The Treasury Regulations’ concept of “substantial economic effect” is the holy grail of partnership special allocations. Special allocations that have substantial economic effect will come within a safe harbor in the regulations and have assurance that the allocations that are provided in the partnership agreement will be respected. In order for the allocations to come within the substantial economic effect safe harbor, the partnership must (1) maintain capital accounts in accordance with the Treasury Regulations’ standard; (2) provide for liquidation in accordance with capital accounts in all events; and (3) either (a) provide for a deficit restoration obligation (DRO) on the partners, so that they have an obligation to restore any deficits in their capital accounts, or, (b) in the alternative, include in the agreement a qualified income offset provision (“QIO”), so that if a partner’s capital account drops below zero because of an “unexpected distribution,” the partner who experiences this circumstance will be allocated a sufficient amount of the partnership’s gross income to raise his capital account to zero. These requirements are sometimes referred to as the “Big Three.”

The Treasury Regulations, by virtue of these safe harbor requirements, effectively push drafters to write allocation sections of partnership agreements to comply with these requirements, which the Article refers to as the Treasury Capital Account Method of Allocation.

An alternative approach to drafting allocation provisions is sometimes referred to as the “Target Capital Account Method of Allocation” or more simply the “Target Method.” Under the Target Method, all distributions are made in accordance with the partnership distribution provisions. Even though capital account balances are maintained for the partnership in the same manner as under the Treasury Capital Account Method, partners’ capital accounts do not govern...
the distributions upon liquidation of the partnership, which they do under the Treasury Method. Rather, distribution provisions determine liquidation distributions without regard to the partners’ capital accounts. However, allocations of income, gain, losses and deductions are made and affect capital account balances in a manner so that the capital accounts reflect liquidation distribution priorities.

This Article discusses both methods and argues in favor of the superiority of the Target Method in both achieving the economic goals of the partners and in achieving the overriding purposes of the Section 704(b) special allocation regulations. It sets forth and analyzes several situations in which the two allocation methods diverge in liquidation distribution results and explains how the Treasury Capital Account Method may fail to carry out the economic deal of the partners whereas the Target Method always does.

In the course of the discussion of the Target Method, the Article addresses several important interpretive issues in the current Treasury Regulations that inject unfortunate doubt regarding the acceptability of Target Method allocations for partnerships that desire certainty that their allocations will be respected, which drafters of allocation provisions should be aware of and appreciate. The Article ultimately recommends revision of the partnership special allocation regulations to safe-harbor Target Method allocations.