Implications of Section 704(c) for Partnership Agreements

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Poll: 1. Under the Treasury regulations, which method is reasonable for purposes of making section 704(c) allocations?

Section 704(c) Basics

- **Section 704(c) governs tax allocations**
- **Section 704(c) applies when a partner contributes to a partnership property with built-in gain (BIG) or built-in loss (BIL)**
  - BIG or BIL is the difference between the tax basis of the property and its Section 704(b) book value
  - As depreciable property is depreciated, the gap between tax basis and book value diminishes and BIG/BIL is reduced. BIG/BIL is eliminated when property is fully depreciated
- **Section 704(c) requires the partnership to make allocations of income, gain, loss or expense so that the BIG/BIL in contributed property is borne by the contributing partner, and is not shifted to the non-contributing partner**
- **Section 704(c) achieves this result by allocating**
  - MORE tax gain to the contributing partner
  - LESS tax depreciation to the contributing partner
- **Section 704(c) allocations are intended to put the non-contributing partner in the position it would have been in had the contributed property had a FMV basis at the time of contribution**

Ceiling Rule

Ceiling Rule: A partnership may not allocate to the partners more of any item than the partnership has actually realized

The effect of the ceiling rule is to shift BIG/BIL from the contributing partner to the non-contributing partner

This shift of BIG/BIL will generally be reversed when the partnership liquidates

However, the reversal is not always as valuable as the item limited by the ceiling rule:

- Reversal on liquidation far in future has lower time value
- Gain/loss on liquidation is generally capital, which might be less valuable or hard to use

Ceiling Rule

The Section 704(c) regulations provide three alternative methods for addressing the ceiling rule:

Traditional Method:	Incorporates the ceiling rule
Curative Method:	Allows special allocations of similar actual tax items to counteract the ceiling rule
Remedial Method:	Allows special allocations of similar notional tax items to counteract the ceiling rule

Traditional Method

Depreciation of section 704(c) property:

- Allocate to the non-contributing partner the same amount of tax depreciation as book depreciation, subject to the ceiling rule
- Allocate remaining tax depreciation (if any) to contributing partner

Gain or loss on sale of section 704(c) property:

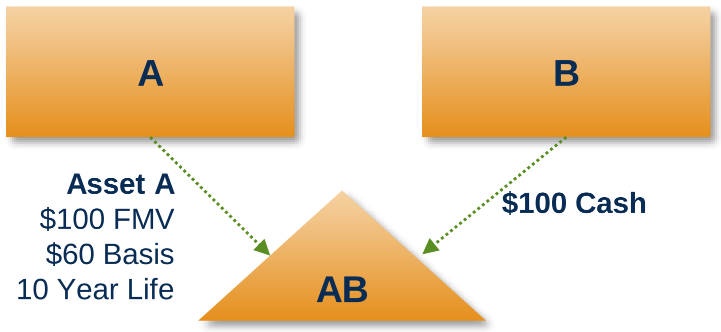
- Allocate to the contributing partner tax gain/loss equal to the BIG/BIL remaining at the time of sale, subject to the ceiling rule
- Allocate remaining tax gain/loss to partners based on partnership agreement

Traditional method allocations are limited by the ceiling rule:

- If the partnership’s tax depreciation, gain or loss is not sufficient to make the traditional method allocations described above, no further adjustment is allowed

Traditional Method – Depreciation

Example 1: Ceiling Rule does not apply



The opening book capital accounts and tax basis are:

	Book			Tax		
	A	B	Total	A	B	Total
Asset A	50	50	100	60	0	60
Cash	50	50	100	0	100	100
Total -- Beginning of Year 1	100	100	200	60	100	160

$40 of BIG at time of contribution

Traditional Method – Depreciation

Example 1 (cont'd)

Asset A will generate $100 of book depreciation and $60 of tax depreciation over its 10-year life

- Allocate to B the same amount of tax depreciation as book depreciation
- Allocate remaining tax depreciation to A

	Book			Tax		
	A	*B*	*Total*	*A*	*B*	*Total*
Beginning of Year 1	100	100	200	60	100	160
Allocate Book Depreciation (Yrs 1-10)	(50)	(50)	(100)			0
Allocate to B Tax up to Book					(50)	(50)
Allocate Remaining Tax to A				(10)		(10)
End of Year 10	50	50	100	50	50	100

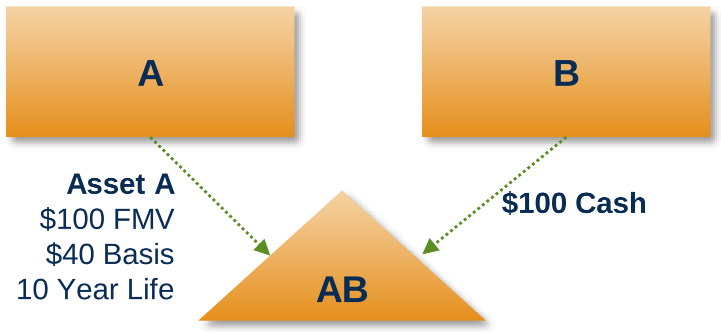
Equal book capital account and tax basis

Ceiling rule does not apply because total tax depreciation ($60) exceeds B's book depreciation ($50)

B's book capital account and tax basis are equal ($50), which indicates that no BIG has been shifted to B

Traditional Method – Depreciation

Example 2: Ceiling Rule applies



The opening book capital accounts and tax basis are:

	Book			Tax		
	A	B	Total	A	B	Total
Asset A	50	50	100	40	0	40
Cash	50	50	100	0	100	100
Total -- Beginning of Year 1	100	100	200	40	100	140

$60 of BIG at time of contribution

Traditional Method – Depreciation

Example 2 (cont'd)

Asset A will generate $100 of book depreciation and $40 of tax depreciation over its 10-year life

- Allocate to B the same amount of tax depreciation as book depreciation
- Allocate remaining tax depreciation to A

	Book			Tax		
	A	*B*	*Total*	*A*	*B*	*Total*
Beginning of Year 1	100	100	200	40	100	140
Allocate Book Depreciation (Yrs 1-10)	(50)	(50)	(100)			
Allocate to B Tax up to Book					(40)	(40)
Allocate Remaining Tax to A				0		0
End of Year 10	50	50	100	40	60	100

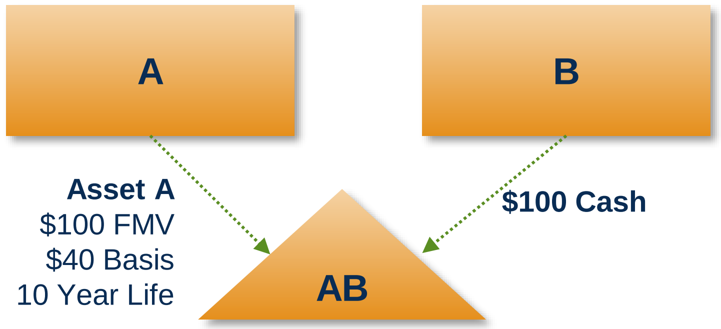
Ceiling Rule shifts $10 of BIG to B

Ceiling rule applies because total tax depreciation ($40) is less than B's book depreciation ($50)

B's tax basis is $10 more than its book capital account, indicating that $10 of BIG has been shifted to B over 10 years ($1/year)

Traditional Method – Sale

Example 3: Ceiling Rule does not apply to sale of Asset A for $100



At the end of Year 1 the partners' book capital accounts and tax basis are:

	Book			Tax		
	A	*B*	*Total*	*A*	*B*	*Total*
Beginning of Year 1	100	100	200	40	100	140
Depreciation Year 1	(5)	(5)	(10)	0	(4)	(4)
End of Year 1	95	95	190	40	96	136

$1 of BIG shifted in Year 1 due to ceiling rule

At the end of Year 1 the book value, tax basis and BIG in Asset A are:

	Book	Tax	BIG
Beginning of Year 1	100	40	60
Depreciation Year 1	(10)	(4)	(6)
End of Year 1	90	36	54

Traditional Method – Sale

Example 3 (cont'd)

At the beginning of Year 2 Partnership AB sells Asset A for $100

- Book Gain = $10 = $100 - $90 book value
- Tax Gain = $64 = $100 - $36 tax basis
- Remaining BIG = $54 = $90 - $36

	Book			Tax		
	A	*B*	*Total*	*A*	*B*	*Total*
Beginning of Year 2	95	95	190	40	96	136
Allocate Book Gain	5	5	10			
Allocate to A Tax Gain up to BIG				54		54
Allocate Remaining Tax per Psh Agr				5	5	10
Total After Sale	100	100	200	99	101	200

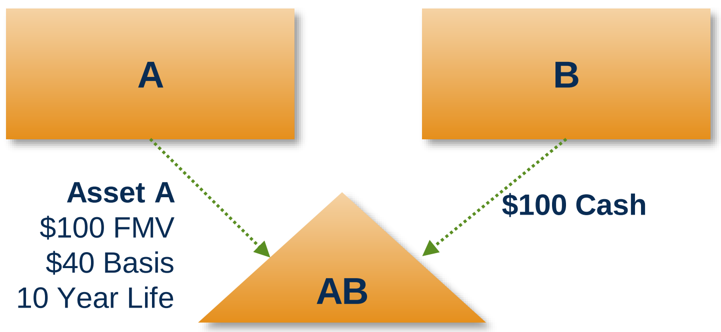
$1 of BIG shifted in Year 1 has not been reversed

Ceiling rule did not apply to the allocation of gain on sale

But note that the $1 shift in BIG due to the ceiling rule limit on depreciation in Year 1 still exists because 704(c) allocation of sale gain is limited to BIG remaining at time of sale, not original BIG

Traditional Method – Sale

Example 4: Ceiling Rule applies to sale of Asset A for $80



At the end of Year 1 the partners' book capital accounts and tax basis are:

	Book			Tax		
	A	*B*	*Total*	*A*	*B*	*Total*
Beginning of Year 1	100	100	200	40	100	140
Depreciation Year 1	(5)	(5)	(10)	0	(4)	(4)
End of Year 1	95	95	190	40	96	136

$1 of BIG shifted in Year 1 due to ceiling rule

At the end of Year 1 the book value, tax basis and BIG in Asset A are:

	Book	Tax	BIG
Beginning of Year 1	100	40	60
Depreciation Year 1	(10)	(4)	(6)
End of Year 1	90	36	54

Traditional Method – Sale

Example 4 (cont'd)

At the beginning of Year 2 Partnership AB sells Asset A for $80

- Book Gain (Loss) = $(10) = $80 - $90 book value
- Tax Gain = $44 = $80 - $36 tax basis
- BIG = $54 = $90 - $36

	Book			Tax		
	A	*B*	*Total*	*A*	*B*	*Total*
Beginning of Year 2	95	95	190	40	96	136
Allocate Book Gain (Loss)	(5)	(5)	(10)			
Allocate to A Tax Gain up to BIG				44		44
Allocate Remaining Tax per Psh Agr				0	0	0
Total After Sale	90	90	180	84	96	180

$6 of BIG shifted to B

Ceiling rule limited allocation of gain on sale

Ceiling rule shifted $6 of BIG from A to B – $1 due to depreciation in Year 1 and $5 due to taxable gain in Year 2

Said differently, B has suffered an economic loss of $10 but only gets $4 of tax loss

Curative Method

Curative method allows special allocations of similar actual tax items to counteract the ceiling rule limit under the traditional method

Curative allocations can be made only of *existing* income, expense, etc. of the partnership

Curative method affects tax allocations, but not book income or book capital accounts

The curative item must generally be of the same character as the item limited by the ceiling rule

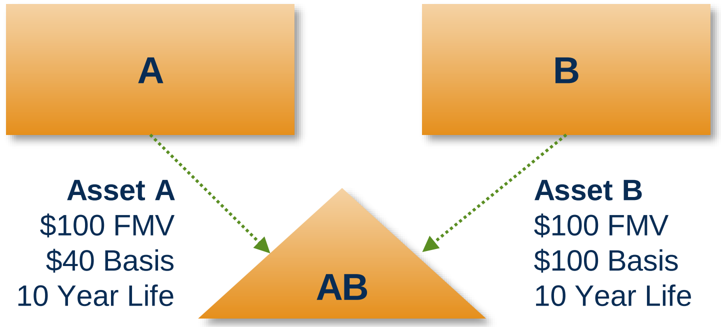
- For depreciation, items of the same character include ordinary income and ordinary expense
- However, gain on sale may be used to cure depreciation limited by the ceiling rule

Curative method cures ceiling rule limit over the remaining life of the Section 704(c) property

If there are insufficient similar items to cure the ceiling rule limit, then no further adjustments are permitted

Curative Method – Depreciation

<u>Example 5</u>: Curative method reverses ceiling rule limit



The partners' opening capital accounts and tax basis are:

	Book			Tax		
	A	B	Total	A	B	Total
Asset A	50	50	100	40	0	40
Asset B	50	50	100	0	100	100
Total -- Beginning of Year 1	100	100	200	40	100	140

Assets A and B will generate the following book and tax amounts over 10 years:

	Asset A			Asset B		
	Book	Tax	BIG	Book	Tax	BIG
Beginning of Year 1	100	40	60	100	100	0
Depreciation Years 1-10	(100)	(40)	(60)	(100)	(100)	0
End of Year 10	0	0	0	0	0	0

Curative Method – Depreciation

Example 5 (cont'd)

The traditional method ceiling rule limits B's allocation of tax depreciation on Asset A to $40, which is $10 less than B's book depreciation on Asset A

Curative method: Partnership AB can specially allocate $10 of depreciation on Asset B (or similar items) from A to B to "cure" the shortfall:

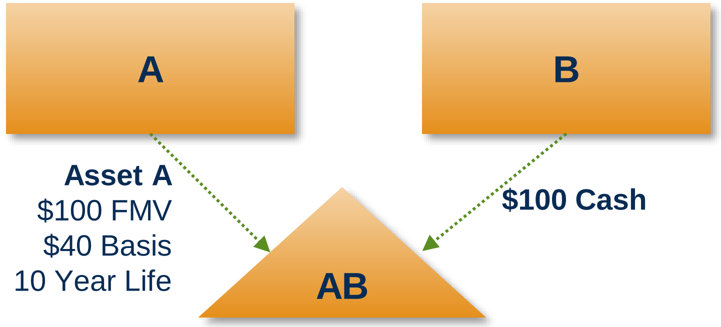
	Book			Tax		
	A	*B*	*Total*	*A*	*B*	*Total*
Beginning of Year 1	100	100	200	40	100	140
Depreciation Years 1-10						
Asset A	(50)	(50)	(100)	0	(40)	(40)
Asset B	(50)	(50)	(100)	(40)	(60)	(100)
End of Year 10	0	0	0	0	0	0

$10 curative allocation from A to B

The fact that B's capital account and tax basis are equal ($0) indicates that the ceiling rule limit has been fully cured

Curative Method – Sale

Example 6: Curative method reverses ceiling rule limit



At the end of Year 1 the partners' book capital accounts and tax basis are:

	Book			Tax		
	A	*B*	*Total*	*A*	*B*	*Total*
Beginning of Year 1	100	100	200	40	100	140
Depreciation Year 1	(5)	(5)	(10)	0	(4)	(4)
End of Year 1	95	95	190	40	96	136

$1 of ceiling rule limitation on depreciation allocation

At the end of Year 1 the book value, tax basis and BIG in Asset A are:

	Book	Tax	BIG
Beginning of Year 1	100	40	60
Depreciation Year 1	(10)	(4)	(6)
End of Year 1	90	36	54

Curative Method – Sale

Example 6 (cont'd)

At the beginning of Year 2 Partnership AB sells Asset A for $100

- Book Gain = $10 = $100 - $90 book value
- Tax Gain = $64 = $100 - $36 tax basis
- BIG = $54 = $90 - $36

	Book			Tax		
	A	*B*	*Total*	*A*	*B*	*Total*
Beginning of Year 2	95	95	190	40	96	136
Allocate tax gain up to BIG	0	0	0	54	0	54
Allocate remaining tax gain 50/50	5	5	10	5	5	10
Curative Allocation	0	0	0	1	(1)	0
Total After Sale	100	100	200	100	100	200

Book Capital Account = Tax Basis

A $1 curative allocation reverses the $1 ceiling rule limit on the allocation of depreciation in Year 1

This fully reverses the shift of $1 of BIG – B's book capital account and tax basis are equal

Remedial Method

Remedial method allows allocations of *notional* items to fully counteract the ceiling rule limit under the traditional method

- Unlike the curative method, the remedial method is not limited by the availability of *actual* items in the partnership

Remedial method allocates notional tax items of income or expense to the non-contributing partner, and allocates offsetting notional tax items to the contributing partner

Depreciation: Asset with BIG/BIL is hypothetically divided into 2 assets:

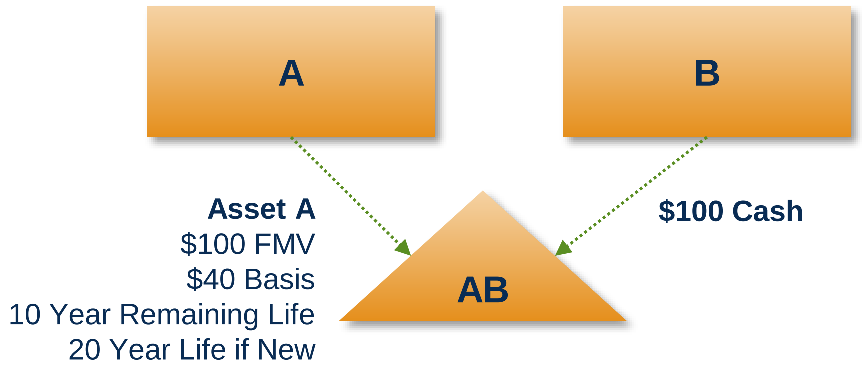
- Non-Section 704(c) asset with book value = tax basis and life equal to actual remaining useful life; book and tax allocations made per partnership agreement
- Section 704(c) asset with $0 tax basis, book value = BIG, life equal to useful life as if the asset were new; allocate depreciation under traditional method; offsetting remedial tax allocations to reverse ceiling rule limits

The remedial method will cure the ceiling rule limit over a longer period of time than the curative method

Result to non-contributing partner is similar to Section 743(b) step-up to partner acquiring a partnership interest in a partnership with a Section 754 election in effect

Remedial Method – Depreciation

<u>Example 7</u>: Remedial Method reverses ceiling rule limitation



Asset A will be hypothetically divided into 2 assets, A1 and A2:

- Asset A1 ***is not*** a 704(c) asset:
  - Book Value = Tax Basis = $40
  - BIG = Book Value of Asset A1 – Tax Basis of Asset A1 = $0
  - 10 year life
- Asset A2 ***is*** a Section 704(c) asset
  - Book Value = Total Book Value of Asset A – Book Value of Asset A1 = BIG = $60
  - Tax Basis = $0
  - 20 year life

Remedial Method – Depreciation

Example 7 (cont'd)

In Years 1-10 tax depreciation is generated by both Asset A1 and Asset A2:

Year 1	Book			Tax		
	A	*B*	*Total*	*A*	*B*	*Total*
Beginning of Year 1	100	100	200	40	100	140
Asset A1 (not a 704(c) property)						
Allocate Book/Tax per Psh Agr	(2)	(2)	(4)	(2)	(2)	(4)
Asset A2 (704(c) property)						
Allocate Book Depreciation	(1.5)	(1.5)	(3)			
Allocate to B Tax up to Book					0	0
Allocate Remaining Tax to A				0		0
Remedial Allocation				1.5	(1.5)	0
End of Year 1	96.5	96.5	193	39.5	96.5	136

Years 2-10	Book			Tax		
	A	*B*	*Total*	*A*	*B*	*Total*
Beginning of Year 2	96.5	96.5	193	39.5	96.5	136
Asset A1						
Allocate Book/Tax per Psh Agr	(18)	(18)	(36)	(18)	(18)	(36)
Asset A2						
Allocate Book Depreciation	(13.5)	(13.5)	(27)			
Allocate to B Tax up to Book					0	0
Allocate Remaining Tax to A				0		0
Remedial Allocation				13.5	(13.5)	0
End of Year 10	65	65	130	35	65	100

Remedial Method – Depreciation

Example 7 (cont'd)

At the end of Year 10, the book value, tax basis, and BIG in Assets A1 and A2 are:

	Asset A1			Asset A2		
	Book	Tax	BIG	Book	Tax	BIG
Beginning of Yr 1	40	40	0	60	0	60
Depreciation Yrs 1-10	(40)	(40)	0	(30)	0	(30)
End of Yr 10	0	0	0	30	0	30

Asset A1 has $0 of book value and tax basis, so it will generate no further book or tax depreciation

Asset A2 has $30 of book value and $0 tax basis

- Book value will be amortized over the remaining life of Asset A2 (Years 11-20)
- B will receive remedial allocation of $1.5/year of notional tax expense to match its book expense
- A will receive remedial allocation of $1.5/year of notional taxable income to offset B's notional tax expense

Remedial Method – Depreciation

Example 7 (cont'd)

Total Years 11-20 allocations for Asset A1 and Asset A2 are:

	Book			Tax		
	A	*B*	*Total*	*A*	*B*	*Total*
Beginning of Year 11	65	65	130	35	65	100
Asset A1						
Allocate Book/Tax per Psh Agr	0	0	0	0	0	0
Asset A2						
Allocate Book Depreciation	(15)	(15)	(30)			
Allocate to B Tax up to Book					0	0
Allocate Remaining Tax to A				0		0
Remedial Allocation				15	(15)	0
End of Year 20	50	50	100	50	50	100

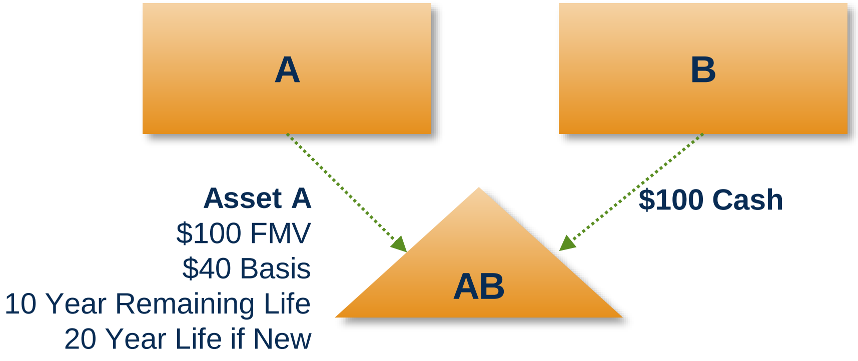
Equality of Book and Tax demonstrates that BIG has been eliminated

At the end of Year 20 the book value, tax basis and BIG are:

	Asset A1			Asset A2			Asset A Total		
	Book	Tax	BIG	Book	Tax	BIG	Book	Tax	BIG
Beginning of Yr 1	40	40	0	60	0	60	100	40	60
Depreciation Yrs 1-20	(40)	(40)	0	(60)	0	(60)	(100)	(40)	(60)
End of Yr 20	0	0	0	0	0	0	0	0	0

Remedial Method – Sale

Example 8: Remedial Method reverses ceiling rule limit



At the end of Year 1 the partners' book capital accounts and tax basis are:

Year 1	Book			Tax		
	A	*B*	*Total*	*A*	*B*	*Total*
Beginning of Year 1	100	100	200	40	100	140
Asset A1 (not a 704(c) property)						
Allocate Book/Tax per Psh Agr	(2)	(2)	(4)	(2)	(2)	(4)
Asset A2 (704(c) property)						
Allocate Book Depreciation	(1.5)	(1.5)	(3)			
Allocate to B Tax up to Book					0	0
Allocate Remaining Tax to A				0		0
Remedial Allocation				1.5	(1.5)	0
End of Year 1	96.5	96.5	193	39.5	96.5	136

Remedial Method – Sale

Example 8 (cont'd)

At the end of Year 1, the book value, tax basis and BIG in Asset A are:

	Book	Tax	BIG
Beginning of Year 1	100	40	60
Depreciation Year 1	(7)	(4)	(3)
End of Year 1	93	36	57

At the beginning of Year 2, Partnership AB sells Asset A for $100

- Book Gain = $7 = $100 - $93 book value
- Tax Gain = $64 = $100 - $36 tax basis
- BIG = $57 = $93 - $36

	Book			Tax		
	A	*B*	*Total*	*A*	*B*	*Total*
Beginning of Year 2	96.5	96.5	193.0	39.5	96.5	136.0
Allocate Book Gain (Loss)	3.5	3.5	7.0			
Allocate to A Tax Gain up to BIG				57.0	0.0	57.0
Allocate Remaining Tax per Psh Agr				3.5	3.5	7.0
Remedial Allocation						0.0
Total After Sale	100.0	100.0	200.0	100.0	100.0	200.0

Equality of Book and Tax demonstrates that BIG has been eliminated

Comparison of Methods – Depreciation

- **For the non-contributing partner:**
  - ***Curative*** provides full and fastest depreciation and highest PV
    - so long as partnership has sufficient “similar” items for full curative allocation
  - ***Remedial*** provides full but slower depreciation and intermediate PV
    - because of longer life of hypothetical zero-basis BIG asset
  - ***Traditional*** provides incomplete depreciation and lowest PV
    - because of ceiling rule

Years	Traditional Method			Curative Method			Remedial Method		
	A	*B*	*Total*	*A*	*B*	*Total*	*A*	*B*	*Total*
1 - 10		40	40	(10)	50	40	5	35	40
11 - 20							(15)	15	0
Total		40	40	(10)	50	40	(10)	50	40
PV	0	30.89	30.89	(7.72)	38.61	30.89	(3.25)	34.14	30.89

PV of A’s Deductions

PV of B’s Deductions

PV of Total Deductions

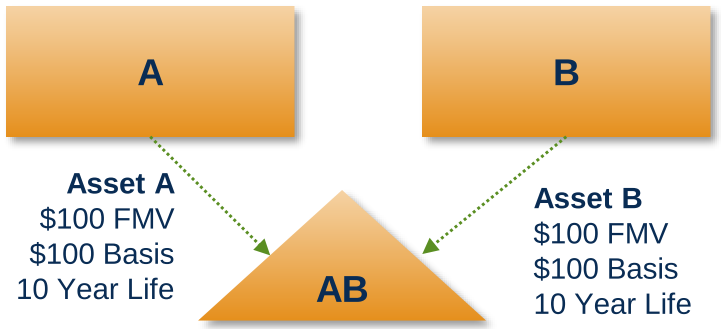
Revaluations and Reverse 704(c) Allocations

- **Partnership property may be revalued ("booked up") upon certain events, for example:**
  - Contribution of property or money to partnership
  - Liquidation of the partnership
  - Distribution that changes a partner's interest in the partnership
- **The book up adjusts the book value but not the tax basis of the property**
- **The difference between book value and FMV at the time of book up is treated as if it were newly-contributed Section 704(c) property**
- **Allocations with respect to the booked up layer of value are called "reverse 704(c) allocations"**
- **A partnership may have multiple book up layers from multiple book up events**
- **Different Section 704(c) methods may be chosen for each property for each layer**

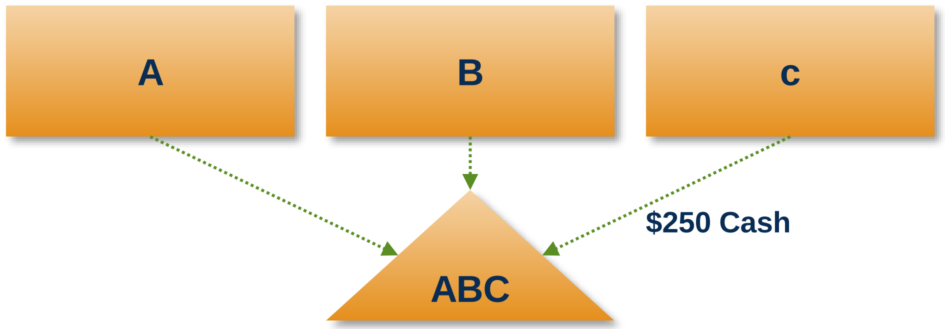
Revaluations and Reverse 704(c) Allocations

Example 9

- **A and B form Partnership AB in Year 1 with contributions of $200 of property:**



- **By Year 2 the property has appreciated to $500 ($250 for each). C becomes a 1/3 partner in exchange for a contribution of $250 cash:**



Revaluations and Reverse 704(c) Allocations

Example 9 (cont'd)

- **The existing property in Partnership AB is booked up to FMV:**

	Asset A			Asset B		
	Book	Tax	BIG	Book	Tax	BIG
Before Book Up	100	100	0	100	100	0
Book Up	150	0	150	150	0	150
After Book Up	250	100	150	250	100	150

- **A's and B's book capital accounts are adjusted as if they contributed the booked-up property to a new partnership at the same time as C contributed cash:***

	Book				Tax			
	A	B	C	Total	A	B	C	Total
Asset A	83	83	83	250	100	0	0	100
Asset B	83	83	83	250	0	100	0	100
Cash	83	83	83	250	0	0	250	250
	250	250	250	750	100	100	250	450

* Assume no depreciation in Year 1 for simplicity

Revaluations and Reverse 704(c) Allocations

Example 9 (cont'd)

- **Suppose Partnership ABC sells Asset A and Asset B for $650**
  - Book Gain = $150 = $650 - $500 book value
  - Tax Gain = $450 = $650 - $200 tax basis
  - BIG = $300 = $500 book value - $200 tax basis

	Book				Tax			
	A	B	C	Total	A	B	C	Total
Before Sale of Assets A and B	250	250	250	750	100	100	250	450
Allocate Book Gain	50	50	50	150				0
Allocate to A and B Tax Gain up to BIG					150	150		300
Allocate remaining Tax Gain Per Psh Agr					50	50	50	150
After Sale of Assets A and B	300	300	300	900	300	300	300	900

Equal Book and Tax Basis means no BIG has been shifted to C

- **$300 of pre-book up tax gain shared equally by A and B ($150 each)**
- **$150 of post-book up tax gain shared equally by A, B and C ($50 each)**

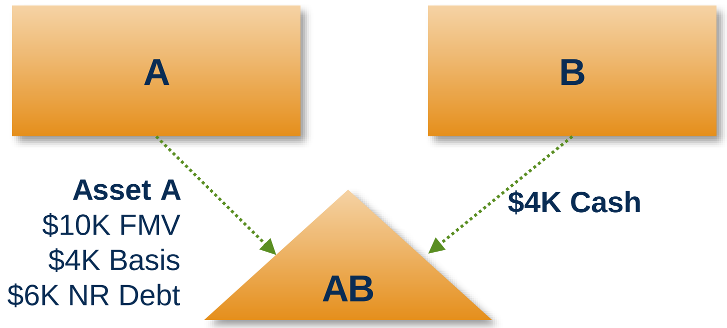
Section 704(c) And Outside Basis

- **Section 704(c) method can impact the way nonrecourse debt is allocated**
- **Under Section 752, the amount of partnership liabilities allocated to a partner increases the partner’s outside basis in its partnership interest**
- **Nonrecourse liabilities are allocated in three tiers**
  - Tier 1: Section 704(b) minimum gain
  - Tier 2: Section 704(c) minimum gain
  - Tier 3: Excess nonrecourse debt - Profits
- **Tier 2 allocation is maximized by choosing the remedial method**
- **Treas. Reg. §1.752-3 amended Tier 3 to allow a partnership to allocate to a partner up to the remaining amount of his or her BIG**
  - Can get same debt allocation without remedials as long as partnership agreement provides for Tier 3 allocation

Section 704(c) And Outside Basis

Example 10:

- **A and B form Partnership AB and agree that each will be allocated a 50 percent share of all partnership items. A contributes depreciable property.**



- **Tier 1: no allocation ($10M section 704(b) basis > $6M debt)**
- **Tier 2: A is allocated $2M ($6M consideration - $4M basis = $2M tax gain allocated entirely to A, contributing partner)**
  - **But what if the partnership elected the remedial allocation method? *See* Rev. Rul. 95-41.**
- **Tier 3: A and B allocated the remaining nonrecourse debt in proportion to their interests in total Partnership AB profits *or*, if designated in agreement, Partnership AB to allocate to a partner up to the remaining amount of his or her BIG**

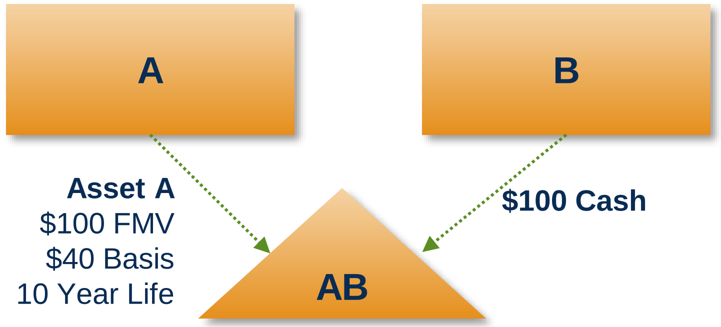
Sections 704(c)(1)(B) and 737

- **The goal of Section 704(c) is to allocate the BIG/BIL in an item of contributed property to the contributing partner**
- **Sections 704(c)(1)(B) and 737 backstop Section 704(c) in certain cases in which this goal cannot be achieved**
- **Section 704(c)(1)(B): If the contributed property is distributed by the partnership to a non-contributing partner within 7 years of the contribution date, the contributing partner recognizes the BIG/BIL as if the property were sold for its FMV**
- **Section 737: A partner who contributes appreciated property to a partnership is required to include net precontribution gain in income to the extent that the value of other property distributed by the partnership to that partner within seven years of the contribution exceeds his or her adjusted basis in his or her partnership interest**
  - **Not clear why Section 737 is necessary where partner is not fully redeemed because Section 704(c) asset remains in the partnership**
- **Sections 704(c)(1)(B) and 737 do not apply to reverse Section 704(c) layers**

Sections 704(c)(1)(B) and 737

Example 11:

- **A and B form Partnership AB at the beginning of Year 1**



- **At the beginning of Year 2, the book value, tax basis, and BIG in Asset A are:**

	Book	Tax	BIG
Beginning of Year 1	100	40	60
Depreciation for Year 1	(10)	(4)	(6)
Beginning of Year 2	90	36	54

Sections 704(c)(1)(B) and 737

Example 11 (cont'd)

- **At the beginning of Year 2, Partnership AB distributes Asset A to B (the non-contributing partner). FMV of Asset A at time of distribution = $100.**
- **Under Section 704(c), if Asset A were sold for its $100 FMV, A (the contributing partner) would recognize $54 of BIG**
  - Book Gain = $10 = $100 FMV - $90 book value
  - Tax Gain = $64 = $100 FMV - $36 tax basis
  - Remaining BIG = $54 = $90 book value - $36 tax basis

	Book			Tax		
	A	*B*	*Total*	*A*	*B*	*Total*
Allocate Book Gain	5	5	10			
Allocate to A Tax Gain up to BIG				54		54
Allocate Remaining Tax Gain per Pshp Agrmt				5	5	10
Total Gain Allocated	5	5	10	59	5	64

Section 704(c) allocation of BIG to A

- **Thus, under Section 704(c)(1)(B), A would recognize $54 of BIG on the distribution of Asset A to B (the non-contributing partner)**
  - A would not, however, recognize the $5 of non-BIG that it would have recognized on an actual sale of Asset A for its $100 FMV

Section 704(c)(1)(C) – BIL Property

- As with BIGs, Section 704(c) requires BIL on contributed property to be allocated to the contributor
- Prior law: If the contributor sells its interest in the partnership to third party, regulations required that the BIL be allocated to the purchaser as the successor in interest (same rule applies to BIG property)
- If the partnership had no Section 754 election in place, the loss was duplicated – the contributor would recognize loss on sale of its interest, successor would recognize loss when partnership sells the asset
- 2004 Jobs Act intended to prevent duplication of loss requiring that the BIL be taken into account only by the contributor
- In determining amount allocated to other partners, the basis of the contributed property to the partnership is its FMV at the time of contribution
- Proposed regulations provide that the contributor has excess section 704(c)(1)(C) basis – similar to section 743 adjustment
- Loss is eliminated when the contributor leaves the partnership (either by sale or liquidation)
- Proposed regulations clarify that section 704(c)(1)(C) does not apply to reverse section 704(c) amounts (revaluations)

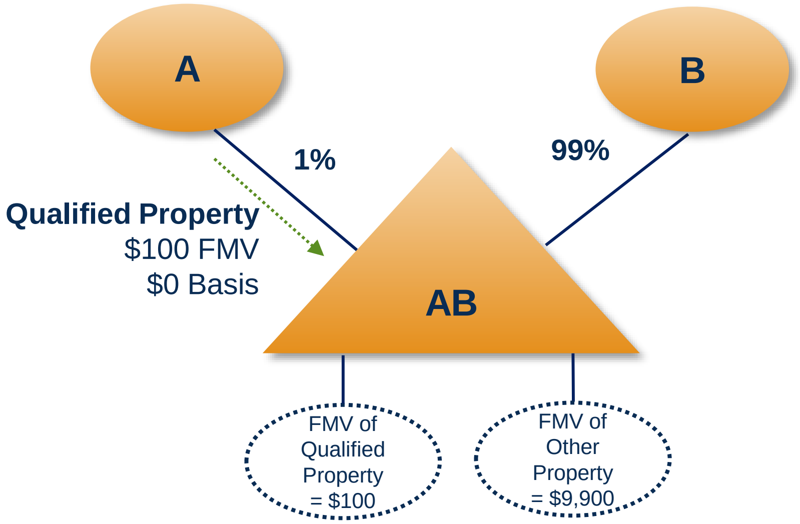
Immediate Expensing of "Qualified Property" under Section 168(k)

- **Under the TCJA, taxpayers may now deduct the full cost of qualified property placed in service after September 17, 2017, and before January 1, 2023, regardless of whether the property is new or used**
- **With the repeal of the original use requirement, this type of "bonus depreciation" is now available not just for the purchase of tangible personal property from inventory, but also for the purchase of tangible personal property in an asset acquisition of a going concern, including a stock acquisition treated as an asset acquisition under section 338(h)(10)**
- **To prevent abuse, certain acquisitions of tangible personal property are not eligible, including carryover basis acquisitions and acquisitions from related parties**
- **Partnerships are frequent buyers of tangible personal property**
- **But partnerships also acquire basis in property in other ways, not just in taxable deals:**
  - a transfer of a partnership interest in a partnership with a section 754 election in effect (section 743(b))
  - a distribution of cash in excess of basis in a partnership with a section 754 election in effect (section 734(b))
  - a tax-free liquidating distribution (section 732(b))
  - Final section 168(K) regulations provide that neither section 734 nor 732(b) basis qualifies. Section 743 basis, however, does qualify for the additional first-year depreciation deduction under section 168(k), provided transferee is not related to the transferor and transferee (or predecessor) did not have a depreciable interest in the property deemed acquired from the transferor. Treas. Reg. § 1.168(k)-2(b)(3)(iv)(B), (C), and (D).

Section 168(k) and the Remedial Method

Example 12

A contributes "qualified property" with $100 of built-in gain subject to Section 704(c) to Partnership AB in exchange for 1% interest



- **A defers $100 of gain under Section 721. Assume B's share of the book depreciation on the Section 704(c) property is determined under the remedial method.**
  - Qualified property is depreciated over the same period as newly purchased property. Treas. Reg. § 1.704-3(d)(2). If property were newly purchased, buyer would expense the full $100 under section 168(k).
  - Final section 168(K) regulations provide that remedial allocations under section 704(c) do **not** qualify for the additional first-year depreciation deduction under section 168(k). Same rule applies for reverse section 704(c) allocations. Treas. Reg. § 1.168(k)-2(b)(3)(iv)(A).
  - Although bonus depreciation is not permitted for remedial allocations, for non-PTPs, the final section 168(k) regulations provide bonus depreciation with respect to the portion of certain section 743(b) basis increases that are attributable to section 704(C) BIG, even if the partnership is using the remedial allocation method with respect to the property. Treas. Reg. § 1.168(k)-2(b)(3)(iv)(D).

Anti-Abuse Rule – Treas. Reg. § 1.704-3(a)(10)

An allocation method is not reasonable if selected "with a view" to shifting built-in gain or built-in loss in a manner that substantially reduces the present value of the partners' aggregate tax liability.

- **Eliminates many transactions designed to take advantage of the ceiling rule**
- **Prevents abuse of section 704(c) methods**

The IRS can use its authority under the section 704(c) anti-abuse rule to require a partnership to use curative allocations, but not the remedial method.

Section 704(c) Anti-Abuse Rule Applied

In 2020, the IRS issued FAA 20204201F, advising that the section 704(c) anti-abuse rule applied to the use of the gain on sale method with respect to intangible property that a U.S. partner contributed to a partnership with a related foreign partner.

- **Facts**
  - U.S. corporate members of a consolidated group contributed high-value, zero-basis intangible assets to a foreign partnership.
  - Related foreign partner contributed high-value assets that either had high bases or were non-amortizable and non-depreciable.
  - Partnership adopted the traditional method with curative allocations limited to back-end gain (the “gain on sale method”).
- **Conclusion: allocation method violated the anti-abuse rule**
  - The section 704(c) method was made **with a view** to **shifting the tax consequences of the intangible property’s BIG to the foreign partner** in a manner that **substantially reduced the present value of the U.S. Corporate Partners’ aggregate tax liability**
    - The curative allocations were effectively illusory
      - Limited to tax gain from the sale of assets unlikely to be sold
      - If sold, unlikely to have sufficient tax gain to cure the ceiling rule distortion
    - The method was “highly likely to result in a substantial reduction in the present value of the partners’ aggregate federal tax liability”
      - Foreign partner was not subject to U.S. federal income tax
      - Partnership’s income was not U.S. source income
    - Partners were all related, and the taxpayer “contemplated” or “recognized as a possibility” the income shifting and tax savings, even though the partnership formation and contribution of the assets were done to effectuate a substantial nontax business objective

Section 704(c) Anti-Abuse Rule Applied (cont.)

The FAA provides that the IRS may exercise its authority under Treas. Reg. § 1.704-3(a)(10) to place the partnership on the curative method to cure the distortion caused by the ceiling rule.

The relevant transactions addressed by the FAA predated the regulations under Section 721(c) and Notice 2015-54. Both the Section 721(c) regulations and the notice generally provide that, unless a partnership with related foreign persons that is controlled by a U.S. transferor adopts the remedial method for all appreciated property contributed by the U.S. transferor, the nonrecognition rule under section 721(a) will not apply, and the U.S. transferor will recognize all existing BIG immediately upon contribution to the partnership.

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