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MAY 06 1985

FEDERAL TAX DIVISION

of the

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Comments on Proposed Amendments to Treasury Regulations Sections 1.704-1(b)1 - 5 Regarding Partner's Distributive Share

Submitted to the
Internal Revenue Service

APPENDIX F

FEDERAL TAX DIVISION

of the

American Institute of Certified Public Accountants

Comments on Proposed Amendments
to Treasury Regulations Sections 1.704-1(b)1 - 5
Regarding Partner's Distributive Share

GENERAL COMMENTS

The Proposed Regulations under Section 704(b)(2) provide much-needed clarification in the complex subject of partnership allocations.

Our members have submitted many comments and suggested improvements. A brief listing of their major concerns includes the following issues.

1. We believe the effective date of these new Regulations should be for partnership taxable years beginning after December 31, 1983. The partial retroactivity contained in the proposals should be eliminated.
2. The "partner's interest in the partnership" is a facts and circumstances determination in each individual case. More guidance is needed in the Regulations as to the Treasury's views on this subject.
3. The special rules for allocations where there are disparities between tax and book capital accounts should be revised to remove references to "financial accounting" and to clarify the meaning of "book" capital accounts.
4. The new concepts in the Proposed Regulations regarding allocations of loss or deduction attributable to nonrecourse debt should be clarified in several respects.

Our specific comments on these and other matters are contained in the following pages.

SPECIFIC COMMENTS

I.

Section 1.704-1(b)(1)(i)

Effective Date - The general rules contained in Proposed Regulation Section 1.704-1(b)(1)(i) provide that the fundamental principles of Section 1.704-1(b)(2) are generally applicable for partnership taxable years beginnning after December 31, 1975. There are numerous reasons suggested by our members for eliminating this retroactivity including the following:

1.) It is unclear which portions of the subsection are considered "fundamental" and are to be applied retroactively.

2.) Taxpayers will be burdened with substantial professional fees merely to review old agreements.

3.) The language contained in Section 1.704-1(b)(2)(iv) requiring that capital accounts be maintained in accordance with tax accounting principles to establish economic effect is a new concept and it should not be retroactively applied.

4.) Many oil and gas partnerships have been structured in reliance on Revenue Ruling 68-139; 1968-1CB311 to achieve substantial economic effect, since the basic principles of substantial economic effect were not changed by the Tax Reform Act of 1976. The holding of that ruling appears inconsistent with the requirements of Section 1.704-1(b)(2)(ii).

The Proposed Regulations are intended to establish "safe harbors" of which taxpayers may avail themselves to avoid challenge of their allocations. The implications of retroactive application are that revenue agents should apply these safe harbors as audit criteria to challenge any partnership's allocations that do not fit within the new requirements. <u>The retroactivity should be eliminated in its entirety.</u>

2.

1.704-1(b)(2)(ii)

The rule regarding determination of deficit capital accounts where cash and property is held by the partnership at the end of its taxable year and there is a "reasonable expectation" it will be distributed to a partner prior to a corresponding increase in that partner's capital account needs to be clarified. An example should be added to demonstrate its application. The existence of a "reasonable expectation" should be limited to cover only cases of abuses and patterns of tax avoidance.

3.

1.704-1(b)(2) (iii)(c)

This section should be clarified to explain further the relationship of items such as accelerated cost recovery deductions with the transitory allocation concept and the related illustration in Example 2(ii) of paragraph 1.704-1(b)(5). This section should also be expanded to include intangible drilling costs.

4.

1.704-1(b)(3)

There is a need for further clarification of the meaning of the partner's interest in the partnership. The Proposed Regulations give some guidance in certain examples in paragraph (b)5; however, Example 13(i) causes considerable confusion as to its meaning. This confusion arises from the language in the example indicating a reallocation as necessary where the facts seem clearly to point to the original allocation being in accordance with the partners' interest in the partnership.

An additional clarification in this area would be most helpful if a conclusion was reached as to the partners' interest in the partnership under the facts of Example 16(i) of paragraph (b)(5) of the proposals.

5.

1.704-1(b)(4)(i)

The special rules for allocations where there are disparities between tax and book capital accounts should be revised and clarified in several respects.

This section permits some allocations to meet the safe-harbor tests of the Regulations if their "book" capital accounts are adjusted upward or downward prior to the recognition for tax purposes of the gain or loss reflected by such adjustments. The proposals limit

recognition of these adjustments to include only those made "in accordance with sound financial accounting principles" and where certain other conditions are met.

Our concerns are based on the fact that "sound financial accounting principles" may be different than generally accepted accounting principles, and that partnership allocations may be invalidated or validated because of this difference. Example 18(ii) of paragraph (b)(5) illustrates this issue. The admission of MK into the partnership, in that example, would not be viewed by many of our members as an event permitting an increase in the capital accounts of WM and JL in the application of generally accepted accounting principles. The facts of this example assume these adjustments are based on sound financial accounting principles.

If the partnership in the example prepared its financial statements in accordance with generally accepted accounting principles (eliminating the increases to WM and JL's capital accounts) what would constitute "book" capital accounts? If the partnership agreement clearly contemplates the valuation increases in WM and JL's capital accounts, but the issuance of financial statements in accordance with generally accepted accounting principles prevents these increases, what are the appropriate "sound financial accounting principles"?

Another concern is that the proposed safe-harbor permits allocations under section 704(b)(2) only if they impose the concepts of section 704(c)(2). While this may operate to reduce shifting of tax liabilities through allocations pursuant to section 704(c)(1), there does not appear to have been the requisite legislative history to limit the effect of that section.

Allocations under section 704(c)(2) are elective with the partnership. There is no known Congressional intent to mandate its principles in the enactment of the Tax Reform Act of 1976.

1.704-1(b)(4)(iv)

The special rules applicable to losses and deductions attributable to nonrecourse debt should be clarified with respect to the following matters:

1.) In defining the "minimum gain", reference is made to the excess of the outstanding principal balance of such debt over the basis of the property securing such debt. The principal balance used for this measurement is further limited to exclude any portion not treated as an amount realized under section 1001 and Reg. section 1.1001-2, if such debt were foreclosed upon.

We recommend that the measurement of this minimum gain be revised to include the principal amount of the nonrecourse debt plus any accrued interest thereon, but limited in all cases to the amount realized pursuant to section 1001 if the property were foreclosed upon. We

believe this is the result that was intended. The language in the Proposed Regulation could cause confusion and represent a trap for taxpayers who did not convert interest accrued into principal amounts in the terms of their debts.

2.) It should be made clear that the partnership allocations of gain required under section 1.704-1(b)(4)(iv)(b) will be reduced to the extent of any other income or gain recognized by a partner which results from a reduction in the debt and the operation of sections 752 and 731. This is necessary in order to prevent an allocation of income by the partnership when the partner has previously included the deficit in capital into income due to the latter sections.

3.) The timing of required income or gain allocations under section 1.704-1(b)(4)(iv)(b) is not clear from the language in that section. It can be interpreted as requiring allocations of gross income or net income. It can be read that if no income exists for the taxable year when the minimum gain is reduced, no allocations would be required in a later year. Example 17(vi) of paragraph (b)(5) also contains confusing language on this issue in citing the requirement that such allocations coincide, in amount and time, with any principal reduction in the amount of nonrecourse debt.

We suggest the regulatory language and examples be clarified to make clear the intent that allocations of income or gain will be made as soon thereafter as possible (after reduction in minimum gain) and that gross income allocations are not required for this purpose.

4.) The rule for determining the sum of partners' deficit capital account balances in this section, dealing with anticipated distributions after the end of a taxable year should be clarified as suggested earlier with respect to section 1.704-1(b)(2)(ii).