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SPECIAL REPORT

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by Jeffrey N. Bilsky

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In this report, Bilsky analyzes practical considerations in determining allocations of profit and loss based on "the partner's interest in the partnership" — an area lacking clear guidance under the code's partnership allocation rules.

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I. Summary

Most investment fund operating (or partnership) agreements include income and loss allocation provisions that are driven by distribution rights. These so-called targeted allocation partnership agreements don't necessarily provide explicit instructions regarding a partner's share of realized profit or loss. Rather, the focus of these partnership agreements is on the partner's rights to partnership capital and associated distributions with distributive shares of profit or loss derived from these data. The allocation provisions often reference an intent to achieve ending capital account balances commensurate with future distributions. Consider the following example.

Example 1. Fund X has $100 million of capital invested in Investment A ($25 million), Investment B ($25 million), Investment C ($25 million), and Investment D ($25 million). The partnership agreement provides that income or loss is to be allocated among the partners in an amount sufficient to cause each partner's capital account to equal, as closely as possible, the partner's rights to distributions upon liquidation of the partnership. The partnership agreement further provides that available cash is to be distributed entirely to the limited partners (with no return thereon) until they have received their invested capital. Later distributions are split 80 percent to the limited partners and 20 percent to the general partner. At the end of year 1, Fund X sells Investment A for $35 million. The values of Investment B and Investment C remain unchanged, but the value of Investment D drops to $20 million.

At the end of year 1, Fund X needs to determine how to allocate the $10 million of gain realized on the disposition of Investment A and whether 100 percent of the distributable cash ($35 million) may be distributed to the limited partners. This isn't necessarily a simple exercise.

Upon a hypothetical liquidation of the partnership at current book value, total capital would be $110 million.[1] Based on the terms of the partnership agreement, the first $100 million would be distributed to the limited partners and the remaining $10 million (reflecting the realized gain on Investment A) would be allocated 80/20 between the limited partners ($8 million) and the general partner ($2 million). (See table.)

Example 1: Allocations

Distributable cash	$35 million
Investment B	$25 million
Investment C	$25 million
Investment D	$25 million
Total capital	$110 million

Since the partnership agreement provides for an allocation of gain based on a hypothetical liquidation, allocating $8 million of income to the limited partners and $2 million to the general partner appears reasonable. However, because the value of Investment D has declined by $5 million, a hypothetical liquidation at actual fair market value would result in less cash available for distribution to the general partner.[2] Does this mean Fund X need only allocate $1 million of recognized gain to the general partner? Finally, does the fact that the economic deal provides for a distribution of 100 percent of available capital affect the way the $10 million of recognized gain should be allocated?

This report discusses those questions and suggests factors to consider when trying to develop a reasonable, supportable answer in the practical world. Readers are cautioned, however, to not expect certainty in this area. Existing partnership allocation rules provide significant flexibility in determining allocations among partners, potentially including so-called anticipatory allocations.[3] With this flexibility, however, comes a high degree of uncertainty. In the absence of clearer guidance, the best strategy may be a detailed, clearly documented assessment of each taxpayer's particular facts supporting the ultimate determination of each partner's share of annual profit or loss.

II. General Allocation Rules Under Section 704(b)

A. Overview

In recent years, economic arrangements between limited partners and fund managers have become more complex. To address some of these complexities, funds have shifted to allocation provisions intended to match income allocations with cash distributions. Fund agreements today generally provide clear instructions meant to ensure the intended cash distribution results are achieved. Tax return preparers, however, are faced with a lack of clear guidance under the partnership allocation rules. The result can be material variances between intended and reported tax allocations.

Before working through a detailed case study, it will be helpful to provide a framework in which tax return preparers review partnership agreements, determine partner allocations, and ultimately sign a fund tax return. The starting point for developing this framework, of course, is section 704 and the associated regulations.

Section 704(a) generally provides that partners are free to allocate partnership income and loss in whatever manner determined by the partners. This unlimited flexibility is restrained by section 704(b). Under section 704(b), the allocation provisions described in a partnership's partnership agreement will be respected provided the allocations have substantial economic effect (SEE). In the absence of allocations having SEE, the partnership must determine each partner's distributive share of partnership income or loss in accordance with the partner's interest in the partnership (PIP). The

[1] The $110 million total capital valuation at current book value reflects the $10 million realized gain on Investment A but not the unrealized $5 million drop in the value of Investment D.

[2] Instead of $110 million of total capital, at FMV, Fund X would have available capital of $105 million. A liquidation at $105 million would result in only $1 million of capital allocable to the general partner.

[3] *See* R. Brown James, Catherine Harrington, and Carlos Schmidt, "A Framework for Evaluating Anticipatory Allocations," *The Partnership Tax Practice Series: Planning for Domestic and Foreign Partnerships, LLC, Joint Ventures, and Other Strategic Alliances* (2022).

statute defers to Treasury and the IRS the responsibility to define both PIP and SEE. Treasury regulations provide extensive guidance regarding SEE but provide little guidance in determining PIP.

As we begin exploring our case study, an overview of the SEE and PIP rules is instructive. We will need an understanding of the rules defining economic effect,[4] substantiality,[5] and PIP.[6] Also, as we'll see in our case study, the capital account maintenance rules[7] are fundamental to determining the potential supportability of purported partnership income or loss allocations.

B. Economic Effect

In its simplest terms, the objective of economic effect is to ensure that allocations of income or loss commensurately affect the partner's economic position. For example, a $100 allocation of income to a partner should entitle that partner to the benefits associated with the income — that is, future cash distribution entitlement. Similarly, a $100 loss allocation to a partner should reduce the partner's entitlement to capital. Capital account maintenance is the mechanism through which we can determine whether an allocation has economic effect under the regulations.

The regulations effectively provide three safe harbors intended to give certainty that an allocation will have economic effect. These include the general test,[8] the alternate test,[9] and economic effect equivalence (EEE).[10] Each of these safe harbors is discussed in the following section.

1. The general test of economic effect.

Allocations in a partnership agreement will satisfy the general test of economic effect only if the following requirements are satisfied:

1. the partnership maintains capital accounts in accordance with the rules of section 704(b);
2. upon liquidation of the partnership, liquidating distributions are required to be made to the partners in accordance with positive balances in the partners' capital accounts; and
3. if a partner has a deficit balance in its capital account at the time of liquidation, the partner is unconditionally obligated to restore the deficit amount by the end of the partnership's tax year or, if later, within 90 days of the partnership's liquidation.

The third requirement, referred to as a deficit restoration obligation (DRO),[11] is seldom found in fund agreements. More typically, fund agreements explicitly provide that no partner shall be unconditionally obligated to restore a negative capital account balance. Consequently, it would be unusual for a fund agreement to satisfy the general test for economic effect.

2. The alternate test of economic effect.

The alternate test of economic effect similarly requires satisfying three requirements. Under the alternate test, the first two requirements of the general test must be satisfied. However, in lieu of a DRO, the partnership agreement must contain a qualified income offset (QIO) provision. Treasury regulations provide that an partnership agreement will be considered as containing a QIO provision only if the agreement provides that a partner who unexpectedly receives an adjustment, allocation, or distribution 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 that

[4] Reg. section 1.704-1(b)(2)(ii).

[5] Reg. section 1.704-1(b)(2)(iii).

[6] Reg. section 1.704-1(b)(3).

[7] Reg. section 1.704-1(b)(2)(iv).

[8] Reg. section 1.704-1(b)(2)(ii)(b).

[9] Reg. section 1.704-1(b)(2)(ii)(d).

[10] Reg. section 1.704-1(b)(2)(ii)(i).

[11] Reg. section 1.704-1(b)(2)(ii)(c) provides that a DRO may exist in situations in which the contribution is not expressly provided for in the operating agreement. For example, a DRO exists to the extent of (1) the outstanding principal balance of any promissory note (of which the partner is the maker) contributed to the partnership by that partner and (2) the amount of any unconditional obligation of that partner to make subsequent contributions to the partnership whether by agreement or under state or local law. These obligations will be respected only if the obligation is required to be satisfied no later than the end of the partnership tax year in which the partner's interest is liquidated or, if later, within 90 days after the date of that liquidation.

year) in an amount and manner sufficient to eliminate the deficit balance as quickly as possible.[12] Many fund partnership agreements contain a QIO provision intended to meet the definition described in the regulations. However, because funds generally do not liquidate in accordance with positive capital account balances, the alternate test of economic effect is seldom satisfied.

3. Economic effect equivalence.

The third safe harbor provision, EEE, is often referenced to support allocations made in accordance with a partnership agreement. Reliance on these rules, however, is questionable in most fund partnership agreements. Treasury regulations provide that allocations made to a partner that do not otherwise have economic effect under the general or alternate tests will still be deemed to have economic effect, provided that as of the end of each partnership tax year, a liquidation of the partnership at the end of that year or at the end of any future year would produce the same economic results to the partners as if the requirements described in the general or alternate test were satisfied. In essence, then, the EEE safe harbor requires that liquidation distributions at the end of the current or any future year always match the partner's capital account balance. While it's certainly possible that this test may be satisfied in any given year, the "any future year" requirement merits extreme caution.[13]

C. Substantiality

1. General rules.

While the concept of economic effect is tied to reflective changes in a partner's share of capital, substantiality seeks to ensure that per-partner allocations aren't made with an eye toward reducing the partners' collective federal income tax liability. Under the general rules described in the regulations:

> The economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.
>
> Notwithstanding the preceding sentence, the economic effect of an allocation (or allocations) is not substantial if, at the time the allocation becomes part of the partnership agreement: (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement.

Regulations further describe two categories of allocations that will be viewed as lacking substantiality: (1) allocations that result in shifting tax consequences and (2) transitory allocations.

2. Shifting allocations.

Under the first category, allocations of specific items of income or loss that reduce the partner's collective tax liability without substantially affecting the economic effect among the partners will not be considered substantial.[14]

[12]Reg. section 1.704-1(b)(2)(ii)(d) describes adjustments, allocations, or distributions to be considered for purposes of ensuring the existence of a QIO. These include reasonably expected capital account adjustments relating to oil and gas depletion allowances, reasonably expected allocations of loss and deduction under section 704(e)(2), section 706(d), and reg. section 1.751-1(b)(2)(ii), and distributions in excess of reasonably expected offsetting increases (excluding increases under a minimum gain chargeback provision). Reasonably expected increases under a minimum gain chargeback provision are generally taken into account as an offset to distributions of nonrecourse liability proceeds.

[13]As noted in William S. McKee, William F. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, section 11.02 n.31 (5th ed.) ("This 'dumb but lucky' rule is likely to be significant only in the simplest of situations.").

[14]Reg. section 1.704-1(b)(2)(iii)(b) provides: "The economic effect of an allocation (or allocations) in a partnership taxable year is not substantial if, at the time the allocation (or allocations) becomes 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 such taxable year will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such year if the 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."

Example 2. Assume M and N are partners in the MN partnership, which is established for the purpose of making investments. The MN partnership agreement provides that all income and loss of the partnership will be shared equally among the partners. During its first tax year, MN generates $10,000 of interest income from tax-exempt bonds and $10,000 of taxable dividend income. M is exempt from tax while N is fully taxable. The MN partnership agreement is amended to specially allocate 90 percent of the tax-exempt interest and 10 percent of the taxable dividends to N. The remaining income is allocated to M. Assume the proposed allocations have economic effect — that is, each partner is allocated $10,000 of income with corresponding rights to $10,000 of cash. The substantiality of the allocations is determined by comparing the tax consequences of proposed allocations with those of the original allocations. Since the partners will, on a combined basis, have a lower federal income tax liability resulting from the proposed allocations, the economic effect of the proposed allocations is not substantial under this rule.

3. Transitory allocations.

Under the second category, substantiality may be lacking in situations in which one or more purported allocations will be largely offset by one or more other allocations.[15]

Example 3. Assume partners in equal partnership AB LLC, include A (a taxable partner) and B (a tax-exempt partner). The AB operating agreement provides that 100 percent of all partnership income will be allocated to A during years 1 through 3 and 100 percent of partnership income starting in year 4 will be allocated to B until B is allocated partnership income equal to the amounts allocated to A. All income thereafter is allocated equally between A and B. Under the transitory allocation rules, the allocations among A and B will not be substantial if there is a strong likelihood that (1) the cumulative allocation to A and B will not vary from their intended 50/50 sharing ratio and (2) the aggregate tax liability of the partners will be reduced on a net present value basis.[16]

D. Capital Account Maintenance

1. General rules.

Capital accounts are effectively the partners' scorecard reflecting their respective shares of economic activity occurring within the partnership. As noted in the regulations,[17] whether purported allocations have economic effect depends on an analysis of the partners' capital accounts. Similarly, the PIP rules introduced above appear to rely, at least in part, on a partner's economic entitlement to partnership capital. A potentially important distinction between the rules, however, is the regulatory requirement to evaluate economic effect annually. No such requirement is explicitly stated when evaluating PIP.

While a detailed analysis of the capital account maintenance rules is beyond the scope of this report, a summary of the general rules will aid in the subsequent case study. Regulations provide that proper maintenance of a partner's capital accounts requires upward and downward adjustments for specific items. These adjustments include:

- upward adjustments to capital:
  - the amount of money contributed by the partner to the partnership;
  - the FMV of property contributed by the partner to the partnership (net of liabilities that the partnership is considered to assume or take subject to); and

[15] Reg. section 1.704-1(b)(2)(iii)(c) provides that if the original allocation will be largely offset by an offsetting allocation, "and, 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 account for such years if the original allocation(s) and offsetting allocation(s) were not contained in the partnership agreement and (2) the total tax liability of the partners . . . will be less than if the allocations were not contained in the partnership agreement (taking into account [the partners' non-partnership tax attributes]), the economic effect of the original allocation(s) and offsetting allocation(s) will not be substantial."

[16] Importantly, the flush language of reg. section 1.704-1(b)(2)(iii)(c) "the original allocation(s) and the offsetting allocation(s) will not be insubstantial . . . and . . . it will be presumed that there is a reasonable possibility that the allocations will affect substantially the dollar amounts to be received by the partners if, at the time the allocations become part of the partnership agreement, there is strong likelihood that the offsetting allocation(s) will not, in large part, be made within five years of the original allocations."

[17] Reg. section 1.704-1(b)(2)(iv)(a).

  - allocations of partnership income and gain (or items thereof), including income and gain exempt from tax and income and gain described in reg. section 1.704-1(b)(2)(iv)(g) but excluding income and gain described in reg. section 1.704-1(b)(4)(i).
- downward adjustments to capital:
  - the amount of money distributed to the partner by the partnership;
  - the FMV of property distributed to the partner by the partnership (net of liabilities that the partner is considered to assume or take subject to);
  - allocations of expenditures of the partnership described in section 705(a)(2)(B); and
  - allocations of partnership loss and deduction (or items thereof), including loss and deductions described in reg. section 1.704-1(b)(2)(iv)(g) but excluding allocations of expenditures of the partnership described in section 705(a)(2)(B) and loss or deduction described in reg. section 1.704-1(b)(4)(i) or (iii).

2. Revaluations.

As noted, a detailed assessment of the capital account maintenance rules is beyond the scope of this report. One additional area, though, does merit some attention. Reg. section 1.704-1(b)(2)(iv)(f) provides that partnerships may revalue partnership property in certain situations.[18] Further, reg. section 1.704-1(b)(2)(iv)(s) provides that partnerships must revalue partnership property upon the exercise of a noncompensatory partnership option (NCPO). Capital account revaluations under reg. section 1.704-1(b)(2)(iv)(f) are recorded immediately before the event triggering the revaluation. However, revaluations under reg. section 1.704-1(b)(2)(iv)(s) are recorded immediately after the exercise of the NCPO.

E. Allocations Based on PIP

1. General rules.

When purported allocations in a partnership agreement do not have SEE, the partnership is required to allocate income and loss in accordance with PIP.[19] Most investment fund partnership agreements do not liquidate in accordance with positive section 704(b) capital accounts. Consequently, allocation provisions within these agreements will not meet the general or alternate test of economic effect. Further, as noted above, satisfying the EEE test is rarely possible and may lead to multiple years of allocation uncertainty. Instead, investment funds must allocate income and loss based on a determination of PIP. Unfortunately, and despite the critical importance of defining PIP for most private investment funds, Treasury regulations provide scant guidance.

Reg. section 1.704-1(b)(3) provides:

> References in section 704(b) and this paragraph 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. Except with respect to partnership items that cannot have economic effect (such as nonrecourse deductions of the partnership), this sharing arrangement may or may not correspond to the overall economic arrangement of the partners. Thus, a partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in a particular item of income or deduction. (For example, in the case of an unexpected downward adjustment to the capital account of a partner who does not have a deficit

[18] Revaluations are generally permitted in connection with (1) non-de minimis section 721 contributions of money or other property to the partnership by a new or existing partner; (2) liquidation of the partnership or non-de minimis distributions of money or other property to a partner under section 731; (3) the grant of a non-de minimis interest in the partnership on or after May 6, 2004 in exchange for services provided to or for the benefit of the partnership; (4) issuance by the partnership of an NCPO; or, under generally accepted industry accounting practices, if substantially all the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

[19] Section 704(b).

makeup obligation that causes such partner to have a negative capital account, it may be necessary to allocate a disproportionate amount of gross income of the partnership to such partner for such year so as to bring that partner's capital account back up to zero.) The determination of a partner's interest in a partnership shall be made by considering all facts and circumstances relating to the economic arrangement of the partners.

The regulations go on to provide a nonexclusive list of facts that will be considered in determining PIP. These include:

- the partners' relative contributions to the partnership;
- the interests of the partners in economic profits and losses (if different from that in taxable income or loss);
- the interests of the partners in cash flow and other nonliquidating distributions; and
- the rights of the partners to distributions of capital upon liquidation.

2. Special rule for determining PIP.

The regulations then provide a "special rule," despite having narrow applicability, that may ultimately prove helpful in deciphering PIP.[20] If this rule applies, a partner's allocations are generally determined with reference to changes in a partner's right to capital following a hypothetical sale of partnership assets at book value and a subsequent hypothetical liquidation of the partnership. However, this rule applies only if:

- the general capital account maintenance rules are applied;
- the partnership agreement provides for liquidation of the partnership in accordance with positive capital account balances; and
- all or a portion of an allocation of income or loss does not have economic effect.[21]

3. Typical application in practice.

Although this special rule is unlikely to explicitly apply in typical fund allocation structures, it may be helpful to consider in determining PIP. Of particular interest is the special rule's use of book value for the hypothetical liquidating distribution model. The factors described under the general rule include rights of partners to capital distributions upon liquidation of the partnership. (This implies an actual liquidation, which presumably would occur at actual FMV, which may not be equal to the current book value). No reference is made to rights based on recorded book value. In the fund setting, this should be a highly relevant factor given the uncertainty of portfolio company valuation.

As previously noted, Treasury regulations provide detailed rules for the proper maintenance of partner capital accounts. However, except for property contributions, distributions, or permitted property revaluations, book value is not necessarily correlated to actual FMV. Consequently, a partner's rights to liquidating distributions based on book value versus actual value may be vastly different in any given year. Further, value inherent in a fund's investments may vary upward or downward from one tax year to the next.

Let's revisit the example highlighted in the introduction.

Example 1 redux. Fund X has $100 million of capital invested in Investment A ($25 million), Investment B ($25 million), Investment C ($25 million), and Investment D ($25 million). The partnership agreement provides that income or loss is to be allocated among the partners in an amount sufficient to cause each partner's capital account to equal, as closely as possible, the partner's rights to capital upon liquidation of the partnership. The partnership agreement further provides that available cash is to be distributed entirely to the limited partners until they have received their invested capital. Later distributions are split 80 percent to the limited partners and 20 percent to the general partner. At the end of year 1, Fund X sells Investment A for $35 million. The values of Investment B and Investment C remain unchanged, but the value of Investment D drops to $20 million.

[20] Reg. section 1.704-1(b)(3)(iii).

[21] The regulations provide an important caveat to this special rule. A determination of PIP made under the special rule will have no force if the economic effect of the otherwise valid allocations made in the same manner is determined to be insubstantial.

Upon liquidation of the partnership at book value, total capital would be $110 million. The first $100 million would be distributed to the limited partners, and the remaining $10 million (reflecting the realized gain on Investment A) would be allocated 80/20 between the limited partners and the general partner. This would result in allocating $2 million of the $10 million realized gain to the general partner.

Is it correct to allocate the general partner $2 million in this illustration? A determination of PIP under a hypothetical liquidation model would support this allocation. This would also be the result under the special rule described above. However, the special rule doesn't apply in this situation because the partnership doesn't liquidate in accordance with positive capital account balances. Instead, we should determine PIP by evaluating relevant factors forming the basis of the partners' overall economic arrangement.

This, of course, is where the analysis gets murky. It seems reasonable, and arguably consistent with the general economic effect rules, to simply allocate based on a hypothetical liquidation model. However, had Treasury and the IRS intended taxpayers to determine PIP based on a hypothetical liquidation model, why wasn't that method established as the general rule in the regulations?[22] Treasury and the IRS determined that a facts and circumstances analysis is necessary except in limited circumstances. This implies that a determination of PIP based on something other than a hypothetical liquidation at current book value may be perfectly reasonable and appropriate.[23] Identifying when such a divergent approach is appropriate and how to demonstrate PIP under these factors often proves challenging in practice. However, as discussed in the following case study, careful assessment and documentation of relevant facts in the context of the PIP factors enumerated in the regulations may aid in substantiating alternate determinations.

The question, of course, is how to define PIP with enough certainty to prepare and sign a tax return that will withstand IRS scrutiny. The preceding example demonstrates the fundamental challenge when determining PIP in an investment fund setting: The economic arrangement among the partners isn't defined by a single tax year, and future uncertainty can affect the economic arrangement. To illustrate these complexities in more detail, let's consider the following multiyear case study.

III. Defining PIP in Practice: A Case Study

A. Facts and Key Assumptions

Since determination of PIP is based on facts and circumstances, each situation needs to be addressed separately. However, investment funds often have multiple common business and economic considerations that may strongly affect the determination of PIP. This case study is

[22] In the preamble to the December 1985 final regulations (T.D. 8065), Treasury and the IRS noted the following intent regarding the determination of PIP:

> Section 704(b) provides that a partner's interest in the partnership shall be determined by taking into account all the facts and circumstances. The final regulations provide rules and examples for determining a partner's interest in the partnership. Under the final regulations a partner's interest in the partnership is to be determined with reference to the underlying economic arrangement of the partners relating to the particular allocation under consideration. If that economic arrangement cannot be determined, each partner's interest in the partnership is presumed to be equal. The examples contained in the final regulations specify, in certain situations, the partners' interests in the partnership.

[23] When evaluating allocations under the substantiality rules of reg. section 1.704-1(b)(2)(iii), taxpayers are directed to consider the possibility of future events. For example, under the general rule, taxpayers are required to evaluate whether there is a reasonable possibility that purported allocations will affect the present value of after-tax consequences among the partners. Similarly, under the special rule regarding transitory tax consequences, an analysis of future events needs to be performed to determine there is a strong likelihood that future allocations will result in offsetting the economic impact of purported allocations. This type of future activity assessment is necessary in evaluating the transitory allocation rule.

Fundamental to establishing whether someone is a partner, the NCPO regulations under reg. section 1.761-3 require an assessment of future activity. When determining whether an NCPO is properly viewed as equity, part of the analysis requires determining whether failure to treat the option as equity results in a substantial tax reduction. Reg. section 1.761-3(e) specifies that "the determination of whether there is a strong likelihood that the failure to treat a noncompensatory option holder as a partner would result in a substantial reduction in the present value of the partners' and the noncompensatory option holder's aggregate Federal tax liability is based on all the fact and circumstances," including the timing of income and deduction allocation and the interaction of those allocations on the partners' and NCPO holder's federal tax attributes.

intended to identify and evaluate potential multiyear considerations that may affect the economic arrangement among fund partners and therefore affect the determination of PIP and resulting tax allocations in a given tax year. Unfortunately, unless and until further guidance is issued by the government, the light we're trying to find in the abyss of current PIP guidance may turn out to be a train heading in our direction. Careful consideration is certainly warranted and recommended in situations in which taxpayers rely on a variation of so-called anticipatory allocations.

Our case study assumes the following provisions are contained within the Investment Fund X partnership agreement.

1. Allocations of profits and losses.

Except as otherwise provided in this agreement, profits, losses, and, to the extent necessary, individual items of income, gain, loss, or deduction of Fund X shall be allocated among the partners in a manner such that, after giving effect to the special allocations expressly provided for in this agreement, the capital account of each partner, immediately after making that allocation, is, as nearly as possible, equal (proportionately) to (1) the distributions that would be made to that partner if Fund X's assets were sold for cash equal to their book value, (2) all Fund X liabilities were satisfied (limited for each nonrecourse liability to the value of the assets securing that liability), and (3) the net assets of Fund X were distributed to the partners in liquidation of the partnership.

Notwithstanding the foregoing, the general partner may make such allocations as it deems reasonably necessary to give economic effect to the provisions of this agreement, considering the facts and circumstances as it deems reasonably necessary for this purpose.

2. Distributions of investment proceeds.

Each distribution of proceeds from disposition of an investment shall initially be made to the limited partners pro rata in proportion to their respective percentage interests for that investment. Notwithstanding the previous sentence, the share of each limited partner of each distribution shall be divided between that limited partner and the general partner as follows:

- First, 100 percent to that limited partner until the limited partner has received distributions (under this clause) from the investment and all realized investments in an amount equal to the limited partner's capital contributions.
- Second, 100 percent to that limited partner until the cumulative distributions to the limited partner (under this clause) from the investment and all realized investments represent a 10 percent per annum, non-compounded return on the amount of the limited partner's unreturned capital contributions.
- Third, 100 percent to the general partner until the general partner has received (under this clause) 20 percent of the sum of the amounts distributed to that limited partner under the preceding clause.
- Thereafter, 80 percent to the limited partner and 20 percent to the general partner.

3. Tax distributions.

Fund X may, in its sole discretion, distribute to the general partner a cash advance against distributions of carried interest to the extent that annual distributions actually received by the general partner are not sufficient for the general partner or any of its direct or indirect beneficial owners to pay when due any income tax imposed on it or them in connection therewith, calculated using the assumed income tax rate that is attributable to income allocated to the general partner (40 percent is used in this case study). Amounts otherwise to be distributed to the general partner under this agreement shall be reduced by the amount of any prior tax advances made to the general partner until all those tax advances are restored to Fund X in full.

4. Operational considerations.

Our case study assumes the following investment structure and performance:

- Fund X raises $100 million of committed capital to be funded by the limited partners. For simplicity, assume that a 1 percent capital contribution made by the general partner is made in its capacity as a limited partner and is therefore reflected as part of the $100 million of contributions funded by the limited partners.

Year of Exit (Exhibit 1)	Profits	Distributable Cash
Year 1	20,000,000	40,000,000
Year 2	2,000,000	22,000,000
Year 3	-	-
Year 4	16,000,000	36,000,000
Year 5	(1,042,000)	38,958,000
Total Profit	36,958,000	136,958,000

Investment Schedule (Exhibit 2)	Total Investment	Investment Value				
		Year 1	Year 2	Year 3	Year 4	Year 5
Investment #1	20,000,000	40,000,000	-	-	-	-
Investment #2	20,000,000	20,000,000	22,000,000	-	-	-
Investment #3	20,000,000	20,000,000	20,000,000	15,000,000	15,000,000	15,000,000
Investment #4	20,000,000	20,000,000	20,000,000	30,000,000	36,000,000	-
Investment #5	20,000,000	18,000,000	19,800,000	19,800,000	21,780,000	23,958,000
Total Investments	100,000,000	118,000,000	81,800,000	64,800,000	72,780,000	38,958,000

- The limited partners, including the general partner in its capacity as a limited partner, contribute $100 million at the beginning of year 1, and Fund X invests $100 million of capital immediately upon receipt of the contribution. Total contributed capital is invested at the beginning of year 1 equally among five distinct investments each having a cost basis of $20 million.
- The investments are sold at various points between years 1 through 5. Each disposition is assumed to occur on the last day of Fund X's tax year, and distributions occur on the first day of the next year. Estimated FMV of each investment is reflected as of the last day of the respective tax years.
- Values of Fund X's investments appreciate or depreciate over time before disposition. Changes in annual value are reflected in the investment schedule.
- All tax distributions are calculated at a rate of 40 percent on each partner's distributive share of recognized gain.
- Fund X has no debt, each of its investments is stock of a C corporation that doesn't pay dividends, and Fund X expenses are disregarded. Consequently, Fund X has no income, gain, or loss apart from gain or loss on the sale of its investments.

Financial performance assumptions are shown in exhibits 1 and 2.

B. Applicability of SEE Safe Harbors

The allocation provisions in the partnership agreement of our case study fail to satisfy the general or alternate tests of economic effect because of the lack of liquidating distributions driven by positive section 704(b) capital accounts. Further, it is unlikely that the allocation provisions have EEE. As noted above, EEE requires certainty that liquidation of the partnership, in any year, will result in partner distributions matching their capital account balances. This is often a difficult assurance to give and makes reliance on EEE troubling to many advisers. Instead, Fund X most likely needs to determine annual income and loss allocations in accordance with PIP. Because Fund X doesn't liquidate in accordance with positive capital accounts, the special rule in reg. section 1.704-1(b)(3)(iii) doesn't apply.

C. PIP Allocations in Hypothetical Liquidation

1. Overview of hypothetical liquidation model approach.

Determining PIP often starts with the general rule and relevant factors described in reg. section 1.704-1(b)(3). A common path would be to determine PIP with reference to annual changes in the partner's share of section 704(b) capital.

The method described in this special rule is often leveraged to determine partner "targeted" allocations when reference to changes in partner capital accounts drives the allocation. Many advisers are comfortable with this hypothetical liquidation approach to determining PIP since it seeks to tie annual income allocations to changes in a partner's entitlement to existing section 704(b) capital. In other words, this approach seeks to approximate the results under the economic effect safe harbor as closely as possible. Presumably, the IRS would be comfortable with this approach.

Allocations of section 704(b) and taxable income or loss under this approach are often made in accordance with the following process:

1. The partnership adjusts each partner's prior-year share of existing section 704(b) capital for contributions and distributions to determine partially adjusted capital.
2. The partnership calculates the total available section 704(b) capital that would be available for distribution to all the partners in a hypothetical liquidation of the partnership. Typically, this includes adjusting the total partially adjusted capital determined in the first step for realized income or loss recognized by the partnership for section 704(b) capital account purposes.
3. The partnership determines each partner's share of total available section 704(b) capital determined in step 2. Each partner's share of total capital is determined under a hypothetical liquidation of the partnership in accordance with distribution provisions of the partnership agreement.
4. The partnership allocates section 704(b) profit or loss for the year among the partners in an amount equal to the difference between each partner's partially adjusted capital (determined in step 1) and each partner's rights to capital in a hypothetical liquidation of the partnership (determined in step 3).
5. Subject to special allocations required under section 704(c), taxable income or loss is allocated to each partner in accordance with the partner's allocation of section 704(b) income or loss determined under step 4.

2. Summary of annual profit and loss allocation under the hypothetical liquidation model.

Exhibits 3 through 8 illustrate each partner's changes in capital account balances and annual income and loss allocations for years 1 through 5 under this method.

Importantly, because this approach results in taxable income allocations to the general partner, it is necessary to make tax distributions to the general partner. As a result of those tax distributions, it's impossible to distribute 100 percent of available cash first to the limited partners to return their invested capital.

a. Year 1.

As illustrated in Exhibit 3, the capital available at the end of year 1 ($120 million) is allocated among the general partner and the limited partners in accordance with the liquidation distribution provisions of the partnership agreement. Based on these calculations, the general partner would be entitled to a hypothetical liquidating distribution of $4 million. This entitlement becomes the general partner's targeted ending capital (year 1). To achieve this target, the partnership must allocate to the general partner $4 million of current-year profits. Importantly, the ending capital account balances for the general partner and limited partners precisely equal the partner's respective entitlement to liquidating distributions — assuming a liquidation were to occur and the value inherent in the partnership is exactly equal to the currently stated book capital. As demonstrated in the investment schedule, we know that isn't an accurate assumption. The value of Investment 5 has declined since the original date of investment.

Capital Accounts Summary Hypothetical Liquidation Model (Exhibit 3)	GP		LP		Total	
	Book	Tax	Book	Tax	Book	Tax
Capital Contributions	-	-	100,000,000	100,000,000	100,000,000	100,000,000
Pre-Exit Distributions	-	-	-	-	-	-
Partially Adjusted Capital	-	-	100,000,000	100,000,000	100,000,000	100,000,000
Year 1 Realized Profit	4,000,000	4,000,000	16,000,000	16,000,000	20,000,000	20,000,000
Ending Capital (Year 1)	4,000,000	4,000,000	116,000,000	116,000,000	120,000,000	120,000,000

Liquidating Distribution Rights (Year 1)	GP	LP	Total
Tier 1: Return of Capital	-	100,000,000	100,000,000
Tier 2: Preferred Return	-	10,000,000	10,000,000
Tier 3: Catch-up Allocation	2,500,000	-	2,500,000
Tier 4: 80/20 Split	1,500,000	6,000,000	7,500,000
Total	4,000,000	116,000,000	120,000,000

Capital Accounts Summary Hypothetical Liquidation Model (Exhibit 4)	GP		LP		Total	
	Book	Tax	Book	Tax	Book	Tax
Opening Capital (Year 2)	4,000,000	4,000,000	116,000,000	116,000,000	120,000,000	120,000,000
Distribution of Year 1 Cash	(1,600,000)	(1,600,000)	(38,400,000)	(38,400,000)	(40,000,000)	(40,000,000)
Partially Adjusted Capital	2,400,000	2,400,000	77,600,000	77,600,000	80,000,000	80,000,000
Year 2 Realized Profit	400,000	400,000	1,600,000	1,600,000	2,000,000	2,000,000
Ending Capital (Year 2)	2,800,000	2,800,000	79,200,000	79,200,000	82,000,000	82,000,000

Liquidating Distribution Rights (Year 2)	GP	LP	Total
Tier 1: Return of Capital	-	61,600,000	61,600,000
Tier 2: Preferred Return	-	16,160,000	16,160,000
Tier 3: Catch-up Allocation	2,440,000	-	2,440,000
Tier 4: 80/20 Split	360,000	1,440,000	1,800,000
Total	2,800,000	79,200,000	82,000,000

b. Year 2.

A similar approach to determining year 2 income and loss allocations occurs. Note, however, that because the general partner was allocated $4 million of income in year 1, the partnership makes a tax distribution to the general partner of $1.6 million (40 percent tax rate times $4 million income allocation for year 1). This, of course, prevents the partnership from distributing 100 percent of available cash to the limited partners. As a result of making the $1.6 million tax distribution to the general partner, the limited partners' total unreturned capital is $1.6 million greater. Consequently, the limited partners continue to earn a preferred return on $61.6 million. (See Exhibit 4.)

c. Year 3.

Similar to year 2, the general partner is entitled to a tax distribution of $160,000 (40 percent of $400,000 profit allocation for year 2)

Capital Accounts Summary Hypothetical Liquidation Model (Exhibit 5)	GP		LP		Total	
	Book	Tax	Book	Tax	Book	Tax
Opening Capital (Year 3)	2,800,000	2,800,000	79,200,000	79,200,000	82,000,000	82,000,000
Distribution of Year 2 Cash	(160,000)	(160,000)	(21,840,000)	(21,840,000)	(22,000,000)	(22,000,000)
Partially Adjusted Capital	2,640,000	2,640,000	57,360,000	57,360,000	60,000,000	60,000,000
Year 3 Realized Profit	-	-	-	-	-	-
Ending Capital (Year 3)	2,640,000	2,640,000	57,360,000	57,360,000	60,000,000	60,000,000

Liquidating Distribution Rights (Year 3)	GP	LP	Total
Tier 1: Return of Capital	-	39,760,000	39,760,000
Tier 2: Preferred Return	-	20,136,000	20,136,000
Tier 3: Catch-up Allocation	104,000	-	104,000
Tier 4: 80/20 Split	-	-	-
Total	104,000	59,896,000	60,000,000

Capital Accounts Summary Hypothetical Liquidation Model (Exhibit 6)	GP		LP		Total	
	Book	Tax	Book	Tax	Book	Tax
Opening Capital (Year 4)	2,640,000	2,640,000	57,360,000	57,360,000	60,000,000	60,000,000
Distribution of Year 3 Cash	-	-	-	-	-	-
Partially Adjusted Capital	2,640,000	2,640,000	57,360,000	57,360,000	60,000,000	60,000,000
Year 4 Realized Profit	3,200,000	3,200,000	12,800,000	12,800,000	16,000,000	16,000,000
Ending Capital (Year 4)	5,840,000	5,840,000	70,160,000	70,160,000	76,000,000	76,000,000

Liquidating Distribution Rights (Year 4)	GP	LP	Total
Tier 1: Return of Capital	-	39,760,000	39,760,000
Tier 2: Preferred Return	-	24,112,000	24,112,000
Tier 3: Catch-up Allocation	4,268,000	-	4,268,000
Tier 4: 80/20 Split	1,572,000	6,288,000	7,860,000
Total	5,840,000	70,160,000	76,000,000

associated with the prior-year allocation of income. Note that the ending capital accounts of the general partner and limited partners no longer equal their respective liquidating distribution rights. Since there is no recognized income in year 3, it's not possible to "correct" the ending capital account balances. Although the hypothetical liquidation model seemed to work well in the first two years of the case study, the year 3 results don't appear to properly reflect the economic arrangement of the partners. (See Exhibit 5.)

d. Year 4.

In year 4, the partnership sells another investment, recognizing gain of $16 million. This gain is sufficient to force the partners' capital

Capital Accounts Summary Hypothetical Liquidation Model (Exhibit 7)	GP		LP		Total	
	Book	Tax	Book	Tax	Book	Tax
Opening Capital (Year 5)	5,840,000	5,840,000	70,160,000	70,160,000	76,000,000	76,000,000
Distribution of Year 4 Cash	(1,280,000)	(1,280,000)	(34,720,000)	(34,720,000)	(36,000,000)	(36,000,000)
Partially Adjusted Capital	4,560,000	4,560,000	35,440,000	35,440,000	40,000,000	40,000,000
Year 5 Realized Profit	(208,400)	(208,400)	(833,600)	(833,600)	(1,042,000)	(1,042,000)
Ending Capital (Year 5)	4,351,600	4,351,600	34,606,400	34,606,400	38,958,000	38,958,000
Distribution of Year 5 Cash	(4,351,600)	(4,351,600)	(34,606,400)	(34,606,400)	(38,958,000)	(38,958,000)
Final Capital Balance	-	-	-	-	-	-

Liquidating Distribution Rights (Year 5)	GP	LP	Total
Tier 1: Return of Capital	-	5,040,000	5,040,000
Tier 2: Preferred Return	-	24,616,000	24,616,000
Tier 3: Catch-up Allocation	3,114,000	-	3,114,000
Tier 4: 80/20 Split	1,237,600	4,950,400	6,188,000
Total	4,351,600	34,606,400	38,958,000

Summary of Cash Distributions & Profit Allocations (Exhibit 8)	General Partner		Limited Partner		Total Fund	
	Cash Distr.	Profits	Cash Distr.	Profits	Cash Distr.	Profits
Year 1	-	4,000,000	-	16,000,000	-	20,000,000
Year 2	(1,600,000)	400,000	(38,400,000)	1,600,000	(40,000,000)	2,000,000
Year 3	(160,000)	-	(21,840,000)	-	(22,000,000)	-
Year 4	-	3,200,000	-	12,800,000	-	16,000,000
Year 5	(5,631,600)	(208,400)	(69,326,400)	(833,600)	(74,958,000)	(1,042,000)
					-	-
Total	(7,391,600)	7,391,600	(129,566,400)	29,566,400	(136,958,000)	36,958,000
Profit Sharing Ratio		20%		80%		

accounts into alignment with their liquidating distribution rights. (See Exhibit 6.)

e. Year 5.

In the final year of Fund X, the partnership generates a loss of $1.042 million and makes a liquidating distribution of $38.958 million. Following a similar targeting income and loss allocation approach, Fund X liquidates in a manner that causes the partners' respective capital accounts to zero out. (See Exhibit 7.)

Summary of cumulative distributions and allocations is shown in Exhibit 8.

3. Assessment of hypothetical liquidation model approach.

This determination of PIP has a simplicity that seeks to ensure that ending section 704(b) capital is always equal to the partners' respective rights to existing capital. Allocations made in accordance with this determination of PIP result in the limited partners receiving total cash of $129,566,400, reflecting a total gain allocation of $29,566,400. The general partner is allocated total profits of $7,391,600 and receives a like amount of cash. In terms of overall profit allocation, the general partner has been allocated 20 percent of the total recognized profits of $36,958,000.

Given these results, one may be inclined to conclude that the hypothetical liquidation approach produces a perfectly acceptable result. It's difficult to imagine the IRS challenging this allocation method. This approach attempts to approximate something close to economic effect under the safe harbor rules.

However, a closer examination of the results highlights an important departure from the "manner in which the partners agreed to share the economic benefit or burden" of Fund X's investment activities. Because of this tax allocation method, the limited partners did not receive a full return of their capital until the final distribution in year 5. Instead, $3.04 million was distributed to the general partner through year 4 to cover the tax liability associated with its income allocation. This violated the economic arrangement between the general partner and the limited partners. While timing of cash flow affects each limited partner's return on investment, there is also an effect on the amount of preferred return that is payable to the limited partners.

Under the relatively straightforward facts of our case study, everything worked out nicely in the end. However, it's not difficult to imagine the effect that changes in financial assumptions and activities could have on the analysis. For example, if the limited partners were not entitled to a preferred return, the timing of cash distributions would have an incrementally greater impact on their respective return on investment calculations. Separately, had Fund X realized larger gains in the early years followed by either no dispositions or significantly smaller gains, the limited partners' preferred return would grow while their access to cash declines. Future exits at a loss could ultimately result in the inability to fully satisfy Fund X's obligations to the limited partners.[24] Finally, fluctuations in values of remaining investments aren't considered except in situations in which capital is revalued. Consider whether unrealized gains or losses inherent in remaining investments should be part of defining PIP in any given tax period.

D. Factors Used to Determine PIP

Based on the regulations, PIP is intended to "signify the manner in which the partners have agreed to share the economic benefit or burden" corresponding to allocated income. Allocating income to the general partner in years before actual entitlement to cash distributions (exclusive of tax distributions) is contrary to the economic arrangement among the partners. Arguably, allocations determined in this manner are not necessarily in accordance with PIP.

The allocations and resulting cash distributions described in the preceding section don't appear well-aligned with the PIP factors described in the regulations. Consider each of the factors listed in reg. section 1.704-1(b)(3)(ii) in the context of the agreement among the partners in our case study.

1. The partner's relative contributions to the partnership.

In the typical fund structure, the general partner likely contributes a small amount of capital alongside the limited partner investment.[25] For example, the general partner may contribute 1 percent of total capital while the limited partners contribute the remaining 99 percent. An allocation of profits in accordance with this 99/1 capital investment structure is reasonable until the fund reaches the point when the general partner earns carry. Under a common carry allocation arrangement, the general partner's entitlement to cash distributions from realized gain may increase from 1 percent to 20 percent. However, realization of gain creating a hypothetical carry entitlement may not be

[24] Absent an offsetting loss allocation, it would be unlikely that the general partner would be obligated to return cash distributions made under the tax distribution provision of the operating agreement. To require a return of tax distributions would cause the general partner to come out of pocket on a net basis. Instead, the limited partners would likely bear the burden of insufficient cash on exit. While this would likely generate a loss to the limited partners, the loss would likely be capital in nature, and its use to offset future income could be in doubt.

[25] In *PNRC Limited Partnership v. Commissioner*, T.C. Memo. 1993-335, the court concluded that PIP was best determined based on the relative contributions to the partnership. In this case, the taxpayer sought to allocate 99 percent of incurred losses to the limited partner. However, the terms of the operating agreement indicated an entitlement to distributions based on percentage interests, which are determined based on relative capital contributions. Given the importance of capital contributions to the determination of each partner's economic rights in the partnership, the court concluded that in determining PIP, the partner's relative contributions to the partnership should control. In this case, the taxpayer only generated losses. It's certainly possible that a different analysis may have been more appropriate had the taxpayer generated overall income or profit.

permanent. In fact, it may not be realistic based on economic conditions of remaining investments. Future investment activity is likely to affect (positively or negatively) the general partner's entitlement to actual distributions of cash associated with realized gains. Many fund agreements will account for the possibility of downward adjustments to carry entitlement by including so-called carried interest clawback provisions.[26] Relative contributions to the partnership may be informative in determining PIP. In fact, until a fund reaches the point at which the general partner is entitled to cash distributions from disposition transactions, the capital contribution factor may be highly relevant. Note, however, that the complexity of an investment fund's economic arrangements may ultimately limit the usefulness of this factor. Detailed investment modeling and documenting the potential appreciation or depreciation in remaining fund investments would help to substantiate the point when the general partner's share of profits meaningfully increases relative to its capital contributions.

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

The facts of our case study indicate that the partners intend profits and losses (determined for both economic and tax purposes) to be allocated based on the manner in which capital would be distributed in a liquidation of the partnership.[27] In our fact pattern, and similar to many investment fund partnership agreements, the targeted liquidation balance is book value. However, as noted in our facts, the manager is not necessarily bound by this approach. Instead, the manager is authorized to adjust annual allocations in whatever manner is determined necessary and appropriate to satisfy PIP. It is worth restating that under section 704(b), allocations provided for in a partnership agreement will be respected only to the extent that they have SEE. In situations in which stated allocations do not have SEE, a determination of PIP will be required. Consequently, while the allocation provisions within the partnership agreement may be instructive, they are not necessarily controlling.

3. The interests of the partners in cash flow and other nonliquidating distributions.

As described in our case study, the general partner has no rights to cash flow or other distributions until the limited partners receive 100 percent of their contributed capital plus a preferred return. An allocation of current profits resulting in distributable cash flow yields the fundamental issue in defining PIP in the investment fund setting. That is, how can PIP be defined in a single year to require an allocation of profits to a partner who has no entitlement to current distributions? Applying this factor alone to the determination of PIP would presumably result in an allocation of income following cash.[28]

4. The rights of the partners to distributions of capital upon liquidation.

A variation of this factor is often relied on by taxpayers and their return preparers as somewhat of a safe harbor. Critically, though, this implementation of a hypothetical liquidation at current book value may yield significantly different results when compared with actual current value. The general view when applying this factor at current book value is that it's unlikely the IRS will challenge allocations that arguably approximate the results under the EEE test. This view is certainly not unreasonable and is potentially the most supportable approach to determining PIP, at least when viewing PIP annually. The economic success of an investment

[26] Most typically seen in fund agreements that determine carry allocations on an investment-by-investment basis, the objective of a clawback provision is intended to ensure that the general partner doesn't receive more than its agreed-to carry as measured over the life of the fund. For example, assume a fund disposes of its initial investment, which creates a carry distribution to the general partner. However, over the remaining life of the fund, later investment dispositions are insufficient to return the limited partners' capital plus preferred return. A clawback provision would require the general partner to return all or a portion of the previously distributed carry, which would then be redistributed to the limited partners.

[27] In *Mammoth Lakes Project v. Commissioner*, T.C. Memo. 1991-4, the court concluded that PIP should be determined based solely on the partner's share of partnership profits. This conclusion was reached based on the available evidence presented to the court. The court noted, "No evidence was presented with respect to other factors that are to be considered. On the record before this Court, we simply cannot find petitioner's share was greater than 10 percent, its interest in net profits of the partnership."

[28] *See, e.g.*, FSA 200131013. Allocations of profits over the life of a partnership are made in accordance with each partner's percentage interest in the partnership respected under the PIP rules. Each partner's rights to annual cash flow are determined by each partner's percentage interest.

fund, however, isn't measured over a single tax year. Importantly, allocations ignoring the fundamental agreement of the partners can result in situations in which there is insufficient gain or loss to achieve correct capital accounts. This result seems inconsistent with the inherent objective of the SEE rules described in reg. section 1.704-1(b)(2). These regulations go to great lengths to ensure that each partner's capital account properly reflects the economic arrangement among the partners. A focus on annual hypothetical distributions of capital upon liquidation in a fund that, by its very nature, is subject to extensive volatility and economic market conditions over its defined life, clearly yields results that are inconsistent with the stated purpose of PIP.

While the allocation language in the partnership agreement arguably supports a hypothetical liquidation at book value model, two important aspects of the allocation provisions need to be considered. First, the distribution rights for each partner upon liquidation are to be determined based on "value." Second, the agreement explicitly grants authority to the general partner to make allocations in any manner intended to ensure overall economic effect. The agreement in our case study, like many similar fund agreements, doesn't try to define value for allocation purposes in any particular year. In fact, when considering a partner's right to capital upon a liquidation, the value of Fund X's investments would be determined based on actual FMV. Given the uncertainty of future investment performance and the difficulty of projecting relative investment values, it would be unreasonable to expect the general partner to formulaically quantify value. Value for allocation purposes changes over time with varying macroeconomic conditions, the nature of underlying investments, and fund-specific economic considerations. The second point referencing the general partner's authority to determine allocations is consistent with the relative uncertainty of value in any particular year.

Ultimately, it's clear that the partners in our case study have not agreed to allocate profits and losses based on a hypothetical liquidation at book value. Rather, the partners have articulated an intent to ensure that cumulative income and loss allocations made by the partnership over its life result in each partner's economic and tax capital account reaching zero upon distribution of the last dollar of cash. As illustrated in the earlier exhibits, allocations based on annual hypothetical liquidations at book value may fail to capture the economic intent of the parties. Consequently, those allocations would appear to have been made in accordance with something other than PIP.

While a determination of PIP following a hypothetical liquidation model may be reasonable (and perhaps even preferred by the IRS[29]), a review of the factors described in the regulations indicates this should not be the only way to determine PIP. Evaluating our case study based on the four factors described in the regulations yields a different result. Importantly, analyzing each of these factors in light of the agreement among the general partner and limited partners indicates that PIP should not be static and will change over the life of Fund X. The challenge, though, will be carefully determining PIP on an annual basis and evaluating the likelihood or possibility of future activities.

E. Redefining PIP Under the Listed Factors

1. Application to case study.

Partnerships are required to file a tax return reporting income for each tax year of the partnership.[30] For most investment funds, the "taxable year" of the partnership will be the calendar year.[31] The investment fund in our case study will be required to file an annual return of

[29]Consider, for example, REG-115452-14 (prop. reg. section 1.707-2). In the preamble, Treasury and the IRS commented on the determination of partner allocations in targeted capital account agreements. They noted that, at least to the extent of relying on the SEE rules, existing regulations require partner capital accounts to reflect the partner's distribution rights as if the partnership liquidated at the end of the tax year. One might question, however, whether a determination of the partner's distribution rights at current section 704(b) value is appropriate in situations in which the underlying partnership property has substantially increased or decreased in value.

[30]Reg. section 1.6031(a)-1(a)(1).

[31]Under section 441(b), the term "taxable year" will generally mean the taxpayer's annual accounting period if that period is either based on a calendar year or fiscal year. Reg. section 1.706-1(b)(2) provides that a partnership is required to use the tax year of its partners holding a majority interest in the partnership. Thus, when the majority interest of an investment fund is held by partners having the calendar years as their tax year, the fund will be required to use the calendar year as its tax year.

Capital Accounts Summary Income Follows Cash Model (Exihibit 9)	GP		LP		Total	
	Book	Tax	Book	Tax	Book	Tax
Capital Contributions	-	-	100,000,000	100,000,000	100,000,000	100,000,000
Pre-Exit Distributions	-	-	-	-	-	-
Partially Adjusted Capital	-	-	100,000,000	100,000,000	100,000,000	100,000,000
Year 1 Realized Profit*	-	-	20,000,000	20,000,000	20,000,000	20,000,000
Ending Capital (Year 1)	-	-	120,000,000	120,000,000	120,000,000	120,000,000
Anticipated Allocation (Year 1)	4,000,000	4,000,000	(4,000,000)	(4,000,000)	-	-

* Corresponds to planned distribution of available cash generated from transactions giving rise to current year profits.

Liquidating Distribution Rights (Year 1)	GP	LP	Total
Tier 1: Return of Capital	-	100,000,000	100,000,000
Tier 2: Preferred Return	-	10,000,000	10,000,000
Tier 3: Catch-up Allocation	2,500,000	-	2,500,000
Tier 4: 80/20 Split	1,500,000	6,000,000	7,500,000
Total	4,000,000	116,000,000	120,000,000

partnership income. For our discussion, we can assume this filing is based on a calendar year.

As stated in the preamble to the final section 704(b) regulations published in 1985 (T.D. 8065), PIP is to be determined with reference to the underlying economic arrangement of the partners relating "to the particular allocation under consideration." This seems clear enough — determine PIP for the allocation necessarily reported on the partnership's annual tax return. The preamble, though, also follows legislative history by stating that "if that economic arrangement cannot be determined, each partner's interest in the partnership is presumed to be equal (determined on a per capita basis)." These regulations effectively created a taxpayer-rebuttable presumption regarding equal ownership among the partners.[32]

One might question whether our fund should be able to simply allocate its first-year income in a manner consistent with cash distributions. This would be in line with at least two of the four factors.[33] This approach might better align with the overall economic arrangement among the partners. Compare the allocations reflected in exhibits 9 through 14 based on a cash flow driven determination of PIP.

a. Year 1.

In the first year of our case study, Fund X disposes of an investment generating $20 million of gain and $40 million of distributable cash. Under the terms of the partnership agreement, 100 percent of the distributable cash is distributed to the limited partners. While it's clear that a hypothetical liquidation of the partnership at book value would result in a distribution to the general partner, the special rule under reg. section 1.704-1(b)(3)(iii) doesn't apply. Instead, we need to determine PIP based on the relevant factors. If

[32] Final regulations published in May 2008 (T.D. 9398) removed this presumption. Treasury and the IRS noted that removal of the per capita presumption failed to consider that could be relevant to a determination of how the partners agreed to share the economic benefits or burdens corresponding to the allocation of partnership items. In other words, the per capita presumption was removed since it often would produce incorrect results.

[33] Specifically, allocations in this manner would be consistent with the partner's original capital contributions (factor 1) and the partner's rights to nonliquidating distributions (factor 3).

Capital Accounts Summary Income Follows Cash Model (Exhibit 10)	GP Book	GP Tax	LP Book	LP Tax	Total Book	Total Tax
Opening Capital (Year 2)	-	-	120,000,000	120,000,000	120,000,000	120,000,000
Distribution of Year 1 Cash	-	-	(40,000,000)	(40,000,000)	(40,000,000)	(40,000,000)
Partially Adjusted Capital	-	-	80,000,000	80,000,000	80,000,000	80,000,000
Year 2 Realized Profit*	-	-	2,000,000	2,000,000	2,000,000	2,000,000
Ending Capital (Year 2)	-	-	82,000,000	82,000,000	82,000,000	82,000,000
Anticipated Allocation (Year 1)	4,000,000	4,000,000	(4,000,000)	(4,000,000)	-	-
Anticipated Allocation (Year 2)	400,000	400,000	(400,000)	(400,000)	-	-
Cumulative Balance	4,400,000	4,400,000	(4,400,000)	(4,400,000)	-	-

* Corresponds to planned distribution of available cash generated from transactions giving rise to current year profits.

Liquidating Distribution Rights (Year 2)	GP	LP	Total
Tier 1: Return of Capital	-	60,000,000	60,000,000
Tier 2: Preferred Return	-	16,000,000	16,000,000
Tier 3: Catch-up Allocation	4,000,000	-	4,000,000
Tier 4: 80/20 Split	400,000	1,600,000	2,000,000
Total	4,400,000	77,600,000	82,000,000

we're unable to determine PIP, query whether some sort of equal or proportionate allocations among the partners may be necessary.[34] Determining PIP simply based on the number of partners or number of units held by each partner certainly seems inappropriate. Although a liquidation of the partnership at current book value would result in a $4 million distribution to the general partner, there has been no liquidation. Instead, the partnership agreement provides that 100 percent of available cash is to be distributed to the limited partner. Rights to cash distributions is a factor enumerated in the regulations. Perhaps current cash entitlement establishes PIP for the current year. Given the importance of tracking the partner's overall economic interest in the partnership, tracking the amount of anticipatory allocations that will be required in the future would be advisable. Moreover, evaluating the potential to reverse these amounts based on future performance is critical. Based on the facts of our case study, we know that Fund X has four remaining investments with potential upward and downward volatility. Based on a current analysis, it may be reasonable to conclude that sufficient future profit or loss will be allocable in a manner to ensure cumulative income equals cash. (See Exhibit 9.)

b. Year 2.

The year 2 allocations largely mirror year 1. A review of the overall economic arrangement of the partners as well as projected future appreciation and depreciation in remaining assets appears to support a continued income follows cash approach. For year 2, the anticipated allocation balance increases by an additional $400,000. (See Exhibit 10.)

c. Year 3.

Given the lack of realized income or loss in year 3, there is no need to make further adjustments. A review of the investment schedule, however, does reveal a continued reasonable expectation of future earnings and cash flow exceeding the cumulative anticipated allocation balance. (See Exhibit 11.)

[34] However, as noted above, *supra* note 32, the per capita allocation presumption was removed in 2008 through T.D. 9398.

Capital Accounts Summary Income Follows Cash Model (Exhibit 11)	GP Book	GP Tax	LP Book	LP Tax	Total Book	Total Tax
Opening Capital (Year 3)	-	-	82,000,000	82,000,000	82,000,000	82,000,000
Distribution of Year 2 Cash	-	-	(22,000,000)	(22,000,000)	(22,000,000)	(22,000,000)
Partially Adjusted Capital	-	-	60,000,000	60,000,000	60,000,000	60,000,000
Year 3 Realized Profit*	-	-	-	-	-	-
Ending Capital (Year 3)	-	-	60,000,000	60,000,000	60,000,000	60,000,000
Anticipated Allocation (Year 1)	4,000,000	4,000,000	(4,000,000)	(4,000,000)	-	-
Anticipated Allocation (Year 2)	400,000	400,000	(400,000)	(400,000)	-	-
Anticipated Allocation (Year 3)	-	-	-	-	-	-
Cumulative Balance	4,400,000	4,400,000	(4,400,000)	(4,400,000)	-	-

* Corresponds to planned distribution of available cash generated from transactions giving rise to current year profits.

Liquidating Distribution Rights (Year 3)	GP	LP	Total
Tier 1: Return of Capital	-	38,000,000	38,000,000
Tier 2: Preferred Return	-	19,800,000	19,800,000
Tier 3: Catch-up Allocation	2,200,000	-	2,200,000
Tier 4: 80/20 Split	-	-	-
Total	2,200,000	57,800,000	60,000,000

d. Year 4.

The activity occurring in year 4 illustrates an important challenge associated with determining PIP other than through a hypothetical liquidation approach. In year 4, Fund X disposes of Investment No. 4, realizing $16 million of profits and creating $36 million of distributable cash. Although the partnership agreement provides for 100 percent of this available cash to be distributed to the limited partners, it's unclear whether allocable income can reasonably follow cash distributions. The concern arises from an analysis of remaining investments compared with a continued build of the general partner's anticipatory allocations balance. Based on the liquidating distribution waterfall model, the general partner's capital entitlement would increase to $7.6 million, with the remaining $68.4 million of available capital distributable to the limited partners. These distributions would be possible if the $20 million original book values of investments Nos. 3 and 5 hold steady.[35] However, failure to allocate any portion of the realized gain in year 4 puts significant pressure on the remaining investments to deliver the full amount of required profit to reverse the anticipatory allocations.[36] Consequently, in our model, the year 4 allocations would reverse the entirety of the established anticipatory allocation balance. Remaining profits would then be allocated based on expected cash distribution ratios. (See Exhibit 12.)

[35]Total available distributable cash would equal $76 million ($40 million from investments Nos. 3 and 5 plus $36 million generated upon disposition of investment No. 4).

[36]Based on the facts described above, at the end of year 4, Fund X anticipates a disposition of investments Nos. 3 and 5 in year 5. Current estimates of value ($15 million for investment No. 3 and $21.78 million for investment No. 5) wouldn't generate the profits needed to reverse the anticipatory allocation balance. Absent evidence supporting a reasonable expectation of generating significant appreciation before the planned year 5 exits, failure to reverse the anticipatory allocation balance seems questionable.

Capital Accounts Summary Income Follows Cash Model (Exhibit 12)	GP		LP		Total	
	Book	Tax	Book	Tax	Book	Tax
Opening Capital (Year 4)	-	-	60,000,000	60,000,000	60,000,000	60,000,000
Distribution of Year 3 Cash	-	-	-	-	-	-
Partially Adjusted Capital	-	-	60,000,000	60,000,000	60,000,000	60,000,000
Year 4 Realized Profit*	3,200,000	3,200,000	8,400,000	8,400,000	11,600,000	11,600,000
Reversal - Antic. Allocations	4,400,000	4,400,000	-	-	4,400,000	4,400,000
Ending Capital (Year 4)	7,600,000	7,600,000	68,400,000	68,400,000	76,000,000	76,000,000
Anticipated Allocation (Year 1)	4,000,000	4,000,000	(4,000,000)	(4,000,000)	-	-
Anticipated Allocation (Year 2)	400,000	400,000	(400,000)	(400,000)	-	-
Anticipated Allocation (Year 3)	-	-	-	-	-	-
Anticipated Allocation (Year 4)	(4,400,000)	(4,400,000)	4,400,000	4,400,000	-	-
Cumulative Balance	-	-	-	-	-	-

* Corresponds to planned distribution of available cash generated from transactions giving rise to current year profits.

Liquidating Distribution Rights (Year 4)	GP	LP	Total
Tier 1: Return of Capital	-	38,000,000	38,000,000
Tier 2: Preferred Return	-	23,600,000	23,600,000
Tier 3: Catch-up Allocation	5,900,000	-	5,900,000
Tier 4: 80/20 Split	1,700,000	6,800,000	8,500,000
Total	7,600,000	68,400,000	76,000,000

Capital Accounts Summary Income Follows Cash Model (Exhibit 13)	GP		LP		Total	
	Book	Tax	Book	Tax	Book	Tax
Opening Capital (Year 5)	7,600,000	7,600,000	68,400,000	68,400,000	76,000,000	76,000,000
Distribution of Year 4 Cash	(1,760,000)	(1,760,000)	(34,240,000)	(34,240,000)	(36,000,000)	(36,000,000)
Partially Adjusted Capital	5,840,000	5,840,000	34,160,000	34,160,000	40,000,000	40,000,000
Year 5 Realized Profit	(208,400)	(208,400)	(833,600)	(833,600)	(1,042,000)	(1,042,000)
Ending Capital (Year 5)	5,631,600	5,631,600	33,326,400	33,326,400	38,958,000	38,958,000
Distribution of Year 5 Cash	(5,631,600)	(5,631,600)	(33,326,400)	(33,326,400)	(38,958,000)	(38,958,000)
Final Capital Balance	-	-	-	-	-	-
Anticipated Allocation (Year 1)	4,000,000	4,000,000	(4,000,000)	(4,000,000)	-	-
Anticipated Allocation (Year 2)	400,000	400,000	(400,000)	(400,000)	-	-
Anticipated Allocation (Year 3)	-	-	-	-	-	-
Anticipated Allocation (Year 4)	(4,400,000)	(4,400,000)	4,400,000	4,400,000	-	-
Anticipated Allocation (Year 5)	-	-	-	-	-	-
Cumulative Balance	-	-	-	-	-	-

* Corresponds to planned distribution of available cash generated from transactions giving rise to current year profits.

Liquidating Distribution Rights (Year 5)	GP	LP	Total
Tier 1: Return of Capital	-	3,760,000	3,760,000
Tier 2: Preferred Return	-	23,976,000	23,976,000
Tier 3: Catch-up Allocation	4,234,000	-	4,234,000
Tier 4: 80/20 Split	1,397,600	5,590,400	6,988,000
Total	5,631,600	33,326,400	38,958,000

Summary of Cash Distributions & Profit Allocations (Exhibit 14)	General Partner		Limited Partner		Total Fund	
	Cash Distr.	Profits	Cash Distr.	Profits	Cash Distr.	Profits
Year 1	-	-	-	20,000,000	-	20,000,000
Year 2	-	-	(40,000,000)	2,000,000	(40,000,000)	2,000,000
Year 3	-	-	(22,000,000)	-	(22,000,000)	-
Year 4	-	7,600,000	-	8,400,000	-	16,000,000
Year 5	(7,391,600)	(208,400)	(67,566,400)	(833,600)	(74,958,000)	(1,042,000)
					-	-
Total	(7,391,600)	7,391,600	(129,566,400)	29,566,400	(136,958,000)	36,958,000
Profit Sharing Ratio		20%		80%		

Capital Accounts Summary Income Follows Cash Model (Exhibit 15)	GP		LP		Total	
	Book	Tax	Book	Tax	Book	Tax
Opening Capital (Year 4)	-	-	60,000,000	60,000,000	60,000,000	60,000,000
Distribution of Year 3 Cash	-	-	-	-	-	-
Partially Adjusted Capital	-	-	60,000,000	60,000,000	60,000,000	60,000,000
Year 4 Realized Profit*	-	-	16,000,000	16,000,000	16,000,000	16,000,000
Reversal - Antic. Allocations	-	-	-	-	-	-
Ending Capital (Year 4)	-	-	76,000,000	76,000,000	76,000,000	76,000,000
Anticipated Allocation (Year 1)	4,000,000	4,000,000	(4,000,000)	(4,000,000)	-	-
Anticipated Allocation (Year 2)	400,000	400,000	(400,000)	(400,000)	-	-
Anticipated Allocation (Year 3)	-	-	-	-	-	-
Anticipated Allocation (Year 4)	3,200,000	3,200,000	(3,200,000)	(3,200,000)	-	-
Cumulative Balance	7,600,000	7,600,000	(7,600,000)	(7,600,000)	-	-

* Corresponds to planned distribution of available cash generated from transactions giving rise to current year profits.

Liquidating Distribution Rights (Year 4)	GP	LP	Total
Tier 1: Return of Capital	-	38,000,000	38,000,000
Tier 2: Preferred Return	-	23,600,000	23,600,000
Tier 3: Catch-up Allocation	5,900,000	-	5,900,000
Tier 4: 80/20 Split	1,700,000	6,800,000	8,500,000
Total	7,600,000	68,400,000	76,000,000

e. Year 5.

In Year 5, Fund X disposes of its final investments and liquidates. As expected, Fund X was unable to generate profits on disposition of investments Nos. 3 and 5. Instead, Fund X disposed of these remaining investments, generating an overall loss of $1.042 million and distributable cash of $38.958 million. Since this is the final year of Fund X, a determination of PIP based on actual liquidating distributions is possible and yields the correct ending balances to ensure $0 capital accounts for the general partner and limited partners. Importantly, the net loss generated in year 5 was sufficient to ensure accurate targeted capital account balances. (See Exhibit 13.)

Summary of cumulative distributions and allocations is shown in Exhibit 14.

Capital Accounts Summary Income Follows Cash Model (Exhibit 16)	GP		LP		Total	
	Book	Tax	Book	Tax	Book	Tax
Opening Capital (Year 5)	-	-	76,000,000	76,000,000	76,000,000	76,000,000
Distribution of Year 4 Cash	-	-	(36,000,000)	(36,000,000)	(36,000,000)	(36,000,000)
Partially Adjusted Capital	-	-	40,000,000	40,000,000	40,000,000	40,000,000
Year 5 Realized Profit	-	-	(1,042,000)	(1,042,000)	(1,042,000)	(1,042,000)
Ending Capital (Year 5)	-	-	38,958,000	38,958,000	38,958,000	38,958,000
Distribution of Year 5 Cash	(7,391,600)	(7,391,600)	(31,566,400)	(31,566,400)	(38,958,000)	(38,958,000)
Final Capital Balance	(7,391,600)	(7,391,600)	7,391,600	7,391,600	-	-
Anticipated Allocation (Year 1)	4,000,000	4,000,000	(4,000,000)	(4,000,000)	-	-
Anticipated Allocation (Year 2)	400,000	400,000	(400,000)	(400,000)	-	-
Anticipated Allocation (Year 3)	-	-	-	-	-	-
Anticipated Allocation (Year 4)	3,200,000	3,200,000	(3,200,000)	(3,200,000)	-	-
Anticipated Allocation (Year 5)	-	-	-	-	-	-
Cumulative Balance	7,600,000	7,600,000	(7,600,000)	(7,600,000)	-	-

* Corresponds to planned distribution of available cash generated from transactions giving rise to current year profits.

Liquidating Distribution Rights (Year 5)	GP	LP	Total
Tier 1: Return of Capital	-	2,000,000	2,000,000
Tier 2: Preferred Return	-	23,800,000	23,800,000
Tier 3: Catch-up Allocation	5,950,000	-	5,950,000
Tier 4: 80/20 Split	1,441,600	5,766,400	7,208,000
Total	7,391,600	31,566,400	38,958,000

Summary of Cash Distributions & Profit Allocations (Exhibit 17)	General Partner		Limited Partner		Total Fund	
	Cash Distr.	Profits	Cash Distr.	Profits	Cash Distr.	Profits
Year 1	-	-	-	20,000,000	-	20,000,000
Year 2	-	-	(40,000,000)	2,000,000	(40,000,000)	2,000,000
Year 3	-	-	(22,000,000)	-	(22,000,000)	-
Year 4	-	-	-	16,000,000	-	16,000,000
Year 5	(7,391,600)	-	(67,566,400)	(1,042,000)	(74,958,000)	(1,042,000)
					-	-
Total	(7,391,600)	-	(129,566,400)	36,958,000	(136,958,000)	36,958,000
Profit Sharing Ratio		0%		100%		

2. Assessment of alternative determination of PIP.

In comparison with the initial hypothetical liquidation model, the cash distribution-driven model reflected above aligns the allocation of profit with the agreed cash distribution priorities. In years 1 through 3, the limited partners were allocated 100 percent of realized profits and received 100 percent of distributable cash. In year 4, the general partner was specially allocated gain. This occurred not because the general partner would receive cash but because it appeared unreasonable to expect subsequent profits to be sufficient to ensure that the general partner would eventually be allocated realized profits commensurate with distributable cash. Year 5 proved these assumptions and expectations to be accurate. This alternative determination of PIP appears to accurately align with the overall economic arrangement of the partners.

Allocations based on anticipatory allocation model are shown in Exhibit 14. Allocations based on hypothetical liquidation model are shown in Exhibit 8.

3. Misapplication of alternative determination of PIP.

It's relatively easy to create a case study that achieves these results. However, real-world applications are likely to be significantly more challenging. A threshold concern with a cash entitlement-driven determination of PIP is the potential for insufficient future gains to fill up each partner's capital account. For example, an allocation of all year 1 gain to the limited partners, while consistent with year 1 cash entitlement, doesn't consider the potential rights to cash held by the general partner. If the partnership were to later dispose of all its investments at cost, there would be no gain available to allocate to the general partner. Thus, a liquidating distribution to the general partner would result in gain recognized outside the partnership. Alternatively, the limited partners will have been overallocated gain relative to cash contributions. This will necessarily result in recognition of loss upon receipt of final liquidating distributions.

Consider the following modifications to the previous illustrations. In this modified fact pattern, the cumulative anticipatory allocation balance cannot be reversed in year 5. Activity from years 1 through 3 remains the same as previously illustrated. However, in year 4, Fund X determines that it should still allocate 100 percent of realized profit to the limited partners. (See exhibits 15 and 16. Summary of cumulative distributions and allocations is shown in Exhibit 17.)

As reflected in the exhibits, the failure to correctly allocate profits and losses between the general partner and limited partners results in "corrections" occurring outside the partnership. Although economically the partners end up in the correct place, Fund X has clearly overallocated income to the limited partners, with an offsetting underallocation of profits to the general partner. This is the inherent risk associated with any determination of PIP that fails to follow a liquidation at actual value model. Unfortunately, since actual liquidation of investment funds doesn't occur annually, such an approach isn't possible.

To protect against possible results shown in Exhibit 17, a multiyear approach to determining PIP seems reasonable. Despite reliance on current-year data when applying a hypothetical liquidation model to determine PIP, the fourth factor listed in the regulations is itself anticipatory. The regulations do not explicitly instruct us to determine PIP based on a hypothetical liquidation that occurs at the end of each year. Rather, we are to consider, among other things, distribution rights that will arise upon occurrence of a future event resulting in liquidation of the partnership. Despite concerns with a multiyear view, the concept of anticipatory allocations is built within the existing regulations.[37] What isn't clear in the context of a PIP determination, however, is how to determine a future event that is subject to uncontrollable events such as economic conditions, investment volatility, capital needs, etc.

Perhaps part of the answer to this challenging question is to incorporate this uncertainty into the determination of annual PIP. With a goal of zeroing out partners' book and tax capital accounts upon distribution of the final dollars of cash, we need to consider the uncertainty of the future. The breadth of variables that need to be considered precludes a one-size-fits-all approach to determining PIP in an investment fund setting. However, it's that breadth of variables that must be considered separately by each investment fund in determining PIP.

Turning back to our case study, the facts and assumptions regarding inherent future value allowed an effective cash-driven allocation model

[37] Consider, for example, reg. section 1.707-1(c), Example 2, which applies a "wait-and-see" approach for purposes of determining recognition of certain guaranteed payments. The NCPO regulations apply a similar concept. When an NCPO is issued but not exercised, it's not possible to determine whether allocations will ultimately have economic effect. This occurs because, until the option is exercised (or not exercised), each partner's entitlement to cash distributions cannot be determined. Once exercised, the NCPO holder's section 704(b) capital is adjusted to increase its entitlement to partnership capital. This is accomplished by first allocating unrealized gain to the NCPO holder's capital account. Any remaining deficiency is then increased through allocations of available gross income.

to work out. As noted above, however, a reduction in expected appreciation could result in capital accounts that are out of balance upon liquidation. Consequently, including the potential impact of investment volatility in a current-year determination of PIP seems not only reasonable but necessary.

IV. Closing Thoughts

Where does this leave us? How does an investment fund that doesn't liquidate in accordance with positive book capital allocate annual profits and losses? Unfortunately, there isn't an easy answer to this question. In most situations, investment fund allocations will not qualify under the general or alternate tests of economic effect. Consequently, investment fund allocations will be made based on either EEE or PIP. Application of the EEE rules is impractical in many situations. Instead, investment funds most often will need to determine annual profit and loss allocations in accordance with PIP.

As discussed in this report, guidance defining PIP is lacking. Following the hypothetical liquidation approach likely produces a reasonable result. As illustrated in our case study, the overall impact of this approach resulted in pre-liquidating distribution capital accounts equal to each partner's rights to available book capital. Presumably, the IRS is less likely to challenge these results. However, variations between actual value and existing book value can create material swings in the partners' entitlement to capital when measured on a FMV approach. Moreover, the hypothetical liquidation approach simply is not required by statute or regulations. In fact, it is described in the regulations as a safe harbor with narrow applicability. Instead, regulations direct taxpayers to determine PIP based on an evaluation of all facts and circumstances. Ultimately, taxpayers and their advisers should consider all facts and circumstances in determining what PIP means to their specific situation. PIP is not a one-size-fits-all solution. The key to finding the right size is sorting through the multitude of varying factors and identifying those of the highest importance. It may very well be that a hypothetical liquidating distribution model is the most appropriate answer. However, as illustrated above, better answers may be available. ■