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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Associate Area Counsel (San Francisco)
CC:LM:CTM:SF

FROM: Donna M. Young, Acting Branch Chief, CC:PSI:3

SUBJECT: TL-N-1993-00

This Field Service Advice responds to your memorandum dated November 9, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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LEGEND

Partnership =
Foreign Partner =
Domestic Partner =
n1 =
n2 =

n3	=
n4	=
n5	=
n6	=
n7	=
n8	=
n9	=
n10	=
n11	=
n12	=
n13	=
date1	=
Year1	=
Year2	=
Year3	=
Year4	=
State	=
Country	=
Assets	=

ISSUES

1. Do Partnership's special allocations of tax items have substantial economic effect so that they may be respected under § 704(b)?

2. If the special allocations do not have substantial economic effect, how should Partnership's tax items be re-allocated?

3. May there be a re-allocation of Partnership's tax items pursuant to § 482?

CONCLUSIONS

Further case development is required before it can be decided whether the special allocations at issue in this case have substantial economic effect and, relatedly, whether Partnership's allocations of nonrecourse deductions are in accordance with the partners' interests in the partnership. Further case development is also required before it can be decided whether there can be a re-allocation of Partnership's tax items pursuant to § 482. This memorandum discusses the known facts and applicable law in response to the issues presented.[1]

FACTS

[1] The § 1.701-2 partnership anti-abuse rule overrides the § 704(b) allocation rules. However, the § 1.701-2 partnership anti-abuse rule is not at issue in this Field Service Advice.

Partnership was formed as a State general partnership in Year1. Partnership is currently organized as a State limited liability company. Foreign Partner, established in Country in Year 2, has an established line of business as a lessor of Assets, having over $n1 of Assets, at original cost, under management. The operations of Partnership consist of purchasing Assets, which are manufactured by third parties to specifications determined by Foreign Partner, and leasing the Assets. Foreign Partner has entered into a management agreement with Partnership under which Foreign Partner assumes responsibility for the leasing, repair, rent collection, and other operations of Partnership's Assets. Foreign Partner is compensated for these services in the annual amount of n2 percent of the acquisition cost of Assets under management.

Domestic Partner is the other partner of Partnership. Foreign Partner owns a n3 percent interest in and is the managing member of Domestic partner. Domestic Partner was formed to serve as an entity through which parties may invest in up to $n4 of Assets which Partnership acquired on date1. The relevant Assets were originally purchased by Foreign Partner in Year3 and Year4 and were placed on initial lease into the Foreign Partner Asset pool prior to being purchased by Partnership. To fund the purchase, Foreign Partner and Domestic Partner each made capital contributions to Partnership equal to n5 percent of the $n4 cost of the Assets. The remaining acquisition cost and initial working capital was funded through nonrecourse loans acquired by Partnership. The Assets are depreciable property and Partnership depreciates the full cost of the Assets over a year life on a basis.

Partnership's partnership agreement is drafted to comply with the regulations under § 1.704-1(b)(2)(ii). Annual operating income or loss (in the absence of an overriding special allocation for a particular taxable year) is generally allocated n6 percent to Foreign Partner and n7 percent to Domestic Partner, with Domestic Partner receiving a larger amount as Partnership's gross operating margin increases from n8 percent. Asset disposition gains or losses are generally allocated n7 percent to Foreign Partner and n6 percent to Domestic Partner, with Foreign Partner receiving a larger amount as Partnership's cumulative disposition net cash flow increases from n9 percent of the original equipment cost.

The partnership agreement also contains special allocations that provide as follows:

[2] We find the wording of this allocation to be less than clear; however, it may be appropriate to interpret this language as only allocating recourse deductions to Domestic Partner up to the amount of that partner's capital contribution.

Because of these special allocations, Domestic Partner will be allocated n6 of Partnership's deductions (which is a considerable amount due to the depreciation of the Assets) in the first few years of the partnership and will recognize n6 percent of Partnership's income in the last few years of the partnership. Foreign Partner, on the other hand, will be allocated n6 percent of partnership income in the first few years of the partnership and n6 percent of the losses in the last few years of the partnership. Approximately n13 percent of Partnership's income would be considered U.S. source income. As such, Foreign Partner has a much lower effective tax rate than the investors in Domestic Partner and appears to be functionally indifferent to the large distributive share of taxable income. The special allocation scheme has the effect of "front loading" deductions for the investors in Domestic Partner.

LAW AND ANALYSIS

ISSUE 1. Do Partnership's allocations of tax items have substantial economic effect so that they may be respected under § 704(b)?

Section 704(a) of the Internal Revenue Code provides that a partner's distributive share of income, gain, loss, deduction, or credit shall be determined by the partnership agreement. This general rule is limited by § 704(b), which states that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

Section 1.704-1(b)(2) provides a two-part test for determining whether an allocation of income, gain, loss, or deduction (or item thereof) to a partner has substantial economic effect. The first part of the test determines whether the allocation has economic effect. The second part determines whether the economic effect of the allocation is substantial.

<u>Economic Effect</u>

Section 1.704-1(b)(2)(ii)(*a*) provides that in order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.

Section 1.704-1(b)(2)(ii)(*b*) provides that an allocation will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides -

> (1) For the determination and maintenance of the partners' capital accounts in accordance with the rules of § 1.704-1(b)(2)(iv);
>
> (2) Upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (2) and requirement (3) of this paragraph (b)(2)(ii)(*b*)), by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), and
>
> (3) If such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (3)), he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which amount shall, upon liquidation of the partnership be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances (in accordance with requirement (2) of this paragraph (b)(2)(ii)(*b*)).

Partnership's agreement, specifically Article 1, section 11, and Article 11, sections 4(a) and (b), contains the three provisions required by § 1.704-(b)(2)(ii)(*b*). Therefore, Partnership's allocation scheme appears to have economic effect. However, while the explicit terms of the agreement appear to meet the requirements for the allocations to have economic effect, the partnership agreement includes all agreements among the partners, whether oral or written. Section 1.704-1(b)(2)(ii)(*h*). Any evidence of a side agreement that negated the deficit restoration obligation for Domestic Partner would prevent the allocations at issue from having economic effect.

Substantiality

In addition to having economic effect, a partnership's allocations must also be substantial in order to be respected under § 1.704-1(b)(1).

Section 1.704-1(b)(2)(iii)(*a*) provides that the economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.

Section 1.704-1(b)(2)(iii)(*b*) and (*c*) describes two situations in which the economic effect of an allocation is not substantial. However, even if an allocation is not described in § 1.704-1(b)(2)(iii)(*b*) or (*c*), its economic effect may be insubstantial under the general rules stated in § 1.704-1(b)(2)(iii)(*a*). The allocations described in § 1.704-1(b)(2)(iii)(*b*), shifting allocations, are not similar to Partnership's allocations, but the allocations described in § 1.704-1(b)(2)(iii)(*c*), transitory allocations, are similar to Partnership's allocations.

Allocations are deemed to be shifting allocations where, at the time the allocation becomes part of the partnership agreement, there is a strong likelihood that the net changes in the partners' respective capital accounts for the taxable year will not differ substantially from the net changes that would be recorded in the capital accounts for such year in the absence of such allocations, and the total tax liability of the partners will be less than if the allocations were not contained in the partnership agreement. As illustrated by § 1.704-1(b)(5), example (6), shifting allocations involve offsetting allocations within the taxable year. The present case does not involve offsetting allocations within the same taxable year, and so the allocations will not be deemed to be shifting allocations.

Transitory allocations involve offsetting allocations over a period of time. If a partnership agreement provides for the possibility that one or more allocations (the "original allocations") will be largely offset by one or more other allocations (the "offsetting allocations"), and, at the time the allocations become part of the partnership agreement, there is a strong likelihood that the net increases and decreases to the partners' capital accounts will not differ substantially from the net increases and decreases to the partners' capital accounts if the allocations were not contained in the partnership agreement, and the total tax liability of the partners will be less than if the allocations were not contained in the partnership agreement, the economic effect of the original allocations and offsetting allocations will not be substantial. However, the regulations provide that if, at the time the allocations become part of the partnership agreement, there is a strong likelihood that the offsetting allocations will not, in large part, be made within five years after the original allocations are made, the original and offsetting allocations will not be insubstantial under § 1.704-1(b)(2)(iii)*(c*).

Section 1.704-1(b)(2)(iii)(*c*) also indicates that where the original and offsetting allocations will not be made within five years, then it will be presumed that there is a reasonable possibility that the allocations will affect substantially the dollar amounts to be received by the partners from the partnership.

Section 1.704-1(b)(5), example (2), involves allocations that have economic effect under § 1.704-1(b)(2)(ii) and that are substantial under § 1.704-1(b)(2)(iii)(*c*). The partnership in the example, which is formed by Partners C and D, leases machinery and enters into a 12-year lease with a financially secure corporation under which the partnership expects to have a net taxable loss in each of its first 5 partnership taxable years due to cost recovery deductions with respect to the machinery and net taxable income in each of the following 7 partnership taxable years, in part due to the absence of such cost recovery deductions. The partnership agreement further provides that partnership net taxable loss will be allocated 90 percent to Partner C and 10 percent to Partner D until such time as there is partnership net taxable income, and thereafter Partner C will be allocated 90 percent of such taxable income until he has been allocated partnership net taxable income equal to the partnership net taxable loss previously allocated to him. The example concludes that even though there is a strong likelihood that the allocations of net taxable loss in taxable years 1 through 5 of the partnership will be largely offset by other allocations in partnership taxable years 6 through 12, and even if it is assumed that the total tax liability of the partners in years 1 through 12 will be less than if the allocations had not been provided in the partnership agreement, the economic effect of the allocations is substantial under § 1.704-1(b)(2)(iii)(*c*). This is because at the time such allocations became part of the partnership agreement, there was a strong likelihood that the allocations of net taxable loss in years 1 through 5 would not be largely offset by allocations of income within 5 years.

The allocation scheme in the present case involves allocations of partnership losses to Domestic Partner that will largely be offset by allocations of partnership income in future years. However, as in § 1.704-1(b)(5), example (2), the offsetting allocations in the present case will not occur within the first five years after the original allocations are made. Therefore, it is presumed that there is a reasonable possibility that the allocations will affect substantially the dollar amounts to be received by the partners from the partnership. Of course, this presumption would not apply if there is any type of agreement that prevents Domestic Partner from bearing the economic loss if the value of the assets falls below the note balance.

Notwithstanding the above discussion, the economic effect of an allocation still may not be substantial under the after-tax economic consequences test in § 1.704-1(b)(2)(iii)(*a*). Although § 1.704-1(b)(2)(iii)(*c*) provides that an allocation that is not described in that section is presumed to have substantial economic effect under the first sentence of § 1.704-1(b)(2)(iii)(*a*) (i.e., the allocation will affect substantially the dollar amounts to be received by the partners from the partnership), the economic effect of the allocation may still be insubstantial under the second sentence of § 1.704-1(b)(2)(iii)(*a*). The second sentence of § 1.704-1(b)(2)(iii)(*a*) provides that, notwithstanding the first sentence, the economic effect of an allocation is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation were not contained in the partnership agreement.

In the present case, the test in § 1.704-1(b)(2)(iii)(*a*) will be met if it is found that Domestic Partner's after-tax economic consequences are enhanced and Foreign Partner's after-tax economic consequences are not substantially diminished. Domestic Partner receives a time value of money advantage from the timing differences in its allocations of partnership loss and income. However, by assuming a deficit restoration obligation, Domestic Partner assumes the risk of economic loss in the event Partnership fails to earn sufficient income to offset its large capital account deficit. As a result, it may be that Domestic Partner's after-tax economic consequences are not enhanced by the special allocations.

Foreign Partner is allocated more income and fewer deductions in the first years of Partnership than it would be allocated if the special allocations were not in the partnership agreement. As a result, depending on whether it has other losses to offset its net income from partnership, Foreign Partner will most likely pay more in U.S. tax under the special allocations than it would if they were not in the partnership agreement. However, Foreign Partner only pays U.S. tax on n13 percent of the income it receives from Partnership. As a result, it may be that Foreign Partner's after-tax economic consequences are not substantially diminished compared to such consequences if the special allocations were not in the partnership agreement.

<u>Nonrecourse Deductions</u>

Allocations of losses and deductions attributable to partnership nonrecourse liabilities ("nonrecourse deductions") cannot have economic effect because the creditor alone bears any economic burden that corresponds to these allocations. Sec. 1.704-2(b)(1). Thus, nonrecourse deductions must be allocated in accordance with the partners' interests in the partnership. <u>Id</u>.

Section 1.704-2(e) provides a safe harbor for determining whether allocations of nonrecourse deductions are deemed to be in accordance with the partners' interests in the partnership. If the test is not satisfied, the partners' distributive shares of nonrecourse deductions are determined under § 1.704-1(b)(3), according to the partners' overall economic interests in the partnership. Sec. 1.704-2(b)(1).

Under § 1.704-2(e), the following four requirements must be met:

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

(2) Beginning in the first taxable year of the partnership in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, the partnership agreement provides for allocations of nonrecourse deductions in a manner that is reasonably consistent with allocations of some other significant partnership item attributable to the property securing the nonrecourse liabilities and those allocations have substantial economic effect;

(3) Beginning in the first taxable year of the partnership that it has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in partnership minium gain, and thereafter throughout the full term of the partnership, the partnership agreement contains a provision that complies with the minimum gain chargeback requirement of § 1.704-2(f); and

(4) All other material allocations and capital account adjustments under the partnership agreement are recognized under § 1.704-1(b) (without regard to whether allocations of adjusted tax basis and amount realized under § 613A(c)(7)(D) are recognized under § 1.704-1(b)(4)(v)).

In the present case, requirements (1), (3) and (4) of § 1.704-2(e) are satisfied in Article 1, section 11, Article 4, section 4(a), and Article 4, section 4(b) of the Partnership Agreement.

It is not clear whether requirement (2) of § 1.704-2(e) is satisfied because, as discussed above, it has not been determined whether any of Partnership's allocations have substantial economic effect. If § 1.704-2(e)(2) is satisfied, Partnership's nonrecourse deduction allocations are made in accordance with the partners' interest in Partnership and will not be reallocated under § 1.704-1(b)(3). If § 1.704-2(e)(2) is not satisfied, the nonrecourse deduction allocations are not made in accordance with the partners' interests and must be reallocated.

<u>ISSUE 2</u>. If the special allocations do not have substantial economic effect, how should Partnership's tax items be re-allocated?

Section 1.704-1(b)(3)(i) provides that a partner's interest in a partnership is the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated. The determination of a partner's interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners. All partners' interests in the partnership are presumed to be equal (determined on a per capita basis). However, this presumption may be rebutted by the taxpayer or the IRS by establishing facts and circumstances that the partners' interests in the partnership are otherwise.

Under § 1.704-1(b)(3)(ii) the following factors are considered in determining a partner's interest in a partnership:

(a) The partners' relative contributions to the partnership,

(b) The interests of the partners in economic profits and losses (if different from that in taxable income or loss),

(c) The interests of the partners in cash flow and other non-liquidating distributions, and

(d) The rights of the partners to distributions of capital upon liquidation.

As discussed above, it is not clear whether any of Partnership's items of deduction, credit, income or loss will need to be reallocated.

ISSUE 3. May there be a re-allocation of Partnership's tax items pursuant to § 482?

Treas. Reg. § 1.704-1(b)(1)(iii) provides, in part, that ". . . an allocation that is respected under section 704(b) and this paragraph nevertheless may be reallocated under other provisions, such as section 482. . . ." This regulation goes on to state that "the examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address the effect of other sections or limitations on such allocations."

Section 482 provides:

> In any case of two or more organizations, trades, or businesses . . . 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.[3]

The first requisite for applying § 482 is that the taxes or income of two or more “organizations, trades, or businesses” be involved. This phrase has been broadly construed. Thus, § 482 has been applied to reallocate income among corporate partners. *Rodebaugh v. Commissioner*, T.C. Memo. 1974-36, *aff’d*, 518 F.2d 73 (6th Cir. 1975).

Another requisite for applying § 482 to a transaction is that the transaction take place between two or more entities owned or controlled by the same interests. This control requirement is, like the first requirement, construed very broadly. Treas. Reg. § 1.482-1(i)(4). Any kind of control whether direct or indirect and whether or not legally enforceable satisfies the control requirement. *Id.* In addition, arbitrary shifting of income or deductions raises a presumption of control. *Id.* The regulations also state that control may exist as a result of the actions of “two or more taxpayers acting in concert with a common goal or purpose.” *Id.* Thus, under the regulations, joint, legal ownership, or overlapping ownership, is not required for unrelated corporations to come within the purview of § 482 if income or deduction shifting is present, or if there is a common goal to shift income or deductions.

Assuming the Secretary has proven that the parties are controlled by the same interests, he “may distribute, apportion, or allocate . . . deductions . . . 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 such organizations, trades or businesses.” Section 482. Generally, the Commissioner’s determinations under § 482 must be sustained absent an abuse of discretion. *G.D. Searle and Co. v. Commissioner*, 88 T.C. 252, 358 (1988). The taxpayer must demonstrate that Commissioner’s determinations are arbitrary, capricious, or unreasonable in order for the courts to set aside the Commissioner’s determinations. *Id.*

Further case development is required before it can be decided whether there can be a re-allocation of Partnership’s tax items pursuant to § 482.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

[redacted] The facts seem to support a ruling that Partnership’s allocations have substantial economic effect under § 1.704-2(b)(2). It is not disputed that the allocations have economic effect; the only question is whether the economic effect is substantial. The allocations in the present scheme largely offset each other over time, but they do not meet the definition of transitory allocations under

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[3] For purposes of § 482, the term “evasion of taxes” is synonymous with “tax avoidance.” *Foster v. Commissioner*, 80 T.C. 34, 157-158 (1983).

§ 1.704-1(b)(2)(iii)(*c*) because the off-setting allocations are not made within 5 years. The allocations may be substantial under the after-tax economic consequences test in § 1.704-1(b)(2)(iii)(*a*) because the after-tax economic consequences of Domestic Partner may not be enhanced by these special allocations. Domestic Partner has a deficit restoration obligation under the partnership agreement and its capital account will have a much greater deficit than if the special allocations were not in the partnership agreement. The economic risk to Domestic Partner that it may be obligated to restore the deficit in its capital account makes it difficult to conclude that Domestic Partner's after-tax economic consequences may be enhanced compared to what its after-tax economic consequences would be if the special allocations were not in the partnership agreement.

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

The principal facts regarding possible application of § 482 are the same as those related to the issue of substantial economic effect. If the partnership allocations lack substantial economic effect, there would seem to be a strong basis for concluding that the allocations result in evasion of taxes or in a failure clearly to reflect income, so that re-allocations may be made under § 482, if the other conditions for its application are established. [redacted].

Please call Catherine Moore at (202) 622-3080 if you have any further questions.

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