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Retroactive Allocations to New Partners: An Analysis of the Area after Rodman

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Retroactive allocations to new partners: An analysis of the area after Rodman

by JOHN W. LEE, III *and* ROBERT S. PARKER, JR.

In the recent Rodman *case, the Tax Court has held that a partner newly admitted near year-end must report his share of the full year's partnership profits. Messrs. Lee and Parker analyze the status of retroactive partnership allocations in view of* Rodman, *the first decision to expressly sanction retroactive allocations of income (and implicitly of losses) to new partners, and reallocations under Section 704.*

FREQUENTLY TAXPAYERS SEEKING tax sheltered investments cannot or do not make such investment decisions until near year-end. Promoters of syndicates in real estate and other shelters commonly represent to limited partners to be newly admitted into the partnership late in the year that shares of deductible expenses previously incurred by the partnership will be allocated to them, retroactively to the first of the tax year.[1] Less frequently, resales to substituted or transferee limited partners are made on the same inducement. Commentators have clashed sharply over whether the Code permits such retroactive allocations.[2]

Interplay of 761 and 706

The competing arguments center on Sections 706(c) and 761(c). Section 706(c)(2)(A)(i) specifically provides that the taxable year of a partnership closes as to a partner if he sells or exchanges his entire interest in a partnership, with his distributive share of the partnership income or loss for such short year to be determined as the Regulations prescribe. Reg. 1.706-1(c)(2)(ii) permits the partners to agree on an estimation of the withdrawing partner's distributive share based upon his pro rata part of the items that he would have included in taxable income had he remained a partner until the end of the partnership's taxable year. Section 706(c)(2)(B) states that the taxable year of a partnership does not close as to the partner who sells or exchanges less than his entire interest in the partnership or whose interest is reduced, but provides that such partner's distributive share is determined by taking into account his varying interests in the partnership during the tax year. The basic question is whether either of these provisions is subject to Section 761(c), which permits modifications of a partnership agreement up until the due date of the partnership information return. If so, does that mean that the prorations called for by Section 706(c) would be applicable only if the parties did not agree otherwise by retroactively amending the partnership agreement? A subsidiary question is whether a retroactive general allocation of partnership ordinary income and loss is subject to the Section 704(b)(2) principal purpose test or to a judicially imposed restriction.[3]

As late as the winter of 1972 the Service had not announced a position on retroactive allocations.[4] Now the Commissioner has argued in *Rodman*, TCM 1973-277, that, where a partner sold his 25% interest in a calendar year joint venture or partnership to the three remaining equal partners on November 2, and three days later the partnership admitted a new partner (apparently by a contribution to capital) with a 22% interest in profits and losses and readjusted the three old partners' interests, the parties intended to retroactively amend the partnership agreement to allow the new partner "to share in the full year's profits and losses of the joint venture."

Rodman *decision*

The Commissioner's surprising litigation posture becomes more understandable in light of the following facts: (1) the partnership return for 1956, the tax year in question, showed substantial ordinary losses and a significant long-term capital gain; (2) the joint venture allocated to the withdrawing partner 25% of such gain; (3) the 1956 partnership return attributed to the new partner 22% of the losses for the entire year and 22% of the remaining (75%) net long term capital gain; and (4) only after the Commissioner wiped out the loss reported on the partnership's return, did the new partner assert that the parties intended his share of the profits and losses of a joint venture to begin only with his entry.

The Tax Court agreed with the Commissioner's adjustments and with his contention that the parties intended to retroactively amend the joint venture agreement to allow the newly admitted partner to share in the full year's profits and losses. The court reasoned as follows: under Section 702(a) a partner takes into account his distributive share of partnership income when determining his own personal income tax. Section 704(a), in turn, mandates that such distributive share be determined, except as otherwise provided, by the partnership agreement. Finally, Section 761(c) provides that the partnership agreement includes modifications made prior to or on the due date of the partnership information return, which all partners agree to or which are adopted as provided by the agreement itself. Such modifications are effective as of, or relate back to, the beginning of the taxable year.[5] Thus the partners may adjust among themselves their share of the partnership earnings and be taxed accordingly.

The court further held that it was entirely proper for the joint venture to allocate to the withdrawing partner 25% of the capital gain since the gain had been fully earned and accrued prior to his withdrawal. Such proration was thought reasonable within the meaning of Reg. 1.706-1(c)(2)(ii).

At first blush the Tax Court appears to have reconciled the requirement of Section 706(c)(2)(A)(i) that the partnership year end with respect to a partner who sells his entire interest with Section 761(c) which permits modifications of the partnership agreement, by holding that the newly admitted partner must compute his distributive share of the joint venture 702(a) items on the basis of the full taxable year, but that such items must be first reduced by any amount attributable to the withdrawing partner. The court did not reconcile its decision with Section 706(c)(2)(B), however, two of the partners had reduced interests after the admission of the new partner, yet their varying interests during the year were not taken into account as expressly required by that statutory provision.

Other decisions and commentary

Prior to the decision in *Rodman* there were only two 1954 Code cases that spoke even indirectly to retroactive allocations to new partners. *Smith,* 331 F.2d 298 (CA-7, 1964), held that, where two partners terminated a partnership, one could retroactively allocate the last taxable year's profits and losses to the other under Section 761(c). The other case, *Town & Country Plymouth, Inc.,* DC Cal., 9/4/67, did involve a retroactive amendment to the partnership agreement after a transferee limited partner had purchased an old limited partner's entire interest halfway into the tax year, but the opinion does not disclose whether any losses were incurred prior to the admission of the substituted partner or if there were such losses, whether they were allocated by the partnership agreement to the withdrawing partner or to the substituted limited partner purchasing his interest.

Commentators relying on *Smith,* have argued that retroactive modifications under Section 761(c) override Sections 706(c)(2)(A) and 706(c)(2)(B).[6] However, it was generally thought that, at most, such retroactive modifications would only override Section 706(c)(2)(B) for a new partner admitted by capital contribution to the partnership and not Section 706(c)(2)(A) for a substituted or transferee partner purchasing a partnership interest from one of the other partners.[7] Some writers believed that even the provisions of Section 706(c)(2)(B) could not be overridden by a Section 761 modification.[8]

A noted partnership tax writer suggested that Section 761 could be read to permit reallocations between successive holders of a particular partnership interest, but not reallocations to a new partner by capital contribution of items accrued prior to his acquiring his interest.[9] *Smith* did not involve this issue since there the two partners retroactively amended the partnership agreement and then terminated the partnership.

One commentator argued that Section 706(c)(2)(B) appeared to be limited to reductions in interest resulting from partnership distributions constituting partial liquidations.[10] Therefore, he reasoned that reductions in interest resulting from additional contributions by new partners would not be governed by Section 706(c)(2)(B) but by the partnership agreement as modified under Section 761(c).

In addition to arguments based on the technical language of the Code provisions, tax writers disagreed on the policy aspects of a retroactive allocation to a new partner. One school suggested that where a new partner's capital contributions went in large part to repay loans used to pay the retroactively allocated losses, such allocation could be economically justified because the new partner's capital contributions bore the cost of those losses.[11] The counter-argument was that such losses were analogous to accrued expenses assumed and paid for by the purchaser of real estate which are added to basis rather than deducted.[12] Furthermore, to some writers retroactive allocations smacked of "trafficking" in previously incurred tax deductions.[13]

In summary, the entire area was quite unsettled until the *Rodman* decision.

Retroactivity after Rodman

In *Rodman,* the three old partners who remained in the partnership throughout the tax year owned varying profit and loss interests in the partnership during that period: 25% each from January 1 through November 1; November 1 through 4, undisclosed interests; and November 5 through December 31, 33⅓%, 22⅔% and 22% (78% in the aggregate). They appear to have reported their distributive shares of the joint venture's income and loss for the entire year, adjusted for the amount allocated to the withdrawing partner, in accordance with the November 5 percentage interests. Thus, the two old partners with the reduced interests did not determine their distributive shares of partnership income or loss by taking into account their varying interests in the partnership during the tax year as Section 706(c)(2)(B) requires. Instead, after carving out the distributive share allocated to the withdrawing partner, they allocated profits and losses according to the retroactively modified profit or loss ratio of November 5. The Commissioner and the Tax Court agreed that their allocation was permissible. Consequently, the "varying interests" rule of

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[1] See Halperin and Tucker, *Tax consequences of operating low income housing (FHA 236) programs,* 36 JTAX 80, 82 (February, 1972).

[2] *Cf., e.g.,* McGuire, *When will a special allocation of deductions among partners be recognized?,* 37 JTAX 74, 77-78 (August, 1972) with Kaster, "Subsidizing Housing: Facts versus Tax Projections," 26 *Tax Lawyer* 125, 129 (1972).

[3] Long, *Tax shelter in real estate partnership: An analysis of tax hazards that still exist,* 36 JTAX 312, 315 (May, 1972), Halperin and Tucker, *Tax consequences of operating low income housing (FHA 236) programs, supra,* n. 1.

[4] Points to remember, No. 11, 25 *Tax Lawyer* 404 (1972).

[5] *Foxman,* 41 TC 535 (1964).

[6] Kanter, "Real Estate Tax Shelters: Everything You Wanted to Know But Did Not Know What to Ask," 51 *Taxes* 770, 796-97 (1973); Halperin and Tucker, *Tax consequences of operating low income housing (FHA 236) programs, supra,* n. 1.

[7] Cowan, Partnerships—Taxable Income and Distributive Shares A-24 (Tax Management Portfolio No. 282, 1973); Lipscomb, *Practitioner's tax planning guide in view of recent developments in partnerships,* 31 JTAX 108, 111 (August, 1969); Bibart, "Partnership Taxation," 40 *Cinn. L. Rev.* 456 (1971); Kanter, "Real Estate Tax Shelters: Everything You Wanted to Know But Did Not Know What to Ask," *supra,* n. 6 at 797; Halpering and Tucker, *Tax consequences of operating low income housing (FHA 236) programs, supra,* n. 1.

[8] McGuire, *When will a special allocation of deductions among partners be recognized?, supra,* n. 2.

[9] Cowan, *supra,* n. 7 at A-29; Cowan, Partnerships —Distributive Shares—Disallowance of Special Allocations A-3 (Tax Management Portfolio No. 283, 1973).

[10] Bibart, *supra,* n. 7 at 504.

[11] See McGuire, *When will a special allocation of deductions among partners be recognized?, supra,* n. 2.

[12] Cowan, *supra,* n. 7 at A-29; McGuire, *When will a special allocation of deductions among partners be recognized?, supra* n. 2.

[13] McGuire, *Limited partnerships: Steps that can be taken to overcome problems in the area,* 34 JTAX 235, 238 (April, 1971).

Section 706(c)(2)(B) is subject to this significant exception: where the partner's varying profit and loss interests are retroactively modified under Section 761(c) as of the beginning of the tax year, the modified formula will be followed throughout the tax year. Thus, *Rodman* opens the door for admission by capital contributions of new partners who will share losses (or profits) for the entire partnership taxable year according to the last modification of the partnership profit or loss ratio prior to or on the due date of the partnership return. Similarly, since the varying interests rule applies equally to sales of less than a partner's entire interest and to reductions of a partner's interest in general, transferee or substituted partners should be able to share retroactively in profit and losses from the first of the year, at least after allocating a share to the transferor partner.

The next question is whether the withdrawing partner's interest in pre-withdrawal profits or losses can in effect be allocated retroactively to the partners newly admitted by transfer or by capital contribution. *Rodman* held that the new partner shared in profits and losses on the basis of the full taxable year, but income and loss first had to be reduced by any amount attributable to the withdrawing partner under Section 706(c)(2)(A)(i). Of course, the joint venturers had actually agreed to allocate to the withdrawing partner 25% of the gain earned and accrued prior to his withdrawal, which allocation the court said comported with the reasonable method of proration requirement under Reg. 1.706-1(c)(2)(ii). The court did not hold that Section 706(c)(2)(A)(i) compels such an allocation; therefore, the decision does not speak to whether parties can retroactively reallocate the profit or loss initially attributed to the withdrawing partner. Section 706(c)(2)(B) in providing for prorations in sales of less than the partner's entire interest or reductions appears on its face more mandatory than Section 706(c)(2)(A) since the proration under the latter subsection is set forth only in the Regulations. Accordingly, because the varying-interests rule of Section 706(c)(2)(B) can be modified by a retroactive allocation under *Rodman,* the partners should also be able retroactively to modify the distributive share of a partner who entirely withdraws, by allocating his share for the period he was a partner to the then remaining partners at least by modifications executed before the partnership year terminates as to him. Then under the holding of *Rodman* the remaining old partners could agree to admit new partners through capital contributions with a fixed distributive share for the entire year. Since an old partner's share could seemingly be allocated to new partners indirectly, successive holders should be able to make the allocation directly.[14]

The confused decisional treatment under the 1939 Code of this and related problems, together with legislative history to the 1954 Code considering that confusion, also militate towards permitting successive holders to determine their tax burdens between themselves by retroactive modifications of the profit or loss ratio made at the time of the transfer of the partnership interest. Under the 1939 Code, a major problem developed as to mid-year transfers of partnership interests to either transferee or existing partners where the partnership had already realized income and the withdrawing partner simply sold his entire interest including such income. A majority of the cases applied the assignment-of-income doctrine to treat that portion of the purchase price attributable to such earned income as ordinary income, but others more strictly adhering to the entity approach of partnership taxation treated the entire purchase price as capital gain to the extent in excess of basis.[15] Several cases so applying the assignment-of-income doctrine noted that there had been no modifications in the profit or loss ratios allocating the withdrawing partner's distributive share to the remaining partner.[16] Furthermore, in *Hulbert,* TCM 1954-7, *aff'd.* 227 F.2d 399 (CA-7, 1955), perhaps the only decision where a purchaser not previously a partner agreed to buy the withdrawing partners' pre-sale profits (without modifying the profit or loss ratio), the Tax Court held against capital gains treatment for the part of the purchase price attributable to such profits. The court relied upon *LeSage,* 173 F.2d 826 (CA-5, 1949), in which a withdrawing partner had attempted in a mid-year transaction to obtain capital gains treatment upon the sale of his distributive share of profit up to the date of withdrawal to the remaining, existing partner.

Congress in drafting the 1954 Code characterized the treatment to be accorded a withdrawing partner under the 1939 Code as among the most confused in the entire tax field.[17] As the Tax Court in *Foxman,* 41 TC 535 (1964) at 551, pointed out, Congress sought to dispel some of this confusion by injecting flexibility into the 1954 Code by permitting "partners themselves to determine their tax burdens *inter se* to a certain extent. . . ." Retroactive modifications are one example of such flexibility.[18] Indeed, *Smith,* in effect overrules decisions such as *LeSage* which did not permit a withdrawing partner to shift his pre-withdrawal distributive share of profit or loss to the remaining old partner. Since *Hulbert* in prohibiting such shift to a new transferee viewed the issue as indistinguishable from a shift to an existing partner, denying both on assignment-of-income principles, Section 761 and *Smith* undermine *Hulbert* as well as *LeSage* for 1954 Code years. Accordingly, retroactive allocations between successive holders of the same partnership interest should be permitted so they may determine their tax burdens among themselves.

It appears clear that after *Rodman,* the following retroactive allocations are permissible: (1) a fixed percentage of partnership income or loss for the entire year to newly admitted partners and to transferee partners where no old partner has disposed of his entire interest, and (2) a fixed percentage to such newly admitted and transferee partners of partnership income or loss for the entire year less a pro rata portion of such income or loss attributable to a withdrawing partner who previously sold or exchanged his entire interest when the partners agreed to such pro rata allocation. *Rodman* does not speak directly to the question of whether a partner selling his entire interest may allocate retroactively his distributive share of partnership profit and loss to other partners, but its application of Section 761(c), as well as prior precedents, indicates that such a withdrawing partner may agree to allocate his pre-withdrawal distributive share of profits and losses to at least old partners and probably to his transferee.

The major future attacks on the validity of retroactive allocations are likely to be based on the tax avoidance test of Section 704 (b)(2), on assignment-of-income principles and on bona fides of the reallocation.

Section 704(b)(2)

Section 704(b)(2) mandates that a partner's distributive share of any item of income, gain, loss, deduction or credit must be determined in accordance with his distributive share of Section 702(a)(9) partnership taxable income or loss if the principle purpose of any allocation of such item to that partner is the avoidance or evasion of taxes. Whether the allocation has a "substantial economic effect" is an important consideration according to Reg. 1.704-1(b)(2). (An allocation of a specific item is referred to as a "special allocation"; an allocation of all the items constituting net profit or loss constitutes a "general allocation.")

In *Smith,* one partner argued that a retroactive modification allocating to him the withdrawing partner's distributive share of profits and losses in their terminated partnership for the short year of termination was ineffective on the grounds that the legislative history of Section 761(c) indicated that modifications of partnership agreements are subject to Section 704(b) and that the modification was made for the purpose of tax avoidance. The Seventh Circuit agreed "that a modification cannot be a vehicle to escape tax liability," but found no evidence indicating that the assigning partner had any intention of avoiding or evading taxes, particularly since he had agreed to the modification believing the partnership would sustain a loss for the period.

In *Kresser,* 54 TC 1621 at 1631, footnote 5 (1970) ,the Commissioner argued that Section 704(b)(2) was fatal to a purported retroactive general allocation of the entire partnership profit to a single partner with an expiring NOL. The Tax Court did not reach the issue because it found that the modification was not bona fide, but noted that the structure of Section 704(b) and the language of the 1954 Senate Finance Committee Report (S. Rept. No. 1622, 83rd Cong. 2d Sess. 379) seemed to support the taxpayer's contention that the provision applied only to "items" of income which must be separately stated on the partnership return under Sections 702(a)(1) through (8), and not to the composite of all the partnership's income or loss ("ordinary income or loss"), exclusive of the separately stated items, which is governed by Section 702(a)(9).

More recently in *Maxcy,* 59 TC 716 (1973), the court refused to consider a retroactive allocation issue first raised by the taxpayer on brief particularly in view of "the interrelationship between Section 761(c) and the existence of a 'principal purpose of . . . avoidance or evasion of tax' in respect of a provision in the partnership agreement as provided in Section 704(b)(2)." The opinion then noted the possible conflict between *Smith* and *Kresser.*

The *Kresser*-Court correctly stated that the structure and legislative history of Section 704(b)(2) indicate its inapplicability to a general allocation. For example, the statutory penalty for a tainted allocation is reallocation in accordance with the distributive shares of taxable income or loss as described in the Section 702(a)(9). The legislative history to Section 704 (S. Rept. No. 1622, at 379 and H. Rept. No. 1337, 83d Cong., 2d Sess. A223), indicates that the House and particularly the Senate envisioned a reallocation in accordance with the provisions of the partnership agreement for sharing income and losses generally (with Section 702(a)(9) being referred to expressly in the Senate Report.) Thus, an invalidated general allocation would have to be "reallocated" in accordance with the general allocation formula, which, in effect, would mean no reallocation.[19] In addition, numerous commentators have pointed out that Section 704(b) expressly refers to a reallocation of "items" of income, gain, loss, deduction, or credit, and not a reallocation of overall income or loss.[20] On the other hand, Conference Report No. 2543, 83d Cong., 2d Sess. 374 (1954), apparently referred to by the court in *Smith,* states that the Section 761(c) "authorization to revise or amend the partnership agreement subsequent to the close of the taxable year is subject, of course, to the provisions of Section 704(b)." Such statement could indicate that the Conference Committee intended that a partnership agreement modification in the form of a retroactive general allocation be subject to Section 704(b), possibly under the rationale that the original general allocation profit or loss ratios would be available as a guide for the reallocation. The Report appears, however, to have been speaking only to a retroactive *special* allocation for it had just illustrated the retroactive modification concept with a "special allocation among the partners of depreciation, depletion or gain or loss with respect to contributed property," and it described Section 704(b) as relating to distributive shares of "partnership items of gain, loss, etc." The Conference Committee no doubt meant that if an initial (special) allocation would be subject to Section 704(b), then a modification to effect such an allocation would also be so subject.

Judicial restrictions

Principal purpose or substantial economic effect test. While most tax writers agree that Section 704(b)(2) is not applicable to a general allocation, whether retroactively modified or an initial allocation, they also conclude that many of the criteria of the principal purpose of tax avoidance or "substantial economic effect" test are applicable to a general allocation, albeit under different guises such as assignment of income or sham.[21] For example, *Kresser* held that any modification of the general profit and loss ratios must be bona fide. It found that the near year-end modifications of two partnership agreements allocating the year's entire income to partner *A* with a 22½% interest in one and a 17% interest in the other

[14] See Cowan, *supra,* n. 9 and accompanying text.

[15] *Cf. Sherlock,* 294 F.2d 863 (CA-5, 1961) with *Swiren,* 183 F.2d 656 (CA-7, 1950).

[16] *Goldstein,* 29 TC 931 (1958); *Johnson,* 21 TC 733 (1954); see *Leff,* TCM 1954-332, *aff'd.* 235 F. 2d 439 (CA-2, 1956).

[17] H. Rep't. No. 1337, 83rd Cong., 2d Sess. 65; *Ely,* TCM, 1960-142.

[18] *Kresser,* 54 TC 1620 (1970).

[19] Cowan, *supra* n. 7 at A-7.

[20] *E.g.,* Bibart, *supra* n. 7 at 470; Long, *Tax Shelter in real estate partnership, supra* n. 3. But see McGuire, *When will a special allocation of deductions among partners be recognized, supra* n. 2 at 76 (such restrictive construction might not be adopted by court).

[21] Long, *Tax shelter in real estate partnership, supra* n. 3 at 315. See Willis on *Partnership Taxation* 33-34 (1971); Pennell & O'Byrne, *Federal Income Taxation of Partners and Partnerships* 49 (2d ed. 1971).

[22] *Cf. Orrisch,* 55 TC 396 (1970), *aff'd. per curiam,* CA-9, 3/30/73, dealing with Section 704(b).

[23] See Halperin and Tucker, *Tax consequences of operating low income housing (FHA 236) programs, supra* n. 1 at 82. *Cf.* Aronsohn, *Partnerships and Income Taxes* 28 (1970 ed.) (partnership general allocation incompatible with actual ratios in which taxable income and liquidations distributions probably not binding on the IRS); 2 Survey, Warren, McDaniel & Ault, *Federal Income Taxation* 128 (1973) (where there is a different ratio for sharing profits or losses and sales proceeds, Reg. 1.752-1(*e*) basis allocations should follow latter).

[24] Pennell and O'Byrne, *supra* n. 21 at 49.

[25] Long, *Tax shelter in real estate partnership, supra* n. 3.

[26] *Willis,* supra n. 21 at 33-34.

[27] Mim. 6767, 1952-1 CB 111, declared obsolete in *Rev. Rul.* 69-31, 1969-1 CB 307.

[28] Aronsohn, *supra* n. 23 at 188, n. 40.

[29] *Canfield,* 168 F.2d 907 (CA-6, 1948); *Woosley,* 168 F.2d 330 (CA-6, 1948); *Harz,* 170 F.2d 313 (CA-8, 1948).

[30] *Davega,* TCM 1952-85; *Ardolina,* TCM 1949-297, *rev'd.* 186 F.2d 176 (CA-3, 1951).

[31] Note, Current Income Tax Aspects of Family Partnerships, 36 *Va. L. Rev.* 357, 369 (1950); Comment, Family Partnerships and the Revenue Act of 1951, 61 *Yale L. J.* 541, 550, n. 36 (1551). But see *Weiss,* 206 F.2d 350 (CA-2, 1953).

[32] See also, Lee, "Shareholder Withdrawal—Loan or Dividend: Repayments, Estoppel, and Other Anomalies," 12 *Wm. & Mary L. Rev.* 512, 533 (1971) (relinquishing income prior to end of year).

was made with the understanding that he would restore to the other partners in later years the amounts allocated to him in the tax year, either by relinquishing his share of income or absorbing all of the economic losses. In addition, cash flow, at least in the form of actual cash withdrawals by *A*, did not follow the general allocation of profit or loss. The court concluded the modified general allocation was merely "a paper transaction having no consequences of substance, and did not represent a true modification or readjustment of the partner's distributive shares of income."

Accordingly, a general allocation, whether or not retroactive, probably must have the potential of actually affecting the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences and probably must be reflected in their capital accounts.[22]

Commentators have also suggested that a variance between allocation of cash flow and the general allocation, a factor noted in *Kresser*, may raise a question as to whether the general allocation is actually being made economically as well as for tax purposes.[23] This could pose a problem for retroactive allocations arising from admission of new partners by capital contributions since such new partners seldom receive cash flow distributions as well as losses back to the first of the year. Yet since they commonly have a priority on such distributions until an amount equal to their original investment is returned, their priority period usually extends for the same number of months but to a later date.

Assignment of income. Writers have asserted that except for family partnerships governed by Section 704(e), the Code does not require that profits and losses be shared in proportion to capital contributions or value of services rendered to the partnership, but that under general assignment of income principles any division that is clearly not arm's-length may be disregarded.[24] They have suggested that an "assignment of income" argument could apply to a general allocation to achieve the same results as application of Section 704(b)(2).[25] Clearly the juggling of income from one year to another involved in *Kresser* could be viewed as an anticipatory assignment of income,[26] but the experience under the 1939 Code as to family partnerships, where the doctrine was limited, and the 1954 Code flexibility for partners to adjust tax consequence among themselves, suggests that the assignment of income doctrine is sharply curtailed in the area of partnership taxation.

The Service believed that, with respect to 1939 Code years prior to 1951 (the date of enactment of the predecessor to Section 704(e)), it could in some circumstances reallocate income among the partners according to the value of their services and capital rather than following the partnership agreement without totally disregarding the existence of a family partnership.[27] The courts generally disagreed.[28] While the Tax Court first permitted such reallocations, expressly relying upon assignment of income arguments, it was uniformly reversed on appeal.[29] In the strongest of such opinions (*Hartz*, 170 F.2d 313, 318 (CA-8, 1948)), the Eighth Circuit held that the alternatives were either to follow the partnership agreement or to disregard the entire partnership if the division of income were artificial or in bad faith; judicial reapportionment was not permitted. Thereafter in *Delchamps*, 13 TC 281 (1949), the Tax Court abandoned its earlier position. "Any reallocation of partnership earnings among the partners contrary to that provided for in the partnership agreement would amount to the making of a new contract for the partners. That action is beyond the province of this Court, in the absence of any patently unreasonable agreement by them."

The Tax Court soon adopted the extreme view that under no circumstance was it permitted to reallocate income if the partnership was valid, so that it was forced to find a partnership invalid where it would prefer to modify the profit ratio.[30] It was thought that no reallocation could be effected absent the application of Section 704(e).[31] In addition, the 1939 Code cases, precluding retroactive reallocations between existing partners based on assignment of income analysis, were clearly overruled by *Smith*.

Furthermore, the assignment of income doctrine assumes, according to *First Security Bank of Utah*, 405 U.S. 394 (1972), that the income would have been received by the taxpayer had he not arranged for it to be paid to another. The landmark decision of *Hellman*, 44 F.2d 83 (Ct. Cls. 1930), held that partners may prospectively adjust between themselves their interest in partnership income in any proportion they agree upon, and that the assignment of income doctrine would be inapplicable since a partner (1) would only be entitled to receive what the agreement provided and (2) could not assign that which the agreement gave to other partners. The fact that a retroactive allocation is involved should yield no different conclusion in view of *Smith* and since a partner is given the express statutory right, prior to the end of a tax year, to relinquish income that he had a right to receive without calling into play the assignment of income doctrine.[32]

Conclusion

Rodman is the first decision to expressly sanction retroactive allocations to new partners. The fact that it is a memorandum decision may only reflect that it involved multiple issues or that the record was overly bare after the passage of 17 years and the death of several of the principals. On the other hand, it might reflect a desire by the Tax Court to deemphasize a hot issue. Certainly the Service may be expected to later reassess and possibly attempt to shift its position. It is likely, however, that retroactive allocations will continue to be approved since the purpose and background of Section 761 virtually mandates such treatment. Future controversies may be expected to rise to a more sophisticated level. ☆

Sub S debt to partnership does not augment partner's loss

Is THERE ANY WAY A partner who is also a shareholder in a Subchapter S corporation can use his part of the partnership's loans to the corporation to increase his basis for deducting the losses of the corporation? The apparent answer, according to *Frankel*, 61 TC No. 38, is "no."

There, two taxpayers were involved. One owned a 5% interest in a partnership and a Subchapter S corporation. The other owned a 20% interest in both entities. The partnership made loans to the corporation and the partners added 5% and 20%, respectively, of such loans to their basis in determining their pro rata deduction of the corporation's net operating loss.

However, the Tax Court held there could be no increased basis and hence no increased NOL deduction as a result. The crux of the decision is the court's holding that the partnership loan could not be treated as if it were made by the individual partners—even if guaranteed by them—for purposes of Section 1374 (c)(2).

The court noted with approval *Rev. Rul.* 69-125, 1969-1 CB 207. In that Ruling, the majority shareholders of a Subchapter S corporation also owned a majority of the interests in a partnership. The Service held that the debts of the corporation to the partnership were not the indebtedness of the corporation to the shareholders within the meaning of Section 1374(c)(2)(B). Therefore, the shareholders could not take into account the partnership loans in computing the allowable net operating loss deductions which pertained to the corporation.

The taxpayers contended that the *Raynor* decision (50 TC 762 (1968)), lent support to its contention that the partners could use the loans of the partnership. In that case, the shareholders made loans to several Subchapter S corporations acting as "partners." They agreed that the amounts owed by each corporation were to be considered as being owed to each shareholder in proportion to his stockholding regardless of who actually advanced the funds on open account. However, in that case, each stockholder was only permitted to use his own direct advances to the corporations in computing his net operating loss deduction.

The effect of the *Frankel* decision, if upheld, is to require similarly situated taxpayers to first have a distribution of funds from the partnership and then lend the money directly to the corporation.

An alternative might be for the partners to borrow from the partnership and then loan the funds to the corporation. But this procedure might seem to present the additional requirement of avoiding the step-transaction doctrine. ☆

Stockholder voting agreements do not destroy Sub S election

STOCKHOLDERS OF A Subchapter S corporation can agree among themselves as to who shall vote their shares without losing Subchapter S status, says the IRS in *Rev. Rul.* 73-611, IRB 1973-53, 56. However, if such an agreement is contained in the articles of incorporation, then a second class of stock will result, thus destroying the election.

At the heart of the controversy is Reg. 1.1371-(g) which states, in part, that a difference as to voting rights in the stock of a corporation will disqualify it from the election.

In *Rev. Rul.* 63-226, 1963-2 CB 341, the Service held that a stockholders agreement requiring the two inactive stockholders to give irrevocable proxies to one or more of the active shareholders invalidated the Subchapter S election. The reason given by the IRS was that the rights and interest of the inactive shareholders in the control of the corporation were not identical to those of the active shareholders.

However, in *A. & N. Furniture & Appliance Co.*, 271 F. Supp. 40 (DC Ohio, 1967), that Ruling was held to be an unjustified departure from the Congressional purpose of enacting the one-stock requirement. Congress, said the court, was not that concerned with the respective voting power of each shareholder. Rather, they were only concerned that businesses making the Subchapter S election be those small businesses which it had intended to benefit and that no accounting complications result.

Similarly, in *Parker Oil Co.*, 58 TC 985 (1972), the court held that a difference in voting rights between shares of stock in a Subchapter S corporation did not create a second class of stock. The court held that the purpose of the one-stock requirement was to avoid complexities in taxing income. Consequently, it felt that *Rev. Rul.* 63-226 was too broad in its scope. The voting arrangement in *Parker* could not alter the reporting of the profits of the corporation by its shareholders. The arrangement was a common way of resolving difficulties among the shareholders of a closely-held corporation. The court did not see why such an arrangement should disqualify the election and therefore held that both the Ruling and the Regulation were invalid to the extent that they require all shares of the stock of a Subchapter S corporation to have equal voting rights.

On the other hand, in *Pollack*, 47 TC 92 (1966), *aff'd.*, 392 F.2d 409 (CA-5, 1968), a corporation amended its articles of incorporation to provide for separate voting powers prior to the issuance of any stock. The court held that this did create a second class of stock since that situation was different from *Pollack.*

In *Rev. Rul.* 73-611, the IRS noted that in *Parker*, the agreement was among the shareholders (this was also the situation in *A & N. Furniture Co.*). However, in *Pollack*, the articles of incorporation were specifically amended to provide for the restrictions. It then concluded that disproportionate voting rights that arise out of a corporation's charter or articles of incorporation create more than one class of stock, thus invalidating a Subchapter S election. However, if the disproportionate rights arise out of agreements among shareholders or between shareholders and third parties, not involving the corporation's formal structure, such disproportionality does not create a disqualifying second class of stock.

In accordance with this change of heart the IRS, in the same Bulletin, has acquiesced in result only in the decision in *Parker Oil Company.* ☆

New decisions

Subchapter S election not timely filed. *(DC)*

The Government contended that a newly-formed corporation's Subchapter S election was not timely even though made in the first month following commencement of active business operations. The election should have been made earlier within 30 days of the acquisition of an asset. It was immaterial that there were no shareholders when an asset was first acquired. The corporation could have made the election and obtained an extension of time for shareholder consents.

Held: For the Government. *Calhoun*, DC Va., 11/15/73.

Loss deduction of Subchapter S corporation shareholders disallowed. *(CA)*

Taxpayers, sole proprietors, transferred their business to a new corporation which then elected Subchapter S status. At the time of transfer, the fair market value of the assets was $293,000, liabilities assumed were $180,000 and the stockholders' adjusted basis in the assets was $119,000. Taxpayers then deducted the corporate loss on their returns, which was disallowed. The Tax Court held for the Commissioner. Pursuant to Sections 351 and 357(c), a gain of $61,000 was recognizable on the transfer to the corporation. Furthermore, taxpayers' basis in the stock in the corporation became zero after these transfers and the losses are not deductible on the returns.

Held: Affirmed. *Wiebusch*, CA-8, 11/26/73.