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PASSING DEPRECIATION TO INVESTOR-PARTNERS

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I. INTRODUCTION

The partnership form is an extremely popular vehicle for raising money for real estate development because of the opportunity to offer high-bracket investors "pass through" of partnership losses. These losses, in all but the most highly leveraged partnerships, are largely the result of depreciation deductions. Despite the tremendous popularity of real estate partnerships, limitations on allocations of partnership losses or of particular items of partnership deduction, have never been carefully defined. The purpose of this article is to explore possible limitations in the context of a variety of allocation arrangements currently in use.

II. STATUTORY AND ACCOUNTING MECHANISMS

Prior to the 1954 Code,[1] there was no limitation on the division of the general profits or losses of a partnership among unrelated partners.[2] Indeed, the Service had conceded that partners could share losses in a different ratio than they share profits.[3] There was, however, a great deal of uncertainty concerning whether special allocations of specific items of income or deduction would be recognized.[4] It had been established at an early date that partners could not, for tax purposes, allocate income from a particular source to one or more of the partners.[5] The

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1. INT. REV. CODE OF 1954, *as amended* [hereinafter referred to as CODE].

2. McDonald, *Distributive Shares of Partnership Income and Loss*, N.Y.U. 15th INST. ON FED. TAX. 41, 45 (1957).

3. Driscoll, *Tax Problems of Partnerships—Special Allocation of Specific Items*, U. SO. CAL. 1958 TAX INST. 421, 423, and authority cited therein. See Rev. Rul. 54-84, 1954-1 CUM. BULL. 284, for an example of a situation in which it was held permissible for one partner to receive a one-half interest in profits and bear all losses.

4. McDonald, *supra* note 2, at 49.

5. O.D. 140, 1 CUM. BULL. 174 (1919); *cf.* Charles C. Ruprecht, 16 B.T.A. 919 (1929), *acquiesced in* VIII-2 CUM. BULL. 46 (1929), *aff'd*, 39 F.2d 458 (5th Cir. 1930).

general rule was that specific items had to be shared in proportion to the partner's share in partnership income.[6] That general rule, however, forced the Service into awkward positions, particularly with respect to non-resident alien partners who had a share of their partnership's foreign income different from their share of its domestic income.[7] In order to accommodate the legitimate business interests in such arrangements without relinquishing its general rule, the Service took the position that a partnership that divided foreign and domestic income in different ratios was, for tax purposes, two different partnerships.[8]

The 1954 Code included a general authorization of separate allocations of specific items[9] that was an attempt to accommodate legitimate business interests in disproportionate allocations of particular items of income, deduction or credit.[10] The general rule now is that a partner's distributive share of any item of income, gain, loss, deduction or credit shall be determined by the partnership agreement.[11] That rule, however, is coupled with the

6. McDonald, *supra* note 2, at 49; *cf.* Frederic H. Chase, P-H 1935 BTA MEMO ¶ 35,039.

7. Driscoll, *supra* note 3, at 423-24.

8. Rev. Rul. 56-134, 1956-1 CUM. BULL. 649.

9. The focus of this paper is the section 704(a) general authorization of special allocations:

> A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

There are, however, two additional specific authorizations of special allocations that should be mentioned. The first concerns payments to a partner for his services or for the use of his capital, to the extent the payments are determined without respect to the income of the partnership. Such payments are termed "guaranteed payments" and constitute deductions for the partnership in computing taxable income. CODE § 707(c). The second specific authorization of special allocations concerns the situation in which a partner has contributed property to the partnership. It permits a special allocation of depreciation, depletion, or gain or loss from property contributed to the partnership, to take into account the difference between the basis and the fair market value of the property at the time of the contribution. CODE § 704(c). *See generally,* Comment, *Allocation of Income, Gain and Loss in Partnership Taxation,* 38 TUL. L. REV. 104 (1963).

10. Thus, for example, a partner who is a resident of a foreign country may be allocated a percentage of the profit derived from operations conducted by him within that country greater than his distributive share of partnership income generally, in the absence of circumstances that show that the principal purpose of the allocation is tax avoidance or evasion. Treas. Reg. § 1.704-1(b)(2), Example (2) (1956). Similarly, a partner who undertakes to pay all partnership research and experimental expenditures may be allocated the deductions for the full amount of those expenditures, provided the allocation is not made for the principal purpose of tax avoidance or evasion. Treas. Reg. § 1.704-1(b)(2), Example (5) (1964).

11. CODE § 704(a).

limitation that an allocation of any item[12] will be disregarded if its "principal purpose" is the "avoidance or evasion" of federal income tax.[13] If the partnership's allocation of any item is disregarded, each partner's distributive share of that item shall be reallocated "in accordance with his distributive share of taxable income or loss of the partnership, as described in section 702(a)(9)."[14]

The "principal purpose" limitation was explained in the Report of the Senate Committee on Finance, in part, as follows:

> Where, however, a provision in a partnership agreement for a special allocation of certain items has a substantial economic effect and is not merely a device for reducing the taxes of certain partners without actually affecting their shares of partnership income, then such a provision will be recognized for tax purposes.[15]

The Tax Court has said this statement was added to allay fears

12. See pp. 232-33 *infra*, for discussion of whether the "principal purpose" limitation applies to allocations of total partnership income or loss, or simply to allocations of particular items of income or loss.

13. CODE § 704(b)(2). The Regulations state the following are among the relevant circumstances in determining whether the principal purpose of an allocation in a partnership agreement is for the avoidance or evasion of federal income tax:

> Whether the partnership or a partner individually has a business purpose for the allocation; whether the allocation has "substantial economic effect", that is, whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences; whether related items of income, gain, loss, deduction, or credit from the same source are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocation. Treas. Reg. § 1.704-1(b)(2) (1956).

The examples included in the Regulations to illustrate the application of these six tests indicate that the presence or absence of any one factor will not necessitate the recognition or disregard of an allocation. All the surrounding circumstances must be considered, and the fact the allocation results in a tax saving to all partners involved does not mean it will be disregarded. Similarly, the fact the parties would not have entered a transaction without a particular allocation does not mean it will be found to have substantial economic effect apart from tax consequences. The six tests are best viewed as interrelated avenues of inquiry to help determine all the economic consequences of a particular allocation.

14. CODE § 704(b).

15. S. REP. No. 1622, 83d Cong., 2d Sess., 379 (1954), (to accompany H.R. 8300, Pub. L. No. 591). See Treas. Reg. § 1.652(b)-2 (1956), for an "economic effect independent of the income tax consequences of the allocation" test in connection with allocation of income items among beneficiaries of a trust.

that "special allocations" would be denied effect in every case in which the allocation resulted in a reduction in the income tax liabilities of one or more of the partners, and to affirm "that special allocations are ordinarily to be recognized if they have business validity apart from their tax consequences."[16]

The term special allocation, therefore, is the concept used to identify allocations subject to the principal purpose limitation and the substantial economic effect test. A special allocation is usually defined as an allocation other than in accordance with the partner's ratio for sharing taxable income or loss, as defined in section 702(a)(9). Since the partner's ratio for sharing 702(a)(9) taxable income or loss is also the Code's reallocation mechanism, the meaning of 702(a)(9) is critical to an understanding of the limitations on partnership allocations.

The 702(a)(9) figure is "taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection."[17] Separate computation is required of "other items of income, gain, loss, deduction, or credit, to the extent provided by regulations,"[18] which require that each partner take into account separately

16. Stanley C. Orrisch, 55 T.C. 395, 400-01 (1970), *aff'd per curiam*, ___ F.2d ___ (9th Cir. 1973).

17. CODE § 702(a) is as follows:

GENERAL RULE.—In determining his income tax, each partner shall take into account separately his distributive share of the partnership's—

(1) gains and losses from sales or exchanges of capital assets held for not more than 6 months,

(2) gains and losses from sales or exchanges of capital assets held for more than 6 months,

(3) gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions),

(4) charitable contributions (as defined in section 170(c)),

(5) dividends with respect to which there is provided an exclusion under section 116, or a deduction under part VIII of subchapter B,

(6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

(7) partially tax-exempt interest on obligations of the United States or on obligations of instrumentalities of the United States as described in section 35 or section 242 (but, if the partnership elects to amortize the premiums on bonds as provided in section 171, the amount received on such obligations shall be reduced by the reduction provided under section 171(a)(3)),

(8) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary or his delegate, and

(9) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

18. CODE § 702(a)(8).

> his distributive share of . . . any items of income, gain, loss, deduction, or credit subject to a special allocation under the partnership agreement which differs from the allocation of partnership taxable income or loss generally.[19]

Although 702(a)(9) is stated in terms of "taxable income or loss" and not "profits or losses," the Regulations,[20] the Tax Court[21] and the commentators[22] have consistently referred to the 702(a)(9) ratio as the ratio for sharing the "general profits or losses" of the partnership. Thus, prohibited allocations are usually discussed in terms of devices for reducing the taxes of certain partners "without actually affecting their shares of partnership income."[23]

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19. Treas. Reg. § 1.702-1(a)(8)(i) (1956). There is, therefore, a certain amount of circularity in the ordinary use of the special allocation concept. A special allocation is stated to be one other than in accordance with 702(a)(9), which, by Regulation, is defined as excluding items subject to special allocations.

20. Treas. Reg. §§ 1.704-1(b)(1) and (2) (1956):

> (b) *Distributive share determined by income or loss ratio.* (1) If the partnership agreement makes no specific provision for the manner of sharing one or more items or classes of items, a partner's distributive share of such items shall be determined in accordance with the provisions of the partnership agreement for the division of the *general profits or losses (that is, the taxable income or loss of the partnership as described in section 702(a)(9))*. In applying this rule, the manner in which the net profit or loss (computed after excluding any item subject to a recognized special allocation) is actually credited on the partnership books to the accounts of the partners will generally determine each partner's share of taxable income or loss as described in section 702(a)(9).
>
> (2) If the principal purpose of any provisions in the partnership agreement determining a partner's distributive share of a particular item is to avoid or evade the Federal income tax, the provision shall be disregarded and the partners' distributive shares of that item shall be determined in accordance with the ratio in which the partners divide the *general profits or losses of the partnership (as described in section 702(a)(9))* (emphasis added).

21. Stanley C. Orrisch, 55 T.C. 395, 400 (1970), *aff'd per curiam*, ___ F.2d ___ (9th Cir. 1973).

22. *See, e.g.*, Jackson *et al*, *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183, 1187 (1954).

23. S. REP. No. 1622, *supra* note 15, at 379. *See also*, Rev. Rul. 60-47, 1960-1 CUM. BULL. 250, concerning the allocation of a deduction for depletion in the case of mineral or timber property held in trust:

> If a mineral property or timber property is held in trust, the allowable deduction for depletion is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income from such property allocable to each, unless the governing instrument (or local law) requires or permits the trustee to reserve or maintain a reserve for depletion in any amount. In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depletion reserve, and any part of the deduction in excess of the income set aside for the reserve shall be apportioned between the income beneficiaries and the trustees on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each.

If the partners include economic profits or losses in the allocation of 702(a)(9) taxable income or loss, the "black letter" law applies fairly neatly to allocations of specific items other than in accordance with their 702(a)(9) ratio. Consider, for example, the agreement of A-B partnership that provides that A be allocated all the depreciation deductions and that A and B divide equally all other consequences of ownership. Under this arrangement, the partners have included everything except depreciation in the allocation of their 702(a)(9) taxable income or loss. The allocation of all the depreciation other than in accordance with their 50-50 ratio for sharing taxable income or loss is a special allocation that will be disregarded if it has no substantial economic effect apart from tax consequences. If it is disregarded, the depreciation will be reallocated according to the 50-50 ratio.

The "black letter" law does not apply so neatly if economic profits or losses are not included in the allocation of 702(a)(9) taxable income or loss.[24] Sophisticated real estate partnership agreements frequently define the rights of the partners[25] in terms of the following three factors: (1) net cash flow[26] from the operation of the partnership; (2) proceeds in the event of refinancing or sale of partnership property; and (3) partnership taxable income or loss. The end result in partnerships using such an allocation system is that none of the economic profits or losses are included in the allocation of taxable income or loss. Stated differently, there is an allocation of "taxable income or loss" that has no effect on the allocation of the net cash flow and debt amortization that "taxable income" supposedly includes. Stated one last way, there is an allocation that determines a partner's distributive share of taxable income or loss *and nothing more.*[27]

This rule is now included in Treas. Reg. § 1.611-1(c)(4) (1960).

24. See McDonald, *supra* note 2, at 43 n. 16, for an early recognition of the fact that, if everything is separately stated and "there is no residual partnership taxable income or loss, the policing provision of section 704(b) will be impossible to apply literally."

25. The partnership agreement may fix an allocation ratio in a variety of ways. The ratio may be either fixed or variable. A fixed ratio may be determined in the abstract, or be based on some other figure that will remain fixed. An extremely popular base for a fixed ratio, for example, is the partners' initial contributions to capital. Variable ratios are ordinarily based on a figure that may change during the operation of the partnership. The most commonly used base for a variable ratio is the partners' capital accounts.

26. Net cash flow is, most basically, cash received less cash spent. Thus, in the case of a typical piece of rental property, the net cash flow consists of rent receipts less maintenance and repair expenses, real estate taxes and debt service.

27. See Hypothetical A, p. 227 *infra*, for an illustration of the operation of a three-

Drafters of real estate partnership agreements, therefore, are relying on the general authorization of allocations of specific items to do much more than accommodate the interests of particular partners in specific items of income, deduction or credit. They are relying on it as authority for dramatic separations of tax and economic benefits. The very purpose of the separate allocation of partnership "taxable income or loss" in the three-way allocation system just described is to give investor-partners a much greater share in tax benefits than they have in cash benefits. The allocation of the tax benefits is stated in terms of "taxable income or loss" in the hope it will be regarded as an allocation of 702(a)(9) taxable income or loss, despite the fact it is an allocation that has been deprived of any significance as a ratio for sharing the partnership's "general profits or losses."

If the allocation of tax losses and nothing more were regarded as a 702(a)(9) allocation, it would not be subject to the principal purpose limitation and substantial economic effect test because it would not be considered a special allocation. Nor would the allocations of net cash flow and proceeds of refinancing or sale be vulnerable. First, it is difficult to consider the allocations of net cash flow or proceeds of refinancing or sale as "special allocations" capable of being disregarded. It is hard to imagine the Service reallocating the basic economic consequences of the enterprise. Second, even if the allocations of net cash flow and proceeds of refinancing or sale were regarded as "special allocations" to be recognized only if they have substantial economic effect apart from tax consequences, it would be difficult to say they have no substantial economic effect apart from tax consequences when they control the allocation of the economic consequences of the enterprise.

In short, under the three-way allocation system described above, the allocation of "taxable income or loss" is used to separate the tax consequences of economic profits or losses from the economic profits or losses themselves. Defenders of such allocation systems would assert that the partnership's allocation of "taxable income or loss" and nothing more should not be scrutinized for "substantial economic effect" because it is not a special allocation, and that the allocations of net cash flow and proceeds

way allocation system that results, *inter alia*, in an allocation of taxable income or loss and nothing more.

in event of refinancing or sale cannot be disregarded. To adopt such a position would immunize allocations in terms of "taxable income or loss," even if the separate allocations of all economic profits and losses have deprived the partnership's allocation of 702(a)(9) taxable income or loss of all meaning as the basic measure by which the partners share in the "general profits or losses" of the venture. Since there is not the slightest suggestion in the history or interpretation of the special allocation provisions that indicates an absolute guarantee of such dramatic separations of economic and tax consequences was ever intended, allocations of taxable income or loss and nothing more should be subject to the substantial economic effect test.[28] The remainder of this paper concerns the way in which the substantial economic effect test might be applied to such allocation systems, and how improper allocations of losses or items of loss should be reallocated if they are disregarded.

III. LIMITATIONS ON ALLOCATIONS OF DEPRECIATION

A. Orrisch—*The Traditional Special Allocation*

In *Stanley C. Orrisch*,[29] the Tax Court disregarded an allocation of depreciation it held had been made for the principal purpose of avoidance or evasion of tax. In 1963, the Orrisches, then husband and wife, formed a partnership with the Crisafis, also husband and wife, to purchase and operate two apartment houses that were to be financed principally by secured loans. The Orrisches initially contributed $26,500 in cash to the partnership, and the Crisafis contributed $12,500. During 1964 and 1965, the Orrisches and Crisafis each contributed additional cash in the amounts of $8,800. Under the partnership agreement, which was not in writing, they agreed to share equally in the profits and losses from the venture. In 1963, 1964 and 1965, the partnership suffered losses, attributable in large part to depreciation deductions. During these three years, pursuant to their partnership agreement, the Orrisches and Crisafis each deducted on their individual income tax returns 50% of the total partnership losses,

28. See p. 232 *infra*, for the suggestion that, under some circumstances, an allocation of total partnership income or loss may be subject to the substantial economic effect test.
29. 55 T.C. 395 (1970), *aff'd per curiam*, ____ F.2d ____ (9th Cir. 1973).

which were, in each year, just slightly smaller than the depreciation deductions.

In 1966 and 1967, the years in question, the Crisafis had no need for the depreciation deductions from the partnership because they had substantial losses from other properties. In early 1966, the partners orally agreed that, for 1966 and subsequent years, the entire amount of the partnership's depreciation deductions would be allocated to the Orrisches, but the entire amount of the "gain or loss from the partnership's business, computed without regard to any deduction for depreciation, would be divided equally."[30] The partners further agreed that the Orrisches' capital account would be reduced by the full amount of the depreciation deductions allocated to them, and that, in the event the property were sold at a gain, the specially allocated depreciation would be "charged back" to their capital account and they would pay the tax on the gain attributable thereto.

The allocation of 702(a)(9) taxable income or loss in *Orrisch* included the economic profits or losses of the partnership. The allocation of all the depreciation to the Orrisches other than in accordance with their 702(a)(9) ratio was, therefore, a traditional "special allocation" that would be disregarded if it had no substantial economic effect apart from tax consequences. The court concluded the allocation did not have the requisite substantial economic effect because it did not "actually affect the dollar amount of the partners' shares of the total partnership income and loss independently of tax consequences" within the meaning of the Regulations.[31] It found that the division of annual profits and losses, computed without regard to depreciation, and the division of proceeds in the event of sale, were to be continued on a 50-50 basis, despite the special allocation of depreciation and resulting disparity in capital accounts. Furthermore, the parties were not going to treat the disparity in capital accounts as a debt obligation of the Orrisches to the partnership.[32] The sole purpose

30. 55 T.C. at 397. Because the partnership agreement was not in writing, the court made this crucial finding of fact, in part, on the basis of its interpretation of a marital property settlement between the Orrisches. *Id.* at 404.

31. 55 T.C. at 404.

32. Under normal accounting procedures, if the building were sold at a gain less than the amount of such disparity petitioners would either be required to contribute to the partnership a sum equal to the remaining deficit in their capital account after the gain on the sale had been added back or would be entitled to receive a proportionately smaller share of the partnership assets on

of the charge-back to the Orrisches' capital account was to document the special allocation of depreciation and thereby support the subsequent allocation of capital gains tax to them.

The most interesting aspect of the opinion is the court's treatment of the argument that the special allocation of all the depreciation was an attempt to reward the Orrisches for their greater economic investment in the enterprise. In the body of its opinion, the court stated that the evidence did not support the "contention" that the special allocation had been adopted in order to equalize the partners' capital accounts. The charge-back to reflect the special allocation sent the Orrisches' capital account far below that of the Crisafis. At the end of 1967, the Crisafis' capital account had a balance of \$405.65 and the Orrisches' capital account had a negative balance of \$25,187.99.

> Thus, rather than correcting an imbalance in the capital accounts of the partners, the special allocation will create a vastly greater imbalance than existed at the end of 1966.[33]

It is fairly clear, however, that the Orrisches were not relying on the argument that their goal was to equalize capital accounts.[34]

The capital accounts in *Orrisch* reflected all cash contributions, withdrawals and distributions, all items of partnership taxable income and loss, but did not include partners' shares of partnership liabilities. There is no uniform rule on the composition of capital accounts, and the computation used in *Orrisch* is not uncommon, particularly among partnerships that have no allocation ratios based on capital accounts.[35] Such a computation, nevertheless, produces a figure that does not reflect accur-

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liquidation. Based on the record as a whole, we do not think the partners ever agreed to such an arrangement. 55 T.C. at 403-04.

33. 55 T.C. at 402.

34. Brief for Appellant at 9, Orrisch v. Commissioner, ___ F.2d ___ (9th Cir. 1973):

> The Tax Court in its decision finds it incredible that equalization of the capital accounts was the objective of the special allocation. Clearly, the Tax Court misread the evidence, for nowhere is this stated to be the objective; rather the evidence states that the depreciation was allocated because of the inequity in the capital and the likelihood of Orrisch having to put in more money.

35. If an allocation ratio is based on capital accounts, it may be unwise to include everything except share of partnership liabillities in capital accounts. Partnership agreements must be drafted carefully to avoid unwanted fluctuations in capital accounts that are not intended to affect any allocation ratios based thereon. A. WILLIS, PARTNERSHIP TAXATION § 4.02 (1971). *See* J. CRANE & A. BROMBERG, LAW OF PARTNERSHIP, 599-601 (1968).

ately tax basis or actual economic investment. Tax basis is not reflected because of the exclusion of the partners' shares of partnership liabilities.[36] Actual economic investment is not reflected because partnership tax losses are deducted. For example, under the *Orrisch* system, if partner A were to contribute $100 additional cash to the partnership, his capital account would be increased by $100, as would his actual economic investment in the enterprise. If he were then to receive a "pass-through" of $100 of partnership tax losses, his capital account would be lowered by $100, not merely by the actual dollar amount the loss would save him on his tax bill, which is the true measure of the reduction of his actual economic investment in the enterprise.

There are, therefore, two reasons why it is doubtful the Orrisches were arguing the goal of the allocation of all depreciation to them was to equalize capital accounts. First, they had no reason to equalize capital accounts *per se*. Under the system of bookkeeping used by the partnership, the capital accounts were not an accurate measure of economic investment in the enterprise. Furthermore, no partnership allocation ratios were based on capital accounts, nor was the disparity in capital accounts caused by the special allocation of depreciation intended to be treated as a debt obligation. Second, it would have been difficult to rely on such an argument because, as the court noted, it was indisputable that the special allocation increased, rather than decreased, the disparity in capital accounts.

The Orrisches' real argument was that the allocation of all the depreciation was an attempt to equalize the economic investment of the partners, not that it was an attempt to equalize capital accounts *per se*.[37] If depreciation deductions are passed to a partner as compensation for his greater cash investment, his capital account is reduced not just by the amount of excess cash investment sought to be equalized, but by the full amount of deductions needed to result in savings on his tax bill equal to the excess of his investment. The increased disparity in capital accounts, therefore, did not negate an intention to equalize economic investment,[38] and the question remained whether it was

36. A partner's basis in his partnership interest includes his share, if any, of partnership liabilities. CODE § 752.

37. Brief for Appellant, *supra* note 34.

38. A partner in the 50% bracket, for example, would be given $28,000 in tax deduc-

permissible to shift all the depreciation deductions to the Orrisches as a reward for their greater cash investment.

The court directly addressed this issue, not in the body of its opinion, but in a footnote in which it indicated its appreciation of the fact that the capital accounts in *Orrisch* did not accurately reflect the economic investment of the partners:

> We recognize that petitioners had more money invested in the partnership than the Crisafis and that it is reasonable for the partners to endeavor to equalize their investments, since each one was to share equally in the profits and losses of the enterprise. However, we do not think that sec. 704 (a) permits the partners' prospective tax benefits to be used as the medium for equalizing their investments, and it is apparent that the economic burden of the depreciation (which is reflected by the allowance for depreciation) was not intended to be the medium used.[39]

The court, therefore, admitted that increased disparity in capital accounts does not negate the conclusion that equalization of investment was the goal of the allocation of all the depreciation. More importantly, it was saying that equalization of investment may not be accomplished in this fashion. Since there was no other substantial economic effect[40] apart from tax consequences, the court's decision was easy.[41] How far the decision can be carried, however, is far from clear. The court's reasoning appears to be that the parties will not be permitted to equalize their economic investment simply by passing depreciation deductions from a

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tions to "equalize" a greater cash contribution of $14,000, because it would take that amount of deductions to result in a $14,000 saving on his tax bill. His capital account ordinarily would be reduced not just by the $14,000 excess investment sought to be equalized, but by $28,000.

39. 55 T.C. at 402 n. 5.

40. A showing that the partners would not have entered the transaction had they known they would not be able to achieve the tax benefits in question is not sufficient to demonstrate substantial economic effect. *See* note 13 *supra*.

41. Feder, *How Real Estate is Faring Under the Federal Income Tax*, 2 REAL EST. REV. 44, 49 (1972):

> The decision [in *Orrisch*] is not terribly surprising. Indeed, one would have been more surprised if it had gone the other way. The most unusual feature of the decision is that it took seventeen years for the Service to find and litigate the case that brought it forth.

Because the partnership agreement was not in writing, the court was free to articulate its "findings of fact" about the understanding of the parties in a way that made its disregard of their special allocation of depreciation almost inescapable. *See* n. 30 *supra*.

partner who has no need for them to one who does unless the change in the allocation of the depreciation is supported by some change in the allocation of economic profits and losses. There is language in the opinion that strongly indicates the court would have regarded a change in the allocation of proceeds of sale as sufficient substantial economic effect, even if the allocation of annual profits and losses were not affected.[42] It is not clear, however, whether the court would have upheld the special allocation had it been supported by nothing more than a showing that the parties had intended to treat the disparity in capital accounts as a debt obligation.

B. *Beyond* Orrisch—*Three-Way Allocations, Priorities and Guarantees*

The issues raised by *Orrisch* must be considered in the context of the more complicated three-way allocation systems used by many sophisticated real estate partnerships:

> Hypothetical A
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> Limited partnership with general partner G and limited partners A and B. The partnership agreement provides that the net cash flow from the enterprise will be allocated 50% to G and 25% each to A and B. The partnership agreement also provides that the proceeds of refinancing or sale will be allocated 60% to G and 20% each to A and B.[43] The partnership agreement further provides that all partnership taxable income or loss shall be

42. After establishing that the allocation of all the depreciation to the Orrisches was to have no effect on the allocation of operating profits or losses or on the allocation of proceeds from the sale of the property at a gain, the court stated:

> To find any economic effect of the special allocation agreement aside from its tax consequences, we must, therefore, look to see who is to bear the economic burden of the depreciation if the buildings should be sold for a sum less than their original cost. 55 T.C. at 403.

The court found that, even in the event of a sale at a loss, the division of the proceeds would not be affected by the special allocation of depreciation to the Orrisches. See Goldstein, *Developments in the Law of Partnerships—1965 to 1971*, 27 BUS. LAW. 603, 606 (1972) and McGuire, *When Will A Special Allocation Among Partners Be Recognized?*, 37 J. TAX. 74 (1972), for the position that an alteration in the allocation of proceeds of refinancing or sale would have been sufficient substantial economic effect to support the special allocation of all the depreciation to the Orrisches.

43. Investor-partners ordinarily think primarily in terms of a fixed cash return on cash investment and the extent to which it is sheltered from tax. The promoter-partner is, therefore, often in a position to take a much more substantial share of proceeds of refinancing or sale than he takes of net cash flow. *See* Malkan, *Who Gets What in a Tax-Shelter Syndicate*, 2 REAL EST. REV. 26, 29 (1972).

allocated among the partners in the same proportion as their initial contributions to capital. G makes no initial contribution to capital and A and B each make an initial contribution to capital of $5,000. An apartment house is bought for $100,000, with the combined initial contributions to capital of A and B, and with the proceeds of a $90,000 non-recourse loan.

The partnership thus has three different allocation ratios:

	Net Cash Flow	Proceeds of Refinancing or Sale	Taxable Income or Loss
G	50%	60%	0%
A	25%	20%	50%
B	25%	20%	50%

Consider what the partners receive in an hypothetical year in which the rent receipts are $10,000, the real estate taxes and maintenance expenses are each $500, the amortization of the non-recourse loan[44] is $2,000, and the interest on the loan is $6,000. In such a year, the net cash flow from the operation of the property is as follows:

$$\begin{aligned} NCF &= RR - RT - ME - (P + I) \\ &= 10{,}000 - 500 - 500 - (2{,}000 + 6{,}000) \\ NCF &= 1{,}000 \end{aligned}$$

Under the ratios established in the partnership agreement, the distribution of the net cash flow is as follows:

G	$500
A	250
B	250

If we further assume that the depreciation deduction in the same year is $12,000, the taxable income or loss of the partnership is computed as follows:

$$\begin{aligned} TI &= NCF - D + P\ ^{45} \\ &= 1{,}000 - 12{,}000 + 2{,}000 \\ TI &= (9{,}000) \end{aligned}$$

44. The loan must be non-recourse to enable the limited partners to share in it for basis purposes. Treas. Reg. § 1.752-1(e) (1956). It is crucial that the limited partners be able to increase their bases by a share of partnership liabilities, because they may only deduct partnership losses to the extent of their respective bases in their partnership interests. CODE § 704(d).

45. Debt amortization is added to net cash flow in computing taxable income because debt amortization is a cash expense for which there is no deduction. Conversely, deprecia-

Thus, in the hypothetical year, the partnership will sustain a tax loss of $9,000. Pursuant to the partnership agreement, the tax loss will be allocated among the partners according to the ratio of their initial contributions to capital:

Initial Capital Contribution		Share of Partnership Tax Losses	
G	$ 0	G	$ 0
A	5,000	A	4,500
B	5,000	B	4,500

In summary, as a result of the year's operation, the partners receive the following:

Share of Net Cash Flow		Share of Partnership Tax Losses
G	$500	$ 0 loss deduction
A	250	4,500 loss deduction
B	250	4,500 loss deduction

The attractiveness of this kind of arrangement to a promoter who wants to pass the bulk of tax losses to his investor-partners is clear. By allocating tax losses according to initial capital contributions, G has established a fixed ratio that passes to the limited partners the benefit of all depreciation and other deductions beyond those necessary to shelter from tax the net cash flow and debt amortization of the partnership.

Despite the dramatic separation of tax and economic benefits in Hypothetical A, there is no reported decision or ruling determining the permissibility of such an allocation system. It already has been established, however, that allocations of "taxable income or loss" that do not include economic profits or losses should be considered special allocations subject to the "principal purpose" limitation.[46] We shall, therefore, examine the permissibility of the three-way allocation system in Hypothetical A from two interrelated points of view: first, the substantial economic effect, apart from tax consequences, of such an arrangement; second, the basic principle that income is taxed to the one who earns it and cannot be assigned for tax purposes.[47]

In Hypothetical A, partnership "taxable income or loss" is

tion is deducted from net cash flow in computing taxable income because depreciation is a deduction for a non-cash expense.

46. *See* pp. 218-22, *supra*.

47. Helvering v. Horst, 311 U.S. 112 (1940); Lucas v. Earl, 281 U.S. 111 (1930).

allocated away from net cash flow and proceeds in the event of refinancing or sale. Does this special allocation of taxable income or loss away from economic profits or losses pass the "substantial economic effect" test? The only economic effect of the allocation is that it is based on initial contribution to capital, and the question is whether that is sufficient substantial economic effect to prevent the allocation from being disregarded. At first, it might seem perfectly reasonable to divide partnership taxable income or loss among the partners in accordance with their cash investments in the partnership. The question is, however, whether such a division is permissible when it has no impact on the division of any economic profits or losses. *Orrisch* strongly suggests that initial contribution to capital is not the requisite substantial economic effect to support an allocation of tax consequences away from all other economic consequences. *Orrisch* appears to stand for the proposition that equalization of economic investment in an enterprise may not be accomplished by giving someone a greater share in tax benefits than he has in profits, *i.e.*, by equalizing his investment through the medium of "prospective tax benefits." An allocation of "taxable income or loss" and nothing more, supported solely by initial contributions to capital, is doing precisely that, at least insofar as losses are expected.[48] An interpretation of *Orrisch* to prohibit allocations of tax losses based solely on initial contributions to capital would be supported by the fact the Code is based on the assumption that tax benefits are to follow what is pulled out of a partnership, not what is put in. For example, a limited partner's share of partnership liabilities for basis purposes is determined by his share of profits, not by his share of contributions.[49] Similarly, the reallocation ratio itself is the ratio for sharing "general profits or losses." In short, there is no suggestion in the Code, the legislative history, the regulations, or the decisions thereunder that initial contribution to capital is the requisite substantial economic effect apart from tax consequences to support an allocation of tax benefits away from the economic benefits of operation and refinancing or sale.

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48. An allocation of taxable income or loss and nothing more may also violate the principle that income is taxable to the one who earns it and cannot be assigned for tax purposes. *See* pp. 233-37, *infra*.

49. Treas. Reg. § 1.752-1(e) (1956). In the case of a general partnership, a partner's share of partnership liabilities is determined in accordance with his ratio for sharing losses under the partnership agreement. *Id.*

Even if initial contributions to capital were to be considered the requisite "substantial economic effect" in some circumstances, the economic effect of initial capital contributions is less "substantial" in situations in which there is a priority or guarantee of return of initial capital contribution to the investor-partners. When there are priorities or guarantees, it is easier to see that allocations of tax benefits based on initial contributions to capital constitute *Orrisch*-type attempts to equalize economic investment through the medium of "prospective tax benefits." Consider, for example, the situation in which the investor-partners are allocated all net cash flow and partnership taxable income or loss until they recover their cash investments. At first blush, it would appear that the investor-partners have an interest in "general profits or losses" that supports the allocation of all the tax consequences to them.[50] On the other hand, even if they have such an interest in "profits," it disappears, or at least substantially decreases, after their priority is satisfied. It could be argued, therefore, that even if all tax losses can be passed to the limited partners during the period in which they are receiving all the economic profits, their share of tax losses must be readjusted to match the share of profits they will be receiving after their priority is satisfied.[51] Viewed in this manner, an allocation of "taxable income or loss" based on initial contribution to capital is an attempt to preserve throughout the life of the partnership an allocation ratio that, at best, is justifiable only during the period of the priority. This observation applies equally to priorities and guarantees.

There is, however, an even more basic consideration in the case of a guarantee. It is extremely difficult to view the interest of the investor-partners during the period of the guarantee as an interest in "profits" that tax benefits should follow. Their receipt of cash benefits during the period of the guarantee does not depend on profits. Their interest during the guarantee period is primarily in the solvency of the promoter-partner, not in the profitability of the enterprise. The promoter-partner, on the other hand, has a very real interest in profits because he must suffer

50. See the discussion of *Jean V. Kresser*, pp. 232-33 *infra*, which raises the question whether allocations of total partnership income or loss are subject to the "principal purpose" limitation.

51. Rabinowitz, *Realty Syndication: An Income Tax Primer for Investor and Promoter*, 29 J. TAX. 92, 95 (1968).

out-of-pocket expenses to satisfy the guarantee if there are insufficient profits. Should the investor-partners, nevertheless, be entitled to the benefits of all depreciation and other deductions? Consider the same question from a different point of view. In the case of a limited partnership, a partner's share of non-recourse liabilities for basis purposes is determined in accordance with his ratio for sharing profits.[52] If the general partner is the only one who has an interest in "profits," he is the only one who can add any portion of partnership liabilities to his basis in his partnership interest. The decision whether a partner has an interest in "profits" should be the same for both purposes, particularly since a partner is not allowed to deduct losses below his basis in his partnership interest.

One more issue concerning priorities and guarantees should be mentioned in connection with *Orrisch.* Would the "principal purpose" limitation have applied had the Orrisches been allocated all partnership income and loss until they had recouped the amount by which their economic investment was superior? It has never been decided whether the "principal purpose" limitation applies to allocations of total partnership income or loss, or only to allocations of "any item" of income or loss.

In *Jean V. Kresser*,[53] the court raised this issue, but did not "reach the question," which it stated to be a difficult one. *Kresser* involved an alleged allocation of all the 1965 income of two partnerships to W.H. Appleton, one of the partners, to enable him to take advantage of a large net operating loss carryover that would expire by the end of 1965. The court stated it was not certain whether the "principal purpose" test should be applied to an allocation that involved all of the partnership's income:

> While we are fully prepared to accept the contention that the principal purpose of the alleged modifications was the "avoidance or evasion" of tax on Appleton within the meaning of sec. 704(b)(2), we are faced with the petitioners' troublesome argument that sec. 704(b)(2) applies only to "items" of income, etc., dealt with in pars. (1) through (8) of sec. 702(a) and does not govern par. (9) relating to the composite of all of the partnership's income (sometimes referred to as its "ordinary income") which is here involved. The point is not without difficulty. Al-

52. Treas. Reg. § 1.752-1(e) (1956).
53. 54 T.C. 1621 (1970).

> though there is general language in *Smith v. Commissioner*, 331 F.2d 298, 301 (C.A. 7), in accord with the Government's argument, the structure of the statute itself and language in the legislative history would seem to give support to petitioners' position. See S. Rept. No. 1622, 83d Cong., 2d Sess., p. 379.[54]

The court did not have to decide whether the "principal purpose" limitation applies to an allocation of total partnership income and loss because it found there had not been a *bona fide* allocation of income among the partners.

Even if allocations of total partnership income or loss are not subject to the "principal purpose" limitation, they may run afoul of the basic principle that income is taxable to the one who earns it and cannot be assigned to another for tax purposes.[55] Since this principle is our second avenue of approach to the permissibility of allocations of tax losses based solely on initial contribution to capital, we can begin by considering its application to an allocation system that involves an even more extreme separation of tax and economic consequences than in Hypothetical A.

Some real estate partnerships allocate all items of deduction to the investor-partners in accordance with their respective contributions to capital. The difference between such an arrangement and the allocation of "taxable income or loss" in Hypothetical A is that, when all items of deduction are allocated to the investor-partners, those items are not first applied against net cash flow plus debt amortization. The investor-partners, therefore, are allocated the full benefit of all items of deduction, not just surplus deductions reflected in partnership taxable income or loss; and the promoter-partner absorbs taxable income. In such a situation, the partners are doing, with respect to all deductions, what was done in *Orrisch* with respect to depreciation alone—allocating the deductions and then allocating partnership "taxable income or loss" computed without regard to the deduc-

54. 54 T.C. at 1631 n. 5.

55. Driscoll, *supra* note 2, at 439:

> *Lucas v. Earl* and *Helvering v. Horst* . . . established the principle that income is taxable to the one who earned it and that it cannot be assigned to others for tax purposes. These principles would continue to apply notwithstanding the provisions of Section 704 (a), which states that a partner's distributive share of partnership income shall be determined by the partnership agreement. Section 704(a) would probably be construed as not establishing a rule contrary to the basic principles of income attribution.

tions. The computation of "taxable income or loss" under such an allocation system deprives the figure of all meaning as a composite of items of income and deduction, and results in an impermissible shift of taxable income to the promoter-partner.

The question then becomes how different such an arrangement is from the allocation system in Hypothetical A, which does the same thing, but only after items of deduction are applied against net cash flow plus debt amortization. At first, the allocation system in Hypothetical A appears less vulnerable because all items of income and deduction are included in the computation of "taxable income or loss."[56] Only surplus deductions, in the form of partnership losses, are being allocated away from economic consequences, and there initially does not appear to be an impermissible shift of investor-partners' taxable income to the promoter-partner.

Consider, however, the effect of the allocation if taxable income were to occur. According to the allocation system in Hypothetical A, all of the partnership's taxable income would be allocated entirely to the limited partners. There would be, therefore, the same kind of shift of taxable income that exists in the situation in which all items of deduction are allocated to the limited partners. The only difference is that the limited partners would be allocated any share of partnership taxable income that would otherwise be reportable by the general partner.

This avenue of inquiry ultimately leads to a fundamental question concerning the three-way allocation system represented in Hypothetical A: how should the general partner's receipt of net cash flow be treated for tax purposes? Initially, there are three basic possibilities: (1) as a return of capital in reduction of basis; (2) as a distribution in excess of basis; and (3) as payment in compensation for services.

A partner must have a basis in his partnership interest to argue that his receipt of net cash flow is a return of capital. Because the general partner in Hypothetical A has made no contribution to capital, he would have to argue that he shares in partnership liabilities for basis purposes. To share in the loan to

56. Even though the promoter's interest is in allocating tax losses, not taxable income, to the investor-partners, the allocation is stated in terms of "taxable income or loss" to give it the appearance of an allocation in accordance with 702(a)(9). *See* pp. 221-22 *supra*.

the partnership for basis purposes, the general partner would have to argue that his interest in net cash flow is an interest in profits.[57] There are, however, two fundamental reasons why he might not want to take such a position. First, if a large portion of the partnership liabilities were added to his basis, the purpose of the allocation of all tax losses to the limited partners could be defeated, for the simple reason that partners may not deduct partnership losses below their respective bases in their partnership interests.[58] Second, if the general partner were to characterize his interest as one in profits, that characterization would make it more apparent that the allocation system results in an impermissible separation of economic profits from their tax consequences.

The second possibility is that the general partner make no claim to any basis in his partnership interest and report his annual receipts of net cash flow as distributions in excess of basis, taxable as capital gains.[59] This, however, would be a very difficult position to sustain. Because he has made no contribution to capital, his receipts of net cash flow could only be in return for services, and he would be without precedent in arguing that he is entitled to capital gains treatment for annual compensation for services.

Distributions of net cash flow to general partners are commonly reported as payments in compensation for services, often improperly. If a general partner receives an interest in profits as compensation for past services, he must value that interest and

57. In the case of a limited partnership, when none of the partners has any personal liability with respect to a partnership liability, all the partners share in that liability for basis purposes "in the same proportion as they share the profits." Treas. Reg. § 1.752-1 (e) (1956).

58. CODE § 704(d).

59. CODE § 731(a):

> PARTNERS.—In the case of a distribution by a partnership to a partner—
> (1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and
>
> * * *
>
> Any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.

In short, a gain resulting from a 731(a) distribution in excess of basis is a capital gain. Treas. Reg. § 1.731-1(a)(3) (1956).

report it immediately as ordinary income.[60] On the other hand, it has not yet been held that the receipt of an interest in profits for services to be performed in the future is a taxable event. At the partnership level, payments to a partner may be deducted as they are made only if they qualify for treatment as "guaranteed payments." If a payment to a partner for services is not a "guaranteed payment" deductible at the partnership level, it is properly viewed as a receipt by the partner of a distributive share of partnership profits.

Payments to a partner for services constitute "guaranteed payments" if they are not based on "income."[61] The purpose of this rule is to allow partnerships to deduct fixed salary payments that must be made to a partner independent of the profitability

60. In Sol Diamond, 56 T.C. 530 (1971), the taxpayer assisted one Kargman in acquiring an office building by obtaining financing in the full amount of the purchase price:

> As compensation for his services Kargman agreed to give petitioner an interest in the venture whereby for 24 years petitioner would become entitled to 60 percent of the earnings from the property and would be chargeable with losses in the same proportion; also, in the event of future sale of the property petitioner would become entitled to 60 percent of the net proceeds after Kargman had been reimbursed in full for the funds expended by him in the acquisition of the property. 56 T.C. at 543-44.

The petitioner argued on the basis of the nonrecognition provisions of CODE § 721, as interpreted by Treas. Reg. § 1.721-1(b)(1) (1956), that when a taxpayer receives a partnership interest as compensation for services he is required to report that interest at once as ordinary income if he acquires an interest in partnership capital, but not if he receives only the right to share in the partnership's future profits and losses. The court rejected this position, stating that

> nothing in the foregoing regulations explicitly states that a partner who has received a partnership interest like the one before us *in exchange for services already performed* comes within the provisions of section 721. 56 T.C. at 546 (emphasis added).

The court concluded that the taxpayer's receipt of the profits interest for past services constituted ordinary income to him when it was acquired, within the meaning of CODE § 61(a)(1) and Treas. Reg. § 1.61-2(d)(1), but suggested that receipt of a profits interest for future services might qualify for nonrecognition under section 721. Before *Sol Diamond*, it generally had been believed that "a profits interest received in exchange for services, whether past or future, was not intended to be a taxable event under the regulations." Cowan, *Receipt of an Interest in Partnership Profits in Consideration for Services: The* Diamond *Case*, 27 TAX L. REV. 161, 181 (1972). *See also* Lane, Sol Diamond: *The Tax Court Upsets the Service Partner*, 46 S. CAL. L. REV. 239 (1973).

61. CODE § 707(c):

> GUARANTEED PAYMENTS.—To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses).

of the enterprise, that is, as if he were not a partner.[62] Payments to a general partner dependent on the existence of available net cash flow are based on "income" within the meaning of this rule, and are not deductible by the partnership. It is clear, therefore, that the general partner's attempt to report his receipts of net cash flow as compensation for services when the partnership itself can not obtain a deduction for those payments, is an attempt to disguise the fact that partnership profits are being separated from their tax consequences.

IV. CONCLUSION

Many real estate partnerships distribute their economic profits or losses by allocations of net cash flow and proceeds of refinancing or sale, and provide separate allocations of taxable income or loss. The separate allocation of taxable income or loss is structured to give investor-partners a greater share in tax benefits than they have in economic benefits, and should be subject to the "principal purpose" limitation and to the principle that income must be taxed to the one who earns it, and cannot be assigned to another for tax purposes.

In general, the benefit of partnership deductions should follow the economic profits or losses of the enterprise, which ordinarily will be reflected primarily in net cash flow. There are situations, however, in which net cash flow is of little or no significance. In some highly-leveraged real estate transactions, the partners never expect to receive any net cash flow because all available cash is spent paying off debt service on partnership obligations.[63] It would not make sense to say that the ratio for sharing

62. Senate Report, *supra* note 15 at 387:

> Subsection (c) provides a rule with respect to guaranteed payments to members of a partnership. A partner who renders services to the partnership *for a fixed salary*, payable without regard to partnership income, shall be treated, to the extent of such amount, as one who is not a partner, and the partnership shall be allowed a deduction for a business expense. The amount of such payment shall be included in the partner's gross income, and shall not be considered a distributive share of partnership income or gain. A partner who is *guaranteed a minimum annual amount* for his services shall be treated as receiving a fixed payment in that amount (emphasis added).

63. Although some real estate partnerships produce no net cash flow at all, even the most highly-leveraged partnerships ordinarily involve some net cash flow to provide a "cushion" to assure that unforeseen occurrences will not require infusions of additional cash to pay off debt service.

net cash flow should guide the allocation of tax benefits in situations in which net cash flow is insignificant or never expected. If there were such a rule, the drafters of agreements for partnerships that never expect net cash flow would simply provide a paper allocation of net cash flow to the investor-partners. In such situations, the real interest in economic profits or losses is in the way debt is amortized,[64] and tax benefits should follow the ratio for sharing proceeds of refinancing or sale.

The most difficult situation is that of the partnership that is so highly leveraged the partners never expect to receive any cash flow or proceeds from refinancing or sale. In such a situation, the ratio for sharing losses is the only ratio that means anything at all to the partners. How would you reallocate losses in such a partnership? The answer seems to be, not at all, unless you can say the general partner has made an implied contribution to capital that must be taken into account in computing the allocation of losses,[65] decide the limited partners are not "owners" of depreciable property entitled to receive depreciation or other deductions,[66] or conclude the transaction makes no sense to all apart from tax consequences, and should be completely disregarded.[67]

64. It is, at any rate, if the partners ever expect to receive any proceeds of refinancing or sale.

65. In Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972), a stockholder of a corporation was held to have made an implied contribution of capital by guaranteeing payment of some of the corporation's obligations. The general lesson of *Plantation* appears to be the more crucial the guarantee to the commencement of the enterprise, and the greater the likelihood, at the time it is made, that it will be called upon, the greater the likelihood it will be deemed to be an implied contribution of capital by the guarantor.

66. Although "debt-equity" principles have been developed and applied almost exclusively in the corporate context, the Tax Court has stated emphatically they apply to partnerships as well. Joseph W. Hambuechen, 43 T.C. 90, 100-01 (1964). A fact situation closely analogous to many real estate partnership transactions was involved in Comtel Corporation v. Commissioner, 45 T.C. 294 (1965), in which it was held that "purchasers" of stock were, in economic reality and for tax purposes, suppliers of debt capital.

67. In Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), the taxpayer was held not entitled to a deduction for interest paid on loans that were undertaken solely to obtain the deduction.