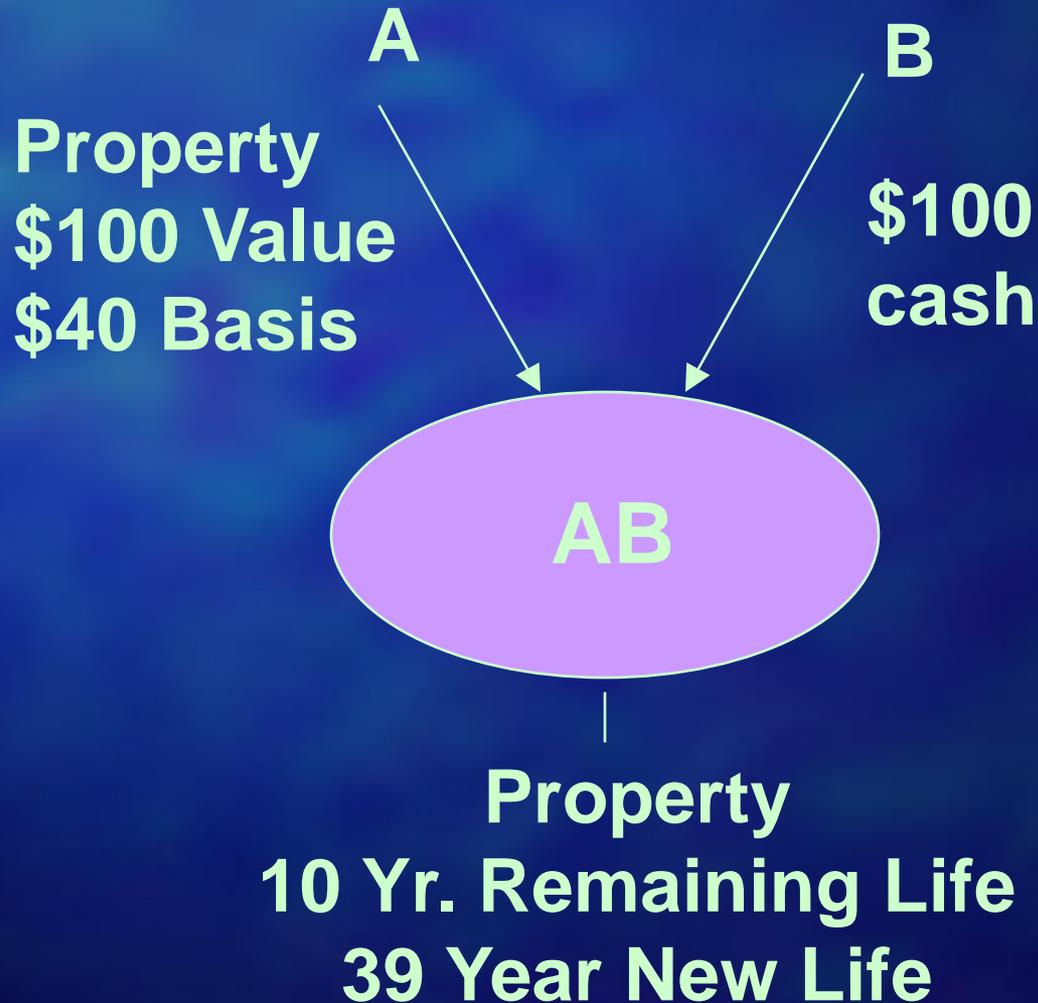


MAKING SECTION 704(c) WORK FOR YOU

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SECTION 704(c) BASICS



SECTION 704(c) BASICS

- **Built-in gain in contributed property must be allocated back to A on sale**
- **B must be allocated depreciation on contributed property equal to depreciation B would receive if basis equaled value**

SECTION 704(c) BASICS

TAX

Prop. 40
Cash 100

40 A
100 B

BOOK

Prop. 100
Cash 100

100 A
100 B

SECTION 704(c) BASICS

- Book depreciation is \$10/year, allocated under 704(b) \$5 each to A and B
- Tax depreciation is \$4/year

SECTION 704(c) BASICS

- Under 704(c), B must be allocated tax depreciation equal to book depreciation
- Since B's book allocation is \$5, and only \$4 tax depreciation, ceiling rule limitation

TRADITIONAL METHOD

- **Traditional method: B gets \$4 tax depreciation**
- **After 10 years, Property is fully depreciated and capital accounts are as follows:**

TRADITIONAL METHOD

TAX

Prop.	0
Cash	100

40	A
60	B

BOOK

Prop.	0
Cash	100

50	A
50	B

TRADITIONAL METHOD

- If Property is sold for \$0 and \$100 cash distributed in liquidation \$50 to A and \$50 to B --
- A will recognize \$10 of gain and B will recognize \$10 of loss

SECTION 704(c) BASICS

- Partners may elect to cure ceiling rule limitation using either the curative allocation method or the remedial allocation method

SECTION 704(c) BASICS

- Rules apply property by property; may elect different methods for different properties
- But overall combination must be reasonable
- Cannot switch methods year to year for same property

CURATIVE ALLOCATION METHOD

- **Curative allocation method: income is allocated to A or deduction to B to cure ceiling limitation**
- **Items generally must be same character as ceiling limited items - ordinary for depreciation**

CURATIVE ALLOCATION METHOD

- **BUT may cure ceiling limited depreciation with allocation of gain on sale**
- **Curative allocations affect tax capital accounts but not book capital accounts**

CURATIVE ALLOCATION METHOD

- Under curative allocation method, A would be allocated \$1 extra taxable income each year, or B \$1 extra deduction each year
- Ceiling limitation is cured over remaining depreciable life of property

REMEDIAL ALLOCATION METHOD

- Under remedial allocation method, “notional” rather than actual items of income and deduction are allocated
- Ceiling rule limitation is cured over a period equal to new depreciable life of property

REMEDIAL ALLOCATION METHOD

- Remedial allocation method: Book depreciation is \$5.54/year for first 10 years, \$1.54/year for next 29
- \$40 divided by 10 year old life, plus \$60 divided by 39 year new life

REMEDIAL ALLOCATION METHOD

- B's book allocation is \$2.77/year for first 10 years, \$.77/year for next 29
- B gets tax depreciation equal to book for all years, totaling \$50

REMEDIAL ALOCATION METHOD

- A gets \$1.23/year tax depreciation for first 10 years, \$.77/year income for next 29, totaling \$10 income

COMPARISON OF METHODS

- RESULTS DURING FIRST 10 YEARS:

	<u>INCOME TO</u>	<u>DEDUCTION TO</u>
	<u>A</u>	<u>B</u>
TRADITIONAL	\$0	(\$4)
CURATIVE	\$1	(\$5)
REMEDIAL	(\$1.23)	(\$2.77)

COMPARISON OF METHODS

- Differences are magnified if A's interest is smaller
- Assume A contributes same property but receives 1% interest - UPREIT deal

COMPARISON OF METHODS

	<u>INCOME TO</u> <u>A</u>	<u>DEDUCTION TO</u> <u>REIT</u>
TRADITIONAL	\$0	(\$4)
CURATIVE	\$5.90	(\$9.90)
REMEDIAL	\$1.48	(\$5.48)

COMPARISON OF METHODS

- In general
 - Traditional method maximizes deferral for contributor, minimizes depreciation to non-contributor

COMPARISON OF METHODS

- In general
 - Curative allocation method minimizes deferral for contributor, maximizes depreciation to non-contributor
 - Remedial allocation method provides intermediate result

SECTION 752/704(c) INTERPLAY

- Nonrecourse liabilities allocated based on:
 - 704(b) minimum gain (first tier)
 - 704(c) minimum gain (second tier) -- See Rev. Rul. 95-41
 - Profits (third tier) -- See Rev. Rul. 95-41

SECTION 752/704(c) INTERPLAY

- **Choice of Section 704(c) method affects allocation of nonrecourse debt**
- **Under Rev. Rul. 95-41, remedial allocation method maximizes allocation of nonrecourse debt to contributor (under second tier)**

SECTION 752/704(c) INTERPLAY

- **10/31/00 Section 752 Regulation amendment now permits additional nonrecourse debt to be allocated to contributor under third tier**
- **Remedial allocation method therefore less appealing to contributor**

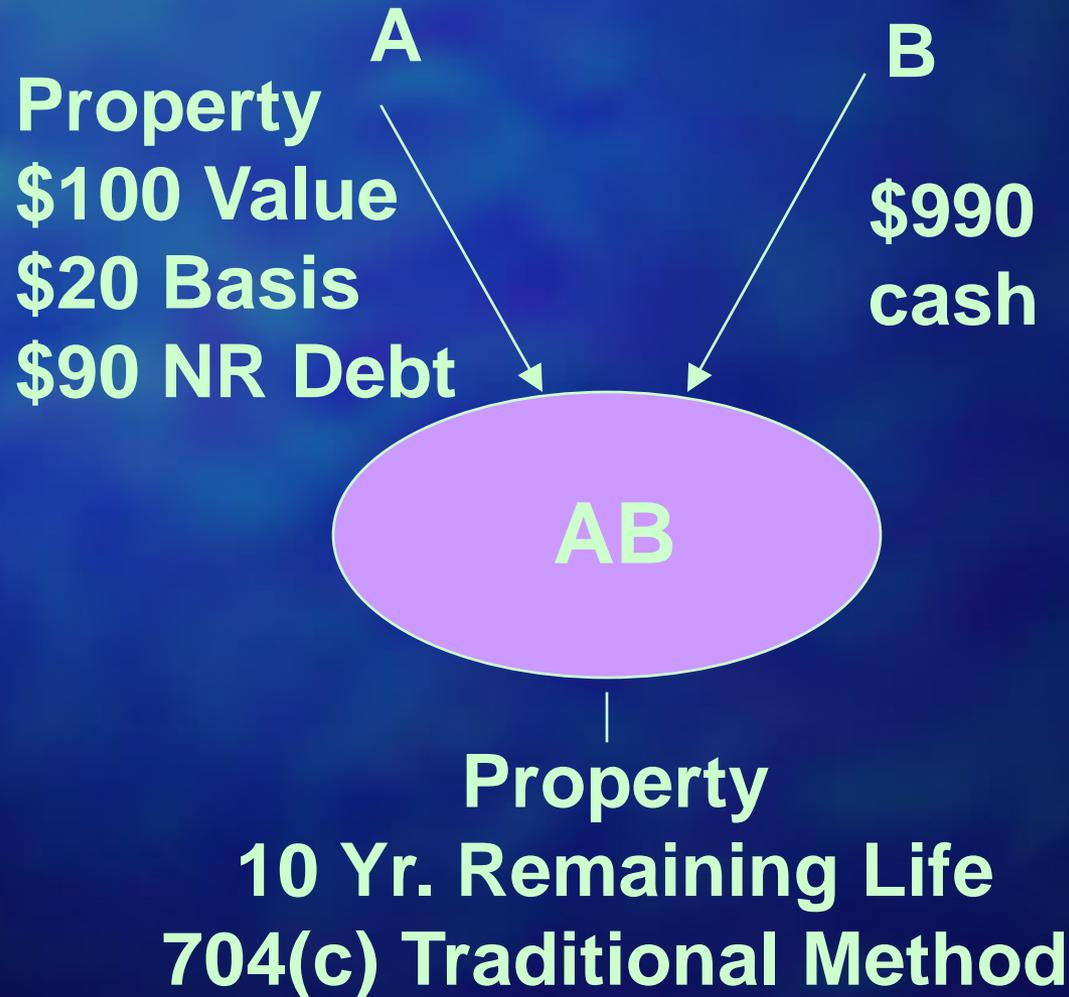
SECTION 704(c) BASICS

- At any time, remaining 704(c) gain is difference between book basis and tax basis
- 704(c) gain “burns off” over time

NEUTRALIZING SECTION 704(c)

- Assume A and B want to share \$4/year of tax depreciation equally
- Allocate book depreciation \$8/year to A, \$2/year to B
- Use gain on sale to equalize book capital accounts

SECTION 754 TRAP



SECTION 754 TRAP

UPON FORMATION

TAX

Prop. 20	Debt 90
Cash 990	
	(70) A
	990 B

BOOK

Prop. 100	Debt 90
Cash 990	
	10 A
	990 B

SECTION 754 TRAP

- **Nonrecourse liability allocation to A:**
 - **First tier: \$0**
 - **Second tier: \$70**
 - **Third tier: \$.20**
- **A's basis = \$.20 (\$20 - \$90 + \$70.20)**

SECTION 754 TRAP

After 1 Year - \$100 Income and \$5 Debt Reduction

- 704(c) gain = \$72 (\$90 - \$18)
- Nonrecourse liability allocation to A:
 - First tier: \$0
 - Second tier: \$67 (\$85 - \$18)
 - Third tier: \$.18

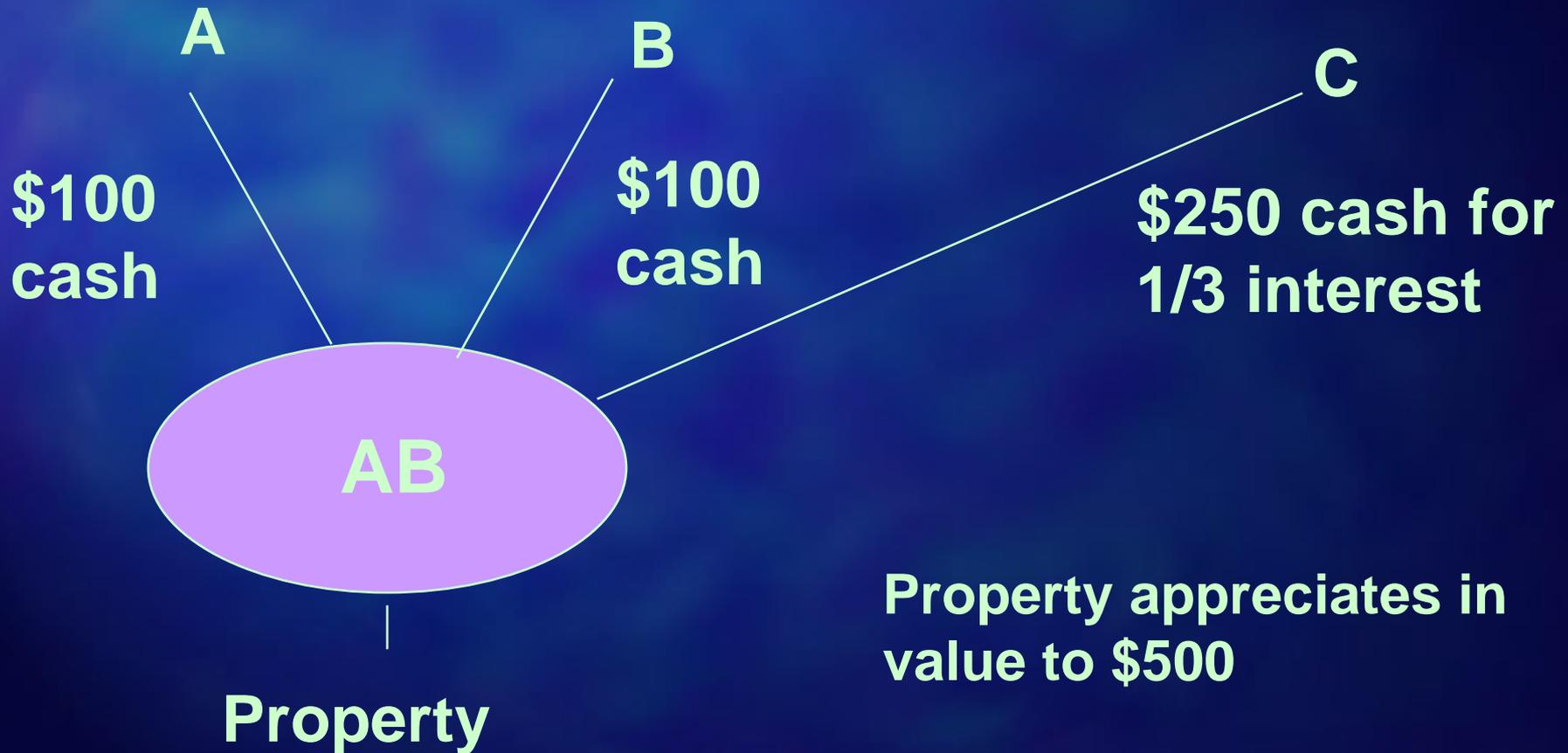
SECTION 754 TRAP

- Reduction in A's share of debt is \$3.02
- A's basis before was \$1.20 (\$.20 + \$1.00 income)
- A recognizes \$1.82 gain
- 754/734(b) step-up of \$1.82

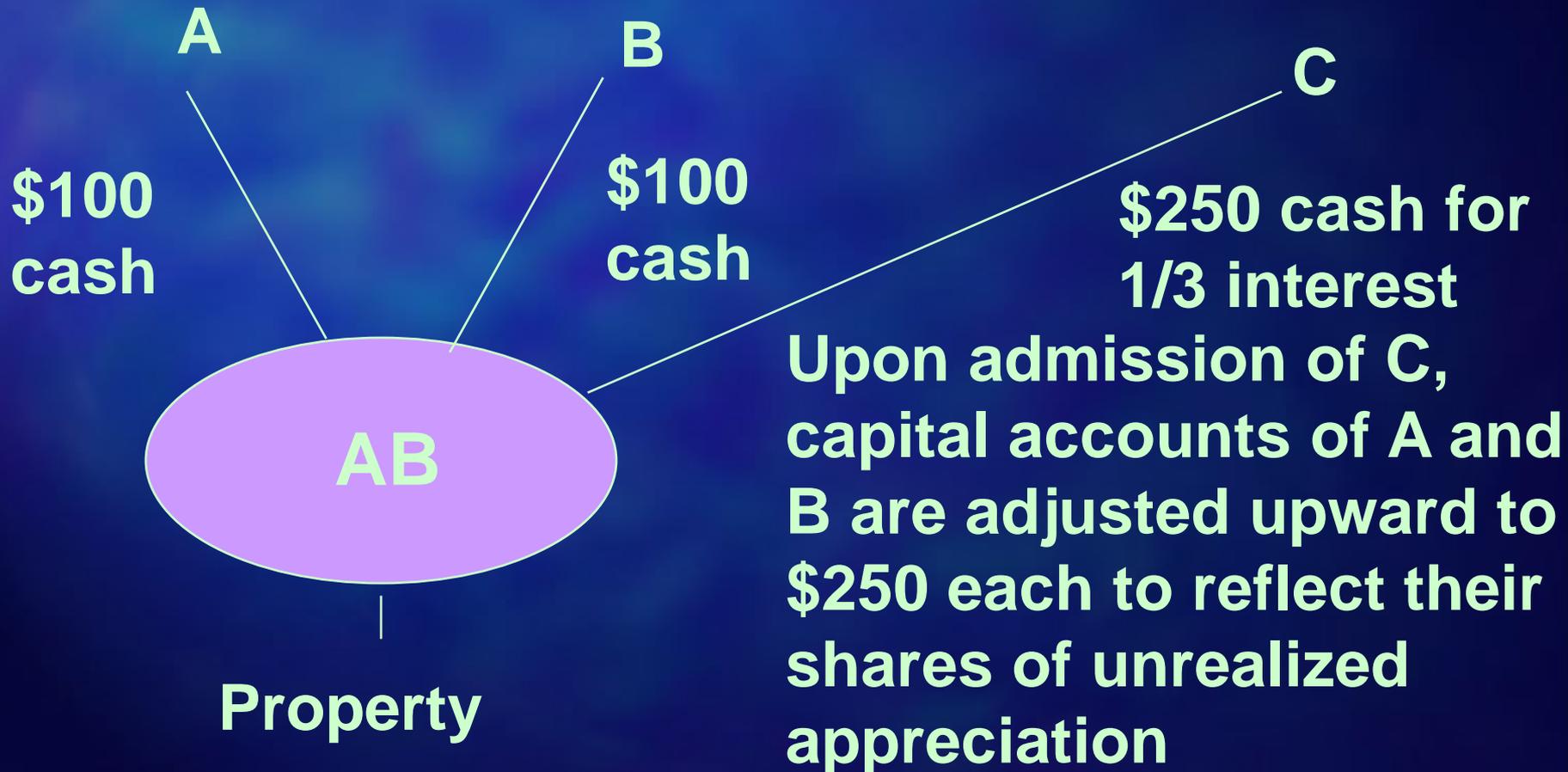
SECTION 754 TRAP

- **Step-up reduces 704(c) minimum gain**
- **Further reduction in liability triggers more gain**
- **Additional gain results in basis step up**
- **Step-up again reduces A's 704(c) gain and second tier liability allocation**

PROPERTY CONTRIBUTIONS AND BOOK-UPS



PROPERTY CONTRIBUTIONS AND BOOK-UPS



PROPERTY CONTRIBUTIONS AND BOOK-UPS

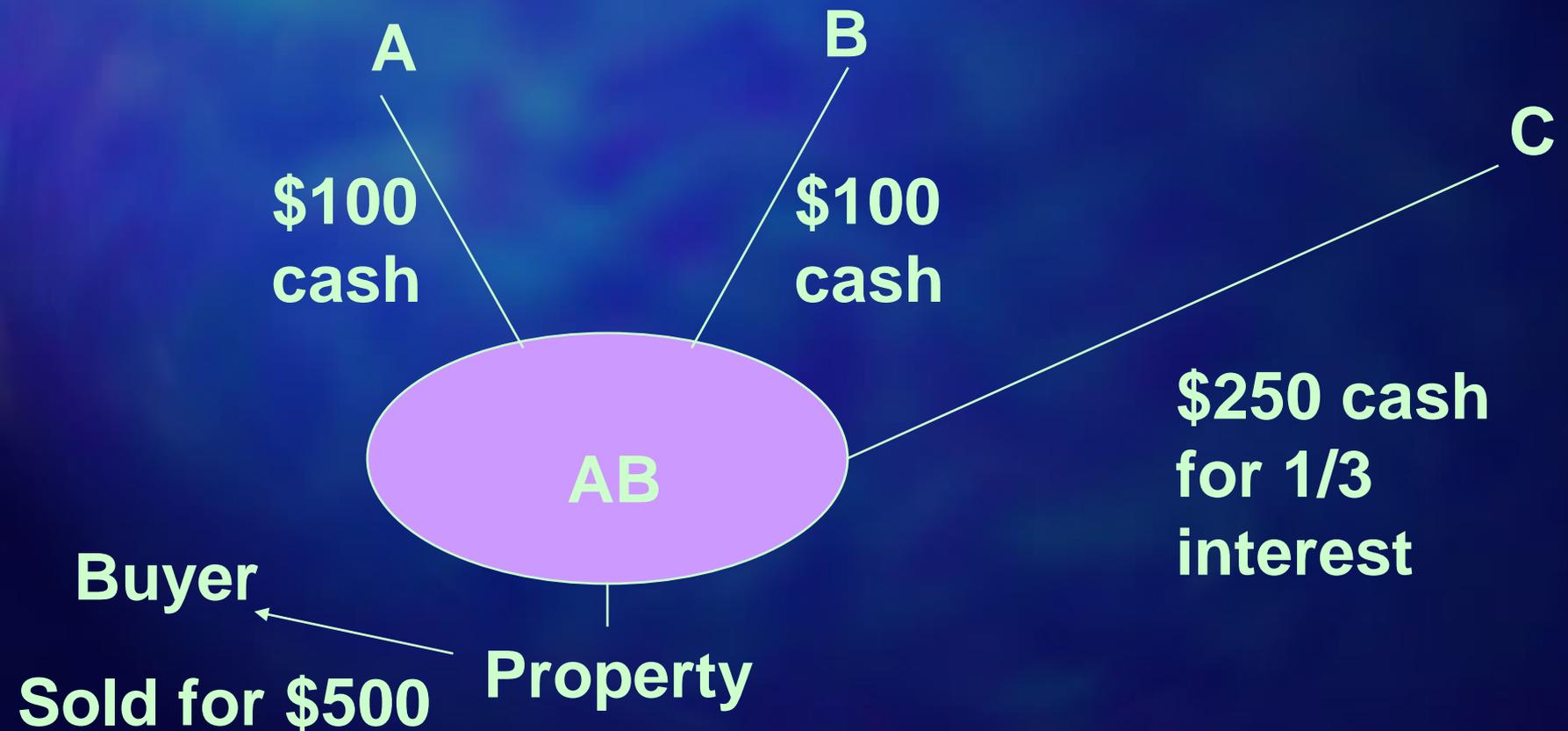
AB's balance sheet on formation:

Asset	Book	Tax	Partner	Book	Tax
Cash	\$200	\$200	A	\$100	\$100
			B	\$100	\$100

AB's balance sheet after purchase of property and admission of C:

Asset	Book	Tax	Partner	Book	Tax
Prop.	\$500	\$200	A	\$250	\$100
Cash	\$250	\$250	B	\$250	\$100
			C	\$250	\$250

PROPERTY CONTRIBUTIONS AND BOOK-UPS



PROPERTY CONTRIBUTIONS AND BOOK-UPS

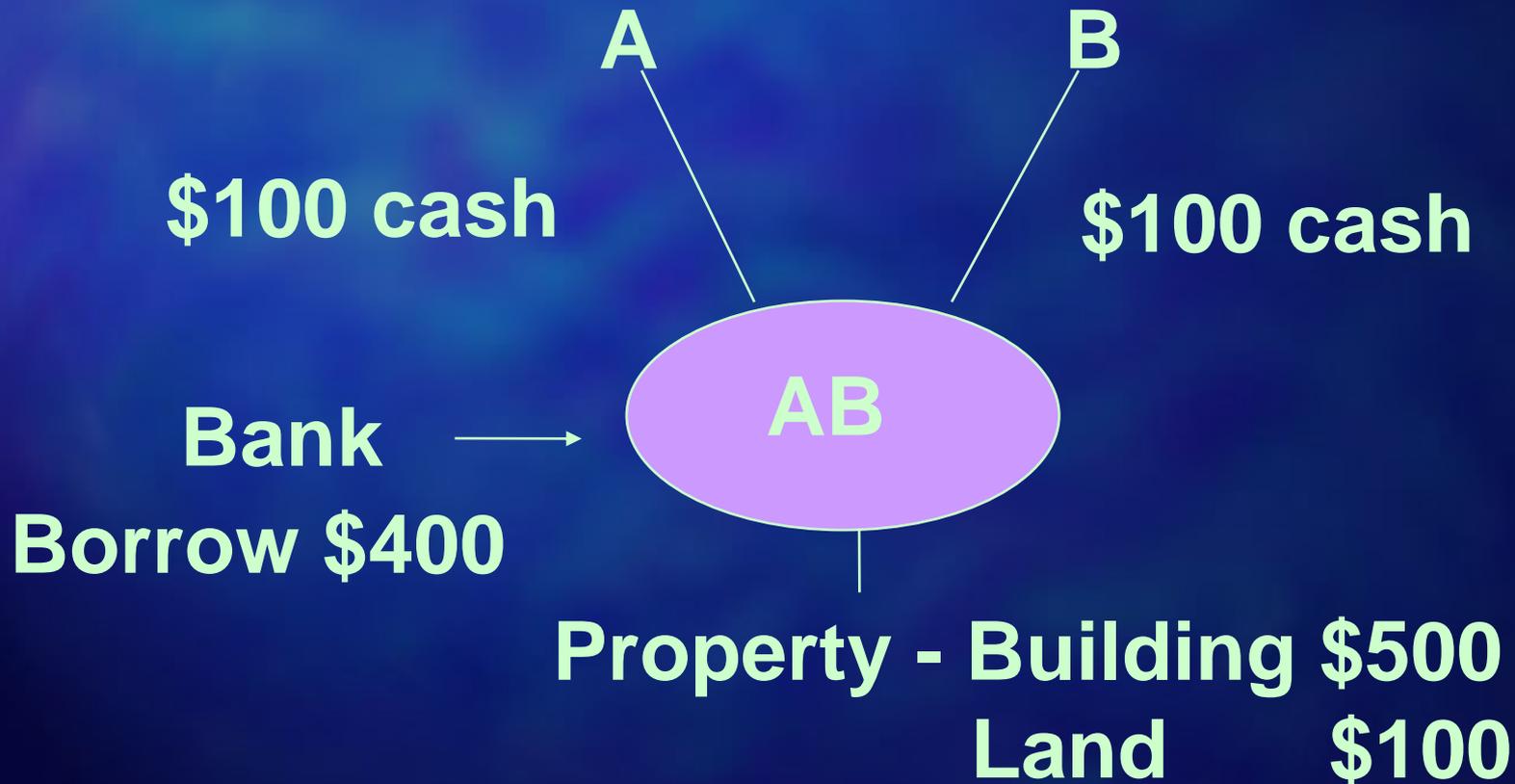
- Amount Realized on sale of Property \$500
- Book Gain Zero (\$500 amount realized minus \$500 book basis)
- Tax Gain \$300 (\$500 amount realized minus \$200 tax basis)
- Tax Gain allocated equally to A and B - \$150 each ("built-in gain" inherent in Property at time C admitted)

PROPERTY CONTRIBUTIONS AND BOOK-UPS

Theory for “reverse” section 704(c)
allocations:

- Partners should be in no different position as a result of C’s admission than if AB had contributed property to a newly formed partnership with C.

BOOK UPS AND NONRECOURSE DEBT



BOOK UPS AND NONRECOURSE DEBT

AB's balance sheet after purchase of property:

Asset	Book	Tax	Liability	Book	Tax
Building	\$500	\$500		\$400	\$400
Land	\$100	\$100	Partner		
			A	\$100	\$100
			B	\$100	\$100

BOOK UPS AND NONRECOURSE DEBT

- Depreciation deductions of \$450 allocated disproportionately
 - A \$350
 - B \$100
- Assume allocations are respected under Section 704(b)

BOOK UPS AND NONRECOURSE DEBT

AB's balance sheet after depreciation deductions:

Asset	Book	Tax
Building	\$ 50	\$ 50
Land	\$100	\$100

Liability	Book	Tax
Debt	\$400	\$400
Partner		
A	(\$250)	(\$250)
B	\$ 0	\$ 0

BOOK UPS AND NONRECOURSE DEBT

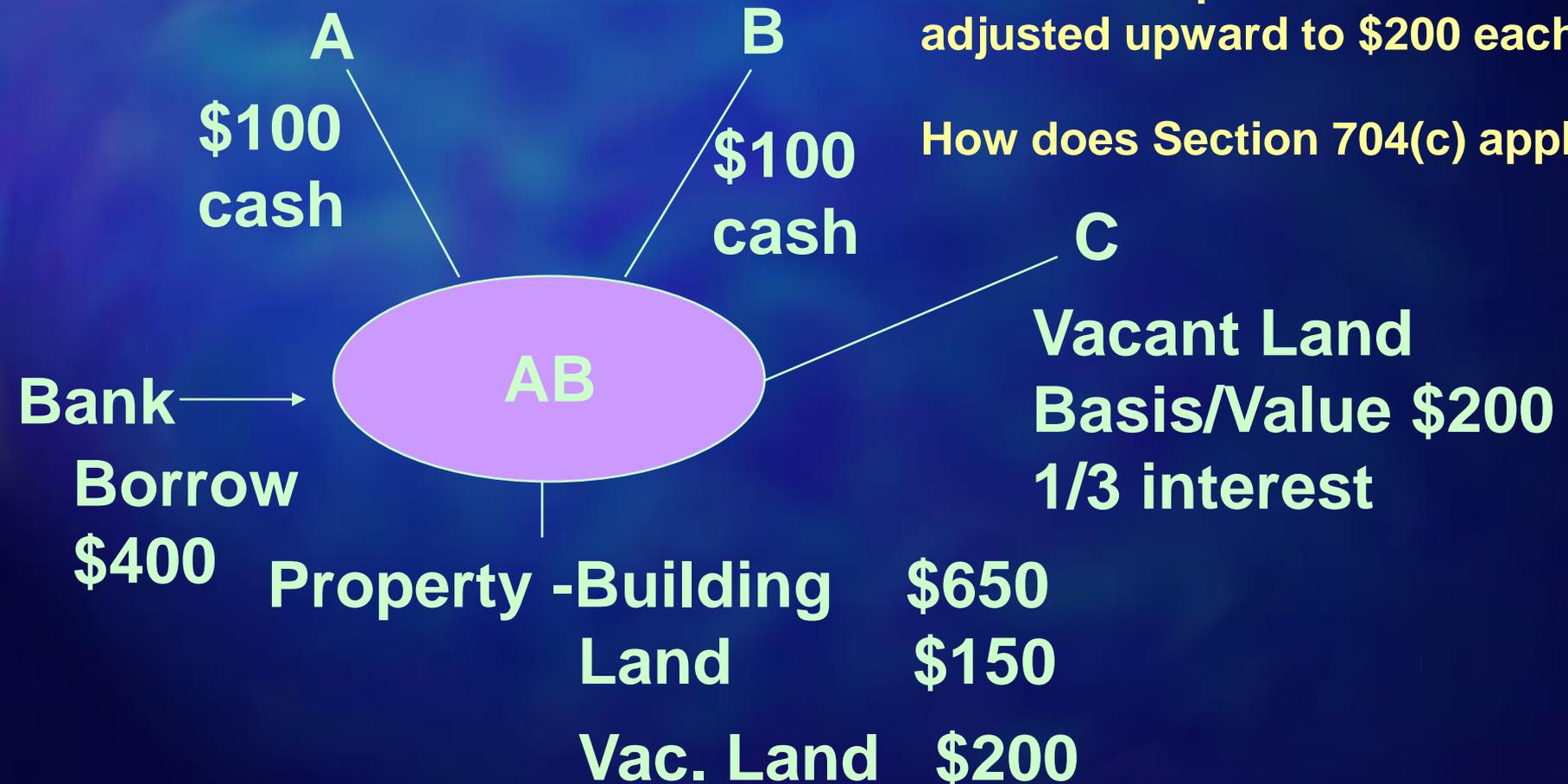


Building appreciates to \$650 and Land appreciates to \$150

BOOK UPS AND NONRECOURSE DEBT

A and B's capital accounts are adjusted upward to \$200 each .

How does Section 704(c) apply?



BOOK UPS AND NONRECOURSE DEBT

AB's balance sheet after admission of C and book-up:

Asset	Book	Tax	Liability	Book	Tax
Building	\$650	\$ 50	Debt	\$400	\$400
Land	\$150	\$100	Partner		
Vacant Land	\$200	\$200	A	\$200	(\$250)
			B	\$200	\$ 0
			C	\$200	\$200

BOOK UPS AND NONRECOURSE DEBT

- A and B are equal partners - Should they each be deemed to contribute half of each asset?

	<u>Basis</u>	<u>Value</u>	<u>BIG</u>
A	\$75	\$400	\$325
B	\$75	\$400	\$325

If sell assets for \$800, pay off debt \$400, A and B both allocated gain of \$325

BOOK UPS AND NONRECOURSE DEBT

- A and B are equal partners - Should they each be deemed to contribute half of each asset?

	<u>Basis</u>	<u>Value</u>	<u>BIG</u>
A	\$75	\$400	\$325
B	\$75	\$400	\$325

Upon liquidation, \$200 cash distributed to each of A, B and C and A recognizes \$125 gain, B recognizes (\$125) loss

BOOK UPS AND NONRECOURSE DEBT

SHARE OF LIABILITIES PRIOR TO C'S ADMISSION

	A	B
First tier allocation		
partnership minimum gain	\$250	zero
Second tier allocation		
section 704(c) min. gain	zero	zero
Third tier allocation		
remaining liabilities	\$75	\$75
Total	\$325	\$75

BOOK UPS AND NONRECOURSE DEBT

LIABILITIES AFTER C'S ADMISSION - EQUAL BIG

	A	B	C
First tier allocation partnership minimum gain	zero	zero	zero
Second tier allocation section 704(c) min. gain	\$125	\$125	zero
Third tier allocation remaining liabilities	\$ 50	\$ 50	\$ 50
Total	\$175	\$175	\$ 50

BOOK UPS AND NONRECOURSE DEBT

- A's tax basis negative capital account is (\$250)
- If A and B are each deemed to contribute undivided 1/2 interest in assets, A's share of debt is only \$175 - A recognizes \$75 gain

BOOK UPS AND NONRECOURSE DEBT

FMV of assets deemed contributed
= share of partnership's liabilities
+ post book-up capital account

Basis in assets
= tax basis capital account
+ share of partnership's liabilities

	<u>FMV</u>	<u>Basis</u>
A	$\$525 = \$325 + \$200$	$\$75 = (\$250) + \$325$
B	$\$275 = \$75 + \$200$	$\$75 = 0 + \75

BOOK UPS AND NONRECOURSE DEBT

A and B deemed to contribute following basis and value:

	Basis	FMV	Debt	BIG
A	\$75	\$525	\$325	\$450
B	\$75	\$275	\$75	\$200

Issue: How is this basis and value allocated among the assets on AB's balance sheet?

BOOK UPS AND NONRECOURSE DEBT

Approach 1: Allocate basis and value by percentage of total value of AB's assets each is deemed to contribute.

	<u>Basis</u>	<u>Value</u>	<u>Built-In Gain</u>
A's Undivided Interest in Building	\$ 32.81	\$426.56	\$393.75
A's Undivided Interest in Land	65.62	98.44	32.82
B's Undivided Interest in Building	17.19	223.44	206.25
B's Undivided Interest in Land	34.38	51.56	17.18

BOOK UPS AND NONRECOURSE DEBT

Approach 2: Allocate basis and value each deemed to contribute based on the relative basis and value of assets.

	Basis	Value	Built-In Gain
A's Undivided Interest in Building	\$ 25	\$426.56	\$401.56
A's Undivided Interest in Land	50	98.44	48.44
B's Undivided Interest in Building	25	223.44	198.44
B's Undivided Interest in Land	50	51.56	1.56

BOOK UPS AND NONRECOURSE DEBT

Approach 3: Allocate basis among AB's assets based on the relative asset bases, allocate value in a manner that forces \$450 of BIG in Building to equal earlier depreciation allocation.

	Basis	Value	Built-In Gain
A's Undivided Interest in Building	\$ 25	450	\$425
A's Undivided Interest in Land	50	75	25
B's Undivided Interest in Building	25	200	175
B's Undivided Interest in Land	50	75	25

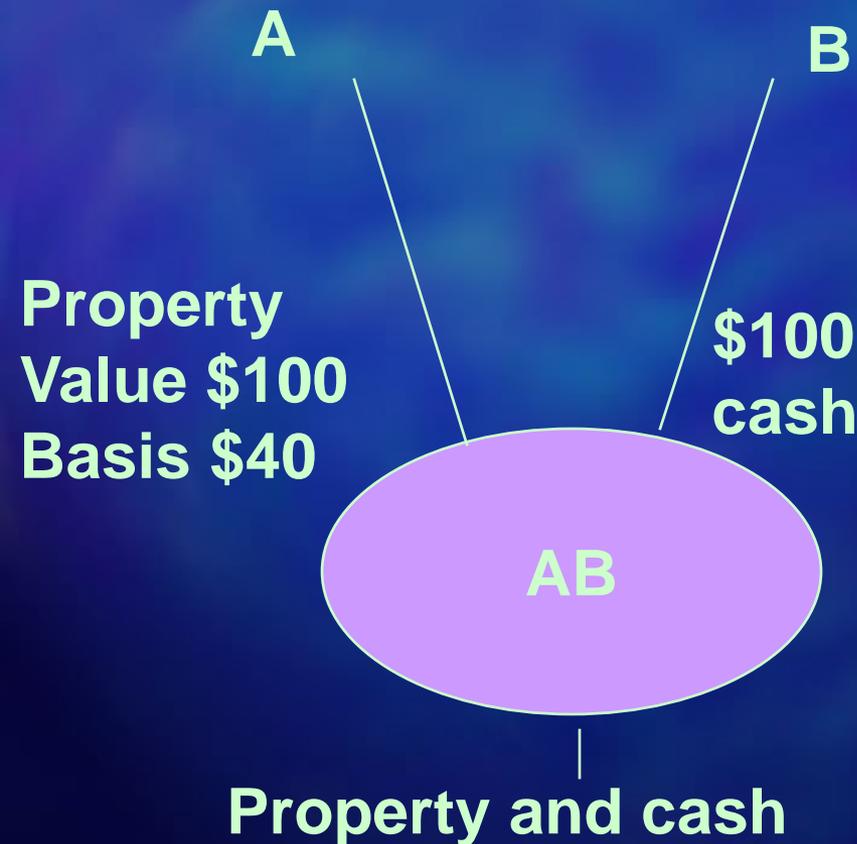
BOOK UPS AND NONRECOURSE DEBT

Approach 1 distorts inside and outside basis and BIG

Approach 2 preserves each partner's BIG but overstates or understates respective BIG in Land and Building

Approach 3 preserves BIG and takes into account earlier disproportionate depreciation deductions on Building

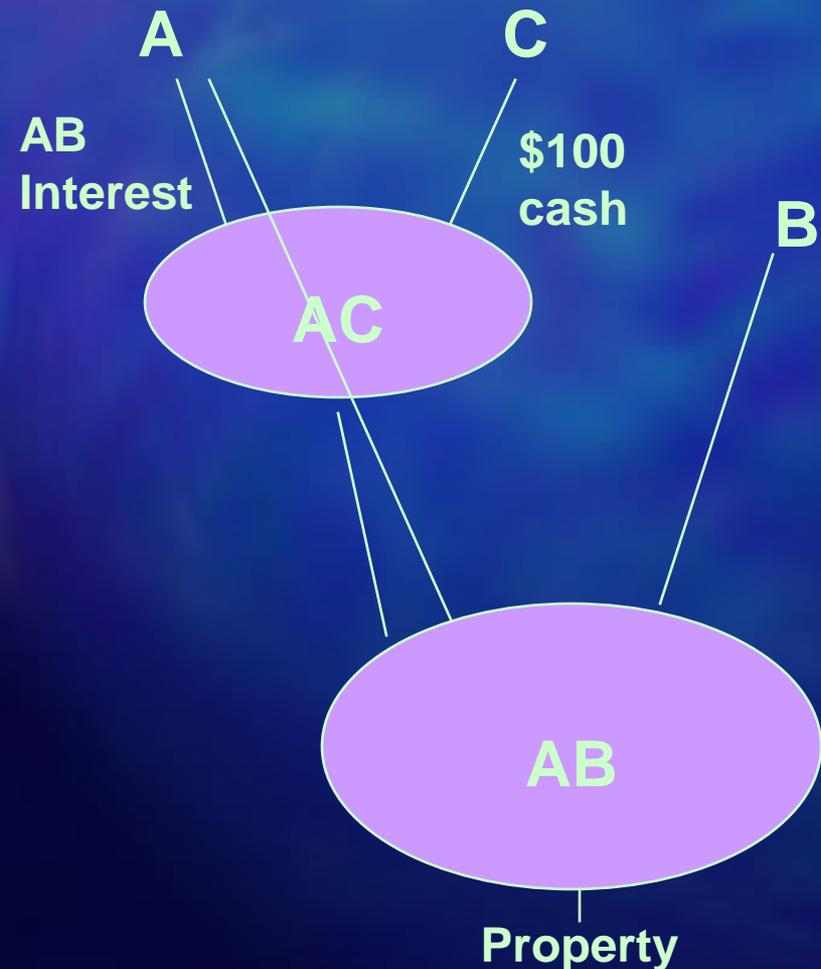
TIERED PARTNERSHIPS: REGULATORY GUIDANCE



AB's balance sheet:

Asset	Book	Tax	Partner	Book	Tax
Property	\$100	\$ 40			
Cash	\$100	\$100			
			A	\$100	\$40
			B	\$100	\$100

TIERED PARTNERSHIPS: REGULATORY GUIDANCE

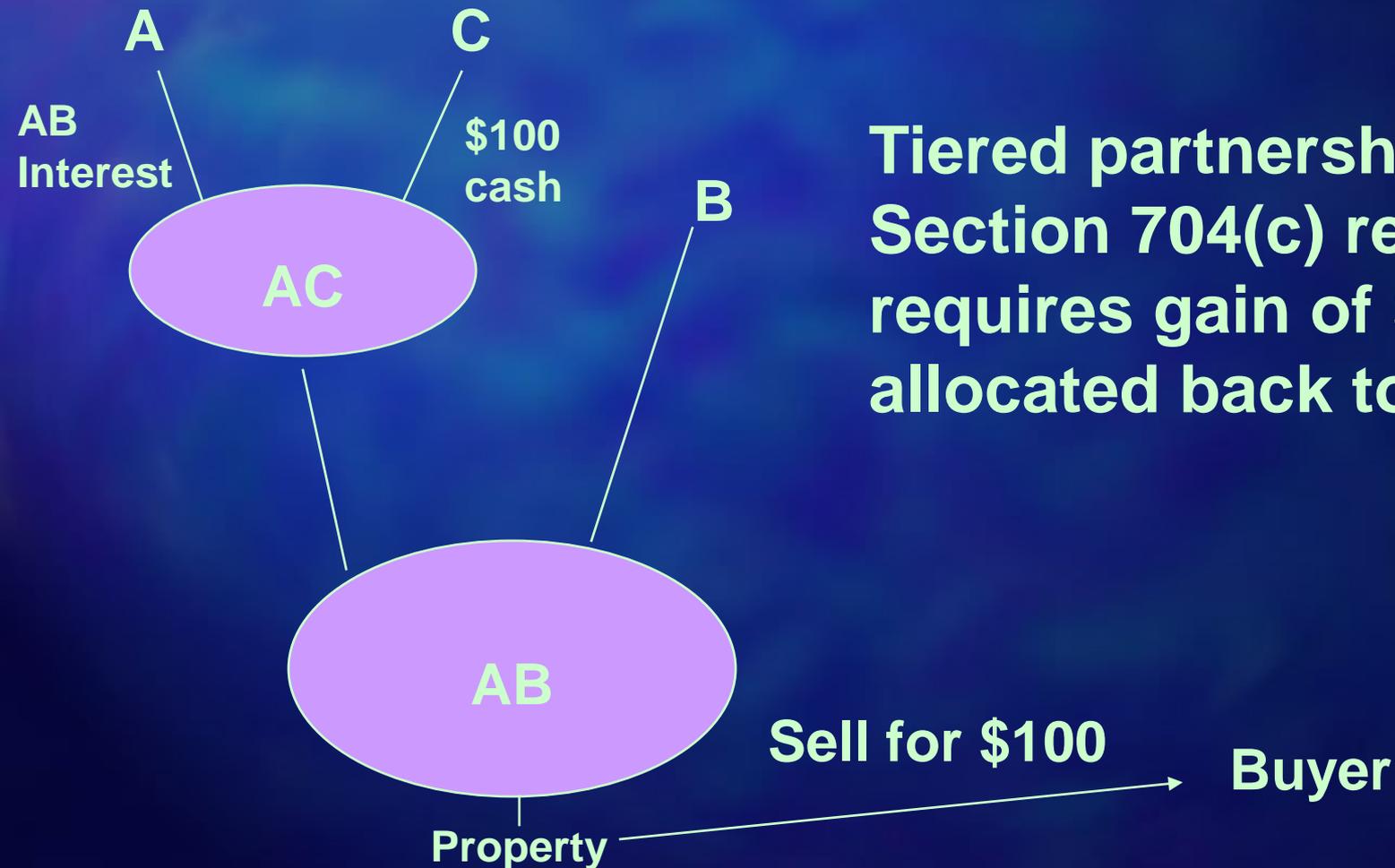


AC's balance sheet:

Asset	Book	Tax	Partner	Book	Tax
AB Interest	\$100	\$ 40			
Cash	\$100	\$100			
			A	\$100	\$40
			C	\$100	\$100

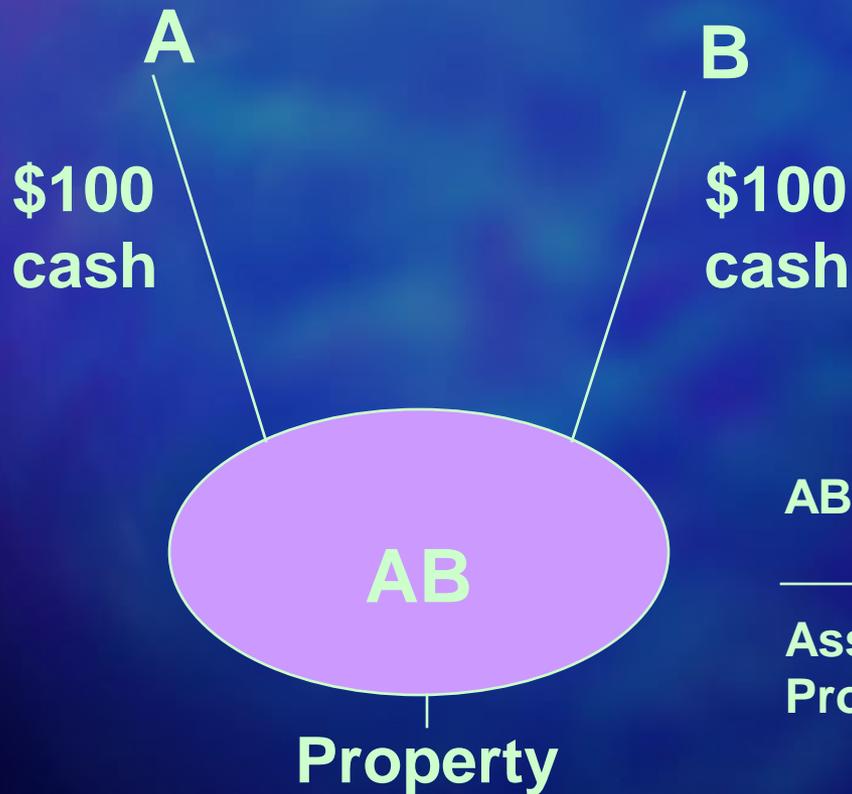
**AB Interest constitutes
section 704(c) property**

TIERED PARTNERSHIPS: REGULATORY GUIDANCE



Tiered partnership rule in Section 704(c) regulations requires gain of \$60 to be allocated back to A

TIERED PARTNERSHIPS: NO 704(c) GAIN IN ASSETS

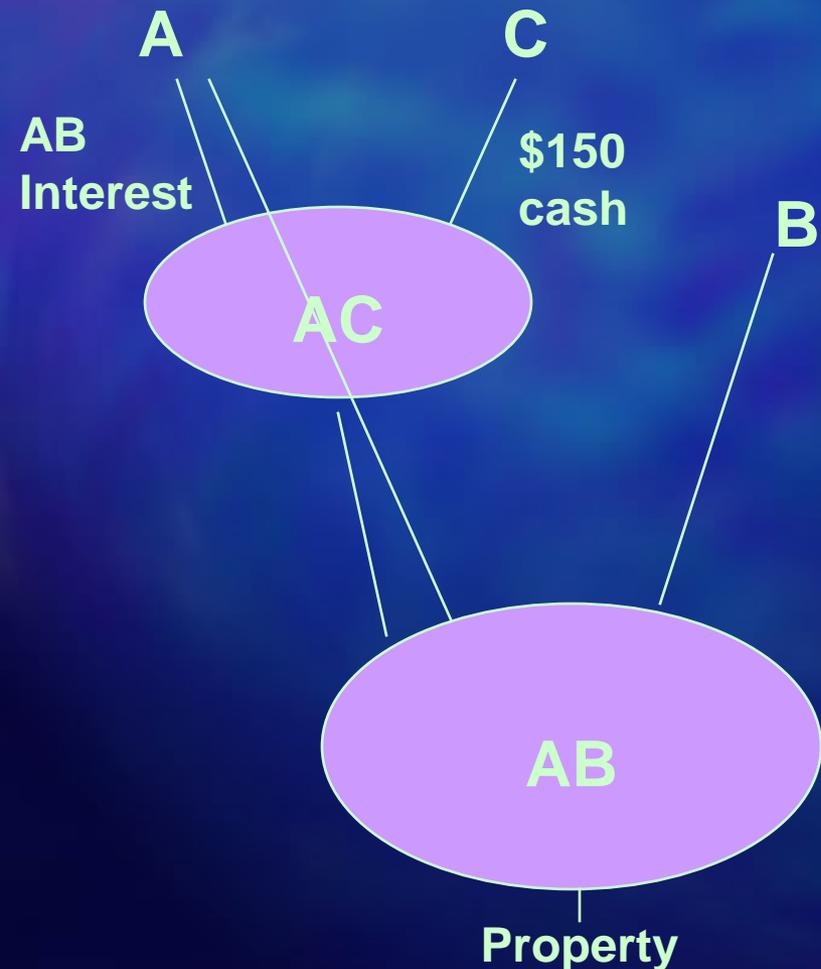


Property appreciates in value to \$300

AB's balance sheet:

Asset	Book	Tax	Partner	Book	Tax
Property	\$200	\$200	A	\$100	\$100
			B	\$100	\$100

TIERED PARTNERSHIPS: NO 704(c) GAIN IN ASSETS



AC's balance sheet:

Asset	Book	Tax	Partner	Book	Tax
AB Interest					
Interest	\$150	\$100			
Cash	\$150	\$150			
			A	\$150	\$100
			C	\$150	\$150

AB Interest constitutes section 704(c) property

TIERED PARTNERSHIPS: NO 704(c) GAIN IN ASSETS

- **704(c) Regulations do not require AC to allocate its distributive share of items from AB in a manner that takes into account BIG in AB's assets at the time of contribution of AB interest to AC**

TIERED PARTNERSHIPS: NO 704(c) GAIN IN ASSETS

- If AB sells Property for \$300 and liquidates:
- Taxable gain \$100 allocable equally \$50 to AC and B
- Absent 704(c) - AC allocates \$25 of gain to A and C

TIERED PARTNERSHIPS: NO 704(c) GAIN IN ASSETS

- **Result is shifting of gain from A to C
A undertaxed \$25; C overtaxed \$25**
- **Although regulations don't require
application of 704(c), should be permitted
to apply because to do so is reasonable**

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