



American Institute of CPAs
1455 Pennsylvania Avenue, NW
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February 11, 2014

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Re: Draft Revenue Ruling on Partnership Targeted Allocations

Dear Messrs. Koskinen, Wilkins, and Wilson and Ms. Zarlenga:

The American Institute of Certified Public Accountants (AICPA) respectfully submits this draft revenue ruling on partnership targeted allocations for your consideration. We believe guidance on partnership target allocations methodology is necessary because of its widespread use and the misunderstanding of many people that the government has approved this approach by acquiescing in it use.

The AICPA is the world's largest member association representing the accounting profession, with more than 394,000 members in 128 countries and a 125-year heritage of serving the public interest. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We would appreciate the Internal Revenue Service (IRS) considering this draft revenue ruling and the issuance of additional guidance in this area. We welcome the opportunity to discuss our proposed draft revenue ruling or answer any questions that you may have. I can be reached at (304) 522-2553 or jporter@portercpa.com; or you may contact William O'Shea, Chair, AICPA Partnership Tax Technical Resource Panel, at (202) 758-1780, or woshea@deloitte.com; or Cari Weston, AICPA Senior Technical Manager, at (202) 434-9267, or cweston@aicpa.org.

Sincerely,

Jeffrey A. Porter, CPA
Chair, Tax Executive Committee

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Proposed Revenue Ruling

Issue:

Are the targeted allocation provisions provided below in compliance with section 704(b)¹?

Facts:

A contributes \$100x to partnership AB. B contributes property X with a value and basis equal to \$100x to partnership AB. There are no liabilities in the partnership. AB will conduct a trade or business in which A and B will participate equally. Neither A nor B is legally or effectively exempt from federal taxation as described in Treas. Reg. § 1.701-2(c)(5).

The partnership agreement contains all the provisions necessary to comply with Treas. Reg. § 1.704-1(b)(2), including maintaining section 704(b) capital accounts for each partner. However, upon liquidation of the partnership, liquidating distributions will not be made in accordance with the positive capital account balances of the partners as required by Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2). Instead, the partnership will liquidate based upon the business arrangement that is reflected in the liquidating distribution provision of the partnership agreement (the “liquidation waterfall”). The liquidation waterfall provides that first, each of A and B will receive their section 704(b) capital back. Thereafter, A will receive a cumulative 5% return on A’s contributed capital. Any additional amount will be distributed 50% to A and 50% to B.

The partnership agreement provides that after taking into account all allocations required by the regulations, all remaining net profits and losses are allocated to the partners and to the partners’ capital accounts in a manner such that, after such allocations have been made, the balance of each partner’s capital account is as close as possible to the amount that would be distributed to such partner, determined as if the partnership were to sell all of its assets for section 704(b) book value and distribute the proceeds thereof pursuant to the liquidation waterfall.

Situation 1: Partnership AB’s partnership agreement permits the allocation of only net items and AB has \$10 of net income for the taxable year.

Situation 2: The facts are the same as in Situation 1 except that partnership AB’s partnership agreement permits the allocation of only net items and AB has zero net income for the taxable year.

¹ All section references in this letter are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated there under, unless otherwise specified.

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Situation 3: The facts are the same as in Situation 2 except that partnership AB's liquidation waterfall provides that first, A will receive its section 704(b) capital back, plus a cumulative 5% return on its contributed section 704(b) capital. Second, B will receive its section 704(b) capital. Finally, any remaining amount will be distributed 50% to A and 50% to B.

Law:

Section 704(a) provides that a partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement.

Section 704(b) provides 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.

Treas. Reg. § 1.704-1(b)(1)(i) provides that under section 704(b) if a partnership agreement does not provide for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner, or if the partnership agreement provides for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner but such allocation does not have substantial economic effect, then the partner's distributive share of such income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with such partner's interest in the partnership (taking into account all facts and circumstances). If the partnership agreement provides for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner, there are three ways in which such allocation will be respected under section 704(b) and this paragraph. First, the allocation can have substantial economic effect in accordance with paragraph Treas. Reg. § 1.704-1(b)(2) of this section. Second, taking into account all facts and circumstances, the allocation can be in accordance with the partner's interest in the partnership. Third, the allocation can be deemed to be in accordance with the partner's interest in the partnership pursuant to one of the special rules contained in paragraph Treas. Reg. § 1.704-1(b)(4) of this section and Treas. Reg. § 1.704-2. To the extent an allocation under the partnership agreement of income, gain, loss, deduction, or credit (or item thereof) to a partner does not have substantial economic effect, is not in accordance with the partner's interest in the partnership, and is not deemed to be in accordance with the partner's interest in the partnership, such income, gain, loss, deduction, or credit (or item thereof) will be reallocated in accordance with the partner's interest in the partnership (determined under Treas. Reg. § 1.704-1(b)(3)).

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Treas. Reg. § 1.704-1(b)(2)(i) provides that the determination of whether an allocation of income, gain, loss, or deduction (or item thereof) to a partner has substantial economic effect involves a two-part analysis that is made as of the end of the partnership taxable year to which the allocation relates. First, the allocation must have economic effect (within the meaning of Treas. Reg. § 1.704-1(b)(2)(ii)). Second, the economic effect of the allocation must be substantial (within the meaning of Treas. Reg. § 1.704-1(b)(2)(iii)).

Treas. Reg. § 1.704-1(b)(2)(ii)(b) provides that generally an allocation of income, gain, loss, or deduction (or item thereof) to a partner 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 paragraph Treas. Reg. § 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 Treas. Reg. § 1.704-1(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 Treas. Reg. § 1.704-1(b)(2)(ii)(b)).

Treas. Reg. § 1.704-1(b)(2)(ii)(d) provides that if —

(1) Requirements (1) and (2) of Treas. Reg. § 1.704-1(b)(2)(ii)(b) are satisfied, and

(2) The partner to whom an allocation is made is not obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (3) of Treas. Reg. § 1.704-1(b)(2)(ii)(b)), or is obligated to restore only a limited dollar amount of such deficit balance, and

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(3) The partnership agreement contains a “qualified income offset,” then such allocation will be considered to have economic effect under this paragraph (b)(2)(ii)(d) to the extent such allocation does not cause or increase a deficit balance in such partner’s capital account (in excess of any limited dollar amount of such deficit balance that such partner is obligated to restore) as of the end of the partnership taxable year to which such allocation relates.

The partnership agreement contains a “qualified income offset” if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation, or distribution described in Treas. Reg. § 1.704-1(b)(2)(ii)(d)(4), (5), or (6), will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible.

Treas. Reg. § 1.704-1(b)(2)(ii)(i) provides that allocations made to a partner that do not otherwise have economic effect under Treas. Reg. § 1.704-1(b)(2)(ii) shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if requirements (1), (2), and (3) of paragraph Treas. Reg. § 1.704-1(b)(2)(ii)(b) of this section had been satisfied, regardless of the economic performance of the partnership.

Treas. Reg. § 1.704-1(b)(3)(i) provides that references in section 704(b) and Treas. Reg. § 1.704-1 to a partner’s interest in the partnership, or to the partners’ interests in the partnership, signify 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.

Treas. Reg. § 1.704-1(b)(3)(ii) provides that in determining a partner’s interest in the partnership, the following factors are among those that will be considered:

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

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Analysis:

The economic effect rules of Treas. Reg. § 1.704-1(b)(2)(ii) are based on the principle that the partnership allocation will affect the economic sharing of the partners including the sharing upon liquidation. Not liquidating based upon appropriately maintained positive section 704(b) capital accounts is fundamentally inconsistent with the economic effect rules.

Partnership AB's targeted allocation provisions do not satisfy the three-part economic effect test of Treas. Reg. § 1.704-1(b)(2)(ii)(b) because partnership AB does not liquidate in accordance with the positive capital account balances of the partners — instead liquidating in accordance with partnership AB's distribution waterfall. The targeted allocation provisions do not satisfy the test for alternate economic effect under Treas. Reg. § 1.704-1(b)(2)(ii)(d) for the same reason.

Under the economic effect equivalence test of Treas. Reg. § 1.704-1(b)(2)(ii)(i), allocations made to a partner that do not otherwise have economic effect shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year *or at the end of any future year* would produce the same economic results to the partners as would occur if the requirements of the economic effect rules had been satisfied, regardless of the economic performance of the partnership. As long as the ending capital accounts of partners A and B for each year are equal to the amount distributable to partners A and B if there were a partnership liquidation at the end of that year, the allocations would be deemed to satisfy economic effect equivalence.

In Situation 1, partnership AB earned \$10 of net income for the taxable year. If partnership AB liquidated for section 704(b) book value, partnership AB would distribute \$107.5 to A and \$102.5 to B. Therefore, partnership AB will allocate the first \$5 of net income to A. The remaining net income will be allocated 50 percent to A and 50 percent to B, which is \$2.5 to each. As a result of this allocation, the capital accounts will be equal to the amount distributable to A and B under the liquidation waterfall as of the end of the year. Therefore, the economic effect equivalence test is satisfied.

In Situation 2, the partnership earned no net income for the taxable year. If partnership AB liquidated for section 704(b) book value, under the agreement, partnership AB would distribute \$100 to A and \$100 to B. AB has no net income or deductions to allocate. The capital accounts remain at \$100 for A and \$100 for B, so they exactly equal the amount distributable to A and B under the liquidation waterfall as of the end of the year. Therefore, the economic effect equivalence test is satisfied.

In Situation 3, the liquidation waterfall provides for payment of the preferred return to partner A before Partner B is repaid its section 704(b) capital account. Moreover, the partnership

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earned no net income for the tax year. If partnership AB liquidated for section 704(b) book value, under the agreement, partnership AB would distribute \$105 to A and \$95 to B. AB has no net income or deduction to allocate, so both A and B's section 704(b) capital accounts remain at \$100 and do not equal the amount each is entitled to upon liquidation of partnership AB at the end of the tax year. Situation 3 also raises the issue as to whether the partners' future sharing provisions can create current income and deductions under a taxable capital shift or guaranteed payment analysis. This revenue ruling does not address that issue.

As Situation 3 demonstrates, in any given year, there may be insufficient items to allocate in a manner that aligns the capital accounts with the liquidation waterfall. This is more likely to happen where the partnership permits allocations of net income only, but it can happen where the partnership permits allocations of gross income if the partnership has insufficient gross income items.

A net or a gross income shortfall should not generally impact the allocations in Situations 1 or 2, however, the liquidation waterfall in partnership AB's agreement calls for repayment of all partners' (*i.e.*, partner A's and partner B's) section 704(b) capital accounts prior to payment of a preferred return to partner A. Situations 1 and 2 are a different economic arrangement than Situation 3. Thus, under either Situation 1 or Situation 2, partnership AB's allocations of net income should satisfy economic effect equivalence for that year. Conversely, Situation 3 does not satisfy the economic effect equivalence test for that year. However, had partnership AB in Situation 3 generated (1) sufficient net income to support partner A's preferred return for the tax year and (2) sufficient cumulative net income since formation to support partner A's cumulative preferred return, the economic effect equivalence test would have been satisfied.

The regulations provide that partnership AB's allocations may also be respected if they satisfy the partner's interest in the partnership rule of Treas. Reg. § 1.704-1(b)(3). In Situations 1 and 2, partnership AB's net income allocations reflect the manner in which the partners have agreed to share the economic benefits associated with the net income of the partnership. Aside from the preferred return to partner A, everything is contributed, distributed, and allocated 50/50. Under all the facts and circumstances, each partner's interest in every item other than the preferred return is their 50% share. Generally, reasonable preferred returns for the use of capital are allowed for partnerships, for example, as specifically provided for in Treas. Regs. §§ 1.707-4(a)(3) and 1.514(c)-2(d). Thus, under all the facts and circumstances, partnership AB's allocations reflect the partners' interest in the partnership and both the reasonable preferred return and the allocation of the remaining net income will be treated as satisfying section 704(b) in Situations 1 and 2. Moreover, under all the facts and circumstances, partnership AB's allocations reflect the partners' interest in the partnership and both the reasonable preferred return and the allocation of the remaining net income will be treated as satisfying section 704(b) in Situation 3 for any tax year so long as, at the end of such tax year, (1) capital has not been reduced (*i.e.*, partnership AB has generated sufficient cumulative net income since formation to support partner A's cumulative 5% preferred return) and (2)

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partnership AB generates sufficient net income for that tax year to satisfy full payment of partner A's 5% preferred return.

Conclusion:

The allocations in Situation 1 and 2 satisfy the economic effect equivalence test. The allocations in Situation 3 satisfy the economic effect equivalence test for any tax year in which partnership AB has (1) sufficient net income in that tax year to satisfy full payment of A's 5% preferred return and (2) sufficient cumulative net income since formation to support partner A's cumulative preferred return.

In addition, the partnership agreement for partnership AB contains valid section 704(b) allocation provisions in Situations 1 and 2. The partnership agreement for partnership AB contains valid section 704(b) allocations in Situation 3 for any tax year so long as, at the end of such tax year, capital has not been reduced below zero and the net income of partnership AB for that tax year is sufficient to satisfy A's 5% preferred return. Even if the earnings are insufficient to support the preferred return, the reasonable preferred return in situation 3 is a valid section 704(b) allocation. At some point, if there is insufficient income, the preferred return will result in a shift from B to A that will need to be taken into account.

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Situation 1 Targeted Allocation Computations

Hypothetical Distributable Capital at End of Year	
Initial capital	0
Contributions by partners	200
Net Profits	10
Distributable Capital	<u>\$210</u>

Partners' Cash Entitlements Under Liquidation Waterfall		
	A	B
1 st : to A and B to return capital	\$100	\$100
2 nd : to A to extent of 5% return on capital	5	0
3 rd : 50% to each of A and B	2.5	2.5
Entitlements to Ending Capital	<u>\$107.5</u>	<u>\$102.5</u>

Allocation of Partnership AB Profits		
	A	B
Hypothetical Cash Entitlements	\$107.5	\$102.5
Less Beginning Capital + Contributions	<u>(100)</u>	<u>(100)</u>
Change in Entitlements	7.5	2.5
\$10 Net Profits Allocation for Year	\$7.5	\$2.5

Partners' Capital Accounts		
	A	B
Initial Capital	0	0
Plus Contributions	100	100
Plus Net Profits	7.5	2.5
Capital Accounts at End Of Year	<u>\$107.5</u>	<u>\$102.5</u>

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Situation 2 Targeted Allocation Computations

Hypothetical Distributable Capital at End of Year	
Initial capital	0
Contributions by partners	200
Net Profits	0
Distributable Capital	\$200

Partners' Cash Entitlements Under Liquidation Waterfall		
	A	B
1 st : to A to return capital	\$100	0
2 nd : to B to return capital	0	100
3 rd : to A to provide a 5% return on capital	0	0
4 th : 50% to each of A and B	0	0
Entitlements to Ending Capital	\$100	\$100

Allocation of Partnership AB Profits		
	A	B
Hypothetical Cash Entitlements	\$100	\$100
Less Beginning Capital + Contributions	(100)	(100)
Change in Entitlements	0	0
\$0 Net Profits Allocation for Year	0	0

Partners' Capital Accounts		
	A	B
Initial Capital	0	0
Plus Contributions	100	100
Plus Net Profits	0	0
Capital Accounts at End Of Year	\$100	\$100

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Situation 3 Targeted Allocation Computations

Hypothetical Distributable Capital at End of Year	
Initial capital	0
Contributions by partners	200
Net Profits	0
Distributable Capital	\$200

Partners' Cash Entitlements Under Liquidation Waterfall		
	A	B
1 st : to A to return capital plus 5% simple return	\$105	\$0
2 nd : to B to return capital	0	95
3 rd : 50% to each of A and B	0	0
Entitlements to Ending Capital	\$105	\$95

Allocation of Partnership AB Profits		
	A	B
Hypothetical Cash Entitlements	\$105	\$95
Less Beginning Capital + Contributions	(100)	(100)
Change in Entitlements	5	(5)
\$0 Net Profits Allocation for Year	0	0

Partners' Capital Accounts		
	A	B
Initial Capital	0	0
Plus Contributions	100	100
Plus Net Profits	0	0
Capital Accounts at End Of Year	\$100	\$100