Private Letter Rulings

Private Letter Ruling 8931001, 03/15/1989, IRC Sec(s). 46
UIL No. 0046.00-00; 0704.00-00

Headnote:
Reference(s): Code Sec. 46;

Private Letter Ruling 8931001

Code Sec. 46 INVESTMENT CREDIT -- partnership allocations .

The limited partners of a limited partnership, formed in 1984 to operate a medical facility, contributed a total of $435,000 to initial capital. Of the two corporate general partners in the medical facility, one contributed $565,000; the other made no capital contribution. The partnership agreement provided that, in 1984, more than 89% of the net income was to be allocated to the limited partners, with the remainder allocated to the general partners. From 1985 through 1989, net income was to be allocated first to all partners to the extent of net losses previously allocated. For this same period, but after allocations according to previously allocated net losses were accomplished, more than 59% of net income was to be allocated to the limited partners, with the remainder going to the general partners. The agreement provided that, beginning in 1990, net income will be allocated first to all partners to the extent of net losses previously allocated, and then approximately 33% will be allocated to the limited partners, with the remainder going to the two general partners. The net income allocations include income resulting under Sec. 48(d)(5) from investment tax credits (ITCs) on leased property. The agreement's terms entitled the managing general partner to a guaranteed payment of 10% of the partnership's gross receipts. For all tax years, the partnership agreement provided for a net loss allocation of more than 89% for the limited partners, with the remainder to the general partners until the capital accounts of the limited partners are zero. The agreement provides for all net losses incurred after that point to be allocated to the general partners. The agreement provided for ITCs to be allocated to the partners in the same ratio as net income was allocated for the year in which the property creating the credit was placed in service. It further provided for distributions after the partnership was dissolved, and after all liabilities and reserves were paid, to be made to all partners in proportion to the positive balances in the their capital accounts up to the full amount of their capital balances. Of the remaining amounts, approximately 27% will be distributed to limited partners; about 73% will go to the general partners. The partnership incurred losses in 1984, 1985, and 1986, and had a gain in 1987. No partner ever had a negative capital account. The partnership leased equipment from a corporate lessor under a five-year operating lease. The lessors elected to pass through to the partnership the ITCs relating to the leased equipment under Sec. 48(d). Under the partnership agreement, the limited partners were allocated over 89% of the credit, even though they contributed only 43.5% of the capital. Assuming the limited partners were in the 50% tax bracket, an agent computed that the limited partners' deductions and credits were worth about $27,000 more than their contributions. The general partners couldn't use the credits and so were trading early credits and losses for higher percentages of net income in later years. RULED: In technical advice, the IRS ruled that Reg. 1.46-3(f)(2)(i) doesn't support the use of the net income allocations found in the partnership agreement for 1984 and 1985: those allocations don't reflect the real economic profit-sharing arrangement of the partners. Reg. 1.46-3(f)(2)(i) requires that the general profits ratio reflect the real economics of the partners' profit-sharing arrangement. The partnership's ITCs must be allocated in accordance with the general profits ratio that reflects the partners' interests in the partnership. The allocation for 1984 does not satisfy the substantiality test of Reg. 1.704-1(b)(2)(iii), and the same is likely true for 1985. The partnership's net income allocation for 1984 and 1985 was not sustainable under prior law. The agent should make a facts-and-circumstances determination of the partners' interests in the partnership and should calculate the proper ITC allocations for 1984 and 1985 under Reg. 1.46-3(f)(2)(i) using the general profit-sharing ratio that reflects those interests instead of the net income allocations found in the partnership agreement. The tax avoidance the partnership sought was flagrant: the 1984 and 1985 net income allocations were never made. The net income allocations served no purpose except to support artificially high investment tax credit allocations to the limited partners. (Technical Advice Memorandum)

Full Text:
March 15, 1989

Whether the allocations of the investment tax credit ("ITC") made by Partnership for 1984 and 1985 are correct.

Facts
Partnership is a limited partnership formed in 1984 which files its tax return on a calendar year basis. The limited partners contributed $ 435,000 to initial capital, the general partners $ 565,000. One of the two general partners contributed the entire $ 565,000, the other made no capital contribution. Partnership was formed to establish, operate, and manage a medical facility.

At the time of th formation of Partnership, the general partners were newly formed corporations. Partnership's private placement memorandum ("PPM") states that, because it is anticipated that Partnership will generate deductions in excess of income in early years, and because it is not anticipated that Partnership will experience significant positive cash flow in such years, an investment in Partnership is best suited for persons who have substantial income from other sources which is subject to high rates of federal income tax.

Section 6 of the partnership agreement provides for the allocation of net income, net loss, and tax credits.

For the tax year 1984, 89.71875 percent of the net income is allocated to the limited partners, and the remainder to the general partners. For the period January 1, 1985, through December 31, 1989, the allocation of net income is first to all partners to the extent of net losses previously allocated to them in proportion to such prior net loss allocations, taking into account any net income previously allocated. Thereafter, during the 1985 through 1989 period, 59.81250 percent of the net income is allocated to the limited partners and the remainder to the general partners. Beginning January 1, 1990, net income is allocated first to all partners to the extent of net losses previously allocated, and thereafter 32.62500 percent to the limited partners and the remainder to the general partners. The net income allocations include the income resulting under section 48(d)(5) from ITCs on leased property.

The managing general partner is entitled under the partnership agreement to a guaranteed payment of 10 percent of the gross receipts of the partnership. Such partner is also entitled to an incentive management fee for the years 1987-89. The incentive fee is determined by taking 35 percent of revenues in excess of specified minimum revenues in the partnership agreement. However, the incentive fee cannot exceed 35 percent of cash available for distribution.

For all tax years, net losses are allocated 89.71875 percent to the limited partners and the remainder to the general partners until the capital accounts of the limited partners are zero. Thereafter, net losses are allocated 100 percent to the general partners.

ITCs are allocated to the partners in the same ratio as net income is allocated (or would be allocated if there were net income for such year) for the year in which the property to which the tax credit relates is placed in service.

Section 5 of the partnership agreement controls distributions of cash from operations as well as distributions upon dissolution of Partnership.

Distributions from operations are to be made first to the holders of certain loans, in proportion to the then outstanding principal balances, up to the full extent of the total principal amount of such loans. Once such loans are paid, for any year ending prior to January 1, 1990, 59.81250 percent of the cash from operations available for distribution will be distributed to the limited partners and the remainder to the general partners. For any period beginning after December 31, 1989, 32.62500 percent of such cash will be distributed to the limited partners and the remainder to the general partners.

Upon dissolution of Partnership, and after provision for the payment of Partnership's liabilities, the setting up of reserves for contingent, unforeseen, and not-yet-payable liabilities, and the repayment of partner loans and additional capital contributions, distributions are made to all partners in proportion to the positive balances in their capital accounts, up to the full amount of such capital account balances, after giving effect to all allocations of net income, gain, net losses, deductions, and all previous distributions. Any remaining amount will be distributed 27.1875 percent to the limited partners and 72.8125 percent to the general partners. The partnership agreement did not contain a deficit makeup provision. Nor were the limited partners obligated to contribute a fixed additional amount to the partnership. However, section 4.4 of the partnership agreement provides that limited partners who have received the return, in whole or part, of their capital contribution may be liable to Partnership for any sum, not in excess of such return with interest, necessary to discharge Partnership's liability to all creditors who extended credit or whose claims arose before such return. In addition, limited partners are liable under section 4.3.3 of the partnership agreement for their pro rata share of a portion of the lease payments on equipment leased by Partnership under leases entered into in 1984, in the event Partnership is unable to make the lease payments out of partnership funds.

As stated in the PPM, Partnership's income projections for its first five taxable years, prepared prior to the beginning of operations, were as follows:

$ 244,000 loss in 1984, $ 49,000 loss in 1985, $ 173,000 income in 1986,

$ 152,000 income in 1987, and $ 135,000 income in 1988. Cash distributions were projected to begin in 1986 in the amount of $ 86,000, and total $ 172,00 in 1987 and $ 165,000 in 1988. Actual income figures for the first four taxable years were as follows: $ 76,000 loss in 1984, $ 255,000 loss in 1985, $ 595,000 loss in 1986 and $ 624,000 gain in 1987. No partner ever had a negative capital account.

In 1984, Partnership leased certain equipment from a corporate lessor and its affiliates under five-year operating leases. Pursuant to section 48(d) of the Code, which provides for the pass-through of ITCs, the lessors elected to pass through to Partnership the ITCs relating to the leased equipment. For its 1984 and 1985 taxable years, Partnership allocated a qualified investment of

$ 3,717,781 and $ 23,661, respectively, among its partners. Pursuant to the terms of the partnership agreement, the limited partners were allocated 89.71875 percent of the credit although they contributed only 43.5 percent of the capital and were expected to receive no distributions or income allocations in excess of 59.8125 percent (other than income allocations that merely offset prior loss allocations).

During the years 1984 and 1985, the limited partners were allocated $ 331,000 of losses. Assuming the limited partners to be in the 50 percent tax bracket (in accordance with the PPM), the Agent calculated that the limited partners' tax deductions and credits were worth approximately $ 27,000 more than their contributions. In addition, he concluded that the general partners could not use the ITCs at that time. During the period relevant hereto the general partners had no significant income from any source other than Partnership. Therefore, the general partners were trading early credits and losses (which were of very limited current use to them) for higher percentages of net income in later years.

Law

Section 1.704-1(b)(4)(ii) of the Income Tax Regulations provides that, with respect to the investment tax credit provided by section 38 of the Internal Revenue Code, allocations of cost or qualified investment made in accordance with section 1.46-3(f) shall be deemed to be made in accordance with the partners' interests in the partnership. Section 1.46-3(f)(2)(i) states that each partner's share of the basis (or cost) of any section 38 property shall be determined in accordance with the ratio in which the partners divide the general profits of the partnership (that is, the taxable income of the partnership as described in section 702(a)(8)), regardless of whether the partnership has a profit or a loss for its taxable year during which the section 38 property is placed in service.

Section 704(a) of the Code provides that a partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided, be determined by the partnership agreement. Section 704(b) provides, that a partners'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 if (i) the partnership agreement does not provide as to the partner's distributive share or (ii) the allocation to a partner under the agreement does not have substantial economic effect.

Section 1.704-1(b)(1)(i) of the regulations provides that an allocation in a partnership agreement will be respected if it satisfies any one of the following three tests: (1) The allocation has substantial economic effect in accordance with section 1.704- 1(b)(2); (2) the allocation is in accordance with the partner's interest in the partnership, as described in section 1.704-1(b)(3); or (3) the allocation is deemed to be in accordance with the partner's interest in the partnership under one of the special rules in section 1.704-1(b)(4).

Section 1.704-1(b)(2)(i) provides that an allocation has substantial economic effect if it (1) has economic effect and (2) such economic effect is substantial.

In general, under section 1.704-1(b)(2)(ii) an allocation has economic effect if (1) the partnership's capital accounts are maintained in accordance with section 1.704-1(b)(2)(iv), (2) upon liquidation of the partnership the partnership (or any partner's interest in the partnership) liquidating distributions will be made to the partners in accordance with their positive capital account balances, and (3) partners are unconditionally required to restore the negative balance of their capital accounts to the partnership upon the liquidation of their interests in the partnership. Section 1.704-1(b)(2)(ii)(i), relating to the economic effect equivalence test, provides that allocations made to a partner that do not otherwise have economic effect under the section 704(b) regulations 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 taxable year or at the end of any future year would produce the same economic results to the partners as would occur if the above three requirements had been satisfied, regardless of the economic performance of the partnership.

The regulations articulate the substantiality concept by stating a general rule as to when the economic effect of an allocation will be considered substantial, and by providing specific rules that delineate circumstances under which an allocation will be deemed to be insubstantial even though the general rule is satisfied.

In general, under section 1.704-1(b)(2)(iii)(a) the economic effect of an allocation is considered 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 the tax consequences.

One of the exceptions to this general rule, the "transitory allocations" rule of section 1.704-1(b)(2)(iii)(c), renders insubstantial those allocations that have the possibility of largely offsetting one another under the terms of the partnership agreement if, at the time the allocations become part of the partnership agreement, there is a strong likelihood that (1) the net increases and decreases that will be recorded in the partners' respective capital accounts for the taxable years to which the allocations relate will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such years if the original and offsetting allocations were not contained in the partnership agreement, and (2) the total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement, taking into account tax consequences that result from the interaction of the allocation with partner tax attributes that are unrelated to the partnership. Under section 1.704-1(b)(2)(iii)(c), a safe harbor provides that, notwithstanding the foregoing, the original and offsetting allocations will not be insubstantial as transitory allocations if, at the time the allocations become part of the partnership agreement, then is a strong likelihood that the offsetting allocations will not, in large part, be made within five years after the original allocations are made.

Under section 1.704-1(b)(3) of the regulations, the determination of a partner's interest in a partnership is made by taking into account all facts and circumstances relating to the economic arrangement of the partners. In determining a partner's interest in the partnership several factors are considered, including (a) the partner's relative contributions to the partnership, (b) the interests of the partners in economic profits and losses, (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. A partner's interest in a partnership may vary with respect to allocations of income, gain, loss, deduction, or credit.

Under section 1.704-1(b)(1)(ii) of the regulations, the provisions of section 1.704-1(b) are generally effective for partnership taxable years beginning after December 31, 1975. For partnership taxable years beginning after December 31, 1975, but before May 1, 1986, an allocation that is not respected under section 1.704-1(b) nevertheless will be respected under section 704(b) of the Code if such allocation has substantial economic effect or is in accordance with the partners' interests in the partnership as those terms have been interpreted under the relevent case law, the legislative history of the Tax Reform Act of 1976 ("the Act"), and the provisions of section 1.704-1(b) in effect for partnership taxable years beginning before May 1, 1986.

Prior to amendment by the Act, section 704(b) of the Code provided that a partner's distributive share of any item of income, gain, loss, deduction, or credit shall be determined in accordance with his distributive share of taxable income or loss of the partnership for the taxable year if (1) the partnership agreement did not provide as to the partner's distributive share of such item, or (2) the principal purpose of any provision in the partnership agreement with respect to the partner's distributive share of such item is the avoidance or evasion of tax. The present "substantial economic effect" language in the current section 704(b) replaces this pre-Act language. The regulations, as in effect prior to the adoption of amended regulations by T.D. 8065, 1986-1 C.B. 254, provided as follows:

In determining whether the principal purpose of any provision in the partnership agreement for a special allocation is the avoidance or evasion of Federal income tax, the provision must be considered in relation to all the surrounding facts and circumstances. Among the relevant circumstances are the following: Whether the partnership or a partner individually has a business purpose for the allocation; whether the allocation has "substantial economic effect", that is, whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences; whether related items of income, gain, loss, deduction, or credit from the same source are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocation. (Section 1.704-1(b)(2) prior to amendment in 1985.)

The legislative history of the Act, relating to the amendment of section 704(b) of the Code, stressed the importance of substantial economic effect. After adopting the section 1.704-1(b)(2) (prior to amendment in 1985) definition of substantial economic effect, the Senate report states that " {o} ther factors that could possibly relate to the determination of the validity of an allocation are set forth under the present regulations (Regs. 1.704-1(b)(2))." The Senate report specifically references, among other things, "the duration of the allocation . . . and the overall tax consequences of the allocation." Further, " {w} hile there is a difference in language, the intent of the committee amendment and the House bill are essentially the same -- both versions seek to prevent the use of special allocations for tax avoidance purposes, while allowing their use for bona fide business purposes." S. Rep. No. 94-938, 94th Cong., 2d Sess. 99, 100 (1976), 1976-3 (vol. 3) C.B. 49, 137, 138.

Discussion

A. UNDER CURRENT REGULATIONS

A basic question presented by this case is whether the rule provided in section 1.46-3(f)(2)(i) of the regulations, considered by itself apart from any section 1.704-1(b) considerations, was intended to require the use of all bottom line net income allocations set forth in partnership agreements. The reference to the general profits ratio in that section (having been added to the regulations in 1964 when partnerships were generally not as complex and tax-oriented as they often are today) was based upon the premise that that ratio would reflect the real economics of the partners' profit-sharing arrangement. Where that is not the case the regulation was not intended to, and does not, authorize the use of bottom-line net income allocations for ITC purposes. Therefore, the rule in section 1.46-3(f)(2)(i) does not support Partnership's ITC allocations for 1984 and 1985. Accordingly, those allocations do not satisfy section 1.704-1(b)(4)(ii), and Partnership's ITCs must be allocated under section 1.46-3(f)(2)(i) in accordance with the general profits ratio that reflects the partners' interests in the partnership (as defined in section 1.704-1(b)(3)).

Even assuming arguendo that section 1.46-3(f)(2)(i) of the regulations, considered by itself, supported use of the net income allocations in the present case, Partnership's ITC allocations are invalid on other grounds. The "general profits" allocation described there must meet the requirements of section 704(b) of the Code and section 1.704-1(b) of the regulations. If read otherwise, section 1.46-3(f)(2)(i) would impose the unreasonable requirement that ITC allocations be based on invalid profits allocations.

Therefore, in order to be used for ITC purposes a net income allocation contained in a partnership agreement must fall within one of the three means of recognition in section 1.704-1(b)(1)(i). It must either have substantial economic effect in accordance with section 1.704-1(b)(2) of the regulations, be in accordance with the partners' interests in Partnership under section 1.704-1(b)(3), or be deemed to be in accordance with the partners' interests in Partnership under section 1.704-1(b)(4). If the partnership agreement's allocation fails all three of the applicable standards, then the general profits will be allocated in accordance with the partners' interests in Partnership under section 1.704-1(b)(3). Once the general profits allocation is recognized under section 1.704-1(b)(1)(i), ITCs allocated pursuant to section 1.46-3(f)(2)(i) fall within the deemed partners' interests in the partnership provision of section 1.704-1(b)(4)(ii).

In the present case the net income allocation is clearly not in accordance with the partners' interests in the partnership under section 1.704-1(b)(3). Nor does the allocation fall within one of the deemed rules of section 1.704-1(b)(4). Therefore, it must either have substantial economic effect or be reallocated under section 1.704-1(b)(3).

Under section 1.704-1(b)(2)(ii)(b) economic effect is defined in terms of what the partnership agreement provides with respect to capital accounts. In this case it appears that the partnership agreement meets the capital accounts requirements except that it does not contain an unconditional deficit makeup agreement or its equivalent. However, the facts in this case may result in deemed economic effect under section 1.704-1(b)(2)(ii)(i).

Substantiality is defined in the general rule of section 1.704- 1(b)(2)(iii)(a) of the regulations in terms of what happens under the agreement. The general rule 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 the tax consequences.

Because profits were not even remotely expected by Partnership in 1984 there was no reasonable possibility that for that taxable year the net income allocation contained in the partnership agreement could have affected substantially the dollar amounts to be received by the partners from the partnership independent of the tax consequences. Therefore, Partnership's net income allocation lacks substantiality under the general rule. It appears likely from projections that the general rule also invalidates the net income allocation for 1985 for the reasons stated above.

Moreover, the net income allocation in 1985 may lack substantial economic effect under the transitory allocation rule of section 1.704-1(b)(2)(iii)(c). Whether or not the allocation fails the transitory allocation rule requires facts-and-circumstances determinations of the anticipated overall effect of all offsetting allocations of losses and net income (including any allocation of net income for 1985) on capital accounts and on Federal income tax liabilities, taking into account the whole period over which the original and offsetting allocations were expected to take place.

B. UNDER PRIOR LAW

The question raised in the first paragraph under the present law discussion above is also applicable to the discussion under prior law discussion and is incorporated herein.

Since 1984 and 1985 are the taxable years at issue, section 1.704-1(b)(1)(ii) requires the allocations to be considered in light of prior law. The intent of that section is to pick up all the old law that bears on substantial economic effect. Of specific relevance are the references in section 1.704-1(b) (prior to amendment in 1985) and in the legislative history of the 1976 Act to "substantial economic effect", the "duration of the allocation", the "overall tax consequences of the allocation", and the disallowance of allocations used for tax avoidance rather than business purposes. It is noteworthy that the earlier regulations employed the same test of substantial economic effect as that found as the general rule in section 1.704-1(b)(2)(iii); i.e., "whether the allocation may actually effect the dollar amount of the partners' shares of the total partnership income independently of the tax consequences."

In this case, as anticipated, Partnership's 1984 and 1985 net income allocations were never made. Thus, they had no effect whatsoever on the dollar amounts received by the partners independent of tax consequences. Accordingly, we believe that they are not sustainable under the prior regulations. Although relevant court decisions generally determined economic effect by a capital accounts analysis (because of the facts of those cases), we see no indication that the courts interpreting prior law would have concluded that tax- avoiding allocations that have no nontax economic consequences for the partners have substantial economic effect. See Orrisch v. Commissioner, 55 T.C. 395 (1970), aff'd per curiam, 31 A.F.T.R.2d 73- 1069 (9th Cir. 1973); Allison v. Commissioner, 701 F.2d 933 (Fed. Cir. 1983).

The tax avoidance sought by Partnership in this case is flagrant. Partnership's 1984 and 1985 net income allocations were never made. They served no purpose other than to support artificially high ITC allocations to its limited partners which were totally out of line with the real economics of the arrangement, and the limited partners were expected to save more in taxes than their entire investment in Partnership. Partnership's sharp focus on tax avoidance is further evidenced by its timing of the 1984 ITCs (all of the $ 3.7 million in leased equipment became operational in the final 11 days of 1984) and the perfect precision with which the partnership agreement avoided the application of the ITC recapture rule under section 1.47-6 of the regulations. If the limited partners' proportionate interest in the general profits of the partnership had dropped in 1987 below

66-2/3 percent of their original allocation, their ITCs would have been subject to partial recapture. Under the agreement, the allocation dropped to EXACTLY 66-2/3 percent (59.81250/89.71875) of its original amount in that year.

Conclusion

Section 1.46-3(f)(2)(i) of the regulations does not support the use of the net income allocations stated in the partnership agreement for 1984 and 1985 because those allocations do not reflect the real economic profit-sharing arrangement of the partners. Moreover, that allocation for 1984 does not satisfy the substantiality test of section 1.704-1(b)(2)(iii) of the regulations and it is likely that the same is true for the 1985 allocation. Furthermore, Partnership's net income allocation for those years was not sustainable under prior law.

Accordingly, the agent should now make the facts-and- circumstances determination of the partners' interests in Partnership (as they relate to general profits) in accordance with section 1.704- 1(b)(3) of the regulations. The agent should then compute the proper ITC allocations for 1984 and 1985 under section 1.46-3(f)(2)(i) using the general profits sharing ratio that reflects those interests rather than the net income allocations provided for those years in section 6 of the partnership agreement.