Partnership Anti-Abuse Rule. Although the IRS could persuasively argue that the three factors discussed above are implicated, this does not conclusively establish that the Partnership Anti-Abuse Rule applies.⁵⁵ And, particularly in light of its contentious history, a judge may hesitate to rely on the Partnership Anti-Abuse Rule given that partnership allocations are covered by the extremely detailed rules in the section 704(b) regulations. Second, given the intensely fact-specific nature of the rule, application of the Partnership Anti-Abuse rule in particular cases will not necessarily prevent widespread use of related-partner allocations. Taxpayers who use related-partner allocations could argue that their facts are materially different and force the IRS to play the "whack-a-mole" game in litigation. Therefore, even though we believe that the Partnership Anti-Abuse Rule generally applies to related-partner allocations, we believe that a specific and prophylactic rule nevertheless would still be useful.

52. See *supra* Part III.A.

53. See *supra* note 22 and accompanying text (observing that the purpose of the substantiality test is to prevent overly tax-motivated allocations).

54. Reg. §§ 1.701-2(b)(4), -2(b)(1). Instead of relying on the Partnership Anti-Abuse Rule to argue that the partnership should be disregarded, the IRS could contend that a supposed partnership among related parties is not, in reality, a partnership at all, based on more general substance over form principles. Like an argument based on the Partnership Anti-Abuse Rule, this argument is vulnerable to litigation risks because a court may not be receptive to an argument based on substance over form principles.

55. Reg. § 1.701-2(c).

IV. PROPOSED REFORM: DISALLOWING SPECIAL ALLOCATIONS AMONG RELATED PARTNERS

A. *The Proposal*

To close the unintended gap in existing law, the section 704(b) regulations should be revised to disallow special allocations among related partners. In particular, allocations between related partners should be deemed to automatically fail the substantial economic test, and the PIP test (which governs how tax items are allocated when the substantial economic effect test is not satisfied) should be revised to require that these allocations be made on a pro rata basis in accordance with the respective value of each related partner's equity interest in the partnership. For this purpose, partners would be "related" whenever they had a relationship that sufficiently interfered with arm's length bargaining.

The relatedness definition could be borrowed from an existing Code provision (or a combination of existing provisions) such as section 267 and section 707(b).⁵⁶ To trigger the rule, the relatedness threshold should be less than 100 percent. This is because the tax benefits of avoiding relatedness will often outweigh the nontax costs of inserting a de minimis unrelated "accommodation party" into the deal. To prevent circumvention via accommodation parties, other related party rules in the tax law typically use the 80 percent relatedness threshold, and it probably makes sense to use the same threshold in this context.

It is important to emphasize that, while the degree of relatedness between partners is significant, the aggregate ownership interest percentages of related partners in a given partnership is not at all important. For example, assume that X is a wholly-owned subsidiary of Y, X and Y own interests in a partnership equal to 15 percent and 10 percent, respectively, of the partnership's total equity, and the remaining 75 percent of partnership equity is owned by unrelated partners. Under our proposal, special allocations between X and Y would be disallowed and re-allocated pro rata between them. The fact that X and Y do not collectively own a majority or controlling

56. Adopting a precise definition of relatedness does create a risk that taxpayers will use the clear definition as a roadmap for designing transactions that do not fall within the scope of the proposed rules. In order to mitigate this risk, the relatedness definition could be accompanied by attribution rules that treat taxpayers as owning interests in a partnership owned by related taxpayers. The attribution rules could be similar to the attribution rules contained in section 267(c) or similar to even broader attribution rules contained elsewhere in the Code. Alternatively, instead of adopting a precise definition of relatedness, the proposed reform could rely on a general standard—such as the standard in section 482. This would be more difficult for taxpayers to avoid through tax structuring, but it would, at the same time, be more difficult for taxpayers to apply and for the IRS to administer.

interest in the partnership does not make the allocations between them any less problematic; the critical fact is that there is no arm's length bargaining between X and Y.⁵⁷

The specific mechanics of our proposal are as follows. If all of the partners in a partnership are related to each other, then all of the partnership's tax items will be allocated among the partners pro rata based on the value of their respective equity interests in the partnership.⁵⁸ While valuation of the interests might appear unduly onerous, recall that to pass muster under section 482, each related partner's actual and expected contributions of capital and services must be proven to be commensurate with the respective value of the partner's equity interest.⁵⁹ This means that the respective values of the related partners' equity interests must already be determined under existing law. Therefore, taxpayers and the IRS would incur no additional administrative burden in applying this rule.

If only some of the partners are related to each other, the proposal would require two steps. First, the allocations among the members of the

57. One might believe that the fact that X and Y do not collectively own a majority or controlling interest is relevant because, without such an interest, they have less of an ability to influence the partnership agreement and the resulting partnership tax allocations. For example, the Partnership Anti-Abuse Rule includes captive partnerships as a factor suggesting abusiveness, but the existence of related minority partners is not a factor. *See* Reg. § 1.701-2(c)(4) (listing as a factor indicative of abusiveness: whether "substantially all" of the partners are related to one another). However, because the allocations between X and Y do not affect the other partners in the partnership, those partners may readily agree to special allocations between X and Y, or X and Y might enter into a side agreement providing for special allocations between themselves.

58. Special allocations can be of the "shifting" variety or the "transitory" variety. Shifting allocations involve allocations that offset in a single taxable year, while transitory allocations offset over multiple tax years. In each case, the reallocation rule proposed above would reallocate the allocations pro rata in accordance with the value of each related partner's equity interest in the partnership. Thus, if two related partners own the partnership interests of identical value, but partner X is allocated all of the net capital gains in Year 1 and partner Y is allocated all of the net ordinary income in that year, then each partner would be allocated half of each character of income in Year 1. If, instead, partner X is allocated all of the net income in year 1, and partner Y is allocated all of the net income in year 2 and if the amount of income expected to be earned in each year is such that the partnership interests have identical value, then each partner will be allocated half of the net income in each year. The reallocation in both cases is made in accordance with the value of each partner's equity interest in the partnership.

59. If the proposed reforms utilized a definition of "related" partner that was broad enough to encompass family members, the relative contributions by those partners would be tested under section 704(e) (if it applied given the particular facts involved), or, if section 704(e) did not apply, the relative contributions could be tested under similar principles that could be incorporated into the proposed reforms.

related partner group must be determined. These must be made on a pro rata basis, so that each related partner receives a pro rata “slice” of all items of the partnership’s income, gain, loss, deduction, or credit that are allocated to the related partner group. The size of each related partner’s slice is based on the respective value of that partner’s interest in the partnership relative to the entire related partner group’s interest. (Again, because the relative value of each related partner’s interest is required under section 482, there is no marginal administrative burden resulting from this first step.) Second, the partnership’s allocations would be tested under the regular substantial economic effect test, but, for purposes of this test, partners who are related to each other would be grouped together and treated as one partner.⁶⁰ For example, when testing whether the allocations make partners better or worse off after tax for substantiality purposes, the effect on a related partner is not examined separately—rather the relevant inquiry is whether the related partner group as a whole is made better or worse off.⁶¹

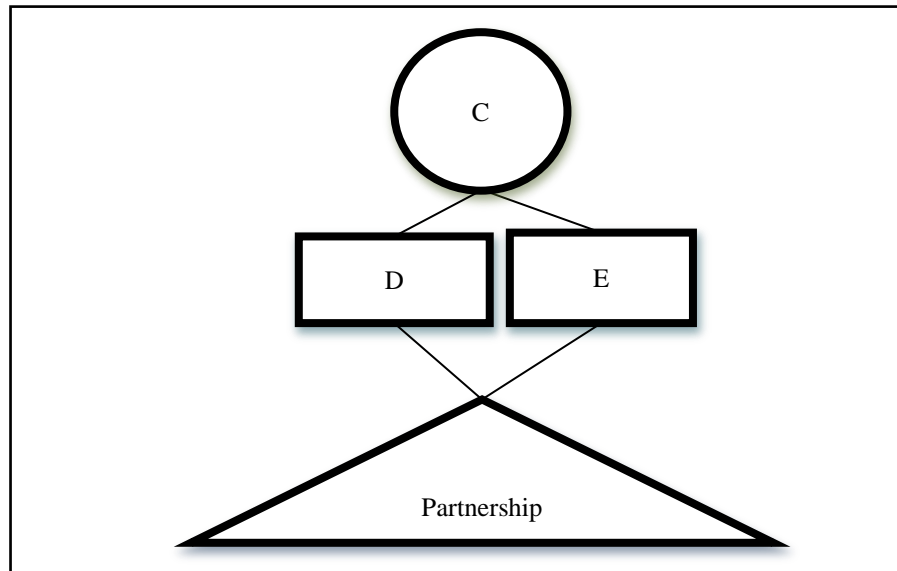
The following examples demonstrate the parameters of the proposal and its effects:

Example 1. C owns 100% of each of two corporations—D and E. D and E hold the only equity interests in a partnership and the value of each of their interests is equal. This ownership structure is shown in Figure 3 below. D and E each contribute equal value to the partnership; therefore, the arrangement passes muster under section 482. The partnership earns \$300 of taxable income and \$200 of tax-exempt income. As a result of the proposed reform, the partnership could not allocate any item of income between D and E in a way that differed from their relative equity interests. Thus, the partnership must allocate to each partner \$150 of taxable income and \$100 of tax-exempt income.

60. If the allocations failed the substantial economic effect test, then items of the partnership would be reallocated in two steps. First, items would be reallocated based on the regular PIP test, but, for purposes of this test, partners who are related to each other would be grouped together and treated as one partner. Second, any item that was reallocated to the related partner group would be allocated within that group among the members pro rata based on the relative value of the related partners’ interests in the partnership.

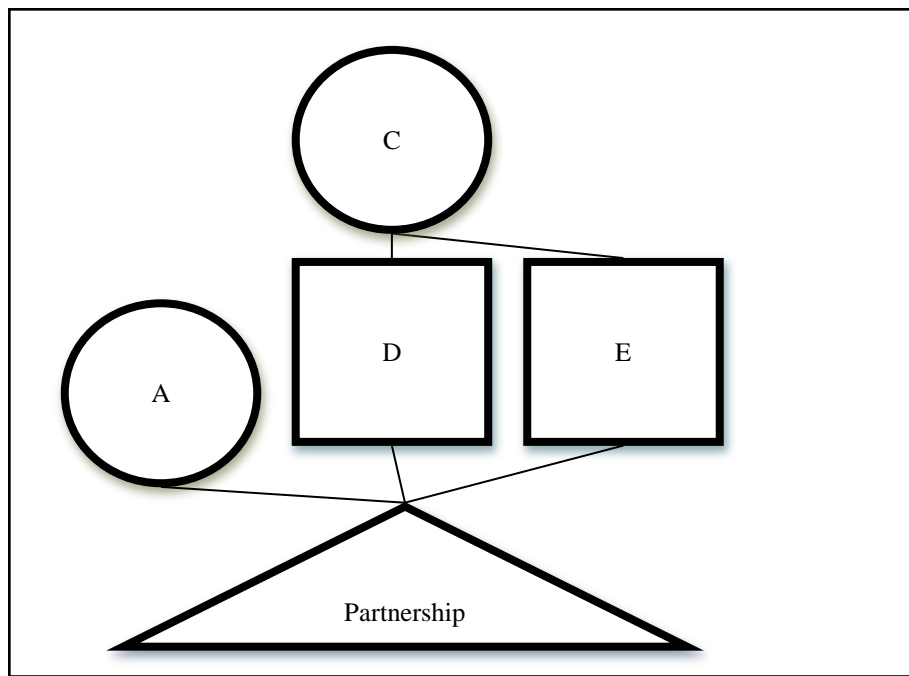
61. Furthermore, when measuring the after-tax consequences of the allocation of an item to the related partner group, one would assume that the item was allocated among the members of that group in the manner required by step one (in other words, pro rata based on the relative value of the related partners’ interests in the partnership).

Figure 3



Example 2. C owns 100 percent of each of two corporations—D and E. D and E each hold a 25 percent equity interest (by value) in a partnership. A, an unrelated partner, owns a 50 percent equity interest (by value) in the partnership. This ownership structure is shown in Figure 4 below. Because D and E each contribute equal value to the partnership, section 482 is satisfied. The partnership earns \$300 of taxable income and \$200 of tax-exempt income. Under step one, any item that is allocated to D and E, as a group, must be allocated equally between D and E. Under step two, as long as doing so would be respected under the existing section 704(b) regulations while treating D and E as one partner, the partnership could allocate to A amounts that differed from 50 percent of taxable income and 50 percent of tax-exempt income, and to D and E (as a group), amounts that differed from 50 percent of each type of income. Thus, if consistent with step two, the partnership allocated to A \$100 of taxable and \$50 of tax-exempt income, the remaining \$200 of taxable income must be allocated \$100 to each of D and E, and the remaining \$150 of tax-exempt income must be allocated \$75 to each of D and E.

Figure 4



Example 3. Assume the facts of the CFC example. If B's and C's partnership interests have equal value, then the partnership must allocate to each of B and C 50 percent of each of the partnership's tax items in each year. (Section 482 would also require that B's and C's capital contributions be equal.)

Example 4. Assume the facts of the PTP example. If the Blocker's partnership interest is worth 20 percent of the total partnership's equity and the Exempt PTP Parent's partnership interest is worth the remaining 80 percent, then the partnership must allocate to the Blocker 20 percent of each tax item (regardless of whether the item represents qualifying income or nonqualifying income), and the partnership must allocate to the Exempt PTP Parent the remaining 80 percent of each tax item.

B. Justifying the Proposal

The proposed reforms are consistent with any legitimate rationale for allowing partnerships to use special allocations. Many criticize the ability to

use special allocations even among unrelated partners.⁶² Given some of the problematic uses of special allocations by unrelated partners, those criticisms are understandable. Yet, while special allocations among unrelated partners may be used abusively, they are even more susceptible to abuse by related parties. Furthermore, although special allocations among unrelated partners may, in some cases, serve nontax purposes by shifting risk and reward among independent economic actors, they perform no such legitimate function among related partners, who represent a single economic unit.⁶³ The traditional rationale justifying special allocations is that they provide the necessary flexibility to allow partners to implement their business deal.⁶⁴ For example, if one partner is responsible for managing a particular asset, allocating disproportionate amounts of income or loss from that asset to the partner could provide an extra incentive for the partner to manage the asset well. Alternatively, the business deal could simply be that one partner is to bear disproportionate risk and reward from a particular asset or activity of the partnership, and special allocations implement that economic arrangement.

However, these rationales do not justify allowing flexibility among related partners because these partners represent a single economic unit. A partner who is responsible for managing a particular asset may be better motivated to manage it well if income or loss from that asset is allocated towards that partner and away from an unrelated partner. However, if both partners are sufficiently related so that they are indifferent regarding how they share economic gains or losses from the asset, disproportionate allocations motivate the partner in charge of managing the asset no better than proportionate allocations.⁶⁵ Likewise, a “business deal” that shifts risk

62. See, e.g., Curtis J. Berger, *W(h)ither Partnership Taxation*, 47 TAX L. REV. 105, 108–09, 127–28 (1991) [hereinafter Berger, *W(h)ither Partnership*]; Gergen, *Reforming Subchapter K*, *supra* note 19; David Hasen, *Partnership Special Allocations Revisited*, 13 FLA. TAX REV. 349 (2012) [hereinafter Hasen, *Allocations Revisited*]; Jeffrey L. Kwall, *Taxing Private Enterprise in the New Millennium*, 51 TAX LAW. 229, 243–44, 251 (1998); Philip F. Postlewaite, Thomas E. Dutton & Kurt R. Magette, *A Critique of the ALI’s Federal Income Tax Project – Subchapter K: Proposals on the Taxation of Partners*, 75 GEO. L. J. 423, 493–94 (1986).

63. We refer to “single economic unit” even though we acknowledge that the proposal would need to cover less than 100 percent economic overlap to preclude the use of accommodation partners to circumvent the proposal.

64. See, e.g., Berger, *W(h)ither Partnership*, *supra* note 62 at 131–32; Gergen, *Reforming Subchapter K*, *supra* note 19 at 33–34 (“Three sorts of arguments have been made for special allocations. . . . [One] argument is that the flexibility of special allocations is essential because of the infinite variety of business structures.”); Walter D. Schwidetzky, *The Partnership Allocation Rules of Section 704(b): To Be or Not to Be*, 17 VA. TAX REV. 707, 724–26 (1998).

65. One might argue that, while the economic unit might not care how items are allocated between its subsidiary units, the managers of the subsidiary units might

and reward between two or more parties that are effectively a single economic unit is illusory; the deal has no more substance than a deal that shifts risk from a person's left pocket to her right pocket.

In summary, if partners are sufficiently related, they are indifferent as to how they share overall economic gains and losses. If they are indifferent, they have no need for flexibility in sharing those items. And, if flexibility is unnecessary, then there is no legitimate justification for special allocations and, one can infer, the only purpose of those allocations is to reduce taxes.

C. *Potential Restructuring in Reaction to Proposed Reform*

This Subpart will consider how taxpayers might restructure their related partner transactions if the proposed reforms were enacted.⁶⁶ Some taxpayers are using special allocations to achieve beneficial tax results that they could have otherwise achieved without the use of a partnership, although using the partnership is likely somewhat more efficient than the alternative. In some cases, if our proposal were adopted, these taxpayers could be expected to shift to the nonpartnership structure. Nevertheless, the

care deeply because, for example, their bonuses might be based on their unit's profitability. But even this does not justify flexibility in making allocations because compensation arrangements can be based on metrics other than a unit's taxable income. In other words, in determining entitlements to bonuses, the profit or loss of a unit can be calculated in any manner the parties choose.

66. If the proposed reform was enacted, there might be a concern that taxpayers could set up tiered partnership structures to circumvent the new rule. For instance, in the PTP example, a taxpayer might consider using a structure in which two partnerships—P1 and P2—were partners in a third partnership ("Lower-Tier Partnership"). Lower-Tier Partnership would allocate all qualifying income to P1 and all nonqualifying income to P2. The partners of P1 would be the PTP and unrelated third parties that owned small interests. The partners of P2 would be a blocker (wholly-owned by the PTP) and unrelated third parties that owned small interests. P1 and P2 would each allocate tax items pro rata among their partners based on the value of each partner's equity interest in P1 or P2. However, as long as the definition of relatedness is sufficiently broad, this structure would not successfully circumvent the proposed reform. For instance, if the definition of relatedness covered partners who were related under section 707(b)(1)(B), P1 and P2 would be considered related given that the same persons own, directly or indirectly, more than 50 percent of P1 and P2 (or more than 80 percent, if an 80 percent threshold is adopted). In particular, once constructive ownership is taken into account (as directed by section 707(b)(3)'s instruction to apply section 267(c)), the PTP owns more than 50 percent of P1 and more than 50 percent of P2 (or more than 80 percent, if an 80 percent threshold is adopted for purposes of the proposed reform). As a result, Lower Tier Partnership would be precluded from specially allocating income between P1 and P2.

proposed reforms would still serve a valuable purpose—they ensure that related taxpayers cannot achieve results through partnerships that they could not achieve outside the partnerships. Indeed, proponents of special allocations frequently defend them by arguing that special allocations merely allow partners to bring about results, through a partnership, that they could attain otherwise.⁶⁷

1. *Related Partners Simply Hold Assets Differently*

In the PTP example, the parties might restructure their arrangement so that the Blocker directly owns a 100 percent interest in any asset that generates nonqualifying income and the Exempt PTP Parent directly owns a 100 percent interest in any asset that generates qualifying income. This new structure obviates the need to use partnerships and special allocations to subject the qualifying income to only a single level of tax.

This predictable taxpayer response, however, does not involve abuse of the partnership tax allocation rules. Taxpayers who are able to respond in this way are not, under current law, engaging in the type of *partnership* abuse at which the proposal is aimed because they are simply accomplishing something through a partnership that they could achieve without a partnership.⁶⁸ Thus, consistent with one of the justifications for allowing special allocations, these taxpayers are merely using such allocations to bring about results, through a partnership, that they could have attained otherwise.⁶⁹

67. See Mark P. Gergen, *Subchapter K and Passive Financial Intermediation*, 51 SMU L. REV. 37, 66 (1997) (“[W]e suspect a result is wrong when a partnership is used to circumvent tax rules contained outside Subchapter K or to achieve tax results that could not be achieved were the same thing done not using a partnership entity Subchapter K is particularly susceptible to the argument that it should not be used to circumvent other tax rules because its rules are often justified on the ground that they enable people to do through a partnership what they could also do outside of a partnership. For example, the rule allowing special allocations was originally justified in this way”).

68. Even under current law, if an asset generates entirely nonqualifying income, a blocker might own that asset in its entirety rather than through a partnership. For instance, in the case of an Exempt PTP that is entitled to share in income earned by a private equity firm, a blocker might own the right to receive management fees from the funds that the private equity firm sponsors. However, the right to receive carried interest from any given fund sponsored by the private equity firm is an asset that potentially generates some qualifying income and some nonqualifying income and therefore cannot be owned entirely by the Exempt PTP or a blocker.

69. See *supra* note 67 and accompanying text for discussion of this justification for special allocations.

However, this sort of restructuring may not be feasible in some situations. In particular, a partnership may hold a single asset that generates different tax items, and the partnership could allocate some tax items to some partners while allocating other tax items to other, related partners to achieve results that would be difficult to replicate outside of the partnership context. For example, if an Exempt PTP acquires an asset that may generate substantial amounts of both qualifying income and nonqualifying income, partnership allocations are necessary to achieve the desired tax result of exempting the qualifying income from corporate tax. Without the ability to use a partnership and special allocations, the blocker corporation likely would have to own this asset entirely and earn all of the income generated by it. Doing so would protect the Exempt PTP from earning excessive amounts of nonqualifying income to ensure its status as an Exempt PTP. However, this structure subjects all income generated by the asset (even qualifying income) to the entity-level tax imposed upon the blocker corporation. Under current law, a partnership and special allocations can be used to achieve a much better result, where only the nonqualifying income will be subject to entity-level tax. The proposed reform would put an end to the taxpayers' ability to use partnership allocations to achieve this improved result.⁷⁰

To illustrate, consider an Exempt PTP that owns and operates a casino for a period of time after which it sells the casino, recognizing a gain. Income from operating the casino is nonqualifying income, while gain

70. For similar discussion in the context of proposals to prevent special allocations generally, see Gergen, *Reforming Subchapter K*, *supra* note 19, at 9 (“Outside a partnership, A and B could accomplish the same thing if A purchased tax-exempt bonds and B purchased taxable bonds. To prohibit the special allocation penalizes A and B for owning the assets through a partnership. Character shifting allocations really pose a problem akin to that posed by disguised sales. The problem is that partners may use special allocations to exchange interests in assets without recognition of gain or loss.”); *Id.* at 34–35 (discussing the fact that the results of some special allocations could be achieved by placing assets in different partnerships); Hasen, *Allocations Revisited*, *supra* note 62, at 383 (“As long as the partners carry through the consequences of the altered sharing consistently, there should be no problem of improper assignment. Consider that, instead of a special allocation, the partners in many cases could have established a separate partnership that owned just the assets for which a different sharing arrangement was desired and effectuated through a special allocation. If allocations in that separate partnership tracked the capital account balances or, more generally, the PIP in that partnership, there would be no special allocation. Accordingly, the provision of special rules that permit varying ownership ratios of specific items of partnership property in a single partnership ought to not pose a problem as long as the ownership ratios are respected all the way down.”); *Id.* at 384–85 (“In general, a special allocation creates assignment problems because it allocates part but not all aspects of ownership of a partnership item to the partners in a ratio that differs from the general sharing ratio.”).

recognized upon sale of the casino, to the extent that it is attributable to real estate, is qualifying income.⁷¹ As long as related partners can utilize special allocations, a partnership in which the Exempt PTP and a blocker were partners could own the casino, and the partnership could allocate operating income to the blocker while allocating gain attributable to the sale of real estate directly to the Exempt PTP. If related partners could no longer benefit from special allocations, the blocker might have to own and sell the casino, and, as a result, all income generated by the casino would be subject to entity level tax at the blocker level.⁷²

2. *Imitating Structures Used by REITs*

Exempt PTPs are not the only entities operating beyond the confines of their traditional scope yet still managing to reduce their corporate tax burden. As the *New York Times* recently reported, many companies have recently restructured themselves in order to qualify as real estate investment trusts (“REITs”) for tax purposes.⁷³ If an entity qualifies as a REIT for tax purposes, it can, like Exempt PTPs, avoid entity-level tax.⁷⁴ In order to qualify as a REIT, an entity must satisfy a number of tests, among which are income tests that require the entity to earn predominantly income related to real estate and certain types of investment income. Companies that earn mainly income derived from real estate have long benefited from the special tax regime applicable to REITs. The new-style REITs described by the *Times*

71. See I.R.C. § 7704(d)(1)(D).

72. One potential alternative structure would be unavailable to the Exempt PTP because of a special rule that treats rent received from a related party as nonqualifying income. In particular, the Exempt PTP could not own the casino and lease it to the blocker in exchange for rental payments while the blocker operated the casino, because rent received from a related taxpayer is treated as nonqualifying income except in certain circumstances. I.R.C. section 7704(d) (3) (defining rent by reference to section 856(d) with certain modifications); I.R.C. section 856(d)(2)(B) (providing that rent excludes amounts received from related taxpayers except in certain circumstances). Likewise, the blocker could not own the casino while it was being operated as a casino and transfer the casino to the Exempt PTP prior to sale by the Exempt PTP without the blocker recognizing any built-in gain in the casino that existed at the time of the transfer. However, the Exempt PTP could own the casino building and lease it to an unrelated party as discussed below. See *infra* Part IV.C.2.b.

73. See, e.g., Gretchen Morgenson, *A Corporate Tax Break That's Closer to Home*, N.Y. TIMES, Aug. 10, 2014, at BU1. For earlier coverage, see, for example, Nathaniel Popper, *Resyled as Real Estate Trusts, Varied Businesses Avoid Taxes*, N.Y. TIMES, Apr. 22, 2013, at A1.

74. REITs are entitled to a deduction for dividends paid to their shareholders. I.R.C. section 857(b)(2)(B). As a result, by paying out all of its taxable income as dividends, a REIT becomes effectively exempt from entity-level tax.

differ from the traditional REITs in that they engage in businesses other than traditional real estate investment and management. For example, some of these new REITs own and operate prisons and some own casinos.

Unlike Exempt PTPs, however, REITs cannot employ a blocker structure and use special allocations to ensure compliance with the applicable income tests. This is because the REIT qualification rules effectively disregard special allocations,⁷⁵ much like our proposal. Yet, the new-style REITs were successful in attaining REIT status, in part because the IRS has issued private letter rulings broadly interpreting qualifying income to include some non-traditional income⁷⁶ and also because they used other tax structuring techniques. Accordingly, if our proposal were adopted, it can be expected that at least some of the structures that currently use related-partner allocations would be merely replaced by structures used by these new-style REITs.

a. Why REITs Cannot Use Special Allocations

In order to qualify as a REIT, an entity must pass two income tests and an asset test, in addition to complying with other requirements.⁷⁷ The first income test provides that at least 75 percent of the entity's gross income must consist of rent from real property, interest on obligations secured by mortgages on real property or on interests in real property, and other enumerated types of income related to real estate.⁷⁸ The second income test requires that the entity derive at least 95 percent of its gross income from dividends, interest, rents from real property, and other specified types of investment income.⁷⁹ An entity passes the asset test if at least 75 percent of the value of its assets is represented by real estate assets, cash and cash items (including receivables), and government securities.⁸⁰

75. See *infra* notes 81–86 and accompanying text.

76. For example, recently, the IRS has issued private letter rulings concluding that amounts paid to use billboards were rent from real estate. See, e.g., P.L.R. 2011–430–11 (Oct. 28, 2011). Also, the IRS has issued a private letter ruling concluding that when a REIT that owns a prison building grants to governmental authorities the right to use the building to house inmates in exchange for a per diem per inmate payment, the payment received by the REIT constitutes rent from real property. See, e.g., P.L.R. 2013–20–007 (May 17, 2013). Furthermore, the IRS ruled that a telecom company's transmission lines qualify as real estate assets. See, e.g., *Telecom Firm Announces Latest Tax-Free REIT Spinoff Transaction*, 2014 TAX NOTES TODAY 146-1 (July 30, 2014).

77. For other requirements, see I.R.C. §§ 856–857.

78. I.R.C. § 856(c)(3).

79. I.R.C. § 856(c)(2).

80. I.R.C. § 856(c)(4)(A).

If a REIT owns an interest in a partnership, Regulation section 1.856-3(g) provides that, for purposes of applying the income tests and asset test, the REIT will be “deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share.”⁸¹ The Regulation provides further that a REIT’s “proportionate share” will be determined based on the REIT’s capital interest in the partnership.⁸² In a number of private letter rulings, the IRS has concluded that a REIT’s capital interest in a partnership is determined by dividing the REIT’s capital account balance by the capital account balances of all partners, assuming those capital accounts are maintained in accordance with the economic effect rules.⁸³

As a result of this regulation, a REIT could not use the structure employed in the PTP example (illustrated above in Figure 2) to ensure compliance with the REIT income tests. If a REIT did use such a structure then, despite the fact that the partnership allocated only qualifying income to the REIT and all nonqualifying income to a blocker, the REIT would nevertheless be treated (for purposes of applying the income tests) as recognizing nonqualifying income in an amount equal to the partnership’s total nonqualifying income multiplied by the REIT’s capital interest in the

81. Reg. § 1.856-3(g). While it is clear that this rule applies for purposes of determining a REIT’s compliance with the income tests and asset tests, it is less clear whether this rule applies more broadly, such as for purposes of determining the REIT’s taxable income. Some have concluded that it does not apply more broadly. *See, e.g.*, PETER M. FASS, MICHAEL E. SHAFF & DONALD B. ZIEF, REAL ESTATE INVESTMENT TRUSTS HANDBOOK § 6:46 (2013) [hereinafter FASS ET AL., REIT HANDBOOK] (“For purposes of calculating REIT taxable income, however, the allocation rules of Sections 704(b) and (c), which are based on a capital account analysis and not solely on a partner’s capital interest, prevail. Thus, a special allocation of income or loss may be made to the REIT, and section 704(c) rules, with respect to contributed property to the REIT, apply to determine the REIT’s taxable income under section 857(b).”). However, others have noted that this issue may not be entirely free from doubt. *See, e.g.*, Robert J. Crnkovich, Mark C. Fisher & John W. Cullins, *Will IRS Threaten Current Tax Treatment of REITs Owning Partnership Interests?*, 90 J. TAX’N 39, 39 (1999) (“Most tax advisors interpret [Regulation section 1.856-3(g)] . . . as applicable only for purposes of Section 856 REIT testing. They should be aware of an informal view held by attorneys in the IRS Office of Chief Counsel that the Regulation’s reach might not be limited to the REIT income and asset tests of section 856, but could be applicable for all purposes of the Code . . . , effectively overriding a number of well-established statutory and regulatory provisions.”).

82. Reg. § 1.856-3(g).

83. *See, e.g.*, P.L.R. 1994-52-032 (Dec. 30, 1994); P.L.R. 2003-10-014 (Mar. 7, 2003). Furthermore, a REIT’s capital interest in a lower-tier partnership is determined by multiplying the REIT’s capital interest in an upper-tier partnership by the upper-tier partnership’s capital interest in the lower tier partnership. *Id.*

partnership.⁸⁴ This result is similar, though not identical, to the result under our proposal. One difference is that our proposal would allocate the partnership's tax items based on the respective *value* of partnership interests, while the REIT rule allocates the tax items based on the respective capital accounts. Another difference is that the REIT rule apparently applies only for purposes of qualifying the parent entity as a REIT and not for purposes of calculating tax liability,⁸⁵ while our proposal would apply broadly for all tax purposes.⁸⁶

Because the REIT rule regarding special allocations predates the current partnership tax allocation rules, some practitioners have taken the questionable position that special allocations that have substantial economic effect will be respected for purposes of applying the REIT income tests.⁸⁷ Furthermore, lobbyists have urged the Treasury to modernize the REIT rule to take into account changes to the partnership tax allocation rules that have transpired since the REIT rule's adoption.⁸⁸ If Treasury were to modernize

84. See, e.g., FASS ET AL., REIT HANDBOOK, *supra* note 81 (“[The rule in Regulation section 1.856-3(g)] also strongly implies that if a REIT has a 25 percent interest in a partnership which has \$100 of rental income and \$100 of service income, any special allocation of the \$100 service (nonqualifying) income to Non-REIT partners is ignored, even though such allocation complies with all the requirements under Section 704(b) and has substantial economic effect. The REIT would be treated as receiving \$25 of rental income and \$25 of service income, irrespective of any special allocations.”).

85. For further discussion, see *supra* note 81.

86. There are a couple of additional differences. First, the existing regulation in the REIT context applies even if the REIT is unrelated to the other partner(s) in the partnership, while our proposal applies only to special allocations among related partners. Second, while our proposal is motivated by concerns over existing and potential future abuses, there is no indication that concern about abuse motivated the existing regulation in the REIT context—the rule was adopted in 1962 along with the other REIT regulations, and the Treasury Decision contains no explanation of the rationale for the rule. See T.D. 6598, 1962-1 C.B. 92.

87. See, e.g., FASS ET AL., REIT HANDBOOK, *supra* note 81, at § 5:48 (“Some practitioners have taken the position that allocations of partners' distributive shares of income as set forth in the partnership's operating agreement, which have substantial economic effect within the meaning of Reg. § 1.704-1(b)(2), result in a proper calculation of qualified income for purposes of the 75 percent and 95 percent gross income tests. Informal discussions with IRS personnel, however, indicate that such an interpretation giving effect to special allocations for purposes of Section 1.856-3(g) would require a change in the regulations.”).

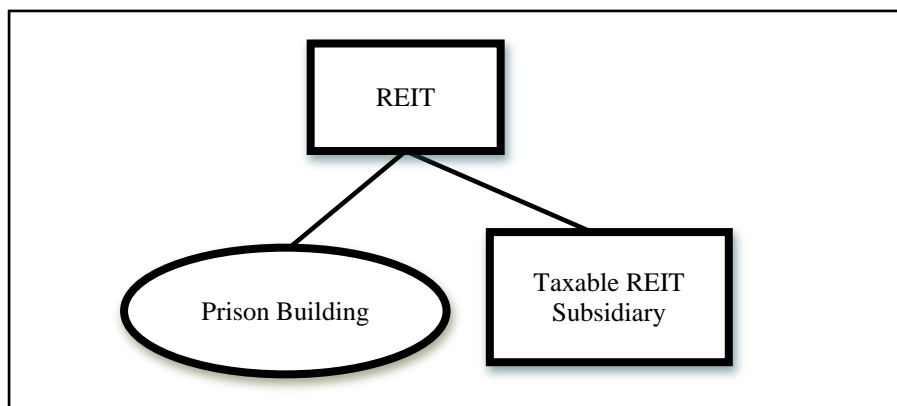
88. A letter from the National Association of Real Estate Investment Trusts (NAREIT) states: “First, we hope that the IRS will open a regulations project to modernize Treasury Regulation section 1.856-3(g). As you know, this regulation section acts as a crucial junction between the REIT and partnership tax rules. However, the existing regulation does not reflect any of the fundamental changes made to Subchapter K in the last few decades. This item was on the Business Plan

the rule, it ought to do so cautiously—with the goal of not allowing REITs to use special allocations for purposes of complying with the REIT income tests at least when nonqualifying income is allocated to a partner related to the REIT.

b. Alternative Structures Used by REITs

Despite the fact that REITs cannot use special allocations to ensure compliance with the REIT income tests, REITs have still expanded beyond their traditional scope. Traditionally, REITs were found exclusively in businesses that produce almost entirely qualifying income. Recently, however, other types of businesses have been using the REIT structure. For example, a company that owns and operates prisons was restructured as a REIT, as illustrated in Figure 5 below.

Figure 5



In this structure, the REIT directly owns prison buildings and it grants to government entities the right to use the prison buildings to house inmates.⁸⁹ In exchange, the government entities pay the REIT a fee calculated on a per day per inmate basis.⁹⁰ In private letter rulings, the IRS has ruled that this fee will be treated as rent from real property and, therefore, is qualifying income for purposes of both REIT income tests.⁹¹ In exchange for a fee paid by the government entities, the Taxable REIT Subsidiary (the “TRS”) provides various services such as security, food

for 1993, and NAREIT submitted a draft regulation to your office on October 17, 1994.” See 95 TAX NOTES TODAY 199-28 (Oct. 12, 1995).

89. P.L.R. 2013–20–007 (May 17, 2013).

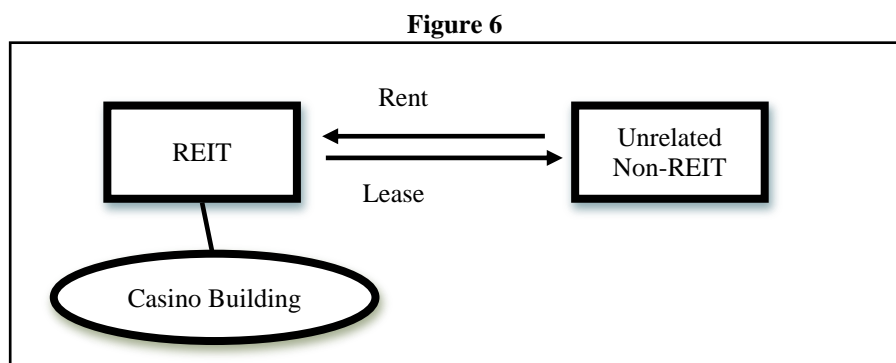
90. *Id.*

91. See, e.g., P.L.R. 2013–20–007 (May 17, 2013).

services for inmates, medical and dental care for inmates, and inmate transportation.⁹² The TRS is taxed at an entity level on the income it earns, but it can earn income that would be nonqualifying income if earned directly by the REIT without jeopardizing the REIT's ability to pass the income tests. In order to ensure compliance with the REIT qualification tests, the REIT's interest in the TRS cannot exceed 25 percent of the value of the REIT's assets.⁹³

If special allocations among related partners were disallowed, an Exempt PTP in a similar line of business could use the structure employed by REITs. Furthermore, unlike a REIT that must ensure that the value of its interest in the TRS does not exceed 25 percent of the value of its assets, an Exempt PTP's interest in a taxable corporate subsidiary is not subject to any such limitation.

Similarly, a REIT that owns casinos uses the structure shown in Figure 6 below.



In this structure, the REIT owns a casino building and leases the building to a Non-REIT (an unrelated company).⁹⁴ The Non-REIT operates the casino and pays the REIT rent that is in part fixed and in part based on revenues earned from operating the casino. The rent received by the REIT is qualifying income.⁹⁵ Leasing the casino to an entity that is unrelated to the

92. *Id.* In some cases, the charge for services is not separately stated so the government pays the entire amount to the REIT, and the REIT pays the TRS a fee for providing the services. *Id.*

93. I.R.C. § 856(c)(4)(B)(ii).

94. This structure is similar to the structure used by Penn National Gaming Inc. after engaging in a spin-off. For a description of the spin-off and the private letter ruling obtained by Penn National Gaming Inc., see Robert Willens, *Analyzing Penn National Gaming's Groundbreaking IRS Ruling*, 2013 TAX NOTES TODAY 239-10 (Dec. 12, 2013) [hereinafter Willens, *Penn National Gaming's Ruling*].

95. Rent from real property does not include an amount that depends on the income or profit derived from property by any person; however, an amount will not

REIT ensures that the payments under the lease are treated as rent for purposes of the REIT income tests because amounts paid by lessees that are related to a REIT are generally not treated as rent for purposes of applying the income test.⁹⁶

If special allocations among related parties were disallowed, an Exempt PTP that owned a casino building could use a similar structure, and, like a REIT, an Exempt PTP would have to be wary of leasing the casino to a related entity.⁹⁷

In summary, if special allocations among related partners were disallowed, some entities that would not traditionally qualify as Exempt PTPs could continue to engage in tax structuring techniques to achieve Exempt PTP status. Nevertheless, the flaw in the existing partnership tax allocation rules ought to be fixed for three reasons. First, in some cases, it will not be feasible to restructure in a way that replicates the results achieved through related-partner allocations. Second, the problem of related-partner allocations extends beyond the Exempt PTP problem, as illustrated by the CFC example. Finally, and most importantly, it can be expected that creative tax planners will continue to find new ways to exploit the mismatch between the underlying premises of the substantial economic effect test and the economic realities of related-partner allocations.

V. CONCLUSION

This Article has argued that the current set of intricate rules governing partnership allocations have a critical blind spot: allocations among related partners. These rules were clearly drafted without related-partner allocations in mind because they rely on adverseness of economic interests to deter abusive allocations. Because of this blind spot, related parties can use partnerships to obtain tax benefits that they could not otherwise achieve. While the IRS currently has a tool available to disallow these tax benefits, namely the Partnership Anti-Abuse Rule, this Article

be excluded from rent solely because it is based on a fixed percentage or percentages of receipts or sales. I.R.C. section 856(d)(2)(A). Furthermore, Penn National Gaming received a private letter ruling stating that the amount paid by the Non-REIT would be treated as rent from real property. See Willens, *Penn National Gaming's Ruling*, *supra* note 94; P.L.R. 2013-37-007 (Sept. 13, 2013).

96. See I.R.C. § 856(d)(2)(B) (setting forth the general rule that payments from related persons are not treated as rent); I.R.C. § 856(d)(5) (providing that constructive ownership rules will apply when determining whether a person is related to a REIT); I.R.C. § 856(d)(8) (describing limited circumstances in which amounts received from a related person can be treated as rent).

97. See I.R.C. § 7704(d)(3) (defining rent by reference to section 856(d) with certain modifications); I.R.C. § 856(d)(2)(B) (providing that rent excludes amounts received from related taxpayers except in certain circumstances).

recommends that the section 704(b) regulations be amended to deal specifically with related-partner allocations.

The regulations should provide that the substantial economic effect safe harbor does not apply to related-partner allocations. Therefore, these allocations must be made in accordance with the partners' interests in the partnership. This would mean that allocations among related partners are always made on a fully pro rata basis in accordance with the respective values of the related partners' interests in the partnership. In short, special allocations would be eliminated in the context of related partners.

The proposed reform would entail little, if any, additional administrative burden on the related partners. And, given the significant overlap of economic interests necessary to be characterized as related partners, the reform would have no effect on legitimate, nontax uses of special allocations.

That said, the proposed reform would be no panacea. While the reform would provide significant friction against certain tax-motivated transactions, in other situations it might cause the taxpayer merely to engage in economically insignificant restructuring. While this is a concern for the tax system generally, it is not a partnership tax concern.

While a full ventilation of this broader concern is left for another day, it is worth noting that the critical issue appears to be whether the tax system should, in the context of publicly traded entities (1) *always* tax qualifying income at the entity level, (2) *never* tax qualifying income at the entity level, or (3) *sometimes* tax qualifying income at the entity level depending on the amount of qualifying income earned by the entity—a factor that is sometimes within the entity's control if it avails itself of sophisticated tax planning. Our current system can be described as using the third approach, which seems to be the worst of the three options.