

# Partnership Allocation Issues: An Analysis of Functional Allocations, Target Allocations and the New Disguised Sale Regulations

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## Partnership Special Allocations: In the Beginning

- Why do partnership special allocations of income and expense matter?
  - Partners seek to optimize the after-tax economic results associated with their contributions of cash and other property, and their obligations and undertakings with respect to the partnership
  - Allocations of partnership income and expense impact the partner's annual income subject to federal income tax

## Why are We Talking About Partnership Special Allocations in the First Place?

- For many years, parties to drilling transactions elected out of the subchapter K partnership tax provisions and relied on oil and gas tax rules for their after-tax results
  - “Pool of Capital” Doctrine and IRS rulings usually provided the right after-tax economics for the parties based on their respective contributions
    - Party contributing drilling funds claimed the IDC and depreciation deductions
    - Party contributing the oil and gas working interest claimed the cost depletion deductions
- Along the way, the parties encountered two obstacles to their approach

## The Early Obstacle and The Solution

- The Early Obstacle
  - Treasury regulations section 1.612-4 and the “complete payout” rule
    - Many drilling transactions did not contain a “complete payout” provision
    - Without such a provision, IDC deductions to the party providing the drilling funds would not be optimized
- Industry’s solution
  - Strike Article IX in the model form joint operating agreement and instead include tax partnership provisions as an exhibit to the JOA
  - Use partnership special allocations to replicate the after-tax economics of an “elect-out” drilling transaction by allocating income and deductions to the parties based on the parties’ functional contributions to the transaction

## The Problem with Early Special Allocations

- Partnership agreements were specially allocating income and deductions to partners for tax purposes but the allocations did not impact the amount of money or other property that the partner was entitled to upon liquidation of the partnership
  - Ex: The partnership agreement allocated all of the IDC incurred by the partnership to the “high net worth” individuals who funded the drilling costs in a drilling fund partnership but the allocation had no impact on the those partners’ value received upon liquidation of the partnership

## Early Court Cases

- *Allison v. U.S.*, 701 F.2d 933 (Fed. Cir. 1983) and *Estate of Carberry v. Commissioner*, 933 F.2d 1124 (2d Cir. 1991)
  - Tax year is 1970 – prior to the 1976 amendment to section 704(b)
    - Section 704(b) at the time contained a “tax avoidance” test, while the operative regulation contained the “substantial economic effect” test
  - Indonesian oil and gas drilling partnership allocated IDC and other deductions to the parties who contributed the cash to pay for the related expenditures
  - Distributions in liquidation per the partnership agreement were based on percentage interests in the partnership, which were different than the contribution percentages
  - Both federal appellate courts held that under section 1.704-1 of the Regulations as it existed at the time, the allocations did not have substantial economic effect and were made for the principal purpose of tax avoidance because the allocations did not impact liquidating distributions to the partners

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